

E-Procurement — Successfully Using and Managing Reverse Auctions

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Today, reverse auctions are perceived more realistically than in years past but still offer many benefits for both buyer and seller.

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Procurement-based processes have begun to govern outsourcing practices in many pharmaceutical companies. This means that transactions with contract service providers will be increasingly incorporated into the e-procurement infrastructure that sponsor companies are developing.

Most sponsors still are feeling their way regarding how they will use their e-procurement capabilities, and an important area of experimentation is reverse auctions. Reverse auctions are the opposite, or reverse, of traditional auctions in which the seller accepts bids from would-be buyers. In the reverse auctions that are now commonly hosted on Web sites, a buyer accepts bids from several would-be sellers and settles on the best offer. Goods are bought and sold, and information is exchanged among buyers and sellers in a private (i.e., hosted by a single company) or a public (i.e., with many firms) e-marketplace.

On-line reverse auctions have been used frequently in the chemical industry, in which huge amounts of commodities are bought and sold daily. Reverse auctions also are being used increasingly for products and services related to day-to-day maintenance, repair, and operations requirements. A Forrester Research survey of 361 businesses found that on-line auction use across all industries rose from 17 to 23% of buyers in the final quarter of 2001 (1).

Reverse auctions have experienced a boom-and-bust cycle paralleling the dot.com phenomenon. By the late 1990s, numerous fledgling on-line exchanges were targeting the \$1.7-trillion chemical industry and its 50,000 buyers and sellers.

By 2001, however, according to the research and consulting firm IDC (Framingham, MA), many e-marketplaces had folded, while others continued operating after layoffs and restructuring. The initial, widespread belief that on-line auctions would revolutionize and even replace the traditional procurement process now has given way to the more realistic view that they are a sometimes-useful adjunct to established modes of buying and selling. The number of public chemical-industry on-line exchanges has fallen from 74 to 42, according to a December 2001 Gartner G2 Group report (2).

Reverse auctions are less common in the pharmaceutical industry, in which highly specialized goods are exchanged less easily on-line. However, auctions have been attempted for the purchase of chemical raw materials and early-stage intermediates as well as R&D materials, both through private auctions and Inceutica.com (a reverse-auction site for R&D services that closed last year when it ran out of venture-capital funding).

Reverse auctions can benefit both buyers and suppliers of goods and services, according to business analysts, executives,

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and users of such Internet-based procurement tools. However, much preparation is required to successfully exploit these on-line marketplaces. Moreover, the value of on-line auctions depends on industry conditions and the enterprise's needs. Proponents claim that the auctions can provide many economic advantages, while critics believe that these benefits are overstated.

This article will examine how buyers can obtain the most benefit from reverse auctions. A companion article in next month's issue of *Pharmaceutical Technology* will describe how suppliers should respond in a reverse-auction situation and how they can determine the pros and cons of public versus private auctions.

The buyer's perspective

Reverse auctions attract buyers with the allure of lower prices, a broader supplier base, and a more efficient procurement process. On-line buyers often do save on purchases of goods because the nature of auctions tends to force a supplier to progressively reduce its asking price. Carol Rozwell, vice-president at Gartner G2 Group (Stamford, CT), said that the savings on an average purchase at a reverse auction "can be between 5 and 25%." AMR Research (Boston, MA) service director Roddy Martin noted, "Some companies have saved tens of millions of dollars on reverse auctions." Auctions also generate valuable pricing data for planning future purchases.

Reverse auctions also can save time. "They can reduce the cycle time of the transaction significantly, by 50–70%," Rozwell said. Auctions commonly decrease the entire bidding process from months to days. The Gartner report about chemical-industry auctions found that "on-line negotiation reduces the elapsed time by at least 50% by eliminating the need for phone calls, faxes, and face-to-face meetings" (2).

Furthermore, buyers can widen their supplier base by posting product specifications on Internet-based exchanges. The Gartner report also stated that the ability to identify new suppliers electronically is valuable especially in a fragmented international industry such as chemicals and plastics. With these marketplaces, buyers can quickly find backup and alternative sources of supply. Additional benefits may

include reductions in process costs and accelerated product development, according to a recent IDC study (3).

Michelle Hincks, ChemConnect's vice-president of marketing, said that to obtain the greatest benefits from the auction process the key is to determine which products should be auctioned. Reverse auctions are better suited to certain kinds of products such as high-volume bulk commodities (e.g., methanol). Among the products commonly bought and sold are benzene, toluene, ethanol, and naphtha. The average purchase at one major chemical auction house is \$1.3 million.

Reverse auctions "are not as useful with small quantities," noted Rozwell. Reverse auctions also are less advantageous for more-specialized goods. "High-price, high-quality items are dealt with outside the reverse-auction process," said Martin. "The more highly specialized the product, and the more complex its specifications, the less likely it could be handled in an auction [because they are more risk-prone, and their specifications are more difficult to define]."

An exception to this rule is Chemfinet Services, Inc. (Overland Park, KS), an auction house for custom-manufactured molecules and specialty chemicals. The company works with more than 1000 suppliers of complex chemicals, from intermediates to drug candidates.

Rozwell advised that, to gain a competitive position, buyers should seek exchanges that feature five or more suppliers. Also, the buyer has an advantage when suppliers have similar supply capabilities. Some e-marketplaces enable buyers to pre-screen suppliers for certain characteristics. For example, a company concerned about protecting its intellectual property rights may want to screen suppliers by their country of origin, and a firm worried about reliable sources of supply may want to screen suppliers by corporate size or years in business. Reverse auctions do not offer as many benefits for products on which one or two dominant suppliers exert market control or if the supplier base is not fragmented. However, in markets in which suppliers are few, buyers have been known to reduce the suppliers' advantage by restricting the information suppliers see about one another on-line.

Skeptics of reverse auctions say that

price savings fail to reflect other, less-obvious costs. Such expenses include the time and effort of resourcing (i.e., setting up and fostering relationships with new suppliers). Poor product quality as a result of buying from an untested supplier is another potential downside. Buyers must have realistic expectations about moving from one supplier to another, according to Robert Emiliani, president of RPI's Center for Lean Business Management. Although measuring the price component of an auction is easy, "there's no metric for the supply relationship," noted David Stec, the center's vice-president.

"You always lose some of the savings from auctions, upwards of 50%. Buyers don't understand the total cost of acquisition," Emiliani said. Costs can rise further if a new supplier fails to deliver the product. In such cases an embarrassed buyer may have to return to the previous supplier, who will likely raise prices for the privilege. "If it looks too good to be true, it probably is," states a report by Emiliani and Stec (4).

In addition, establishing, administering, and finding personnel for a company's auction program can lead to significant expenses. Large firms could spend up to \$40 million to establish a private trading house (5). Registering with a public auction house also entails new expenses such as annual subscription fees ranging from a few hundred dollars to a few hundred thousand dollars.

Moreover, reverse auctions can put undue pressure on the industry's supplier base. Buyers representing large corporations "are using their leverage to force suppliers into a bidding frenzy," noted Stec. Before engaging in reverse auctions, "firms should consider whether they are damaging their existing supplier relationships," Rozwell said. Such relationships can require years and considerable resources to establish. Emiliani and Stec urge buyers to engage in collaborative cost reduction with suppliers.

Some corporate buyers who are dubious about the value of e-marketplaces believe that if they conduct enough extensive research to make smart purchases from suppliers, on-line auctions will be unnecessary. Certainly, buyers must decide on a multitude of details before entering an auction. A great deal of up-front

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planning and preparatory work must be accomplished. "The transaction itself," said Rozwell, "takes a small amount of time."

Even after finding potential sources of supply, buyers still must thoroughly research prospective suppliers. "Buyers must understand exactly what they're buying in an on-line environment just as they do in a traditional auction," said Martin. Product content as well as supply reliability must be considered. The Gartner report states, "In an e-marketplace, buyers should deal only with suppliers they know and have qualified" (2). Subsequently, purchasing agents must ensure that suppliers live up to their commitments.

Knowing the volume of goods to request and setting the floor and ceiling prices are key decisions for buyers. Even in an on-line marketplace, business locale is another consideration. According to Hincks, some companies won't conduct business with suppliers from certain regions because transportation costs are too expensive or because the product doesn't ship well.

Buyers also must decide when the best time to hold an auction is on the basis of market conditions, noted Hincks. A buyer should be wary of auctions when market prices are going up because the auction might accelerate upward pressure on prices.

Auctions are a two-way street, and buyers must pay heed to their suppliers' needs. They should make sure suppliers understand an auction's requirements and conditions, including packaging and shipping arrangements, before they participate. An important step is writing a comprehensive, well-understood request for quota-

tion that is clear about such criteria as inventory requirements and raw material input specifications. If an auction makes last-minute changes, all suppliers must be promptly informed before the auction begins. Obviously, buyers must remember to exclude from reverse auctions the suppliers with whom they have long-term supply agreements.

Analysts say that for a buyer to gain a quick win at the supplier's expense is self-defeating. "Is it really all just about money?" asked Martin. "The long-standing buyer-supplier relationship is the big question." Martin advised that buyers should ask themselves these questions: "How can I incorporate content into a reverse auction? How can I be sure to get a good price in addition to the service and support I usually get from my regular suppliers?" In short, "the buyer needs a supplier strategy [i.e., a strategy for choosing a reliable, cost-effective supplier]," noted Martin. The emphasis on the reduction of transactional costs (common during the early days of reverse auctions) — to the exclusion of much else — has largely fallen aside. The goal for today's buyers may be not to get the best price, but to get a fair price from the supplier of choice.

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