

# Bidding for a better bottom line

*by*

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30<sup>th</sup> October, 2004

One of the crucial decisions that anyone procuring supplies or selling assets needs to make is the format by which they run their tenders and auctions. Many businesses run tenders based on a traditional sealed bid format. In this situation, potential suppliers are invited to solicit their bids in a sealed envelope and the purchaser chooses the bid with the best value and awards the contract to them.

The alternative is to use an open auction format. This involves suppliers progressively submitting lower and lower bids until no one wants to reduce their bid anymore. The firm with the lowest bid is then awarded the contract.

According to a celebrated result in economic theory by Nobel prize winner William Vickery, purchasers should be indifferent between these two procurement formats. Both would generate the same revenue. To see this, note that in an open auction format, the contract will be awarded to the supplier with the lowest costs, and that it will end up receiving a payment enough to cover the costs of the supplier with the second lowest costs. In a sealed bid tender, bidders play a guessing game. Each bidder trades off the chances of winning the tender with a lower bid, versus the amount of profits (i.e., payments above their costs) they would receive in that event. It turns out that both of these bidding strategies for these different formats will likely give the same result for the purchaser.

What is interesting is that despite this economic theory regarding the equivalence of revenues for alternative formats, most procurement officers know which one they prefer. The pages of this newspaper are littered with a clear preference for sealed bid tenders. The markets for asset sales tell a different story. Can we sort these clear practices out?

Recent research at Stanford University has uncovered at least one factor that might drive real choices. Susan Athey, Jonathan Levin and Enrique Seira identify the costs of soliciting bids as a real issue. They argue that in many business tenders, potential bidders need to spend time and money gathering the information necessary to solicit a real bid. Moreover, you are only going to spend this time, if you feel you have a real shot at winning any contract.

For larger bidders who can routinise how bids are formulated and who know they may have low costs, this decision is easy. For smaller firms, whether to go for a tender is a far bigger decision.

It is here where the guessing game that is part of the bids in sealed-bid tenders comes to play. For an open auction, the lowest cost firm always wins. For a sealed-bid auction, that happens much of the time but not all of the time. The smaller firm is always in with a chance and for that reason will be more likely to participate in those auctions.

The Stanford researchers find that in US Timber Auctions, this has a real impact. The sealed-bid format and the competition it generates drives real improvements. Possibly too large, but that is a story for another column.

The moral of the story is that when there are bidder costs you need to think carefully about what format will attract the most of them. That will generate competition and give you a better bottom line.

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