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The 6 Myths of Commodity Pricing—and why it is about time to do away with them

A fun score settling

by Dr. Ralf Schmidt

Foreword

From wrong-way driving to a change of direction …

After more than 25 years of consulting chemical businesses on Marketing & Sales Excellence, the time has come to do away with some time-honoured traditions that unfortunately still drive too many managers in commodity businesses. The reason for doing this now is that at the beginning of my 25 years in chemical businesses, I still felt that as a newbie in the industry you should better not start messing around with the well-kept secrets of success, even though in these days I already sensed that something was really off. And many times I thought, “Gosh, that can’t be possible!”, when certain topics came up. And, of course, being new in the industry, it also makes you wonder who really is the wrong-way driver when you’re the only one driving on your side of the road, constantly looking into many oncoming lights.

So it took a few years until—after lots of discussions, countless projects and deepening insights into Marketing, Sales and also Finance & Controlling in the chemical industry—the suspicion grew that, indeed, “a lot is not right here!”. And I noticed that there are, after all, more wrong-way drivers than you might think—or wish for.

This small paper is supposed to contribute to the demythologisation of some commodity pricing evergreens and help to do away with widespread traditions, legends and tales in the business management for commodities. And if you enjoy reading this half as much as I did writing it, then it was worth it.

Have fun with it.

Ralf Schmidt

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Who doesn't know them: consultants who do not grow tired of spreading tempting messages such as, "there ain't such a thing like a commodity." They try to explain to us with missionary eagerness that you can differentiate and gain additional value in any business.

And even though they may certainly not be completely wrong about that, we have already reached ***myth number 1*** **which says that the challenges in the commodity business are self-induced** because just calling a business a commodity business already causes Sales to only use the price as a factor of differentiation and a selling argument, without considering any other option to create added value for the customer. This will then pave the way for walking into the lethal trap of commoditisation. That is why, according to myth number 1, the **term *commodity* should rather not cross your lips at all. Instead, you should speak of "standard products that are difficult to differentiate"** or something like that.

This is simply wrong, as we will show later (→ p. 9). Even though there are always ways of differentiating from the competition, even in real commodity businesses, e.g. through your logistic services, and even though in some cases the commoditisation trap can even be avoided by innovative business models, in most cases you are better off understanding and managing the true price drivers in commodities, as there are: the supply and demand balance today and tomorrow, your competitors' cost position and behaviour as well as your own cost position and set-up.

Myth number 2 is the direct consequence of the first myth: **it says that Value Pricing should be the pricing method of choice to capture the**

value, even for these “standard products which are difficult to differentiate”. Value Pricing sets the price based on the added value provided to the customer. This makes Value Pricing the absolute peak of pricing excellence for many authors and managers. This mind-set is supported by pricing books and articles from the Anglo-American region. On a regular basis, they sell Value Pricing as the Olympus of pricing methods. Apparently, the highest step of the Pricing Maturity ladder cannot even be reached without Value Pricing (cf. e.g. Cressman 2012).

Naturally, this is wrong as well: pricing methods are supposed to handle whatever sets the prices in the respective markets. So, for commodity applications we should rather speak of Supply & Demand Pricing and/or Competitor Pricing instead of Value Pricing. See further below (→ p. 15) for details on the topic.

Myth number 3 leads us to *the* evergreen in commodity management. Who hasn’t heard about it in discussions with experienced commodity managers: the key in these businesses is to fully utilize your capacities. **Because only with fully utilised capacities you can persist in this rather low-margin volume business and make money**. The marketing mix and especially pricing therefore need to be subordinate to the maxim of capacity utilisation. The capacities need to buzz, the chimneys need to smoke. Because high capacity utilisation saves us from being knocked out by the idle costs of capacity in your P/L statement.

Completely wrong: whoever claims that, does not understand their P/L statement and the difference between fixed and variable costs. Taking a detailed look (→ p. 20) may really pay off here.

These principles lead to a corresponding image of the commodity business in which low margins hardly ever seem to allow investing in spacy office furniture. “Oh, those are just commodities …”, is what you can then hear in slightly shabby hallways, kind of as an apology for the supposedly

little sex appeal of the business compared to the shiny specialty businesses. Which has lead us to ***myth number 4*: Commodities are not sexy.**

Also wrong, from our point of view, because commodities are neither more nor less sexy than specialties; they are just sexy in a different way. We will later show you where to find the fun factor in these businesses (→ p. 26).

Most of us will surely also have come across ***myth number 5:*** **“In this business, the market dictates the prices.** Forget your pricing theories, we need to be geared to the market price.“ And this has to be accepted, as we cannot joggle the market prices, after all.

Wrong, because prices are made by price deciders. And price deciders can and do influence prices! Sometimes more, sometimes less ...
(→ p. 29).

Myth number 6 finally states that it's always the competitors who move down the price spiral and who have started the price war everybody is suffering from.

Unfortunately, this **as well** is more often **wrong** than we might wish for—which is also revealed by empirical studies, as we will see later on (→ p. 31).

As contradictory as these myths are, as tenaciously they stick.

After more than 25 years of experience in price management for chemical products and services, we think that it is time to come clean with those myths, because as already mentioned, they are simply wrong, as we will discuss in more detail now.

Myth by myth.

Now, in sequence:

Myth number 1: There are no commodities—or at least we should no longer call them that.

Before we ban the term—or not—we should first clarify what it actually means. To keep it very simple, it could be summarized like this: a commodity is a product that does not differ, no matter who produces it.

The **term 'commodity'** is used for goods that are difficult to differentiate and came from agricultural products, such as the trade with coffee beans, rice, maize or pork belly, which were sold almost exclusively based on the price (cf. Enke/Reimann/Geigenmüller 2005, pp. 17f.), because apparently the price is the only factor of differentiation left in a market with homogenous goods (which, of course, is not true, as we will see later on).

Strictly speaking, we should already differentiate here, because not the product itself but its application makes a product a commodity or at least defines the degree of commoditization. Let's take maize as an example: 5 kg of forage maize are currently available for 2.95 € online. That corresponds to a price of 0.59 €/kg, as opposed to 3.81 €/kg for "iska sweet corn" for our salad or even 7.26 €/kg for "Bonduelle Goldmais" ("brand maize") in the online shop (cf. Amazon 2016).

The same applies to sand: masonry sand, concrete sand, sand for playing, mortar sand, riding arena sand or golf course sand; if you look closely, you can find all kinds of sand. They are all applications with differences in quality, brands, product-supporting services and potential for differentiation.

And still: how relevant are all the funny examples of value consultants really, like the one of the sand vendor who successfully uses differentiation strategy and added value to sell quartz sand to golf course owners at a high price (cf. Schönfelder 2016)? This is just one of many examples for how to achieve differentiation from the competition at an impressive price premium with commodities—excuse me, apparently undifferentiated products.

The message of such examples is pretty clear: it is our job to recognize the added value as well as differentiating opportunities, and to capitalize on them. And calling those products commodities makes it a lot harder, because the term “commodity” already signals (in too many people’s minds) that the business can only be made with the right price. And this has already caused dangerous and well-known consequences, as numerous profit-killing campaigns such as “20 % off on everything—except for pet food” (as used by the German hardware store chain *Praktiker*, which declared bankruptcy in 2013; cf. Kubsova/Hinze 2012) have shown.

Now, there are without any doubt products in the chemical industry that are commodities in all or at least most of their applications. We only need to look at the products noted at ICIS: polystyrene, benzenes, ethylene oxides and so on, all of them exchangeable products with clearly specified chemical properties.

But does that really mean that we can only differentiate via price here?

Of course it doesn't. Because even if the product is exchangeable and requires little technical service, we still have more differentiating factors which we should of course make use of to achieve a positive effect on our prices and margins: the supply reliability and logistical services, our reputation and the quality of our customer relationship can e.g. make the difference in these markets and justify price differences compared to the competition. And we should definitely make use of that and price it in.

So yes, there is more than just the price! The initially quoted consultants weren't wrong about that.

And of course, we should also keep our eyes and ears open to recognize in which commodity businesses we can integrate commodity products and customer-specific service features into customer-integrated solutions and business models, as for example seen in the Gas Treatment branch at BASF (cf. BASF 2013).

Unfortunately, such examples for successful "ways out of the commodity trap" will remain exceptional for most commodity applications, just like bunker sand on golf courses will remain an exception in the sand market.

So let's not get carried away. **Banning the term of commodity is deceptive**. Under the mantra of differentiation, lots of development and formulation resources are being wasted unsuccessfully and irretrievably on a finally inconclusive search for an opportunity of differentiation. And all of that happens in markets where your position on the industrial cost curve can be crucial.

So, would it really be a good idea for one of the bigger manufacturers of sand to direct the energies of the business at value differentiation? With about 15,000 golf courses in the US (with a downward drift, by the way, cf. author unknown, 2015) compared to a US sand market with a market volume of 8,300,000,000 US dollars in 2015 and an annual global growth of 5.5 % (cf. author unknown, 2016)? Or wouldn't we rather risk lousing up the company's future by keeping half the staff busy looking for such treasures in selected applications?

Not calling a spade a spade tends to obstruct the view of essential things:

Commodity markets are highly transparent and characterized by price-driven competition. The controlled price is highly dependent on supply & demand balance. Furthermore, raw material costs account for a great part of product-related costs and customers only require little technical support. Apart from a competitive cost structure, what's most required is flexibility and speed (cf. Bestvater 2005, p. 39).

Those are the factors we need to understand and master if we plan on managing commodities successfully; and that is the big difference between commodities (applications) and highly differentiated specialty products (cf. e.g. Feustel 2016).

A product branch of a worldwide leading chemical company impressively proved this a while ago. Thanks to a confession of operating in a commodity market, the appropriate re-direction of resources, the reduction of R&D costs and an invest in adequate pricing methods and competencies, they mastered a U-turn: from a divestment candidate the branch turned into one of the most profitable businesses of the company.

This business unit thus came clear with two myths at once: firstly, they named their product what it was instead of beating about the bush (myth 1), and secondly, they adjusted their pricing methods accordingly (myth 2).

So instead of covering our eyes and thinking what we do not see is no longer there, like little children do, we should understand what commodity pricing really is about.

Myth number 2: Value Pricing is THE solution

Value Pricing means setting the price based on the added value perceived by the customer. Compared to the Next Best Alternative (NBA) for the customer, we determine and—ideally—quantify how much added value we offer the customer. The created added value is then divided between us and the customer through pricing in a way that the customer has enough incentive to accept our offer and our results grow sufficiently. Methods such as value maps, value curves, value cards, value quantification, value waterfalls and so on can help with that.

The principles of Value Pricing seem to take effect here as well, since we can also achieve differentiation and added value through our services, reputation and customer relationships in commodity businesses, as shown above.

And what is better than setting the price based on the customer benefit offered? More customer centricity is hardly possible. And finally, this way we can also get rid of Cost-Plus Pricing, which has nothing to do with market mechanisms anyway.

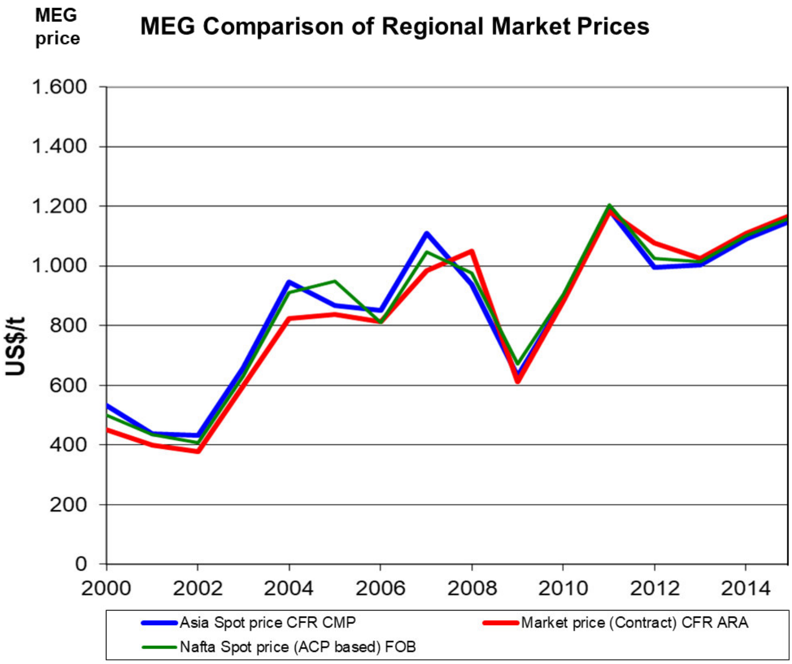
Therefore, in many books Value Pricing is introduced as basically being the only option. And lots of authors and consultants do not grow tired of equalizing Value Pricing with pricing excellence on the highest level of pricing maturity.

But watch out: didn't we just say that commodity markets depend on the relation between supply & demand, raw material costs and their development as well as the competitors' pricing behaviour?

All of this is hardly considered in Value Pricing—and therefore, Value Pricing cannot be a solution for such markets. Even though it does take differences in value into account, it does not consider the main price-driving factors in commodity markets.

Let's highlight this in more detail with a practical example and take monoethylene glycol (MEG). It is a liquid, colourless secondary product from ethylene oxide production, that is generated by adding water and is, among others, used in PET chips for the production of PET bottles, the production of polyester fibres for functional sports and casual clothing or in engine coolants for vehicles as well as many more applications (cf. BASF 2016). A commodity in nearly all applications.

The following chart shows the price development of MEG in different regions from 2000-2014:



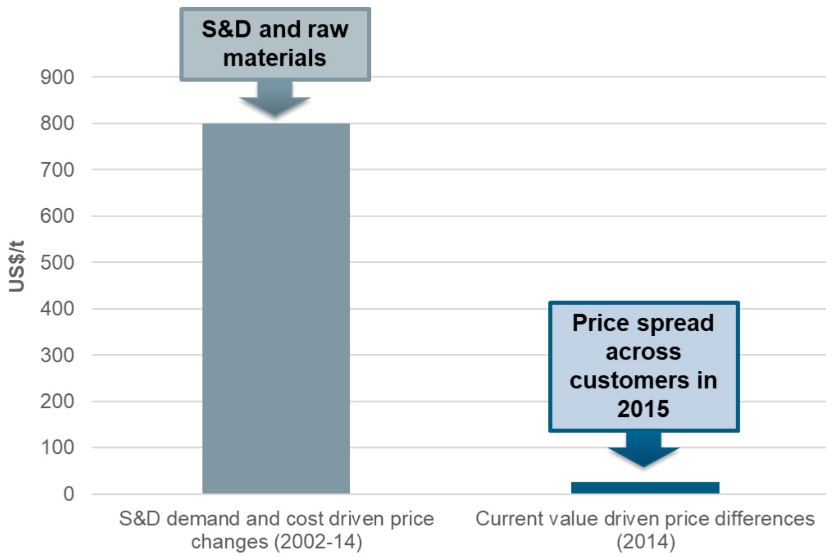
The price development was basically based on the development of the supply & demand balance and raw material costs, which during this time span led to price differences of about 800 US$ per ton.

Value Pricing does not take those deviations of price development into account.

What Value Pricing does take into account are value differences for customers, which mainly occur through logistic services in a market like this. So what about MEG?

Since we did not have access to price data of different MEG suppliers over one time span, we managed differently: we took a closer look at the customer-related price differences of one MEG supplier in a reference year (2014), because different customers obtain different services with different added value. And therefore, we have derived the price range over the customers as an indicator for the value-related price differentiation.

The data in comparison:



In this example, Value Pricing would only cover the small blue price differences, whereas the large grey area of price differences caused by supply & demand as well as raw material costs is not captured in Value Pricing. Which means that we are barking up the wrong tree with Value Pricing in those markets.

Instead, in commodity markets we first of all need to understand supply & demand developments, competitors' behaviour, changes in raw material costs, the industrial cost curve, capacities, capacity utilisation, competitors' cost positions and price tactics as well as price-quantity-dynamics and their impact on profit growth. This puts completely different tools into focus than Value Pricing does, and we are better equipped for such markets with supply & demand pricing or competitor pricing.

Myth number 3: In commodity businesses you make your money by utilizing your capacities!

Now this is one of the most tenacious errors in commodity management. If you ask for the "why", the argument of the idle capacity costs will surface quickly.

There is only one explanation why this argument cannot be killed, just like the zombies in the 1985 trash horror movie "The Return of the Living Dead": it's an apparently—and unfortunately—widely spread economical incompetence in handling your own P/L statement.

[http://www.starburstmagazine.com/reviews/dvd-and-blu-ray-home-entertainment-reviews/2543-blu-ray-review-the-return-of-the-living-dead]

To explain that we have to dig a little deeper into the P/L statement and the predetermined and final costing procedures of a chemical company:

In **predetermined costing**, the quantities of the product to be produced are planned as normal capacity, based on the availability of the production line.

Let's take the **example of a cake:** you know your oven's availability. Taking into account the usual downtime due to maintenance, cleaning and so on, it is functionally available for let's say 337.5 hours a month. You also know that you can produce 150 cakes an hour. That means that you will assume a normal capacity of 50,625 cakes a month.

As your recipe tells you exactly how much flour, milk, eggs, sugar and chocolate are required per cake, it is easy to plan the material costs for producing the expected normal capacity of cakes. Let's assume the result is 1.40 € of material costs per cake. As a reminder: these material costs are variable costs because they change depending on the quantities produced.

Which the fixed costs for production do not. That is why they're called fixed costs. As simple as that! You will have to cover these fixed costs, even if you do not produce a single cake. Fixed costs are, for example, depreciation, the major part of personnel costs in production or parts of your energy and logistics costs, which are necessary for getting ready to later provide energy or logistics.

Those fixed costs are planned for the production cost unit. Let's say we have 112,500.00 € of fixed predetermined manufacturing costs a month in our cake example. The variable predetermined manufacturing costs of the cake production cost unit are also planned. In our example we assume they are 37,500.00 € a month. That makes 0.7407 € per cake.

Our ERP system then calculates that we have 2.22 € (112,500.00 €/50,625 cakes) of fixed predetermined production costs and 0.7407 € of variable predetermined production costs. Per cake! So much for planning.

Now in reality, in our example we only produce 41,513 cakes instead of 50,625 cakes a month, which results in a capacity utilisation of 82 %. Now we get to the heart of all misinterpretations of the P/L statement mentioned above.

Final costing, which apart from actual/predetermined variances mainly also calculates the costs of idle capacity (cf. Chamoni/Gluchowski/Hahne 2005, p. 135ff.) works as follows: if you actually only produce 41,513 cakes, that results in 92,250.00 € of fixed predetermined production costs a month, given 2.22 € of fixed production costs per cake (and compared to the initially planned 112,500.00 €).

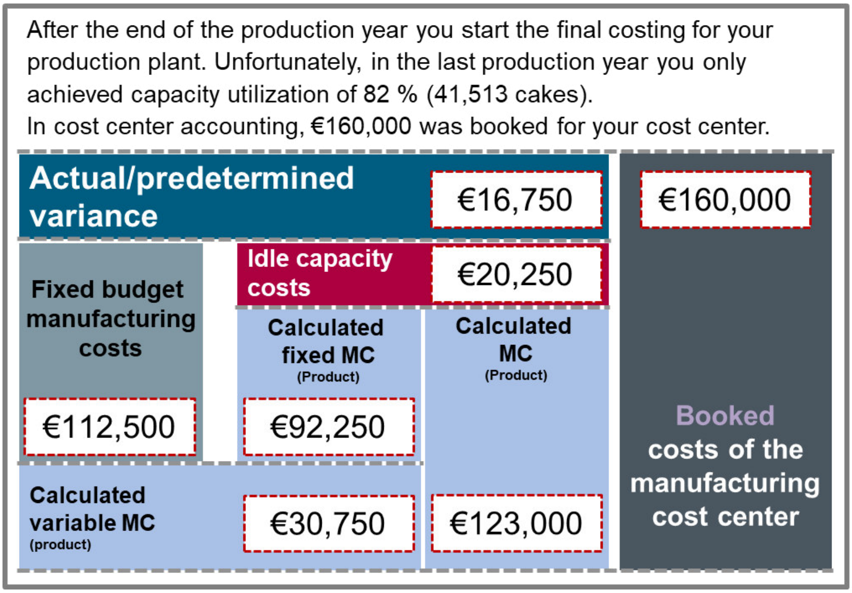
“Hold on ...“, you will say, “… that is not possible. Those are fixed costs. And we’ve all learned that fixed costs don’t change with the quantity of cakes baked. Furthermore, it doesn’t make any sense to calculate fixed costs per kg. That is misleading.”

You’re absolutely right! Your P/L just splits the fixed manufacturing costs into two parts: what you can see in your P/L under fixed manufacturing costs after final costing is only the share of fixed production costs that was allocated to the produced quantities.

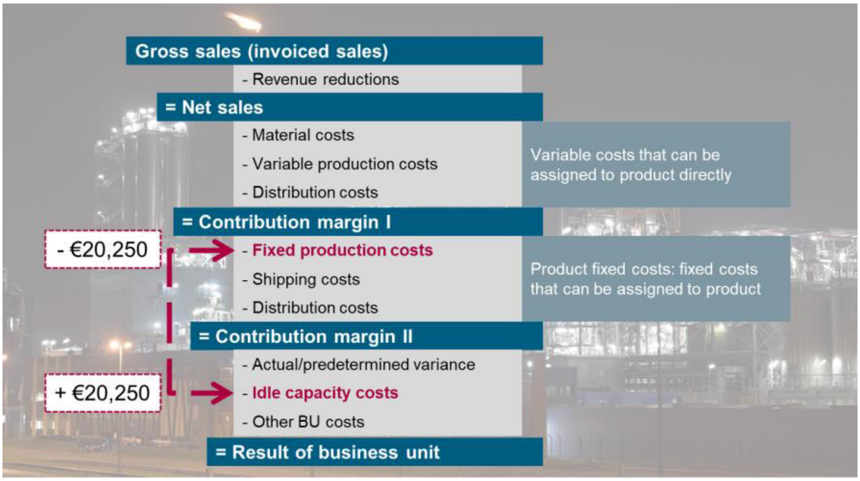
And where did the rest of the fixed costs go? They must still be there, even if we are producing less. Paul Panzer, a German comedian, would say: “Corrrrrrrrect!” The share of the fixed costs that is not allocated to the quantities produced is moved to the idle costs of capacity.

In our example: we had planned with fixed predetermined manufacturing costs of 112,500.00 €. 92,250.00 € of those go into the allocated fixed manufacturing costs. That leaves 20,250 € of fixed costs that we consider costs of idle capacity in the P/L statement of our cake business.

The following chart illustrates the data from our case study:



So, it is actually correct that with low utilisation of capacities the idle capacity costs increase. However, the profit of the business unit or the company's EBIT couldn't care less about that because it is only a switchyard: to the same degree that the costs of idle capacity increase, the allocated fixed manufacturing costs will decrease. In our example, 20,250.00 € are simply transferred from one fixed costs bucket to another:



Along the way you will also guess what happens if you count on contribution margin II as an exclusive indicator for a product's success …

"Corrrrrrrrect!" The contribution margin II will be increased by lower utilisation of your capacities, which can be deceiving and lead to wrong decisions.

And what does that mean for our myth? There is no KPI to be maximised by pricing other than contribution margin I. The costs of idle capacity are not relevant for the EBIT. What you need to make sure of in Marketing and Sales is increasing the contribution margin I, of course taking into account strategic market share goals.

Any increase of contribution margin I ultimately leads to an increase of the EBIT. Independent of the degree of capacity utilisation. It doesn't have to smoke. It has to pay off.

As simple as that.

But in case of sustainably high costs of idle capacity you should maybe think about adjusting your production capacities or use them differently.

However, in no case should you reduce the price if the additional quantities related to that are not sufficient to increase the contribution margin I.

Admittedly, we have been neglecting one factor: it is of course possible that cost experience effects or economies of scale due to the higher degree of capacity utilisation may result in a decrease of the specific variable costs, e.g. due to lower raw material purchasing costs. However, this has nothing to do with the again and again brought up arguments mentioned above.

Myth number 4: Commodities aren‘t sexy

Yes, the margins per kilogram or ton and the contribution margin rates for commodities are usually lower than for specialties. Instead of high margins with low quantities, the money here is rather made with low margins for higher quantities.

The lower margins of course lead to a higher liability of the business to fluctuations, whether it be price fluctuation in the market, changes in raw material costs or exchange rate effects.

Therefore, commodities depend on completely different factors than specialties. Cost advantages towards competitors are often crucial, which is why cost efficiency counts in the entire internal value chain, incl. procurement, production, supply chain, customer service, marketing and sales. Or, as one of our customers’ commodity managers put it in a nutshell: “Lean, lean, lean.“

A swift internal flow of communication can be worth a lot of money. It also requires agility and quick action to benefit from the fluctuations. That applies to tracking and internally communicating market changes (especially regarding supply & demand and competitors' behaviour), price validities, the timing and frequency of internal price or S&OP calls and more.

The skilful balancing of spot and contract business, the analysis of export and import price parities, the optimisation of supply chain and inventory management, actively influencing the supply & demand curve, if necessary hedging; these are all further examples for typical efforts in commodity businesses.

You will have to decide for yourself whether you find that boring or sexy.

However, experience has taught us that it is so different from specialty businesses that organisational separation of commodity and specialty management should always be an option to be considered, if possible. In more than 25 years in the chemical industry, we have met only very few managers who were both willing and able to manage both businesses well on a superior level. Such outsourcing of commodity businesses into a slimmer and more cost-efficient unit also protects you from cost allocation of general expenses to businesses that can neither bear nor use them (cf. Schönfelder 2016, p. 40).

Regarding the financial result of such commodity activities, however, there is definitely no lack of sex appeal: the market capitalisation of Ryanair in 2015 was about 1.8 times as high as that of Lufthansa and more than twice as high as that of Singapore Airlines (cf. Statista 2015).

What kind of businesses do the wealthiest people in the world represent? Computer & IT, investment businesses, telecommunication, cheap furniture, retail, petrochemicals, steel, cheap clothing, health and cosmetics items, media, oil and gas and a mixture of pipeline, refineries, fertilisers and fibres – for the most part commodity businesses.

And—admittedly—there is *one* luxury enterprise in there as well (cf. Finanzen.net, 2016).

Myth number 5: Forget about your pricing theories. The market decides on the prices. And there's nothing we can do about market prices.

Every time we hear this sentence—which, by the way, occurs more often than you would think—I ask for relevant information on where to find this market. For I have a few questions that I would like to ask it.

Despite intense research we have not yet found a "price god" in heaven who lonely but wisely is looking into his crystal ball, saying: "Today I feel like the European PET price should settle at 900-940 € a ton."

Even if there are market prices that unfold based on the relation of supply & demand and/or raw material cost developments and are published by market reporters such as ICIS on a regular basis: those are exclusively average considerations of prices made and agreed on by human beings. People like you and me.

Of course, you might be working for a company too small to actually have an active influence here, but believe me: we do not only come across the quote mentioned above in these kinds of companies.

In the end, you decide on your prices. You decide which quantities you pump into the market. You decide on the timing of maintenance work on your sites. You decide on the share of the spot business in your company. You decide, taking into account import and export price parities, whether to shift quantities to different regions and applications or whether to invite competitors from other regions to your party with your prices.

You decide—completely in accordance with compliance and antitrust laws, of course—which price changes you communicate to the market (and by that we mean the customers).

You also decide what to tell the fellows from ICIS & co. when they ask you about your evaluation of the further market development.

And hopefully your marketing & sales teams will let your production know which quantities to produce in the next month or quarter.

And you say there’s nothing you can do about the market prices?

Myth number 6: Price war? The others started it!

This myth has already repeatedly been proved in empirical studies: half the companies believe themselves to be in a price war. However, 86 % believe their competitors to have started the price war (cf. Simon Kucher & Partners 2016, p. 8).

Just like in the playground: it's always the other one who started the fight.

Only that in the chemical industry, it is a little bit more complex than in the playground, because our business structures and their complexity often lead us to misinterpreting competitors' price-aggressive behaviour. What we consider an attack is sometimes the reaction to a customer being attacked by our colleagues from a different business unit.

This shows the importance of competitive intelligence in such highly competitive markets. Tools for competition-oriented pricing, such as a competition mapping and/or 'war gaming', can be of additional help here.

Conclusion

Commodities are anything but boring and Commodity Pricing is exciting, challenging and immensely important for earnings.

So, do it right, have fun doing it and don’t let your fun get spoiled by the myths uncovered in this paper.

There is one thing, though, that you have to live with in Commodity Pricing, and that is the cyclicity of the business. In a business like this you need to be able to deal with the tide. Sometimes the market is short and your customers are on their beam-ends, sometimes it is long and you may be up to your neck in deep water.

And unfortunately, the tide is not as regular in those markets as we are used to from the beach.

But that is definitely exciting.

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If you would like to know more about appropriate tools and methods of Commodity Pricing, or if you wish to optimize your pricing or price organisation, get in touch with us.

For more than 20 years we have been supporting our customers in the chemical industry and other manufacturing B2B businesses in Pricing, Marketing & Sales Excellence and Organisational Development. Unconventionally and successfully.

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