

# The 6 Pitfalls of Reverse Auctions

## Summary

Reverse auctions are rapidly becoming the bid collection technique of choice for leading procurement organizations. Learn how to avoid some of the common mistakes that lead to disappointing results. Get tips on what materials to select, how many suppliers to invite, and the role of target prices. Avoiding these pitfalls will help procurement professionals implement a new competitive bidding process with greater speed and success.

## Lack of Supplier Preparation

Despite the hype and the misconceptions associated with the term *reverse auction*, it is simply a different way to collect bids. However, running a successful auction program does require the development of new procedures and places greater emphasis on supplier preparation when compared to more traditional methods.

Reverse auctions do not change the need to carefully review drawings, set technical specifications, and develop commercial considerations that match the business objectives of the organization. Nor does a reverse auction eliminate the need to meet with suppliers to discuss the opportunity and collect their ideas on how to meet your requirements. The only difference is once this work has been completed and the suppliers are fully prepared, rather than sending in paper bids, they submit their bids on-line with the ability to adjust their pricing based on real-time competitive market data.

A common mistake of organizations is that they cover the technical and commercial terms, but fail to adequately explain the nature of the opportunity beyond the bid package. Companies have to explain their business, its potential, and their objectives relative to developing dynamic supply bases. *Failing to project the vision of the organization will reduce the organizations ability to develop a competitive environment.*

## Inviting the Wrong Suppliers

Inviting the wrong suppliers is the most common cause of poor reverse auction results. Supplier selection is the most difficult part of developing a successful reverse auction for production materials. The goal is to select a group of suppliers that meet the requirements of the program with similar quality and performance characteristics. Based on this premise, buyers can select the winning supplier using price as their dominant variable. It becomes increasingly difficult to evaluate the results of an auction when quality and performance factors vary significantly from supplier to supplier.

Obtaining quality and performance data on new suppliers is expensive and time consuming. Too frequently the process of supplier selection is haphazard and relies solely upon contacts from a few people either in engineering or procurement. The result of this process is a pool of suppliers who may or may not have similar quality and performance

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### Preparation Mistakes

- ✓ *Inadequate review of documentation.*
- ✓ *Incomplete commercial considerations.*
- ✓ *Fail to explain the goals of the business to suppliers.*

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### Selection Mistakes

- ✓ *Including suppliers that have not been qualified.*
- ✓ *Suppliers lack the optimal equipment to produce the material.*
- ✓ *Suppliers are too small or too large for the contract.*

capabilities. This mistake leads to erratic reverse auction results that are hard to interpret. It can also cause a company to choose a supplier who offered a low price, but who turns out to be unsuitable for the business in the long-term.

## Including Too Many Suppliers

Many companies run reverse auctions by allowing as many suppliers to participate as possible. The idea is that more suppliers will create a more competitive market. This can work for commodity goods that are highly defined, but does not work well for custom production materials.

A properly constructed auction requires the selection of qualified suppliers prior to bidding. Too many suppliers makes this process overly time consuming and costly. Program goals, drawings, and commercial considerations all have to be thoroughly reviewed with suppliers to ensure proper bidding. This too becomes problematic for auctions with a large number of suppliers. The other fallout of a large auction is that good suppliers do not always participate. Many feel they are wasting their time preparing to quote on a package that is being bid on by 30 or 40 suppliers. They equate the process to buying a lottery ticket.

The average auction for production materials can be executed with 4 to 8 qualified suppliers. This is typically enough to ensure a competitive market. An auction for production materials has more to do with preparation than the number of suppliers bidding.

## Starting with Difficult Materials

Implementing a reverse auction program represents a change in the procurement practices of a manufacturing organization. Regardless of what the company's mission statement claims, most organizations resist this process. Therefore, building on small successes is the best way to get the organization to support the new process.

Frequently, companies have the desire to start with their most problematic set of materials. A good example would be printed circuit boards. Companies routinely struggle to procure custom pc boards in moderate volumes. However, the problem is rarely one of choosing a new supplier or obtaining a lower price. Often the problem lies in faulty documentation, the lack of testing protocols, and the constant substitution of new components. Developing a reverse auction for most printed circuit boards takes time

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### ***Too Many Suppliers***

- ✓ *Time consuming and expensive to pre-qualify suppliers.*
- ✓ *Hard to prepare suppliers thoroughly.*
- ✓ *Can discourage the best suppliers from bidding.*

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### ***Materials to Avoid***

- ✓ *Avoid complex printed circuit boards.*
- ✓ *Avoid parts where the incumbent supplier owns expensive tooling.*
- ✓ *Bid packages of less than \$100,000.*

and engineering involvement. The process can take up to eighteen months to begin producing savings.

Try to avoid starting with materials where an incumbent supplier has a substantial investment in tooling to produce the part. This can make it difficult to create a competitive market because new suppliers have to include tooling costs. Also, avoid very small bid packages of less than \$100,000. The size of these packages makes it harder to develop a robust auction and to can lead to disappointing results.

*Pick a set of production materials with an expected annual value of \$250,000 that can be organized and put out to bid in 6 to 8 weeks. Items like sheet metal and machined parts are good examples.* The documentation for these materials is easy to prepare and the qualification process for these parts is typically less complex when compared to electronics. A series of small, successful auctions will provide invaluable learning needed for larger events and will create the buy-in necessary to develop a long-term competitive bidding program.

## Not Enforcing the Rules

Since a reverse auction is part of a process, it is important that all the selected suppliers understand why it is being implemented, how it works, and how they will be judged. This is a critical step for managing internal and external expectations. Simply running a reverse auction without adequate explanation of the process and the rules can cause suppliers not to take the program seriously.

The first time a company runs a reverse auction for a commodity, the incumbent suppliers may complain. Common threats include, "Our price will go up" and "We don't participate in reverse auctions". The reality is that suppliers are always better off having a chance to compete, than to be told that the business is being moved after the fact. However, suppliers do not always share this enlightened position. As a result incumbents may not bid aggressively, may bid higher than their current price, and in rare cases may not bid at all.

In these cases it is important to stick with the process. Do not allow suppliers to place bids after the auction is completed. This will undermine a company's reverse auction program and create unnecessary work for the procurement team. This discipline will send a strong message to suppliers and will give the new process its best chance of success.

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### **Enforcing the Rules**

- ✓ *Explaining the process and the rules to suppliers in detail.*
- ✓ *Do not allow suppliers to bid outside of the reverse auction process.*

## Setting Artificially Low Targets

It is common knowledge that when you negotiate you start with a price below your target. When companies first start running reverse auctions they employ the same principle and low-ball their target price. The confusion comes from the difference in dynamics between personal negotiation and reverse auctions. In a personal negotiation the price is being set by the psychology of the two parties. In a reverse auction the price is being set by the open competition of comparable suppliers.

In a properly constructed reverse auction, the target price simply lets suppliers know the highest price that will be considered for awarding the contract. It does not influence the competition between suppliers for the contract. *Therefore, a company wants to set a realistic target price. An artificially low target price can cause qualified suppliers not to participate.* This weakens the auction event and can lead to poor post auction results. Also, it sets unrealistic expectations internally. This can cause people within the company to view an auction as a failure when the results were excellent relative to the historical cost of the materials. Artificially low target prices undermine the credibility of a company's reverse auction process and create no sustainable advantage for the buyer.

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### **Unrealistic Targets**

- ✓ *Discourages qualified suppliers from bidding.*
- ✓ *Sets unsupportable expectations internally.*

## Keys to a Successful Reverse Auction

- ✓ *Qualify suppliers before running the event.*
- ✓ *Start with material packages that can be easily organized and quoted.*
- ✓ *Carefully review and correct technical and commercial requirements.*
- ✓ *Set reasonable target pricing.*
- ✓ *Invite 6 to 8 qualified suppliers that meet the program requirements.*
- ✓ *Explain the process to suppliers thoroughly and project the vision of your organization.*
- ✓ *Enforce the bidding rules that were established prior to running an auction.*
- ✓ *Don't underestimate organizational resistance.*
- ✓ *Get started, the risks are low and the upside is high. There is no substitute for experience.*