SAP White Paper
SAP Solutions for E-Sourcing

REVERSE AUCTION BEST PRACTICES: PRACTICAL APPROACHES TO ENSURE SUCCESSFUL ELECTRONIC REVERSE AUCTION EVENTS

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EXECUTIVE SUMMARY

Procurement organizations have been running electronic reverse auctions for many years. However, the use of auctions has a long way to go to reach full potential. In fact, many organizations have yet to explore the benefits of auctions. Most others have yet to apply auctions to the full range of goods and services for which auctions can deliver value.

Reverse auctions are hosted by a single buyer and feature two or more suppliers competing for business. Such auctions are commonly used by organizations as a tactical way to achieve sourcing objectives.

We have all heard the objections: "Auctions don't fit the category we're sourcing." "Our suppliers would never participate." "Our company does not do business this way." Every objection stems from valid concerns. However, if your organization's goal is to conduct fair and open competition among your supply base, reverse auctions can be a very effective tool in bringing transparency to the sourcing process.

This white paper provides information that will assist your organization in driving the use of auctions and – most important – delivering bottom-line results for your procurement organization.

THE STRATEGIC SOURCING PROCESS AND REVERSE AUCTIONS

Strategic sourcing is a systematic process to formally select a supplier or suppliers to provide products or services. Organizations should build a sourcing strategy with defined expectations and benefits. For example, one expectation could be as follows: "Our organization will reduce the number of suppliers with whom we do business from 1,000 to 500."

To achieve such goals, organizations can use a variety of processes, such as the request for proposal (RFP) process and the reverse auction process. In the RFP process, a buyer creates, issues, collects, and analyzes one or more of the following documents: request for information (RFI), request for quote (RFQ), and RFP. Reverse auctions take the supplier selection process a step further, enabling a buyer to collect and compare price and bid information of two or more suppliers in a real-time, open bidding environment.

These strategic sourcing processes are supported by electronic tools, including RFx and reverse auction tools. RFx stands for RFI, RFQ, or RFP. Note that the process is referred to as RFP but that the electronic tool is called RFx.

Electronic tools that support automated negotiation can be important elements of a sound strategic process; however, these tools are not strategies in themselves but rather tactical ways to achieve sourcing objectives.

Supplier Selection Tools and Benefits

Many organizations use electronic RFx and reverse auction tools because of the significant benefits they provide. RFx tools often integrate with reverse auction tools to streamline the supplier selection process.

An RFx tool is a Web-based application for defining supplier selection criteria, soliciting information and proposals from suppliers against those criteria, and analyzing suppliers' proposals in order to make the best award on a total cost of ownership basis. RFx tools can produce substantial benefits over traditional software such as e-mail, Microsoft Word, Microsoft Excel, and so forth.

An RFx tool offers the following benefits:

- Consistent and streamlined use of RFPs, especially in highly fragmented organizations
- Well-documented objectivity in the supplier selection process, especially for organizations governed by legal compliance
- Speedier RFP cycle times by automation and simplification of the RFP response collection and analysis process
- Cost savings associated with a paperless process

Unlike the process that uses an RFx tool, in which suppliers have no insight into bids from other suppliers, a reverse auction is a process in which suppliers participate in an openly competitive bidding event in real time, using a Web-based application. Suppliers receive a login and use a Web browser to access the application. Once they are logged in, the software gives them the following tools to assist in their bidding:

- An area to place bids
- Summary information indicating the status of the auction, details about the marketplace, and the supplier's competitive position in the marketplace
- Question-and-answer functionality, such as instant messaging
- Online help

Auctions generally occur in a compressed time frame, anywhere from 20 minutes to a couple of hours. Typically, the auction provider will also offer a telephone hotline for bidders to call if they have questions during the live auction.

The role of an auction is an alternative to one-on-one negotiations with each supplier. Auctions are meant to obtain best-and-final bids from qualified bidders; they never eliminate the need to manage a sound sourcing process.

When used appropriately, reverse auctions support the goal of strategic sourcing to significantly reduce the cost of purchases without sacrificing quality and service. Buying organizations can also realize the following benefits of auctions:

- Greater insight into current market pricing
- Superior savings as a result of the competitive dynamics
- Less time spent negotiating best-and-final pricing

There are virtually no limitations to what can be sourced via reverse auctions, including the following examples:

- Raw materials (such as iron ore, crude oil, and natural gas)
- Processed goods (such as steel, chemicals, and polymers)
- Business services (such as travel, accounting, printing, and legal)
- Components and subassemblies (such as molded or machined parts, electronic components, or finished products)
- One-time capital buys (such as cell towers or laboratory equipment such as freezers or centrifuges)

WHEN TO USE REVERSE AUCTIONS

Guidelines for when and how to use RFP only, RFP plus reverse auction, and reverse auction only, on the basis of spend characteristics, can help you determine the right tool for your electronic-sourcing (e-sourcing) strategy. (See Figure 1.) For example, auctions are not recommended for a spend category with highly customized specifications where only a small number of suppliers have the appropriate manufacturing capabilities. However, for a commodity or off-the-shelf item that has a manufacturer's part number, you could directly run an auction by inviting dealer-distributors to the event.

	E-Sourcing Strategy		
	Use of RFP Process Only	Use of RFP Process and Reverse Auction	Use of Reverse Auction Only
Spend Characteristic	**Complex**	**Custom**	**Generic**
Specifications	Developed jointly by supplier and buyer (may be patented)	Created by buyer (may be patented)	Defined by industry standard
Market driver	Value only	Value and price	Mostly price/volume
Industry competitiveness	Not very competitive (monopoly/oligopoly)	Competitive	Very competitive (commoditized)
Supplier availability	Single or few	Many	Very many (large pool)
Riskiness of switching suppliers	Very high	Medium	Low
Supplier relationship	Strategic	Limited	Transactional
Switching cost	Very high	Medium/low	Negligible
Level of detail for supplier qualification	High	Medium	Low
Supply lead time	Long	Medium	Short/immediate
Spend examples	Patented carbon block filter; patented drug delivery system	Plastic enclosures; circuit boards; machined parts	Noncustom packaging; bulk chemicals; lab supplies

Figure 1: How to Determine the Right E-Sourcing Strategy

For companies that are just starting to conduct reverse auctions, the best practice would be to use an RFP process plus an auction. The buyer would use the RFP to prequalify suppliers and obtain quotes before running the auction event. By obtaining quotes as part of an RFP process, the buyer gets a good sense of the market pricing and can determine the auction parameters with greater confidence. This process ensures the least risk and greatest success of an auction event.

SELLING AUCTIONS TO INTERNAL STAKEHOLDERS

At a macro level, the trend for reverse auctions is steadily increasing. Analyst firm AMR Research predicts a compound annual growth rate of 12% through 2010 for revenue from sourcing applications (spend analytics, RFx, reverse auctions, and contract management).[1] However, running auctions is still a relatively new and unfamiliar process for many companies. Thus, it is important to sell the concept internally to the buying organization.

The key to ensuring a successful auction program begins with developing an organizational reverse auction goal in terms of monetary value, number of events, and target spend categories. Once your auction goal and strategy are in place, your next step is to align them to specific business units and individuals using specific metrics. For example, your organization has buyers who need to execute two auction events in the first 90 days of starting an auction program, followed by three events on an annual basis. The objective is to determine the criteria to identify those spend categories that will deliver double-digit savings in an auction event and establish proof of success. You can offer buyers the following key selling points of auctions:

- Auctions save a tremendous amount of time compared with one-on-one negotiations.
- The dynamic nature of auctions drives pricing to levels that cannot be achieved in one-on-one negotiations.
- Auctions provide objectivity and transparency in the supplier selection process.
- The time savings generated through auctions can be used on more strategic initiatives.
- Auctions do not replace relationships; they can solidify relationships by providing an even playing field.

Once you have conducted several auction events, you should recognize the successes and challenges by offering recognition awards in a publicized event and documenting best practices and common pitfalls. Such actions build confidence and encourage adoption within an organization.

1. Mickey North Rizza, AMR Research, "The Procurement and Sourcing Applications Report, 2005–2010," July 27, 2006.

ENSURING SUPPLIER BUY-IN

In order to ensure a successful reverse auction event, the buyer also needs to sell the concept to and get buy-in from suppliers. Some selling points to suppliers are as follows:

- Auctions can reduce the sales cycle time, as award decisions can be made very quickly upon the completion of the bidding event.
- Auctions offer transparency and set an even playing field, since all suppliers follow the same rules of engagement.
- Participating in one auction event for an organization may create opportunities to sell to other divisions or business units.
- Awards are made on the basis of more factors than just price, including quality and service level.
- Auctions promote fair competition driven by market dynamics.

CHOOSING THE RIGHT AUCTION SETTINGS

A successful auction event is one in which you can maximize price compression by creating a healthy competitive environment. To do so, you must understand the impact of the various auction parameters:

- **Visibility or disclosure rules**
  Visibility refers to how much information you want to disclose to bidders. See Figure 2 for the most common types of visibility rules – also known as disclosure rules – and their applicability.

Visibility Rule	What It Is	When to Use It and Why
Leading bid only	Bidders can see only their bid and the leading bid.	▪ Is most effective in auctions driven by price/market share ▪ Is for a category that is commoditized and competitive ▪ Has price as key factor in award decision ▪ Can be used with as few as two bidders
Rank only	Bidders can see only their bid and rank; they cannot see the leading bid.	▪ Is most suitable when the bid values have a large spread ▪ Features value-based categories ▪ Has a supply market sensitive to price disclosure ▪ Has price as weighted factor in award decision ▪ Needs at least six to eight suppliers for a successful event
Leading bid and rank	Bidders can see the leading bid and their rank.	▪ Is used in events with a large number of bidders (more than 30) and lots ▪ Is used as a mechanism to establish a “preferred supplier base” for subsequent auctions comprising actual line-item awards

Figure 2: Visibility Rules and Guidelines

Do you want bidders to see just the leading bid, or do you want them to see the leading bid and their rank? Alternatively, do you want to hide bids and allow bidders to see only their rank? Each of these visibility rules has an impact on the level of bidding activity and competitiveness. With commodity items such as standard (noncustom) packaging or copy paper, where the markets are driven by volume/market share, “leading bid only” tends to drive maximum price compression. Conversely, with a value-based commodity or service such as legal services, the rates per hour may vary significantly, so it is best to go with a “rank-only” event.

- **Line item versus lot bidding**
  You can set up auctions so that bidders compete on prices per line item or on a group of line items, called a lot. (See Figure 3.) Lots force suppliers to bid on all the line items in a lot. Hence, you should package line items around a supplier capability. For example, in an auction event for labels, you can create two lots: one with line items for plastic labels and the other with those for aluminum labels. However, if you are unsure of the supplier capabilities in the market, it is best to not create lots but simply list all line items. Typically, organizations set up lots by delivery location, raw material, manufacturing process, and award strategy.

Line-Item Type	What It Is	What It Does and When to Use It
Line item	A line item is an individual item on which the suppliers can bid. Bidders enter the price per line item.	▪ Enables the buyer to cherry-pick on a line-item basis to come up with the lowest award mix; however, note that suppliers can also then cherry-pick which items on which to bid ▪ Provides more visibility into pricing ▪ Used when the buyer is unsure of volume demand
Lot	A lot is a grouping of line items, based on delivery location (Boston or Houston, for example), raw material (plastic labels or aluminum labels, for example), manufacturing process (through-hole technology or surface-mount technology, for example), or award strategy (lot A or lot B or winner takes all, for example). Bidders enter the price per line item for each item in the lot; the application calculates the extended value (price multiplied by quantity) and uses the extended value for visibility and bid-decrement rules.	▪ Enables the buyer to get bids on low-margin or low-volume items on which suppliers might not bid if the items were listed individually ▪ Enables the buyer to consolidate the supply base ▪ Used only if the volumes indicated for bidding are actual volumes, not estimates, that will translate into award volumes

Figure 3: Line Items and Lot Bidding Guidelines

If you have a large number of line items that make up the total spend, you can use a market-basket approach. With this approach, you select a cross section of line items – on the basis of delivery location, raw material, manufacturing process, and so on – to create the market basket. You can then choose to use a line-item or lot approach. Note that the goal of market-basket-type events should be to identify and establish contracts with a group of preferred suppliers for the organization. Each division or subsidiary of the procuring organization then conducts independent auction events with this select group of suppliers to make the final award.

- **Bid decrement**
  You can specify two types of bid-decrement parameters: percentage or monetary value (such as dollar or yen). Determining the right bid decrement is extremely important to the success of an event. A too-large bid decrement will prevent some companies from bidding and thus reduce competition. Also, when there is a wide range in the price of the line items, you should use percentage instead of a monetary amount.
- **Beating leading bid or beating own bid**
  Beating leading bid generally works better in forward auctions, which are used by suppliers to solicit buyers, than reverse auctions. For reverse auctions, you should have suppliers beat their own bid. This allows suppliers to give the best possible price on the basis of their costs and processes. In a strategic sourcing process, price is only one factor of supplier selection. Often, you may find that the lowest bidder is not meeting quality and service grades and thus may select the second-lowest bidder. In such situations, you want to ensure that the second-lowest bidder has given you its best possible price.
- **Duration and use of extensions**
  The duration of an auction depends on the number of line items and the number of suppliers participating. For auctions with 15 to 20 line items (and four to eight suppliers), the minimum auction period recommended is 20 minutes. However, bidders commonly wait until the last few minutes to place their bids. In order to ensure an even playing field, you should enable time extensions, which would kick in only if bids are placed in the last few minutes of an event, thus extending the period of the event for an additional few minutes. The number of extensions largely depends on the number of line items and number of bidders.

For events with more than 20 line items, you should use a staggered open or close; this enables bidders to focus only on those line items that are currently open so as to not overwhelm the bidders with the bidding activity.

RUNNING AN AUCTION

The approximate timeline for a reverse auction – from determining the category to capturing savings – is between four and six weeks. However, the timeline can vary dramatically, depending on the type of category and whether the category has been previously sourced. For example, conducting an auction event for a highly commoditized product or service could take an experienced buyer as little as one week, whereas a full-blown selection in a new category would start with an RFI, then an RFP, and then an auction, with the entire process lasting from two to six months or more.

Take the following steps to run a successful auction:

1. **Determine category spend amounts and specifications.**
   The first and most important step in any sourcing process is to obtain accurate and comprehensive category spend data and specifications. Data to be collected includes historic annual spend, estimated future spend, line-item detail (last item price or average item price for last year), annual usage quantities, pricing trends, market assessment (such as level of fragmentation), current specifications/drawings, and commercial terms (such as payment terms, shipping requirements, and so on).
2. **Identify suppliers and get initial quotes.**
   Identify suppliers to invite to the auction event, including any incumbents. New suppliers should be required to go through an RFI process to ensure they meet the basic qualifications for event participation.

   If your organization is new to auctions, or the category is new, acquire initial quotes through an RFP process to ensure adequate interest from suppliers as well as provide the buyer with data to support the auction strategy and parameters.
3. **Determine the auction strategy and rules, and then build the event.**
   Once suppliers are on board – and, if necessary, the buyer has received initial bids through an RFP process – the buyer needs to analyze the bids to determine the best strategy and parameters for the event. This is explained in detail in the "Choosing the Right Auction Settings" section of this white paper. The buyer then sets up the auction event.
4. **Train suppliers.**
   Once the auction is built, the buyer should conduct a Web-based training event to demonstrate to suppliers how to navigate the auction tool and place their bids, as well as answer any questions related to the auction event.
5. **Conduct the live auction.**
   For the live auction event, suppliers log on to the Web site and place their bids. Ensure that all suppliers have access to the buyer's hotline for any issues that may arise during the auction event. It is important to keep communication lines open with suppliers during an auction for any questions that may come up during bidding.
6. **Award business.**
   Run bid analysis reports to analyze bids, determine the award, and execute the contract or issue the purchase order. The buyer should communicate the award decision to suppliers within 30 days of the live event.
7. **Capture savings.**
   The buyer should document savings and publish the results to other buyers within the organization and plan for the next event.

CONCLUSION

Reverse auctions are an emerging tool that sourcing organizations can use to bring about huge success if executed along with a well-defined sourcing process. Careful thought and planning must precede an auction event in order to achieve double-digit price compression. Organizations that have succeeded in using the tool have the following commonalities:

- A strong mandate to use auctions
- A well-defined process to use auctions
- A centralized point of contact to drive the adoption through best practices and to minimize pitfalls

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