The Ins and Outs of Using Price Indexes / Indices in Sourcing (Part 1)

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Related Categories: Jason Busch

This morning, I'd like to welcome Rob Patton, Sourcing Associate at Paladin Associates,Inc. Rob brings more than 33 years of purchasing experience with Procter & Gamble's global purchasing organization. His many assignments spanned P&G's diverse product categories and geographic regions. Rob was one of only seven individuals to receive P&G's prestigious Phoenix Award in recognition of his exceptional leadership, innovation and mastery in purchasing and strategic sourcing. Please join me in officially welcoming Rob to the blogosphere.

One of the critical challenges facing sourcing professionals is the determination of pricing mechanisms to deliver best value looking ahead to next quarter, next year and the next decade. This need is magnified by today's onslaught of price volatility combined with future price and supply uncertainties. Buyers in all sectors need to examine prices not already tied to indexes and seriously question their risk. Likewise those prices already tied to indexes should be closely re-examined to determine if the index mechanism should be revamped.

HISTORICAL PERSPECTIVE

Sourcing professionals have used various published indexes to determine the change in pricing for commercial materials and services for decades. Reliance on such pricing mechanisms exploded in the mid-1970's in the wake of widespread market turbulence. Unprecedented increases in crude oil pricing, totally unexpected and large-scale supply shortages, severe cash flow and credit concerns and other market distortions sent most buyers and sellers scrambling to protect against inflation, price volatility and supply uncertainty. The use of price indexing took what was deemed to be the unknowable and uncontrollable out of the equation with the goal of protecting margins and restoring some measure of predictability on both sides of the buyer-seller relationship.

Fortunately the upward spiral of inflation and supply uncertainty did not last forever but the widespread use of price indexing endured. Now that we are faced with the biggest economic upheaval in over 30 years it seems appropriate to carefully re-evaluate this subject. The alternative is to leave all pricing initiative to your sellers. While this may be reasonable for small value and noncritical spend it is extremely risky for anything strategic.

SETTING PRIORITIES

At a time when sourcing professionals already stretched to the limit, there is good news with price indexing. With limited time and effort you can perform a fairly reliable needs assessment by following the steps below. This exercise should give you a clear picture of whether price indexing is a top priority. It will also help you quantify the magnitude of spend that is impacted by a relatively small array of key cost drivers. This in turn enables you to focus further effort to achieve maximum gain.

Here are the recommended steps:

1. Starting with major spend categories create two lists – one of those items not currently indexed and one of items tied to one or more price indexes.

2. Looking at the non-index list eliminate items where current and projected pricing for the remainder of the current fiscal year and at least 3 years beyond is not concern, and where you feel relatively confident of your forecasting reliability.

3. For the remaining non-index items make a rough determination of those where total pricing is significantly affected by one or two major cost components. (These items should be immediately targeted for further evaluation of indexed pricing.)

4. Next address the list of price indexed items ranking them from oldest to newest based on formula creation date. As a general rule any formula more than 3 years old is worth re-evaluating unless you are certain that market conditions, quality and all other relevant value elements have remained static. This is not likely!

5. Now add a second column to the indexed list and rank each item based on your knowledge and comfort level with the current indexes and formula. Do you understand the subject matter enough to explain it crisply to your top management? Does the information make logical sense? Items with high marks will likely be those where you have already invested significant time and effort. Low ranking items may include those that you simply inherited from a predecessor.

6. Add a third column and rank each item according to your need for future price improvement. Consider where you feel the most pressure from your internal customers. Think strategically considering which items, if cost were reduced, will deliver the most toward your company’s future profitability, market growth, etc. Where is your biggest potential for cost improvement?

7. Add a fourth optional column and rank each item based on the reliability of your price forecast. How much confidence do Finance and general management have in your price forecast? How much confidence do you have? What is the degree of acceptable error (e.g. +/- 20%)? Are there some items that consistently baffle everyone in terms of price movements up or down? Items that on the fringe of your forecasting capability are prime candidates for re-evaluation.

8. Looking across the rows and columns of this table will enable you to set priorities.

If you breeze through the above and conclude there are no opportunities, you are one of the few strategic sourcing organizations that have stayed abreast of price indexing. If you are not among this select few then you will find value in Part 2 of this post on creating and optimizing price indexes early next week.

Please join me in thanking Rob Patton for his contribution to Spend Matters. Stay tuned for Part 2 of Rob's post on Price Indexing.

- Jason Busch

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