

The price of good value

Purchasers know all about price, cost and value. But how can you make sure to pay the lowest price for the best value? Jonathan O'Brien offers some insights into the way suppliers arrive at the prices they charge.

Procurement people are constantly on the lookout for better value for money, and never more so than in the current and continuing uncertain economic climate.

This means that, for the procurement professional, it is essential to ensure that the price being paid reflects the value of the item being purchased.

Consider this scenario: a large, successful company pays a relatively miniscule proportion of its third-party spend to a small, growing company for a service which is nonetheless crucial.

Now contrast this: a global company has devolved much of its procurement to local geographies. Within some of these regions, large amounts of cash are spent with suppliers who have forged a close relationship with the people who commission them.

Over time, the amount being paid by the global corporate has risen to the point where a properly run market testing exercise would reveal huge potential savings.

In the first scenario the big company is paying a relatively small price for a highly valued service, while in the second case the company is paying a very high price in exchange for little real value.

Pricing, for the supplier, is not an exact science. A common mistake is to think that suppliers work to a precise formula to determine what they charge.

In some sectors this may well be so, but for the most part price is a very flexible quantity.

The key to achieving the optimum relationship between value and price is to examine what kind of model the supplier - consciously or otherwise - is working to. This, in turn, will provide clarity about the figure you are willing to pay.

There are several pricing models. "Greed pricing" for example, applies when the supplier takes advantage of its position in the marketplace to hike up the price.

This is most likely to occur when there is a shortage of a given commodity or service. Greed pricing can be seen where the price is significantly greater than expected in a supply/demand balance.

In the "value pricing" model a customer is persuaded to pay more for the extra value perceived. Typically, where this model is in operation, we can ask whether the identified value for which a premium has been paid is worth the extra level of pricing.

Equally, in "budget pricing" where the supplier is given a certain budget and asked to identify the services they would be able to provide for it (an approach favoured in the world of advertising and marketing), we might ask if a lower budget would be able to achieve the same outcome. Indeed, we might ask if we need to move to a cost-based approach and move away from budget pricing entirely.

There are other models operating in different ways for the purchaser and supplier depending on a range of factors.

The key for successful procurement is to understand what those factors are and which model is in operation.

So the most useful question for purchasers to ask is not necessarily “what are my supplier’s costs?” as is sometime suggested, but “how did my supplier arrive at their price?”

Understanding this will shine a light on the pricing model adopted by the supplier and enable the purchaser to negotiate more effectively to achieve a price acceptable to both parties.

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