How to develop long-term relationships with suppliers

by Michael W. Gozzo and Scott R. Williams

Today's competitive and economic pressures have increased the expectations and requirements we have of our suppliers. Increased quality, greater overall value, and excellent on-time delivery performance can only be achieved and sustained through long-term supplier relationships. To support these relationships, operating personnel will be called upon to embrace new behaviors as well as new business processes.

From the operations perspective, you will never get an argument that the right material, when it is required, is essential. However, when you look at the materials process, there are many characteristics or requirements that are well entrenched and very difficult to change. In order to improve the materials management process, we, the users, will have to support and implement change.

With any re-engineering process comes adjustment. This is the case with the materials management process.

What has changed
What has changed in our business? What's driving the need to challenge how we do business? In our case, what's driving how we handle materials and how we deal with our suppliers?

✔ The impact of continued competition — oil, electric heat pumps, FERC Order Nos. 436 and 636 have all affected LDCs' competitive positions.

✔ General unfavorable economic conditions over the past several years from which we have only just begun to see improvement.

✔ Rate increases can no longer be counted on. In my company, we're proceeding on the premise that we probably will not be able to go in for a rate increase until the year 2000.

✔ We are moving quickly to zero increase, flat budgets. Materials directly or indirectly represent 20 to 40% of overall annual budgets.

✔ The material component of the budget can no longer be increased by 4, 5, or 6%/yr.

✔ The growing realization that if material costs cannot be held constant or reduced, overall cost containment or reduction will have to come from the labor component — a direction that some of us may already have experienced.

Material costs
Having material on hand, inventory, means a carrying cost comprised of cost of capital, stores personnel salaries, facilities, field delivery costs, obsolescence of inventory, information systems costs, utilities, insurance, security, and so on.

What are your carrying costs? 40%? 60%? We recently completed a study and found that our carrying cost, direct and hidden, is 61%. For us, this equates to an annual cost of $6.9 million.

There is a cost of quality. Do you have to inspect all incoming materials because you can't rely on suppliers to deliver defect-free products? How often do you have to return materials? What is the cost of repacking and shipping material back to the supplier and then receiving the replacement material? How often does defective material cause a job postponement? Job site delays? What's the cost of reworking jobs as a result of material defects? Are you able to recapture these costs?

What is the cost of an incident? This is generally from 10 to 30%. There is a cost of inadequate sourcing. Have you limited yourself to local suppliers? Have you moved away from competition to a supplier of choice? Our experience has shown that the use of restricted supplier base and unstructured supplier relationships adds 20 to 30% to the cost of procured materials.

How to change
We have to change how we view our relationship with our suppliers. We have to move from being adversaries to being allies or partners. The big question to be answered is “What's in it for me?” Like all relationships, to survive and grow, it must be beneficial for both parties.

There must be a realization that our suppliers have a technical expertise that is a valuable resource to us if properly cultivated and applied. Many of our suppliers have been doing business with us for many years. They probably have a better understanding of our strengths and weaknesses than we have. If we truly want to achieve technical or general materials process improvement, we have to tap the wealth of knowledge.

We have to have open, two-way communication. We have to learn to become better listeners. As hard as it is to believe, we do not always have all the facts nor do we always make the best decisions.

With open communications, we can share information. Often suppliers are afraid to speak up out of fear of biting the hand that feeds them. We have to measure supplier performance so we know exactly where a supplier is in non-compliance. As an example, if a box of nipples, 144 to a box, is opened and there are 12 that are faulty, are they collected and reported or are they

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threw away? This is a 12% waste. There’s no question that if we were discussing 8-in. valves, we would be discussing the problem with the appropriate supplier. However, with much of our material, we do not effectively capture supplier performance. How can we expect improvement unless we are communicating the specifics?

Or, if a supplier’s deliveries are late, how late or how often does the supplier have to be late before we tell him there is a delivery problem? Having clearly defined performance standards and measurement systems in place to capture supplier performance, let us identify opportunities for improvement.

We have to look to our suppliers to introduce new opportunities or technical advances. We should be encouraging and supporting our present suppliers in the development of new products or new product applications.

We should never let our present supplier become complacent or satisfied with our business. They should be working hard to retain or grow their business with us.

If we have to bring new ideas and concepts to our present suppliers and ask them to look into them, the very items their competition is working on, alarm bells regarding our present suppliers should be going off.

Involvement

We must involve ourselves in joint problem solving. When opportunities for improvement are found, do we bring in our suppliers and tell them to “just correct the problem” or do we use these opportunities to hold in-depth discussions and, if necessary, establish problem-solving teams to seek out the root cause of the problem? The second method will result in finding the real or root cause of the problem, elimination of the problem, probable cost reduction, and eventual or possible price reductions.

We have to be looking toward long-term supplier relationships. This may translate into long-term contracts. As a supplier, if I know I may lose the annual contract with you because I came in $0.02 higher on a $5 item, I’m not going to look to develop a long-term commitment or investment with you. You are not providing me with enough incentive.

We can’t beat our suppliers over the head just to reduce prices. This is especially so if the supplier has been selected competitively. The profit margin for a supplier operating in the competitive arena may be so low that he can’t afford to reduce his price. We want to concentrate on two components:

✔ What can the supplier do to improve his manufacturing or business processes to reduce his costs? Is he implementing TQM and continuous process improvement?

✔ What are we doing that adds to our suppliers? We may find that we are a major contributor to our suppliers’ costs.

It is only through cost and waste reductions that meaningful, lasting price containment and price reductions can be achieved.

It’s equally important that we understand our suppliers’ cost structures and their cost drivers. For example, when a supplier approaches you and asks for material increases of 5%, should he get this increase? The answer is a qualified yes. Yes, if his contract permits an adjustment, but only to the extent that the material contributes to his overall cost. If the material in question represents only 20% of his overall cost, he would be entitled to 5 of 20% — or only a 1% price increase.

There are a great number of economic indicators that can help you, the user, or
your purchasing group in tracking costs. A key index is the Bureau of Labor Statistics Producer Price Index. The Producer Price Index for Finished Manufactured Goods showed no increase in 1993. What did your material costs go up by in 1993?

One word of caution: many of our suppliers want to enter into long-term alliances in partnerships with us. In instances where they have been the supplier of choice and have not had to bid competitively, you should be careful not to lock in at the present price as a baseline. Our experience has shown that in certain situations, profit margins have grown excessive. The re-introduction of competition and then the discussion and development of new relationships has resulted in price reductions from 10 to 90%. Embarrassing, yes, but also necessary.

Unfortunately, many of us have b

Another harsh reality is that as our line organizations go through manpower reductions, even if we wanted to do our own supplier sourcing, we simply do not or cannot afford the time to do so.

We must also recognize and accept that we do not need a large supplier base to be effective. We want to optimize our supplier base. In our company, we see this as meaning probably not more than three suppliers for a specific commodity.

You as the user will be called upon to let go of suppliers that just can’t meet your needs. It’s very difficult when the supplier has become part of our extended work family.

We have to expand product standardization. We have to get away from not-invented-here, not-invented-with-our-company, and not-invented-within-our-industry thinking, assuming this means it can’t be any good.

In my own company, we have three approved products. All of them can do the job or meet the requirements equally as well. Why do we buy and use three? The answer is because we have three different user divisions. Each has their preferred product and supplier.

If the users could agree on one or possibly two, we could leverage volume and secure much better prices.

We have to improve job planning and how we communicate requirements to our suppliers. Let’s look at what we know:

✓ Much of our work is seasonal, and usage patterns do exist.
✓ Replacement programs are known and designed in advance.
✓ New business requirements can be projected, with projections revised or updated as required.
✓ Special projects are planned months in advance.

Making it work
How do we put this all together and make it work? It is most important that we are to obtain a co-operative attitude. We must provide information regarding how this process will proceed. This will start with an initial presentation to a selected group of suppliers (usually by commodity or different commodities, if the number of suppliers involved does not exceed your predetermined budget limit). The contents of this symposium consists of telling them why this new approach, who will be involved, what the process will address, what’s the payback for both of us, and how long will this process take.

The presenters represent our leadership. They each explain their role and respective questions. A similar introduction occurs with our people. They must be aware and trained where applicable. In both situations there will be continued communications. This is necessary in order to ensure success (co-operation can only happen when people are constantly tuned in).

Training will be needed. It will be the vehicle used to demonstrate the principles mentioned. We can use external resources and/or develop our own. The success of the process will be its continuous application. The establishment of an on-going training process is a must.

Once the initial training has been accomplished, we must also recognize that change is continuous. Change affects people and technology. People move on, get promoted, and retire. Who will continue on? We must structure our training to satisfy the different needs levels as we transition in our companies.

The structure will have a core (basic) training for all. It will address basic principles, operating philosophies and techniques. The next level is the specific functional techniques for doing your job, such as purchasing/buyer practices, inventory control methods, and so on. The third level would be advanced/new, state-of-the-art techniques that let individuals develop and grow.

The plan
Any program needs to have a plan. Without such, there isn’t any map to guide us to our destination. In addition, there isn’t any baseline to measure against. The following 10 steps can be used to guide you to a successful partnering relationship with your suppliers:

✓ Establish an organization structure consisting of a steering committee, facilitator, and implementation team.
✓ Develop a detailed plan for selecting a commodity pilot and/or item.
✓ Initiate an education and training plan.
✓ Create criteria for classifying suppliers and execute such (approved vs. preferred and so on).
✓ Introduce the process to the suppliers and the internal organization.
✓ Develop a survey and audit process/documentation package, including quantitative values and guidelines.
✓ Establish a supplier rating system, based on performance measurements.
✓ Employ an agreement which includes criteria for continuous improvement and measurement.
✓ Start a program of awarding performance.
✓ Maintain an on-going communication process, internal and externally.

This is not the end, it is only the beginning of an on-going process for improving supplier and customer performance.

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Gas Industries  MAY 1995