FellonMcCord™
Knowledge in Energy

White Paper

Energy Reverse Auctions in North America

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INTRODUCTION

Online commerce has gained in popularity over the past decade. Vendor sites such as Amazon.com, eBay, and others have led the charge and helped users become comfortable with the idea of conducting business electronically. The trend toward e-business has advanced into supply chain and corporate sourcing applications. Online tools such as reverse auctions have yielded some positive results and have thus become valuable procurement mechanisms for busy corporate buyers.

Traditional auctions originate from the vendor; buyers enter bids, driving the price up to the highest point any buyer is willing to pay. E-Bay is an example of an online traditional auction. A reverse auction is the opposite. Originated by the buyer, vendors enter bids, driving the price lower to the lowest point at which any vendor is willing to sell the item.

Used in energy procurement, results have been mixed. In theory, a reverse auction should result in the lowest price. Unfortunately, lowest "price" does not always equal lowest cost or best option.

REVERSE AUCTIONS VS. CONVENTIONAL SOURCING

There are several cases in which reverse auctions may yield the best results:

1. One-time purchases of a homogeneous product, such as tons of steel, gallons of milk, or other commodity.

2. Markets in which there is little price transparency, such as tires.

3. New, immature markets, where liquidity is low, and deep understanding of the marketplace is rare, such as energy in newly deregulated markets in Europe.

Energy markets in the U.S. do not share those characteristics, and as such, energy procurement via online reverse auction is not always the best choice.

1. Energy is not a homogeneous commodity. Yes, electrons are electrons and molecules are molecules, however there are quality differences in vendors, transportation options, storage availability, contract terms, and pricing structure. Focusing on price alone ignores other factors that can affect total cost, such as reliability and flexibility.

   Additionally, energy procurement is typically for long-term arrangements (i.e., multiple months or years into the future) instead of one-time off-the-shelf purchases. Knowledge of past vendor performance can be the deciding factor between two bids with prices that are comparable.

2. U.S. energy markets are some of the most liquid and transparent markets in the world. Online exchanges such as The IntercontinentalExchange (ICE) and the New York Mercantile Exchange (NYMEX) post prices for most major trading points at least daily. The validity of prices received in auctions is easily verified by comparing them with exchange prices. The availability of exchange pricing reduces the need for the auction mechanism for price discovery.

3. Natural gas and deregulated power markets in the U.S. are well established and mature. Expertise has had time to develop on both the supply and demand sides of the market. Supplier reputations have been earned, good and bad. Years of experience have helped market participants better anticipate potential pitfalls and create purchasing strategies that are customized to the buyers' needs. An online reverse auction often involves anonymous participants and the format is typically designed by the auction host (website). This generic approach can miss a buyer's specific circumstances—such as the need for supply flexibility or other operational requirements—and fail to take advantage of the normal give and take of direct negotiations.

ADVANTAGES OF CONVENTIONAL SOURCING METHODS FOR ENERGY

A well-structured procurement process for energy supplies can achieve the lowest overall cost for the buyer, not just the lowest price. A conventional Request for Proposal (RFP) managed by an energy market expert will outperform an online auction in these areas:

- **Supplier selection:** Online auctions will typically include any and all suppliers willing to bid, provided they meet a minimum acceptable level of creditworthiness and legal compliance. A competent energy professional will know the best, most reliable suppliers by reputation or past experience. They will know whether the supplier is actually a producer or just a marketer, whether the supplier owns physical assets such as natural gas storage or electric generation assets, and how the supplier has performed in the past during emergencies or unusual market events.

- **Market timing:** Once a buyer has initiated an online auction, the process can be completed quickly. But the auction mechanism does not advise the buyer on the best time to conduct the auction. The best procurement outcomes result from a process that is market-based, not calendar-based. A professional who watches the market daily can best determine when market conditions are favorable.
- **Pricing structure:** In online auctions, vendors respond to requests from the buyer, but do not have sufficient knowledge of the buyer's operations or energy consumption patterns to be able to recommend the best pricing structure for that particular buyer. Experienced professionals will determine the optimal pricing structure before the request for pricing begins.

CONCLUSION

The goal of an online energy auction, traditional "paper" RFP, or any other procurement process is to secure reliable energy supplies at the lowest available cost. An online reverse auction can find the lowest price at the time the auction is performed, but price is just one component of total cost, and the timing of the auction may not coincide with the best market opportunities. A conventional RFP performed by a qualified, experienced energy professional will more times than not outperform online auctions in supplier selection, market timing, and pricing structure, resulting in the lowest total cost.

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