



Time to forge better supply chain deals with China

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>Published: March 27 2006 03:00 | Last updated: March 27 2006 03:00

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From Dr Cagri Haksoz.

Sir, The phenomenon explained succinctly in your interesting editorial "Muscling in on iron" (March 23) is real for China and the world. As it is suggested, China should definitely manage its total demand for iron ore before pushing for lower contract prices from the producers. On the other hand, it is getting harder for Chinese buyers to obtain contracts with lower fixed prices as in the past due to rising and more volatile spot prices. In any commodity market today, with increasing liquidity and transparency, rising spot market prices entice the producers to trade directly in the market instead of selling via long-term contracts that bind them with fixed prices.

Of course, hedging the price risk with futures contracts gains more significance in case of sole trading in the spot market, which is possible with rapid evolution of market exchanges.

I would like to propose a different perspective based on our recent research focusing on the optimal design of supply chain contracts, which I think can help the commodity producers enhance their profitability and better design their strategic moves against buyers like China in such volatile markets.

Our research results suggest that the commodity producers can take advantage of favourable spot market prices by negotiating with the buyers to write a variety of real options in the contracts that can be exercised during the course of the contract. One such option is the abandonment option; ie, abandoning to sell via the long-term contract with fixed price before the contract terminates, which may be interestingly valuable for the producer in a highly volatile spot market.

The value of such an option can be quantified. However, creating and using this option in the contract requires an intelligent design of the overall contract terms with the correct contract price, the abandonment penalty, and the duration of the contract.

Such an option may enable iron ore producers to obtain better contract terms, for example higher prices, from big and strategic buyers such as China, thereby taming her appetite to obtain lower contract prices. Thus, intelligent design of supply chain contracts could help the commodity producers decide on their strategic moves while negotiating, especially the contract price, with buyers in order to preclude undesirable operational and financial consequences.

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