

## Creating Transparency

### Executive summary

A lack of transparency in the way a supplier's costs determine the prices they ask for goods and services is often a challenge for businesses. Suppliers are increasingly presenting prices as a total figure without a breakdown of the various elements of which they are comprised.

For procurement professionals, the task is to analyse the pricing to understand the various elements that make up the supplier's costs and margins which add up to the total price they charge. This puts the purchaser in a stronger position in the negotiation process.

There are ways to tackle a lack of transparency in suppliers' pricing. In this issue of Viewpoint we assess the challenge in more detail and present some ideas on how to achieve greater supplier pricing transparency in your procurement projects.

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### Background

In our recent survey of grassroots opinion among procurement professionals across a range of sectors, many respondents said difficult economic conditions were driving suppliers towards providing less transparency in the make-up of their costs.

Typically this is because such pressures are forcing suppliers to maximise the margin in every element of their cost structure. Bundling all the cost components together enables them to conceal the margins they have built in to their total price more effectively.

The cost of different materials and components often varies widely between suppliers even though the final price for a particular item may be similar. This means that if procurement can identify the supplier's costs and margins by "unbundling" cost components, they will be able to negotiate prices for the constituent parts of the item as well as the total cost.

This kind of transparency also ensures that the supplier's profit margins more accurately reflect market conditions, creating the additional benefit that the relationship with the buyer will be more sustainable in the longer term: both sides are likely to be happier if the deal makes economic sense from their own point of view.

## **Analysing costs**

Being able to break down a price into its components depends on certain factors. If you are buying a raw material it is a simple matter to look at a publicly-available index on commodity prices and add a proportion of logistics costs to arrive at a total.

For a “near commodity” -- an item including a high proportion of one or more commodities -- a more sophisticated approach is required whereby you need to understand how much of the product is associated with a commodity, index that component and fix all other costs. For non-commodities, it is important to break down the various elements into logical cost components including raw materials, manufacturing, labour, parts, logistics, overheads and profit.

For services, the process is more difficult. Typically the service being purchased can be broken down by the roles involved so that you can set the hourly rates according to role levels.

The challenge with services is that it is difficult to measure productivity, so no matter how much you negotiate decreases in hourly rates, suppliers can claw it back by increasing the number of hours charged.

One solution is to agree rates for completed projects rather than by the time they take. The risk then is that the supplier may cut corners, so it is all the more important in this scenario to ensure that the specification is as clear as possible so that you and your supplier understand exactly what is being provided and how much it will cost.

Much of the information you need to analyse the costs of the goods and services you are paying for, however, must by necessity come from the supplier. The question then is how to persuade the supplier to provide the information.

Suppliers will often respond to a request for this kind of detailed information by claiming it does not exist or that their systems are unable to provide it. However, this is unlikely to be true and with some perseverance there are ways of persuading them to part with the data you need.

Broadly speaking, there are two approaches to the challenge of unbundling your suppliers' prices: you can do it collaboratively or competitively.

### **Unbundling prices: the collaborative approach**

The collaborative approach means working with your incumbent supplier to elicit information about their costs and margins. However, it may prove difficult to persuade an incumbent supplier to adopt a more “open-book” approach to pricing unless you are prepared to offer them something in return.

This could include, for example, increasing the volume of your contract or extending its length. For the supplier, the value of the extra business may make it sufficiently economically attractive to persuade them that providing detailed information on their costs amounts to a good deal.

It is of course important to remember that your suppliers are naturally constantly seeking to increase their margins, so you need to watch out for unforeseen ways they might try to claw back the gains you have made or to conceal the whole truth about their own costs. This could include, for example, omitting information about rebates from their own suppliers.

## **Unbundling prices: the competitive approach**

Unbundling pricing by competitive means is likely to be by far the most effective approach: essentially it involves making use of market forces to incentivise your suppliers into delivering the information you seek.

This can be done by using a well-structured RFP which includes the kind of pricing templates you need. This allows you to request unbundled pricing from suppliers and enables you to compare pricing across several potential suppliers.

In most markets it is likely new suppliers will be eager to gain your business, so they are likely to accept your request for information as a way of helping secure the contract. In this way you can take advantage of the market forces at work in the supplier market to secure the information you need to complete a full analysis of supplier costs and margins.

If you inject competition into the bidding process in this way and the product or service you are purchasing is well defined, the pricing information from the various suppliers can be pieced together to provide visibility into appropriate cost structures.

Each supplier may not provide complete information, but other suppliers may fill in these gaps: a “jigsaw” approach can provide the complete picture.

A further benefit of this approach is that the process of analysing costs can produce additional opportunities in value engineering and specification rationalisation leading to more cost savings opportunities.

### **Action checklist**

- Analyse the various components of the goods or services you are purchasing
- Assess how much publicly-available information you can gain on the various cost components, especially if it is a commodity
- Work with incumbent suppliers to access detailed information on their costs -- offer incentives where possible
- If you are considering open book pricing, watch out for rebates or subsidies the supplier may not have revealed
- Issue an RFP to the supplier market including a request for detailed information on their costs
- Compare the responses to build a broad view of suppliers' costs in the marketplace

**A report on the full results of the *Efficio Grassroots Procurement Survey* will be published shortly**