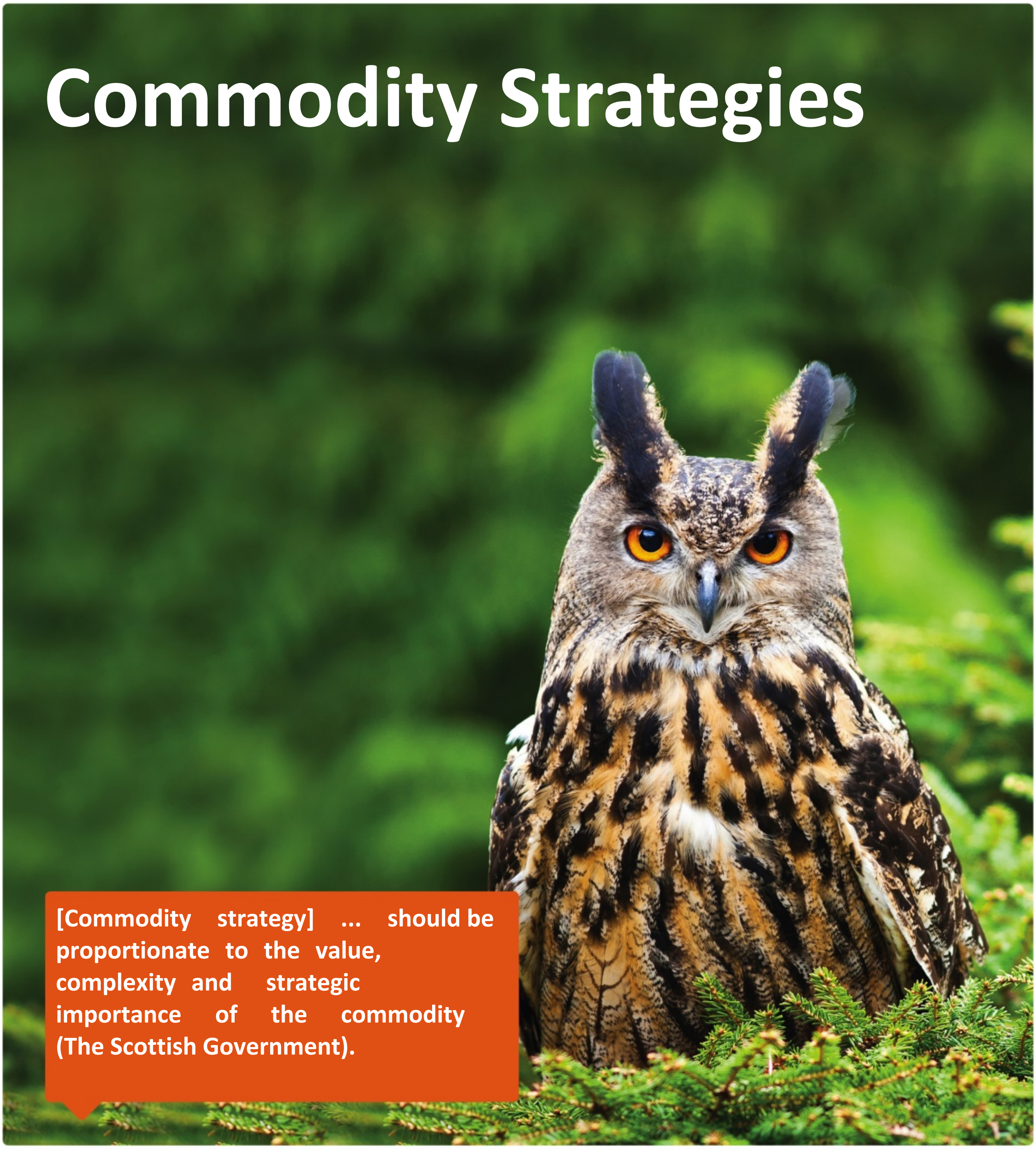
CIPS Procurement Topic

CIPS KNOWLEDGE

Commodity Strategies



[Commodity strategy] ... should be proportionate to the value, complexity and strategic importance of the commodity (The Scottish Government).

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Introduction

A commodity sourcing strategy is a specific sourcing strategy for a category or group of supplies or services (Rendon, 2005). There are two categories of commodity strategies. The first refers to spot-market transactions, or cash transactions. Spot market is the traditional commodity instrument where buyers purchase the commodity in a predefined quality category on the cash market, acquire possession and have no direct contact with the supplier (Ferris, 1997). Spot market offers flexibility but is characterised by higher commodity prices and greater price uncertainty (Seifert et al., 2004). The second category includes forward purchasing mechanisms. This commodity instrument is usually used by firms to secure the commodities needed for future production. Forward purchasing includes two mechanisms: forward buys and forward contracting. In a forward buy, manufacturers purchase and take possession of a commodity in advance of manufacturing needs at times when spot-market prices are favourable. In a forward contract, the supplier specifies delivery of a commodity at a certain future date. Such contracts usually include all of the transaction's details, such as quantity to be traded, quality of the commodity, delivery time and place, and price determination (Ferris, 1997).

Successful commodity strategy is usually characterised by market efficiency, perishability, seasonality, storage requirements, commodity cost share, budget constraints, cooperative involvement, limited supply, price risk, storage availability, traceability and volume (Jones et al., 2007). Additional factors that affect commodity strategy decisions are sales forecast accuracy, special promotions and supplier service level. Thus, these factors can be viewed as product constraints, company constraints and service constraints. The former are physical characteristics of the commodity itself or from the economics of the commodity's market. Company constraints are created by financial, managerial or organisational characteristics of the firm. Finally, service constraints are related to the manufacturer's relationship with buyers of the finished goods as well as with purchasers of the commodity (Jones et al, 2007).

Definition

Commodity strategies (sometimes referred to as 'commodity sourcing strategies') are purchasing strategy plans that refer to commodity goods - widely traded raw materials and agricultural products, such as wheat, corn, or rice (Seitz, 1994).

Successful Application

Key elements for successful implementation include the following: (1) Common processes and tools - given that commodity strategies focus on leveraging the purchasing power of the entire organisation, establishment of a commodity strategy process and implementation of spend-analysis tools would determine the what, who, where, and when of organisational spending; (2) Team sponsorship and authority - sponsorship of the strategic sourcing initiative and the level of authority enjoyed by the sourcing team are vital. The sponsor's role is to provide goals and resources, and to advocate the sourcing initiative by eliminating obstacles and barriers. Similarly, the level of the commodity team's authority includes accountability for meeting the sourcing goals and making decisions; (3) Requirement management includes consolidating all of the organisation's requirements for a specific supply or service into one or more standardised configuration requirements. The way the organisation manages the specification of the supply or service being procured determines the degree of leverage power of the organisation in the marketplace, thus stern specification management is required (Rendon, 2005).

Steps to Successful Application

- Perform a spend analysis of all the goods and services that are purchased and are forecasted to be purchased in the future. This involves aggregating total purchases across all organisational divisions both for supplies and services, and by suppliers.
- Perform an industry analysis: the examination of the supply industry in order to determine the major suppliers of the specific supply or service by market share and geographical region; Porter's Five Forces and SWOT analysis are helpful tools in this step.
- Identify and document cost and performance drivers: mapping the manufacturing process and document technology options at each stage in order to locate cost and performance drivers for the specific supply or service is an effective instrument.
- Analyse the role of suppliers and service segmentation in order to determine the type of suppliers needed and the roles they should play in terms of supply management.
- Confirm the alignment of the organisation's business processes and their integration with the commodity strategy: cost analysis drivers and supplier roles that realign business process priorities and which reflect the desired degree of integration with selected suppliers are crucial.
- Quantify the savings: ensures that the commodity strategy will result in measurable savings, and uses them as a metric not only for measuring the progress of the strategy, but also for 'selling' the resulting commodity strategy to senior organisational management.
- Implementation: should be approached as any major project, which means translating the planned strategy into a set of tasks that will result in the targeted savings. These tasks should reflect activities, resources, and milestones for achieving the savings targets.

Rendon (2005)

Hints and Tips

- Focusing on the customer is a central success factor. A key element of effective commodity strategies is an understanding of the customer (their wants/needs, important buying characteristics, the procurement process). Yet, many companies have the tendency to concentrate on pricing and become disoriented for the customer-centric approach (Jones et al., 2007).
- Having a written sourcing strategy for every supplier and every part/commodity is very important success factor that facilitates the organisation of commodity strategy planning (Rendon, 2005).
- It is important to consider the current and possible future state of relationships with suppliers and to demonstrate your intention to develop any long-term relationship (The Scottish Government).

Potential Advantages

- Commodity strategy helps to maintain commodity supply in order to meet production demands (Jones et al., 2007).
- An effective commodity strategy can help manage risks and is a critical element of successful supply management (Zsidisin and Ellram, 2003).
- Cost minimisation is a benefit of successful commodity strategy. It can be achieved by developing an optimal procurement strategy for each commodity depending on a variety of factors such as volume needs, associated risks and potential costs (Hayenga, 1979).

Potential Disadvantages

- A company's commodity strategy comprises of unique characteristics that add complexity to the procurement function (Jones et al, 2007).
- Commodity strategy has a certain degree of uncertainty, especially when large price fluctuations occur for input materials or when there is a price risk inherent in seasonal and potentially volatile commodity markets (Leenders et al., 2006).
- When purchase price becomes more important, it can directly affect the purchasing policy. In that case commodity strategy can fail to achieve its basic objective (Simon, 2005).

Performance Monitoring

- Key Performance Indicators (KPI's): used to measure the performance of various areas of the commodity strategy. Typically, the different areas should include: procurement value, stakeholders, operational excellence/process efficiency and supplier performance management and employees (Lindstrom, 2010).
- Procurement Value Key Performance Indicators (KPI's): define the value-added of the procurement to the corporation. It can also be used to assess the organisational and process maturity of the procurement function; can include savings, sourcing Return on Investment (ROI), spend per employee, savings per employee, procurement leverage applied/managed spend, sourcing rigor applied/proactive engagement and finally commodity strategy maturity (Lindstrom, 2010).
- Customer satisfaction and engagement: can be measured with surveys, either electronic or in focus groups, quarterly or bi-annually; most insight is gained through focus groups or free-text input. It is important to keep the questions short, simple and consistent to allow continuous measurement and tracking (Lindstrom, 2010).

Case Studies

- In the 1990s IBM developed and implemented a strategic commodity plan that included centralising the company's purchasing function and creating 17 commodity councils to leverage its corporate buying power. The implementation of the plan resulted in a major reduction in IBM's supplier base and cost savings. Between 1994 and 1999 IBM reduced its 4,900 production supplier base by about 85%. As a result, the company's US$17.1bln production buy was limited to 50 suppliers (Rendon, 2005).

- Cessna Aircraft Co.'s strategic sourcing included long-range strategic plans and commodity teams of representatives from various departments (supply chain, manufacturing engineering, quality engineering, product design, reliability engineering, product support and finance). The teams developed commodity strategies that supported the company's corporate strategy. As a result, Cessna achieved an 86% improvement in supply chain quality, 28% improvement in material availability, 113% improvement in production inventory turns and a significant cost reduction in the supply chain (Rendon, 2005).
- Lucent Technologies had sourcing strategies for about 70 different commodities. Each commodity team identified top suppliers, looking at their financials, global capacity, location, technology advantage and competitors. In 2002, Lucent reduced suppliers from 3,000 to fewer than 1,500. About 60 suppliers now account for over 80% of Lucent's spend (a reduction from more than 1,000 suppliers in 1999). Furthermore, in some commodities Lucent was able to reduce prices by 50% (Rendon, 2005).

Further Reading/References

Web Resources

- The Scottish Government: developing commodity strategy www.scotland.gov.uk/Topics/Government/Procurement/buyer-information/spdlowlevel/routetwotoolkit/developstrategyroutetwo/
- Sustainable procurement and commodity strategies www.capgemini.com/blog/procurement-
- Industry week article: commodity strategy www.industryweek.com/articles/commodity_costs_hit_procter__gambles_profits_in_fiscal_q2_26479.
- Commodities Strategies pensionpulse.blogspot.co.uk/2011/05/investors-turning-to-active-commodities.
- Commodity strategy planning www.cssp.com/strategicplanning/blog/?tag=commodity-

Books

- Commodity Strategies, Dorsey, DeRosier, Keeton, Morrison & Parker, ISBN 978-0470126318
- Timing Techniques for Commodity Futures Markets, Alexander, ISBN 978-0071496018
- The Purchasing of Maintenance Service Delivery in the Dutch Social Housing Sector, Mossel, ISBN 978-1586038779
- Agribusiness and Commodity Risk, Scott, ISBN 978-1904339106
- The New Commodity Trading Guide, Kleinman, ISBN 978-0137145294

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- Zsidisin, G. and Ellram, L. (2003) An Agency Theory Investigation of Supply Risk Management. The Journal of Supply Chain Management, Vol. 39(3), pp. 15-26.

Video

Oil & Commodities Strategy

www.youtube.com/watch?feature=player_embedded&v=nxZW_HsbKV0

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