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Quick Answer: How Should CIOs and Their Teams Strategize Vendor Negotiations to Combat Inflation?

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Inflationary times create added complexity when negotiating with vendors. Cost modeling using data points from economic indicators is critical to effectively analyze the fairness of increases. CIOs and their teams can include these models in their negotiation strategy and playbook to optimize deals.

Quick Answer

How should CIOs and their teams strategize vendor negotiations to combat inflation?

- Require your vendor sales teams to provide root cause cost details when renewal pricing is excessive and proposals appear overpriced.
- Leverage data points from economic indicators for cost modeling to determine the fairness of new deal and renewal pricing.
- Include cost models in your negotiation playbook as powerful tools for leverage and bargaining power.

More Detail

Vendor negotiations are challenging even in the most favorable economic conditions. When economic uncertainty and changes drive inflation, there is an added layer of complexity to decipher whether what appear to be exorbitant price hikes and excessive renewal costs are fair and in line with economic indicators.

The two scenarios below are representative of the types of vendor proposals our clients have reported receiving over the past six to 12 months with increases ranging from 10% to as much as 30% in some cases. These increases are alarming and highly visible by executive management as the operating expenditure (opex) impact is substantially above the standard year-over-year 3% to 5% increases that organizations are accustomed to and use for budgeting and forecasting.

Scenario 1: Sample Vendor Inflation Proposal

A SaaS vendor sends a renewal proposal with an annual price increase of 21% over the previous year with no explanation or details on the reason for the increase. When questioned by the procurement team, the vendor sales team states that the increase is due to inflation, and must be passed through to customers.

Scenario 2: Sample Vendor Inflation Proposal

An application maintenance service provider sends an annual renewal statement of work (SOW) with an 18% increase in the maintenance and support fees stating that the increase is due to labor shortages driving up internal staffing costs.

The three essential components listed below should be incorporated in your negotiation strategy and playbook to analyze the fairness of vendor proposals as well as to provide leverage and bargaining power during negotiations:

- Require your vendor sales teams to provide root cause cost details when renewal pricing is excessive and proposals appear overpriced.
- Leverage data points from economic indicators for cost modeling to determine the fairness of new deal and renewal proposal pricing.
- Include cost models in your negotiation playbook as powerful tools for leverage and bargaining power.

Require Your Vendor Sales Teams to Provide Root Cause Cost Increase Details

CIOs should ensure IT procurement and negotiation processes require vendors to provide detailed explanations to justify unexpected price hikes and exorbitant renewal increases. Vendors often provide vague answers when questioned about increases, with responses such as “due to inflation” or “due to economic uncertainty” or “due to supply chain delays.” These vague and general answers can in no way serve as sufficient detail to explain or justify the fairness of these unexpected increases that result in hefty budget overruns.

Processes for both new technology acquisitions as well as contract renewals should ensure adequate time is built into the negotiation strategy and planning process to engage vendors for fact-finding discussions. The aim is to understand the root cause of these high and unexpected increases vendors often blame on and generalize as “inflation.”

If these fact-finding engagements become contentious, C-level executives should be ready to step in and participate in these discussions and request that vendor sales teams also include sales executives and their CFO as well. Including your organization’s CIO and CFO and the vendor organization’s executives and CFO can take the discussion to a higher level for strategic rather than solely tactical discussions.

The executive-level meetings serve as an opportunity to relay the message loud and clear that pricing and cost play a key role in how you will view the vendor relationship going forward. In addition, these executive-led meetings can serve as learning engagements to understand each other’s financial situation and challenges. The engagements are an effective vehicle to discuss partnering opportunities to offset cost challenges with innovative solutions. Examples of these may include co-creation of new products/services or proof-of-concept engagements where the vendor can market a new idea and the client gets the product at no charge.

Leverage Data Points From Economic Indicators for Cost Modeling

IT budget processes typically leverage economic indicators such as the Consumer Price Index (CPI) and Employment Cost Index (ECI), using data from publicly available sources such as the U.S. Bureau of Labor Statistics [1] to monitor changes across profit and loss (P&L) accounts for an accurate rolling estimate/forecast.

Tracking and monitoring changes to these economic indicators should also be an integral step in your negotiation planning process. Monitoring indexes such as CPI, ECI and even the Producer Price Index (PPI) helps you estimate vendor pricing and forecast future price changes as part of your cost modeling exercise to analyze vendor proposals. When cost models use the data points from these publicly available sources, the models serve as powerful negotiation tools, as illustrated using the example in the next section.

Include Cost Models In Your Negotiation Playbook for Leverage and Bargaining Power

Let's use the Scenario 2 Applications Maintenance Service Provider example described above under the following assumptions:

- The service provider is a publicly traded U.S.-based vendor.
- The renewal increase would result in a payment of $1.416 million, an 18% increase over the previous year's service fee of $1.2 million for the same SOW service scope and deliverables.
- ECI percentage change for the 12-month period ended December 2021 is 4.1%. [2]

The ECI 12-month percentage change statistic of 4.1% can easily be used to calculate a simple "should cost" model that you can use as your counteroffer and as evidence to justify your offer during the negotiation process. The service provider in the above scenario has explained the cost increase is due to labor shortages driving up internal staff costs, and the applications maintenance services being performed are purely labor-based costs. Therefore, you can use the ECI rate of 4.1% to calculate what a fair renewal price should be.

> **Renewal "Should Cost" Calculation**
>
> $1.2 million (last year's service fee) x 1.041 (ECI rate percentage change) = $1.249 million renewal

In this example, your "should cost" renewal calculation of $1.249 million would reduce the vendor's proposed renewal fee of $1.416 million by $167,000 and can be used as your counteroffer.

Tailor Your Negotiation Playbook to Be Vendor- and Deal-Specific

Even though the ECI is a powerful data point to use during negotiations, to improve your negotiating position you should always research and identify additional tactics that are vendor- and deal-specific. For the above scenario, the tactics below combined with use of the ECI data would serve as a robust negotiation strategy for this type of deal:

- Time the negotiation to align with the vendor's quarter- and/or fiscal-year end date.
- Research alternatives to create a competitive environment. For the applications maintenance services example, lower-cost alternatives such as offshore providers with lower labor rates would be a powerful tactic.
- Incentivize your vendor sales team by letting them know that if your counteroffer is accepted, you would be open to evaluating an option for a multiyear deal.

One negotiation process doesn't fit all vendors, so engage Gartner to provide you with the tips, tactics and techniques that are tailored to your specific vendor and deal type to help ensure negotiation success.

Ensure Your Negotiation Playbook Includes Terms and Conditions

A good negotiator is always careful not to agree to or accept a final offer too quickly. Inexperienced negotiators often make the mistake of closing the deal as soon as they get the vendor to say yes to the price reduction. It is important to always use every negotiation opportunity for concessions but also to improve terms and conditions. For the Scenario 2 example, adding price increase caps to the contract is critical to the negotiation to ensure that you're not in the same situation the following year and facing the same 18% (if not higher) renewal price increase.

Adding the right price protection language to your contract that locks in the increase will protect you when economic conditions are unfavorable — and also give you the benefit when they are back to normal. For example, let's assume CPI is the index that is most applicable to the particular type of deal/spend and will be used for the price increase cap calculation. Instead of your contract verbiage stating increases will be tied solely to CPI, discuss crafting language similar to the following with your legal counsel:

> "In the event you (customer) elects to renew, increases will not exceed CPI or 3% (whichever is less) over the pricing referenced in (Attachment X, Table Y)."

The additional "(whichever is less)" language reduces cost risk during periods of unfavorable economic conditions and gives you a cost benefit when economic conditions recover to a more favorable status.

Recommended by the Authors

Consumers Begin to Blame Companies for Price Increases

CIOs Should Exploit Financial Models to Become Better Business-Technology Executives

Toolkit: How CIOs Can Use 3 Powerful Financial Models for Negotiation Leverage and Bargaining Power

Evidence

[1] Leverage the following sources to monitor changes across profit and loss accounts:

- U.S. Bureau of Labor Statistics
- CPI Inflation Calculator, U.S. Bureau of Labor Statistics
- 12-month percentage change, Consumer Price Index, selected categories, U.S. Bureau of Labor Statistics
- Employment Cost Index Summary - 2022 Q01 Results, U.S. Bureau of Labor Statistics

[2] See ECI Table 4. Employment Cost Index for total compensation, for civilian workers, by occupational group and industry. Refer to Service-Providing Industries reflecting 4.1 percent change for 12-month period ended December 2021.