

## "Reverse auctions - not just about cost? I'd like to see that."

So spilled the words of Jonathan Dutton, CEO of CIPS Australia. My suggestion that reverse auctions are not just a rude and callous way to beat suppliers into submission and possible bankruptcy was met with a healthy dose of scepticism. This is not an uncommon point of view amongst procurement professionals.

Certainly cost reduction is the glistening prize that attracts initial attention. With touted savings averaging between 10% and 20% better than that achievable by mere mortals alone, and individual auctions achieving 30, 40 and 50%, who cares about anything else?

Over the past 5 years, the use of reverse auctions in North America and Europe has sky rocketed in both the private and public sectors to the extent that it is now widely accepted as a standard procurement tool. In Australia and New Zealand, usage has tended to be limited to multinational subsidiaries and the resources sector with limited or sporadic use in all other sectors. However, signs of life in Australia and New Zealand are beginning to emerge.

### ***A good negotiator can do just as well - True***

There is no doubt that, given sufficient time, a skilled procurement professional can equal or better the results achievable through reverse auction. And therein lays the rub, time. The following example, witnessed by a colleague at the close of a reverse auction is fairly representative:

*Having just watched a 7 supplier, 40 minute auction achieve significant savings the excited CEO asked the buyer "How long would that negotiation have taken without an auction?" Buyers reply: "It wouldn't have happened. I would only have had time to deal with the incumbent and maybe 1 or 2 others."*

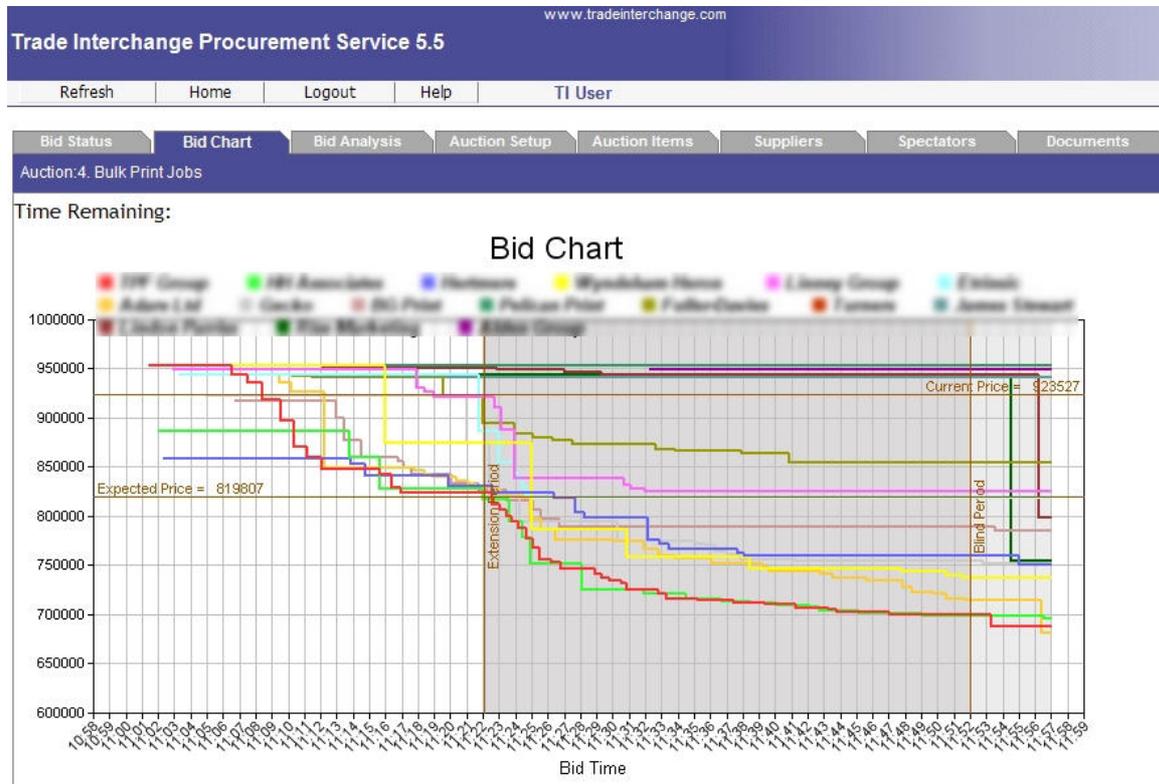
This scenario is not unusual and highlights the pragmatic approach that has to be taken by procurement professionals when allocating and prioritising their scarcest resource, time. But there is a downside. Shortage of time often results in a premature negotiation conclusion and a less than ideal breadth of suppliers. This in turn prevents the buyer from reaching the ultimate price achievable. One could argue that this is a hidden cost that the organisation pays for underinvestment in the procurement function. So whilst it is certainly true that experienced buyers are capable of matching or beating the results achievable through reverse auctions, to the frustration of the committed buyer, it often fails to materialise due to limited time and other organisational pressures.

***Over the past decade, the number of Australians working more than 50 hours a week has increased by 36% for males and 77% for females.***

*Source: Australian Bureau of Statistics. 4102.0 - Australian Social Trends, 2006*

## The more, the merrier

Take a look at this chart of a recent auction for an annual print contract:



This is the bid chart as seen by the buyer. Each coloured line represents the live bids made by prospective suppliers. Suppliers (bidders) see only their current position in the bidding (1st, 2nd, 3rd etc).

The opening bids are on the left of the chart. This usually represents the quotations received as the result of a tender or some kind of request for quotation.

In this auction, there are 16 prospective suppliers (their names are blurred for confidentiality reasons). Each of them has been pre-qualified as a viable supplier for this contract. However, you can't negotiate with them all, there just isn't time. You have to do some culling and make a shortlist of say 3 or 4. Your shortlisting criteria will probably be a combination of qualitative factors and their submitted quotations.

When seen in this light, the issue becomes clear. The culling process has unavoidably taken place on the wrong side of the price negotiation process. An important part of the evaluation criteria, price, was based on the price the supplier would like to receive rather than the price they were willing to sell for. Would red have made it into your shortlist?

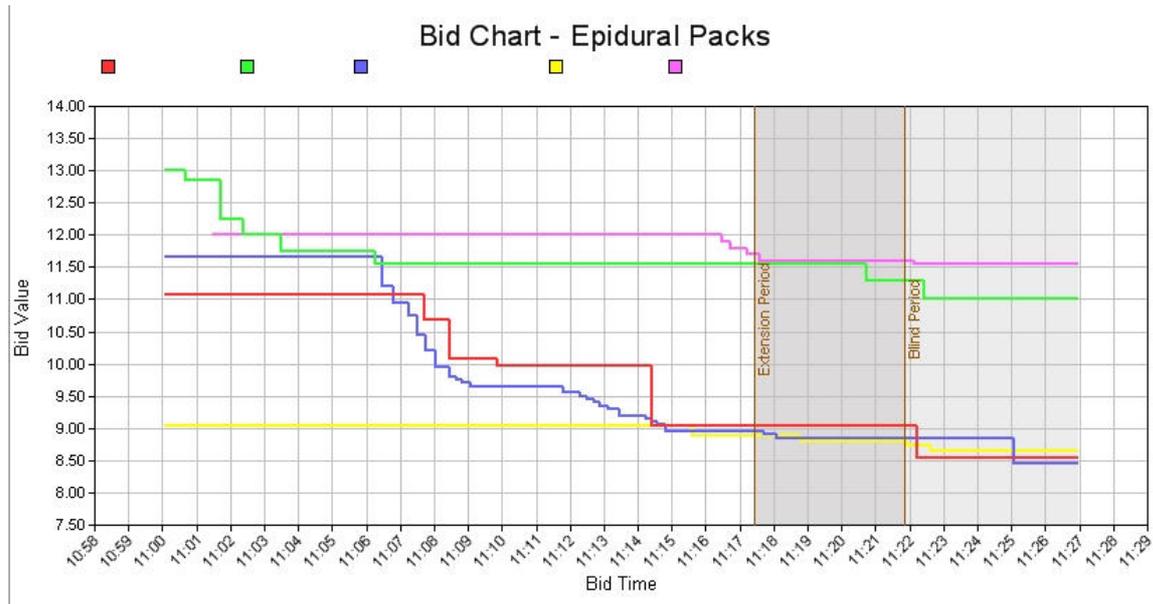
***This process allowed HPV to efficiently deal with a larger field of quality suppliers and achieve the best possible price without having to compromise on quality.***

*Source: Reverse Auction Case Study, Health Purchasing Victoria and Portland Group.*

Whilst 16 is a large number of suppliers, even for a reverse auction (4-6 is typical), the price negotiation takes the same amount of time and effort as it would if there were only 3 or 4 suppliers. In this case it took about 1 hour to solicit more than 150 offers across 16 suppliers.

### Greater choice

Some suppliers seem to come in so far off the mark that they exclude themselves from further consideration. The following bid chart for epidural packs highlights the identification of true market price as suppliers hunt for the leading position.



The opening bids are the result of a traditional quotation process. As can be seen, the ultimate result of this auction made only a very minor price improvement when compared with yellow's pre-auction offer. However, whereas prior to the auction yellow was the only game in town, by the end of the 30 minute exercise there were 3 suppliers within a very tight range. This common effect of clustering around true market price gives the buying organisation greater flexibility and more choice with less need to compromise on the qualitative aspects of the contract.

***'e-Auctions effectively allow for an infinite number of bid re-submissions by suppliers in an open and competitive environment, at a relatively low overhead cost. This turns the concept of a 'true market price' into a reality...'***

*Source: What are e-Auctions... and how to get started. UK local government guide.*

### Personal protection and the question of probity

High standards of probity are important in all business dealings. However, the procurement function exposes individuals to the risk of inadvertent probity breaches or accusations of unfair dealings on such a regular basis and to such an extent that it is a minor miracle that anything gets purchased.

For public sector procurement, probity is the highest order consideration. All it takes is for a disgruntled supplier (curiously this is rarely the successful contract winner) to take their complaint through political channels and the organisation suddenly has twice as much work to do as they review, investigate, document and report every interaction and justify every decision.

As a result of this, the default approach for many public sector organisations and their procurement professionals is not to negotiate once tender responses have been received. This provides the highest level of safety for both the individuals and their organisations. But, safety comes at a price: As we have seen earlier, there is often a considerable difference between the price the supplier would like to receive and the price they are willing to sell for. Further, we've also seen the importance of clustering suppliers around true market price in order to provide a greater choice of supplier for the buying organisation.

*"Our first use of Reverse Auctions in an area of traditionally very challenging suppliers proved to be a delight. Not only were we able to confirm the value of the process by achieving better than expected savings, we also received an unexpected (but in hindsight logical) bonus of added transparency and high level of probity. The exercise was remarkable for the unquestioning acceptance by participating suppliers of the results. The process was tamper proof and seen as such by some very hard headed if not cynical suppliers. Quite an achievement."*

*Source: Gabe Furlan, Project Manager Supply Services, NSW Health.*

The massive growth in the use of reverse auctions in the public sector in Europe and North America is driven in large part by the high probity levels and the ability to negotiate in relative safety. There are a number of unique aspects of reverse auctions that help to provide this level of protection:

### ***The buyer as observer***

The reverse auction price negotiation process takes place between the suppliers. The buyer is merely an observer and does not participate in any way. This separation can be extended further by restricting buyer access to bidding details during the live auction. Methods include hiding the suppliers' names, viewing in a 'locked down' room with no phone or other access to the outside world, the presence of a probity advisor or no access until the conclusion of the event. The use of a third party reverse auction provider also increases separation and, because of this, is the preferred approach for the public sector in the UK.

### ***On the record***

Because it is an online process, every interaction is securely recorded. This includes every bid and its submission time, any instant messages that may have taken place and all auction set up parameters and criteria. On conclusion of the auction, a full auction report is immediately available and can be sent as a secure PDF record to appropriate parties such as an independent probity advisor. The data then remains as a permanent record of the negotiation on the reverse auction system. Should there be a dispute regarding the

negotiation, all of these safeguards provide a non-repudiable audit trail that will stand up to scrutiny.

### ***Transparency and fairness***

Because of the on-line presence of all suppliers, they all receive exactly the same information at the same time. The computer is cold and heartless and incapable of favouritism. The skilled relationship salesperson is stripped naked (just during the auction and in the privacy of their own office) as the power shifts to the market and away from the performance of individuals.

### ***Quality and value for money***

Yes, reverse auctions are transparent and fair but surely all they do is strip the price to bare bones. What about quality and value?

Whilst it is true that the primary focus of reverse auctions is price negotiation, this does not mean that quality, or value for money, are ignored. The most common scenario is that the results of the auction are combined with the qualitative ratings after the auction has concluded to produce the final winner. All the reverse auction has done is to ask the question 'and now, what is your best price?'. The qualitative elements are just as important as they always have been and not diminished in any way by the price negotiation method.

A fully specified tender document can mean that value or qualitative ratings can be applied during the live auction. This can enable a 'first past the post' auction where all price, value and quality factors are calculated instantly and reflected in the positions of the bidders.

The incorporation of qualitative factors act as either absolute weightings (eg \$50,000 cost to switch suppliers) on the total contract value or percentage weightings (eg weekly Vs monthly deliveries worth 0.5%) on each bid and can be set at different levels for each supplier.

In fact anything that can be represented numerically can be reflected in the auction including items such as payment terms, lead times, local content, incumbency, returns policies, delivery points, recycling and carbon credits.

### ***And so to the suppliers***

For suppliers its love / hate. Comfortable incumbents hate it, previously excluded suppliers love it.

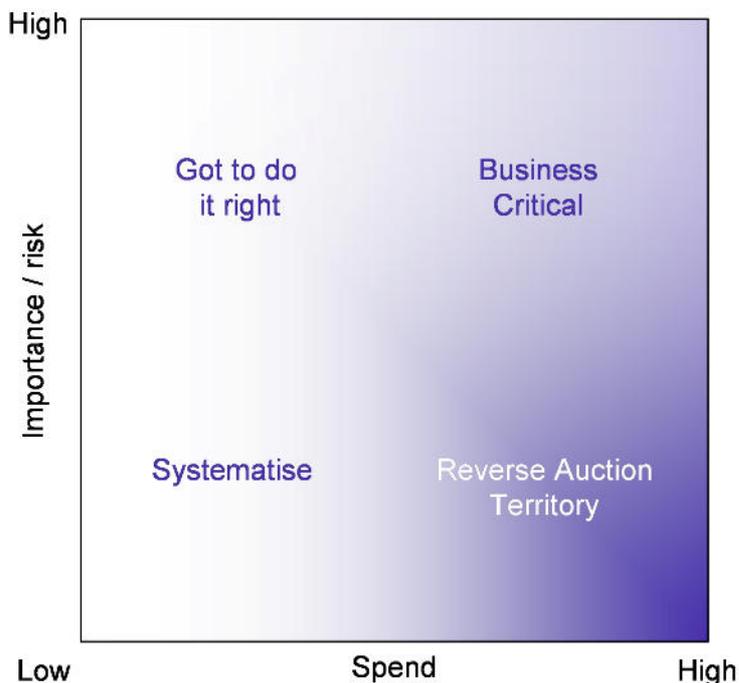
In general, suppliers find the process fairly nerve-wracking. It's short, intense and millions of dollars worth of business can hinge on the outcome. But even if they aren't successful, they can learn a lot about where they sit competitively.

In submitting a quotation as part of a tender or some other process, a supplier has to perform a balancing act between the price they'd like to get for their products and services and their level of desire for the business. If they get it wrong they can be eliminated in the first round. With a reverse auction they can immediately see where they sit competitively. At no time can they see the names or bids of their competitors but they will see their bid position (1st, 2nd...6th, 7th etc). Depending on the auction set up, they may even see their price difference compared with the leading bid.

As they improve their offers, their position changes. The usual pattern is that the suppliers will make a series of lower bids in an effort to gain 1st position. The lead can change hands many times, ultimately settling on the true market price for a particular supply with that particular group of suppliers. For the supplier that has exhausted their bidding capacity and finds themselves in 6th or 7th place they have some serious thinking to do about their organisation and their capacity to compete. It is a very clear and tangible signal that is often used by salespeople or agents to go back to their management or supplier to trigger review and change.

### ***Not right for every situation***

Reverse auctions are not suitable for every situation. A variation on the familiar quadrant below shows the sweet spot for considering use of a reverse auction.



Even so, there are still 3 important questions to ask before seriously considering using a reverse auction:

1. Can the supply be unambiguously specified?
2. Is there strong competition amongst suppliers?



3. Is the value of the contract high enough to excite the suppliers?

If the answer to all 3 is yes, and you want to put a bit more excitement in to your life, then what are you waiting for?

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