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Industrial Marketing Management 34 (2005) 526–534
INDUSTRIAL MARKETING MANAGEMENT

Regulating B2B online reverse auctions through voluntary codes of conduct

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Received 13 June 2004; received in revised form 12 October 2004; accepted 14 December 2004
Available online 2 March 2005

Abstract

In response to real and perceived abuse by market makers, buyers, and sellers, some industry trade groups representing suppliers have developed voluntary codes of conduct, white papers, and other forms of guidance for online reverse auction participants. The intent of these guidelines is to improve both the reverse auction process and relationships between buyers and sellers. This paper examines the rationale for creating guidelines and codes of conduct, and examines their efficacy in regulating reverse auctions to achieve improved outcomes for market makers, buyers, and sellers. Data from primary and related secondary sources indicate that industry-specific codes of conduct and guidelines have not had a favorable impact.
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Keywords: e-Business; Codes of conduct; Reverse auctions; Purchasing; Supply management

1. Introduction

Business-to-business (B2B) online reverse auctions, also called "e-reverse auctions" or simply "reverse auctions," have become a common method to source production and non-production goods and services by Fortune 2000 companies since 1995 (Richards, 2000; Tully, 2000). Widespread use of this tool by buyers is of great concern among incumbent suppliers due to potential negative outcomes such as margin erosion and loss of sales volume to other suppliers (B2BRC, 2003; Berning & Flanagan, 2003; Emiliani, 2000; Emiliani & Stec, 2002a; Kobe, 2001; Leonard, 2004; MHEDA, 2003; Stein, Hawking, & Wyld, 2003; Tulder & Mol, 2002). Additional incumbent supplier concerns relate to whether or not buyers and the "market makers"–companies that provide reverse auction services–give adequate consideration to other important factors such as quality, service, technology, or production capabilities (Bartholomew, 2001, 2002; Brindley, 2000) or total costs (Emiliani & Stec, 2001, 2002a, 2004, 2005b).

Previous studies have shown that reverse auctions–with rare exception; e.g. purchase of industry standard commercial goods (Smart & Harrison, 2003)–damage supplier relationships and create distrust among incumbent suppliers (B2BRC, 2003; Beall et al., 2003; Emiliani & Stec, 2004, 2005b; Jap, 2001, 2003; MHEDA, 2003; Smeltzer & Carr, 2003). There is a widespread perception among incumbent suppliers that reverse auctions are not fair and have been abused by buyers and market makers (Brindley, 2002a; EU, 2004; Glimm, 2003; Morris, 2003). It has been characterized as an unfair bidding process used by large corporations as a substitute for poor purchasing practices (Brindley, 2002b; Emiliani & Stec, 2002a, 2002b). In addition, the value proposition for incumbent suppliers, to this day, remains un-addressed, save for the coercive threat of losing business (Emiliani & Stec, 2002b, 2004, 2005b; Leonard, 2004; Richards, 2000; Stein et al., 2003; Tulder & Mol, 2002). New suppliers, of course, stand to gain important business from new customers, provided they understand customer requirements, their costs, and do not underbid.

Previous studies of simple and complex commodities have also shown that the benefits of reverse auctions for

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doi:10.1016/j.indmarman.2004.12.003

both buyers and suppliers do not exist or have been greatly overstated by market makers and buyers (CLBM, 2004; Emiliani & Stec, 2002a, 2004, 2005b). For suppliers, they purportedly include:

- 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.

While for buyers, they purportedly include:

- Fast return on investment
- Achieve quick savings
- Obtain market price
- Reduce sourcing cycle time from weeks to hours
- Streamline the sourcing process
- Make better buying decisions
- Improve supplier relationships.

In most cases reverse auctions over-promise and under-deliver, whether for complex custom or simple standard goods or services. Not surprisingly, the outcome is:

- The poor financial performance of leading market makers (Ariba, 2004; Butters & Bennett, 2002; Kisiel, 2002a, 2002b, 2003; Ryan, 2003),
- Closure, merger, or sale of market makers such as CommerceOne, Cordiem, Covisint, eScout, FreeMarkets, and PurchasePro (Barlas, 2004, 2004a; Ericson, 2003, 2004)
- Reverse auctions are typically used for less than 15% of total corporate purchases (Beall et al., 2003)
- Flat or declining use of reverse auctions among large industrial buyers (Hannon, 2003a)
- Declining levels of supplier participation (Emiliani & Stec, 2004, 2005b).

Despite this, senior managers of many Fortune 2000 corporations continue to believe in the efficacy of reverse auctions to reduce unit prices (Emiliani & Stec, 2005b; FreeMarkets, 2003; Grant, 2003; Judge, 2001; Reason, 2001). That is partly because the common metric used to determine unit price savings–purchase price variance–is easily gamed (Emiliani, Stec, & Grasso, 2004). Accurate measurement of total cost would reveal that reverse auctions, in most cases, yield unfavorable results (Emiliani & Stec, 2002a).

Reverse auctions have been shown to be a technologically assisted form of power-based bargaining (Carbone, 2004; Emiliani, 2003, 2004; Emiliani & Stec, 2001, 2002a, 2002b, 2004, 2005b; Jap, 2001, 2003; Stein et al., 2003; Tulder & Mol, 2002). As such, it is subject to abuse principally among buyers and market makers (Beall et al., 2003; OESA, 2002; Sawhney, 2003). The different forms of abuse include:

- Ambiguous or shifting auction rules
- Threatening incumbent suppliers to bid or risk losing the work
- Changing contract terms and conditions between RFQ and award
- Phantom bidding (buyer or market maker pretends to be a supplier)
- Drive down unit prices with no intention of switching sources
- Allowing unqualified suppliers to bid
- Showing the identities of the bidders and their bids
- Post-auction renegotiation
- Awarding only portions of the items in a bid package
- Forcing supplier to honor unreasonably low prices
- Providing incomplete or inaccurate specifications
- Allowing specification relief to winning bidders
- Including internal departments as bidders
- Repetitive re-bidding to drive down prices
- Not informing bidders of outcomes.

However, new and incumbent suppliers could also abuse reverse auctions by:

- Not abiding by auction rules
- Not adhering to request for quote parameters
- Placing bids with no intention of honoring them
- Bidding when the supplier is in fact unwilling or unable to assume the business if it were awarded to them
- Known inability to meet contract terms and conditions
- Collusion (legal or illegal, depending upon country laws)
- Win new business and charge high prices for “extras”.

This has resulted in the creation of voluntary guidelines of conduct for buyers, sellers, and market makers in the U.S. auto industry (OESA, 2002), the European aluminum foil industry (EAFA, 2002), the European flexible packaging industry (EF, 2002), European carton makers (ECMA, 2003), European wire and cable makers (EPC, 2003), Canadian general contractors (CCA, 2001), and British aerospace companies (SBAC, 2003).

It has also resulted in the creation of “white papers” for general contractors in the United States (AGC, 2003), manufacturers of housewares (IHA, 2002), and printers (Stoddard, 2003). In addition, eleven European packaging-related trade associations endorse the European flexible packaging industry code of conduct (EF, 2002). Industry-specific codes of conduct and white papers vary in structure and content, but all share the same basic objective: to help ensure that reverse auctions are used in a manner that supports fair trade and improves trust between market makers, buyers, and sellers.

Non-industry specific recommendations on how to correctly use or improve reverse auctions have also

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