Module 2

Supplier Selection and Contract Negotiations:

- **Using Total Cost to assess Supplier Performance**: When making the outsourcing decision or comparing suppliers, many firms make the fundamental mistake of focusing only on the quoted price, ignoring the fact that many factors affect the total cost of using a supplier. For instance, suppliers have different replenishment lead times. Does it pay to select a more expensive supplier with a shorter lead time? Or consider suppliers that have different on-time performance. Is the more reliable supplier worth the few extra pennies it charges per piece? When scoring and assessing suppliers, one can organize the factors influencing total cost as shown below:

Performance Category	Category Components	Quantifiable?
Supplier price	Labor, material, overhead, local taxes, and compliance costs	Yes
Supplier terms	Net payment terms, delivery frequency, minimum lot size, quantity discounts	Yes
Delivery costs	All transportation costs from source to destination, packaging costs	Yes
Inventory costs	Supplier inventory, including raw material, in process and finished goods, in-transit inventory, finished goods inventory in supply chain	Yes
Warehousing cost	Warehousing and material handling costs to support additional inventory	Yes
Quality costs	Cost of inspection, rework, product returns	Yes
Reputation	Reputation impact of quality problems	No
Other costs	Exchange rate trends, taxes, duties	Yes
Support	Management overhead and administrative support	Difficult
Supplier capabilities	Replenishment lead time, on-time performance, flexibility, information coordination capability, design coordination capability, supplier viability	To some extent

- **AUCTIONS AND NEGOTIATIONS**: Before selecting suppliers, a firm must decide whether to use single sourcing or multiple suppliers. Single sourcing guarantees the supplier sufficient business when the supplier has to make a significant buyer-specific investment. The buyer-specific investment may take the form of plant and equipment designed to produce a part that is specific to the buyer or may take the form of expertise that needs to be developed. Having multiple sources ensures a degree of competition and also lowers risk by providing a backup should a source fail to deliver. The selection of suppliers is done using a variety of mechanisms, including offline competitive bids, reverse auctions, or direct negotiations.
    - **Auctions in the Supply Chain**: When outsourcing to a third party, firms have historically obtained competitive bids and in recent years have used reverse auctions on the Internet. Competitive bids are a form of auction in which the bids are not revealed to the other bidders. Potential suppliers are first qualified and then allowed to bid on how much they would charge to perform the function. It is important for the buyer to specify performance expectations along all dimensions other than price. The purpose of the auction is to get bidders to reveal their underlying cost structure so that the buyer can select the supplier with the lowest costs.
    - **Negotiation:** Once the third party that will perform a given supply chain function has been identified, and the firm enters into a negotiation to set the terms of the contract. Negotiation is likely to result in a positive outcome only if the value the buyer places on outsourcing the supply chain function to this supplier is at least as large as the value the supplier places on performing the function for the buyer. The value that a supplier places on performing a function is influenced by its cost as well as other alternatives that are available for its existing capacity. Similarly, the value

that the buyer places is influenced by the cost of performing the function in-house and the price available from alternative suppliers. The difference between the values of the buyer and seller is referred to as the bargaining surplus. The goal of each negotiating party is to capture as much of the bargaining surplus as possible.