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The Ins and Outs of Using Price Indexes / Indices in Sourcing (Part 2)

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This morning, I'd like to welcome back 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.

In Part 1 of this post on price indexing I covered a bit of history and outlined an 8 step exercise to determine whether price indexing qualifies as a top priority. In today's post I'll discuss:

HOW TO CRAFT A PRICE INDEX

There are virtually endless possibilities depending on the specific goods or services involved, the nature of the buyer-seller relationship and the availability of reliable published information. In spite of this there are a few essential elements that will greatly facilitate your quest for the right index formula to meet your needs.

1. Am I optimizing or creating?

The process begins by determining if you are creating a new index or optimizing an existing index. Typically, you will not start from scratch. The initiative normally comes from the seller who provides a proposed price adjustment mechanism. If the seller's price already includes an index-based formula then focus your attention on understanding it and finding ways to optimize. If there is no index formula then the first step is to gain seller agreement to explore possibilities. At this point you are seeking agreement in principle to consider an indexed price. You should not encounter significant resistance since a good index protects both the buyer and seller.

2. What are the cost drivers?

In the vast majority of cases the prime cost drivers will be self-evident. Look at your spend and ask yourself what is the single major cost driver? What does the seller blame every time there is a price increase? For example, if you are buying paper-based packaging you will look at pulp, or an intermediate board or paper product. For plastic packaging (bottles, closures, films, injected-molded parts, etc.), your pricing will be heavily influenced by plastic resins (Polyethylene, Polypropylene, Polystyrene, etc). For chemical ingredients there will usually be one key feedstock that is the lightning rod for all price movement. Sometimes it's a basic building block like ethylene, or a key solvent like benzene or ethanol. In all cases you should also evaluate whether this spend is particularly energy, labor, capital or transportation intensive? This is all basic information you should know for your strategic sourcing work. .

3. What sources can I use?
Once you understand cost drivers you must identify published price or index sources. Your investigation might include talking to your suppliers and their feedstock suppliers, checking industry trade publications and blogs, networking with colleagues, benchmarking with similar users, or using a consultant. The electronic age puts all of these resources at your fingertips!

4. How do I build the right formula?
Building the formula is usually an iterative process involving give and take between the buyer and seller. You are both seeking a fair proportion of acceptable risk. Whenever possible, consult with multiple suppliers. A Request for Information is an excellent vehicle to poll a large group of suppliers on their proposed price index(es).

5. What are the watch-outs to consider?
It is always wise to consider the pitfalls to avoid

- *Assuming the indexed feedstock is 100% of the price.* Corrugated linerboard is about 65% of a container price yet price indexes often reflect a 100% price pass-through. In a down market, this works in the buyer's favor. However, since markets typically increase this allows the supplier to increase their margin. The best way to craft an index is to closely approximate the feedstock component and use this percentage in the formula.

- *Adjusting prices too infrequently.* With a large feedstock price component, neither the buyer nor supplier can afford to be out of synch with the market. In volatile markets, consider adjusting prices at least quarterly and perhaps monthly. Neither side should make money on an adjustment; it merely maintains the status quo.

- *Re-evaluating a formula too infrequently.* Things change. For example, technology reduces labor costs or innovation reduces feedstock utilization. Therefore, each time a contract is renewed, the formula should be re-evaluated.

- *Trusting that suppliers will automatically adjust pricing consistent with the agreed upon index.* Trust but verify. You must have mechanisms to ensure the agreed upon index is implemented on time.

- *Assuming that price indexes will keep you competitive very long term (+3 years).* Indexes should maintain margins. However, a competitive margin in a seller's market may be significantly lower in a buyer's market like today's. You cant rely on price indexes to keep you competitive over the long term. Whenever possible, use competition to validate market pricing and re-establish indexes.

TAKING ACTION

If you struggled with the above assessment, if you're uncomfortable crafting an index, if you are daunted by the weight of one more task, or if your resources are already stretched to the limit then third-party experts can play either highly targeted or broader roles in helping organizations make the most from pricing indices. Sometimes, just basic education, coaching and technology enablement -- even in Excel on the most basic levels -- is required. Other times, the challenges require significantly greater involvement. But regardless, there's no reason to let a lack of internal expertise delay deploying pricing indices regardless of current knowledge and skill levels.

Please join me in thanking Rob Patton for his contribution to Spend Matters.

- Jason Busch

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