The New Manufacturing PPI: Preparing for Price Increases

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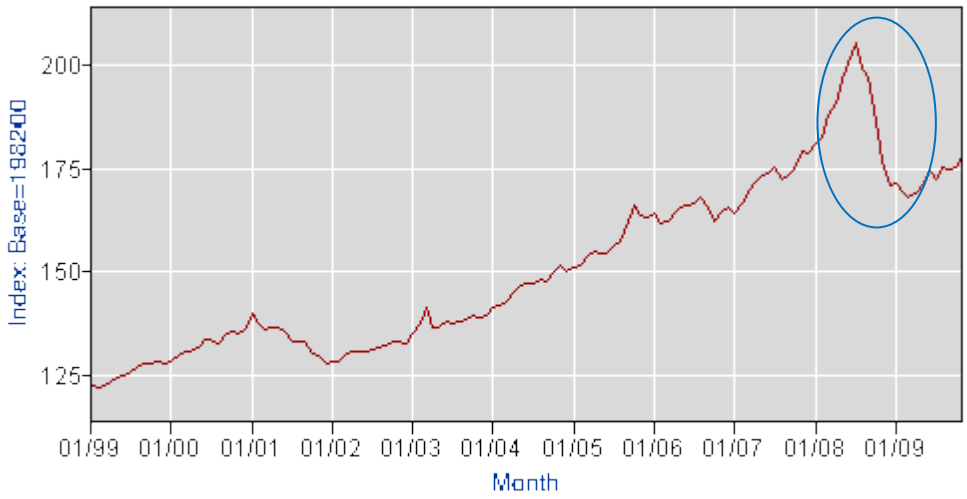
Abstract. After many manufacturing supply managers have enjoyed steep declines in raw material prices at the end of 2008 and beginning of 2009, it's now time to prepare for the upward pricing pressures ahead – if not already upon you! While there are many ways to respond to the supplier requests for price increases that are sure to come, one of the most effective strategies includes the development of your own "PPI" (Preparation for Price Increases) protocol. Such a protocol focuses on the use of both standard tools/templates and standard processes/procedures. The tools and templates are designed to capture data from the suppliers in a structured and fact-based manner, requiring that suppliers provide evidence of the cost impacts on the underlying product BOM (Bill of Materials). The processes and procedures are designed to ensure that all supply managers within your company respond in a similar and consistent manner, so that all price increase requests are addressed equitably appropriately, based on company policy. Developing your own PPI protocol is not only the best preparation for combating supplier price increases, but also a best practice in supply management.

The Opportunity. Two primary components of an effective PPI protocol for manufacturing companies include:

- Standard tools and templates to request supporting data from suppliers, such as a "PCW" (Price Change Worksheet) tool.
- Standard processes and procedures to provide guidelines on how and when to respond to supplier price increase requests both internally within the company and externally to the supplier.

Objectives. The objective of this workshop is to encourage manufacturing supply managers to develop their own PPI protocol and to provide them with a sample tool (e.g., PCW) as well as practical strategies and tactics to implement an effective PPI protocol.

Proceedings. Manufacturing pricing pressures are a recurring, not a new, phenomenon. In fact, looking back over the last ten years, we have seen a continuous trend of small "puts" and "takes" during an otherwise strong growth period in the Bureau of Labor Statistics' Producer Price Index for all commodities. What is somewhat new is the relative size of the fall we witnessed in late 2008 – early 2009:



BLS: Commodity Producer Price Index – All Commodities (199-2009)

The index for all commodities dropped almost 20% in only a 6 month period. Moreover, the ISM Purchasing Manager Index (PMI), a well-respected barometer for the health of specifically the manufacturing sector, fell approximately 33% in the same six-month period.

Such a dramatic erosion in prices has created a significant desire in many raw material suppliers' minds to now recoup as much of that loss as possible. Thus, we can expect to face more significant price increase pressure than we did in the past, as suppliers push to reestablish their historical price points, while we in turn look for a "new normal" in many product prices. Regardless of where the final equilibrium may lie, two things remain certain: 1) suppliers will still look for price increases, and 2) manufacturing supply managers must determine how to respond.

Responding to Supplier Price Increase Requests. Supply managers have several options when considering how to respond to supplier price increase requests:

- Provide no response at all
- Accept it
- Reject it
- Say "Prove it"

While the first response is probably how most manufacturing supply managers would like to respond – basically ignoring the request and hoping it goes away, a legitimate response is going to be based on one of the last three options. In choosing the right response, a supply manager should consider several factors related to this specific purchase category, such as: any existing contract provisions, past history of price increases and decreases, the overall strategic importance of the category, and the current supplier relationship with an honest recognition of supplier leverage. For example: If a contract provision specifies how a price increase should be handled, then that should be honored accordingly, which may mean you need to accept it. But if the history of past price increases and decreases have not mirrored the economic reality for that purchase category, then a supply manager may legitimately reject

it or at a minimum ask the supplier to provide supporting data. Similarly, if the category is deemed to be a strategic priority for your company and even if the supplier clearly has more leverage than you, asking the supplier to prove their position is probably the best response.

In majority of cases, the most effective response is to challenge the suppliers to "prove it," and request the supporting data for their increase. This provides a few key benefits to the supply manager:

- It facilitates the collection of relevant manufacturing data and cost drivers for this purchase category
- It puts the burden of the data collection effort on the supplier (although a supply manager will want to validate the data as well)
- It enables the supply manager to use facts and data to make the best decision now
- It enables the supply manager to reference the same cost drivers when anticipating and responding to future price increase requests, or when identifying and issuing your own price decrease requests
- It buys time, and delays any potential price impacts.

It's important to note that simply requesting the suppliers to provide more data and information doesn't mean that you accept the price increase in full or in part. It simply communicates to the supplier that any price change consideration must be supported in full by facts and data, and that as an effective supply manager you are not going to respond to emotional appeals or one-off examples, but rather follow a disciplined fact-based decision-making approach.

Standard Tools and Templates. To facilitate the request to suppliers for supporting facts and data, a best practice in supply management is the use of standard tools or templates. Standardizing such tools/templates accomplishes several things for the supply manager:

- Enables the supply manager to respond in an efficient manner – i.e., standard tools/templates that don't require customization
- Provides a uniform format for the data – so that the supply manager does not need to "normalize" supplier responses or spend time going back and forth with suppliers to ensure the same data is collected
- Facilitates the collection of relevant category data – i.e., cost drivers, relative impact on BOM (bill of material) components, market indices or other benchmarking data, etc.
- Conveys to your supplier that your company has a standard procedure for handling such requests – thus approval of any price increase is going to require a solid justification based on relevant facts and data vs. persuasive appeals based on emotion.

A PCW template is an example of such a tool that can be used for these purposes, especially in manufacturing companies. Leading supply management groups in manufacturing companies have a standard PCW template that all supply managers use when responding to supplier price increase requests. A typical PCW template would include basic overview information, such as: supplier name, purchase category/commodity, date of request, sku's impacted, etc. An effective PCW would also require suppliers to specify key factors such as: date of last price change, underlying raw materials, data or evidence of change in those raw materials, and relative impact on the net product cost:

Supplier Costs	**Time Period**		**Pricing**			**% of Product Composition**	**% Change on Net Product Cost**
Key Raw Material(s)	**Start**	**End**	**Start Current Cost**	**End Current Cost**	**% Change**		
Polystyrene Resin (GPPS)	Jul-09	Mar-10	93¢ / lb	110¢ / lb	18%	50%	9%

In addition, an effective PCW requires that a supplier specify the relevant impact at the individual sku level, as required, so that a supply manager can gauge the total net impact of any proposed price increase:

Sku & Location Data

			Unit Pricing					
Location	**SKU's**	**Description**	**Current**	**Proposed**	**% Change**	**Est. Annual Vol.**	**Annual Spend**	**Net $ Impact**
Plant A	123456	Plastic Widget	$0.75/ea	$0.818/ea	9%	1,000,000	$750,000	$68,000
				Wtd. Avg.			**Total Net Impact**	$68,000

Again, the request for this data using a standard tool/template does not imply or require that a supply manager accept such a proposal. Rather, it establishes a common platform of facts and data from which the supplier and supply manager can have the discussion. Upon receipt of a completed PCW from their supplier, effective supply managers validate the PCW data, using both their own research findings as well as data from other recent or prior PCW responses that may have been received. The key is to utilize the standard tools/templates for collection of facts and data, so that supply managers can make fact-based decisions regarding any potential pricing changes.

Standard Processes and Procedures. Using standard processes and procedures in conjunction with the standard tools and templates discussed above leads to the development of an effective "PPI" protocol. The primary purpose of the standard processes and procedures is to ensure that supply managers proactively manage and communicate potential price impacts to key stakeholders within their company. Common elements often addressed in these processes/procedures include:

- Price change request register – a central log or database of all supplier price change requests received by date and by commodity. Ideally, such a register will not only include the request but also the completed PCW form for future reference.
- Communication guidelines – focused on early notification to the appropriate stakeholders within the company once a price increase has been received (e.g., Category Directors, Manufacturing Managers, and potential Sales/Marketing Managers). Communication guidelines should also address appropriate external communication to the suppliers, including: initial response, use and requirement of any standard tools/templates, and explanation of the company's price change management process to help manage expectations.
- Mitigation strategies and tactics – designed to avoid, reduce, or delay the total net impact of any price increase. Once a price increase request has been validated, effective supply managers explore a range of different mitigating actions including such things as: process improvements (e.g., expanded demand forecast and/or inventory management visibility,

order bundling/batching, electronic funds transfer), offsetting volume or rebate commitments, and other negotiation tactics (e.g., delayed effective dates, phasing in the increase, use of competitive threats, etc.).

- Price change announcement letter – formal notification within the company that a supplier price increase request has been validated and an increase, either in full or in part, is recommended by the sourcing organization. In recommending a price increase, this procedure should require the supply manager to address several key components: rationale and justification for the price increase including key cost drivers, calculated net impact and timing of the increase by business unit and/or manufacturing location, review of key risks and other alternatives should an increase not be granted, and recommended strategy and action plan for implementation.
- Approval process – outlines the necessary approvals required to enact a mid-term price change on non-index based contract categories, typically over a specified impact threshold (e.g., $50,000). In addition to the Category Director, the Chief Procurement Officer, impacted Manufacturing or Operations Leader, and impacted Business Unit Leader may all need to approve a price change announcement letter prior to implementation of any increase.

The benefits derived from standard processes and procedures are the same as those derived from standard tools and template – i.e., efficiency, consistency, and formality. While both of these best practices in supply management lead to the same results, they do so by different means. Standard processes and procedures focus on internal alignment by requiring full communication and joint approval within the organization, while standard tools/templates focus on the external alignment and communication with the suppliers. When used together, as the key components in an effective "PPI" protocol, they provide the best preparation for supply managers to deal confidently with the pricing pressures that they face now and in the future.

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