

Good Buy II – Get me results!

Achieving sourcing results in strategic categories

By Dr. Veronica Schey and Georgi Krastev

Total Cost of Ownership (TCO) properly applied never runs out of fashion because it requires mastery and integration of many disciplines beyond a procurement focus. Procurement and sourcing excellence continued to gain management attention over the last decade. Many companies have been successful in unlocking potentials. Nevertheless, additional value remains to be captured by considering TCO and applying a Quality Results Procurement (QRP) approach to strategic categories.

While the types of challenges addressed by procurement: from scarcity of supplies to competition – have remained the same over time, it is not only about the lowest purchasing cost at high and reliable quality. A well-designed procurement process gives companies an edge in procurement and allows for results having an immediate and direct impact on the bottom line. The positive effects of applying a TCO span well beyond the reduced price as discussed in “Good Buy I”, published by Step-Change Consulting in Essentials II.

This article provides a practical introduction to applying the TCO model in procurement optimization projects by applying the StepChange Quality Results Procurement (QRP) approach.

Before detailing the approach to the implementation of QRP, it is essential to provide a brief overview of the TCO concept. The main challenge is to get an exhaustive picture of all elements influencing the costs. The Total Cost of Ownership (TCO) approach scrutinizes all cost drivers with regards to their direct and indirect impact. Holistic procurement optimization always targets the reduction of full costs per ton or unit produced, considering all costs and related benefits across the value chain.

In addition to price, process costs and usage drivers make up the TCO triangle (see Figure 1). These factors are typically dependent on each other. The framework offers a comprehensive approach to determine a company's cost-benefit-optimum for each material and supplier. “Identifying the price-process-usage equilibrium (TCO-optimum) will lead to the lowest cost sourcing strategy.”¹

Total Cost of Ownership Triangle



Figure 1 - Total Cost of Ownership Triangle

Directly measurable benefits from TCO include:

- Price reductions
- Improved commercial terms & conditions
- Improved demand management
- Standardization of processes, contracts, and products used

Indirectly measurable benefits include:

- Reduced risk
- Improved negotiation skills
- Increased innovation driven by sourcing
- Improved pricing performance against market developments

¹: "Good Buy! Part I: Essentials II"; 2012

TCO Model

	Indirect measurable benefits	Directly measurable benefits
Pricing & terms	<p>Cost avoidance</p> <ul style="list-style-type: none"> Improved pricing performance against market developments 	<p>Cost reduction</p> <ul style="list-style-type: none"> Price reduction Other commercial terms & conditions (group synergies, volume discounts, payments terms,...) Demand management
TCO beyond direct spend	<p>Non-monetary benefits</p> <ul style="list-style-type: none"> Risk reduction Transformation and training of organization Negotiation skills Innovation driven by sourcing Protection of intellectual property Transformation of procurement organization 	<p>Additional monetary benefits</p> <ul style="list-style-type: none"> TCO savings beyond current approach Standardization Process and usage alternatives Top-line growth through increased competitiveness

Figure 2 – TCO model: Directly vs. indirectly measurable benefits

As companies are faced with the need to reduce costs and stagnant or reduced budgets, they will also turn to their suppliers for support. A company typically has two main types of sourcing:

- 1) Spot purchase sourcing
- 2) Contractual sourcing

Spot purchase sourcing addresses one-off demands or repeated requests. The target is to achieve the lowest possible price. The approach usually focusses on existing materials, with ad-hoc negotiations and typically does not yield sustainable long-term savings. By definition, spot purchasing exposes the organization fully to market developments both in terms of price and security of supply.

Contractual sourcing, on the other hand, focus on negotiations with suppliers for recurring demands. The target is to ensure competitive prices for categories of strategic importance to the company. This process can also be standardized. It is often a familiar routine that companies engage in with their suppliers on a yearly basis and thus offers little potential for disrupting the status-quo and driving significant improvements.

Combining both types of sourcing is a common practice and helps balance security of supply with flexibility. To facilitate the application of the TCO model in daily work, StepChange has developed the Quality Results Procurement approach (QRP). QRP helps companies capture real sourcing benefits especially in strategic categories

for the pulp, paper and packaging industry – yielding both financial and non-financial benefits.

The QRP methodology combines the advantages of different sourcing approaches into one concept. On the one hand, it focuses on best prices as pursued through spot purchase sourcing, on the other hand, it drives mid-term advantages from contractual purchases by seeking co-operation with suppliers. The target is to sign framework contracts and identify possibilities to work on improvements together to further lower costs while de-creasing process costs and improving product specifications.

QRP increases savings by offering the opportunity to break the established procurement routines and look for new opportunities. It focuses on category review and enables different sourcing strategies across the whole business. The TCO model is applied to each category reviewing specifications and the supplier base. Thereby, QRP drives a paradigm change.

Getting the best results from procurement efforts

Developing the right sourcing strategy is the cornerstone of successful procurement efforts. Sourcing strategies depend on internal importance of a category and external complexities of the supply markets. Keeping track of all factors influencing a category and deriving sourcing strategies is a challenging task. The QRP approach considers qualitative and quantitative factors while helping develop new skills across the organization ultimately delivering results.

Key parameters to consider when developing a sourcing approach for a category include:

- Relevance of the category & optimization opportunity for the company
- Bargaining power of all parties involved
- Underlying requirements that drive sourcing requirements
- Readiness of the organization in terms of:
 - Strategic sourcing skills
 - Available systems and processes
 - Available information (internal/external)
- Relevant markets and its drivers
- Supplier structure and relevant players in the industry
- Local procurement and spot market strategies

Additionally, a company's power position always needs to be assessed realistically to achieve procurement success. The parameters mentioned above should be reviewed periodically as they may shift over time.

The StepChange approach to TCO: A guide to Quality Results Procurement (QRP)

Given the significant importance of sourcing to the bottom line of a manufacturing company, applying a structured approach is one of the pillars for the success of a procurement initiative. The StepChange QRP methodology consists of 3 phases designed to facilitate the implementation and maximize the benefits from the TCO model. A brief overview for each of the 3 phases will follow (Figure 3). The process can be conducted in a traditional way or can be combined with electronic platforms.

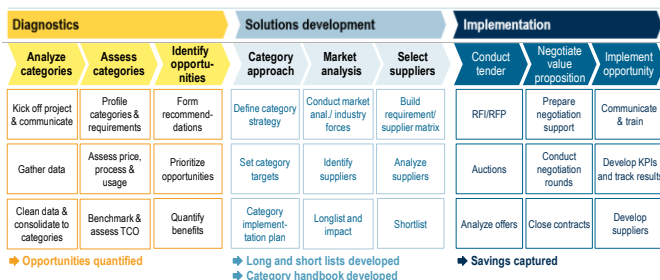


Figure 3 – The StepChange QRP methodology

Phase 1: Diagnostics

The QRP diagnostics phase focuses on profiling the categories and identifying the opportunities. Information to be analyzed includes the volumes consumed, specifications, prices, and current suppliers. The current supplier spend and pricing is benchmarked to determine the potential for optimization. Sourcing markets are analyzed and buyer requirements and constraints are assessed. The outcome of this phase are quantified benefits and prioritized opportunities. A successful 1st phase answers five key questions:

- 1) Category definition: *What do we buy?*
E.g. Volumes, spend, terms & conditions, specifications
- 2) Category key characteristics: *How do we buy it?*
E.g. Purchasing processes, order sizes
- 3) Market understanding: *What could we buy?*
E.g. Supply market segmentation
- 4) Category evolution: *What can we buy instead?*
E.g. substitutes
- 5) Peculiarities: *What else should be considered?*
E.g. Customer / storage/ product requirement

Phase 2: Solutions development

During phase 2, the sourcing strategy for each category is developed, market analysis is performed, and suppliers shortlisted.

As the 1st step, it is important to conduct a buying power assessment and analyze current supplier relationships and agreements (Figure 4). At this stage opportunities to improve/simplify product specifications and consolidate volumes are considered. Furthermore, possibilities to leverage global sourcing effects are explored. The strategy will vary from category to category depending on the expected impact and implementation requirements and complexity.

Supply and demand power matrix

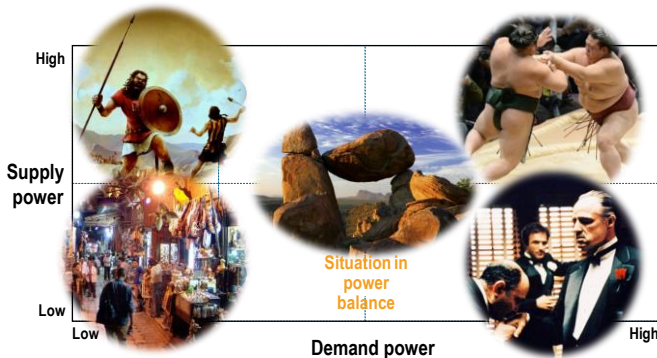


Figure 4 – Supply vs. Demand Power

Next, a detailed analysis of the market is conducted and long and short lists of suitable suppliers (based on pre-defined criteria) developed. The long list of suppliers is generated based on a supplier database, research and current suppliers. Once the long list has been established, it is evaluated according to predefined criteria to short-list potential suppliers. As the last step, a customized RFI (request for information) and RFP (request for proposal) are prepared.

The purpose of the RFI is to:

- 1) **Mobilize:** signal the market that the organization is looking for opportunities and jolt existing suppliers into action as they realize the existing supplier base is being reviewed
- 2) **Learn:** gain market insights
- 3) **Screen:** create a short list of suppliers interested in participating in an RFP

It is crucial that an RFI is properly designed. To that end, it is essential that buyers have a good understanding of the different categories. Contrary to common belief, suppliers do not participate in every RFI/RFP they receive. They have limited business development resources and must carefully choose where to invest them. Therefore, creating a good RFI/RFP increases the chances of their participation in the tender.

A good RFI is short, inviting and professional. It consists of two parts. The 1st part focuses on general information about the supplier such as: Sales revenue, major customers, major competitors, number of employee and fur-

ther profile information. The second part is category specific. It should clearly communicate the needs, display category knowledge, and be easy to understand. A simple rule of thumb is that it should consist of about 10 category related questions. A good RFI is very important for the tendering process: It represents the client company and can therefore be the difference between a supplier participating and not participating. In parallel, a request for proposal is developed (RFP). The RFP process ensures that the buyer dictates the content and terms to get comparable offers. An RFP should include the following elements for each product and location (Figure 5):

- 1) Specifications
- 2) Quantities
- 3) Delivery information
- 4) Offer 1: Like4Like: Considering the exact specifications as defined
- 5) Offer 2: Suggestion based on what the supplier believes would be the most cost effective solution
- 6) Offer 3: Like4Like + specification 1
- 7) Offer 4: Like4Like + specification 2

Offers 1, 3, and 4 ask the vendor to submit a bid for the product that exactly matches the specifications requested. Offer 2, on the other hand, gives them the opportunity to submit a proposal for a product that they think fits the needs best. Giving vendors this option is vital as it allows identification of new opportunities for improvement.

Using a standardized RFP allows organizations to quickly compare the offers of various suppliers. Failing to do so will later cost a lot of hours trying to understand the differences between the participants in the tender. Applying industry-specific RFI and RFP templates for the relevant categories will speed up this process.

Illustrative section RFP document

Product	Site	Specifications NaOH Technical information	Estimated Volume	Unit	Delivery		Offer 1: Like4Like (considering exact specifications as defined)				
					Delivery Location	Delivery country	Total Price EXW (1) (per unit)	Total Price DDP (2) (per unit)	Unit	Currency	
				kg						kg	
				kg						kg	
				kg						kg	

Figure 5 – An illustrative section of an RFP document

Phase 3: Implementation

Phase 3 is about capturing the value identified by tendering and negotiations.

Step 1: Conduct tender

The suppliers shortlisted in phase 2 are contacted together with the RFI document. Following further screening based on the information provided in the RFI, a selection of suppliers is invited to participate in the tender process and submit a quotation using the RFP document. Some important considerations that can negatively affect a supplier’s willingness to participate in a specific tender could be for example that their core expertise is not in the tendered category or they were unable to meet the customer’s requirements in the past.

It is important to proactively understand and address those concerns to ensure a broad participation in the tender process. As a rule of thumb, the more suppliers participate in the tender, the better the negotiation position for the buyers.

The suppliers responding to the request for proposal (RFP) are further screened and analyzed based on prices, certifications, product portfolio, and available capacity as well as other quantitative or qualitative criteria defined. The outcome of the process is a set of viable suppliers, interested to work with the client organization (Figure 6). At this point, depending on the category under review, product tests are conducted to determine if the

shortlisted suppliers meet the requirements of the company.

Developing a portfolio of potential suppliers

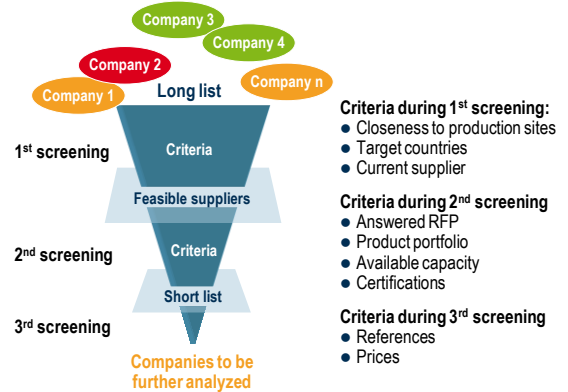


Figure 6 - Screening methodology for short-listing of potential suppliers

Step 2: Negotiate value proposition

Once the offers from suppliers have been analyzed, it is important to choose the appropriate implementation path and the tone of the negotiations to come. This is determined by answering three questions:

- Do we know the preferred suppliers?
- Do we have clarity about the desired type of relationship (e.g. competitive vs. cooperative)?
- Do we have the power to drive suppliers to cooperate?

Choosing the right implementation path

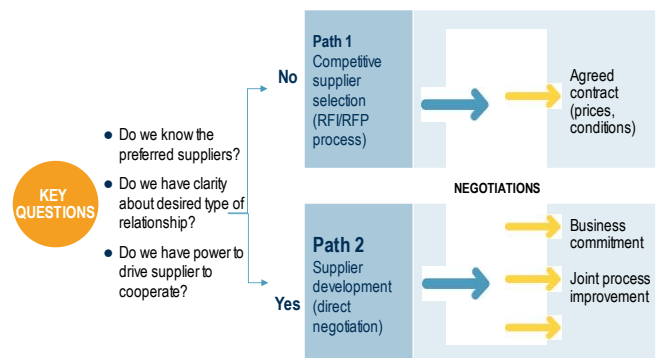


Figure 7 - Selection of appropriate sourcing implementation path

Depending on the answers to the previous questions, two alternatives are available (Figure 7): In case there are no clear preferences towards the supplier and the type of relationship, as well as no real influence for driving cooperation, the method of competitive supplier selection

should be applied. In all other cases, supplier development would be the preferred option.

Once the approach towards the suppliers has been selected, the most relevant suppliers are cherry-picked from the short list and invited for negotiations. The negotiation strategy and negotiation with suppliers follows a clear 4-stage framework (Figure 8). While stages 1 and 2 focus on the thorough preparation process for the negotiations, stage 3-4 refer to the actual execution. The following paragraphs provide a brief overview of each stage.

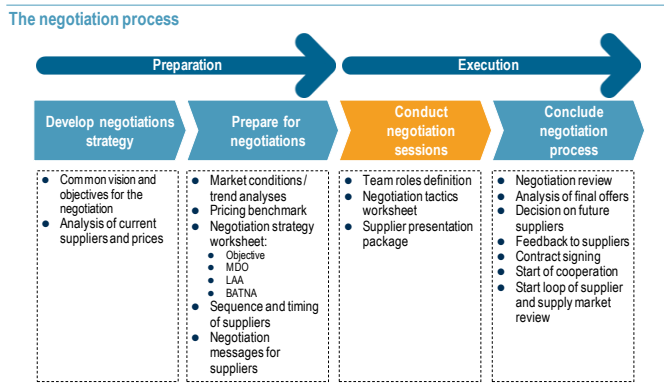


Figure 8 - Framework for supplier negotiations

The objective of stage 1 is to develop an appropriate negotiation strategy. Furthermore, common objectives for the negotiations need to be established across the negotiation team based on analysis of the current suppliers and prices.

In stage 2, a detailed analysis of the offers received is performed. Offers are benchmarked and a negotiation strategy worksheet is prepared.

For each product, the following needs to be defined: Objective, MDO (most desirable outcome), LAA (least acceptable alternative), and BATNA (best alternative to a negotiated agreement) (Figure 9).

LAA — Least Acceptable Agreement	MDO — Most Desirable Outcome	BATNA — Best Alternative to a Negotiated Agreement
<ul style="list-style-type: none"> The minimum we can agree to without sacrificing our main interests Settling for anything less is not a viable business option 	<ul style="list-style-type: none"> The opposite of LAA Represents the best possible result Independent of what the other party will accept An opening, not a closing proposal We will never get more than we ask for (i.e., ASK!) Be ambitious but have a defensible rationale 	<ul style="list-style-type: none"> Existing alternative if we cannot get a mutually acceptable agreement with this supplier Helps protect against making an agreement that should be rejected Strengthens our position in the negotiation Knowing supplier's BATNA helps us to understand his position in the negotiation

Figure 9 - Illustrative negotiation strategy worksheet

Furthermore, a custom negotiations message is developed for each supplier. This ensures that the negotiation team has a thought-through reply for every negotiation scenario (Figure 10).

Definition of objectives and key scenarios per topic

Item	Objective	LAA	MDO	BATNA
Price	Lower prices to match best offers for all products	Offer Supplier 1	15% lower than the offer of Supplier 1	Supplier 1
Payment terms	Get the best payment terms possible	14 days / 3% or 30 days / 2% (offered) 90 days net	Even better payment terms without price increase	14 days / 2% offered by them
Annual bonus	Secondary, focus on best price	1.5% for xx tons 3.0% for xxx tons	Translate annual bonus offer into price reduction	0.5% to 2.5% depending on volume
Consignment stock (volume)	Minimize TCO	50% of the volume	100% of the volume	75% of the volume
Consignment stock (conditions)		No price increase for 50% of in consignment		
Delivery size				
Lead time				
Volume commitment				

Figure 10 - Exemplary negotiation scenario definition sheet

Preparing the team for the actual negotiations is the focus of Stage 3 of the negotiations framework. This entails negotiation training, defining and assigning roles, discussing the negotiations strategy worksheet, and the supplier presentation package and deciding on the right negotiation tactics. A selection of possible tactics can be used such as the classical “Good Cop/Bad Cop”, “Nibble”, or “Bogey” for example. Stage 3 finishes with the actual negotiations with selected suppliers.

Stage 4 is the conclusion of the negotiation process. At this point, a re-view of the negotiations is conducted. In some cases, the personal negotiations are followed by subsequent negotiation rounds to improve offers. Based on the results, multiple scenarios are created considering price level and supplier reliability (Figure 11).

Analysis of supplier reliability vs. price offered

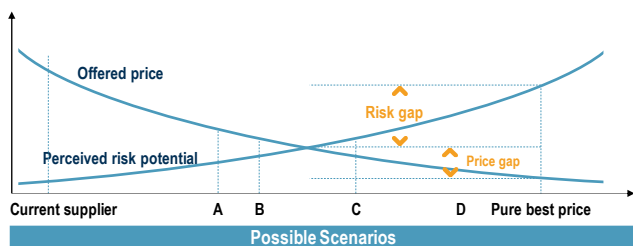


Figure 11 - Scenario visualization: Analysis of supplier reliability vs. price offered

Once the brokering and analytical stages have been completed, a decision is made about future suppliers and contracts are signed.

Step 3: Implement opportunity

A set of KPI's will be developed to ensure that the savings are achieved and that negotiated terms are kept. Strategic sourcing is not a "one-time-effort" especially in paper and packaging. It is important to keep and develop long-term relationships with suppliers. To do so, it is important to develop suppliers further, so that synergies for both parties can be achieved.

As a result of this stage, savings are ready to be captured and KPIs developed to track success of the project using the procurement performance cockpit.

The closure of the contracts is also the beginning of a supplier and market review, carried out by the client organization periodically. The target of the cycle is to ensure the company always retains best conditions. As a result, a higher value from procurement is achieved, the sourcing strategies are aligned, and relationships with suppliers are improved.

The KPIs and any changes in contracts need to be clearly communicated internally and employees need to be trained. As part of a procurement project training, requirements are identified and trainings organized accordingly. Customized training is offered. Some of the trainings could be:

- New tools in procurement
- Tender process balancing demand and supply power
- Negotiate to win-win

Figure 12 shows some examples from negotiation trainings. "Negotiate to win-win" – is a specific training to simulate real negotiations in situations where different teams of buyers and sellers negotiate with each other, each one having a different set of information. During this training, the participants have the possibility to play different roles in a risk-free environment and analyze their own performance vs. the performance of peers also using a video analysis. It gives the procurement managers the possibility to apply new skills in real situations during the negotiations with suppliers.

Selection of negotiation training material

The negotiation process flowchart shows Preparation (Prepare for negotiations) and Execution (Conduct negotiations, Conclude negotiation process). Below is a table of negotiation messages for suppliers.

Key message	Anticipated response	Desired response	Consequences	Impact
Price Get best price	Already the best possible price	Help to explore the many suppliers want to have Other supplier with better price	In case that we do not achieve the targeted KPI, the payment terms and/or management fees have to be improved	High
Volume discount Get the biggest volume discount possible	Already the best offer	We are already giving you more of the best price Other suppliers offered better payment terms	We can give you more of the best price if you offer discounts to your partner	Medium
Payment terms Get the best of the received payment terms	Already the best offer	Standard conditions	Can there a better price be offered? Other suppliers offered	Low
Service levels Order lead time (max 1 day) Warranty time (max 30% to be best) Cancellation fees Accuracy of goods Penalty for delivery performance (OT) Multi-period time frame Closed footer	Share best time means higher price	Standard conditions	Can there a better price be offered? Other suppliers offered	Low
Contract flexibility Get the maximum contract flexibility (length of notice period possible for termination)	Standard conditions	Can there a better price be offered? Other suppliers offered	Can there a better price be offered? Other suppliers offered	Low
Additional support What support does the company offer us? (Electronic data interchange (EDI))	Standard conditions	Can there a better price be offered? Other suppliers offered	Can there a better price be offered? Other suppliers offered	Low

Figure 12 – StepChange negotiation training overview

Another example might be the use of e-tender tools for specific categories especially in the freight category. Figure 13 shows how e-tenders can help analyze a very large amount of data applying a technology, which is already widely implemented. Applying sourcing experience from different regions reduces the need to long-list suppliers. The aim is to empower the organization; therefore, anchoring real change within the organization is considered as a key for sustainable success. To ensure that learnings are sustainable, a “train-the-trainer” approach is recommended so that trainings can be cascaded through the organization.

e-tender process for freight

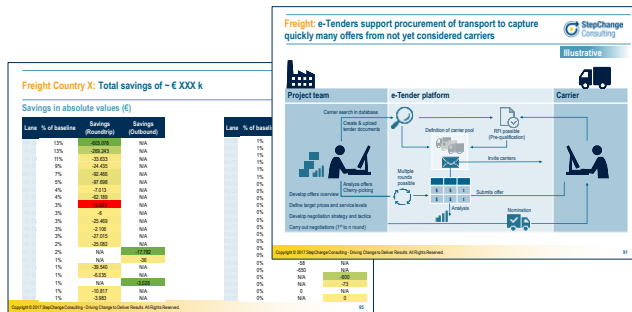


Figure 13 - Overview of StepChange e-tender freight process

Summary

The holistic StepChange QRP methodology allows to achieve short-term results and helps companies capture both financial and non-financial benefits. The main goal is to capture value by reducing total cost of ownership. As described previously, the StepChange Quality Results Procurement (QRP) sourcing model follows three phases. It is of utmost importance to know the categories and have a deep operational understanding about the categories in terms of material requirements, consumption drivers and supply chain and end-product impacts. This is key to the development of relevant RFIs and RFPs and for the information exchange with potential suppliers.

A deep industry and category understanding helps create the long-list and select the suppliers for the short list. It further aids to define the best negotiation strategy, lead the negotiations and ultimately get the results targeted.

Actual results - Overview by category

StepChange has supported and accompanied numerous sourcing projects in all strategic categories in pulp, paper and packaging among others in wood, pulp, chemicals, recovered paper, felts & wires, consumables, spare parts & services, packaging materials, cores, energy, logistics,

services. Based on this experience combined with the QRP methodology StepChange can help quickly capture value.

Below is an overview of results achieved across different categories of strategic materials in the pulp & paper industry

	Category Challenge ⚡	StepChange Approach 🔄	Results 🔑
<p>Recovered Paper</p>	<ul style="list-style-type: none"> • Sellers' market (typ.) • Different sources of origination • Global commodity • Marginal pricing • Logistics cost • Cost vs. security of supply • Volatility in quality • Intransparent structures 	<ul style="list-style-type: none"> • Sourcing channel review • Internal and external benchmarking • Segmentation of supplier base • Marginal pricing analysis • Total-Cost-of-ownership-approach • Implement stringent quality control and supplier performance measurement 	<ul style="list-style-type: none"> • Increased security of supply • Visibility & control along supplier base • Significant reduction of recovered paper spend • Savings up to 10%
<p>Wood</p>	<ul style="list-style-type: none"> • Seasonality of supply • Consumption/Yield • Typically fragmented supplier base • Competition for supply • Certifications • Marginal pricing • Logistic costs 	<ul style="list-style-type: none"> • Transparency of costing • Supplier performance and cost assessment • Shift towards proactive sourcing approach • Supplier Scoring Model • Marginal pricing management model 	<ul style="list-style-type: none"> • -5% of direct raw material cost • -8% of inbound logistics costs • -8% of on-site material handling costs
<p>Chemicals</p>	<ul style="list-style-type: none"> • Diverse supplier base • New emerging players • Patent protected detailed technical specifications • Long-testing period for standardization alternatives 	<ul style="list-style-type: none"> • RFI and RFQ tender process • Volume bundling • Global sourcing • Supplier development • Joint product improvement/standardization 	<ul style="list-style-type: none"> • Standardized recipes across sites • Savings of >17%
<p>Freight</p>	<ul style="list-style-type: none"> • Fragmented supply base • Variability of destinations and volumes • Local requirements • Commoditized but volatility in pricing 	<ul style="list-style-type: none"> • Transparency across sites • Internal and external benchmarking • RFI, tendering and negotiation • Implementation and tracking of savings 	<ul style="list-style-type: none"> • Savings in overall transport cost up to 10% • Improved service levels
<p>Pulp</p>	<ul style="list-style-type: none"> • Specifications & requirements • High price volatility • Global supply and demand • Logistics dependent • Inventory driver 	<ul style="list-style-type: none"> • Transparency and comparability • Standardization & definition of alternatives • Testing • Inventory management policies • Tendering 	<ul style="list-style-type: none"> • Cost reduction of 3-8%
<p>Plastics</p>	<ul style="list-style-type: none"> • Global market • Increasing demand • Global overcapacity • Changing supplier base • Strongly dependent on feedstock energy costs 	<ul style="list-style-type: none"> • Global sourcing strategy development • Supply chain performance analysis • Volume bundling • Standardized qualification and testing procedure • RFI and RFQ tender process 	<ul style="list-style-type: none"> • Consolidation and switching of supplier base • Reduction by 1-4%
<p>Energy</p>	<ul style="list-style-type: none"> • Markets relatively fragmented • Different levels of maturity regulatory restrictions 	<ul style="list-style-type: none"> • Load profile analysis • Development of supply market profiles • Country/site specific strategy development (e.g. differentiation between high and low peak, demand bands, ...) • Standardized tender process • Personal negotiations followed by trading brokerage 	<ul style="list-style-type: none"> • Up to 15% cost reduction on price
<p>Spare parts</p>	<ul style="list-style-type: none"> • Very high number of SKUs across sites • Comparability not given • Criticality dependent • Working capital drivers 	<ul style="list-style-type: none"> • Categorization of SKUs and substitution analysis • Prioritization • Inventory and stock keeping policy • Criticality policy • Tender process 	<ul style="list-style-type: none"> • Up to 20% cost reduction



**TAKING
THE RIGHT TURNS**
WOOD · PAPER · PACKAGING

About StepChange Consulting

StepChange is an industry focused and independent management consulting company with a proven track record in supporting clients to achieve sustainable value. StepChange provides support to top tier organizations in the industry from strategy development to implementation of operational improvements.

With an international team of industry experts StepChange can hit the ground running. StepChange provides innovative and yet pragmatic solutions, placing an emphasis on delivering measurable business results.

For further inquiries and comments regarding this Point of View please contact us at leapfrog@stepchange.com.

Dr. Veronica Schey is COO at StepChange Consulting. She has global management consulting experience since 2001 and concentrates on strategic industry topics, sourcing strategies and implementing performance improvements.

Georgi Krastev is a consultant at StepChange Consulting and focuses on supply chain management and operational performance improvements.



**DRIVING CHANGE
TO DELIVER RESULTS**

