

Rises in Raw Materials and Energy Prices: what strategy should be used to counteract a long-term trend?

Rises in materials and energy prices are structural

In 2004, there was a sharp upturn in global growth accompanied by a sudden rise in the price of raw materials. Oil, precious and industrial metals, agricultural materials, the leading metals on the CRB index all rose by more than 50% in one year. Today, it is China who is driving this growth: it is the world's number one consumer of copper, tin, zinc, platinum and steel; the second largest user of aluminum and the third of nickel. Tomorrow, it will be India...

It looks like there will be a lull in 2005, but this pressure on prices could persist. What is more, it is likely to be made worse by an anticipated rise in electricity prices as a result of renovations to production facilities, and the introduction of greenhouse gas emissions permits.

Assessing as long term these new constraints that the materials and energy markets are imposing on them, Purchasing Departments have to focus on ways of achieving cost reductions.

Making supplier negotiations more streamlined

Currently, there are two conflicting approaches:

A cooperative tactic: seeking to reach an agreement on a level of increase that is acceptable to both parties often based on a rule-of-reason evaluation of amounts of raw materials and energy.

A conflict tactic: refusing to accept increases until the supplier threatens to cut off supplies. This approach gains (manufacturers) a few precious months but can also result in the risk of them running out of stock and missing out on additional barter deals (extended or expanded contracts). Of course, such situations can be influenced by how essential the raw material is to the end product.

A more streamlined, organised and in-depth 3-step approach makes it possible to better understand such negotiations:

- Step 1: Get the entire company involved in a strategy where price increases are bartered in exchange for trade. This has to be applied across the company's business;
- Step 2: Analyse in detail the impact of the rises;
- Step 3: Identify bargaining power and develop innovative strategies.

Getting the entire company involved

The long established practice of involving various departments (Design, Marketing, Sales, Production and Finance) in the reduction of purchasing costs is an approach that can run out of steam after a time due to problems pertaining to priorities and resources.

To get these players back on board Senior Management can “declare war” on material price increases by initiating a plan to reduce costs by putting together a cross-functional team. Its task will be to identify pertinent technical, financial and commercial levers, for example:

- redesigning products to reduce the amount of material used, easing up on some specifications that are too restrictive, optimising their size or shape and associated transport costs, reducing the core requirements, etc
- reducing material consumption by reducing scrap, material tolerance ranges on cold or hot rolled steel reels, etc
- reducing energy consumption in plants by synchronising the start-up of production machines to limit surges in electricity consumption and by reducing compressed air leakages that eat up electricity, etc
- thoroughly reviewing the hedging policy for raw materials and energy so that the final decisions are better shared between the Purchasing, Finance and Sales Departments, etc
- negotiating price rises with Customers by creating an effective sales pitch for the reps.

Analysing in detail the impact of price rises

The Purchasing Department can objectify the short and medium term impact of structural increases in raw materials and energy through the creation and analysis of a reliable cost model by product.

The quality of information collected and how it is used is a key issue: suppliers' financial data and product manufacturing processes need to be carefully analysed.

Generally, this initiative reveals that the actual amount of raw materials and energy on which increases are based, is lower than that previously assessed by means of a breakdown of suppliers' prices that are more “commercial” than “industrial” or by too much macro analysis.

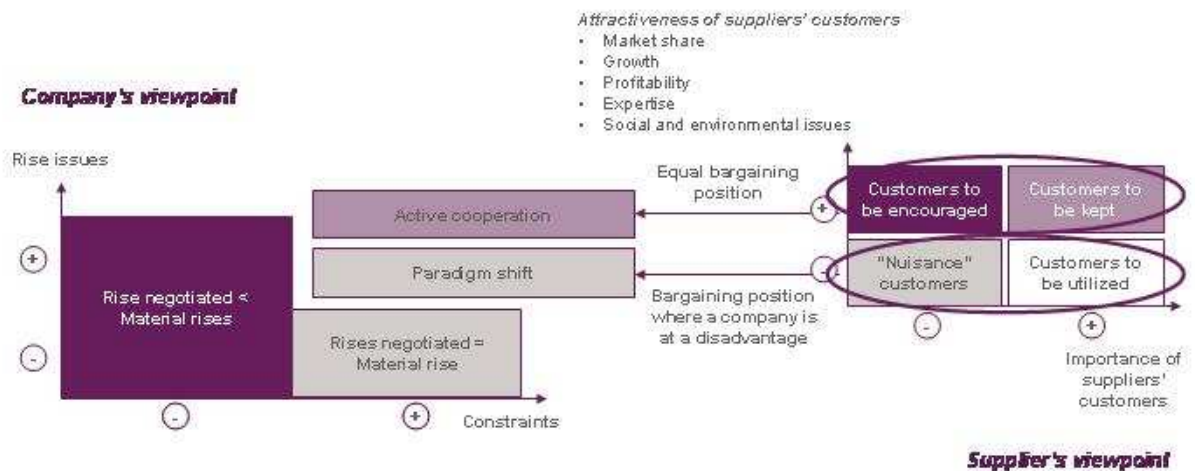
Once the real impact of the increases on the price of products purchased has been properly ascertained, all that remains is to devise a strategy for negotiating with suppliers.

Identifying bargaining power and developing innovative strategies

Three major criteria make it possible to analyse bargaining power with suppliers:

1. economic issues linked to rises in material and energy prices, identified thanks to the precision of cost models;
2. the level of internal (linked to prescriber requirements) and external (according to the complexity of the market) constraints;
3. how suppliers position a company in comparison to other customers in terms of business attractiveness (supplier's viewpoint).

According to how the product/supplier is ranked in the “Company's viewpoint”, new supplier negotiation strategies may be envisaged for major issues:



An Equal Bargaining Position: a company is attractive to its supplier, although there is a high level of constraints, it has the means to enter into an active cooperation with its supplier to trade against rises in material and energy costs by means of joint productivity initiatives.

A Bargaining Position where a company is at a disadvantage, which is often the case for raw materials and energy where suppliers are in a dominant position: it is then preferable to change the rules of the game.

Paradigm shifting to escape the constraints of a market is an approach that involves redefining needs and a review of the value chain. Here are some examples:

- Redefining needs may involve redesigning a product as we have seen previously or substituting a raw material for another less costly one, such as anthracite instead of coke
- An alternative solution may involve purchasing a sub-assembly that contains the raw material that has become too costly from a low-cost country. This approach can serve as an additional negotiating lever in dealings with current suppliers faced with the threat of losing business. If we take the example of steel, we will see that changing the country of supply is not enough.

Purchasing hot-rolled reels on a world market that is much more fragmented than the European market, from countries such as Bulgaria, South Africa, Egypt, Slovakia, or Turkey does not achieve a significant reduction in costs. In fact, prices remain high due to anti-dumping legislation in force and prices for exported products being adjusted in line with world prices. And it is sometimes necessary to carry out slitting, optimising material losses from jumbo rolls. It is then better to transfer a proportion of the added value made on the material to these countries so as to take advantage both of the lower labour costs and lower costs of local materials.

Continuing the approach despite a lull in rises

A probable, but temporary, lull in rises over the next few months may dissuade companies from taking this approach. However, the years of low cost raw materials and energy are behind us, urgent action needs to be taken now.