

Contract Pricing Mechanisms for Volatile Markets



Report overview

An essential insights brief provides a short overview of a topic, including insights based on best practices, benchmarks, study data and case studies.

SUMMARY

- Designing commercial price mechanisms enables procurement to better manage market volatility, demand uncertainty and supplier risk while strengthening cost transparency and financial control. Traditionally, most contracts have been designed for cost stability, which can erode cost savings in volatile markets. Leading organizations address this by shifting from static price models to adaptive, risk-calibrated pricing mechanisms that protect margins, enhance contract resilience and sustain supplier resilience amid changing market conditions.
- This report guides procurement leaders on designing and operationalizing commercial price mechanisms to improve resilience, transparency and value realization. It provides an introduction to the topic, an overview of common pricing mechanisms, a review of the role of “should cost” modeling, guidance on the selection of optimal pricing mechanisms and information on best practices, benefits and stakeholder alignment.

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Executive summary

Executive summary

<p>Fixed price certainty no longer works in volatile markets</p>	<ul style="list-style-type: none">▪ Traditional fixed price contracts fail under sustained inflation, commodity swings or geopolitical disruption, leading to renegotiations and disputes.▪ Volatility, which has become a permanent feature of recent years, requires models that flex with market realities.▪ Overreliance on static pricing embeds risk premiums, erodes cost savings and weakens supplier resilience.
<p>Pricing mechanisms should be selected based on volatility exposure</p>	<ul style="list-style-type: none">▪ Leading organizations choose pricing models based on which cost drivers are volatile and uncontrollable (e.g., commodities, labor, energy, FX).▪ Indexed, hybrid and capped variable models are increasingly preferred to absorb volatility rather than react to it.▪ One size fits all pricing approaches are ineffective across diverse categories and supply markets.
<p>Risk sharing is replacing risk transfer as a dominant commercial principle</p>	<ul style="list-style-type: none">▪ Gainshare, painshare and outcome-based models reduce embedded supplier risk premiums and encourage collaboration.▪ Balanced risk allocation improves supplier viability, long-term performance and innovation.▪ Pricing models that distinguish controllable versus uncontrollable cost drivers deliver fairer outcomes for both parties.
<p>“Should cost” models are foundational to effective pricing design</p>	<ul style="list-style-type: none">▪ Clean sheet cost visibility enables fact-based selection of fixed, indexed, variable or hybrid pricing mechanisms.▪ Understanding cost components (e.g., materials, labor, overhead, margin) reduces information asymmetry in negotiations▪ “Should cost” models support transparency, challenge unjustified increases and mitigate the risk of overpayment.
<p>Governance must be designed into pricing models, not retrofitted later</p>	<ul style="list-style-type: none">▪ Effective contracts define caps, floors, indices, triggers, review cadence and escalation authority upfront.▪ Scenario modeling before contract signature confirms margin protection, budget exposure and supplier viability.▪ Ongoing monitoring, audits and recalibration prevent value leakage across the contract lifecycle.

Introduction to how pricing mechanism selection is changing in volatile markets

How pricing mechanism selection is changing in volatile markets







CURRENT ENVIRONMENT

- **Fixed-price certainty is breaking down:** Traditional fixed-price contracts are insufficient to manage sustained inflation, commodity swings and geopolitical disruption. Failure leads to more renegotiations, increasing disputes and supplier margin distress.
- **Pricing decisions now start with volatility exposure:** Procurement teams are selecting pricing mechanisms based on which cost drivers are volatile and uncontrollable (e.g., commodities, labor, energy and currency), not on historical contracting norms.
- **Indexed and hybrid pricing models are becoming mainstream:** Index-linked, fixed-price with indexation and capped variable models are increasingly preferred because they absorb market movements rather than react to them.
- **Risk-sharing is replacing risk-transfer:** Gainshare and outcome-based pricing are expanding. These models enable suppliers to influence efficiency, reducing embedded risk premiums.
- **Governance is inseparable from pricing design:** Caps, floors, benchmarks, triggers and review cadences are now defined upfront instead of being negotiated reactively.

HOW PROCUREMENT SHOULD RESPOND

- **Reposition pricing as a strategic risk lever:** Treat pricing mechanisms as tools for managing volatility related-risk, not just commercial terms.
- **Understand cost components:** Use “should cost” modeling to understand cost components, including which are linked to volatility (i.e., potential cost drivers).
- **Select a suitable pricing model based on volatility and controllability:** Use indexed pricing for external drivers, performance-linked models for supplier-controlled outcomes, and hybrid models where both apply.
- **Standardize pricing governance guardrails:** Establish approved indices, adjustment logic, thresholds and escalation authority across categories and contracts.
- **Test pricing resilience before contract signature:** Require scenario modeling to validate margin protection, supplier viability and budget exposure under multiple market outcomes.
- **Embed pricing logic into contract execution:** Proactively monitor, audit and recalibrate pricing mechanisms throughout the contract lifecycle before issues arise.

Key challenges in designing commercial pricing mechanisms

Challenge	Description	Mitigation strategy
 <p>Inadequate alignment with the category strategy</p>	<p>Pricing structures developed in isolation from category and sourcing strategies can result in commercially attractive contracts that fail to deliver long-term business or cost transformation objectives.</p>	<p>Integrate pricing design with category planning, ensuring commercial mechanisms reinforce sourcing objectives, cost levers and long-term value creation priorities.</p>
 <p>Over-standardization of pricing models across diverse contracts</p>	<p>Applying uniform pricing mechanisms across diverse spend categories can ignore supply market realities and reduce the effectiveness of negotiated commercial outcomes.</p>	<p>Customize pricing frameworks for spend categories and supply markets to reflect demand volatility, supplier maturity and cost drivers relevant to each contract type.</p>
 <p>Underestimating market and cost volatility exposure</p>	<p>Failure to embed appropriate adjustment mechanisms (e.g., indexation) can expose the organization to inflationary pressures, commodity swings and currency risks that erode contract value over time.</p>	<p>Embed indexed adjustments and price protection clauses to balance risk between parties and preserve commercial competitiveness throughout the contract lifecycle.</p>
 <p>Insufficient linkage between price and performance</p>	<p>Decoupling pricing from service or outcome delivery can weaken accountability and limit the buyer's ability to drive continuous improvement from suppliers.</p>	<p>Link pricing to performance metrics and outcomes to reinforce accountability, service excellence and supplier-driven value enhancement.</p>
 <p>Limited transparency to cost elements and purchase price components</p>	<p>Lack of visibility into cost elements limits the ability to negotiate optimal pricing or select the most appropriate price adjustment mechanisms to include in the contract.</p>	<p>Encourage “should cost” modeling and open-book principles to enable fact-based negotiations and the use of optimized price adjustment mechanisms.</p>
 <p>Poorly designed pricing governance guardrails</p>	<p>Poorly defined price change triggers and approval processes increase the risk of savings leakage, disputes and suboptimal commercial decisions.</p>	<p>Establish approved indices, adjustment logic, thresholds and escalation authority across all spend categories and contracts. Ensure proactive contract review cycles to manage ongoing contract value.</p>

Overview of common pricing mechanisms

Overview of common pricing mechanisms

A variety of pricing mechanisms can be used in contracts. They are often aligned with industry or supply market norms. The expected contract value can be lost if pricing mechanisms fail to address market volatility, cost transparency or potential risks. Indexed, gain/pain-share, outcome-based and hybrid pricing models can be used to absorb volatility, align incentives and actively balance buyer and supplier risk.

Pricing model	Description	Strengths	Weaknesses	Best-fit scenario
Cost-plus fixed fee (CPFF)	Reimburses allowable costs in addition to a fixed supplier fee. The structure reduces supplier risk but provides limited motivation for cost optimization.	<ul style="list-style-type: none"> Ensures transparency Reduces supplier risk where there is uncertainty 	<ul style="list-style-type: none"> Provides weak incentives for the supplier to be cost-efficient Buyer absorbs volatility 	Purchases with high uncertainty where suppliers are not eager to bid
Cost-plus incentive fee (CPIF)	Reimburses costs with a variable fee linked to performance or savings achieved. It aligns supplier incentives with efficiency, quality and delivery objectives.	<ul style="list-style-type: none"> Aligns incentives Promotes cost discipline Improves value-for-money 	<ul style="list-style-type: none"> Complex to structure Requires strong governance 	Complex purchases and deals with high levels of innovation
Dynamic or market-based pricing	Allows prices to fluctuate in real time based on prevailing market conditions. It enhances market responsiveness but increases exposure to price volatility.	<ul style="list-style-type: none"> Access to lower pricing for off-peak periods (e.g., energy, travel) Buyer benefits from price drops in the short-term 	<ul style="list-style-type: none"> Makes budgeting unpredictable Increased cost when prices rise (e.g., surge pricing, market volatility) 	Spot buys or short-term sourcing. Supply markets with perishable inventory or high price transparency (e.g., commodities, energy, travel)
Firm fixed price (FFP)	Locks a single price for a clearly defined scope regardless of actual cost incurred. This model provides strong budget certainty but transfers cost and delivery risk to the supplier.	<ul style="list-style-type: none"> Provides cost certainty Simplifies budgeting Minimizes administration 	<ul style="list-style-type: none"> Higher purchase cost (i.e., embedded contingency cost) Lack of transparency to supplier costs Inflexible if things change 	Purchase of stable, low-risk, well-specified goods or services.

Overview of common pricing mechanisms (cont.)

Pricing model	Description	Strengths	Weaknesses	Best-fit scenario
Fixed price with indexation or escalation	Establishes a base price with periodic adjustments linked to agreed external indices. It protects both parties from inflationary pressures while preserving overall price discipline.	<ul style="list-style-type: none"> Ensures supplier stability Provides fair risk distribution Reduces renegotiations Establishes a transparent formula for pricing changes 	<ul style="list-style-type: none"> Makes budgeting unpredictable Relies on index quality and pricing formula Increases administration 	Contracting for long-term supply for spend categories affected by inflation or volatility.
Guaranteed maximum price (GMP) or price cap	Sets a maximum ceiling price with flexibility below the cap. It protects the buyer from cost overruns while.	<ul style="list-style-type: none"> Provides budgeting certainty Protects against cost overruns Encourages collaboration 	<ul style="list-style-type: none"> Works best with scope clarity Higher level of scope disputes Complex change control 	Project-based purchases (e.g., construction, engineering, EPC contractor, IT).
Indexed or commodity-linked	Adjusts prices directly in line with market or commodity indices. It ensures realistic prices in volatile markets but reduces short-term price certainty.	<ul style="list-style-type: none"> Increased price transparency (i.e., linked to public index) Fair risk mitigation for volatility Lowers need to renegotiate 	<ul style="list-style-type: none"> Exposes buyer to price swings Increases the administration level of the contract Budget uncertainty 	Purchase of commodities, energy, logistics or raw materials.
Pass-through or reimbursable	Reimburses actual third-party or statutory costs at source without markup. This approach improves transparency and limits supplier margin on pass-through items.	<ul style="list-style-type: none"> Enhances cost transparency Avoids margin stacking Allows flexibility in scope without renegotiation 	<ul style="list-style-type: none"> Shifts volatility risk to buyer Requires audit rigor of pass-through costs Doesn't promote cost efficiency 	Purchases with high levels of cost uncertainty and complex scope (e.g., construction, professional services).
Performance or outcome-based	Links payments to the achievement of defined outcomes rather than inputs or effort. It shifts commercial focus toward results, accountability and business impact.	<ul style="list-style-type: none"> Shifts focus to value delivery Easier to justify spending Encourages supplier innovation 	<ul style="list-style-type: none"> Difficult to define and measure outcomes Higher cost than a fixed fee if the supplier meets performance 	Purchases where value is clearly measurable (e.g., industrial equipment, logistics).
Subscription or recurring fee	Charges a fixed recurring fee for defined access or services over a set period. This model improves spend predictability and supports ongoing supplier relationships.	<ul style="list-style-type: none"> Ensures budget predictability Lower upfront cost Ability to scale services up or down based on current needs 	<ul style="list-style-type: none"> Requires active management (i.e., to avoid auto-renew) Higher long-term cost 	Procure SaaS, platforms or standardized services.

Source: The Hackett Group®

Overview of common pricing mechanisms (cont.)

Pricing model	Description	Strengths	Weaknesses	Best-fit scenario
Target cost with gain/pain share	Sets an agreed target cost with savings or overruns shared between buyer and supplier. This model promotes collaboration and disciplined cost management.	<ul style="list-style-type: none"> Embeds risk-sharing Incentivizes collaboration Encourages supplier cost efficiency 	<ul style="list-style-type: none"> High administrative burden Difficult to set realistic targets Requires trust for open-book Disputes over allowable costs 	High-risk, complex projects with initial scope uncertainty (e.g., construction, infrastructure, engineering).
Time and materials (T&M)	Pays for actual labor hours and materials consumed at pre-agreed rates. This approach offers flexibility for evolving scope but limits upfront cost predictability.	<ul style="list-style-type: none"> High flexibility for scope changes Maximizes transparency Enables rapid mobilization 	<ul style="list-style-type: none"> Makes budgeting unpredictable Weak supplier cost discipline Higher administration costs 	Purchases of services with an ill-defined scope (e.g., construction, consulting, maintenance and repair).
Two-part tariff (fixed + variable)	Combines a fixed access or capacity charge with variable usage-based pricing. This structure balances cost recovery with demand-driven flexibility.	<ul style="list-style-type: none"> Lower per unit price than fixed pricing High-volume usage yields lower overall pricing 	<ul style="list-style-type: none"> Complex billing Higher cost with low usage 	Services with a cost to connect and measurable usage (e.g., utilities, telecom, platforms, shared infrastructure).
Unit price or rate card	Defines the cost of a single unit of a good, service or project (e.g., as cost per hour, per foot, per item). It provides transparency and supports fair comparisons.	<ul style="list-style-type: none"> Enables volume scalability Simplifies benchmarking Encourages competitive bidding 	<ul style="list-style-type: none"> Makes budgeting unpredictable Exposed to inflation risk Ignores fixed-cost absorption 	Transactional, high-volume, repeatable services or outputs (e.g., media, logistics, professional services).
Value-based pricing	Offerings are priced based on the value they deliver to the business rather than the underlying costs. It requires clear value metrics and robust governance.	<ul style="list-style-type: none"> Maximizes ROI alignment Higher quality and customization Better customer service 	<ul style="list-style-type: none"> Lack of price transparency Difficult to benchmark Potential to overpay 	Highly differentiated offerings with strong brand equity (e.g., niche, high-impact advisory, IP-led services).
Volume tiered or rebates	Reduces unit prices or applies rebates as purchase volumes increase. It encourages demand aggregation and longer-term volume commitments.	<ul style="list-style-type: none"> Reduces total cost Discrete cash flow that becomes a verified savings 	<ul style="list-style-type: none"> Delayed savings Encourages overbuying to meet rebate thresholds High administrative burden 	Purchase from B2B supply markets (e.g., MRO, chemicals, raw materials, commodities)

Source: The Hackett Group®

The role of “should cost” modeling

“Should cost” modeling overview

Description

A "should cost" model is a tool that calculates the theoretical fair price of a product or service by building it from the ground up, including raw materials, labor, overhead and profit margins. It is also referred to as clean-sheet costing, a should-be model or a cost breakdown analysis.

Relevance to contract pricing mechanisms

“Should cost” models are critical for selecting and negotiating contract pricing mechanisms by providing a granular, bottom-up analysis of cost drivers. They enable buyers to choose the most appropriate pricing model (e.g., fixed-price, index-linked, variable) to ensure fair negotiations and mitigate risks of overpaying.

Approaches to develop “should cost” models

Common approaches to developing “should cost” models include building them internally with commodity and market data, working with third-party market intelligence providers to source typical cost models, or gathering cost breakdowns directly from suppliers (i.e., as part of quotes requested during a sourcing event).

Other considerations

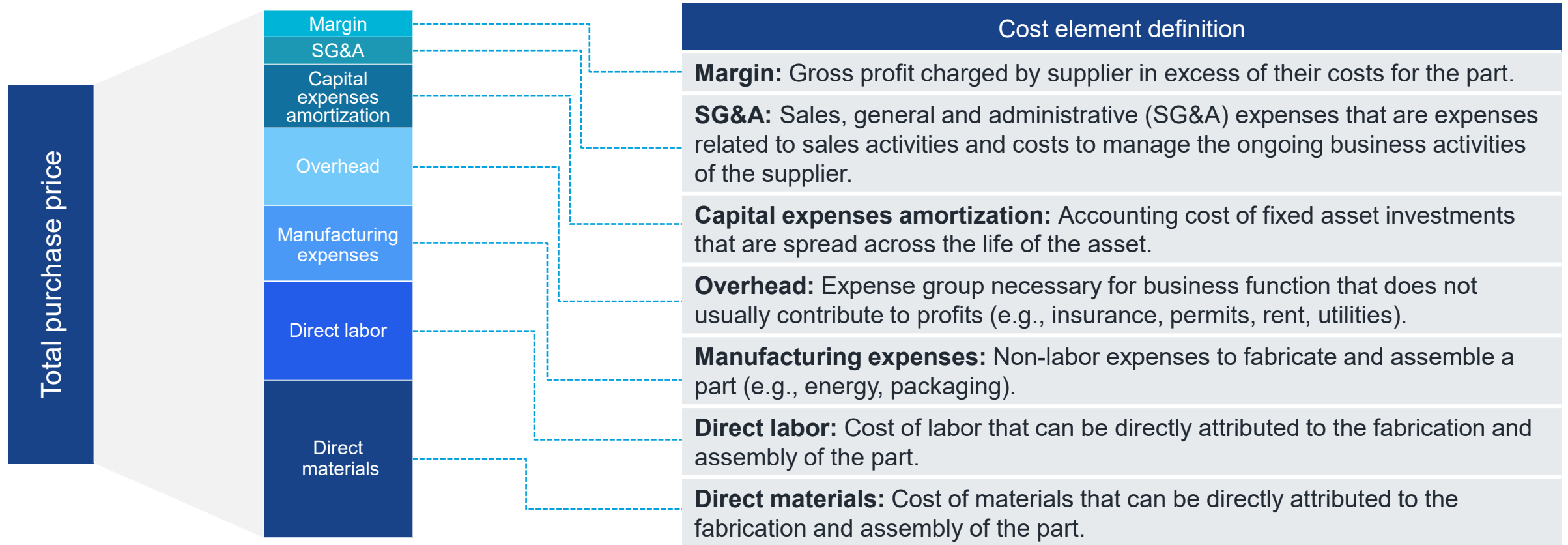
Suppliers are operating in the same volatile market conditions experienced by your organization. Ensure that supplier concerns regarding cost inflation are thoughtfully considered, look for opportunities to help each supplier reduce its cost to serve your organization, and select pricing mechanisms that will not cause financial distress to either party.

“Should cost” models provide insights into which cost elements contribute most to the purchase price

Use “should cost” modeling to identify the key cost components driving the supplier’s purchase price. When volatility is linked to cost drivers (e.g., commodities, labor, energy, currency), contract mechanisms to reduce pricing risk should be considered.

EXAMPLE

SUPPLIER COSTS ALLOCATED TO THE UNIT

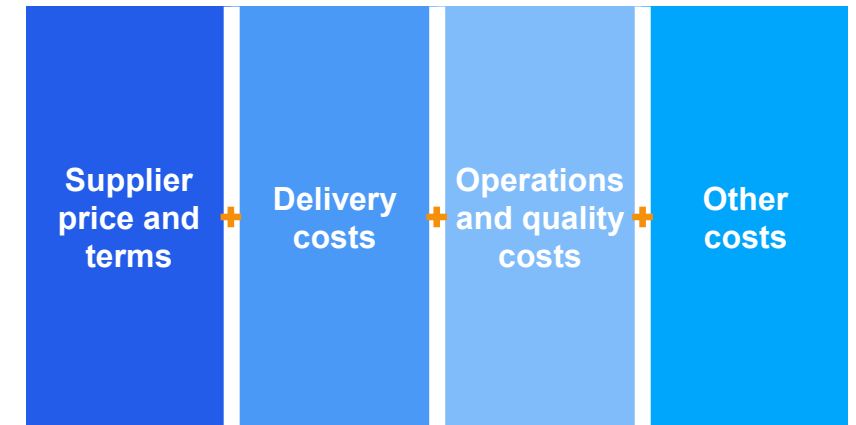


“Should cost” models are an element of total cost of ownership (TCO) models, which are used to optimize costs over the lifecycle of the product or service

Major cost groups within total cost of ownership

- Supplier price and terms
 - Unit price charged by a supplier to create a material or service that is ready for delivery
 - Includes the transaction terms for payment
- Delivery costs
 - Refer to the costs to deliver a completed material or service to its internal point of use
 - Sometimes included in the price, so freight on board (FOB) terms need to be understood
- Operations and quality costs
 - Operational cost and supporting infrastructure implications associated with purchasing a product or service from a supplier
 - Quality cost implications of purchasing a product or service from a supplier (e.g., scrap rates, stockouts due to quality issues)
- Other costs
 - Miscellaneous standard and situational costs associated with purchasing a material or service from a supplier

Total cost of ownership



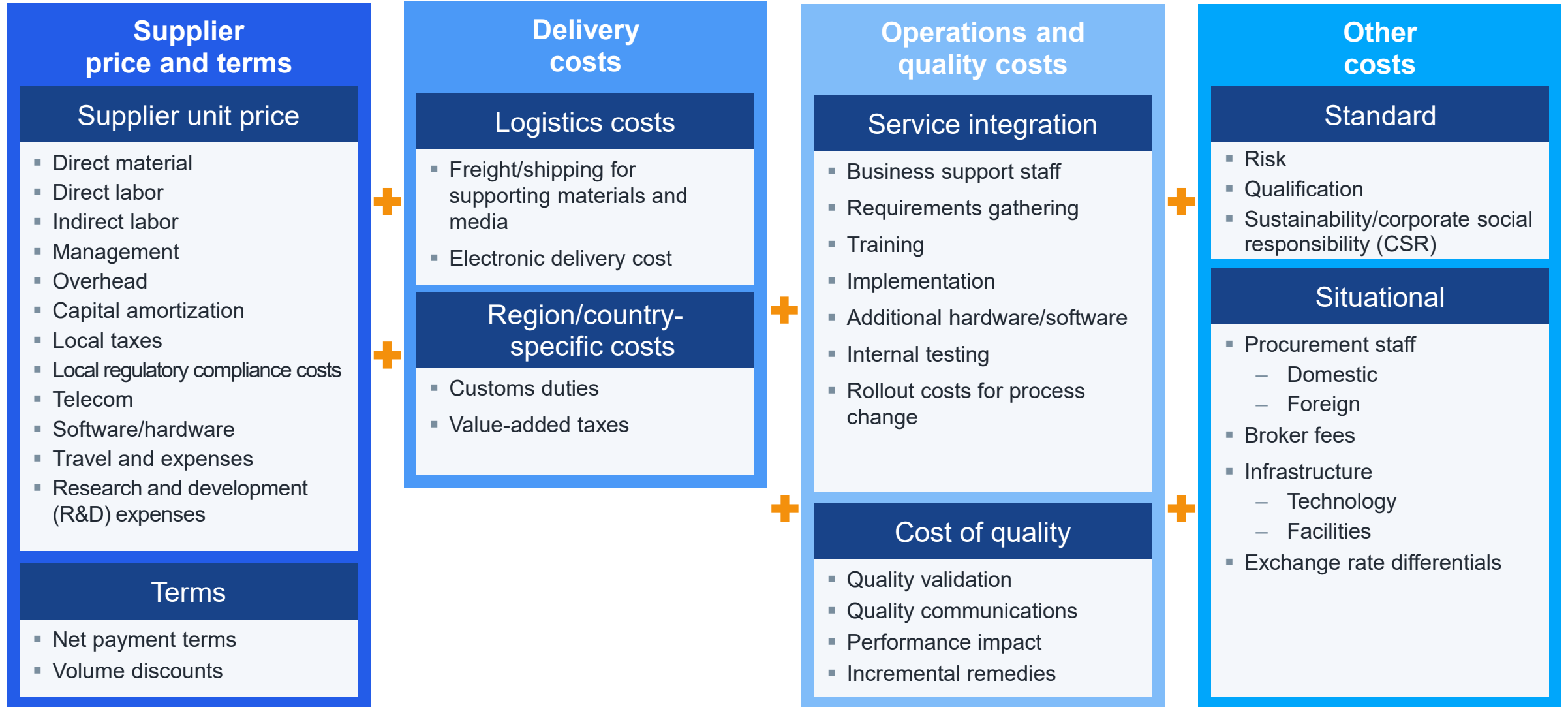
“Should cost” models typically cover these elements of TCO

Note: Delivery costs are included in “should cost” models only when the supplier includes the cost element in the purchase price.

Products/materials total cost of ownership model elements



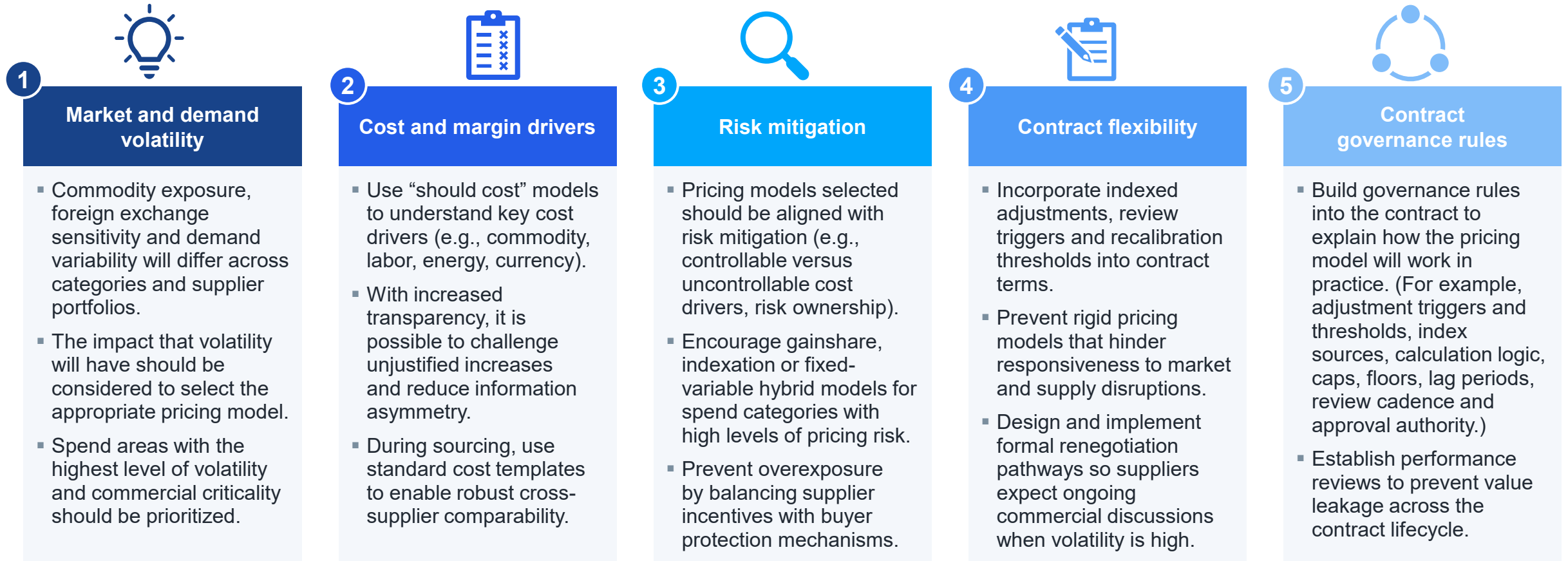
Services total cost of ownership model elements



Selecting the optimal pricing mechanism

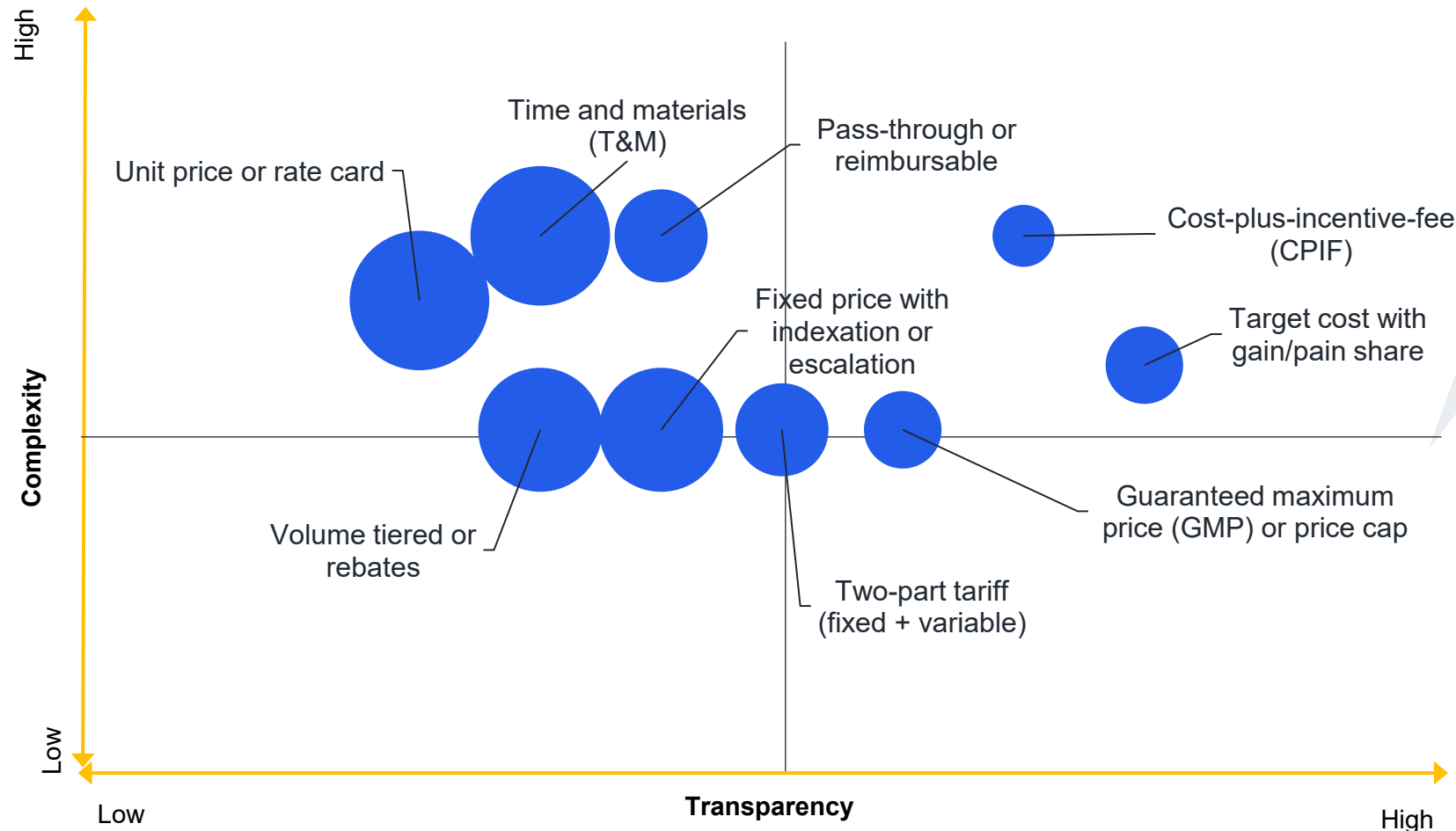
Pricing model design considerations for supplier contracts

PRICING MODEL DESIGN CONSIDERATIONS



Future-ready pricing mechanisms for resilient commercial contracting

CONTRACT PRICING MECHANISMS – TRANSPARENCY VERSUS COMPLEXITY



Designing effective commercial price mechanisms in volatile markets means shifting from inflexible models with price certainty to more flexible mechanisms that absorb market shifts and preserve cost transparency.

Future-ready pricing models embed indexation, risk-sharing and adaptive mechanisms to remain resilient under fluctuating costs, demand uncertainty or evolving supply risk.

- **Complexity:** Effort to design, negotiate and manage
- **Transparency:** Buyer visibility into cost/price drivers
- **Adoption:** Degree of use across industries

○ **Bubble size** indicates the level of market adoption of each pricing model.

Note: Firm-fixed-price, cost-plus-fixed-fee, subscription, value-based, performance-based and dynamic pricing models are commonly used; however, their inherent limitations in managing volatility, ensuring transparency or enabling contractual flexibility reduce their suitability for volatile markets. These models are not as effective where adaptability to fluctuating costs, demand uncertainty and supply risk is the primary design objective.

Selecting the optimal pricing mechanism

When selecting the best pricing mechanism to use in a contract, consideration should be given to risk and governance factors, the supply market environment and the feasibility of implementing the selected pricing model.

Pricing model	Risk and governance considerations	Common application	How the mechanism works	Calculation example
Cost-plus-fixed-fee (CPFF)	Supports scenarios with unclear scope by ensuring supplier cost recovery through capped profit margins, but needs strong open-book governance and audit rights to maintain transparency and prevent the pass-through of supplier cost inefficiencies.	Common in regulated or high-uncertainty markets	Buyer reimburses actual allowable costs plus a pre-agreed fixed fee, irrespective of cost variance.	Total price = actual cost + fixed fee
Cost-plus-incentive-fee (CPIF)	Aligns supplier incentives with efficiency, quality and delivery objectives to improve value for money. It is adaptable in volatile environments but requires robust KPI design to avoid disputes and ensure incentives reflect controllable supplier outcomes.	Incentives tailored to regional performance drivers	Fee varies based on cost or performance against target benchmarks, incentivizing efficiency.	Total price = actual cost + base fee ± incentive [incentive = (target cost – actual cost) × share %]
Dynamic or market-based pricing	Aligns closely with current market conditions to improve responsiveness and fairness. However, it increases governance complexity and leaves the buyer open to shifts in market pricing.	Prices reset based on real-time market signals	Price fluctuates based on market indices, benchmarks or real-time supply–demand conditions.	Price = market index (t) × adjustment factor
Firm-fixed-price (FFP)	Locks in price certainty and simplifies governance, but there is the potential to overpay where “should cost” modeling is weak and/or there is a lack of transparency to supplier costs. This approach is inflexible and unable to react to changing market conditions.	Used in stable markets; limited applicability in hyperinflationary or foreign currency–volatile regions	A single, non-adjustable price for goods or services; the supplier bears cost and performance risk.	Total price = agreed fixed price x units bought

Source: The Hackett Group®

Selecting the optimal pricing mechanism (cont.)

Pricing model	Risk and governance considerations	Common application	How the mechanism works	Calculation example
Fixed price with indexation or escalation	Balances budget predictability with market reality by embedding transparent adjustment formulas to reduce contract renegotiations in volatile markets. Relies on applicable index and strong understanding of cost structures (i.e., to index the relevant cost drivers).	Ability to link cost drivers to publicly available index (e.g., CPI, wage indices, regional foreign currency benchmarks, commodity)	Base price is adjusted periodically using an external index to manage inflation or cost volatility.	Adjusted price = base price × adjustment ratio [Adjustment ratio = (current index/future index)]
Guaranteed maximum price (GMP) or price cap	Balances risk by limiting downside exposure while allowing upside flexibility. This is particularly effective in volatile markets but requires the ability to set the cap at the right level and a full understanding of cost drivers.	Project-based purchasing with caps adjusted for local cost inflation assumptions	Buyer pays actual costs up to a capped maximum price; overruns borne by supplier (or shared).	Total price = minimum of [(actual cost + fee) or the GMP]
Indexed or commodity-linked	Aligns pricing with commodity movements, reducing speculative premiums and disputes while increasing transparency and responsiveness in markets exposed to raw material volatility or supply-demand imbalances.	Commodity purchases with links to relevant commodity indices	Price tied directly to commodity indices (e.g., steel, oil, copper) with defined weightings.	Adjusted price = base price × adjustment ratio [Adjustment ratio = (current index/future index)]
Pass-through or reimbursable	Isolates uncontrollable cost elements to improve transparency and reduce supplier risk premiums. Requires clear definitions of allowable expenses and audit mechanisms to prevent uncontrolled costs.	Commonly used for taxes, duties, logistics or statutory labor costs	Specific cost components reimbursed at actuals, often with or without markup.	Total price = fixed fee + total reimbursable costs
Performance or outcome-based pricing	Shifts commercial focus toward results, accountability and business impact. Requires robust measurement frameworks and enforceable service levels to ensure appropriate pricing.	Purchases where value delivery is clearly measurable	Payment linked to achievement of measurable outcomes or KPIs rather than inputs.	Payment = base fee + (outcome achievement % × incentive pool)
Subscription or recurring fee	Simplifies contracting for repeat services and improves spend predictability. Requires careful monitoring to switch off services no longer used and avoid autorenewal, which can lead to overpayment.	Subscription services (e.g., telecom, data feeds, SaaS)	Fixed periodic charge for ongoing access or service, typically independent of usage.	Total annual price = monthly fee × 12

Source: The Hackett Group®

Selecting the optimal pricing mechanism (cont.)

Pricing model	Risk and governance considerations	Common application	How the mechanism works	Calculation example
Subscription or recurring fee	Simplifies contracting for repeat services and improves spend predictability. Requires careful monitoring to switch off services no longer used and avoid autorenewal, which can lead to overpayment.	Subscription services (e.g., telecom, data feeds, SaaS)	Fixed periodic charge for ongoing access or service, typically independent of usage.	Total annual price = monthly fee × 12
Target cost with gain/pain share	Shares cost overruns and savings to foster collaboration and transparency. Particularly effective for long-duration global contracts exposed to demand variability and uncertain input cost trajectories.	Complex, high-risk projects with initial scope uncertainty	Buyer and supplier share savings or overruns relative to an agreed target cost.	Final price = actual cost ± [(target price – actual cost) × share %]
Time and materials (T&M)	Pays for actual labor hours and materials consumed at pre-agreed rates to provide flexibility when the scope is not well-defined. Requires rigorous rate governance, productivity controls and audit mechanisms to mitigate cost leakage.	Purchases of services with an ill-defined scope	Buyer pays for actual labor hours and materials consumed at agreed rates.	Total price = Σ (hours × rate) + materials cost
Two-part tariff (fixed + variable)	Balances cost recovery (for the supplier) with demand-driven flexibility. Typically, usage needs to be high to make this approach cost-effective. Billing can be complex and difficult to audit.	Services with a fixed-access fee plus variable usage charges	Fixed access or readiness fee plus variable usage-based charges.	Total price = fixed fee + (variable unit rate × volume)
Unit price or rate card	Standardizes unit prices or rates with enough flexibility to accommodate regional differences in the rate card. Improves comparability and encourages competitive supplier bidding but requires accurate rate benchmarking to avoid overpayment.	Transactional, high-volume, repeatable services or outputs	Pre-defined unit rates applied to actual quantities delivered.	Total price = Σ (unit rate × units delivered)

Selecting the optimal pricing mechanism (cont.)

Pricing model	Risk and governance considerations	Common application	How the mechanism works	Calculation example
Value-based pricing	Supports pricing based on defined business impact instead of cost. Supports strategic supplier relationships but requires strong stakeholder alignment and clearly defined value metrics. Overpayment is a risk due to the lack of cost transparency.	Highly differentiated offerings with strong brand equity	Price linked to quantified value delivered to the buyer (e.g., cost savings, revenue uplift, time savings).	Price = hours of time saved (e.g., 10 hrs.) × business value assigned to time saved (e.g., \$20/hr) [Price = 10 x \$20 = \$200]
Volume-tiered or rebates	Incentivizes consolidation of spend to increase purchase volumes in exchange for a rebate. Effectiveness depends on realistic volume commitments to prevent overbuying in an effort to hit the next volume tier. Rebates are typically paid quarterly or annually, so there is a delay in the savings. However, the discrete cash flow is readily accepted by finance as realized savings.	Purchase from B2B supply markets; thresholds commonly adjusted to regional demand patterns	Unit price or rebate varies based on volume thresholds achieved.	Net price = gross price – rebate Rebate = (volume × tier rebate %)

Common issues when designing commercial pricing mechanisms

Ensure common issues are effectively addressed when designing commercial pricing mechanisms for supply contracts.

Issue	Description	Resolution
Overlooking the importance of business value drivers	Pricing structures often emphasize short-term cost reductions without reflecting broader business outcomes, such as service continuity, innovation enablement or speed to market, thereby diluting the ability to create value, especially for strategic purchases.	Where appropriate, align pricing mechanisms with value drivers to explicitly link commercial terms to outcomes such as service resilience, time-to-value and strategic differentiation.
Overreliance on static price models	Fixed and inflexible pricing models fail to respond to dynamic market conditions, supplier cost fluctuations or evolving demand patterns, resulting in value leakage and reduced commercial competitiveness.	Design adaptive pricing structures, incorporating indexed adjustments, reopeners and scenario-based pricing triggers to maintain appropriate pricing across the whole contract lifecycle.
Lack of balanced risk-sharing models	Contracts can concentrate financial risk on one party. When suppliers bear the bulk of the risk, pricing can be less competitive and/or suppliers will be less willing to work collaboratively over the long term.	Develop balanced risk-sharing mechanisms, embedding gainshare, painshare and margin protection clauses to encourage sustainable supplier performance and investment.
Insufficient commercial transparency and auditability	Lack of clarity in price build-ups (i.e., cost components) and adjustments can reduce trust, limit negotiation effectiveness and increase the probability of disputes and savings leakage.	Use transparent pricing structures with traceable cost components, auditable adjustments and standardized commercial documentation.
Lack of ongoing contract governance	When more complex pricing models are used in contracts, the absence of a definition of how the pricing mechanism operates in practice can lead to reduced financial control and execution gaps post-award.	Build governance rules into the contract to explain how the pricing model will work in practice (e.g., adjustment triggers and thresholds, index sources, calculation logic, caps, floors, lag periods, review cadence, approval authority). Establish performance reviews to prevent value leakage across the contract lifecycle.

Best practices, benefits and stakeholder alignment

Best practices for designing contract pricing mechanisms for volatile markets

Effective commercial pricing mechanisms enable procurement to proactively manage volatility and protect margins by embedding risk-calibrated structures, market-linked pricing and data-driven governance.

BEST PRACTICES FOR DESIGNING CONTRACT PRICING MECHANISMS FOR VOLATILE MARKETS

1

Focus on adaptive pricing models

5

Use scenario-based models to test price structures

2

Use “should cost” modeling for cost transparency

6

Use commercial levers to drive performance outcomes

3

Support the use of indexed adjustment clauses

7

Embed price reviews across the contract lifecycle

4

Design calibrated risk-sharing pricing models

8

Develop price intelligence analytics

Best practices for designing contract pricing mechanisms for volatile markets (cont.)

1 Focus on adaptive pricing models

- Establish pricing models that dynamically respond to prevailing market conditions across the contract lifecycle (e.g., commodity indices, foreign exchange movements, demand variability). This will ensure contract prices remain aligned with current conditions.
- Define clear adjustment triggers, reference benchmarks and recalibration thresholds to institutionalize disciplined price movements rather than reactive renegotiations.
- Ensure adaptive pricing models are embedded into sourcing and contracting strategies to protect savings, enhance commercial agility and reduce value leakage in volatile markets.

2 Use “should cost” modeling for cost transparency

- Use a “should cost” model to develop an understanding of cost components that go into supplier pricing (e.g., materials, labor, overheads, margins) to create visibility into underlying price drivers and create information parity with suppliers.
- Define standardized cost templates and validation protocols to improve data integrity and comparability across supplier bids and contract renewals.
- Ensure cost transparency is systematically used to strengthen negotiation leverage, challenge unjustified increases and select the most appropriate pricing mechanism for contracts.

3 Support the use of indexed adjustment clauses

- Integrate escalation and de-escalation clauses linked to credible external benchmarks to ensure price movements are anchored in objective market realities rather than subjective supplier claims.
- Define frequency, caps and floors to prevent excessive volatility while simultaneously preserving contractual fairness and predictability.
- Ensure indexation mechanisms are consistently applied across contracts to enhance auditability and simplify portfolio-level price governance.

4 Design calibrated risk-sharing pricing models

- Design gainshare and painshare mechanisms aligned to controllable and uncontrollable cost drivers to ensure risks are equitably distributed between buyers and suppliers.
- Define clear criteria to distinguish supplier-driven efficiencies from market-driven fluctuations.
- Ensure shared-risk constructs incentivize continuous cost optimization, productivity improvements and proactive supplier collaboration.

Best practices for designing contract pricing mechanisms for volatile markets (cont.)

5 Use scenario-based models to test price structures

- Use multi-scenario price modeling to evaluate how contract pricing models will perform under varying conditions (e.g., falling or increasing price, demand variability, supply shortage).
- Define downside, base-case and upside price scenarios to proactively identify exposure points and sensitivity thresholds.
- Ensure scenario-modeling insights are embedded into contract design to strengthen commercial resilience.
- Establish the capability to support category managers to refresh assumptions and scenarios based on the latest market intelligence and commercial activity.

6 Use commercial levers to drive performance outcomes

- Anchor pricing outcomes to service levels, quality metrics and delivery reliability to ensure commercial incentives reinforce operational performance rather than volume or scale alone.
- Define measurable and auditable performance criteria tied directly to price adjustments or rebates.
- Ensure commercial levers promote supplier accountability while aligning financial outcomes with value creation objectives.

7 Embed price reviews across the contract lifecycle

- Establish structured price review cycles aligned to contract phases, market movements and business criticality to preserve long-term competitiveness.
- Define governance protocols covering review triggers, approval thresholds and structured renegotiation pathways to ensure disciplined and consistent price management.
- Ensure price reviews are proactive and data-driven, rather than event-driven and reactive, to preserve competitiveness across contract lifecycles.

8 Develop price intelligence analytics

- Leverage procurement analytics and market intelligence platforms to continuously benchmark contracted prices against market trends and peer performance.
- Define anomaly detection and early-warning mechanisms to flag deviations and emerging value leakage risks.
- Ensure digital insights are systematically integrated into negotiation strategies and commercial decision-making processes.

Benefits of selecting optimal pricing mechanisms

Strengthens negotiation effectiveness and financial control by enabling disciplined cost management, balanced risk allocation and improved long-term value predictability.

1

Enhances cost predictability by structuring pricing models to stabilize budgets, improve financial forecasting accuracy and reduce unplanned commercial exposure across multiyear contracts.

2

Strengthens value realization by defining service levels contractually, performance metrics and volume commitments.

3

Optimizes total cost of ownership through negotiated pricing levers (e.g., volume discounts, bundling, lifecycle pricing) to reduce long-term spend levels.

4

Improves risk allocation by using escalation clauses, indexation formulas and price caps to balance inflation, commodity volatility and currency exposure.

5

Increases negotiation leverage by standardizing pricing models and benchmarking triggers to empower procurement to challenge supplier assumptions and secure more competitive contracts.



Benefits of selecting optimal pricing mechanisms (cont.)

Elevates procurement's strategic impact by driving supplier accountability, commercial agility and sustainable enterprisewide savings through structured, performance-linked pricing mechanisms.

6

Drives supplier performance accountability by embedding outcome-based pricing and gainshare models to incentivize continuous improvement, innovation and operational excellence.



7

Increases supply market responsiveness by incorporating pricing and demand-based adjustments to respond more effectively to market shifts and evolving business needs.



8

Supports supplier collaboration through transparent pricing logic and open-book mechanisms that foster trust and encourage joint cost-reduction initiatives.



9

Improves contract effectiveness by clearly defining pricing formulas and audit protocols to reduce disputes, simplify contract reviews and strengthen commercial oversight.



10

Enhances savings delivery by operationalizing tiered rates, rebates and continuous-improvement incentives that support the delivery of measurable financial benefits.



Alignment of stakeholders

Selecting optimal pricing mechanisms requires cross-functional alignment to balance budget predictability, risk allocation and value creation while enhancing transparency, financial control and supplier collaboration.

Stakeholder	Common challenges	Resolutions
Procurement teams	<ul style="list-style-type: none"> ▪ Difficulty selecting the most appropriate price mechanism across varied contract types and spend categories. ▪ Limited visibility to market benchmarks and cost drivers to make informed pricing decisions. 	<ul style="list-style-type: none"> ▪ Define clear guidelines on optimal price models for buying environments. ▪ Use market intelligence and “should cost” models to select the optimal pricing strategy.
Category managers	<ul style="list-style-type: none"> ▪ Misalignment between category strategy and applied pricing structures. ▪ Inability to balance cost predictability with flexibility. 	<ul style="list-style-type: none"> ▪ Align price mechanisms with category objectives and supply market dynamics. ▪ Adopt hybrid models (e.g., fixed + indexed) where appropriate..
Business and functional teams	<ul style="list-style-type: none"> ▪ Limited visibility into the financial impact of variable or indexed pricing models. ▪ Preference for simplicity over commercially optimal pricing structures. 	<ul style="list-style-type: none"> ▪ Establish financial scenario modeling during contract design. ▪ Educate stakeholders on trade-offs between simplicity, risk and value.
Legal and contracting teams	<ul style="list-style-type: none"> ▪ Inexperience in drafting pricing clauses and adjustment triggers. ▪ Inconsistent interpretation of pricing terms across contracts. 	<ul style="list-style-type: none"> ▪ Standardize pricing clauses and define clear adjustment and escalation provisions. ▪ Create contract playbooks with approved pricing language and models.
Operations teams	<ul style="list-style-type: none"> ▪ Inability to influence service delivery variability with rigid pricing models. ▪ Limited linkage between performance and commercial outcomes. 	<ul style="list-style-type: none"> ▪ Ensure pricing reflects operational realities and demand variability. ▪ Introduce performance-linked or outcome-based pricing where feasible.
Suppliers	<ul style="list-style-type: none"> ▪ Lack of clarity on pricing logic and adjustment mechanisms. ▪ Perceived imbalance of risk allocation in price mechanisms. 	<ul style="list-style-type: none"> ▪ Transparently discuss pricing structure and change drivers during negotiations. ▪ Design pricing models that equitably distribute risk and reward.

Ways to use AI to support the design of commercial pricing mechanisms

There are a variety of ways to use AI-enabled solutions to support the design of commercial pricing mechanisms for contracts:

- AI-enabled pricing engines recommend optimal price structures by evaluating contract type, demand volatility, cost drivers and supplier market conditions to ensure commercial fit and value protection.
- Machine learning models simulate multiple pricing scenarios and forecast their financial impact to enable data-driven selection of fixed, indexed, variable or hybrid pricing mechanisms.
- Intelligent cost decomposition tools analyze supplier cost structures and external benchmarks to support “should cost” modeling and fact-based price negotiations.
- Predictive models assess the likelihood of price erosion, margin leakage or supplier non-compliance to support proactive adjustment of commercial terms.
- AI-driven contract intelligence extracts, compares and standardizes pricing clauses across contracts to improve consistency and reduce commercial risk.
- AI-powered dashboards consolidate pricing performance, index movements and variance trends to provide real-time visibility for procurement, finance and legal teams.
- Natural language processing enables rapid querying of contract pricing terms and change triggers to improve accessibility and decision-making speed.
- Workflow automation governs price revisions, index updates and approvals to ensure auditability and policy adherence across the contract lifecycle.
- AI-driven compliance monitoring automatically flags deviations from approved pricing mechanisms and contractual thresholds to enable timely corrective actions and strengthen commercial governance.



Conclusion

Key actions to strengthen the design of contract pricing mechanisms for volatile markets

- **Embed the requirement to use commercial pricing mechanisms as core levers for volatility management**, margin protection and supply continuity.
- **Use a risk-calibrated approach** to align pricing models with market volatility, demand uncertainty and supplier risk profiles rather than using a traditional fixed-price approach for all contracts.
- **Deploy value-oriented pricing model design** to link commercial terms to outcomes such as service resilience, performance delivery and time-to-value.
- **Encourage transparency discipline** to enable “should cost” modeling, cost driver visibility, auditability and fact-based negotiations to reduce information asymmetry and value leakage.
- **Develop pricing models to embed indexation**, reopeners and scenario-based triggers to maintain contract relevance across the entire contract lifecycle.
- **Balance risk allocation between both parties** by deploying gainshare and price-cap mechanisms to sustain supplier investment while protecting buyer economics.
- **Leverage AI and analytics** to simulate pricing scenarios, monitor contract performance and develop proactive contract performance monitoring.
- **Integrate pricing logic into contracts** to support ongoing contract management that enforces compliance, financial discipline and accountability post-award.
- **Design for both today and the future** by prioritizing pricing models with high transparency, the ability to easily modify over the life of the contract to support resilient commercial contracting.



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