

Electronic Reverse Auctions – The Good and the Bad

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It is important for supply management professionals to be familiar with the various “tools” which are available to maximize their efficiency and productivity.

One of these tools, which is rapidly gaining popularity is the electronic reverse auction. Such auctions are not new, but they are a valuable, and controversial tool in the supply management professionals toolbox. This author’s experience has revealed that much of the controversy is attributable to either a lack of understanding of the tool, or to inappropriate use of the tool. To properly assess the electronic reverse auction, let’s review the key components:

- 1) use of e-procurement software to conduct an on-line, real-time bidding event;
- 2) one buyer, and multiple sellers of the desired commodity or service;
- 3) prices are driven down by sellers during the bidding event.

As may be noted, these elements are essentially the opposite of what occurs during the traditional auction which occurs at famous auction houses like Sotheby’s or Christie’s, where multiple buyers drive up the price of an item. This is why the title “reverse auction” is relatively descriptive.

It is essential that we recognize that the software component of a reverse auction is merely an “enabler”, and not a different procurement methodology, i.e.: it is a tool with which to conduct the procurement process, and optimize the competition. This is a critical perspective, because any deficiencies in the underlying procurement process, such as inadequate product specifications, will result in defective proposals – just as they ultimately would in a traditional procurement process. In fact, our watchword, based upon experience, is that success of an e-auction is as much about the quality of the procurement process as it is about the technology. I believe most e-sourcing service or tool providers would agree with this perspective.

Another important perspective is that electronic reverse auctions are not appropriate for every spend category. In fact, our experience indicates that a reverse auction may be inappropriate for many commodities or services. However, our experience has disproved the theory that reverse auctions are not useful for both direct and indirect materials. We have had success with commodities in both of these categories, as well as with procurement of support services.

To determine whether a particular procurement is appropriate for a reverse auction, we must critically review both the product or service being procured, and the market in which we are procuring.

With respect to the appropriateness of the product or service, we should ask ourselves:

1. are the items strategic to the purchaser?
2. is the supplier relationship critical to the purchaser?
3. is there an adequate specification for the items or services?

4. is price the key determinant of success of an event?
5. are there other factors, which might preclude success of an event?

With respect to the market from which we are procuring, we must consider:

1. are there multiple suppliers of the commodity or service, with the requisite capacity?
2. are market conditions for this commodity or service conducive to competition?
3. have these suppliers previously participated in electronic reverse auctions?
4. will the "price transparency", which results from a reverse auction, be acceptable to the suppliers?

A good summary of some of the conditions, which favor a reverse auction, versus those which do not, is provided as Exhibit A.

It should be noted that some internal factors, such as resistance to change might also preclude utilization of a reverse auction. Never underestimate the resistance to such a significant change from both within and outside the procurement organization

Many "unsuccessful" competitive bid events (CBE) can be attributable to inadequate consideration of the aforementioned factors.

As may be noted, many of these considerations are not necessarily limited to e-procurement or reverse auctions, but are equally useful in developing our sourcing strategy in a traditional procurement environment.

Once you have determined that an electronic reverse auction is appropriate for a specific procurement, preparation for the CBE is the key to success. This includes:

1. Preparing the procurement organization to utilize the electronic tool - as in avoiding culture shock.
2. Preparing the RFP - this is similar to, but more complex than a traditional, paper RFP. The bidding terms and award parameters of the auction event must be extremely clear.
3. Preparing the specification or statement of work. Since bid price is generally the key evaluating factor in the CBE, these documents may need to be more precise than with a paper-based RFP.
4. Preparing the suppliers. You may be assured that many suppliers do not welcome this "opportunity" to participate in CBE. Therefore, you will need to do some reverse marketing to convince them that it is to their benefit to participate. Also, be critical in your supplier selection, and avoid suppliers who have a reputation for "buy in" with unrealistic prices. Such a supplier strategy is particularly problematic in a reverse auction.
5. Develop realistic pricing expectations. This will require serious consideration of current price, current and forecasted market conditions, number of suppliers participating, etc. Unrealistic expectations can result in unnecessary disappointment.
6. Determine which reverse auction format is the most appropriate. These formats are generally:
 - a. Full Service - the auction service provides personnel and electronic tools to conduct a CBE. They will work with you through all of the preparation steps

enumerated above. This is a particularly valuable format in today's environment where we have fewer personnel to perform the procurement function.

- b. Self-service - the auction service provides only the electronic tools and nominal technical support with which to conduct the CBE. All of the aforementioned preparation steps will therefore be conducted by your procurement staff.
- c. Hybrid format - the auction service will provide the electronic tools, as well as the personnel to perform selected steps in the conduct of the CBE. Such providers generally perform their services on a menu basis, where you choose the level of support, with a separate fee assessed for each level chosen.

A wise person once said that none of us will live long enough to learn what we need to know from our own mistakes; therefore, we must learn from the mistakes of others. In that context, I would propose to share some of the mistakes and misconceptions that have been made by some of our colleagues with the reverse auction tool:

- 1) Failure to analyze the supply market to ensure that the timing is right to conduct a reverse auction. This is critical because of the virtual price transparency, which results in the electronic auction environment.
- 2) Failing to recognize that all supplier price reductions come from somewhere, i.e.: if we didn't reduce their cost of doing business with us, what is the source of the price reduction? We must understand the supplier's cost structure to properly analyze their proposal. This is also appropriate with the traditional procurement model.
- 3) Failing to recognize that the supplier relationship may be damaged by this "impersonal" process. Suppliers often feel that they are considered "expendable" when this business format is utilized.
- 4) Obtaining prices which are too low to allow the supplier to make a reasonable profit. Suppliers sometimes get caught up in the emotion of the bidding event, and subsequently find they cannot perform at the price proposed in the CBE.
- 5) Presuming that the second or third round of CBE will yield the same level of price reduction as the first round, i.e.: we must control management "expectations". Supplier prices can only be compressed so far before suppliers may no longer find your business desirable.
- 6) Failure to recognize that flaws in the underlying procurement process will create serious problems in the electronic environment. My colleagues and I have repeatedly marveled at how the reverse auction seems to exaggerate or accelerate the flaws in our existing procurement processes.
- 7) Repeatedly conducting reverse auctions without awarding to the low bidder, i.e.: using the low bid as a lever to negotiate with the incumbent supplier to avoid switching suppliers. This impugns the credibility of the purchaser, and the reverse auction process.

As may be concluded, electronic reverse auctions are a valuable tool when properly utilized, and with adequate experience. This paper was intended to provide some substantive insight based upon several years of actual experience in this challenging and rewarding environment.

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EXHIBIT A

FAVOR REVERSE AUCTION	FAVOR ALTERNATIVE
Many qualified suppliers	Few qualified suppliers
Commodity or standardized product	Specialized or custom product
Transactional prevalent supplier relationships	Long-term, strategic relationship is important
Buyer is important to suppliers	Buyer's business is small or transactional to suppliers
Excess capacity in industry	Little or no excess capacity
Price is the key selection criterion	Other issues are as, or more, important than price
Buyer is willing to award business based on results of reverse auction	Buyer is not fully committed to awarding based on results (desire flexibility)

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