

CHANGE YOUR BUYING POLICIES OR RISK A FAILED BUSINESS!

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explains why
buyers need to
change their
mindset

Most producers of consumer goods and other manufacturing organizations still acquire their commodities in exactly the same way as they procure non-commodity products.

But with prices rising, and every indication that they will continue to do so, commodities have become a much larger part of the average cost structure.

Thus rising prices are also accompanied by unprecedented levels of volatility in commodity values. As a result corporate earnings are prone to significant fluctuations: 50+ per cent is not unknown, which puts management jobs on the line. It is no longer prudent to purchase commodities passively as just another link in the supply chain. Instead it requires active management to optimize commodity acquisition and protect earnings.

Real-time price fluctuation of commodities means the item may frequently be purchased at an index price that will be issued at some point in the future by a publication such as Platts.

This is done to protect both the seller and the buyer from price movements. Commodities are often bought for delivery in the future; it is relatively common for organizations to buy today for delivery in March of next year, for example. Of course, the price of the commodity may change between the time of purchase and the time of delivery. If it goes up, then the buyer benefits. But the seller is out of the money. However, by valuing the commodity against an index that will be published close to the date of delivery this problem is greatly reduced, and both parties get the going price when the commodity is actually delivered.

This raises a series of questions for the buyer. When should you buy at an index or choose a fixed price? What is your risk in each case? Should you buy just-in-time?

Currently, the typical procurement function within an organization is not set up to answer these questions. It receives a projection of the raw materials required, including commodities, plus details of when and where they will be needed, based on demand forecasts for the finished product.

Based on this projection, the procurement function purchases these commodities in a fashion that limits the cost of carry, i.e. just-in-time. This price is based either on an index, so that they pay the going rate

at the time of delivery, or on a fixed price that correlates to market price at the time of purchase.

This approach works perfectly well when commodity prices are stable. However, if prices are not stable then the organization can get into a lot of trouble with this approach.

MOVING AWAY FROM PROCUREMENT

So what does it take to move your organization away from a procurement mindset and towards a market mindset when it comes to commodities?

We believe the key is to change the way the procurement performance is measured. In order to do this the organization needs to be structured in a way that is conducive to such measurement. Simply stated, a separate commodity management function needs to be established.

Once a separate commodity management function has been established, tools to facilitate a trading mindset as well as a means to measure performance are essential. Commodity material requirements should appear to the commodity management function as a short position that is sold at a time-of-delivery index value or as a current-market fixed price - or some combination of the two, that is in effect a transfer price between the manufacturing and commodity management function.

This position would then be marked-to-market each day in order to show whether money is being made or lost. The job of the commodity management function is still to deliver the material when manufacturing needs it, but now it is given the flexibility over when to buy, whether to store, and whether to hedge using financial derivatives such as futures, options and swaps. The measure of success would include the mark-to-market profit and loss, as well as the ability to deliver on time.

EXTENDING THE MARKET MINDSET BEYOND RAW MATERIALS

Handling commodity raw materials with a market mindset is only a first step to full commodity management. The same concepts can be extended to deal with other commodity resources, most notably energy that drives a plant and transportation fuel and freight.

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