

E-auctions bring only marginal benefits for companies that have already implemented effective business purchasing practices, as information from recent surveys in various industries indicate

E-technology Should Enable, Not Drive, Efforts to Reduce Costs with Suppliers

By STEVEN J. TRECHA

Intense competitive pressures and a flailing economy have pulp and paper companies pursuing all avenues of immediate cost reduction and longer-term revenue improvements. Purchase goods and services are key targets. At the same time, e-technology has fueled a rush to embrace business solutions that promise to simplify buying and selling while significantly reducing costs. As result, business-to-business (B2B) e-auctions have emerged to a hopeful, yet somewhat skeptical, reception.

In the late 1990s, the hottest concept became e-procurement. Cropping up by the hundreds, e-technology firms offered financial controllers and purchasing executives a new vision—one where technology was used to take cost out of the supply base. Unfortunately, what began as Web-based strategic sourcing tools, quickly lapsed into an online competitive bidding frenzy. Based on relatively simplistic technology and a rudimentary understanding of purchasing, e-auction houses advertised better source selection and price reductions of up to 50%. The premise was simple—aggregate the purchasing spend and let suppliers square off in an open forum, creating a bidding war to drive to the lowest possible price. Unfortunately, what was promised was not always delivered. In fact, e-technologies have cost companies millions in investments and have many times degraded product quality and supplier relationships.

So, what can companies do? Clearly, technology is one of many tools. The real opportunity lies in the systematic development of lowest total cost supply side strategies and continuous improvement programs. Technology can then enable these practices, not strategically drive them. It's time to rationalize the technology value and focus on total lowest cost supply relationships. In other words, take three steps forward, enabled by one step in technology. Improving and aligning decisions across the supply chain, monitoring performance and reliability, and mentoring supply chain processes will prove to be the added value of the Internet. E-procurement exchanges and consortiums are beginning to learn this.

FOREST PRODUCTS AND E-AUCTIONS. In 2002, Integrated Strategies conducted a forest products e-procurement survey to better understand if forest products firms and their suppliers had embraced e-auctions. However, the survey showed that these firms were more interested in sharing their lack of results and frustrations with online bidding practices. They emphasized that operating sourcing in a strategic manner and carving out long-term lowest total cost supply side relationships brought far greater value than focusing on simple price reductions. The survey results speak to the astute cautiousness of those firms who have elected to use the technology on a selected basis and those firms who simply ignore it in favor of advancing sourcing contribution through solid strategic business performance.

One-hundred percent of the time, the surveyed forest products companies with best practice supply side strategies in place found e-auctions simply did not save dollars and often brought higher prices. These firms understood their total supply chain costs and had previously rationalized their supply chain processes (for example, technology integration, specification development, supplier qualification and selection, transportation, receiving, inventory management, quality, warehousing, materials disposition to the job site, reverse logistics, and accounting closeout functions).

Yet, some forest products companies did achieve price reductions from non-critical, non-engineered, and/or production materials, and, at the same time, experienced improvements in their bid preparation and evaluation processes. It is worth noting that these same companies admitted having fundamentally weak purchasing practices to begin with. Consequently, while the technology has been a benefit, the

investment made compared to the relative benefits achieved is questionable.

According to survey results, forest products companies that have not participated in e-auctions indicate that a sound business case and cost/benefit rationalization are the primary factors that will influence whether they join an e-procurement exchange. Survey respondents' concerns include uncertainty over the actual benefits of joining an exchange and/or conducting the auctions, as well as the level of supplier participation in the auction process. For example, many of the major exchanges do not include some of the largest forest product suppliers. These suppliers see zero benefit in participating in a public forum for market share they already hold. Further, they would rather work with purchasing organizations on cost-based versus price-focused continuous improvement programs.

Operating in the red, some exchanges have experienced difficulties in consistent technology deployment and lack the business management knowledge to offer full-service procurement support. Some exchanges have had to go back to their original investors, seeking second- and third-round funding. Most alarming is that more than 75% of exchanges have either merged or gone out of business. This model has many challenges to confront.

Utilities Industry Speaks Out on E-procurement

Thirty-seven leading electrical utilities participated in the 2002 utility e-procurement exchange survey sponsored by Integrated Strategies. This survey was similar to the one conducted in the forest products industry. Electric utilities continue to explore the benefits and opportunities available through e-procurement technologies, and the survey was conducted to understand the benefits and opportunities, limitations and concerns, and value provided by utility e-procurement exchanges. What was learned may provide further insight into what the pulp and paper industry is experiencing in the use of e-auctions.

Approximately 50% of the utilities who participated were members of an e-procurement exchange. Ninety-three percent of those exchange members reported benefits were not being achieved as expected. Here is what utility executives are saying about the flaws in the thinking of the auction houses:

1. Purchase volume for standard parts in the electrical utility industry is relatively small compared to their total purchase requirements (only a small portion part of the total expenditure can be leveraged).
2. Attempting to drive standardization across multiple utilities is good in concept, but poor in performance.
3. Key suppliers—those who have major influence in the marketplace already—simply opt out. Who else will handle the volumes?
4. Utilities that are operating sourcing and supply chain strategically focus on total lowest cost. Price is only one component, and they recognize that by forcing price, other cost components can be driven up.
5. The concepts and technology are pretty thin. A flood of dot-coms rushed in to fill this marketplace, but many have quickly disappeared.
6. Utility exchanges have not generated the revenues they had expected. Exchange executives are going back to industry, exchanges are seeking second- and third-round funding, and the outlook for profit contribution continues to wane.

While many of these respondents presented business cases to senior management prior to joining the exchange, a vast majority said they do not expect to recover their investments for years to come. On average, exchange members reported a 1 to 5% price reduction using e-auctions. Like forest product firms, utilities with best practice sourcing strategies in place are experiencing zero price reductions. And similar to the forest products industry, major utility suppliers have simply opted not to participate because of few proven successes and the uncertainties regarding the actual cost/benefits.

WHAT OTHER INDUSTRIES SAY. Some of the biggest names in sourcing have publicly offered their opinions of e-auctions in a recent magazine article on the topic (E-auction Playbook published by Purchasing Magazine). For example:

- Thomas T. Stalcamp, former president and vice president of procurement at Chrysler Corp., has said, "I don't understand why, even for a commodity, you would want to put all your requirements online in an auction."
- R. Gene Richter, former chief procurement officer at IBM, adds, "I don't understand auctions at all. Everything is strategic to someone. Talk about ballpoint pens. The secretary has spots all over her brand new blouse because the pen you bought for a cent and a half is leaking."
- R. David Nelson, vice president of worldwide supply management at Deere and Co., remarked, "The auction firms saved money by doing upfront work that we are supposed to be doing anyway. If we do our legwork well, there won't be much in the auction business to get more bucks."

These executives understand that sound purchasing practices and supply side continuous improvement programs rationalize price.

Further, executives caution that suppliers can be so desperate to keep or gather new business, they will bid below cost and ultimately damage themselves. According to Jim Byrd, former purchasing director at Georgia-Pacific Corp., this approach "severely limits achieving a truly sustainable competitive advantage." In reality, the pulp and paper supply base has shrunk significantly. Product offerings have diminished, and full customer service is a luxury. Supplier margins are greatly reduced while buyers' demands have spiked. Consequently, suppliers are more judicious in deciding which customers they will supply product and which they will simply service.

WHERE'S THE HYPE COMING FROM? It appears that much of the e-auction hype is coming from the exchanges themselves. Initially, price reductions up to 50% from online auctions were routinely advertised. Today, many auction houses still promote savings figures ranging from 10 to 20%. However, e-auctions are now admitting that when best practice supply side strategies are in place, firms should not expect pricing reductions.

Consulting firms have also positioned themselves as proponents of online auctions. Many of these firms emphasize how to run a competitive bidding process rather than how to develop and implement a lowest total cost supply side strategy. Recognizing the shelf life of e-auctions, all major consulting firms have established at least one senior executive responsible for their e-procurement, e-sourcing, or e-supply chain technology offerings. They recognize many companies will continue to spend on e-sourcing technologies with a professional service bill that is, on average, five times greater than the technology spend.

MAKING E-AUCTIONS WORK. Based on this research, Integrated Strategies visited some of the largest e-auction houses in the world and interviewed seven of their market makers (as they term themselves) to better understand the value being delivered by the technologically enabled auctions. Market makers—the e-auction employees who are responsible for understanding commodity markets and suppliers—were open to sharing their experiences and insights. These market makers represented transportation, chemical, office supply, packaging, and MRO purchase commodities. They were asked to prioritize the relative value of five areas of e-auction contribution. The results and rankings are as follows, listed from most critical to least critical for achieving the desired results (Figure 1):

Figure 1: According to a major global e-auction marketplace, the greatest value in conducting an e-auction comes from outside of the technology tool. The online bidding capability ranked 5th, bringing the least value.



Ensure executive and cross-functional focus. Like any purchase initiative, unless executives and cross-functional leadership are on board, the resultant supplier(s) will never be successful. In all cases, the market makers indicated that e-auctions can help align senior management and cross-functional executives on the purchase opportunity.

Rationalize purchasing specifications. Market makers were emphatic that unless purchase specifications are cross-functionally reviewed and rationalized, reductions will be difficult. In specification rationalization, references to specific suppliers are removed, tolerances are opened, and redundancy is eliminated. In general, there is a drive toward industrial standards. Market makers were insistent that these improvements were critical in achieving true pricing reductions.

Identify alternative supplier(s). There was a universal belief that new suppliers must be introduced into the bidding mix to shift the pricing to lower levels. The market makers believe that current suppliers understand the buyer's current pricing levels, but need to be incentivized by the introduction of new competition.

Further, e-auction market makers believe that by introducing a new supplier they will be aggressively seeking market share they currently do not hold. Market makers attempt to introduce at least one (preferably two) suppliers into each new bidding event.

Lotting strategies. Based on their newfound training, e-auction market makers believe they bring value to their client organizations by helping them determine the ultimate lotting strategy. Lotting strategy is the e-auction terminology for supplier sourcing patterns (i.e., how many suppliers should be selected to provide a particular commodity). For example, should the product be single sourced or split 60/40, etc.?

Conducting the e-auction event. Bidding has now become a theater event. Most big exchanges like to conduct auctions in an amphitheater setting, with the buyer and market maker sitting side-by-side in bid control boxes, watching prices on the big screen theoretically fall. The expectation is that the sense of urgency and bidding frenzy will drive price reductions never seen by the buying organization.

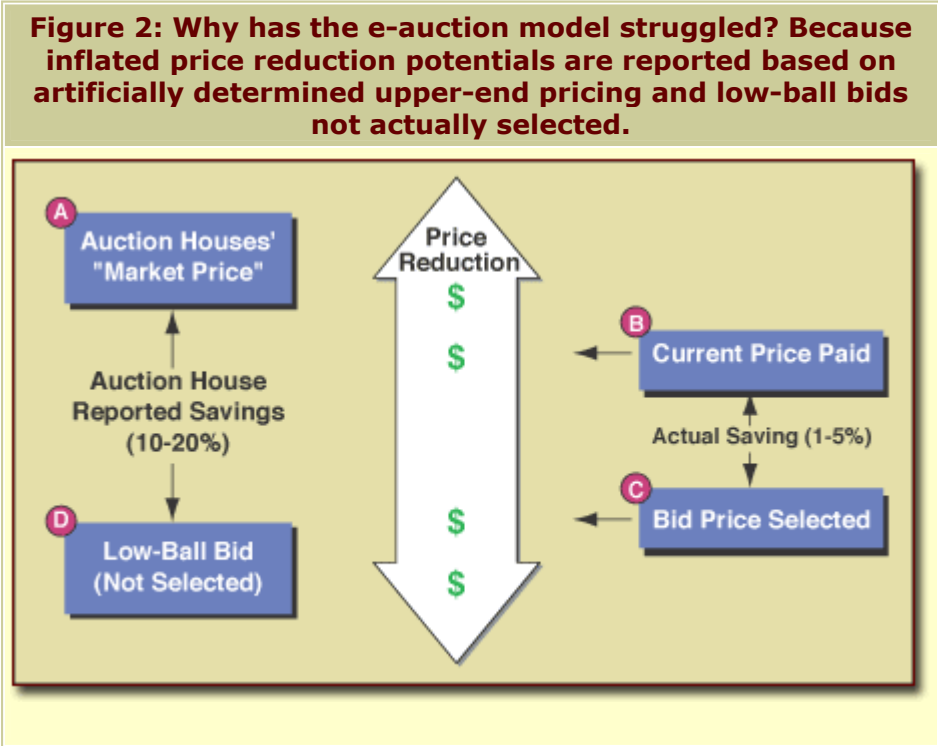
The seven market makers unanimously agreed the majority of benefit is made up of 1) ensuring executive and cross-functional focus, 2) rationalizing purchase specifications, and 3) introducing new qualified suppliers to the bidding process. Technology simply did not contribute to any major benefits. Further, if appropriately trained, firms could conduct these activities internally and not require the

technology piece to achieve any level of results. Yet, there is an even better lesson.

Firms can capture available total cost reductions by simply implementing improved strategic sourcing and supply chain practices without the accompanying bidding technology support. Once new business strategies are in place, appropriate technologies can be reviewed to sustain and replicate the best contributing practices. In these cases, the e-technologies would be used to mentor, monitor, and integrate business decisions and transaction processes on a real-time basis versus forcing price-based relationships.

SHOW ME THE SAVINGS. Where are the advertised "typical" price reductions of 10 to 20%? According to survey research, it is all in the measurement process. What was discovered is the e-auction "market maker's" definition of "price reduction"—one that demonstrates why the model has struggled.

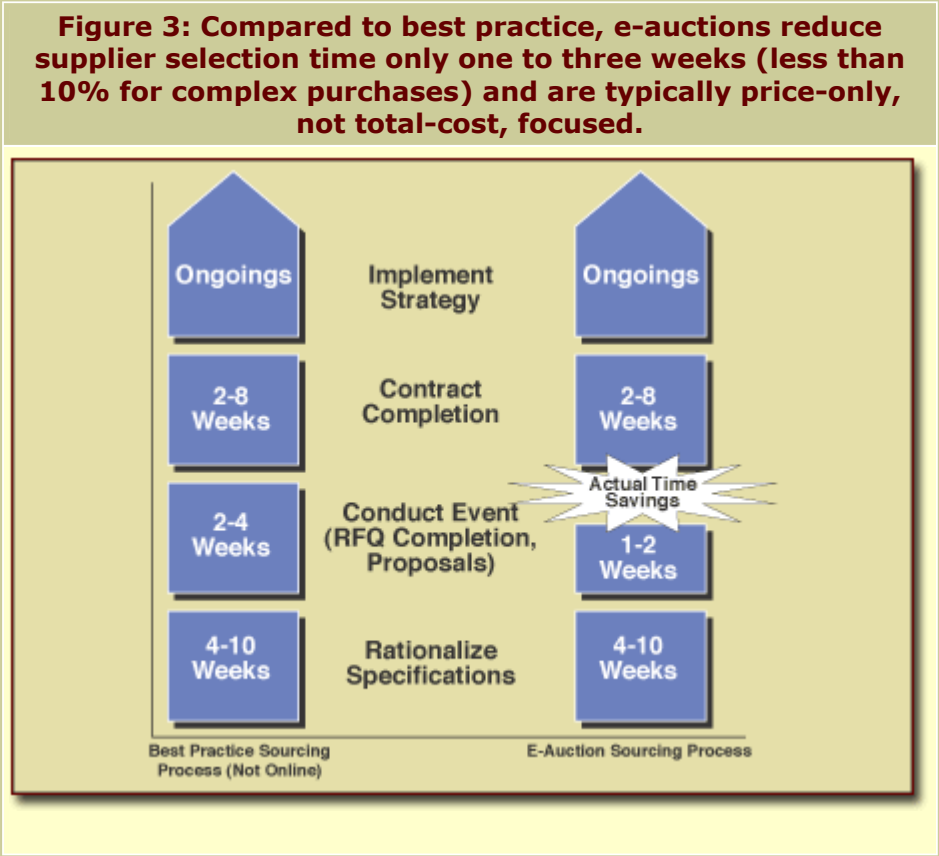
Here is how it works: The upper-end price that the reduction is to be measured from is a "market price," developed by the market maker. It is the market maker's best guess of what the market price should be. The market price has no relationship to what the buying organization is actually paying (Figure 2). The low price, used to measure the savings potential, is the low-ball bidder. The low bidder does not have to actually be accepted in order to be used for calculating the price reduction, they only have to enter the lowest bid. Consequently, the auction house reports savings as the difference between their market price (A) and the low-ball bid (D). In reality, the reported price reductions should be the current price (B) paid and the new bid price accepted (C) by the purchasing organization.



Exchanges argue that they are comfortable with their market price measurement because it is made by an expert market maker. Further, they argue that selection of the supplier by the buying organization is not within their control. When asked what the average percent reduction is between current and actual bid price selected, one exchange responded, "We do not measure that number."

E-auction houses are quick to suggest that significant purchasing productivity is available by the use of the online auction. We found that firms can expect to reduce their total source selection time by one to three weeks (less than 10%) for typical (six-month strategy development effort) sourcing strategies (Figure 3). Time compression only occurs during the actual event—all other segments of the sourcing process remain the same.

For less complex products (for example, office supplies—the one most frequently exercised by auction houses), the time savings may be greater. However, logistics, inventory, and overall business processes reengineering opportunities can be lost and may more than make up for any time savings that occurred in the bidding process.



MIXED MESSAGES. Companies throughout all industries remain mixed about e-auctions and exchanges. For some, it depends on whether you buy or sell. Others comfortably argue both sides. One executive in charge of supply chain for a multi-billion dollar global chemical producer argues that e-auctions are an important part of their purchasing process, despite having best-in-class sourcing strategies in place. The executive defended, "We can't look at everything we buy. We use the auctions in our low-dollar purchases—around \$1 million. We don't have time to deal with such purchases, and the auction helps us here." When asked if his company participates on the selling side of the auctions, he answered, "No, we do not participate from the sales side. We don't believe they help in truly reducing cost or helping customer relationships. They are just price focused."

Clearly, the research, academic studies, and marketplace hype will continue. Many consulting firms have published at least one detailed study on why e-auctions are important to their clients. Most recently, the Institute of Supply Management has commissioned research on the same topic. However, all the hype can't hide the fact there is limited, experience-based success for those firms who already employ best practices in sourcing and supply chain management. Companies who have invested millions in exchanges are now scurrying to realize benefits by advancing total cost considerations, as well as sourcing and supply chain strategy capabilities.

As one procurement executive comments, "We are rushing to use technology, but the result is that suppliers are beaten up and driven to poor performance, quality, and responsiveness. Our job is to look at the total cost of the supply relationship and rationalize it accordingly."

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