

Using Contracts to Manage Capacity in this Up-Down World

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As Yogi Berra said, "Predicting is hard, especially about the future." Suppliers would love slow and steady growth, but for the past few years, volumes have fluctuated wildly.

Contracts can help suppliers manage volume uncertainty. Because demand for vehicles is inherently unpredictable, few automotive supply contracts list a specific quantity. Under the law, however, contracts must have a quantity, unless they are expressly tied to customer requirements. And if you provide an estimate of volume to your suppliers, you cannot later demand an amount "unreasonably disproportionate" to that estimate.

Quotes often condition pricing upon actual production volumes being within a certain range of forecasted volumes. But most terms and conditions of purchase say the opposite: that volumes are not guaranteed, but prices are, regardless of volume.

While the legal landscape is far from certain, buyers have been faced with suppliers attempting several ways to address volume issues in contracts:

1. Tie prices to volume ranges (e.g., require price adjustments for anything beyond plus or minus X% of projections);
2. Index variable costs (e.g., raw material) to market costs;
3. Treat any dedicated initial investment (e.g., capital and equipment) separately, akin to tooling, or amortize it over the lowest possible volume;
4. Communicate to sub-suppliers volumes committed to the customer, and lock those same volumes in with them;
5. Raise the floor: reserve the right to not only increase prices, but also reallocate capacity if forecast volumes don't materialize; and
6. Lower the ceiling: document maximum capacity, and don't promise a volume that you or your suppliers can't reach.

Purchasing professional should be on the look-out for these attempts, and prepared to deal with them. While most buyers try to reject them, because so many suppliers are now demanding capacity protection measures, these discussions are becoming more difficult than simply saying no.

Before you send out your next RFQ, think about capacity, and what will happen if volume is twice, or half, what you anticipate. With see-sawing volume, capacity issues in the supply chain will only continue. Whether a rebound or a nosedive comes next, thinking through your contracts with your suppliers can only help your company.

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