

# Commodity Management in Strategic Sourcing

How to optimise the sourcing of commodity-driven categories

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As buying organisations get smarter with their supplier base, regular tender exercises and subsequent negotiations can yield significant cash benefits. Whether the results can be sustained in the long run depends on a buyer's ability to understand their costs and its constituents and keep them under tight control.

Many organisations spend a considerable amount of time and effort on tenders and negotiations, only to find that prices are on the increase again shortly after a deal was sealed. Suppliers repeatedly manage to justify their demands by referring to rising commodity prices that affect their bottom line. Their argument usually revolves around the "I have to pass my increase on, or I will not be able to supply what was agreed" line. However, buyers rarely challenge this reasoning in an effective way, and tend to accept an increase without fully understanding the real impact of rising commodity prices on purchased goods and services. Meanwhile, very few suppliers come forward to offer a reduction when commodity prices display a downward trend.

Efficio has extensive commodity management experience within strategic sourcing, which we have undertaken for a variety of blue chip organisations. In this White Paper we explain the value of treating commodity-driven categories with a difference, explore the strategic sourcing steps that should be followed, and recommend an approach for effective commodity management.

# About Efficio

Efficio is a results-focused procurement consultancy, with a track record of helping leading organisations achieve more value from their procurement. Whether the challenge is delivering significant savings to the bottom line or managing suppliers to create value for the longer term, Efficio provides a range of client-tailored services including:

- Procurement Opportunity Assessment
- Strategic Sourcing Execution
- People and Process Development
- Procurement Transformation

## About the author

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Comprised of experienced professionals with a blue-chip consultancy heritage, Efficio combines the credentials of a top tier firm, with the depth of expertise and execution of a flexible niche player. With offices in the UK and Germany, and a growing operation in the USA, we service clients from a broad range of sectors throughout Europe and the United States.

To learn more, please visit [www.efficioconsulting.com](http://www.efficioconsulting.com) or call **+44 20 7553 6900**

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# Introduction

Virtually all buying organisations will come across products and services that are linked to a commodity of some kind. Active commodity management for every single sourced category might require disproportionate efforts from buyers, but universally dismissing the significance of commodities could result in unwanted consequences.

Within the value chain of most products and services there is a component of a commodity that is traded on efficient, transparent markets. The extent to which commodities influence the final price of finished goods varies from product to product but their significance in general is often overlooked. Negotiations or tenders may result in improved prices but buyers seldom investigate the cost constituents of purchased materials or services and their affinity to established commodities.

This is a serious flaw, which can result in substantial loss of value to the buying organisation. Without a conscious commodity management strategy buyers are unable to benefit from falling commodity prices, whilst increases are almost instantly transferred by suppliers. There are three factors that underpin this common phenomenon:

- There is considerable information asymmetry between buyers and sellers. When it comes to price agreements, many buyers believe to have the ability of 'outsmarting' suppliers but this is more an illusion than reality. Firstly, buyers have to diffuse their sourcing efforts amongst several sourcing categories that make up their finished goods. Consequently, some raw materials will get higher priority than others, exposing the latter to the mercy of suppliers, who are likely to act upon the ignorance of buyers and appropriate the majority of value to themselves. Conversely, suppliers have full insight into the cost breakdown of the said raw material, which is their finished product and ultimate revenue generator.

Secondly, suppliers are also closer to the source of information; in other words, they have first hand supply market data from their own supply base to build an accurate picture of their cost structure. Buyers can only second guess this true cost model, which is rarely revealed to them in real detail.

- Some commodities are prone to extreme volatility. For instance 2008 saw aluminium reach an all time high at more than \$3 per kilogram, but by May 2009 this dropped to just over \$1.10 a kilogram, the lowest in five years at a reduction of more than 60%. Similarly, in 2008 oil hit a new record at nearly \$150 a barrel but by the end of the same year the price had collapsed to just \$32.40. Within one year after that, the price crept back to just over \$74 a barrel.

Unless commodity prices are monitored and managed closely, some buyers may be exposed to dire price fluctuations that could represent a lost opportunity.

- Commodity price fluctuations have significant bearing on the final price if the said commodity represents a high proportion or weight within the make-up of the purchased goods or services. For example, on corrugated cardboard, paper related commodities such as kraftliner and testliner account for circa 50% of the product's unit cost. This is a significant cost driver and should therefore be subjected to further scrutiny. Often the link to the commodity is less obvious however. Take a technical textile that is manufactured with a combination of petrochemical items, which also absorb high transportation costs. Ultimately the cost driver of most of its components and their transportation is oil, but its weight is not immediately obvious.

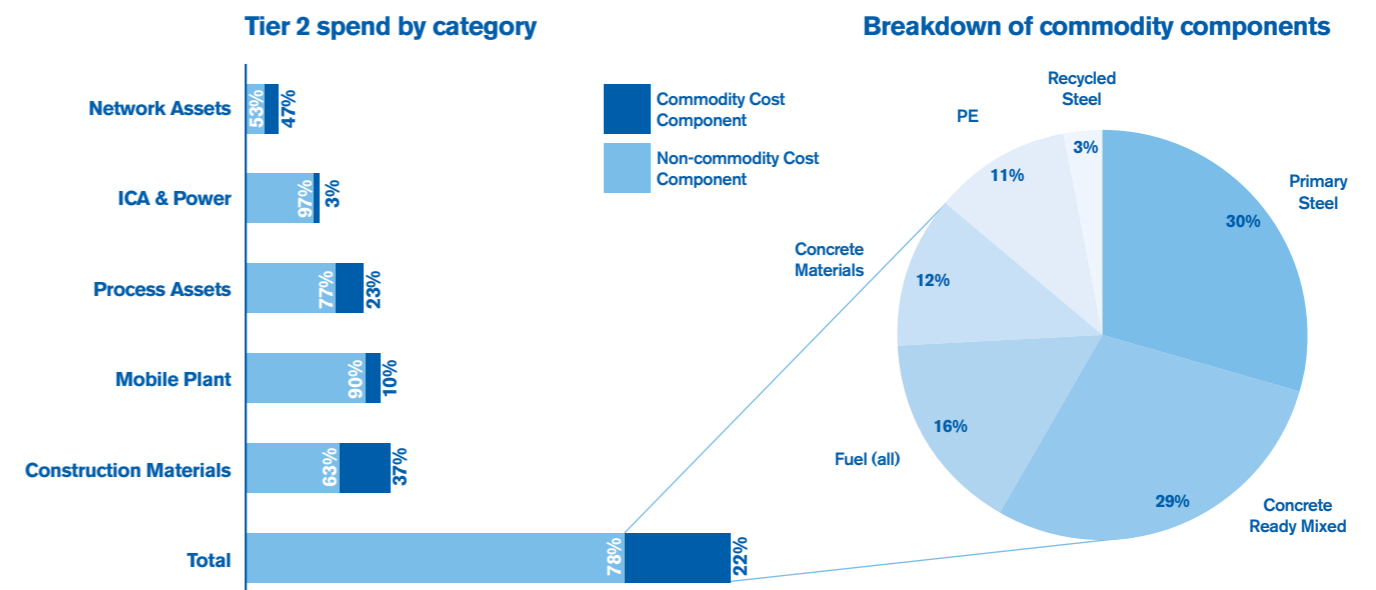
# Sourcing Strategy for Commodity-driven Categories

Successful commodity management requires particular emphasis on some critical steps of the strategic sourcing process

A rigorous, fact-based category management strategy is of crucial importance when the purchased goods have a close link with commodities. Buyers are often found to quickly jump into RFPs and negotiations without laying the groundwork for a comprehensive tender process. This could later turn out to be detrimental, as in the absence of granular data and an in-depth category and market insight, buyers will be unable to exploit the sourcing levers available to them to stay ahead of the game.

Figure 1 demonstrates an analysis of this depth that was performed on behalf of a large UK Utilities company. A thorough study of Tier 2 supplies revealed that over 20% of the cost was traceable to a commodity of some kind. This level of insight had never been brought to light before but without it, the company would have lacked the necessary sourcing levers to positively influence the outcome of subsequent supplier negotiations.

Figure 1: Commodity components of Tier 2 supplies within a utilities supply chain



# The Strategic Sourcing Process

Figure 2: Steps of the Strategic Sourcing Process

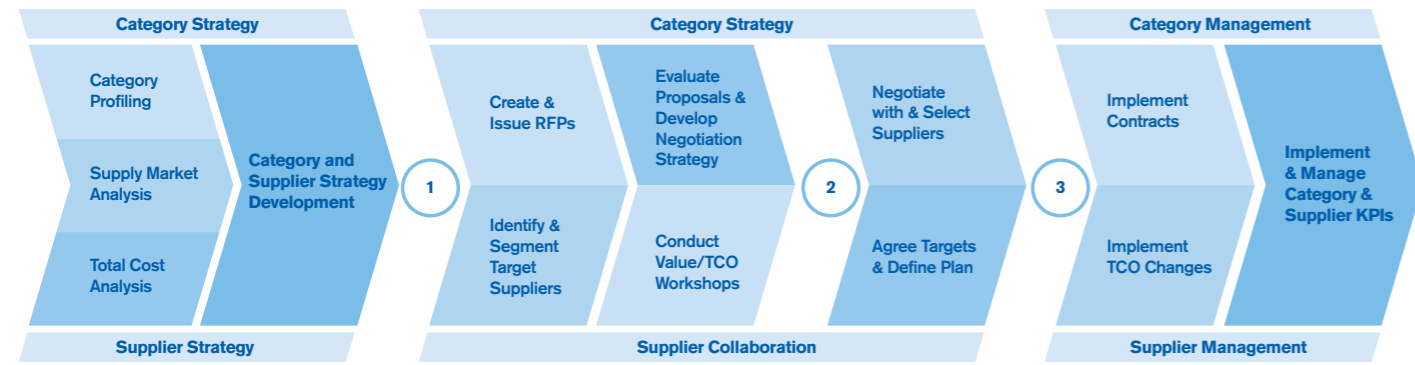


Figure 2 illustrates the Strategic Sourcing Process proposed by Efficio; the key steps to be explored in detail for commodity driven goods and services are outlined below:

- **Category Profiling** – an understanding of the category and related supply chains

Some buyers might have been purchasing the same materials or services for decades, but this fact may not automatically imply a clear understanding of fundamental cost constituents. It is not always sufficient just to shop around in order to receive the best quotes, but it is imperative to break down the purchased goods to its building blocks in physical and monetary terms. Furthermore, it is also desirable to investigate the upstream supply chain for commodity components, which may not necessarily be obvious at first glance. This analysis should identify the historical volatility of the commodity component together with its weight within the final price, also taking the expected length of the contract into consideration.

Whilst some benchmarks and spend figures might be available internally, incumbent suppliers should be the key point of contact in gathering the necessary data. They might feel threatened by this request initially but should nevertheless cooperate if serious about retaining the business. The provided information should then be duly assessed in order to conclude the baseline, both in terms of the total spend and individual cost constituents.

- **Supply Market Analysis** – the supply markets of the commodities identified

Very few organisations carry out full blown market research for the purchased goods and services. This activity usually manifests in the detection of a couple of extra vendors, who are used to refresh the gene pool of existing suppliers for forthcoming RFPs. Whilst this is an essential undertaking, it should be complemented with other valuable insights about the commodity element of the purchase.

The commodities identified during the category profiling phase should be analysed in terms of trading currencies, sources of supply, price trends, historical volatility, etc. Most importantly, a market index or price reference should be established to benchmark the price of the purchase.

Some commodities are traded on commodity exchanges (e.g. metals, energy) for which indices are readily available from established online and offline publications. For others, there are a number of institutions who compile market intelligence, typically sector associations, magazines or specialised research companies. When in doubt, it is worth requesting any potential indices from suppliers. Figure 3 lists a number of sources for price indices and references.

- **Total Cost Analysis** – the Total Cost of Ownership along the useful life of a purchase

Often the purchase price of a durable product represents only a fraction of the total cost to be sustained during the course of its useful life. For example, years of fuel consumption could easily dwarf the purchase cost of a vehicle. Therefore the selection criteria and negotiation strategy of a particular product needs to be built around a model, which incorporates all the relevant cost elements, instead of relying on commonplace quality scorings that do not translate results into a monetary value. Consequently, the commodity content needs to be considered within the Total Cost of Ownership and treated as any other element of the purchase cost.

- **Category Strategy Development** – choosing the most suitable sourcing levers

Assuming that preceding steps of the sourcing process have produced compelling insights, buyers should by now be in a position to generate hypotheses around the suitability of various sourcing levers. These levers can encompass formal tendering, 2nd tier agreements, long term contracts, volume consolidation, low cost country sourcing, specification review and process optimisation, to name but a few. If preceding analyses showed the required goods and services to be commodity-driven, particular focus should be laid on either long term indexed agreements or spot buying. An inquiry into the costs and risks of renegotiating the contract or switching suppliers will provide an indication as to which of these alternative levers is more appropriate.

High costs and risks (for either or both parties) are likely to pave the path towards long term indexed agreements, as a more profitable option. Conversely, in the case of low negotiation and switching costs, the emphasis should be on the effectiveness of spot buying, in particular when the commodity's link to a recognised index or price reference is rather loose or contested by the negotiating parties.

Long term agreements minimise supplier switching costs for the buyer and reduce business uncertainty as well as client acquisition costs for the supplier. They also mitigate transactional and joint operation set up costs by bringing stability to the relationship. Indexing, meanwhile, eliminates the risk of commodity fluctuation, enabling long term contracts to take effect in an unstable market environment.

Moreover, these agreements can be flexibly structured to consider changes in the volume and mix of demand thereby securing value in the long run. The advantages of implementing this strategy can often be demonstrated upfront through historical data analysis. Potential savings can be assessed by juxtaposing the historical prices of supply to the costs adjusted with the relevant index or price reference. The historical trend of cost exclusive of a commodity component will reveal if the supplier has built extra margin into its pricing model over time. The hypothetical contract could be run against a series of realistic scenarios highlighting the value of the proposed agreement.

Figure 3: Examples of sources for price indices and references

Type of commodity	Example of materials / services	Example of sources of indexes and price references
Metals	Copper; Lead; Zinc; Tin; Aluminium; Aluminium alloy; Nickel, Gold; Silver, Platinum; Palladium	LME, NYMEX, CBOT, London Metal Bulletin, Supply Management, The Steel Index
Chemicals	Petrochemicals, Plastics	ICIS, WDK, Platts
Energy	Crude Oil; Ethanol; Natural Gas; Heating Oil; Gasoline; Propane; Uranium	NYMEX, ICE, Platts
Agricultural products	Corn, Oats, Rough Rice, Soybeans, Wheat, Cocoa, Coffee, Cotton, Sugar, Olive and Sunflower oils, Orange juice	CBOT, NYBOT, POOLred, Oleosemanal
ITC components	Semiconductors, Hard drives, CPUs	Gartner, DRAMeXchange, NANDEXchange
Other raw materials	Wood and derivatives, Natural rubber, Palm oil, Wool	CBOT, RISI, FOEX, SICOM, Bursa Malaysia, ASX
Construction services and materials	Concrete, Cement, Construction	BCIS
Logistic services	Bulk and container sea freight, Road freight	Baltic Exchange, RHA

## Case Study: Food Retail Business

### A multinational restaurant and food retailer saved 10 per cent of its spend on olive oil by introducing an indexed agreement for this spend category.

#### Background

The client had an annual consumption of over 1.5 million litres of olive oil. Category buyers usually purchased the requirements on local spot markets by inviting a few suppliers to submit quotations. This was a time consuming exercise, not to mention that the prices paid were rather ad hoc, depending on the demands of the wider market and suppliers' capacity. There was no contract in place with any particular supplier and the organisation lacked vision on how to manage the category more effectively.

#### Approach

A cross-functional team of two buyers, a logistics manager and an Efficio consultant, was formed to tackle the challenges associated with the category. As the product was a pure commodity, there were many suppliers with limited differentiation between them. It was therefore recognised that market potentials should be exploited to the maximum, whilst time and effort spent on the sourcing activity should be minimised. Consequently, Efficio recommended to run an e-auction for the annual bulk olive oil requirement and to subsequently link the best offer price to a recognised commodity index: this approach would guarantee the price of the most cost effective supplier to move in accordance with the wider market so that initial benefits would be sustained in the longer run.

The strategy was successfully adopted with a large number of suppliers participating in the e-auction. Suppliers were essentially bidding on the so called spread, or value added, cost component, which represented the difference between suppliers' prices and the value of the agreed commodity index fixed on the day. In the final stage of the process one supplier was selected to sign a contract with the client.

#### Results

The final agreed contract price was 10 per cent below the average price paid over the course of the preceding year. This was a significant cost saving for a product that was perceived to be purchased on efficient spot markets. Additionally, the client was now in a position to spend their efforts on more strategic sourcing activities – as opposed to frequent tactical buying – safe in the knowledge that their nominally “fixed” prices were in line with prevailing market conditions.

- **Create & Issue RFPs** – conditioning supplier responses

A well structured tender will make all the difference when it comes to evaluating suppliers' bids. Investing time and effort in the creation of a first-class Request for Proposal document will not only ease the strife associated with tender response analysis, but will also signal to suppliers the buying organisation's finesse and competence. The findings of the previous sourcing steps should endow buyers with the necessary knowledge for building a comprehensive framework to govern suppliers' responses. Rather than allowing suppliers to dominate the process with their often ambiguous submissions, buyers should take ownership of the procedure so the desired benefits would be delivered.

Spot buying may be the preferred solution when changing suppliers is effortless, negotiating is inexpensive, there is little value for the supplier to secure volumes for a relatively long time horizon and/or the parties are unable to agree on a workable contract due to a lack of price references, supply security, clear and stable specifications, etc. In the case of fresh fruit and vegetables for example, spot buying is often a preferable strategy since prices and supply fluctuate daily, price references are not meaningful and suppliers could suffer sudden drops or spikes in product availability.

If the chosen strategy is to introduce indexed agreements for commodity driven goods and services then the RFP document should solicit inputs on the following criteria:

#### Weight of commodity within total price

Suppliers should specify within their cost breakdown the percentage weight attributed to a particular commodity component in financial as well as physical terms. This is an important piece of information as it will simultaneously provide other relevant clues about a particular supplier such as efficiency (use of resources) and efficacy (buying power with tier two suppliers). It will also make an interesting read in comparing the various submissions, and will help to filter out any inconsistencies, together with suppliers, that are way off from the established median response. Most importantly, the agreed weight will provide the base on which any future price adjustment would be applied.

#### Proposed index to be used

As mentioned before, in some instances, a number of different indices will be available to monitor the price of a certain type of commodity. In order to conclude the mutually most acceptable option, suppliers should provide their preferred index and its source (publication, provider, industry association, etc) within their tender response. This insight would facilitate further meaningful comparisons between suppliers: those who respond with 'N/A' could be of some concern to buyers, as any serious organisation should be in a position to benchmark their own costs and prices against that of the wider market. In general, the selected index should be issued by an independent and competent body, and easily accessible to both parties.

#### Agreed spread of commodity price fluctuation

Different suppliers are prepared to take different amounts of risk in order to gain or maintain market share. Some may offer prices to be fixed for one year or more, others, being more risk averse, may only grant prices for shorter periods or even command a price review for each new order. In the RFP response, suppliers should primarily provide the length of the time period during which they are willing to honour their initial bid price.

Once this period expires though, the price of purchased goods or services should be linked to the agreed commodity index. Suppliers should therefore indicate the amount of variation or spread they are willing to accommodate before adjusting prices. Since prices can go both up and down, this action will naturally have an inverse affect benefitting one party whilst simultaneously disadvantaging the other. Thanks to the indexed agreement however, the price adjusting mechanism will become an automated process, which is designed to deliver a far more equitable relation between buyers and suppliers than before, in line with prevailing market conditions. The frequency of the reviews should be proportionate to the effort required to update the price.

If the chosen strategy is to implement spot buying, the key to success is to minimise the cost of negotiations whilst maximising their effectiveness. The use of automated tendering tools (e.g. eRFX) is highly advisable, since they can shorten process time, reduce costs for both parties and guarantee the effectiveness of negotiations. Standard “Invitations to Tender” templates can be incorporated within the tool and sent to a group of preferred providers on a regular basis. This will ensure adherence to market price fluctuations for commodity-driven goods and services.

- **Evaluate Proposals and Negotiate** – selecting the best deal

In the case of a long term indexed agreement, a sound RFP will allow buyers to carry out an “apples to apples” comparison of the various submissions. Providing that suppliers completed all required information, a fairly accurate picture should be emerging on the cost make-up of purchased goods and services. The parameters stipulated for a future indexed agreement should warrant buyers to calculate the ‘value-added’ portion of the final price. In other words, by ‘fixing’ the commodity component as market-dictated, the remaining cost constituents will become the real differentiator amongst suppliers' bids. The increased transparency will also create an opportunity to negotiate on individual cost components, especially if the pricing of individual suppliers display considerable irregularities. A robust process such as this will inevitably unveil the suppliers that are most capable of delivering best value.

If eAuctions are chosen to support a spot buying strategy, the negotiation process is very straightforward: provided that the tenders are run rigorously and enough bidders are involved, the final price of purchased goods should follow the price fluctuation of commodities they mostly depend on. This will minimise the commodity risk for both parties by transferring downstream the inputs of upstream commodity markets. If spot buying was correctly chosen, the implementation of the purchasing contract should present no issue.

- **Contract Implementation** – concreting the deal

With a long term agreement, once the successful supplier(s) has been selected, the contract should be drawn up with special emphasis on the indexing. The commodity weight, chosen index, price spread and review period concluded during the negotiations should be incorporated into the final contract together with the monitoring and reporting mechanisms. Responsibilities should be clearly defined so the results of intensive up-front work and negotiations are not wasted. Even if suppliers are contractually instructed to monitor indices and adjust prices accordingly, a lack of proactive buyer involvement may annul the expected benefits. Therefore it is strongly recommended to set up, as a minimum, quarterly review meetings with suppliers to monitor the movement of commodity prices.

### **A global market-leader of marine, defence and aerospace survival technology achieved 6 per cent savings by leveraging a long term indexed agreement for its most important raw material.**

#### **Background**

The client was a major consumer of technical textiles, rubber coated fabrics in particular, which were mainly used for a set of key product lines. The destination of the product rendered the technical specifications very strict with the incumbent supplier considered to be the only qualified global source. Whilst efforts of testing a second supplier were under way, the process was expected to take 6-12 months with uncertain results. The lack of alternatives was a serious threat to the reliability of supply and overall profitability of the client. The supplier had already demonstrated its readiness to take advantage of the situation by imposing subsequent price increases for the previous 5 years irrespective of the cost of raw materials (i.e. natural rubber, PA66, various chemicals). When the sourcing programme with Efficio was launched, the incumbent had just asked for a further 5 per cent rise. From the client's perspective, shifting to a different material was the only alternative, which would have implied a major technological and operational change with a potentially more severe cost increase and a barrier to global expansion plans.

Whilst the client's dependence on the supplier was apparent, investigations revealed that the client had a relatively high importance to the supplier as well. The supplier was a major chemical corporation but for the specific division and product line in question, the client represented one of the largest customers. The client's expansion prospects with increased demands would have benefitted the supplier via an uplift in the number of existing shifts together with an investment in manufacturing capacity.

#### **Approach**

After testing all viable alternatives, Efficio instigated negotiations with the incumbent supplier to implement a long term indexed agreement, in which the contract price of each SKU would be reviewed every 6 months, reflecting the weighted average and trend of main cost drivers. The two parties subsequently agreed on the estimated weight of natural rubber, oil, chemicals and manufacturing costs within each item. An independent source for an index or price reference was then identified for all cost drivers.

#### **Results**

The supplier renounced its previous demand for a price increase and the client managed to secure a long term indexed agreement with a 6 per cent price reduction instead. The contract ensured security of a critical supply for the client meanwhile providing an important expansion opportunity to the supplier. The deal proved to be profitable to both parties, since the rapid fluctuation of raw materials (natural rubber and oil) would have made a fixed price deal uneconomical to one of them, ultimately resorting to continuous renegotiations in which the supplier had already demonstrated to have the upper hand.

## The Compromise of the Market

The ability to beat the market is a desirable position to be in. However, this ambition is seldom realised on a sustainable basis. Individual players are usually too small to have a significant influence on the overall market price of commodities. This is not to say though that securing market prices is not a substantial achievement by itself. Market prices provide a fair and transparent foundation for buyer-supplier relations, transforming them into a more stable and equitable liaison.



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