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Congress of the United States

U.S. House of Representatives

Committee on Small Business

2361 Rayburn House Office Building
Washington, DC 20515-6515

To: Members, Subcommittee on Contracting and the Workforce, Committee on Small Business

From: Committee Staff

Date: May 17, 2013

Re: Hearing: "Building America: Challenges for Small Construction Contractors"

On Thursday, May 23, 2013, at 10:00 am, in Room 2360 of the Rayburn House Office Building, the Subcommittee on Contracting and Workforce of the Committee on Small Business will meet for the purpose of receiving testimony on barriers to the maximum practicable utilization of small business construction and architect and engineering (A&E) contractors. The hearing will specifically address the following areas that often limit small businesses from effectively competing on construction projects: 1) surety bond issues; 2) the use of reverse auctions for construction and construction services; 3) subcontracting credit allowance; and 4) failure to properly use a two-step procurement process for design build contracts. In each case, the Subcommittee will discuss potential legislative solutions.

I. Executive Summary

As described in Section II, while construction and A&E contracting account for about eight percent of federal prime contract dollars, the segment accounts for over 17 percent of the awards to small businesses.[1] Therefore, issues affecting construction and A&E contracts have a disproportionate effect on small business opportunities. This memorandum will discuss four significant issues limiting the ability of small business to compete for federal construction and A&E contracts.

1. Surety Bonds

As described in Section III, access to capital prohibits some small businesses from competing for federal construction contracts. Federal construction contracts require that all offerors provide surety bonds attesting to the businesses ability to perform the work and meet its necessary obligations. While the Small Business Administration (SBA) will guarantee bonds issued to small businesses, the terms are such that corporate bonding companies do not find the guarantees attractive. As a consequence, individual sureties have filled the void in the market. However, some disreputable individual sureties offer bonds backed by insufficient or speculative assets, placing the government and any subcontractors at risk.

Therefore, the Subcommittee will consider H.R. 776, the Security in Bonding Act of 2013, introduced by Chairman Richard Hanna. This legislation will raise the bond guarantee rate offered by SBA, which should

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[1] Analysis based upon the Federal Procurement Data System (FPDS), *available at* https://www.fpds.gov (last accessed March 6, 2012). Copies of reports are on file with the Committee.

attract more corporate sureties, without increasing the cost to taxpayers. If more sureties are active in the program, it will make it easier for small businesses to obtain legitimate bonds and make the disreputable sureties less attractive. Further, it puts in place restrictions on the types of assets an individual surety may pledge, and requires a transfer in custody of any assets backing the bonds, so that the government and any subcontractors will be protected.

2. ***Reverse Auctions***

As discussed in Section IV, some agencies are using a procurement method designed to be used for the purchase of commodities in order to buy supplies. Under a reverse auction, companies continue to under bid each other, usually through a digital portal, until one is declared the winner. The intention is to drive down prices to the lowest possible amount. However, the United States Army Corps of Engineers (USACE) found that this methodology did not work for construction contracts due to their high degree of variability. Further, USACE found that the methodology did not deliver the promised savings. Consequently, it issued a policy to stop using reverse auctions for construction contracts.

However, small businesses have complained that the use of reverse auctions for construction continues, placing them at a competitive disadvantage. Therefore, the Subcommittee will consider draft legislation intended to limit this practice. The draft would prohibit the use of reverse auctions for construction contracts suitable for award to small business.

3. ***Credit for Subcontracting Goals***

Section V will discuss how to better encourage the use of small businesses as subcontractors on construction contracts. Specifically, while large prime contractors are currently required to negotiate subcontracting plans detailing how they will obtain the maximum practicable utilization of small businesses as subcontractors, and these prime contractors are required to do the same with each of their large subcontractors, there is little accountability or transparency regarding small business subcontracting below the first tier. In part, this is due to a policy that allows the federal government to take credit for lower tier subcontracting, but does not allow the prime contractor to do the same. However, because of variability in the types of subcontracting plans, any changes would need to make sure that small business subcontracting is not double counted.

Therefore, the Subcommittee will examine draft legislation intended to allow prime contractors with contract-specific subcontracting plans to take credit for lower tier subcontracting. It would simultaneously require an analysis of the systems necessary to allow this credit to be universal.

4. ***Design Build Contracting***

In Section VI, the Memorandum examines the misapplication of the current laws regarding design build contracting. These policies are intended to keep the cost of bid and proposal packages from becoming a barrier to entry for small businesses by limiting the circumstances under which a full proposal is required. However, agencies are not adhering to the current rules which in turn makes bidding on contracts cost prohibitive for qualified small business prime and subcontractors. Consequently, the Subcommittee will discuss proposed legislation intended to reinforce current statutes and best practices so that small businesses will be encouraged to compete.

II. The Importance of Construction to Small Businesses

Federal construction and A&E contracting represents a significant portion of all federal prime contract spending, but plays an even greater role in small business prime contracting.[2] Of the over $500 billion the federal government spends annually through contracts for goods and services, approximately eight percent is spent on federal construction and A&E projects.[3] However, when considering the $100 billion in federal prime contracts awarded to small businesses in fiscal year (FY) 2012, the percentage is over twice as high, exceeding 17 percent for federal construction and A&E work.[4] In FY 2012, the majority of those dollars were expended by the Department of Defense (DoD),[5] with nearly 60 percent of DoD's spend coming through USACE.[6] Among civilian agencies, the General Services Administration (GSA) and the Department of Veterans Affairs (VA) were responsible for a major share of the work.[7] In each case, small businesses were well represented, with over 40 percent of total construction spend, and over 23 percent of A&E work. The federal sector is a significant and growing portion of the construction market, accounting for 40 percent of the value of ongoing overall private and public sector construction activity in 2010, compared to about 20 percent in the prior decade, with a special focus on industrial/heavy construction.[8]

Table 1. FY 2012 Federal Contracts for Construction and A&E[9]

	Construction (Percent to Small Business)	A&E (Percent to Small Business)
Federal Government	$36,201,703,428 (43.82%)	$5,308,247,712 (26.21%)
DoD (including Army)	$25,914,807,888 (43.80%)	$2,688,833,491 (28.48%)
Army	$17,449,216,142 (41.05%)	$1,622,009,860 (47.21%)
GSA	$1,478,359,672 (42.21%)	$192,453,660 (38.57%)
VA	$2,617,159,564 (65.49%)	$310,020,545 (55.78%)

However, while the federal work is increasingly important to construction and A&E contractors, federal construction spending is down 28 percent since August of 2011.[10] Consequently, while employment by

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[2] For purposes of this memorandum, federal construction means the initial construction, alteration, or repair (including dredging, excavating, and painting) of buildings, structures, or other real property. *See* 48 C.F.R. § 2.101, § 22.502 and § 22.502 (2010). A&E is statutorily defined as the professional services of an architectural or engineering nature performed by contract that are associated with research, planning, development, design, construction, alteration, or repair of real property, [or] other professional services of an architectural or engineering nature, or incidental services, which members of the architectural and engineering professions (and individuals in their employ) may logically or justifiably perform, including studies, investigations, surveying and mapping, tests, evaluations, consultations, comprehensive planning, program management, conceptual designs, plans and specifications, value engineering, construction phase services, soils engineering, drawing reviews, preparation of operating and maintenance manuals, and other related services" as regulated by state laws. 40 U.S.C. § 1102.

[3] Prime Award Spending Data, List View, USASpending.gov, *available at* http://www.usaspending.gov (last accessed May 9, 2012). The total spent was $516.9 billion in FY 2012, $535.9. billion in FY 2011, and $538 billion in FY2010.

[4] FPDS.

[5] *Id.*

[6] GOVERNMENT ACCOUNTABILITY OFFICE (GAO), *PRIOR EXPERIENCE AND PAST PERFORMANCE AS EVALUATION CRITERIA IN THE AWARD OF FEDERAL CONSTRUCTION CONTRACTS*, GAO-12-102R, (October 18, 2011) *available at* http://www.gao.gov/products/GAO-12-102R.

[7] Prime Award Spending Data, List View, USASpending.gov, *available at* http://www.usaspending.gov.

[8] U.S. Census Bureau, Value of Construction Put in Place, Annual Data, *available at* http://www.census.gov/const/C30/ototal.pdf.

[9] Federal Procurement Data System ad hoc report, *available at* https://www.fpds.gov (last accessed May 9, 2013) Copy on file with the Committee.

[10] Chris Isidore, *How Construction Can Lose Jobs in Middle of Home Building Rebound*, CNNMONEY (May 3, 2013) *available at* http://money.cnn.com/2013/05/03/news/economy/construction-jobs/index.html.

homebuilders is increasing, employment by public works contractors declined by 19,700 jobs in April 2013.[11] Therefore, this hearing will examine whether adopting common sense reforms and best practices in construction and A&E contracting will reduce the barriers to entry for small businesses.

III. Surety Bond Program

Surety bonds protect the government and small businesses alike by providing a third party guarantee that the prime contractor will complete construction, commonly call a performance bond, and that the prime contractor will pay its suppliers and subcontractors, commonly called a payment bond. Under federal law, to bid on most federal construction and A&E projects above $150,000, the prime contractor must provide the contracting officer with a surety bond, and both the performance and payment bonds become binding upon contract award.[12] Thus, when bonds are issued by a surety, the surety vouches for the creditworthiness and capacity of the contractor, protects the government against uncompleted projects and liens, and protects subcontractors against unscrupulous or over extended prime contractors. This subsection will discuss the problems bonding itself creates if qualified small businesses cannot obtain the necessary bonding, or if the guarantor of the bond is not willing or able to meet its obligations, and then will discuss proposed legislation seeking to address these issues.

The first challenge posed by bonding is that if a small construction company cannot provide the necessary level of bonding, a contracting officer will not accept their proposal no matter how technically well qualified the firm. The Small Business Investment Act (SBIA) sought to provide an avenue for small business bonding by creating two surety bond guarantee programs within SBA.[13] Pursuant to the SBIA, SBA can use one of two programs to guarantee bonds for contracts up to $6.5 million: the Prior Approval Program (PAP)[14] or the Preferred Surety Bond Program (PSBP).[15] Pursuant to the PAP, SBA provides sureties with up to a 90 percent guarantee, meaning that if the small business fails to fulfill its obligations and the bond is called upon to pay subcontractors or the agency, SBA will reimburse the surety up to 90 percent of its cost. To obtain the guarantee, sureties must seek prior approval from SBA before issuing the bonds, and such approval is typically granted in three days. In contrast, the PSBP only pays a 70 percent bond guarantee, but sureties are preauthorized to issue bonds and audited every three years, and are not required to seek approval before issuing individual bonds.

To fund both programs, SBA charges the small business receiving the bond 0.729 percent of the contract price for the bond guarantee, and the surety company 26 percent of the fee the surety charges the small business. As of May 2013, there are approximately 7,494 active bonds with an actual bond liability of $2.9 billion.[16] Each program is operating at a zero subsidy from taxpayers.[17] Despite the different guarantee amounts and the differing levels of review, both the PAP and PSBP have similar levels of default. However, over the years, the PSBP program has become less effective for small businesses since only four sureties currently participate in the program because the guarantee rates are no longer competitive enough to encourage commercial sureties to participate.[18]

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[11] *Id.*
[12] 40 USC § 3131(b).
[13] 15 U.S.C. § 692 *et seq.*
[14] 15 U.S.C. § 694b(a).
[15] 15 U.S.C. § 694b(a)(3). The caps were increased from $2 million to $6.5 million pursuant to the National Defense Authorization Act of 2013, PUB. L. NO. 112-239 (2013). These provisions also made it possible for SBA to provide proportional coverage if notice requirements were not met.
[16] E-mail from Frank Lalumiere, Director, SBA Surety Bond Program to Committee staff (May 13, 2013). (on file with the Committee).
[17] *Id.*
[18] *Id.*

The second issue regarding bonding occurs when the surety cannot back its bonds, thereby exacerbating the very risks the bond is intended to mitigate. This problem is usually tied to a lack of assets associated with the surety. There are two types of surety-provided guarantees: corporate and individual. Corporate sureties are incorporated entities (often subsidiaries of insurance companies) that are certified to write surety bonds in one or more states in the United States, licensed and regulated by the state(s) where the surety does business, and approved by the Department of the Treasury, each of which ensure that sufficient assets exist to back the bonds.[19] However, this is not always the case with individual sureties. Individual sureties are not: 1) incorporated and usually are a single individual or a group of individuals who own or control a large amount of cash or other liquid assets; 2) licensed or regulated by state agencies; and 3) listed on the Department of the Treasury's list of approved corporate sureties. The assets serve as collateral to the project owners guaranteeing the project's completion. However, pursuant to the Federal Acquisition Regulation (FAR), an individual with surety needs only to pledge assets to the government, it does not need to allow the government to hold the assets.[20] In addition, an individual surety may pledge more volatile assets such as stocks and bonds traded on an exchange or rights in real property.[21] Thus, while the FAR does permit contracting officers (COs) to accept individual sureties, the decision as to whether or not the bid bond is acceptable is left to the CO's discretion; and not all government COs are familiar with individual sureties and their acceptable assets.[22] If the CO does not adequately scrutinize the individual surety, and the individual surety pledges nonexistent or insufficient assets, or the assets are not readily convertible into cash to pay the obligations of the defaulted contractor, the federal government's construction project is at risk for failure and financial loss as are any small businesses that acted in reliance upon the bonds. In 2012, a hearing before the Subcommittee on Courts, Commercial and Administrative Law of the House Committee on the Judiciary provided detailed testimony on the risk these types of bonds pose to the government and small businesses.[23]

H.R. 776, the Security in Bonding Act of 2013, was introduced by Chairman Hanna to address both the issue of bonding availability and the problem on unscrupulous individual sureties. A copy of this legislation is attached. First, the legislation increases the guarantee rate on the PSBP to 90 percent, which should attract new sureties to the program. While agency briefings indicate that the program could cover this additional guarantee out of existing authorizations – the current program actually makes money – it is important to note that should the current funding not prove sufficient, SBA has the ability to increase the fees on the bonds to prevent cover additional costs. Second, H.R. 776 confronts the problem of underfunded individual sureties by requiring that any asset pledged to back the bonds be reviewed by government officials and then deposited so that the government will have control of the assets should the company fail to meet its obligations. This would prevent sureties from pledging assets of dubious or speculative value, or from pledging the same assets numerous times. While similar language passed the

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[19] Surety and Fidelity Association, "About Industry" available at http://www.surety.org/?AboutIndustry. According to the Surety & Fidelity Association of America, corporate sureties generate $3.5 billion or more in written premiums annually from surety bonds. Because of their greater access to capital, corporate sureties dominate the industry, and have issued the majority of bid bonds, performance bonds, payment bonds, etc. Corporate sureties provide most of the bonding for federal construction projects and the Department of the Treasury maintains a formal list of federally approved corporate sureties. The Department of the Treasury's Financial Management Service (FMS) administers the surety bond program for the federal government pursuant to 31 U.S.C. §§ 9304-9308 . FMS's Listing of Approved Sureties (Department Circular 570), *available at* http://www.fms.treas.gov/c570/c570_a-z.html.

[20] 48 C.F.R. § 28.203.

[21] *See, e.g.* Richard Korman, *A Bold Individual Surety Claims His Coal-Back Bonds are Rock Solid*, ENGINEERING NEWS RECORD, Feb. 27, 2013, *available at* http://enr.construction.com/business_management/ethics_corruption/2013/0225-a-bold-individual-surety-claims-his-coal-backed-bonds-are-rock-solid.asp.

[22] Under FAR § 28.203(c), if the contracting officer "determines that no individual surety in support of a bid guarantee is acceptable, the offeror utilizing the individual surety shall be rejected as nonresponsible."

[23] *Security in Bonding Act of 2011: Hearing Before the Subcomm. on Courts, Commercial and Administrative Law of the House Comm. on the Judiciary*, 112th Cong. (2012).

House of Representatives in 2012, the hearing will provide the Subcommittee with an opportunity to hear from government and industry on the merits of the legislation.

IV. The Use of Reverse Auctions for Construction and Construction Services

Reverse auctions are a contracting methodology that have become increasingly prevalent over the last decade, but which pose special challenges for small businesses and construction contractors, leading many to question whether additional legislative or regulatory guidance is required. In order to understand these challenges, this section will first explain reverse auctions, then summarize the criticism of this methodology as it applies to construction, and finally discuss proposed legislative solutions.

The term "reverse auction" is not defined by statute or regulation. However, a 2004 USACE study explained it thusly:

> Under this reverse auction methodology, there is an 'auction' process whereby [contractors] offer multiple and consecutively lower bids on a rapid 'auctioning' basis to eventually arrive at the lowest bid-price of goods or services for the privilege of a standard contract award. In the case of government reverse auctions . . . [t]he government publicly solicits for specific goods and/or services from responsible and responsive contractors to provide these specific goods or services. The reverse auction process simply is the method by which contractors submit their bids and the lowest bid is received. The award is then executed through a standard firm fixed price contract.
>
> Yet, there is a major difference in the operational dynamics of the reverse auction methodology that is unlike anything available in the standard sealed bid process. In the standard sealed bid process, the contractor only gets only one chance to submit a bid. Additionally, the contractor does not know the relative ranking of his bid versus others during the bid process. Hence, in a standard sealed bid process, a contractor cannot bidgame, because he is forced to submit his best bid with only one chance to bid.[24]

Therefore, a reverse auction is a multi-round low-bid process where the lowest bids are disclosed. A typical reverse auction will be conducted for commodities – products that are standardized and where price is the principle differentiator.[25]

The use of reverse auctions for construction services has been denounced by most of the construction-related trade associations.[26] They allege that reverse auctions do not guarantee the lowest price, may encourage imprudent bidding, do not allow for a thorough evaluation of value, do not assure that the successful bidder is responsive and responsible; and may contravene federal procurement laws.[27] When

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[24] USACE, FINAL REPORT REGARDING THE USACE PILOT PROGRAM ON REVERSE AUCTIONING 11 (2004) (hereinafter USACE STUDY). Generally, the term "sealed bidding" is used to describe a process where bids are all submitted by a time certain, publicly opened and recorded, with immediate award to the lowest bidder; however, within the construction industry it is commonly preceded by a round when an offeror's technical capability is evaluated. 48 C.F.R. § 14.

[25] While the use of reverse auctions for commercial goods itself remains controversial, it is outside the scope of this memorandum.

[26] *See, e.g.*, Sheet Metal and Air Conditioning Contractors National Association, REVERSE AUCTIONS (2004), *available at* http://www.smacna.org/pdf/ACF6BF7.pdf; Chuck Scislo, *To the Lowest Bidder*, PROFESSIONAL ROOFING March 2006, *available at* http://docserver.nrca.net/technical/8633.pdf (National Roofing Contractors Association opposes reverse auctions); Associated General Contractors of America, WHITE PAPER ON REVERSE AUCTIONS FOR PROCUREMENT OF CONSTRUCTION 2005, *available at* http://newsmanager.commpartners.com/agcleg/downloads/AGC%20Position%20on%20Reverse%20Auctions%20-%20FINAL.pdf (hereinafter AGC WHITE PAPER).

[27] AGC WHITE PAPER.

these auction are conducted by third parties, work that should be reserved for small business is frequently awarded to large businesses, and pricing information that the FAR insists remain private is publicized.[28] Indeed, even the chief legislative proponent of reverse auctions, former Congressman Tom Davis (R-VA), specifically exempted construction from any legislation he introduced promoting the use of reverse auctions.[29]

Industry's assertions are borne out by the only study on the use of reverse auctions for construction services. USACE spent a year studying the use of the procurement methodology and found that, "it offered not even marginal edge in savings over the sealed bid process for construction service projects" and that construction was too variable to be considered a commodity.[30] As a result, USACE no longer uses reverse auctions for construction contracts. However, even though USACE has the most construction contracting of any federal agency, not all federal agencies have followed USACE's example and construction contracts continue to be awarded using reverse auctions.[31] Specifically, they are being awarded as commercial item contracts, in direct contravention of Office of Management and Budget Guidance.[32]

In response, draft legislation is being circulated that would exempt any contract for design and construction services that is deemed suitable for award to small business from being awarded using a reverse auction methodology. A copy of the draft legislation is attached. The hearing will discuss whether such a step is necessary, and whether there are ways to improve the approach advocated by the draft legislation.

V. Credit for Subcontracting Goals

While the participation of small businesses as prime construction contractors is important, it is additionally important that small businesses have opportunities as subcontractors on any tier of construction contracts. SBA regulations indicate that standard practice in construction is to subcontract a far greater amount than in other industries.[33] This section will discuss the policies in place to encourage small business participation as subcontractors, challenges in maximizing opportunities for lower tier small businesses, and potential legislative solutions.

In order to ensure the maximum practicable utilization of small businesses, the federal government has a goal of awarding 23 percent of all prime contract dollars to small businesses, five percent of prime and subcontract dollars to women-owned small businesses (WOSB) and to small disadvantaged businesses (SDBs), and three percent of prime and subcontract dollars to service-disabled veteran-owned small

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[28] Small businesses win most contracts awarded using reverse auctions; however, given that all of the awards are under the statutory amount reserved exclusively for small businesses, these awards should be exclusively to small companies. Likewise, pricing is frequently disclosed in contravention of FAR § 52.203-2.

[29] H.R. 2067, 109th Cong. (2005).

[30] USACE STUDY at 34-37.

[31] *See, e.g.*, Department of the Interior, *Solicitation P12PS25233* (Jun 13, 2012), *available at* https://www.fbo.gov/?s=opportunity&mode=form&tab=core&id=b55a55a0cc7346ab722e4c4b011c4911&_cview=0 (supply and deliver flexible road base); VA, *Solicitation VA24413Q0363*, (Jan 31, 2013), *available at* https://www.fbo.gov/?s=opportunity&mode=form&id=039ef8d115384d0cebef055c25934d07&tab=core&_cview=1 (testing or poser distribution system); VA, *Solicitation VA24312Q1952* (Jul 30, 2012), *available at* https://www.fbo.gov/?s=opportunity&mode=form&id=8a576e312880690d317f3fc78314f401&tab=core&_cview=0 (complete overhaul of chiller).

[32] Memorandum From Angela Styles, Administrator, Office of Federal Procurement Policy, Applicability of FAR Part 12 to Construction Acquisitions (Jul. 3. 2003) *available at* http://www.whitehouse.gov/sites/default/files/omb/assets/omb/procurement/far/far_part12.pdf.

[33] 13 C.F.R. § 125.6(a)(3)-(4).

businesses (SDVOSBs) and to HUBZone small businesses.[34] Additionally, SBA establishes a governmentwide subcontracting goal, currently set at 35.9 percent of prime contract dollars.[35]

To achieve the subcontracting goals, large prime contractors receiving federal contract awards valued over $650,000 ($1.5 million for construction) are required to establish subcontracting plans and goals for each of the aforementioned five categories, both by dollar and percentage of total subcontracting opportunity.[36] Subcontracting plans must contain a description of the methods and efforts used to assure that small business enterprises have an equitable opportunity to compete for subcontracts, and be submitted by contractors for review prior to the award of any contract. The plan must include: (1) separate percentage goals for each small business category; (2) a description of the efforts that the company will make to ensure that all small businesses will have an equitable opportunity to compete for subcontracts; and (3) assurances that the prime will require subcontracting plans from any subcontractors that are not small businesses and that receive awards above $650,000 ($1.5 million for construction).[37] The actual dollars subcontracted with small businesses are reported into the SBA's Electronic Subcontracting Reporting System (ESRS).[38] Failure of the prime contractor to comply in good faith with its approved subcontracting plan may subject the contractor to liquidated damages or termination for default.[39]

However, companies complain that while the government receives credit for all tiers of subcontracting, prime contractors are only given credit for first tier subcontractors. As a consequence, this means that small businesses may have opportunities at the first tier, but that lower tier subcontracts are less available. This is problematic because on larger contracts the first tier subcontracts may be unsuitable for developing businesses that could thrive at a lower tier.

One of the reasons large businesses are not allowed to take credit for lower tier subcontracting is a fear that dollars would be double counted under some of types of subcontracting plans. Specifically, there are four types of subcontracting plans:

1. Individual Plan - contains the subcontracting plan elements and covers the entire contract period (including option periods), applies to a specific contract, and has goals that are based on the offeror's planned subcontracting in support of the specific contract.
2. Master Plan - contains all the required elements of an individual contract plan, *except* goals, and may be incorporated into individual contract plans, provided the master plan has been approved.
3. Commercial Plan - contains all the required elements *including* goals, covers the offeror's fiscal year and applies to the entire production of commercial items sold by either the entire company or a portion thereof (e.g., division, plant, or product line) and is effective for three years.
4. Comprehensive Subcontracting Plan – This subcontracting plan has been approved under the DoD Comprehensive Subcontracting Plan Test Program, which authorizes the negotiation, administration, and reporting of subcontracting plans on a plant, division or company-wide basis as appropriate. The purpose of the test is to determine whether comprehensive subcontracting plans will result in increased subcontracting opportunities for small business while reducing the administrative burdens on contractors.

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[34] 15 U.S.C. § 644(g).
[35] *See* www.sba.gov/goaling.
[36] 15 U.S.C. § 637(d). *See also*, 48 C.F.R. § 19.7.
[37] 48 C.F.R. § 19.7. Additional requirements apply but are not relevant for these purposes.
[38] 48 C.F.R. § 19.7.
[39] *Id.*

While it is fairly simple to assess credit for subcontracts awarded at the lower tiers of an individual plan, the other types of plans pose unique challenges. For example, assume large business A has a commercial subcontracting plan and large business B has a test subcontracting plan. Assume that A subcontracts to B for computer design on one contract, and B then subcontracts to a small business C for software development. If lower tier subcontracting credit were permitted, both A and B would take credit for the dollars awarded to C on their own subcontracting plan, and the dollars would be counted twice. If B then entered into a contract for weapons engineering and subcontracting to A, the confusion would mount exponentially. There would be no way to avoid double counting in these cases. However, on individual plans, which are the standard in construction contracting, there would not be a duplication issue, and providing credit for lower tier work could incentivize better prime contractor enforcement of the flow down requirements, which could in turn result in greater opportunities for small firms.

Therefore, draft legislation is being circulated in an attempt to partially address this problem. The attached legislation would allow prime contractors with individual plans to take credit for work performed by a small business at any tier. However, it would not allow companies operating under a master, commercial, or comprehensive subcontracting plan to take credit for lower tier subcontracting. Instead, it would direct the Government Accountability Office to study whether ESRS or the Federal Subcontracting Reporting System could be modified to capture lower tier work under a specialized subcontracting plan without duplicating the dollars counted.

VI. Design Build Contracting

Design build (DB) contracts hold substantial benefits for the government, since they combine design and construction in a single contract with a single prime contractor. However, because these contracts would previously have been performed as two separate contracts and they require highly complicated proposals, they pose special challenges for small business contractors. However, it is important to note that these contracts are often still suitable for award to small businesses if the small business can survive the bid and proposal (B&P) process.

Industry reports that developing a full proposal for a DB contract can exceed 3 percent of the value of the project. For example, bidding a $20 million DB project could cost more than $600,000. A winning bidder can often recover its B&P costs, but that remedy is not available to the losing bidders. Thus, if ten firms bid on a $20 million project, that would amount to $5.4 million in unrecovered B&P costs. Likewise, if a firm bids ten such jobs in a year and wins twenty percent of those jobs, the firm still must absorb $4.8 million in unrecovered B&P. Given that the maximum size of small architecture firm is $7 million per year in receipts and the maximum size of a general contractor is $33.5 million per year, these high B&P costs themselves pose a barrier to small business competition.[40] Further, these B&P costs are not isolated to the prime contractor, but also apply to the subcontractor. Given that a subcontractor may be part of several teams bidding on any given job, each with its own approach, the subcontractors' expenses may grow exponentially. Considering that that GSA could be spending as much as $3.2 billion on the design and building of federal courthouses alone over the next five years, these are substantial costs that could amount to $864 million in B&P costs for nine disappointed bidders per job before the subcontractors are considered.[41]

Notably, this is not how Congress intended DB contracting to take operate. Instead, Congress directed agencies to use a two-step process, under which an unlimited number of offerors could provide their

[40] 13. C.F.R. §121.201.

[41] Andy Medici, *GAO Recommends a Halt to 11 Courthouse Projects*, FEDERAL TIMES, Apr. 17, 2013, *available at* http://www.federaltimes.com/article/20130417/FACILITIES02/304170009/GAO-recommends-halt-11-courthouse-projects.

technical qualifications for any given job.[42] From this first group, the agency would select between 3 and 5 of the most technically qualified offerors to make it to the second step, where they would be invited to submit a full proposal.[43] Thus, businesses would only be spending B&P resources on contracts where they had a twenty to thirty-three percent chance of success.

However, agencies have not been abiding by this policy. Both USACE and GSA continue to solicit proposals through one-step design build procurement for large projects in spite of their own policies against it.[44] As a result, you may find as many as twenty DB teams submitting full, detailed and costly proposals. It is the rare small business that can afford to compete on such a project, which means that instead of increasing competition by allowing more offerors, contracting officers are instead dissuading qualified offerors from even submitting their credentials.

USACE has sought to require that any contract above $750,000 receive advance approval from the Headquarters USACE Chief of Construction if it is using a one-step process.[45] While industry has been supportive of the USACE Directive, complaints remain that not all the 45 districts are adhering to the policy. Further, the policy does not address the need to limit the second step to no more than five offerors.

Therefore, the Subcommittee will be examining draft legislation which attempts to address the imperfect application of the two-step process. A copy of the draft legislation is attached. The bill adopts the $750,000 threshold from the USACE Directive and implements it governmentwide. Further, the bill requires that any contracting officer selecting more than five offerors for step two provide written documentation as to why more offerors are necessary and receive approval from the agency head. Thus, in cases where more offerors are in the best interest of the taxpayers, the option will remain.

VII. Conclusion

Given that the federal sector is an extremely vital part of the construction market, legislative and policy changes may offer opportunities to correct and clarify contracting requirements to further maximize small business participation in construction contracting which leads to business growth and job creation.

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[42] 41 USC § 3309(c).
[43] *Id.* at 13. § 3309(d).
[44] James Dalton, PES, Limitations on the Use of One-Step Selection Procedures for Design-Build, Directive No. 2012-23 (2012) (on file with the Committee).
[45] *Id.* at 2.