***Supply Chain Management***

***Topic 2. Inventory, Logistics, Alliances***

Chapters out of Simchi-Levi Text.

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| **Inventory** | **Logistics** | **Alliances** |
| Chapter 2 | Chapter 7 | Chapters 8,9 |
| \*Inventory Control -Stochastic Demand --Continuous Review --Periodic Review --Single Period EOQ\*Inventory Risk Pooling\*Echelon Inventory\*ABC Classification | \*Configurations -Direct Shipment -Intermediate Shipping --Warehousing --Cross-docking --Transshipment \*Transportation Modes -Truck, Air, Rail, Water,  Pipeline | \*Partnerships -3PL (Third-party Logistics) -RSP (Retailer-supplier Partnerships) -DI (Distributor Integration)\*Outsourcing -Products -Components -e-Markets |

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| **Objectives of Supply Chain Management** |
| Balance “High Service Levels” with “Low Costs”Emphasize “Continual Improvement” |

Summary for Supply Chain Management

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| **Inventory**. From Simchi-Levi Text, Chapter 2. |
| \*Inventory Control -Stochastic Demand --Continuous Review --Periodic Review --Single Period EOQ | \*Classical inventory control of single-item inventory policy. -Stochastic Demand. Realistic approach to inventory control. --Continuous Review. Computerized monitoring. For example, low mean high variability inventory demand. --Periodic Review. Established consistent monitoring. For example, high mean low variability inventory demand. --Single Period EOQ. Unique inventory policy. For example, rapidly changing product design, variable cost parameters, or long lead times. |
| \*Inventory Risk Pooling | \*Aggregates inventory through upstream centralized inventory to service multiple downstream demand channels. For the same service levels, inventory risk pooling will usually lower safety stock, lower average inventory, lower inventory carrying cost, and increase efficiency. |
| \*Echelon Inventory | \*Addresses inventory control policies for multiple stages within a supply chain. Coordinates and increases efficiency between supply chain stages. |
| \*ABC Classification | \*Practical inventory control of multiple-item inventories. Simple approach, heuristic technique, and effective management of large, co-located or distributed inventories. |

***Supply Chain Management – Inventory***

***Supply Chain Inventory Model***

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| *🡨 Flow of Information 🡨**🡪 Flow of Material 🡪*

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| Supplier | 🡪 | Manufacturer | 🡪 | Distributor | 🡪 | Retailer | 🡪 | Customer |
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| Policy | 🡨 | Order |  | Demand | 🡨 | Forecasting |
| & Control |  |  |  |  |  |  |
|  |  |  | Inventory |  |  |  |
|  |  |  |  |  |  |  |
| Sourcing | 🡪 | Receive |  | Send | 🡪 | Distribution |
|  |  |  | **** |  |  |  |
|  |  |  | Evaluation |  |  |  |

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| ***Inventory Control*** |
| *Determine inventory policies of lot sizing & lot timing**that balance the objectives of cost & service levels.* |
| * Inventory Types
	+ Primary Types 🡪 Raw material, WIP (Work In Process), FGI (Finished Goods Inventory)
	+ Inventory Policy Types 🡪 Order Quantity, Safety Stock.
	+ Supply Chain Types 🡪 Pipeline (Logistics), Warehouse (Centralized), Positioned (Decentralized)
	+ Special Types 🡪 Anticipation (Seasonal), Speculative (Hedge).
* Inventory Management Plan
	+ Forecasting 🡪 *Variability* 🡪 Time Series, Causal, Risk Pooling
	+ Distribution 🡪 *Service Levels* 🡪 Logistics (Centralized, Distributed, VMI)
	+ Evaluation 🡪 *Efficiency* 🡪 Turnover Ratio, EPP=(Average inventory)/(Order frequency)
	+ Sourcing 🡪 *Supply Contracts* 🡪
		- (Buy-Back, Revenue-Sharing, Quantity-Flexibility, Sales Rebate)
	+ Policy & Control 🡪 *Strategy* 🡪
		- Inventory Policy: Lot Sizing & Lot Timing
		- Inventory Objectives: Service Levels (Stockout Levels) & Cost (EOQ)
		- Inventory Period: Single Period & Multiple Periods
		- Inventory Item: Single item & Multiple items (ABC Classification)
		- Inventory Stage: Single stage & Multiple stages (Echelon)
		- Inventory Review: Continuous & Periodic
		- Inventory Demand: Deterministic & Stochastic

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**Inventory Management Plan – Policy & Control**

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|  |  | ***Single Item Summary*** |  |  |
|  |  | Constant Demand |  |  |
|  |  |  |  |  |  |
|  |  | Basic Inventory Policy 🡪 | Q=D\*T |  |  |
|  |  | Optimal Inventory Policy 🡪 | EOQ=sqrt[2\*D\*Co/Cc] |  |  |
|  |  | Deterministic Demand 🡪 | ROP=D\*LT+SS |  |  |
|  |  | Continuous Review 🡪 | (ROP,Q) |  |  |
|  |  | Periodic Review 🡪 | (T,Q) 🡨Deterministic Demand |  |  |
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|  |  |  |  |  |  |
|  |  | Stochastic Demand |  |  |
|  |  |  |  |  |  |
|  |  | Stochastic Demand 🡪 | Stochastic Demand: Xd ~ N( d , 2d ), where d = Mean,2d = Variance, andd = Standard Deviation |  |  |
|  |  | Order Quantity 🡪 | Q=d \*T |  |  |
|  |  | Stockout Level, , 🡪 Statistical Safety Stock 🡪 | ROP=d\*LT+SSSSZ \* d \* sqrt(LT) |  |  |
|  |  | Base Stock Level 🡪 | BSL = QBSL + SSQBSL=(T+LT)\*dSSZ \* d \* sqrt(T+LT) |  |  |
|  |  | Continuous Review 🡪 | (ROP,Q) |  |  |
|  |  | Periodic Review 🡪 | (T,BSL) 🡨Stochastic Demand (T,Q) 🡨Deterministic Demand |  |  |
|  |  | EOQ Single Period 🡪 | EOQ = d + Z \* d where =CL/(CL+CS) |  |  |
|  |  | Stochastic Demand & Lead Time 🡪 | Q=d \*TROP= d \*L + Z \* sqrt( L\*2d + d\*2L ) |  |  |
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|  |  | Inventory Risk Pooling |  |  |
|  |  |  |  |  |  |
|  |  |  |  |  |  |
|  |  | Echelon Inventory |  |  |
|  |  | Echelon Inventory Policy 🡪 | EOQ=sqrt[2\*D\*Co/Cc]ROPe = d \* LTe + Z \* d \* sqrt( LTe )Echelon lead time = LTe = LT + downstream LT |  |  |
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|  |  | ***Multiple Items Summary*** |  |  |
|  |  |  |  |  |  |
|  |  | ABC Inventory Classification |  |  |
|  |  | Economic ABC Inventory Policy |  |  |
|  |  | Item Analysis E–ABC Inventory Policy |  |  |
|  |  | Economically Balanced E–ABC Inventory Policy |  |  |
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|  |  | Continuous Review 🡪 | (ROP,Q) |  |  |
|  |  | Periodic Review 🡪 | (T,Q) 🡨Deterministic Demand |  |  |
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|  |  | Order Quantity 🡪 | Q=d \*T |  |  |
|  |  | Stockout Level, , 🡪 Statistical Safety Stock 🡪 | ROP=d\*LT+SS**SSZ \* d \* sqrt(LT) 🡨** |  |  |
|  |  | Base Stock Level 🡪 | BSL = QBSL + SSQBSL=(T+LT)\*d**SSZ \* d \* sqrt(T+LT) 🡨** |  |  |
|  |  | Continuous Review 🡪 | (ROP,Q) |  |  |
|  |  | Periodic Review 🡪 | (T,BSL) 🡨Stochastic Demand (T,Q) 🡨Deterministic Demand |  |  |
|  |  | EOQ Single Period 🡪 | EOQ = d + Z \* d where =CL/(CL+CS) |  |  |
|  |  | Stochastic Demand & Lead Time 🡪 | Q=d \*TROP= d \*L + Z \* sqrt( L\*2d + d\*2L ) |  |  |
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|  |  | **Inventory Risk Pooling 🡨** |  |  |
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***Inventory Risk Pooling***

*Michael D. Harper, Ph.D.*

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| Inventory Risk Pooling aggregates inventory through upstream centralized inventory to service multiple downstream demand channels. For the same service levels, inventory risk pooling will usually lower safety stock, lower average inventory, lower inventory carrying cost, and increase efficiency. |

Consider two distinct inventory channel configurations.

For the dual channel configuration, the **Dual Stochastic Demand Channels**, X1 and X2, are serviced with two distinct inventories, Inventory-1 and Inventory-2.

The **Inventory Risk Pooling** configuration satisfies both stochastic demand channels with one combined inventory.

Suppose the stochastic demand channels follow a Normal Distribution, X1~N(1,1) and X2~N(2,2).

Graphically,

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|  |  | **Dual Stochastic Demand Channels** |  |  |  | **Inventory Risk Pooling** |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | Inventory-1 | X1 |  | Demand-1 |  |  |  |  |  |  | Demand-1 |  |  |
|  |  |  |  |  |  |  |  | X1 |  |  |  |
|  |  |  |  |  |  |  |  |  | Inventory |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | Inventory-2 | X2 |  | Demand-2 |  |  |  |  | X2 |  | Demand-2 |  |  |
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|  | Suppose each inventory has a 10% stockout level (Z0.10≈1.282) and the same Lead Time (LT). Now consider the safety stock for each inventory in each configuration. |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | X1 ~ N( 1 , 1 )X2 ~ N( 2 , 2 )SS1 =Z0.10\*1\*sqrt(LT) For Inventory-1SS2 =Z0.10\*2\*sqrt(LT) For Inventory-2 |  |  |  | Let X12 = X1+X2 . Then, X12 ~ N( 1+2 , 12 )SS12=Z0.10\*12\*sqrt(LT) For Combined Inventory |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  | Consider a safety stock comparison, SS1+SS2=Z0.10\*(1+2)\*sqrt(LT) SS12=Z0.10\* 12 \*sqrt(LT) |  |  |  |  |
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|  | ***Inventory Risk Pooling*** |  |
|  | 1. It can be shown that 12 ≤ (1+2). Thus, SS12 ≤ SS1+SS2.  |  |
|  | 2. Inventory Risk Pooling will usually result in lower inventory levels for the same service level. |  |
|  | 3. Inventory Risk Pooling will usually result in lower inventory carrying cost for the same service level. |  |
|  | 4. The lower the correlation between the demand channels, the greater the cost savings. |  |
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|  |  | ***Single Item Summary*** |  |  |
|  |  | Constant Demand |  |  |
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|  |  | Basic Inventory Policy 🡪 | Q=D\*T |  |  |
|  |  | Optimal Inventory Policy 🡪 | EOQ=sqrt[2\*D\*Co/Cc] |  |  |
|  |  | Deterministic Demand 🡪 | ROP=D\*LT+SS |  |  |
|  |  | Continuous Review 🡪 | (ROP,Q) |  |  |
|  |  | Periodic Review 🡪 | (T,Q) 🡨Deterministic Demand |  |  |
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|  |  | Order Quantity 🡪 | Q=d \*T |  |  |
|  |  | Stockout Level, , 🡪 Statistical Safety Stock 🡪 | ROP=d\*LT+SSSSZ \* d \* sqrt(LT) |  |  |
|  |  | Base Stock Level 🡪 | BSL = QBSL + SSQBSL=(T+LT)\*dSSZ \* d \* sqrt(T+LT) |  |  |
|  |  | Continuous Review 🡪 | (ROP,Q) |  |  |
|  |  | Periodic Review 🡪 | (T,BSL) 🡨Stochastic Demand (T,Q) 🡨Deterministic Demand |  |  |
|  |  | EOQ Single Period 🡪 | EOQ = d + Z \* d where =CL/(CL+CS) |  |  |
|  |  | Stochastic Demand & Lead Time 🡪 | Q=d \*TROP= d \*L + Z \* sqrt( L\*2d + d\*2L ) |  |  |
|  |  |  |  |  |  |
|  |  | Inventory Risk Pooling |  |  |
|  |  |  |  |  |  |
|  |  |  |  |  |  |
|  |  | Echelon Inventory |  |  |
|  |  | Echelon Inventory Policy 🡪 | EOQ=sqrt[2\*D\*Co/Cc]ROPe = d \* LTe + Z \* d \* sqrt( LTe )Echelon lead time = LTe = LT + downstream LT |  |  |
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|  |  | ***Multiple Items Summary*** |  |  |
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**Echelon Inventory Policy**

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|  | **Echelon Inventory Policy**

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| **Stage 3** | **🡪** | **Stage 2** | **🡪** | **Stage 1** |

ROPe = d \* LTe + Z \* d \* sqrt( LTe ). . . |  |
|  | \*Echelon inventory = on hand + downstream inventory\*Echelon inventory position = on hand + upstream orders not received - backorders\*Echelon lead time = LTe = LT + downstream LT |  |
|  | \*Echelon Inventory Policy. When the echelon inventory position is at or below the echelon reorder point, ROPe=d\*LTe+Z\*d\*sqrt(LTe), order the appropriate lot size, Q. |  |
|  | \*Let demand, Xd , for Stage 1 be stochastic, Xd ~ N( d , 2d ) ,  where d = 539/week and 2d = 6724/week2 . Thus, d = 82/week. \*Stockout Level, =0.10. Thus, Z≈1.282\*Let unit ordering cost, Co, and unit carrying cost, Cc, be: -For Stage 1: Co=$249/order, Cc=$0.41/item/week. -For Stage 2: Co=$254/order, Cc=$0.32/item/week. -For Stage 3: Co=$260/order, Cc=$0.29/item/week.\*Lot Size: -Lot Size for Stage 1: EOQ= sqrt(2\*539\*249/0.41)=809 -Lot Size for Stage 2: EOQ= sqrt(2\*539\*254/0.32)=925 -Lot Size for Stage 3: EOQ= sqrt(2\*539\*260/0.29)=983\*Let Lead Time, LT, be: -Lead Time between Stage 1 and Stage 2: LT1=0.2 weeks -Lead Time between Stage 2 and Stage 3: LT2=0.5 weeks -Lead Time between Stage 3 and Supplier: LT3=0.3 weeks\*Echelon Lead Time: LTe -Echelon Lead Time for Stage 1: LTe1 = 0.2 -Echelon Lead Time for Stage 2: LTe2 = 0.2 + 0.5 = 0.7 -Echelon Lead Time for Stage 3: LTe3 = 0.2 + 0.5+0.3 = 1.0\*Echelon Reorder Point: ROPe = d \* LTe + Z \* d \* sqrt( LTe ) -Echelon Reorder Point for Stage 1: ROPe1 = 539\*0.2+1.282\*82\*sqrt(0.2)=155 -Echelon Reorder Point for Stage 2: ROPe2 = 539\*0.7+1.282\*82\*sqrt(0.7)=465 -Echelon Reorder Point for Stage 3: ROPe3 = 539\*1.0+1.282\*82\*sqrt(1.0)=644\*Echelon Inventory Policy: -Echelon Inventory Policy for Stage 1: (155,809) -Echelon Inventory Policy for Stage 2: (465,925) -Echelon Inventory Policy for Stage 3: (644,983). . . |  |

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|  |  | Inventory Risk Pooling |  |  |
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|  |  |  |  |  |  |
|  |  | ABC Inventory Classification |  |  |
|  |  | Economic ABC Inventory Policy |  |  |
|  |  | Item Analysis E–ABC Inventory Policy |  |  |
|  |  | Economically Balanced E–ABC Inventory Policy |  |  |
|  |  |  |  |  |  |

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| --- |
| **Multiple Items Inventory Policy** |
| **ABC Inventory Classification**

|  |  |  |
| --- | --- | --- |
| Class | Annual Usage ($) | Total SKU Items |
| A | 75% to 80% | 10% to 20% |
| B | 10% to 15% | 20% to 40% |
| C | 5% to 10% | 40% to 50% |

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| SKU | AnnualUsage ($) | PercentUsage (%) | CumulativePercentage | Class | %Usage | %Items |
| 5 | 73728 | 64.7 | 64.7 | A |  |  |
| 8 | 18432 | 16.2 | 80.9 | A | 80.9 | 20 |
| 1 | 8063 | 7.1 | 88.0 | B |  |  |
| 6 | 4478 | 3.9 | 91.9 | B |  |  |
| 4 | 2819 | 2.5 | 94.4 | B | 13.5 | 30 |
| 9 | 2057 | 1.8 | 96.2 | C |  |  |
| 7 | 1515 | 1.3 | 97.5 | C |  |  |
| 3 | 1161 | 1.0 | 98.5 | C |  |  |
| 10 | 920 | 0.8 | 99.3 | C |  |  |
| 2 | 747 | 0.7 | 100.0 | C | 5.6 | 50 |
| Total | 113920 | 100.0 |  |  |  |  |

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| --- |
| **ABC Classification Cost Analysis** |
| \*Assume Unit Ordering Cost is $40/order and Unit Carrying Cost is $0.25/$/year.\*Evaluate the arbitrary inventory policy (10,8,4) that represents the annual order frequency for classes A,B,C, respectively.

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Classi | AnnualUsage($)Mi | Number ofSKUsNi | OrderFrequencyFi | TotalOrdersNiFi | AverageInventory($)Mi/(2Fi) |
| A | 92160 | 2 | 10 | 20 | 4608 |
| B | 15360 | 3 | 8 | 24 | 960 |
| C | 6400 | 5 | 4 | 20 | 800 |
| Total | 113920 | 10 |  | 64 | 6368 |

|  |  |  |
| --- | --- | --- |
| Unit Costs | $40 | $0.25 |
| Total Ordering Cost | $2560 |  |
| Total Carrying Cost |  | $1592 |

|  |  |
| --- | --- |
| Total Inventory Cost | $4152 |

**Objective: Determine order frequency that will minimize total inventory cost.**. . . |

|  |
| --- |
| **Economic ABC Inventory Policy**- |
| Order frequency per class to minimize cost is:**Fi = sqrt[ Mi/(2\*Ni\*EPP) ], i=A,B,C. EPP=Co/Cc**This relationship yields, FA = sqrt[ 92160/(2\*2\*(40/0.25))] = 12 FB = sqrt[ 15360/(2\*3\*(40/0.25))] = 4 FC = sqrt[ 6400/(2\*5\*(40/0.25))] = 2 where EPP = 40/0.25 = 160.

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| Classi | AnnualUsage($)Mi | Number ofSKUsNi | OrderFrequencyFi | TotalOrdersNiFi | AverageInventory($)Mi/(2Fi) | EPP |
| A | 92160 | 2 | 12 | 24 | 3840 | 160 |
| B | 15360 | 3 | 4 | 12 | 1920 | 160 |
| C | 6400 | 5 | 2 | 10 | 1600 | 160 |
| Total | 113920 | 10 |  | 46 | 7360 |  |

|  |  |  |
| --- | --- | --- |
| Unit Costs | $40 | $0.25 |
| Total Ordering Cost | $1840 |  |
| Total Carrying Cost |  | $1840 |

|  |  |
| --- | --- |
| Total Inventory Cost | $3680 |

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| **Item Analysis E–ABC Inventory Policy** |
| \*From the E-ABC Policy: Fi = sqrt[ Mi/(2\*Ni\*EPP) ], i=A,B,C. EPP=Co/Cc\*Let each SKU be its own class. Then an optimal order frequency can be determined for each SKU using: Fi = sqrt[ Mi/(2\*EPP) ], i=SKU. EPP=Co/Cc.

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| SKU | AnnualUsage ($) | Number ofSKUsNi | OrderFrequencyFi | TotalOrdersNiFi | AverageInventory($)Mi/(2Fi) | EPP |
| 5 | 73728 | 1 | 15.179 | 15.179 | 2428.629 | 160 |
| 8 | 18432 | 1 | 7.589 | 7.589 | 1214.315 | 160 |
| 1 | 8063 | 1 | 5.020 | 5.020 | 803.144 | 160 |
| 6 | 4478 | 1 | 3.741 | 3.741 | 598.532 | 160 |
| 4 | 2819 | 1 | 2.968 | 2.968 | 474.889 | 160 |
| 9 | 2057 | 1 | 2.535 | 2.535 | 405.660 | 160 |
| 7 | 1515 | 1 | 2.176 | 2.176 | 348.138 | 160 |
| 3 | 1161 | 1 | 1.905 | 1.905 | 304.762 | 160 |
| 10 | 920 | 1 | 1.696 | 1.696 | 271.293 | 160 |
| 2 | 747 | 1 | 1.528 | 1.528 | 244.459 | 160 |
| Total | 113920 | 10 | 44.337 | 44.337 | 7093.821 |  |

|  |  |  |
| --- | --- | --- |
| Unit Costs | $40 | $0.25 |
| Total Ordering Cost | $1773.5 |  |
| Total Carrying Cost |  | $1773.5 |

|  |  |
| --- | --- |
| Total Inventory Cost | $3546.9 |

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| **Economically Balanced E–ABC Inventory Policy** |
| \*From the E-ABC Policy: Fi = sqrt[ Mi/(2\*Ni\*EPP) ], i=A,B,C. EPP=Co/Cc.\*Suppose the unit costs are unknown. \*Perform analysis of Class A items and determine the order frequency, FA.\*Then, the “Observed EPP” would be “[Ave.Inv.]/[TotalOrders]=“[MA/(2FA)]/[NAFA]” for Class A items.\*Use this Observed EPP for the order frequencies for Class B and Class C items.Suppose after an extensive Class A analysis, it was determined that FA=15.Using FA=15, determine the Observed EPP=[92160/(2\*15)]/[2\*15]=102.4 in the table.Then, FB = sqrt[ 15360/(2\*3\*102.4) ]=5And, FC = sqrt[ 6400/(2\*5\*102.4) ]=2.5

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| Classi | AnnualUsage($)Mi | Number ofSKUsNi | OrderFrequencyFi | TotalOrdersNiFi | AverageInventory($)Mi/(2Fi) | EPPO |
| **A** | **92160** | **2** | **15** | **30** | **3072** | **102.4** |
| B | 15360 | 3 | 5 | 15 | 1536 | 102.4 |
| C | 6400 | 5 | 2.5 | 12.5 | 1280 | 102.4 |
| Total | 113920 | 10 |   | 57.5 | 5888 |  |

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| \*Although not optimal, all classes will have the same Observed EPP. This is called an “Economically Balanced” inventory, EB-ABC Inventory Policy.\*Although not optimal, an economically balanced inventory will be based on the accuracy of the Class A inventory analysis.\*The EB-ABC inventory analysis can also be used to obtain an Item EB-ABC policy.\*It can be shown that the structure of an EB-ABC inventory can be used for further analysis and strategy. \*\*All ABC Inventory analyses can be used for an Echelon Inventory.- |

**APPENDIX**

***Inventory Risk Pooling***

*Michael D. Harper, Ph.D.*

Suppose two distinct stochastic demand channels, X1 and X2, are serviced

with two distinct inventories, Inventory-1 and Inventory-2.

The stochastic demand channels follow a Normal Distribution, X1 ~ N( 1 , 1 ) and X2 ~ N( 2 , 2 ).

Risk Pooling satisfies both stochastic demand channels with one combined inventory. Graphically,

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **Dual Stochastic Demand Channels** |  |  |  | **Inventory Risk Pooling** |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | Inventory-1 | X1 |  | Demand-1 |  |  |  |  |  |  | Demand-1 |  |  |
|  |  |  |  |  |  |  |  | X1 |  |  |  |
|  |  |  |  |  |  |  |  |  | Inventory |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | Inventory-2 | X2 |  | Demand-2 |  |  |  |  | X2 |  | Demand-2 |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |

Inventory-1 will service a stochastic demand with a mean of 1 and a standard deviation of 1.

Inventory-2 will service a stochastic demand with a mean of 2 and a standard deviation of 2.

The combined inventory in the Inventory Risk Pooling will service a combined stochastic demand with a mean of (1+2) and a standard deviation of 12, which is the mean and standard deviation of (X1+X2).

The inventories contain a statistical safety stock, SS1, SS2 and SS12 for inventory-1, inventory-2 and the combined inventory respectively. Suppose each inventory has a 10% stockout level (Z0.10≈1.282) and the same LT=Lead Time. The statistical safety stock for each inventory is given by

SS1 =Z0.10\*1 \*sqrt(LT) for Inventory-1

SS2 =Z0.10\*2 \*sqrt(LT) for Inventory-2

SS12=Z0.10\*12\*sqrt(LT) for Combined Inventory.

Notice the difference between the safety stocks of the three inventories is the standard deviations.

|  |  |  |
| --- | --- | --- |
| Consider the statistical relationships. |  | Consider the relationship 12 ≤ 1+2) |
| Let X1 ~ N( 1 , 1 )Let X2 ~ N( 2 , 2 )Let 12 = correlation between X1 and X2 .  |  |  The standard deviation of the combined inventory, 12 , will always be less than or equal to the sum of the standard deviations of the distinct inventories, 1+2).  Thus, the safety stock for the combined inventory, SS12 , will always be less than or equal to the sum of the safety stock of the distinct inventories, (SS1+SS2) for the same stockout level and lead time. This implies that multiple stochastic demand channels for the same stockout level and lead time can be serviced with less inventory with a combined inventory.   |
| Var(X1+X2) = Var(X1)+Var(X2)+2\*Cov(X1,X2) (12)2 = (1)2+(2)2+2\*1\*2\*12So, for 12<0, [ Var(X1)+Var(X2) ]>[ Var(X1+X2) ]So, for 12=0, [ Var(X1)+Var(X2) ]=[ Var(X1+X2) ]So, for 12>0, [ Var(X1)+Var(X2) ]<[ Var(X1+X2) ] |  |
| Now,  12 = sqrt[ Var(X1+X2) ] = sqrt[ (1)2+(2)2+2\*1\*2\*12 ]Let 12=1,12 = sqrt[ (1)2+(2)2+2\*1\*2\*1 ] = sqrt[ (1+2)2 ] = (1+2) |  |
| So, for -1<12<+1, 12<1+2) |  | This is called Inventory Risk Pooling. |

Consider the Example.

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Example  |  |  |  |  |  |  |  |  |
| Index | X1 | X2 |  |  |  | X1+X2 |  |  |
| 1 | 30 | 30 |  |  |  | 60 |  |  |
| 2 | 24 | 20 |  |  |  | 44 |  |  |
| 3 | 35 | 41 |  |  |  | 76 |  |  |
| 4 | 29 | 21 |  |  |  | 50 |  |  |
| 5 | 25 | 35 |  |  |  | 60 |  |  |
| 6 | 33 | 21 |  |  |  | 54 |  |  |
| 7 | 34 | 48 |  |  |  | 82 |  |  |
| 8 | 30 | 30 | Sum |  |  | 60 |  |  |
| Mean | 30 | 30.75 | 60.75 |  | Mean | 60.75 |  |  |
| Variance | 16 | 103.9 | 119.9 |  | Variance | 161.1 |  | The VarianceIncreased 119.9 to 161.1 |
| StandardDeviation | 4 | 10.2 | 14.2 |  | StandardDeviation | 12.7 |  | The Standard DeviationDecreased 14.2 to 12.7 |
| Correlation | 0.50 |  |  |  |  |  |  |

To illustrate the relationship, 12 ≤ 1+2), for -1≤12≤+1,

consider the decrease in standard deviation between 12  and 1+2) for different correlations.

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Decrease in Standard Deviation | 6.39 | 4.83 | 4.38 | 4.15 | 3.95 | 3.15 | 2.61 | 2.51 | 1.50 | 0.20 |
| Correlation between X1 & X2 | -0.91 | -0.50 | -0.31 | -0.20 | -0.10 | 0.10 | 0.20 | 0.30 | 0.50 | 0.91 |

