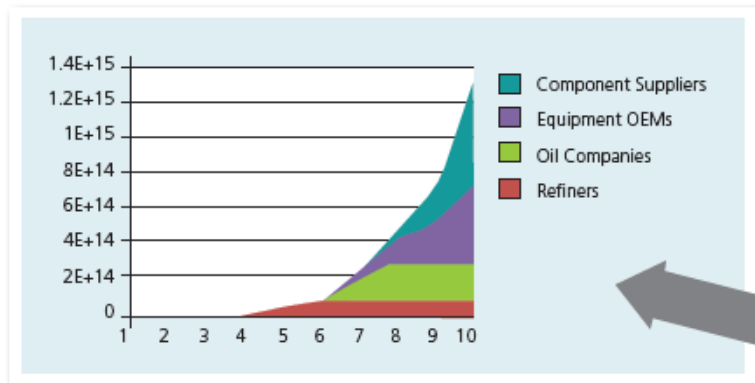


Contracting in Volatile Markets

David Jacoby

Economic bubbles are very costly, and each company bears its share of the cost when the market turns down. Furthermore, in classic bullwhip fashion, the reverberations caused by swings in end-user demand cause wider and more pronounced swings among suppliers and their suppliers, all the way to the ultimate source.



Over time, upstream players bear most of the cost. This occurs in four ways. The first (for suppliers) is the cost of lost orders near the peak - orders that could not be fulfilled due to inadequate capacity. Second (also for suppliers), suppliers over-invest at market peaks, resulting in excess capacity investments. Excess capacity is burdensome to maintain when markets turn down. Look at Dow's recent acquisition of Rohm & Haas - it is still struggling to maintain its debt payments at lower commodity prices. Third is the unanticipated cost, for buyers, of escalating prices of equipment, which are upwardly but not downwardly flexible. Fourth is the cost of holding inventory including the cost of obsolescence and

Supply chain is about more than transactions - it's about win-win cost reductions in long-term commitments.

storage, which applies to all downstream partners. In some supply chains such as oil and gas supply chains, upstream partners (refiners) have little supply chain cost (since most risk is in the selling price) and component suppliers bear the most supply chain cost (most is in the raw material price risk).

The supply chain cost of volatility magnifies in later periods. In fact, there is no impact in the initial years, as the sine

cycle begins. Later periods experience exponential increases in cost as a result of the bullwhip effect. So for anybody in capital-intensive industries, supply chain management is all about multi-year relationships.

What does this all mean for corporate executives? For those that set business strategy, supply chain management means positioning closer to the end-customer (downstream). In the case studied by Boston Strategies International, this means oil companies getting into refining and equipment suppliers getting into refining through performance-based contracts.

For procurement executives, contracts should be for at least six years (based on oil industry economics) and have renewal clauses of equal or greater lengths. Supply chain partners should engage in risk sharing based on unpredictable volumes. Contracts should be flexible and employ cost indexing. Component suppliers should give discounts for longer-term commitments, providing buyers an incentive to commit to long-term agreements that ride through the peaks and valleys of the market.

Boston Strategies International's recently helped one of its clients structure ten-year agreements with three strategic suppliers. It involved nearly a year's worth of preparation, which included benchmarking, cost and price analysis, strategy consulting, and contracting support. That foresight and strategic thinking helped support the suppliers through the recent financial crisis and maintained strong relationships during the most fractured and challenging economic times in 70 years, which is the ultimate testament to the strength of supply chain strategy well implemented. ■

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