CIPS Knowledge Works

Introduction to e-auctions

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Welcome to a guide on e-auctions

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1. INTRODUCTION

The use of on-line auctions (e-auctions) has increased rapidly in the last few years since they came onto the purchasing scene in the late 1990's through the development of internet-based applications. Research undertaken by CIPS in conjunction with Oracle and the University of West England - IAdapt, -estimates that, within the UK alone, during 2002 there have been at least 2500 individual e-auctions undertaken by buyers and that they have grown at least ten fold each year since their arrival. The Financial Times stated on 13/03/02 that worldwide e-auctions turnover had reached $30bn with savings of $6.4bn.

e-auctions initiated by the buyer use the internet to share communications, and this provides both buyers and suppliers with visibility of bid status in real-time and allows an instant response. If conducted properly with adequate participant training, it creates a more level playing field for suppliers through increased transparency. An e-auction allows for a bid on price and/or other quantitative attributes such as carriage charge, quantity discounts, quality etc.

e-auctions should be considered as a tool in the buyer's e-sourcing toolkit. They can be used to renew existing contracts or offer consolidated spend opportunities. They can be used to negotiate significant spot purchases and can be used to receive pricing on frequently tendered communications or service.

2. TYPES OF E-AUCTIONS

Electronic reverse auctions (e-RA) allow buyers to seek competitive pricing by inviting pre-qualified suppliers to participate in a real time dynamic online event. Usually the internet-based auction begins with the buyer posting their requirement for a product or service on an internet site, a reserve price (a price which suppliers must meet in order to be considered) is usually set. The buyer then invites suppliers to bid against each other.

The term 'reverse' simply refers to the bidding process as the participating suppliers submit successively lower priced bids during a specified time period. The key difference between an internet-enabled auction and a traditional purchasing process, is that all suppliers can usually see their bid along with the current lowest bid, as well as having the opportunity to re-bid as many times as they wish.

If other quantitative attributes are included then the auction will be classed as a Weighted Multi-Variable or Parametric Auction. In the same way as an auction based on price alone, suppliers know which rank their own bid is, and can usually view the other supplier bids, but not the identity of the other suppliers. In this case, however, all bids are adjusted in real time from a range of variables from other attributes, which allows buyers to view a figure, which makes up the total cost of acquisition. Other attributes may include carriage, discounts in price for quantities or for successive years, packaging, payment periods, quality, or guarantee periods. Switching costs could be included in the non-incumbent supplier's calculations.

There are several types of reverse auctions. For example it is not uncommon for buyers to use the terms a bundled bid, cherry picked or a scorecard auction.

In the case of a bundled auction the buyer usually bundles together his/her requirements into a single lot. Suppliers then bid for the total package. Usually they will submit a bid for each item, but these will be totalled up and one supplier usually wins the whole bid.

A cherry picked auction is slightly different. As the name suggests, suppliers have the opportunity to 'cherry pick' certain lines from an auction and only bid for these. A buyer can then choose to award the contract to several different suppliers for different lots, or award to one supplier.

A scorecard auction is slightly more complicated in that the buyer can assign an internal scorecard to each potential supplier. Each bid a supplier submits is then recalculated against the values assigned by the value on the scorecard to produce a weighted bid. The buyer may chose to share the scorecard information with the suppliers. This may improve their performance as they will know what they are up against and where they need to improve.

This paper focuses on buyer initiated electronic reverse auctions but it is worth mentioning that forward auctions allow sellers to post single or multiple items in an open ascending price auction. The seller specifies all the requirements, such as quantity, opening bid price, and bid increment. As in the case of an e-RA the seller may also set a reserve price; if this price is not met by the end of the auction, the seller is not obligated to sell. Where the reserve price is met then both buyer and seller are obligated to the sale. There are at least eight defined forward auction types that support catalogue and off-catalogue items. eBay is a good example of a business to consumer open forward auction.

3. WHY ORGANISATIONS SHOULD BE AWARE OF E-AUCTIONS

3a. The Benefits to Buyers

Aberdeen Group research (e-sourcing: Negotiating Value in a Volatile Economy, April 2001) supports the assertion that the internet provides a low cost and efficient mechanism for communications and negotiations between buyers and suppliers. Electronic auctions exploit technology to achieve real time market pricing, which generally results in significant savings for the buying organisation. Overall savings of 10 -20% are commonly reported using the reverse auction process. Other benefits include a reduction in the sourcing cycle time (once the process is established), improved specification of requirements and increased transparency.

The IAdapt research found that when buyers were asked on a scale of 1 to 100 (50 being no change on how the suppliers' performance changed since using an auction to establish a new contract the change in the five key performance factors are shown below:

1. Flexibility (ie, changing order quantities at the last minute)+ 22%
2. Quality of the product or service +20%
3. Delivery/reliability + 12%
4. Dependability (keeping promises) + 11%
5. Account or customer support + 8%

There was an expectation that there would be at least no change or a reduction in at least one or two key factors. In particular, it was expected that the 'soft' factors of flexibility, dependability and account management would deteriorate as the reduced suppliers margins led to a reduction in the level of support provided to their customers. It was surprising to see that this was not the case. This may be because the supplier wants to please the buyer to avoid going through the e-auction process again at the end of the contract, or to factor in an increase in switching costs against other suppliers if the e-auction process is repeated at the end of the contract.

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i. Motivation for Using e-auctions
IAdapt asked buyers what motivated them to choose an e-auction as part of their purchasing process. The reasons for choosing an e-auction are:

- To improve the cost of your product/service - 86%
- As a trial or a pilot (to experience the outcome of an e-auction event) - 69%
- Process improvement (including time/speed) - 67%
- Your strategy for auctions is long term - 64%
- To ascertain current market conditions - 50%
- Told by management - 33%
- Competitors are using it - 22%
- Moving to a less personal approach to sourcing - 19%

Unsurprisingly the key reason for choosing an auction was to reduce cost supported by a need to reduce the process time. However, it was somewhat surprising that many buyers are still in pilot/trial mode although this was mitigated by the majority of buyers seeing auctions as part of their long-term strategy.

ii. Success Criteria
Buyers were also asked what criteria they used to decide whether an auction was a success. The following are the results for the success criteria:

- To obtain the best market pricing - 94%
- Enabling software works satisfactorily - 94%
- Suppliers are able to bid satisfactorily - 89%
- Learnt from activity - 89%
- Time taken for negotiation significantly reduced - 69%
- Easy to repeat with other products - 63%
- Significant number of suppliers agreed to participate - 63%
- Suppliers agreed to participate in future auctions - 60%

Obtaining the best pricing was the top criteria and that the software worked satisfactorily for both the buyer and the supplier. Interestingly, learning from the experience scored highly, which backs up the findings above where many buyers were still in trial mode.

iii. Supplier Management Initiatives
When buyers were asked what specific supplier management initiatives they were using in their e-auction–based procurement process, the following results were found:

- Developing supplier relationships - 90%
- Using a supplier reduction program - 70%
- Employing joint technological development - 53%
- Employing price as a primary factor in your supplier selection - 33%

These results are surprising as auctions have not generally been perceived as encouraging the development of supplier relationships, yet this was recorded as a major objective.

iv. Other Benefits to Buyers
e-auctions generally encourage:

- Competitive behaviour amongst suppliers
- Quick, efficient and paperless way of requesting pricing
- Use for catalogue items or spot shortages
- Identification of new sources of supply

v. Enablers and Inhibitors
Buyers found the top 6 key success enablers to be:

- Comprehensive specification for product/service
- Supplier auction training
- Sound supplier pre-qualifying process
- Selecting suitable commodity
- Enabling software
- Clear auction objective

Generally the e-auction process seems to encourage buyers to be more rigorous and thorough in the purchasing process.

Buyers found the top 5 key success inhibitors to be:

- Lack of supplier participation – there is a community of suppliers with a policy not to enter into e-auctions, even though it may mean losing contracts to their competition
- Unsuitable commodity/service – this might be an item where there is no competition in the market place, or that is too complicated to specify or largely cannot be specified
- Lack of competitive supply base – if a product or service does not have at least three suitable suppliers, then the e-auction process is not generally suitable
- Poor training of buyer/supplier – getting things right first time is imperative to build trust amongst suppliers in your company's e-auction process
- Auction timing – If you are inviting suppliers to participate from a different country and time zone, take care that if the timing chosen to run the auction is convenient to those suppliers, also consider company shut downs within the UK.

vi. Initial Buyer Reactions
There may initially be a number of reactions from buyers - they might claim that they are experts in their field and already have best pricing in the market, or they might claim there is nothing suitable to auction in a certain area. They might feel that e-auctions degrade the professional buyer in the eyes of supplier, or ruin the relationship of strategic suppliers. They might also consider the e-auction process itself to be expensive. It is a good idea to have an e-auction champion within the

organisation with the backing of the board to drive the e-auction programme forward and overcome such perceptions.

3b.IAdapt Supplier Findings

i. Supplier Benefits of Buyers' Auctions
- Ability to react to competitors' price
- Provides a visibility of competitors' market pricing
- Reduced negotiation process time
- Provides impetus to improve competitiveness
- Provides a more level playing field for suppliers

ii. Supplier Drawbacks of Buyers' Auctions
- Customer focused on price alone
- Supplier forced to focus too much on solving cost problems
- Reduces long term competitiveness of suppliers
- Drive down price below sensible economic level, if a supplier is determined to win the auction at any cost, or enters the auction not understanding fully the costs involved which make up their product/service
- Buyer becomes too dominant

iii. General Benefits to Suppliers
- Can obtain real time competitive pricing visibility at no expense by participating in the auction process
- Gives a chance to respond to market pressures
- Can reduce the cost of selling
- Can open up opportunities to bid for new business

In addition the IAdapt research established that 65% of suppliers who won contracts as a result of a buyer's auction believed that they won it on more than just price - only 22% of suppliers thought they had won auctions on price alone. All suppliers interviewed said they would continue to participate in buyer's auctions and over 65% of suppliers questioned thought that buyer's auctions would continue for the foreseeable future - at least the next three to five years.

iv. Benefits to Both Buyer and Supplier
- Transparency, highlighting the integrity of the buyers' sourcing decisions – as the e-auction results and awards are all documented and auditable, it should encourage the buyer to be impartial, and award results on the best bid
- Reduced lead-times, along with time saved within sourcing process, once e-auctions are established this can be considerable
- Availability of 'market price', by giving suppliers the opportunity to rebid, the true market value of the product or service should then be achieved
- Encouragement of suppliers to bid regardless of location – it will probably be simpler to involve suppliers abroad in the process
- Better standards of specification – in the absence of adhoc meetings with suppliers, the buyer is forced to improve written specifications to give suppliers an equal and communicated specification of what is required
- Best Value, rather than cheapest price - the technology now enables a range of factors to be considered as well as the 'unit price'

4. MAKING E-AUCTIONS HAPPEN IN A BUYING ORGANISATION

An e-auction programme is more likely to be successful following a successful pilot. To plan and deliver a pilot the success criteria of the pilot and the agreed number of pilot auctions should be established. The host organisation should consider if they have the expertise to conduct the auctions in-house, including hosting and supporting the software, training the buyers and ensuring third party support is provided as required, which might be for some or all of the process. Then a pilot schedule should be put together and executed, involving users and suppliers.

The results of the pilot and, once underway, the auction experience should be analysed to build internal justification for the programme. The auction programme should be established and agreed including the internal resource plan and budget.

4a. Running the Process

i. Initially
- Appoint an internal auction lead
- Select a commodity where you have sufficiently high demand and which has at least three suppliers capable of bidding
- It is sensible to consider an auction where price would be at least 25% of the decision criteria and where the award value is substantial, ie over £50K
- Communicate planned process for auction
- Research prospective suppliers
- Ensure specification for product/service being auctioned is as clear as possible
- Decide on selection criteria and go through Request for Information (RFI) process prior to auction
- Prior to auction eliminate suppliers whom you would not select for technical or other commercial reasons and shortlist suppliers. If there are less than three suppliers on the shortlist, there is probably not enough competition to make it worthwhile e-auctioning this product or service

ii Planning and Design
- Develop tender (specification and requirements for e-auction)

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- Decide and communicate on format of e-auction event, ie will there be RFI followed by e-auction, will suppliers be required to respond to a traditional/e-tender and then be invited to an e-auction event?
- Decide award criteria, ie lowest bidder wins, make it clear if the lowest price may not win
- Plan and agree timescales for live auction
- Design auction and develop bid strategy
- Agree e-auction rules, ie extensions, award criteria, etc
- Agree training and supplier communication so suppliers are all operating from a level playing field
- Select a time to run the auction that is to your advantage – but which allows all suppliers to participate

iii. Supplier Communication and Training

- Supplier briefing - brief supplier on process
- Spend a lot of time training suppliers so that they are commercially prepared
- Run dummy auction

iv. The Live Event

- Make live auction available to bidders
- Ensure bidders are logged on prior to auction
- Make sure you have a technical helpline open to your bidders throughout the live auction and that bids may be entered on their behalf if problems with technology arise
- Send out any agreed messages

v. Following the Event

- Assess responses against criteria
- Select winner
- Post auction negotiation (if required and specified in the rules of the e-auction)
- Inform participant of results
- Conduct feedback and see what lessons can be learnt

As with any sourcing process, value is only added if the negotiated conditions are really implemented and if internal users comply with them. It is recommended that readers of this paper also read the e-sourcing Topic Reference File, specifically the area of contracts and monitoring and managing suppliers and contracts.

5. THINGS TO AVOID;

- Do not allow suppliers to increase their bids
- Do not allow suppliers to participate if they have not been through a rigorous evaluation process
- Avoid a commodity or service that has constant price volatility, suppliers will probably be unable to commit to holding the prices for any length of time
- Do not allow suppliers who are technically or commercially inept to progress to the auction stage
- Do not bid yourself or enter a false supplier to bid to encourage a lower price, and be aware if you enter suppliers who you have no intention of awarding the contract to should they win, this will demotivate suppliers and have a detrimental impact on trust if they find out
- Do not hold an auction in a non-competitive environment
- If you state that the lowest price or the highest score in a multi-variable auction will win, do not then pick a different supplier to win the auction who has not achieved this
- In a multi-variable auction, display the position of suppliers taking into account all the criteria, and do not display price positions only
- Do not do post auction negotiation on a price only auction

6. THE RISKS

There are risks associated with the use of e-auctions. It is important that buyers and suppliers understand these risks so that their effects can be minimised. They include suppliers not being able to demonstrate the overall value of their product or service and oversimplification of requirements to 'fit the system'. Without effective change management and training of both buyers and suppliers, expectations may never be reached and inexperienced suppliers may bid below a sustainable price.

It is essential to have an e-auction champion with board backing, to drive through the initial e-auctions within a buying organisation, from which to gain experience. Without a champion, the programme may suffer from resistance from buyers and suppliers and may never progress.

If a supplier suffers from a bad e-auction experience (where a buyer may have done some of the things stated above in the 'things to avoid' section), then it is likely they may be reluctant to enter into the process again. Try to make sure, therefore, that before rolling out an e-auction programme, the process is as fair and transparent as possible, and has been approved by a pilot group including suppliers and that feedback from the pilot process is enacted on.

7. SELECTING AN E-AUCTION SERVICE

There is a range of software and service providers offering e-auction capabilities, these tend to fall into one of three camps;

1. As part of their functionality of their e-sourcing application eg* Emptoris, Oracle, Ariba etc
2. As part of marketplace functionality eg* B2eMarkets, Freemarkets, etc
3. Third party providers who provide licensed technology with consultancy

(*These are merely examples to aid understanding and

are not endorsements in any way, to view further suppliers of e-auction services view the Supplier directory in the Tech Zone area of the Supply Management website www.supplymanagement.com, or accessible through www.cips.org)

e-auction users should be aware of agreeing to pay a supplier a fixed percentage of savings (ie, 5%) if outsourcing the e-auction process as this could result in a considerable amount of money being paid to the supplier (it is not unheard of for the buying organisation to pay around £100k for one auction as a result of this agreement), it is probably better to negotiate a fixed cost for running the e-auction, regardless of savings.

It is recommended that people involved in the sourcing decision for an e-sourcing solution, read 'Finding the right solution: A Professional guide to eSourcing' Pathfinder guide available through the CIPS bookshop.

8. TO AUCTION OR NOT TO AUCTION?

i. Examples of commodities which may be suitable for e-auction

Stationery, marketing related printed material, electronic components, energy, workwear, paper, mobile phones, office furniture, computer consumables.

ii. Unsuitable products for e-auction

May include: complex machined parts, bespoke electronic assemblies, microprocessors, cleaning services, castings, in fact anything which cannot be largely specified, or where there is no competition in the market place.

9. SUMMARY

The IAdapt research found that e-auctions are almost always conducted at the end of an exhaustive purchasing process, with most buyers only inviting suppliers to bid that have passed a rigorous evaluation process. This process typically centres on a strong product or service specification, hence the result that a comprehensive specification was the most important enabler to a successful auction. e-auctions can, if conducted properly, both increase standards in the purchasing process and improve transparency, with buyers being more upfront about their requirements (the process forces buyers to be impartial, fair and really think about their requirements and procedures).

The research also found that the key objective within an auction-based negotiation is to develop a strong supplier relationship. 60% of buyer auctions are awarded to incumbent suppliers with only 22% of these suppliers reported to have won an auction on price alone. It would also appear that, by using an e-auction to obtain a competitive market rate, the buyer and supplier could now concentrate on contract execution.

The research further found that 65% of suppliers said that they thought buyer auctions would continue for at least the next three to five years. This is encouraging as, although there is still strong resistance to e-auctions from some suppliers, the research would suggest for suppliers who have been through the e-auction process, understand that process is about improving the total cost of the acquisition and is not a short term product/commodity price saving tool.

Although there are genuine savings resulting from e-auctions, it has been suggested that up to 7% of these savings can be attributed to an improvement in the purchasing process prior to the e-auction. It will never really be known what the quantifiable cost saving of a supplier being able to submit successively lower bids in order to win the auction is. It is the ability of the buyer to achieve this true market price that determines the extent of the savings.

Therefore, the actual savings of an e-auction will vary from case to case. Obviously in deflationary or tough economic times e-auctions will probably achieve better savings especially if it is the first time a product or service goes through an e-auction process. There can only be an estimation of the savings that would have been generated had the contract been awarded through the traditional purchasing process.

There are advantages to buying the e-auction expertise and software to host e-auctions in-house. Although initially expensive and time consuming, the ability to build upon an e-auction programme year on year, introducing an expanding range of products and services provided, does have its advantages. Many large companies who have introduced an in-house e-auction programme started off outsourcing the process to test the process and prove the process internally.

This paper will help buyers and suppliers gain a better understanding of how an e-auction should be conducted and the benefits and perceived drawbacks that this can bring. Buyers will recognise that, if they are willing to conduct e-auctions in a fair and transparent manner, they are a powerful tool to help achieve an improvement in the cost of their acquisition and purchasing process with no serious downside in supplier service levels.

It is recommended that anybody wanting to learn more about the e-auction process, consults the CIPS Public Training brochure, available online at www.cips.org.

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10. FURTHER READING

- 'Finding the right solution:A Professional guide to e-sourcing': available from the CIPS bookshop
- e-sourcing Practice Guide
- 'A CIPS Executive Guide to online auctions': e-business area of www.cips.org
- Iadapt Press Release: e-business area of www.cips.org
- 'Oracle Iadapt' :e-business area of www.cips.org

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