Buying in an Unstable World

Executive summary

Commodity prices have risen dramatically in the recent past, presenting big challenges for procurement people. Many commodities have substantially increased in price, but the movement has not been continuous and there have also been sharp falls.

In this issue of Viewpoint we look at the ways such price fluctuations affect procurement professionals who buy raw materials or manufactured items containing significant amounts of such materials.

We also present some thoughts on the most effective way to approach such unpredictable conditions which seem likely to continue in what has become a very unstable global economic climate. I hope this will be of value to busy procurement professionals seeking insight into coping with this challenge.

James Jenkinson
Principal
Efficio

Background

Wheat, cotton, rare earth metals and most importantly oil – many key commodities fuelling the world economy have fluctuated dramatically in price in the last couple of years. Events such as the floods in Australia and fires in Russia have made predicting commodity prices, to any degree of accuracy, extremely difficult especially for us procurement people.

For those dealing with raw materials the effects of rapidly changing prices are immediate, while for those buying “near commodities” – manufactured items including a high component of raw materials such as metals and plastics – the effects are less immediate but just as real.

In a recent survey by Efficio, more than 55 per cent of procurement executives said commodity price instability was their single biggest challenge. The question for them is how to deal with this challenge.

Managing the risk

Effective management of commodity volatility depends first on how much risk you are prepared to carry. Just like any form of investment, some strategies carry relatively low risk but are also less likely to produce impressive results. A high-risk strategy is likely to deliver high-value returns.

Broadly, there are four strategies to choose from. The easiest option is to do nothing and hope commodity prices start to decrease at some point and that your suppliers will pass these on to you. This is, of course, unlikely to be of much benefit to you as the purchaser. Suppliers, naturally, tend to be very good at passing on increased costs but not so fast when it comes to passing on corresponding decreases.

A second option is to attempt to fix prices with your suppliers for a limited period of time, for example a year. However, faced with this request they will inevitably build a buffer into their pricing model to protect themselves in a fluctuating market. If you are risk-averse and need budget stability this may be a useful option, but taken in the round, it may not be of particular benefit in terms of managing your bottom line.

A similar approach is hedging – this is commonly used for two reasons. The first is for budget security especially when you have fixed price contracts with some of your customers. The second is for speculation, where you essentially take a bet on what prices will do in the future and build this into your procurement strategy.

Unbundling the costs

The final option, and the one most likely to produce the best results, is to unbundle the costs of the commodities in the products you are buying and attempt to index your supplier's prices against them. If the cost of, say, copper, goes down in the London Metal Exchange, you want to be able to reflect this in the price you are paying for a piece of equipment with a high copper content. And, of course, if the price of copper goes up, you will be prepared to see that reflected in the prices you are paying too.

This is a sophisticated approach requiring resources in terms of time and expertise, although it can be very effective in minimising risk while you develop a pricing mechanism that is sustainable and transparent for both you and your supplier. But managed well and with expert support, it is likely to be the most effective.

The first step is to unbundle the underlying cost structure. This can be done in two ways. You can issue a form of tender in which you ask your potential suppliers for the necessary cost breakdown. Many will be eager for your business and will want to help with this. Alternatively, if you have a good relationship with your incumbent supplier you can ask them for the information.

Once you know how much of the product is based on a particular commodity, typically by weight and grade, you can then find the best market-based index to baseline your commodity against, typically one of the major world commodity exchanges.

The final step is to develop an inflator - or deflator - against the index to accommodate additional cost elements, which are then fixed, so that when the cost of the commodity goes up, the price you pay your supplier rises, and when it falls, you pay less. The proportion of fixed as against variable elements must be negotiated with your suppliers.

In summary, this is a difficult area to manage but the right approach can put you as the purchaser in the driving seat, no longer so vulnerable to unpredictable commodity price fluctuations.

A report on the full results of the Efficio *Grassroots Procurement Survey* is due to be published in early March 2011.