Negotiating Through a Translucent Lens

Cooperation, transparency, and pricing models can reduce trips to the bargaining table.

By Kate Vitasek

Many procurement professionals find themselves repeatedly back at the table with their suppliers to renegotiate pricing.

At the heart of the issue is that the price – while probably fair when the contract was inked – no longer seems appropriate for one of the parties when circumstances change. When this happens, the negotiated price becomes a point of contention.

Is there a better way?

The answer is "yes." However, it requires negotiating the economics of the buyer-supplier relationship through a different lens — a lens that includes embracing transparency, cooperation, and smart risk/reward allocation. In some cases, it might include shifting to a pricing model instead of a price.

Each concept is discussed below in more detail.

A Clear View With Transparency

Transparency is the open and timely sharing of all information relevant to a party's ability to make wise decisions for itself and the partnership. Research shows that when negotiators fail to reach a well-balanced agreement, it is often because they fail to exchange enough information to allow each other to identify options.[1]

The adage "information is power" should have a 21st-century spin. If information is power, then information shared is exponential power.

Too often, people succumb to the temptation to share only information that bolsters their position or undermines their counterpart's position while concealing information that exposes a weakness. Whether intentional or unconscious, withholding information skews the ability of others to make good decisions. It also reinforces the belief that no one at the bargaining table can be trusted.

Transparency is powerful because it builds trust. True strategic partnerships are highly transparent — sharing all relevant information to help partners make informed decisions ultimately leading to fairer and more balanced contracts. In addition, better information allows trading partners to collaborate on solutions that can mitigate risk and improve value.

Overcoming Fears About Transparency

While many companies understand the benefits of transparency, they still fear a transparent, open-book approach because they lack trust. Concerns about open-book pricing are real, and contracting parties should address them early in their discussions.

There are two primary concerns when it comes to transparently sharing costs.

First, suppliers often feel too exposed by sharing costs. Many suppliers believe if they divulge their true costs, it will be easy for clients to calculate their profit – a sacred cow for many suppliers. Suppliers fear their customers will use cost information to whittle away at profit margins.

Another fear is that the buying company will use actual costs to create a bidding war among suppliers, leading to competitors inadvertently learning each other's costs.

One way to mitigate these fears is to develop a statement of intent[2] that outlines each party's expectations of the other. For example, contracting parties could come to an agreement that clearly states margin targets for the supplier.

In addition, the parties can agree to formally establish guardrails, which should express profit targets, market share, and other key assumptions. A proper job of setting guardrails early in discussions will make sharing costs and margins more comfortable.

A second criticism regarding transparency involves buyers. Often when it comes time to share critical information, the buyer will narrowly define transparency as a one-way street – that is, the supplier is supposed to share, but the buyer doesn't have to.

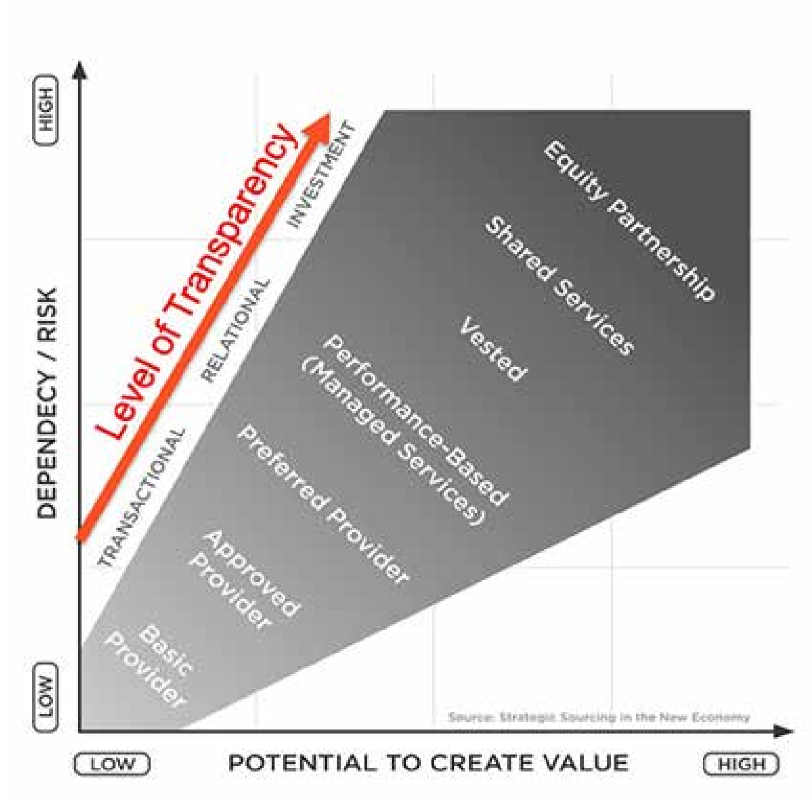
To ensure that the spirit of transparency is addressed early, include the concept of transparency – outlining both parties' expectations – in the statement of intent. To further encourage buyers to be forthcoming, suppliers should explain why they are asking for certain information.

For example, in one case, a third-party logistics supplier asked a buyer about its three-year sales forecast – was it expected to stay the same, grow, or decline? Once the buyer realized the supplier needed this to help estimate the maximum building size it would need to secure for the duration of the contract, the company felt more at ease sharing the information.

When to Use Transparency

There are no black-and-white answers for deciding when to use a transparent approach. As a general rule, using a nontransparent, closed-book approach is best for less complex sourcing business models, while more complex and dependent relationships seeking value and innovation should use a transparent approach (see Figure 1).

FIGURE 1. Relationship Between Transparency and Sourcing Business Models



The Sourcing Continuum (originally described in a white paper by the University of Tennessee and later in *Strategic Sourcing in the New Economy*)

Cooperation, Not Competition

Too often, business people are opportunistic and focus on self-interest in their approach to pricing. However, progressive organizations are challenging this mindset by establishing highly collaborative buyer-supplier relationships. For example, Nobel Laureate Oliver Williamson advocates avoiding opportunism. In fact, he encourages the concept of "leaving money on the table" to build trust with a business partner, arguing that trust greatly reduces business transaction costs.

Robert Axelrod, a professor of political science and public policy, is a pioneer in the science behind the power of using cooperative, rather than competitive, approaches to doing business.

Axelrod invited game theorists to play the Prisoner's Dilemma game,[3] which demonstrates why two individuals might not cooperate even if it is in their best interests to do so.[4] The game gets its name because two players are accused of committing crimes. When questioned by the police, each can confess their own involvement, implicate their partner in crime to receive a reduced sentence, or remain silent.

The Prisoner's Dilemma scenario is a classic game theory exercise that illustrates cooperation's advantages and disadvantages.

The irony of the Prisoner's Dilemma is that both prisoners will get the best outcome if they cooperate and remain silent.

Axelrod's findings were seminal: the greatest odds of winning came from a strategy known as "tit-for-tat." A tit-for-tat strategy is best defined by having a player echo (reciprocate) what the other player did in the previous move. For example, if person A cooperates, person B will cooperate. However, if person A suddenly defects, then person B should follow suit and defect. Defection is a competitive move characterized as noncooperative and self-serving in nature.

Axelrod's findings were described in *The Evolution of Cooperation.*[5] Playing "nice" – or cooperating – led to the best results and maximized mutual gain for both players. Axelrod summarized his findings as follows:[6]

- Be nice: Cooperate, and never be the first to defect; the best results come when both parties consistently cooperate.
- Be "provocable:" Return defection for defection, cooperation for cooperation.
- Don't be envious: Be fair with your partner. Resist the urge to optimize your position at the expense of your partner's position.
- Don't be too clever: Don't try to be tricky in gaming the system for your benefit.

After reading Axelrod's summary, it's worth wondering why more companies don't use highly collaborative approaches. Unfortunately, too many companies don't view opportunism as a bad thing. Rather, many organizations view opportunism as business as usual – especially procurement professionals who have been trained never to leave money on the table. A case in point is a Chief Procurement Officer whose mantra was: "Win-win is we get to win twice!"

This mindset must change if companies are to evolve and use advanced sourcing business models that embrace collaboration and value creation.

Expand the Agreement Zone

Most companies use conventional negotiation approaches that involve tradeoffs and concessions. After a series of back-and-forth negotiations trying to shift risk to the other party, the parties reach a compromise price.

We encourage companies to look at expanding their agreement zone with smart risk/reward allocation. Companies choose this approach to shift the discussion from "price" to a deeper economic discussion that encourages buyers and suppliers to expand the "agreement zone." Partners move away from sitting across the table from each other negotiating over a price to sitting on the same side of the table jointly problem-solving to create value.

An expanded agreement zone encourages the buyer and the supplier to take on risks they would normally shift to the other party. That is, as long as they are compensated with incentives if they achieve success against mutually defined desired outcomes. Figures 2a and 2b illustrates how smart risk/reward allocation expands the agreement zone. Figures 2a and 2b both use a semi-circle as an example. Think of the semi-circle as half of a piece.

Figure 2a represents the conventional approach to negotiating using

FIGURE 2A. Conventional Agreement Zone

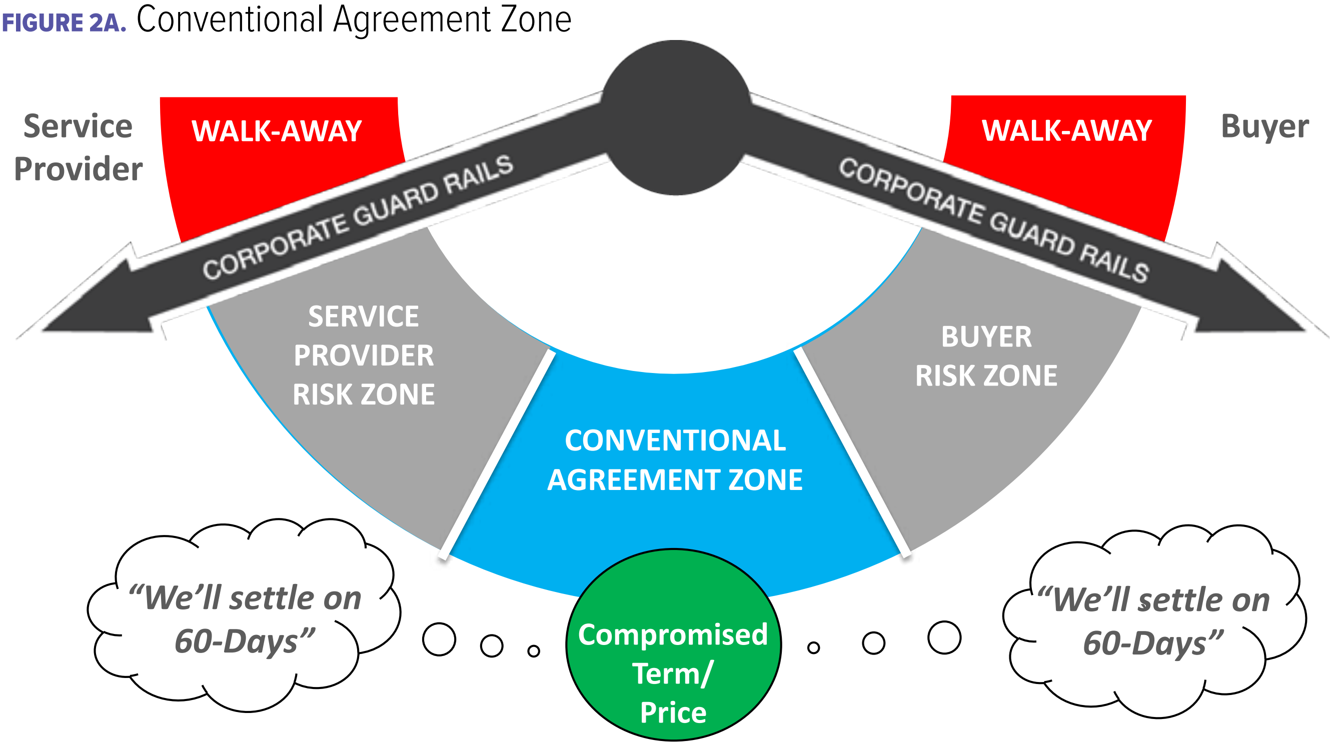
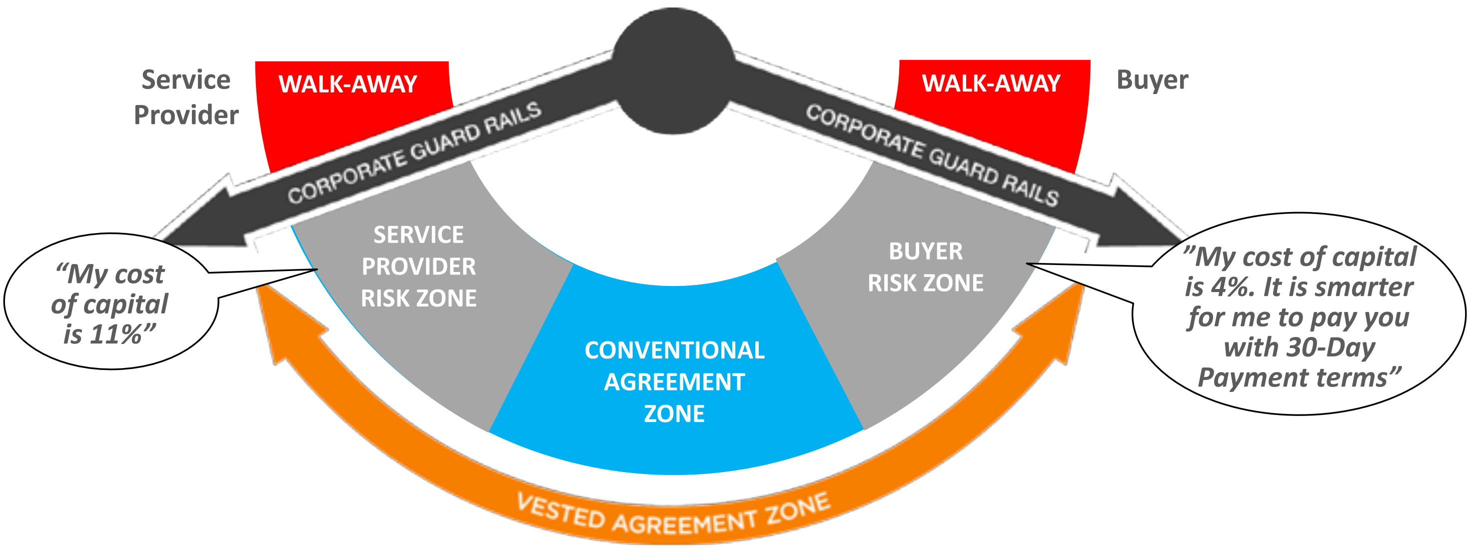


FIGURE 2B. Vested Agreement Zone



payment terms. The buyer wants to shift the risk of payment terms to the supplier – asking for a 90-day payment term. This puts the risk of the cost of capital on the supplier, and they (rightfully so) push back and try to negotiate a 30-day payment term.

In a conventional negotiation, the parties go back and forth with tradeoffs and concessions and often end up in the middle somewhere (e.g., each party compromises with a 60-day payment term). As the parties seek to push risk to the other side, their agreement zone gets smaller (the agreement zone is noted in blue). Essentially, the parties are fighting over a small slice of the pie.

When trading partners openly discuss their risks and embrace a mindset of fair risk and reward allocation, it opens up an entirely new set of opportunities to create value. This is referred to as the Vested Agreement Zone, which represents a larger slice of the pie as value is created.

For example, let's return to the negotiation over payment terms. The supplier shares that their cost of capital is 11%, and the buyer shared their cost of capital is 4%. In this case, if the buyer were to increase payment terms, it would, in essence, be raising their costs for the supplier, which are almost always factored into higher prices. So here it would be smarter for the buyer to take on the risk of the cost of capital rather than push it to the supplier, as it lowers the total cost of ownership (TCO).

Likewise, with the concept of termination for convenience, it is common for a buying organization to want a short termination for convenience, such as 60 days. However, when you look at it from the supplier's perspective, this poses a risk to the supplier. A typical supplier chief financial officer (CFO) will translate a 60-day termination for convenience into a 60-day contract and will likely not be willing to invest in innovation.

A better solution is when the buyer and supplier agree to a longer-term contract with earned contract extension and a fair exit management plan. Now the supplier's CFO is willing to make investments in process efficiencies because when they achieve cost savings targets, the reward is additional business in the form of an extended contract.

In essence, by taking on risk (the buyer takes on the risk of a longer-term contract, and the supplier takes on the risk of investing in process efficiencies), the parties can expand the agreement zone (e.g., the size of the pie) for each party.

From Price to a Pricing Model

For many companies, getting a good price is the endgame in a negotiation. But for more strategic, complex, and longer-term supplier relationships, the better approach is often to collaborate on a win-win pricing model.

Let's start by first comparing a

price with a pricing model. A price is how much you pay for something, such as $4.45 for your Starbucks Grande two-pump vanilla latte. For example, a facility management (FM) provider might have a price of $6 for every work order processed by the company's customer service representative.

In contrast, a dynamic pricing model enables the parties to adapt and adjust to underlying assumptions as business happens. Fundamentally, the pricing model includes mechanisms to determine the optimum monetary exchange between a buyer and a supplier. A good pricing model equitably allocates risks and rewards to maintain fair and balanced economics during the agreement.

In some cases, a pricing model simply includes actual costs, volume targets, and incentives. Most pricing models are expressed in a simple spreadsheet; however, some can resemble a small, customized software package or a macro-based Excel spreadsheet. The best pricing models allow buyers to align a supplier's payment with the value received – in essence, validating that a company is getting what it pays for.

Pricing Model Versus a Price

As a general rule of thumb, use a price when you have a transactional sourcing business model and use a pricing model as you shift up the sourcing continuum to a more strategic performance-based or an outcome-based vested sourcing business model (See Figure 1).

The rationale is simple. The business exchanges in transactional deals are typically shorter term and should be simple and predictable. Because of the short-term nature of the business exchange, there is likely little room for the supplier to create value beyond simply acquiring the good or service. There is also little risk that the price will get out of equilibrium in the short term.

While a price approach can be used in a performance-based deal, a better option is to use a pricing model for performance-based contracts unless what is bought is predictable and smaller in scope. Finally, as organizations shift up the sourcing continuum to a longer term and more strategic vested sourcing business model, they definitely should make the shift to a pricing model.

Beyond Getting to Yes

The saying, "you get what you pay for," is as true today as when it was coined.

Organizations should resist the urge to simply "get to yes" on a price and move on to the next deal. If nothing else, the pandemic and today's economy have taught procurement professionals that getting to yes on a price today will likely mean returning to the negotiation table tomorrow, when the underlying cost structures change.

For this reason, consider negotiating your next contract with a different lens that includes embracing transparency, cooperation, smart risk/reward allocation, and perhaps even shifting to a pricing model instead of a price. **CM**

Sourcing Business Models
For a refresher on sourcing business models, see the article, "Finding the Right Sourcing Business Model," in the July 2016 issue of *Contract Management*. Visit www.vestedway.com/wp-content/uploads/2019/12/Finding-the-Right-Sourcing-Business-Model.pdf.

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ENDNOTES

1 J. K. Butler, Jr., "Trust, Expectations, Information Sharing, Climate of Trust, and Negotiation Effectiveness and Efficiency," Group & Organization Management 24, no. 2 (1999): 217–38.
2 See Chapter 2 of The Vested Outsourcing Manual: Vitasek, K. et. al., The Vested Outsourcing Manual (New York: Palgrave Macmillan, 2011).
3 The Prisoner's Dilemma scenario helps individuals and businesses understand what governs the balance between cooperation and competition in business, in politics, and in social settings. The game demonstrates how two individuals might not cooperate even if it appears that it is in their best interests to do so. It was originally framed by Merrill Flood and Melvin Dresher working at RAND in 1950. Albert W. Tucker formalized the game with prison sentence payoffs and gave it the name Prisoner's Dilemma.
4 Cooperation would mean remaining silent about one's own involvement and the involvement of the other player in the crime.
5 Robert Axelrod, The Evolution of Cooperation (New York: Basic Books, 1984).
6 Ibid, 119.