

## Price Indexes – Why?

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Now that we are faced with the biggest economic upheaval in over 30 years it seems appropriate to carefully reevaluate the use of Price Indexing. The alternative is to leave all pricing initiatives to your sellers. While this may be reasonable for small value and noncritical spend it is extremely risky for anything strategic.

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 reexamined 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. Buyers in all sectors of the economy faced unprecedented increases in crude oil pricing as well as totally unexpected and large-scale supply shortages. The situation was further complicated by government price controls, severe cash flow and credit concerns and other market distortions. This "perfect storm" scenario sent 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.

## **SETTING PRIORITIES**

At a time when sourcing professionals are 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 to 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

Next month we will detail the recommended steps in a needs assessment to help you determine the best opportunities for establishing or reevaluating your price indexes.

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