spend matters

Spend Matters Perspectives

Using Sourcing Intelligence to Combat Commodity Volatility

Background

If you ask just about any business executive in the manufacturing world to reveal their most difficult challenges, chances are that commodity volatility will top the list. At no other time in recent history have we seen so many commodities rise and fall in such a compressed period of time. Thanks in part to flexibly flowing capital in the global investment markets as well as growth patterns in developing economies like China and India, there has never been greater interest in – and physical demand for – commodities that keep the world economy running. Perhaps the case of oil, a commodity that directly and indirectly impacts the cost structure of just about every corporation, is the most telling of all. Between 1869 and 2006, the inflation adjusted price for oil on a global basis averaged $21.66/barrel. But as we have all witnessed over the past two years, prices soared based on a number of factors: speculation, demand increases and supply volatility. Most recently, after reaching a high of almost $150 per barrel in the summer of 2008, prices dipped below $85 per barrel.

Oil is but one example of a commodity that has taken a ride on the volatility rollercoaster. Other forms of energy and raw materials have been equally volatile over the same period. Even major world currencies (e.g., pound, euro, yen, etc.), that have traditionally been fairly stable over time, have seen double and even triple their historic volatility over the past 18 months. These currency fluctuations have, in fact, played a significant role in contributing to overall commodity volatility. Consider, for example, the correlation of oil prices to the dollar. When the dollar is up, oil is down and vice-versa. This is due to a number of factors, the most important being that oil is priced in dollars. Additionally, as it becomes less desirable to keep capital in dollars, investors seek other alternatives such as commodities. While both of these observations hold true for other major commodities, they have also had a direct impact on the pricing of downstream commodities (e.g., plastics, copper, aluminum etc) in the same time window. The net impact of rising prices and volatility on procurement organizations has been significant. In short, procurement organizations, many of which have been tasked with aggressive cost saving targets, have had to retool their efforts to focus on cost avoidance and ways to mitigate and manage global commodity volatility throughout their supply chain. And now that commodity markets have fallen, procurement organizations are equally challenged to minimize inventory and create margin stability.

Sourcing Intelligence: New Arms for a New Battle

Faced with the rising specter of commodity price volatility, many procurement organizations are looking for new ways to manage pricing risk. While sourcing and supply management platforms – and of course excel spreadsheets – have helped many companies better analyze total cost on a global basis (including commodity prices), they alone lack the daily pricing and forecasting intelligence needed to create contracting and supply agreements that factor in global commodity intelligence. And in today's global market, this capability is becoming more essential by the day. Many companies are finding that the specific key is being able to tie commodity prices to underlying global price indices in local markets. Many procurement organizations fail to realize that the price of a commodity (e.g., steel plate, copper sheet, coil) can vary by 10-15% and more across geographic markets on a specific day. This is why traditional indices such as the LME or COMEX, that only track prices in a single market, are insufficient on a global basis when it comes to improving contracting and reducing supply risk.

There are many reasons why leading procurement organizations are using price indices as a core component of the contracting and supplier management process. Some deploy global price indices to unearth cost saving opportunities or as a trigger to examine geographically diverse sources of supply. Others use them as tools to create more accurate total landed cost models. On the most advanced level, one tech manufacturer is using global indices to understand how suppliers price – or miss-price – the various commodity risk elements of a contract (e.g., resin and transportation costs) and are taking advantage of their access to better pricing information and choosing the most advantageous options. Other companies, including GM, have committed to using price indices to reduce commodity price risk and to create more transparent supplier relationships that benefit both the buying and selling parties.

Tactics, Strategies and Price Indices

Manufacturers of all sizes are starting to use price indices as they improve their contracting and supplier management practices. The following scenarios highlight just a few of the areas where a price index can have the greatest impact:

1. Scenario A – A company is seeking to tie a contract to an index to create greater transparency. In this case, a procurement organization might use a price index to establish formula pricing or deploy price escalator/de-escalator clauses. In this example, the index provides a way for a company – and its suppliers – to lock in the value-added elements of a contract but float the underlying commodity price elements (or to separately hedge these components through a futures or options contract, if available). Price indices have numerous advantages when included in a contract from the start.

They can allow the buying organization to monitor when a supplier might request a price increase or when they should ask their supply base for a price decrease.

2. Scenario B – A company is not sure whether a global supplier is telling the complete truth when attempting to negotiate a price increase. By understanding underlying commodity prices in local markets, procurement organizations are better able to decide when a supplier's proposed price increase is fair or not. Indices can also facilitate better negotiations in local markets when it becomes clear to a supplier that the procurement organization possesses equivalent pricing intelligence.

3. Scenario C – By monitoring regional price indices for local markets, companies can easily spot arbitrage opportunities to change or rebalance a category in different geographies based on regional price variances. This strategy is best suited to companies that have previously developed an expanded global supply network and when switching or re-balancing cost options that are low. In addition, this type of local pricing intelligence can also provide early warning of potential supply shortages or disruptions based on underlying commodity availability (e.g., when prices spike in local markets).

These scenarios highlight the many ways that companies can use pricing indices in local and global markets to save money, reduce risk and create greater transparency in buyer/supplier relationships. Given these advantages, Spend Matters believes that companies should seek out pricing indices for those categories in the regional markets that they are doing business in, embedding pricing index data in their supply market research, negotiation tools/methods, transfer pricing analyses and contracts.

Sponsor background: MetalMinder Indx (SM) can save companies money on worldwide metals purchases and avoid market price volatility during unstable economic conditions. By providing visibility to localized global metals markets, MetalMinder Indx (SM) gives procurement organizations the sourcing intelligence they need to better manage total cost across a range of raw and semi-finished metals. Updated daily with prices for 15 different types of metals in multiple international markets (e.g., China, India and Japan), the IndX provides the global intelligence needed to reduce both cost and risk while enhancing procurement performance.

