

# **The Online Auction: A Guide to Competitive Bidding in the Internet Age**

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## Executive Summary

The online auction has introduced competitive bidding to the Internet age. Traditionally, after receiving proposals from a limited set of known suppliers, purchasers undertake the time-consuming process of iteratively contacting suppliers, reducing each to the lowest possible price. The transparency of the online auction streamlines this competitive process, allowing negotiation to occur in real-time as suppliers butt heads, lowering prices to match one another.

After preparing an auction myself and discussing the process with supply chain management industry leaders, a consensus seems to be arising as to the future use of this negotiation tool. Besides saving time and introducing dynamic competition into negotiations, auctions serve as a one-time opportunity to drive down costs so that a relationship can be forged with the ultimate winner. Price discussions no longer need to be an annual event. Further, the auction opens the business opportunity to a global market, allowing the buyer to upgrade its supply base to only the most competitive players in the world. Finally, to match competitive prices suppliers must evaluate internal processes, driving out non-value-added activities (“Speaking of...”).

The critical elements to preparing and implementing a successful auction event are as follows:

1. **Commodity Selection:** The components selected for an auction must be purchased in a large enough volume to justify price analysis. There must be a large population of competent suppliers to create a competitive market. Components may either be standardized such that many suppliers can produce them or, alternatively, be customized to a degree that a long-term partnership would not be feasible. The key to success is that the use of the auction fits into the organization’s overall sourcing strategy.
2. **Internal Communication:** The sourcing strategy and goals of the auction must be clearly defined to all stakeholders. Senior management must outwardly support the auction and incentives must be provided to those with purchase order authority to utilize the auction’s resultant contract. An initial pilot program should be undertaken to build employee confidence in the auction and to ensure subsequent successes.
3. **External Communication:** Despite the likelihood of any angry reaction, incumbent suppliers must be provided with incentive to bid. The auction should be presented as an opportunity to gain a long-term relationship where price is not continuously revisited. Depending on the nature of the component, potential suppliers can be provided with a multitude of reasons to enter into a price-based negotiation process. All parties must clearly understand that price is only one element of the bid and that quality, service, warranty, and all relevant terms and conditions will be evaluated as well.
4. **Bid Comparability:** To ensure the integrity of the event, the RFQ must be extraordinarily clear such that all bids are comparable on a real-time basis. Terms and conditions should be set in stone such that a true “apples-to-apples” comparison between proposals can be made. All other variations between suppliers, such as costs of quality, should be offset through multipliers or add-ons that level the playing field.
5. **Process Ownership:** The buying company must take ownership of the auction process. While auction houses offer services including supplier qualification and screening, care must be taken in this area. The auction provider is in business to maximize the benefit of a single-day auction event. It does not have any motivation to build a long-term relationship based on reliable service. In fact, if it is paid on the basis of identified savings, the auctioneer may have incentive to introduce low-price, incapable suppliers.

## **Introduction**

The online auction, still in its infancy, is becoming a much more widely accepted and utilized tool by purchasing professionals. The rise of reverse auctions is due largely in part to the explosion of e-procurement. The world's 100 largest corporations plan to transact an astounding \$400 billion, or 25 percent, of purchases by the end of the year 2002 (Whyte). The majority of these companies will use reverse auctions as a strategically applied component of a larger e-procurement strategy. No one is able to accurately predict just how these auctions will effect buyer-supplier relationships. It is clear, however, that many companies are experimenting with auctions, developing strategies which allow them to reap the best of both worlds: cost savings and fewer, more mutually beneficial supplier relationships. While the following is by no means a comprehensive account of how auctions are being utilized it is indicative of an emerging set of best practices that leading edge corporations are using to successfully integrate online auctions into effective strategic sourcing strategies.

## **Commodity Selection**

Organizations pursuing reverse auctioning today are typically pilot testing the process on "low-hanging fruit," those commodities on which auctions can have an immediate impact and with which there is little chance of breaking a long-standing supplier relationship. The first group of commodities targeted is often maintenance, repair, and operating (MRO) items. Purchasers are finding it much more difficult to proceed into those production components which have a greater strategic impact on operations. Diane Brown, C.P.M., CFPIM, Director of Worldwide Procurement at J.D. Edwards says, "The challenge of online auctions is making sure we target the appropriate types of purchases for this technique." ("Speaking of...") Consensus among professionals does appear to be arising as to several characteristics of purchases that better lend themselves to the auction process:

**Significant Spending** As with any price analysis tool, the spending on the commodity, via either volume or price level, to be placed in the auction must be significant enough to justify the time commitment of preparing the RFQ as well as covering the fee paid to the auction provider. If the potential savings does not far outweigh these costs, there should be no motivation to employ this technique. While auctions are widely touted as a real-time solution, weeks and months must be invested by buyers, engineers, and designers to prepare the quote package and assess the capabilities of the potential supply base.

**Critical Supply Base** Two supply base characteristics must be met in order to ensure the successful implementation of an auction: the ability to switch suppliers and, beyond that, the existence of a critical mass of capable providers to comprise a competitive market. If the costs of switching suppliers due to capital investments, tooling incompatibility, imbedded systems, etc. exists, then resources would be better deployed to further develop the standing relationship. Unless competition can be introduced that will result in a savings relative to current total costs of ownership, the exercise is futile. Suppliers should not be allowed to bid based solely on price at the expense of quality, service, and lead times. All suppliers in the auction must be capable of meeting requirements for delivering on time and in the proper condition. A pure price auction that does not, in the planning stages, take into account other costs of maintaining a supplier relationship may have disastrous effects as the costs of quality skyrocket through numerous field failures and the resultant loss of customer goodwill.

**Commoditized Goods...** The reverse auction process lends itself readily to highly standardized components. These items tend to have minimal design and engineering specifications, which may require such highly specialized suppliers or capital investments that a competitive market can not be created. A large group of capable suppliers is much easier to identify and screen, speeding the RFQ process. Further, standard components will lead to fewer concerns about bids being comparable, as complex specifications often lead to variation between the items on which suppliers are placing bids.

**... or Customized Goods** Other organizations have taken a much different approach, placing customized, project-based components on the auction block. Standard products, according to these buyers' enterprise sourcing strategies, should be purchased through long-term, collaborative relationships with a focus on process improvement rather than price reduction. The commodities that these firms buy through auctions are those for which there is a one-time need to complete a specialized project. These types of purchases lend themselves well to auctions because long-term relationships are impossible to establish in such an environment. For these more engineered and specialized components, it is suggested that each supplier have a technical bid reviewed before the auction takes place. Such a review, performed by supply management and engineering professionals within the buying firm, will ensure the comparability of all bids by evaluating each supplier's proposed solution in relation to the performance specifications required. Doing so ensures that corners are not cut by utilizing lower cost materials and production processes at the expense of the performance expectations of the ultimate consumer. This strategy does overcome one of the primary concerns raised by those suspicious of the auction's benefits by preserving the supplier's creative capabilities. Engineers and designers from each potential supplier are given free reign to craft solutions to a problem, rather than being forced to design a product that meets the exacting specifications required for standardized components.

### **Internal Communications**

The auction process, because it is largely untested, requires a large amount of internal marketing to ensure its success. Without the support of senior management, engineering, and the actual signer of the purchase order, the results of an auction can be impossible to implement. As with any new procurement tactic, a pilot program can be a valuable learning experience that paves the way for subsequent expansion. The pilot should target a highly visible commodity purchased in a large volume such that the first event leads to a major cost savings. The larger the impact, the more aware the entire organization will become of the benefits of auctions and more encouraged sourcing employees will be to use the process for their purchase requirements (Ellram).

As with any initiative that breaks from standard operating procedures, the support of executive management for the auction process is critical. There must be a clearly defined mission statement for procurement activities. Communications must be open and frequent to increase each stakeholder's confidence in the process while reducing resistance to this unfamiliar form of competitive bidding. Auctions threaten current supplier relationships and, to most outsiders, seem in direct conflict with the relationship-based supply management techniques followed by most successful organizations today. It will be critical to be able to explain to all stakeholders how the auction fits into an overarching sourcing strategy (Sostrom).

A primary goal of the internal communication plan should be to present a single, unified face to all suppliers concerned, both potential and incumbent. By effectively communicating the strategies, goals, and logic behind the auction event, the likelihood of misinformation reaching the supply base is minimized. This is of particular concern because incumbent suppliers will often bypass centralized sourcing groups, preferring to interact directly with engineers and tactical buyers with more direct purchase order authority. A supplier will look to these groups to get specifications locked-in and to get competitive information that may allow it to influence the results of the auction. Suppliers will also need to contact engineers and buyers with questions on specifics regarding the RFQ as it prepares its proposal. If standard answers are not provided to each supplier, the comparability of quotes may be sacrificed. By keeping internal stakeholders in the loop, the integrity of the auction is much more likely to be maintained and all suppliers will remain on equal footing.

The most important group to obtain buy-in from for the ultimate implementation of the auction is those buyers that will be signing the purchase orders. Incentives, either financial or personal, must be provided for these buyers to make purchases from the contract forged with the chosen supplier. Lacking financial incentive, buyers will often revert to their current supplier, preferring the comfort of the status quo to the possible radical change that surrounds the auction's implementation. Kodak, in implementing partnerships, has successfully employed a "variance review board" to which buyers must submit applications with valid reasoning for not purchasing under an existing contract (Ellram and Edis). Doing so results in an assurance that the results of the auction will be implemented and that the potential cost savings are fully recognized.

### **External Communications**

**Incumbent Suppliers** Managing the relationship with a current supplier is of the utmost importance to ensure its participation in the auction as well as maintaining a consistent component supply in the time between the RFQ and the auction event. Any price analysis exercise must be the result of gaps found between the current supplier and the marketplace in terms of pricing, processes, or quality. The sourcing group should communicate these reasons for utilizing the auction to the supplier as it would in any competitive bidding scenario, be it either online or offline. The auction should never be used without a strategic reason or simply for the sake of exploring the price markets will bear. If the incumbent is meeting market prices and all "soft" costs are acceptable, the auction should not be taking place in the first place.

One message that must be understood by all parties, both internally and externally, is that the lowest bid does not win the business opportunity. Many other factors must be included in the decision-making process, including history, existing relationships, quality, service, scalability, and willingness to form an open partnership. In most auctions incumbents have a built-in advantage because switching costs must be applied in comparing bids. Half of all incumbents choosing to bid end up retaining the business (Richards). History and the incumbent's position on the learning curve must be respected in the analysis of bids to be fair to existing suppliers. By adding a factor to each supplier's bid to reflect estimates of these non-price cost elements, this point can be driven home quite clearly.

There are many messages that may be conveyed to gain an incumbent supplier's confidence in the auction process. Suppliers tend to react angrily to the announcement of an auction. The supplier is being forced to bid against a more geographically dispersed and economically hungry group of competitors, losing its ability to shield the buyer from a true understanding of market prices (Marlender). If there are multiple incumbent suppliers, the auction should be presented as an opportunity for the supplier to increase its "share of wallet". While the supplier tends to focus on the likelihood of losing business, the buyer must attempt shift its focus to the positive impact an auction can have on both volumes and the depth of relationship sought. The process can be sold on the gains that can be made by becoming a long-term source for a greater portion of the overall pie, allowing the selected supplier to tie increases in its volumes to the buying company's growth.

**Potential Suppliers** Potential suppliers have many incentives to bid in auctions, despite the fact that the process leads to margins lower than those sales made through traditional channels. Glen Meakem, CEO of FreeMarkets, a major auction services provider, best summarizes the benefits to suppliers, "Suppliers win by gaining access to new business, reducing sales costs, and getting a free benchmark to judge how they are doing competitively." Small manufacturers will covet the opportunity to sell to large firms directly, eliminating markups typically paid to distributors (Richards). Cost reductions can be realized as investments traditionally poured into sales and marketing are largely eliminated in the auction process. No longer are multiple sales calls necessary to simply get in position to bid on the next business opportunity. Chuck Dana, VP for Global Sourcing at Owens Corning, says, "What is important in the long run is for suppliers to spend less time selling themselves and more time thinking about how to solve Owens Corning's problems." By doing so, it can eliminate the non-value-added process of making cold calls and focus its resources on improving production processes, raising its chances of becoming a strategic partner to the buyer (Richards).

Buyers can provide further incentive to all bidders by making commitments and following through on them to protect the auction's integrity. Promising a long-term agreement with the "winning" bidder is an excellent means of providing incentive to participate. Suppliers will often offer lower prices based on the promise of an ongoing relationship because an assured customer is provided, enabling more customer-specific capital investments. Advances on the learning curve throughout the life of the contract may also be built into pricing by encouraging a long-term view. The buyer must also commit to purchasing each lot in the auction from a single supplier. There can be no "cherry picking" in which the supplier takes price breakdowns and selects the lowest-cost supplier on each and every individual item. This practice of buying only the low-margin portions in each bid package will quickly lead to an inability to find suppliers willing to bid in ensuing events.

### **Bid Comparability**

One of the most important elements of a truly competitive auction is that the bids received in real-time are "apples-to-apples" comparisons to other bids in the same lot. To do so, careful preparations must be made such that all bidders are absolutely certain of the product's

performance specifications and material requirements. A total cost of ownership approach should be taken such that bids reflect all relevant costs across the life of the business opportunity.

The request for quotation is the primary means of communicating these technical needs. Whenever possible, the RFQ and included drawings should utilize industry standards that can be easily understood by all parties. The use of proprietary drawings, internal codes, etc. will only lead to variability amongst bids, sullyng the integrity of the process. Typically, unclear requirements open the door for suppliers to cut corners to improve pricing at the expense of quality and/or reliability.

The RFQ should set in stone as many of the following terms and conditions as possible to preserve bid comparability: discount and payment terms, warranty periods, lead times and inventory requirements, currency denomination, FOB terms, and the like. By allowing each potential supplier to apply its own “standards” to its bid will necessitate multiple, difficult-to-predict adjustments to level the competitive playing field. Following the auction, these terms can be further negotiated with the selected supplier if there is a plausible reason for a deviation from the RFQ. For the purposes of the auction event itself, these terms must be equivalent. Discount terms and inventory requirements are especially important because they have a material impact on working capital investments. Greater discounts and/or shorter or more reliable lead times can free cash to be invested in higher-margin projects, effectively lowering the bid price vis-à-vis the competition. If each supplier applies its own discounts and lead times, prices shown during the auction will not reflect the true price paid.

For those characteristics that can not be equalized through specifications delineated in the RFQ, adjustments can be made to each bid in real time such that suppliers are competing on an equitable basis. Bids can be adjusted through a multiplier, adders, or both. A multiplier can be particularly useful in adjusting for foreign currency exchange rates. While it is easier to have all suppliers denominate bids in dollars, lower prices can usually be achieved by allowing bids in local currencies such that the supplier does not bear exchange rate risk (Locke). The buyer can then utilize any relevant hedging strategies to protect itself against rate changes over the period of the agreement.

Adders should be used for those terms, conditions, and cost elements that can not be accounted for in the RFQ, including costs of quality and the stage in the learning curve where each supplier lies on the component in question. All quality costs must be included if there is variation between suppliers: preventative maintenance, monitoring, internal failure, and field failure costs (Shank and Govindarajan). Adders should also be applied to all non-incumbent suppliers to cover any relevant switching costs. Other costs that may be candidates for add-ons include logistics, tooling investments, and ordering costs.

### **Process Ownership**

The buying company must take ownership of the auction process, not leaving critical sourcing activities to the auctioneer. The buyer is bound to live by the sourcing decision that arises from the auction. It must build, maintain, and preserve a long-term relationship with the selected supplier. It bears the risks of quality defects and late shipments if the supplier is unable to perform up to standards. The auction provider is in business solely to maximize the

effectiveness of the auction itself. It does not have a long-term incentive. Especially when the auctioneer's compensation is based on savings identified via the event, it has every reason to introduce suppliers that offer cut-rate prices at the sacrifice of quality and service capabilities. This leaves the onus on the buyer to carefully screen every supplier involved to ensure that it should be allowed to bid. The purchasing organization must actively seek capable suppliers by drawing on the experience of its employees and its industry knowledge rather than allowing bids to be made by an anonymous group of suppliers found in a database, sight unseen.

### **Future Directions**

As Geoffrey Colvin wrote in a recent article on online auctioning featured in eCompany Now, "The possibilities are so mind-boggling that we have no idea where web auctions are going, but we know for sure that the revolution is just beginning." Today, auctions are being used primarily for the purchase of MRO and other standard commodity goods. As Gary J. Kilco, C.P.M., Senior Purchasing Manager for Cargill, notes, "I fear that auctions will drive procurement back toward transaction-based activities." ("Speaking of...") Fortunately, it seems that companies are moving in the opposite direction, using auctions as strategic tools to drive costs out of carefully selected commodities and, in the process, optimizing the supply base.

More and more components that require detailed engineering and design support are being auctioned as organizations reach a comfort level with the ins and outs of online auctioning. As commodities auctioned become more strategic, the importance of supplier identification and screening will expand. Suppliers will need to not only meet today's demand but also be well positioned to meet ever-changing future requirements. As such, flexibility, scalability, and adaptability will become imperative considerations when determining who should and should not be allowed to bid (Tompkins).

One of the major barriers to utilizing auctions successfully will be preserving the impartiality of the selection process. Auctioning upsets the status quo both internally with purchasing professionals and externally with the existing supply base. Buyers are wary of any activity that threatens long-standing relationship, requiring well-reasoned justification for breaking from past practices. Suppliers view the process as a power play, squeezing already pencil-thin margins. A sure way to destroy the effectiveness of an auction will be to use it as a battering ram rather than as a strategic tool. Kimberlee Marslander shares this view, in writing, "Maintaining integrity in the process is considered to be the number one challenge of online auctions." In the absence of equitable practices it will become impossible to get either internal buy-in or outside participation, ruining the positive potential this process presents.

Today, one of the major services offered by the auction providers, in addition to software and supplier training for the actual bid process, is to identify and screen suppliers. As supplier capability assessments rise in importance, companies will tend to bring this function in-house to ensure more carefully scrutinized management. The auction provider may be left solely with the responsibility of selling software and training suppliers on its use. It is feasible that major organizations may even insource this activity, developing programs configured to meet highly specific sourcing needs.

The online auction appears as if it is here to stay. It is rising in importance as a strategic tool used to increase competition and accelerate the bidding process. While every organization seems to be using it in a different manner, there is a growing base of best practices and success stories from which newcomers can draw important lessons. According to Dr. Phillip L. Carter, Director of the Center for Advanced Purchasing Studies, an expert on the future of e-commerce and supply management, there is no way to determine the optimal auction strategy. There is, however, a surefire way to lose. He summarizes his assessment of the future in saying, “a clear losing strategy is to do nothing.” The most important lesson is that companies must develop a sourcing strategy for the enterprise, assess how the auction fits in to that strategy, and gain exposure to the process. The potential for reduced prices and an optimized supply base achieved through auctioning is far too great to ignore. Now is the time to experiment with the process and learn how it can work within your organization. The only alternative is to watch your competition learn the process first and gain a competitive advantage. Don’t let them reap the benefits while you play catch up.

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