

Discussion

Commentary on “Reverse auctions for relationship marketers”  
by Daly and Nath

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## 1. Introduction

Daly and Nath pose an interesting question: “. . . can [online reverse] auctions be made more relational and long-term oriented? . . . yet retain their valuable pricing benefits” (Daly & Nath, 2005). Since the start of business-to-business online reverse auctions around 1995 (Richards, 2000; Tully, 2000), the value proposition for suppliers has been weak or nonexistent (Bartholomew, 2001, 2002; Emiliani & Stec, 2004, *in press*). Thus, expanding the value proposition generally and, specifically, buyer–seller relationships and long-term trade orientation are important improvements that could be made to reverse auction design and deployment. The question is: How to do it? Daly and Nath propose three possible solutions:

- (1) Buyer subsidies of relationship-specific investment in winning seller’s operations
- (2) Price negotiation after auction
- (3) Payment to losing bidders

Solutions (1) and (3) will be nonstarters for most purchasing and finance executives since they view reverse auctions as a means to save money on purchased goods and services and not to spend more money, thereby increasing costs. Solution (2) violates reverse auction terms and con-

ditions between reverse auction service providers, buyers, and sellers. In general, postauction price negotiations are not allowed.

The fact that practical means for improving relational and long-term aspects of trade are scarce simply illustrates the fact that this new purchasing tool is fundamentally misaligned with those objectives. If buyers are truly interested in long-term collaborative relationships and managing costs throughout the value stream (Womack, Jones, & Roos, 1990), then they should seek alternate means that have been proven to be effective (Bounds, 1996; Bounds, Shaw, & Gillard, 1996; Cooper & Slagmulder, 1999; Dyer & Nobeoka, 2000; Fujimoto, 1999; Nishiguchi, 1994; Rother & Shook, 1999; Womack & Jones, 2002).

## 2. Long-term relationships

Over the years, reverse auction service providers, also called “market makers,” have made various qualitative claims regarding the benefits of participating in reverse auctions for new and incumbent suppliers, including:

- Reduce operating, selling, or customer acquisition costs
- Improve buyer–seller relationships
- Compete on a level playing field
- Access to new customers
- Increase sales
- Access to new markets

The validity of these and other claims has been examined in empirical studies of aerospace machined parts and wood pallet suppliers (Emiliani & Stec, 2004, *in press*). The results show that most suppliers fail to realize these key

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benefits. In practice, the value proposition for both new and incumbent suppliers is narrow and largely unchanged since reverse auctions were first deployed: new suppliers may gain new business, while incumbent suppliers risk losing hard-won business.

The history of online reverse auctions to-date clearly shows that, with rare exception—e.g., purchase of industry standard commercial goods (Smart & Harrison, 2003)—reverse auctions are designed and deployed in ways that are hostile to relationship building among incumbent suppliers (Bartholomew, 2001, 2002, 2004; Emiliani, 2004; Emiliani & Stec, 2004, *in press*; Richards, 2000; Sawhney, 2003). Indeed, the purpose of reverse auctions is short-term unit price reduction, enabled by advantages that buyers have over sellers—particularly when buyers own the technical specifications of the goods or services. The likelihood of improved relationship between buyers and incumbent sellers is low given current reverse auction designs and deployment practices, which include both implicit and explicit coercion (Emiliani & Stec, 2002a). In most cases, reverse auctions simply extend power-based bargaining routines long used by buyers that possess leverage in the marketplace over incumbent sellers' interests (Emiliani, 2004; Nishiguchi, 1994; Womack et al., 1990). Buyers that use reverse auctions know this, and so, they do not want their customers to use reverse auctions for the goods or services that they supply (Richards, 2000).

New suppliers that win business may in a few cases experience improved relations, but this can be easily undercut by the buyer's inability to meet suppliers' needs or by the seller's inability to meet the buyer's needs in the execution of the contract. A common result is unanticipated demands made by sellers or buyers that later seek alternate sources of supply due to supplier nonperformance (Emiliani & Stec, 2004, *in press*)—outcomes which will damage relationships.

A few winning incumbent suppliers may also experience good relations. However, the more common outcome is deterioration of the business relationship caused by rapid margin erosion (Emiliani & Stec, 2004, *in press*). This is a significant threat to sellers, and losing work to other suppliers—especially to new suppliers with unproven track records of quality, delivery, and service performance—will also damage buyer–seller relationships.

New or incumbent suppliers whose bids were not selected, despite low prices, will complain of their loss and lament the time they spent preparing for the reverse auction. They may also take legal action against the market maker or buyer for bidding rule violations (Castaldo, 2004), which will introduce additional costs to the seller, market maker, and buyer. This will damage potential future relationships, and may also give buyers a poor image in their industry.

While improved buyer–seller relationships have been cited among first-time bidders (Smart & Harrison, 2003), this outcome is rare among bidders that have experience

with reverse auctions. Also, relationship-specific investments made by sellers do not constitute clear evidence of relationship building (Jap, 2001). For example, it can simply be investment needed to meet the sellers' commitment to get the work done, thus fulfilling requirements related to the “winner's curse” (Tulder & Mol, 2002).

### 3. Pricing benefits

On the surface, the primary benefit of reverse auctions for buyers is substantially reduced prices. Unfortunately, it is not that simple. Reverse auctions measure the reduction in unit prices, despite efforts to characterize “total costs” in the request for quote. Digging deeper, one finds that reverse auctions often lead to higher costs in budget categories owned by purchasing or by other departments (Emiliani & Stec, 2002b). For example, new suppliers that are unable to meet quality or delivery performance targets will lead to unanticipated costs incurred by the buyer, including:

- Returns
- Warranty costs
- Litigation expenses
- Overnight freight charges
- Increased supplier oversight

as well as lost sales and dissatisfied customers. These outcomes are common particularly when the item is complex, or when the buyer owns the design of the goods or services.

Further, incumbent suppliers view reverse auctions as opportunistic behavior among buyers to achieve lower prices (Jap, 2001). This often results in “retaliatory pricing” behaviors, where incumbent sellers that have been exposed to reverse auctions wait—sometimes years—for opportunities to charge buyers higher prices for goods or services, including one-time charges such as expediting fees or new tooling (Emiliani & Stec, 2004, *in press*). This adds to the total cost of procurement, especially since incumbent suppliers rarely lose all the work. Instead, they typically lose some of the work and continue doing business with the buyer, all the while seeking higher prices. Other outcomes that are not accounted for in the so-called “total cost” RFQ's include less cooperative relationships and sourcing work back to the original supplier—sometimes at prices higher than what the buyer originally paid.

While unit cost savings is the key measure of success, it is not an accurate measure, nor is it an appropriate measure because it is easily gamed and leads to higher costs (Emiliani, Stec, & Grasso, *submitted for publication*). When total costs increase, reverse auction results become compromised. Not surprisingly, buyers eventually turn their attention to collaborative approaches with established long-term suppliers for managing costs (Barlas, 2003; Drickhammer, 2004).

In addition, there are often many factors that make it difficult for the buyer to secure the savings identified at the conclusion of the reverse auction (Emiliani & Stec, 2002b; Minahan, 2002). Savings typically erode by 30–75% upon implementation of reverse auction results, depending upon the commodity sourced. General Electric, for example, has reported an average savings loss of 50% across a wide range of goods and services (CLBM, 2004). In the worst cases, the use of reverse auctions could cost buyers more money than they appear to be saving.

#### 4. Solutions

In addition to the shortcomings noted previously, Daly and Nath's solutions have additional weaknesses. They are as follows:

##### 4.1. Buyer subsidies

The capabilities that buyers seek, whether related to equipment, R&D capabilities, etc., will have been evaluated at the time suppliers were selected to participate in reverse auctions, thus negating the need for buyers to subsidize suppliers' investments. Also, given the overcapacity that exists in most manufacturing and service sectors, it is unlikely that buyers would need to make relationship-specific investment in winning seller's operations—other than small investments in information technology to facilitate secure communication between buyer and seller. Further, buyers that have historically relied on power-based bargaining routines to manage suppliers generally do not have the organizational capability to fulfill obligations related to making relationship-specific investments. Lastly, since reverse auctions typically constitute 10–15% of a company's annual purchasing spend (Beall et al., 2003), there are ample opportunities to source work to disadvantaged businesses through the traditional sealed bid method.

##### 4.2. Postauction price negotiation

Reverse auction service providers have long held that one of the benefits of reverse auctions for suppliers is the creation of a level playing field among the suppliers invited to bid (Emiliani & Stec, 2004, *in press*). Postauction price negotiation with selected suppliers—e.g., the few with the best prices—un-levels the playing field. Thus, most reverse auction service providers do not allow postauction price negotiation.

From the buyer's perspective, they likely achieved what they perceive to be a good result: 10–30% reduction in unit prices. That's a big win, and most purchasing managers would decline efforts to achieve a few percent additional savings. The more pressing matter is to implement the

reverse auction results and to begin accruing the savings. This is often an activity that requires significant resources from the buyer, especially if the supplier that won the work is new and the good or services are complex (Emiliani, 2000; Emiliani & Stec, 2002b).

If the range between bids is high, then it is likely that buyers made mistakes with respect to supplier selection. The fact is, most buyers do not understand the true cost of the goods or services that they purchase. Evidence for this is found in the dominant metric used to gage the success of purchasing activities—the purchase price variance metric—which tell buyers nothing about supplier's costs (Emiliani et al., *submitted for publication*). Additionally, buyers' use of online reverse auctions is a tacit admission that they do not understand the true cost of what they are procuring (Emiliani, 2000).

From the supplier's perspective, postauction price negotiation will deepen the pressure they face with respect to margin erosion. This will not make them happier. But it could give suppliers a reason to invalidate their bids if postauction price negotiation is a violation of the reverse auction rules. Furthermore, the threat of margin erosion will discourage suppliers from making relationship-specific investments (Jap, 2003).

##### 4.3. Payment to losing bidders

If compensating suppliers for the time taken to prepare for reverse auctions has any merit, then a method must be devised to track the costs and the payments made to them. The cost will vary widely from supplier to supplier, driven by overhead rates. Suppliers in low-wage countries will have low overhead rates, while suppliers in developed countries will have higher overhead rates. Some suppliers will make earnest efforts to prepare their bids and spend a lot of time reviewing specifications. Others will spend little or no time preparing their bids, preferring instead to simply estimate prices. Some will seek to get compensated for preparing bids that they spent little time preparing for, knowing that they have no intention of being a competitive bidder. For some suppliers, this solution will become a profit improvement program at the seller's expense and thus actively seek to participate in many reverse auctions. The potential for gaming is large.

Determining how much to pay the suppliers for their actual efforts quickly becomes complicated and would likely lead some buyers to impose region-specific flat fees. Again, the main idea behind reverse auctions is to reduce purchase price and not to increase costs by paying possibly dozens of losing suppliers to prepare for bidding. This would simply increase the total cost of the items purchased. Remember, the traditional sealed bid method of procurement is an activity for which suppliers are not compensated.

This proposed solution is an ineffective way to increase the number of suppliers participating in reverse auctions.

The fact that most suppliers do not voluntarily flock to reverse auctions speaks volumes as to what they think of them. Clearly, it is a zero-sum tool designed principally to benefit buyers at suppliers' expense (Emiliani & Stec, in press). Lastly, it is unlikely that losing suppliers receiving payment would enjoy a "renewed sense of respect for the buyer." Instead, it is more likely that suppliers would view buyers making payments to losing bidders with less respect because of their single-minded efforts to reduce costs no matter what the cost and consistently failing to understand value (i.e., price plus nonprice factors)—a common occurrence among buyers focused on price and that rely on power-based bargaining.

Finally, a potential solution that Daly and Nath do not identify is the codes of conduct or trade association guidelines designed to improve trust, fairness, and confidence in reverse auctions. However, careful examination reveals that these have had little or no favorable impact with regard to improving buyer–seller relationships (Emiliani, submitted for publication).

## 5. Conclusion

Reverse auctions are an inherently destructive purchasing tool as far as incumbent suppliers are concerned. Whether it can be made capable of improving buyer–seller relationships and embody a long-term trade orientation remains to be seen. To do that, the value proposition for both new and incumbent must be expanded. The solutions that Daly and Nath identify do not address incumbent suppliers' core interest in expanding sales and margins for the goods or services that they produce. Nor do the solutions support buyers' principal objective of reducing the price of purchased goods or services and avoiding other unwanted costs. Importantly, predicting buyer and seller behaviors using mathematical models is often trumped by factors that cannot be easily accounted for. Thus, the practical utility of such models is extremely limited.

The future of reverse auctions is uncertain. First, their use among industrial buyers appears to flat or declining (Hannon, 2003). Second, there is an oversupply of reverse auction service providers, resulting in business closures, mergers, or sales. Examples include CommerceOne, Cordiem, Covisint, eScout, FreeMarkets, and PurchasePro, to name a few (Barlas, 2004a, 2004b; Ericson, 2003, 2004b). These outcomes are entirely predictable given the poor value proposition for all suppliers (Ericson, 2004a) and particularly for incumbent suppliers.

Today, reverse auction use averages about 10–15% of total corporate purchasing spend, mainly for nonstrategic items where buyers have little interest in long-term supply arrangements or relationship-building. Overall, it is probably not worth any effort to make reverse auctions more relational and long-term-oriented. That, after all, is not its intent. Instead, reverse auctions should be recognized for

what it is: a technologically assisted form of power-based bargaining whose benefits for buyers are grossly overstated and which in the long run compromise the mostly shared interests of both buyers and sellers (Emiliani, 2004).

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