

Online Reverse Auctions for Dummies

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Abstract

Online Reverse Auctions have existed for several years now yet many companies have not used this technological innovation. Reverse auctions are not a one-size-fits-all solution to reduce pricing. However, this innovation has proven to be an effective tool to achieve competitive pricing for a wide variety of materials and services in almost every industry. We will explore the factors that make a successful reverse auction, how to identify opportunities, and how to effectively evaluate the results.

Introduction

If you've ever bid on an item on eBay™, you've seen the way your business will someday purchase a significant percentage of both indirect and direct materials and services -- in reverse. Online reverse auctions, or downward price auctions, stand the traditional rising price or English auction on its head. Buyers put out specifications for the commodity or service they want to purchase, and sellers submit bids electronically until someone wins the business. Prices typically begin with a "reserve" or "opening" bid specified by the buyer, and as the auction progresses, suppliers lower their bids in an attempt to win the business.

Businesses are discovering that by allowing suppliers, contractors, and service providers to bid prices down, they save more than just money, they save a significant amount of time as well. "What's driving [reverse auctions] right now is the time efficiency you get out of using them," says William Brandel, research director for e-business at Aberdeen Group in Boston, noting that online reverse auctions can reduce the process from months to a few weeks.

However, simply deciding to utilize a reverse auction does not guarantee that your firm will experience a savings of either time or money. We will examine the anatomy of a successful project below.

Identifying a Project

The most frequently asked question is *“what is the minimum project value necessary to have an auction?”* The answer is, there is none – as long as the project is appealing to the participating suppliers. Don't have larger firms that are accustomed to quoting on multi-million dollar projects participate in your \$200,000 event – they won't be motivated or competitive.

The reverse auction tool is not a panacea – it is not a perfect fit for every business purchase. A buyer must give consideration to a few important issues: 1) are there enough qualified suppliers in the market for healthy competition; 2) is the business appealing to all invited suppliers; and 3) are the project specifications precise enough to minimize diverse supplier interpretations and assumptions that can result in disparate quotes. If the answer is yes to these questions, the project is a good candidate for an online reverse auction.

The Devil is in the Details

In order to ensure the auction is successful and yields the anticipated results, the Request for Proposal (RFP) and supporting documentation must be complete. The goal is to create a clear and concise RFP so suppliers can understand your requirements. It comes down to answering the five basic questions namely: who, what, when, where and how.

First you must state who is responsible for each deliverable at each phase of the project. Who will secure the necessary permits or licenses (if any), who will pay State and local taxes, and who is responsible for shipping and other similar details.

Next, you must specify exactly what you are buying. If it is a work product or a semi-custom manufactured item for example, you must provide detailed technical specifications indicating materials, coatings, required chemical and physical characteristics, etc. Although technical specifications are usually the domain of the engineering department, you must review the specifications to ensure there are no errors or omissions and that there is no wording that would prevent any of the suppliers from submitting an offer.

To answer the when and what, you must state the exact delivery requirements including quantity, required delivery schedule, all of your delivery addresses, any special instructions or restrictions related to the delivery location and your preferred method of shipping. If the project is for an annual contract requiring several deliveries over the course of a year, you must state your expected minimum and maximum quantities and your required minimum lead-time for delivery after an order is placed. You must also state the number of expected deliveries required during the contract period.

Finally, you must answer the how. The how is really what is referred to as the business terms including; payment terms, non-disclosure agreements, insurance and/or bonding requirements, safety requirements, personnel requirements, etc. You should provide as much detail as possible regarding the terms of the contract you expect your chosen supplier to sign. The more detail you provide up-front, the less risk there is for the suppliers. If you can help reduce their risk or exposure, then they can be more accurate (and aggressive) with their pricing.

Supplier Identification

Supplier identification will vary from each service and commodity to the next. Companies will typically invite known or pre-qualified suppliers to bid on more detailed or complex projects. However, they sometimes neglect to investigate new sources of supply. This can quickly be achieved by searching industry and association websites. If you are using a full service auction provider, this service is typically offered. Introducing new suppliers into the current supply base can yield significant saving in a reverse auction. New suppliers are anxious to acquire new business and current suppliers feel the pressure of the new competition, thereby encouraging all participants to sharpen their pencils and offer aggressive pricing during the bid event.

During a reverse auction, you will need a minimum of two suppliers to participate. You will improve your chances of experiencing enhanced bid dynamics during the event by increasing the number of participating suppliers. As a *general* guideline, it is recommended to have four to six participating suppliers to increase the likelihood of an active and successful bid event. Don't make the mistake of assuming "invited" suppliers are "participating" suppliers. As strange as it may seem, qualified suppliers who have taken part throughout the process (e.g., attended pre-bid meeting, submitted documentation, partook in a training session, etc.) have elected not to participate on bid day.

You should be comfortable enough with each supplier that you would consider awarding the business to the lowest bidder. That doesn't mean, however, the lowest bid wins the business. You should still perform a thorough bid analysis to determine the supplier offering the best total value.

The Auction

Current auction facilitators typically have a variety of options to choose from when constructing an auction event. The success of your project will depend upon matching the auction parameters with your specific project. Examples of these parameters include;

- Reserve Price – should you specify a reserve (or budget) price, and if so, should it be visible to the suppliers?
- Complexity – should the suppliers bid a lump sum figure online supported with an offline breakout, or should they bid each line item online?
- Auction Duration – how long should your project be open for offers?
- Auction Format – should you choose an Open Call format (where all suppliers see the low bid), or should you choose a Ranked format (where the suppliers only see how their bid "ranks" against the other bids)?
- Extensions/Overtimes – should the auction close time be fixed or allowed to extend if there is bid activity?
- Minimum Decrements – what should the minimum amount of a bid reduction be?
- Supplier Anonymity – should the suppliers be able to see who they bidding against?

These are only a small sample of the types of auction parameters that have to be considered when setting up your project. If your firm does not possess the experience in-house to make these critical decisions, you might want to consider using a full service auction facilitator to assist you with your project.

Selecting an Offer

Price is only one component of the *total cost*. However, price is usually the starting point. Suppliers can offer the world but the *total cost* must still be competitive. The purchasing professional must still consider, among other things, quality, lead-time, service and support, when analyzing suppliers' offers. As in traditional bidding methods, the lowest price does not guarantee the supplier the award. This should be made clear in the RFP. It is not unusual for the second or third lowest bids to be awarded the business based on the complete offering. The goal is to achieve the best total value and create a win/win situation for you and your supplier.

Auction Post-Mortem

You are encouraged to conduct a post-mortem after a bid event – especially if your company is just beginning to utilize online e-sourcing tools or services. An online auction is not an exact science - one size doesn't fit all. If you are using a full service auction provider, work with them to explore ways to improve upon events and the impact of utilizing alternate features and formats.

Was my event successful? The answer to this question isn't as obvious as it may seem. Securing competitive pricing from a supplier isn't the only criteria for determining an auction's success. You should ask yourself: 1) Did I increase my supplier pool? 2) Do I now have more than one supplier to choose from within a concentrated price range? 3) Have I streamlined the bidding process in any way? 4) Have I generated documents or practices that can be used on future online and offline projects that will result in additional time savings and improved results? 5) Did this process encourage increased collaboration and support between my company's departments? Remember, success can be measured in many ways. What does it mean to your firm?