

# SEALED-BID VS. REVERSE AUCTION

By Phyllis Anzalone

## purchasing electricity

**T**he seemingly inexorable rise in the price of electricity has created an extremely distressed situation for many buyers and has led some to seek radical solutions. This environment has proved highly favorable to sellers of various cost saving schemes. In their desperation, customers who are otherwise sensible buyers have been attracted to a number of questionable products that require the repeal of the laws of thermodynamics or of common sense. It seems that a new concept emerges about every six months in the Texas market – some with substance, others without.

A method developed last year was the marketing of MCPE or spot energy as surplus or “left over” electricity. One of the fundamental ways that electricity is different from all other commodities is that it can’t be stored even for an instant, and thus, there never can be such a thing as a surplus of electricity.

### Reverse Auctions – Fad or Fundamentally Sound?

This year’s new idea may be the reverse auction. The promoters of reverse auctions would have you believe that suppliers of commodities will behave differently when placed in an auction setting than they will behave in an equally competitive sealed-bid environment. By extension, these promoters would have you believe that suppliers have essentially unlimited margins in their prices and that this margin can be “driven out” by the auction process. As demonstrated below, a properly conducted sealed-bid process is equally likely to produce the best price as a properly conducted auction. In addition, because auctions do not allow for shortlisting a subset of the best initial bids, a properly conducted reverse auction will require significantly more upfront work and transaction costs (that are ultimately borne by the buyer) than a sealed-bid approach.

### eBay for Electricity?

Comparisons of reverse auctions to eBay are common but also suspect because electricity is NEVER sold on eBay. There is, however, one respect where the behavior of all sellers in the reverse auction perfectly mirror the behavior of all buyers on eBay – the only important transactions take place in the last minute of bidding. Because bidding in a reverse auction and on eBay takes place in real time, it is impossible for any bidder in either auction platform to make his final bid in response to the final bids of any other active bidders. How many times on eBay have you submitted your final bid – a bid higher than any other bid submitted – only to lose the auction to another bidder who submitted a final bid higher than your own? As a result of this possibility, serious bidders will determine their final bids independently of the final bids of all other bidders. This is exactly the same condition that applies in a sealed-bid process, except that, in the auction model, a bidder will hold his bid for entry until the last possible moment, submitting his bid just before the auction closes. Under this method how can you be assured that the winning bidder, in fact, has submitted his “best” bid?

When the product being sold is a “one-of-a-kind” item, where both buyers and sellers have little advance information about what the selling price should be, the lead-up bidding on eBay, for example, serves as an important price discovery function in advising buyers as to their final bid. In contrast, when the product being sold is a commodity, the range of possible prices is well known by buyers and sellers and preliminary offers are merely opportunistic, placed in the hope of little or no competition, but have no impact on the bids submitted in the final round. In any case, the difference in price between the first bid and the last in a reverse auction does not

represent “savings” achieved by the reverse auction process any more than the difference between first and last bid can be described as the value created by the eBay auction process.

### It Isn't the Auction

The real value of the eBay model does not lie in the auction process, but rather in its universality and ease of transaction. eBay serves to bring together a world-wide pool of buyers and sellers that would not be possible without eBay or an equivalent alternative. Where the product being sold is “one-of-a-kind,” then the eBay transaction, when compared to other alternatives, is both easy and inexpensive – and accounts for the growing popularity of eBay. Where the product is a commodity, then the eBay transaction is expensive and inefficient compared to the existing models that have been developed to sell that commodity. This is why electricity is not sold on eBay.

The real “value” of the reverse auction is to provide governmental and institutional buyers the gloss of an online process and the appearance of a fully competitive and transparent process. In reality, this transparency can be overstated. If we keep in mind that in the sale of a commodity only the final bid is relevant, then a bidder who bids in the early going, but then drops out, adds nothing to the competition. A reverse auction with seven participants, but only two who bid in the final minute, is less competitive than a sealed bid with four bidders. Finally, a sealed bid among the three leading market participants is also more competitive than an auction or a sealed bid among many inactive participants.

### What About Compliance?

Reverse auctions claim to meet Sarbanes Oxley (SOX) compliance requirements of publicly traded companies and institutions. If a buyer’s broker utilizes a reverse auction as



his pricing platform and the broker does not fully disclose his fees – in addition to the reverse auction fees – in a contractual arrangement with the buyer, SOX compliance is simply not achieved. Further, a broker who utilizes the reverse auction platform passes not one, but two layers of procurement fees on to the buyer.

You may have also heard compelling stories about the savings achieved through reverse auctions applications. Before you get too excited, look under the hood. Are the savings derived from the: utility default rate (if you are already in the market, the default rate is moot), highest price posted at the opening of the auction, which could be any number, pick one, or best price achieved through a traditional sealed-bid platform?

Proponents of reverse auctions usually present their product as capable of delivering significant price savings over traditional sealed-bid alternatives. Because it is impossible to conduct a simultaneous sealed-bid and a reverse auction for the same transaction, such projections of savings are derived from something other than a true comparison of the two alternatives – and in most cases are based solely on observation of bidder behavior on their own platforms.

### Other Considerations

Texas suppliers have expressed reservations about the effectiveness or timing and fairness of the reverse auction platform. Considerations:

The only way to conduct a fair and comprehensive auction process is to review the terms and conditions of all of the bidders in advance of the auction itself, to assign a price weighting to each of these differences in terms, and to provide each potential bidder's price weight to that bidder in advance. While

it is theoretically possible to conduct an auction in this manner, it also requires a considerable investment of costly man-hours to actually accomplish. Thus, in practice, auctions are rarely conducted in this manner and instead are conducted according to price only, with contract terms negotiated with the winning bidder after the fact.

Because electricity pricing is not fully transparent, the buyer of electricity can never be sure that subsequent price changes from the winning bidder are the result of real market movements. The winning bidder's now exclusive position resulting from the auction eliminates the buyer's ability to force the bidder to keep the same low margin.

Bidders in a reverse auction have an incentive to bid below their cost of goods sold in the auction in order to achieve a sole source position where margin can be added during the course of subsequent negotiations.

Apples to Apples? – Again, because the auction process does not lend itself to a careful comparison of non-price terms, it is relatively easy for a bidder to offer the lowest price by passing through one or more “retail adders,” whereas his competitor includes all retail adders in the price. The only way to make a definitive assessment of whether the playing field is level is through a thorough review of the product explanation in the electricity contract.

### Why Sealed-bids?

Sealed bids are still the best mechanism to deliver real value to buyers:

1. The process of shortlisting reduces the amount of time that must be spent on legal and business contract review and due diligence of suppliers.
2. Like auctions, the sealed-bid process utilizes an electronic platform.

3. Supplier effort is greater to participate in a reverse auction than a sealed bid.
4. Full participation of top tier suppliers is more likely through a sealed-bid process.
5. The sealed-bid model lends itself better to the evaluation of non-equal contract terms than the reverse auction (single focus on price).
6. It is simply not true that a reverse auction process for electricity will (a) result in the lowest possible price for the buyer or (b) be less expensive to the buyer than a sealed-bid process.

### Conclusion

In short, in a deregulated electricity market, an auction does not produce or even enhance competition. While any third party working in the long-term interest of buyers will do everything in their power to enhance the competitive market, in reality underlying market forces create the competitive environment. The purpose of a third party is to facilitate the interaction of the buyer with that existing environment. An auction is one way to achieve this purpose, but not necessarily “the best.” The “best” method of interaction is the one that produces the most attractive combination of services and price for those services. Like anything else the “best” approach is the one that delivers the greatest value. **N**

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