Why Use a Commodity Index to Model Prices? Because Inflation

by: Nathan L. Phipps

Some companies (and their customers) are tired of playing the "inflation price update" game: trying to determine how much input costs have actually increased and then trying to determine how much of that cost can be passed on to customers. As a result, some companies have decided to opt out of as much of this game as possible by updating their pricing models to include a commodity index, as the author explains. Nathan L. Phipps is a Senior Consultant at Wiglaf Pricing. His areas of focus include pricing transformations, marketing analysis, conjoint analysis, and commercial policy. He can be reached at nphipps@wiglafpricing.com.

The major story across global markets in recent years has been the increase in inflationary pressure across the board and the various ways that businesses and consumers have responded.

These inflationary pressures date back to the early days of the COVID pandemic when factories in Asia were slowing production or closing to prevent the virus from spreading, while at the same time, Western knowledge workers were sent home from the office and began rapidly shifting their consumption from services to goods. This double-edged sword of decreased supply and increased demand cut across all major product categories, and increasing prices were the logical outcome.

Some companies have managed this challenge better than others, taking justifiable price increases that have been necessitated by rising input costs. Other companies have not been as bold with increasing their prices, so they may have been able to retain more of their customer base, but their profitability (and ultimately their sustainability) has suffered.

And now, the concerns of management are shifting. As we approach our third year of elevated inflation (at least, compared to the last 2+ decades), consumers are reluctant to accept more price increases. Questions on the minds of business executives have shifted from "can we raise prices?" to "did we raise prices too much?" and "will customers accept any additional price increases?"

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Stop playing the "inflation price update" game

Some companies (and their customers) are tired of playing the "inflation price update" game: trying to determine how much input costs have actually increased and then trying to determine how much of that cost can be passed on to customers. (And keep in mind that companies get to play the game from two different roles: first when they buy their components and second when they sell their products to customers. Also, there are usually multiple rounds of the game, so treating a customer poorly in one round could have consequences in a later round.)

Some companies have decided to opt out of as much of this game as possible. They have achieved this by updating their pricing models to include a commodity index. A simple execution of this idea involves determining how much of your product's price is driven by commodities (or highly correlated with commodities). Then tie that portion of the product's price entirely to the commodity index. If the commodity increases by 10%, then that portion of the product's price will increase by 10%. If the commodity decreases by 35%, then that portion of the product's price will decrease by 35%.

If your product uses some proprietary components that you do not wish to announce to the world, then you can also create your own internal index for use with your customers. Set the index equal to 1.00 in some previous year (perhaps 2019 or January 2020, so they can quickly see the impact of the pandemic on that component's price). This approach will allow your customers to see how the input costs are affecting the overall price without revealing your secret recipe.

Granted, this solution works best if at least one of your product

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components is a commodity or is highly correlated with a commodity index. For instance, your product uses corn or lumber or iron, or some commodity derivative.

Reduced pricing negotiations

A major advantage of directly tying your prices to a commodity index is that it automates the process of updating prices with your customers and getting your customers to agree to those price changes.

Naturally, some clients will be concerned about the thought of giant price increases going through without further discussion or oversight. However, this is an opportunity to point out the benefits of this approach: the prices will be tied to an index that is correlated with the prices of the components. There is no attempt to take more in price than is justified by the price changes observed in the component indices. Rather, the costs are essentially just passed through.

Quite simply, if the component price goes down, then the finished product's price will go down accordingly. If the component price goes up, then the finished product's price will go up accordingly. But there is no effort to capture additional profits in this process. Rather, your company will transparently pass on whatever price change (positive or negative) is justified by shifts in the commodity index.

And if there is no noticeable price shift among the underlying components, then perhaps there is no price change at all. For example, you could set the price change parameter to ≥ 1% (or whatever level makes sense for your business). If the price does not change at least 1% due to shifts in the component costs, then no price update is needed.

And most of these considerations should be discussed with your customers (at the very least, with your strategic accounts). It is always a good idea to take time to listen to your customers and to find out what they are concerned about and why. If your customers see the value in simplifying their pricing to 1) make it more transparent, 2) make it easier to understand, and 3) make it easier to explain to others, then perhaps you need to find time on your shared calendars for a co-creation meeting.

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