



New South Wales Government

## **NSW Government Procurement Guidelines**

# **Reverse Auctions**

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These guidelines were prepared by the NSW Department of Commerce for the NSW Government. They are available from the procurement process maps on

<http://www.treasury.nsw.gov.au/procurement/procure-intro.htm>

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## Related Guidelines

[NSW Government Procurement Policy](#)

[NSW Government Code of Practice for Procurement](#)

[NSW Government Tendering Guidelines](#)

## Related Instruments

[Public Sector Employment and Management Act 2002](#)

[Public Sector Management \(Goods and Services\) Regulation 2000](#)

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# 1 About this guideline

This guideline will assist NSW Government agencies use internet-based reverse auctions as a method of procurement.

Electronic commerce has the potential to contribute significantly to the procurement process. Agencies are to adopt innovative procurement methods where these may achieve the best value for money, so long as the methods comply with the expectations and principles of the NSW Government procurement policies, relevant legislation, and are appropriate to the circumstances.

This guideline applies on a whole-of-government basis. It is the responsibility of individual agencies to develop detailed procedures, consistent with these guidelines, which reflect the agency's internal delegations, particular needs and circumstances. For [Schedule 1 agencies](#), as defined by the [Public Sector Employment and Management Act 2002](#), instructions issued by the [State Contracts Control Board](#) (SCCB) on the use of reverse auctions will apply.

In future there may be new value-adding features or changes made to the way reverse auctions are conducted. Agencies are to exercise prudence when assessing the suitability of accepting these features or changes.

## 2 What are reverse auctions?

One of the key strands of the [NSW Government Procurement Policy](#) is to improve the procurement process by streamlining and re-engineering procurement processes, and reducing the cost of doing business. Electronic commerce, including the use of reverse auctions, has the potential to contribute significantly to achieving these goals.

The internet allows buyers and suppliers to come together in real time, and to use dynamic pricing models for procurement purposes. Examples of dynamic pricing models include:

- auctions - where buyers bid for the right to purchase
- reverse auctions - where suppliers bid for the right to supply
- consolidated purchasing - where many buyers combine their requirements and negotiate on price with a supplier. The price decreases as the combined requirements increase.

Government agencies are familiar with traditional auctions, for example as used by the Government to dispose of motor vehicles. These involve a single supplier and many buyers. The supplier's objective is to use market forces to drive buyers to raise the price of purchase.

In a reverse auction, there is a single buyer and many suppliers. In this instance, the objective is to use market forces to drive suppliers to lower prices. The buyer indicates its requirement, and suppliers progressively bid lower prices to win the right of supply. This guideline specifically relates to real time reverse auctions on the internet.

While the specific process and rules of reverse auctions can vary, the process generally involves the buyer posting its requirement (including product description, delivery and warranty specifications, and terms and conditions of supply) on the internet. The buyer also notifies suppliers of the starting price, date, time and duration of the reverse auction.

To participate in the reverse auction, suppliers log onto the auction site on the internet. During the reverse auction, suppliers can see the current bid and make lower bids if they wish. At the close of the reverse auction, the bidder offering the lowest price usually wins the right of supply.

Internet-based reverse auctions are a relatively new method of receiving competitive prices from suppliers. The private sector is adopting reverse auctions, taking advantage of this new trading opportunity, and many organisations claim cost savings and increased efficiency as a result of the process. However, there is only limited information currently available regarding the extent of private sector use, and the actual results achieved.

## 3 When to use reverse auctions

Reverse auction is another procurement method available to NSW Government agencies. Agencies should consider the use of reverse auctions only when it makes good business sense to do so.

Reverse auctions could be used in the following situations:

- as part of the tender process, where there is no panel, period or common use contract in place
- as a means of obtaining quotes from suppliers on an established panel, period or common use contract
- as the second stage of a two-stage tender process, where price is the remaining selection criteria.

Where there are panel, period or common use contracts in place, and reverse auctions are used to obtain quotes:

- reverse auctions must be restricted to the suppliers on contract
- all suppliers on contract must be given equal opportunity to participate in the reverse auction
- the contract pricing must be on the basis of 'not to exceed' or 'ceiling' pricing
- the contract should allow for spot, volume or project pricing.

When establishing new contracts that will include the use of reverse auctions to obtain quotes, the terms and conditions of those contracts must indicate the use of reverse auctions and stipulate the appropriate pricing basis.

For existing contracts, review the contract wording to determine if such a procurement option is possible. Existing suppliers should be informed of the introduction of reverse auctions before this method of procurement is used.

## Type of goods

The use of reverse auctions is to be restricted to the procurement of products or commodities with little or no value-added or service component. Suitable products have the following characteristics:

- very strict and unambiguous specifications that ensure homogeneity
- a competitive market
- primary selection criteria is price
- no or limited impact from whole-of-life costs or consideration
- no services or added benefits specified in the requirement, for example there must be no labour hire component such as a requirement for installation services.

Products or commodities which may be suitable include:

- primary building products (eg iron ore, road aggregate, building materials, copper tubing)
- standard information technology equipment (eg specified desktop computers, shrink-wrapped software, modems, toner cartridges)
- photocopy paper
- energy, electricity, coal or gas
- chemicals and possibly pharmaceutical products.

## Nature of the procurement

Some other factors that could affect the suitability of using reverse auctions include:

- the total value of the procurement
- the nature of the supplying industry.

There are costs associated, both to agencies and suppliers, in conducting and participating in reverse auctions. For example, a procurement with the value of \$5,000 may not justify the time and preparatory work required by a supplier to participate in a reverse auction. Similarly for agencies, the potential savings which a procurement of this value might realise may not justify its use. Generally, the higher the value of the procurement, the greater the potential for realising savings.

The nature of the market and industry also affect the potential savings that could be realised in a reverse auction. Consider factors such as the number of suppliers, capacity of suppliers, demand for the product, and also the margin structure of the product. If the market works on very low margins, the potential for savings would probably be minimal (unless countered by a high volume).

## **Applicability to NSW Government procurement policy**

The key objective of the [NSW Government Procurement Policy](#) is for government agencies to realise best value for money in their procurement. Value for money includes all factors relevant to a particular purpose. Value for money does not automatically mean the 'lowest price'.

It includes:

- the cost of the goods and services
- costs for the life of the product
- innovation and value-adding components, such as meeting the Government's economic development, social and environmental policy objectives, where appropriate.

While the policy sets the direction and objectives for Government procurement, the appropriate Government objectives, the selection criteria and their respective weighting for assessing value for money are determined by the procuring agency. It is important that agencies are clear about how value for money should be determined in any particular set of circumstances before assessing tenders. The [NSW Government Code of Practice for Procurement](#) establishes the principles and standards expected of NSW Government agencies and service providers wanting to do business with the Government.

As reverse auctions are assessed primarily on price, the use of pre-qualified or pre-approved suppliers can address non price factors such as economic, environmental and social objectives and compliance with the Government's procurement codes.

The [20% ANZ Price Preference Margin](#) and the [Country Industries Preference Scheme](#) are also applicable in reverse auctions. Consider these margins either during a pre-approval or pre-qualification process, or at the reverse auction stage. If considering preferences at the auction stage, the terms and conditions of the auction must indicate that these preferences will be considered in addition to the bid prices. The reverse auction process must also allow for the imported content to be ascertained.

# 4 Benefits and risks of reverse auctions

## Benefits

There are a significant number of companies providing reverse auction services, and claiming significant benefits for both buyers and suppliers. Some of the benefits that are relevant to Government are:

- utilising a new procurement option that is increasingly used by the private sector
- keeping up with changes in technology and business practices
- achieving a competitive market price, and substantial cost savings through dynamic and real-time trading. Cost savings could be the result of increasing competition, or optimising market conditions such as surplus inventory in the market place or excess production capacity
- gaining better knowledge of the market
- allowing bidders multiple opportunities to offer a price
- reducing the procurement time cycle and increasing efficiency through real-time process
- opening up the government market by improving access to regional suppliers
- reducing administrative and transaction costs for both buyer and supplier. (Having less paperwork simplifies the tendering process.)

In addition, suppliers have indicated that the reverse auction process is transparent and fair, as all bidders have knowledge of the bids being offered, and suppliers have a good idea if they have been successful at the close of the reverse auction period.

## Risks

The use of reverse auctions poses certain risks to Government. The way Government does its procurement differs from the private sector in certain aspects. Government agencies must follow policies and regulations, and meet the expectations of the community. Below are some of the possible risks that the use of reverse auctions might pose and the approaches that could mitigate the impact of these risks.

### Relatively new process with no proven history

Agencies should take a prudent approach to the use of reverse auctions. For example, using the method on a trial basis.

### Reverse auctions focus predominantly on price

Reverse auctions have a limited ability to deal with non-price based selection criteria. For instance, government procurement needs to demonstrate obtaining value for money, which includes additional factors such as economic, social and environmental objectives. Reverse auctions may also fail to apply relevant Government policies where there is a legitimate expectation that the policies would be applied. Nor do reverse auctions assess the financial capability and capacity of suppliers to meet procurement requirements.

The use of pre-approval, pre-qualification or two-stage procurement processes overcomes these risks. Evaluate suppliers on the necessary non-price criteria. Pre-approve or pre-qualify suppliers through expressions of interest, period, panel or common use contracts on the relevant criteria. Reverse auctions then become the final stage, where price is the final determinant.

### Unsuitability for purchase of services or products with 'value added' features

The evaluation of different value adding services is difficult where the focus is on price. It is also difficult to compare and evaluate solutions, especially if there are innovative solutions offered.

Only use reverse auctions to procure products that are readily defined, and where price can be the primary or final determinant in the selection process.

### The perception that Government is condoning opportunistic buying

It may be considered that the Government and the procurement process puts undue pressure on suppliers to reduce prices. Savings may appear to be from aggressive or 'loss leading' prices to gain access to the government market.

Agencies should be aware of market prices, and question any unrealistically low prices.

### Risk of supplier collusion

If bids are visible to all suppliers, suppliers may not offer their best price, especially if there is insufficient competition.

Agencies must have sound pre-auction estimates, and must ensure a suitable level of competition.

### Possible 'bid shopping'

Bid shopping is the trading off of different tenderers' prices against one another in an attempt to obtain lower prices. This is unacceptable in government procurement. The reverse auction process, which involves bidders progressively offering lower prices, may be mistaken for bid shopping.

However, in bid shopping it is typically the buyer who actively seeks a lower price from a supplier by privately revealing the price offered by another supplier, without the knowledge and consent of that supplier. In the reverse auction process, the bidding process is transparent. All participants are provided with, and have access to, the same information at the same time. Agencies must inform suppliers that the reverse auction process will be used.

Aggressive pricing may increase the risk of buying 'seconds' or 'dumped goods' from local and overseas suppliers. Terms and conditions must require that the quality of goods be certified before payment, and stipulate that dumped goods are not acceptable.

### Reverse auctions may favour large organisations

There may be a perception that large suppliers, which have surplus stocks, production capacity or financial capacity, and which have the necessary infrastructure and skills to participate, have an advantage in reverse auctions. There is also the possibility of cutting out the layer of supplier (middleman) between the manufacturer and the retailer, which does not support the Government's goals for regional and local industry, and small to medium enterprises (SMEs). Reverse auctions may be potentially damaging for local or regional retailers and SMEs.

Government agencies should invite regional and SMEs to participate, and factor in considerations for them at the pre-approval and pre-qualifying stage.

### Disadvantaging suppliers with infrastructure and internet limitations

The process may disadvantage regional suppliers due to infrastructure limitations (eg internet access, response times). It may also disadvantage smaller suppliers who do not have the resources to respond to this online form of market.

Online hardware and software requirements are minimal. A personal computer, web browser and internet access are required. However, reverse auction providers should offer alternative means for suppliers to offer bids (eg by phone). Auctioneers must provide instructions to suppliers, if required.

#### Revealing unsuccessful tenders

The disclosure of contracts awarded in government tendering does not permit the prices of unsuccessful tenderers to be revealed.

As reverse auctions make known all bids, participating suppliers are to be made aware in advance that the prices offered are known to all participants.

#### Reliance on information technology

There is a risk from technical failure.

Reverse auctioneers must have back-up systems and contingency plans. Suppliers should have the option of phoning in bids if their computer system fails.

# 5 Reverse auction service providers and their responsibilities

The reverse auction process may be conducted by an agency itself, using licensed software, or contracted to a provider of reverse auction services selected through a competitive process.

## Service provider responsibilities

The responsibilities of the reverse auction provider outlined below apply whether an agency uses an external provider of reverse auction services or conducts the auction itself.

The responsibilities of the service providers are to:

- invite suppliers to participate
- provide notice to potential participants
- provide assistance to suppliers on how to participate
- host the auction website
- conduct the reverse auction bidding process
- provide support to bidders during the reverse auction, if required
- provide a service to accept phone bids from bidders, which are then entered into the online auction process
- maintain IT systems that are secure and have appropriate back-up systems, for example an alternative website
- operate IT systems that can adequately cope with the potential online traffic
- notify participants of outcomes.

The reverse auction service provider must also maintain a management reporting system, which is capable of providing:

- a report of all transactions, including phone bids, that transpired during the reverse auction (required as part of the agency's record keeping obligations)

- statistics (eg number of bids, average decrease of bids, and variance from estimate), if required.

The reverse auction service provider must manage the electronic records. As the provider is managing an aspect of the procurement process on behalf of the agency, and as the process is conducted electronically, it is vital that both the provider and the agency have appropriate systems for managing electronic records. In order that there is reasonable certainty that the electronic records will satisfy evidentiary requirements, there must be:

- a systematic approach to electronic record keeping
- an adequate security infrastructure for the electronic records.

## **Commissions**

Private sector providers of reverse auction services usually charge a commission for their services. The form of the commission varies. Common examples are:

- a percentage of the successful auction price, payable by the successful bidder and/or the agency
- a flat percentage, payable by the agency, which the agency and reverse auction service providers agree to in advance of the anticipated savings
- a flat fee and/or a percentage commission of the successful reverse auction price, payable either by the agency, supplier or a combination of both.

Agencies should factor the amount and form of the commission into any analysis of savings. As the commission structure can greatly impact on the price offered or payable, agencies must give this serious consideration when selecting a provider of reverse auction services.

The provider should also be advised that the commission structure is to cover all charges such as advertising, insurance, administrative fees, connection time costs and miscellaneous charges. No charges above the agreed commission should be paid.

# 6 Conducting a reverse auction

Typically, the reverse auction process is as follows:

1. define the requirements
2. determine a reverse auction price estimate
3. identify and select potential suppliers
4. notify suppliers of requirements, terms and conditions
5. conduct the reverse auction
6. select the successful supplier and place the order
7. conduct post-auction evaluation.

## Pre-reverse auction price estimates

As with the traditional tendering process, the agency should determine an estimate of the price of the goods to be procured. The estimate should reflect the agency's best assessment of the current market value for the goods. The starting point for the reverse auction is typically based on this pre-auction price estimate.

The importance of a pre-auction estimate can be seen in the case when only one bidder participates in the reverse auction and offers a price similar to the pre-auction estimate. The agency could be obliged to accept the bid, unless there are legitimate reasons not to do so.

In such an instance, the agency should assess the reasons for the lack of participation by other suppliers. For example, in a recent reverse auction conducted in the private sector, the lack of participation by suppliers was attributed to an unrealistically low starting price.

## Identification and selection of potential suppliers

Reverse auctions use market forces to drive suppliers to lower prices. It is assumed that the greater the number of suppliers invited to participate in the reverse auction, the greater will be the level of competition and hence better prices realised for buyers. The optimum degree of competition will vary with circumstances, including the

nature of the market, and the value of the procurement. The degree of competition should increase with the value of the procurement.

Whilst reverse auctions can be conducted in an open market to all suppliers, or limited to a number of pre-selected or pre-qualified suppliers, the preferred approach is a two-staged process where the agency pre-selects or pre-qualifies suppliers on criteria such as financial capability and ability to comply with the Government's economic and social objectives. The second stage would be the reverse auction itself, where price is the remaining selection criteria. It is not recommended that Government agencies conduct reverse auctions in the open market.

The selection of suppliers to participate in the reverse auction process is always the responsibility of the procuring agency, and never delegated to an external provider of reverse auction services (if one is used). If conducting reverse auctions with suppliers on a period, panel or common use contract, then all suppliers on the panel must be given equal opportunity to participate in the reverse auction. Agencies must ensure that any period, panel or common use contracts have a sufficient base of suppliers to facilitate a competitive process.

### **Advance notice**

Adequate advance notice of the reverse auction is to be provided to enable suppliers to ascertain if they should participate in the reverse auction or to determine their pricing strategy. Advance notice should stipulate:

- the procuring agency
- all requirements, including any delivery requirements
- the date, time and location (website) of the reverse auction
- the number or name that identifies the procurement (eg lot number)
- all terms and conditions of the reverse auction process
- all terms and conditions of the purchase, including the obligations of buyers and suppliers
- the basis on which offers are evaluated and selected
- that the final decision rests with the agency.

The length of advance notice should reflect the nature of the procurement. For example, if the product has a long manufacturing time, the supplier may require more time to ascertain if the requirements can be met.

### **Duration of the reverse auction**

Typically, a reverse auction is open for bidding for a fixed duration of time. The duration of the auction should reflect the value of the procurement, the greater the value of the procurement the greater should be the duration of the auction. In some reverse auction formats, the closing time of the auction is automatically extended if a bid is received in the last few minutes. As a general rule, this form of reverse auction should not be utilised, as it can be seen as placing undue pressure on bidders to lower prices. It could also disadvantage bidders who may have allocated a fixed period of time to attend the reverse auction. However, it may be considered for very high value procurements.

### **Providing information during the reverse auction**

The reverse auction website should display:

- the number or name that identifies the procurement (eg lot number)
- the starting price for the reverse auction (as determined by the agency)
- the number of bidders
- the current bid
- the time remaining for the reverse auction.

The reverse auction system should not allow the identity of bidders to be made known to one another.

### **Accepting an offer**

The agency must satisfy itself that the best offer is accepted. The terms and conditions of the reverse auction should always indicate that the final decision to accept the offer rests with the agency. This will allow the agency to ascertain if the product meets the standards required.

The final decision clause also provides the agency with the opportunity to apply any appropriate preference margins, after the imported or regional content of the product is determined. Unless there are reasons not to do so, the lowest price offer, after the application of preference margins, should be accepted.

# 7 Post reverse auction action and measurement

## Adherence to the stated requirements

Agencies should adhere to the requirements stated to suppliers, and not change the quality, quantity of the goods required, the delivery conditions or payment terms.

## Failure by the supplier to proceed

Before an order is placed with the selected supplier, agencies should seek confirmation from the supplier that it is able to proceed with the supply. If, for legitimate reasons, the supplier is unable to proceed in meeting the order, the agency should approach the supplier offering the next best value-for-money bid. The terms and conditions of the reverse auction should include a statement for this provision.

## Disclosure of information

[Premier's Memorandum No 2000-11](#), *Disclosure on Information on Government Contracts with the Private Sector*, details the information that agencies must disclose following the award of contracts.

## Evaluation of the reverse auction process

As the reverse auction process is relatively new, it is essential that its use be evaluated and its suitability assessed. Areas to evaluate include:

- the variance between the pre-auction estimate and the auction prices
- the performance of the reverse auction service provider
- the performance of the successful bidders in meeting the requirements
- a cost-benefit analysis of using reverse auctions compared to traditional procurement options.

## **Accountability and recording keeping**

It is expected that agency procurement personnel will be aware of their responsibilities and be able to account for their actions and decisions. Procurement personnel must keep logs of the process and records of all procurement decisions, including reasons for recommending and deciding on the selection and rejection of offers. These records must be kept in a manner that facilitates audit and other normal processes of accountability, and retained in accordance with government or agency requirements.