



As Commodity prices have experienced the roller coaster ride over the last year by quickly rising and falling, Purchasing organizations have had to deal with the effects of battling supplier price increases when commodity prices go up and struggling to recover pricing decreases when commodity prices come back down. Given the current struggling state of the automotive industry, many suppliers can no longer absorb upward fluctuations in commodity prices such as resin, steel, copper, etc. They basically have two choices: 1) pass along the increases to their customers or 2) go under. For the same reason, they are very reluctant to “give back” the pricing increases when commodity prices slide back down.

The problem purchasing organizations face when dealing with increases is that suppliers often come in and make their “request” under dire circumstances. Suppliers need pricing increases immediately or they threaten supply. Buyers are under intense pressure to respond to these immediate “requests” and there in turn lies the problem. Due to the urgent nature of the matter, many buyers grant pricing increases without 1) capturing the cost details to justify the increase and 2) developing a process to capture the price decrease when raw material costs come down again.

Take this scenario for example. Due to the rising oil prices, resin costs have gone up 20% over the past 3 months. In response to the increase, an injection molding supplier has come in for a resin increase of 15% on their entire book of business of \$10 million, which is a \$1.5 million dollar increase. They demand this increase or threaten not to ship any more products. Note that the raw material percentage of the overall supplier cost is 40%. The buyer does his best to negotiate down the increase given the circumstances and settle at a \$1.25 million increase. Great news, the buyer has just negotiated a \$250k cost avoidance and is relieved to have settled the issue, right? Not exactly as one needs to understand what the \$1.25 million increase really represents? How much did the resin actually increase? Quick math says if 40% of the costs increased by 20%, then the buyer's overall costs should have only increased by 8% ($.40 * 1.20 = .48$, up .08 before increases started) not the 12.5% or \$1.25M increase given and definitely not the 15% the supplier is claiming. On top of that, 3 months later oil prices have come back down to levels equivalent to the pre increase cost and the supplier has not given any money back to the customer. There are many questions unanswered, what did the supplier use as their baseline resin cost per pound? What did they use as their current cost? How much money if any are they truly losing? These types of questions can be answered by capturing the cost details through a Cost Breakdown Worksheet.



Cost breakdowns are cost worksheets which capture the details of the major cost drivers within a part's piece price. It captures information regarding part material cost, such as raw material cost per pound and material usage in pounds. It also captures processing costs such as cycle times, labor rates, and overhead rates as well as markup costs such as SG&A and Profit markup percentages. Ultimately, it is used to establish a baseline of the supplier pricing and helps one understand if a supplier price is competitive or uncompetitive. Cost breakdowns are very useful tools when analyzing price changes such as raw material increases or decreases. Since the breakdown captures the cost details, it will outline exactly what the original raw material price was prior to the increase and the pricing after the increase.

Cost Breakdowns can help buyers answer critical questions when evaluating the validity of a price increase request. Below are 5 major questions buyers should assess during negotiations.

- What is the margin markup for the part? Is it inline with what your customers allow and/or industry expectations? For example, if the supplier has a 20% SG&A and Profit markup on this part already and the commodity increases are causing them to ONLY get a 12% markup on the part, then does it really justify a price increase? In this case they are still making a healthy margin; however, lower than they did in the past and they definitely are not losing money.
- Are they adding margin on top of the raw material increase? Assuming you are granting the raw material increase, why should you allow the supplier to markup the increase another 10% to 20% for SG&A and Profit?
- Does the supplier sell raw material scrap for revenue, if so are you getting credit for it? Many suppliers sell scrap raw material for significant amounts of money and never give customers credit for it. For example, steel has gone up over 100% over the past few years but so has scrap steel which can be worth as much as 50% to 70% of virgin steel material. Suppliers are selling this scrap and keeping the profits while still asking for increases.



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Using Cost Breakdowns to Validate Supplier Price Increases & Decreases by Adam Thor, Cost Engineer

Cost Modeling

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- Suppliers may want to focus on the rising raw material cost and talk in detail about how much it has gone up and how they are losing money but putting raw materials aside, what about the value add portion of the cost? Is the value add cost accurate and fair? One must look at the overall cost of the product as a whole. Even though the price increase only affects the raw material, it does not mean the value add portion of the price is fair and accurate. Suppliers may be charging higher labor rates and/or overhead rates than they are truly paying for today to hide margin. Looking into the value add portion of the cost may assist in finding opportunities for cost savings. Performing a full evaluation of all the cost drivers before granting an increase can help offset raw material increases.
- After granting a price increase, has all the detailed information been documented outlining the baseline raw material pricing for future price changes? Also, was a process in place to lower the prices when raw material prices decrease? Ultimately, this process should be as automated as possible without having to negotiate the new pricing every time commodity prices change.

Advanced Purchasing Dynamics was founded in 2004 with the mission of helping Purchasing organizations manage their costs through data driven tools such as Cost Modeling and Cost Engineering.

For information on how APD can help you or your company identify and implement cost savings through cost modeling and cost engineering call 734-927-0836 or e-mail jburris@apurchasingqd.com.

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