



The role of Internet auctions in the expansion of B2B markets

C.M. Sashi*, Bay O'Leary

Department of Marketing, College of Business, Florida Atlantic University, 2912 College Avenue, Davie, FL 33314, USA

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Abstract

In the wake of the advent of the World Wide Web, businesses are scrambling to take advantage of changes in their markets. While the consumer side of the Web explosion has been much touted, it is the business-to-business (B2B) market that has quietly surpassed expectations. An important business model that is responsible for this new market expansion is the Internet or Web auction. Businesses are adapting traditional auctions to the instantaneous “real-time” advantage of the Net to reach new markets that were previously cost-prohibitive by reducing transaction costs. Advantages such as the size and scope of the audience are giving Internet auctions a major role in the emerging global economy. This article examines the enormous impact of Internet auctions on B2B markets. We look at the kinds of auctions being conducted and their relevance to emerging business paradigms. We examine the circumstances under which you choose to conduct Web auctions and their impact on pricing mechanisms, information asymmetries, and channel relationships. © 2001 Elsevier Science Inc. All rights reserved.

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1. Introduction

The Internet, as a medium of exchange, has only come into its own in the past 5 years. When the Internet initially appeared on the horizon, few realized that the new medium was on its way to changing the way consumers and businesses buy and sell products in a global environment and set prices in these transactions. With the growth of the Internet in the past several years, businesses have rapidly become aware of its potential impact and the need to adapt their entire strategies to take advantage of this potential. New institutions have emerged to make use of this new medium.

One way businesses have adapted to the global marketplace of the Internet has been to reengineer the way they do business. Intranets, extranets, and business Web sites are being developed to help companies cope with the expanding marketplace. Information technology and knowledge management have moved into the mainstream of business processes to help facilitate the communications effort necessary in this new era. The development of sophisticated software that enables businesses to buy and sell on the Internet under secure conditions has led to new

strategies suited to this medium and the emergence of new business models.

A business model that is increasingly being used by businesses for transactions with one another is the Internet or Web auction. Web auctions, as a new way to buy and sell, have surpassed expectations for efficiently carrying out intermediate transactions in business-to-business (B2B) markets. Online auctions connect buyers and sellers together in ways that were previously not possible. Businesses can communicate their needs to a global audience in real time and cut transaction costs in the process. New relationships can be developed with suppliers who were previously inaccessible and relationships that are no longer necessary may be severed. Web auctions can cut costs substantially by increasing competition.

Web auctions have proved to be particularly popular for industrial procurement. In the US, it has been estimated that as much as US\$0.35 of every dollar or US\$5 trillion dollars goes to the procurement of industrial parts each year [1]. Traditional methods to elicit bids in an industrial procurement exchange require extensive time and effort. After a lengthy request for quotes (RFQ) process, a business was satisfied if it managed to get a good price from suppliers. The market for the RFQ was usually small and local, leading to inefficiencies in the process. One factor contributing to the RFQ process being inefficient was the lack of

* Corresponding author. Tel.: +1-954-236-1355; fax: +1-954-236-1249.

E-mail address: sashic@fau.edu (C.M. Sashi).

standardization in the request itself. Unlike when products are homogeneous, it is difficult to compare prices when the specifications of a job or purchase opportunity are not the same. A business usually relied on straight rebuy transactions and stayed with one or two main suppliers with whom they had dealt successfully in the past in order to reduce transaction costs for most of their procurement needs. Occasionally, in modified rebuy situations, they might look at one or two newcomers per transaction to avoid becoming too dependent on one supplier.

Online Internet or Web auctions, however, permit businesses to reach suppliers on a global basis in real time without incurring the costs traditionally associated with such access. While estimates of the volume of online B2B transactions vary, Forrester Research suggests that B2B e-commerce will reach US\$3.5 trillion by the year 2004 [2]. Industry analysts predict that 25% of this e-commerce will consist of exchanges engineered by Web auctions.

The proliferation of Web auctions in B2B markets in the past 2 years attests to the fact that Internet markets are well suited to the auction format for conducting transactions between organizations. In order to look at why Web auctions have become so popular for many businesses, we briefly review some rudimentary details of auctions and their pros and cons in the B2B context.

2. Types of Web auctions

A standard or non-Web auction has been defined by McAfee and McMillan [3] as “a market institution with an explicit set of rules determining resource allocation and prices on the basis of bids from the market participants.” While this definition would still hold for Web auctions, some of the rules have changed. Buyers and sellers no longer have to meet face-to-face to conduct an auction. In contrast with standard auctions, the time period of an auction online is longer and it ends at a preset time. The auctioneer also has the right to extend the time in a Web auction if tie bids are given. This usually happens in time increments of minutes or seconds. The technology in terms of software and systems required to ensure a fair outcome must be in place to conduct a Web auction in the virtual world.

A business may participate in Web auctions in several ways. The standard format is the English auction or the Ascending Price auction. In this type of auction, a seller who has something to sell and buyers who want the item are participants in the auction. The seller starts the bidding at a minimally acceptable point usually called the reserve price and the buyers bid higher and higher until no one is willing to go any higher. The buyer with the highest bid wins the item.

Many companies are using the English auction format for Web auctions. The English auction format is suitable for sales by companies holding excess inventory, companies that buy out-of-date inventory, or companies simply trying to reach a larger marketplace.

Another type of auction format commonly used in industrial procurement is the Dutch auction. In a Dutch auction, the company that holds the auction is the buyer and the companies that bid are the sellers. The buyer starts the bidding at a price deemed to be a fair starting point, which is the equivalent of the reserve price in an English auction. Often, companies use the previous price at which the items were bought as the starting point. The price is revealed and the bidding begins. The sellers start to bid lower and lower for the contract (the price at which they are willing to sell the items to the buyer) until a low bid is reached and there are no more offers. At this point, the contract for the items is given to the lowest bidder. The buyer is usually very pleased with the results as the auction has been shown to lower procurement costs by as much as 35% [4].

In the past, industrial procurement has been attempted using standard auctions for certain commodities, but the speed and real-time advantages of a Web auction have enabled it to far surpass traditional auctions. Several aspects of B2B markets are radically changing due to Web auctions. A company looking for a supply of widgets now has the choice of going to the Net. Many companies are using intermediaries to conduct the auction. In this type of auction, an intermediary like Freemarkets.com investigates the background of potential suppliers and acts as a consultant. Once they have narrowed the playing field to qualified suppliers, the auction takes place online.

There are other auction formats such as discriminatory price auctions or uniform price auctions for multiple items, and first price auctions or second price auctions for single items. The discriminatory and first price auctions are the online equivalent of a sealed bid auction. The buyer or seller uses e-mail or another electronic communication method to transmit a bid to the auctioneer. The private bids are sorted with the highest (or lowest in the terms of a contract or procurement auction) winning the bid. Uniform or second price auctions are conducted in the same manner with the second highest or lowest price winning the bid [5]. The formats, however, that have shown the greatest ability to be easily adapted to the Internet as evidenced by the sheer number of companies using them are the English and Dutch auction formats.

3. The growth of B2B Web auctions

In 1995, companies first started to look at Web auctions as a tool to help expand their markets. General Electric (GE) was a pioneer in developing its own auction site in-house. However, the technology had not yet developed to the point where it was feasible to carry out the transactions as envisaged. But after several years and a large investment, GE now runs one of the most successful Web auction sites.

One of GE's employees recognized the new business model that was emerging early in its infancy and left GE to form Freemarkets.com, a company that acts as an inter-

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