

Congress of the United States
U.S. House of Representatives
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515-6315

To: Members, Committee on Small Business
From: Committee Staff
Date: February 5, 2015
Re: Hearing: "Contracting and the Industrial Base"

On Thursday, February 12, 2015, at 11:00 am, in Room 2360 of the Rayburn House Office Building, the Committee on Small Business will meet for the purpose of receiving testimony on barriers to the maximum practicable utilization of small businesses to support the industrial base. This is one in a series of hearings expected to explore this topic. The February 12, 2015, hearing will focus on 1) surety bond issues; 2) the use of reverse auctions; 3) failure to properly use a two-step procurement process for design build contracts; 4) the use of joint ventures and teams; and 5) the nonmanufacturer rule.

I. Executive Summary

Recognizing the importance of small businesses to the economy, Congress has established a series of programs to assist small businesses competing for federal contracts.¹ It did so because the use of small businesses as contractors is "in the interest of maintaining or mobilizing the Nation's full productive capacity, [. . .] in the interest of war or national defense programs, [and . . .] in the interest of assuring that a fair proportion of the total purchases and contracts for property and services for the Government in each industry category are placed with small-business concerns."² These aims are increasingly important when one considers that the federal government spent \$440 billion on contracts in FY 2014, of which approximately \$98 billion was spent with small businesses.³ While this would seem to indicate that a healthy percentage of dollars are being awarded to small businesses, Table 1 on page 4 shows that the use of small businesses is declining even as the percentage of dollars awarded to small businesses increases.

As described in Section II, while construction and architectural and engineering (A&E) contracts account for about eight percent of federal prime contract dollars, these segments account for over 17 percent of the awards to small businesses.⁴ Therefore, issues affecting construction and A&E contracts have a

¹ For information on these programs, please see Committee Memorandum, *Small Business Act Programs for Federal Contractors* (February 2013), available at

http://smallbusiness.house.gov/uploadedfiles/small_business_act_programs_for_small_federal_contractors.pdf.

² Section 15(a) of the Small Business Act (the Act), 15 U.S.C. § 644(a).

³ According to the Federal Procurement Data System (FPDS), available at <https://www.fpds.gov>, \$98,180,623,220.45 in contracts was awarded to small businesses, out of \$444 billion total. (last accessed January 28, 2015.)

⁴ 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.

disproportionate effect on small business opportunities. Thus, this memorandum will first discuss five 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 Committee will consider whether legislation similar to H.R. 776, the Security in Bonding Act of 2013, introduced by Subcommittee on Contracting and Workforce Chairman Richard Hanna during the 113th Congress, should be reintroduced. This legislation sought to raise the bond guarantee rate offered by SBA, in order to 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 sought to 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 Committee will whether legislation similar to H.R. 2751, the Commonsense Construction Contracting Act of 2013, introduced by Subcommittee Chairman Hanna during the 113th Congress should be reintroduced. This legislation sought to prohibit the use of reverse auctions for construction contracts suitable for award to small business.

3. Design Build Contracting

In Section V, 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 Committee will discuss whether legislation similar to H.R. 2750, the Design-Build Efficiency and Jobs Act introduced by Rep. Sam Graves (R-MO) should be reintroduced to reinforce current statutes and best practices so that small businesses will be encouraged to compete.

4. The Use of Joint Ventures and Teams

In Section VI, the Memorandum examines the curious incentives for the use of small business teams and joint ventures. Specifically, the Small Business Act (the Act) encourages small businesses to team and joint venture, and the Small Business Administration will approve joint ventures to facilitate small businesses participating on federal contracts. In the 112th Congress, this Committee successfully passed legislation as part of the National Defense Authorization Act for FY 2013 (FY13 NDAA) to make it easier for small businesses to team by changing the limitations on subcontracting. However, small businesses that do team and joint venture are often unsuccessful at winning contracts when the agency will only consider the past performance or financial responsibility of the joint venture or the prime contractor, not the small business members of the joint venture or the parties to the team. As many joint ventures are unpopulated, this all but disqualifies the small business from competition. Consequently, the Committee will discuss whether legislation is necessary to allow small businesses to successfully compete at joint ventures and teams.

5. The Nonmanufacturer Rule

In Section VII, the Memorandum examines the misapplication of the nonmanufacturer rule (NMR) by the courts. The NMR exists to ensure that when competition for a contract for goods is restricted to small businesses that the good ultimately purchased was indeed the product of a small business. Otherwise, the government risks restricting competition only to have the awardee provide a product it has simply passed along from a large manufacturer or international contractor. The law does provide exceptions in cases where there is not a small business manufacturer. However, a recent court case stated that the NMR applies to service contracts, which could change the way in which construction and A&E companies operate, and exclude more from the industrial base. Consequently, the Committee will discuss whether legislation is necessary to reinforce the traditional understanding of the NMR.

II. The Importance of Construction to Small Businesses and the Industrial Base

From FY11 through FY14, the percentage of dollars awarded to small businesses increased each year, from just over 18 percent to approximately 22.25 percent.⁵ At the same time, despite a decline in overall federal spending, the dollars awarded to small businesses remained fairly constant during this period. While this would normally be heralded as a success, a deeper dive into the numbers shows that the number of small business contract actions fell by almost 60 percent and the average size of a contract action increased 230 percent.⁶ This reflects that fewer small businesses are winning contracts, but those contracts are worth more, which may indicate that some small businesses are doing very well but many others are losing opportunities to compete.

Similarly, at the Department of Defense (DoD), which is arguably a better reflection of the federal government's ability to maintain a healthy industrial base capable of supporting defense programs, the results were worse. The percentage of contract dollars awarded to small businesses at DoD increased from just over 16 percent to just over 19 percent, but the actual dollars only fluctuated by about 10 percent.⁷ The number of small business contract actions at DoD fell by almost 70 percent, and the value of those contract actions rose by nearly 290 percent.⁸ This speaks to a greater problem in the industrial base – a declining participation rate.

Table 1. Small Business Contracting FY10-FY14⁹

⁵ Analysis based upon FPDS, available at <https://www.fpds.gov> (last accessed January 28, 2015). Copies of reports are on file with the Committee.

⁶ *Id.*

⁷ *Id.*

⁸ *Id.*

⁹ *Id.*

FY	Total Contract Dollars (in Billions)	Total Small Business (SB) Dollars	Total Number of SB Actions	Total DoD Contract Dollars	Total DoD Small Business Dollars	Total Number of DoD SB Actions	Average Value of Small Business Contract Action	Average Value of DoD Small Business Contract Action
11	\$549.6	\$103.6	3,346,553	\$374.1	\$60.4	2,325,622	\$30,957.23	\$25,971.55
12	\$518.3	\$100.0	2,584,893	\$290.1	\$60.2	1,453,952	\$38,686.32	\$41,404.39
13	\$462.3	\$91.9	1,560,467	\$308.5	\$50.0	711,998	\$58,892.63	\$70,224.92
14	\$444.7	\$98.9	1,390,987	\$284.7	\$55.6	745,626	\$71,100.59	\$74,568.22

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.¹⁰ Of the contracts awarded by the federal government annually, approximately eight percent is spent on federal construction and A&E projects.¹¹ However, within the dollars awarded to small businesses, the percentage is over twice as high, exceeding 17 percent for federal construction and A&E work.¹² In FY 2012, the majority of those dollars were expended by the Department of Defense (DoD),¹³ with nearly 60 percent of DoD's spend coming through USACE.¹⁴ Among civilian agencies, the General Services Administration (GSA) and the Department of Veterans Affairs (VA) were responsible for a major share of the work.¹⁵ 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.¹⁶ Unfortunately, the number of small businesses registered to compete for federal contractors is only 17,782 concerns,¹⁷ out of 273,072 small businesses registered to compete for federal contracts.¹⁸ To further

¹⁰ 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.

¹¹ 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.

¹² FPDS.

¹³ *Id.*

¹⁴ 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>.

¹⁵ Prime Award Spending Data, List View, USASpending.gov, available at <http://www.usaspending.gov>.

¹⁶ U.S. Census Bureau, Value of Construction Put in Place, Annual Data, available at <http://www.census.gov/const/C30/ototal.pdf>.

¹⁷ Data retrieved from the Dynamic Small Business Search (DSBS) site available at www.dsbs.sba.gov (last accessed January 28, 2015).

¹⁸ Data retrieved from the System for Award Management available at www.sam.gov (last accessed January 28, 2015). This number is down by over 100,000 small businesses from 2012, when DSBS reported a 382,092 active small businesses.

highlight this contrast, in FY2014, there were 753,590 private construction companies in the United States.¹⁹

Table 2. FY 2012 Federal Contracts for Construction and A&E²⁰

	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%)

Given the importance of federal construction and A&E contracting to small businesses, it is surprising that less than seven percent of all registered small contractors are active in this sector, and that only about two percent of all construction contractors are pursuing federal work. Therefore, this hearing will examine whether adopting common sense reforms and best practices in construction and A&E contracting will improve the participation of small business construction contractors in the federal marketplace, thus increasing competition and improving the health of the industrial base.

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.²¹ 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.²² 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)²³ or the Preferred Surety Bond Program (PSBP).²⁴ Pursuant to the PAP, SBA provides

¹⁹ Bureau of Labor Statistics, Construction NAICS 23, available at <http://www.bls.gov/iag/tgs/iag23.htm>. This does not include A&E contractors, nor does it distinguish between the size of companies.

²⁰ FPDS ad hoc report, available at <https://www.fpds.gov> (last accessed May 9, 2013). Copy on file with the Committee.

²¹ 40 USC § 3131(b).

²² 15 U.S.C. § 692 *et seq.*

²³ 15 U.S.C. § 694b(a).

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.²⁵ As of May 2013, there are approximately 7,494 active bonds with an actual bond liability of \$2.9 billion.²⁶ Each program is operating at a zero subsidy from taxpayers.²⁷ 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.²⁸

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.²⁹ 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.³⁰ In addition, an individual surety may pledge more volatile assets such as stocks and bonds traded on an exchange or rights in real property.³¹ 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

²⁴ 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.

²⁵ <https://www.sba.gov/content/surety-bonds-basics>.

²⁶ E-mail from Frank Lalumiere, Director, SBA Surety Bond Program to Committee staff (May 13, 2013). (on file with the Committee).

²⁷ *Id.*

²⁸ *Id.*

²⁹ 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.

³⁰ 48 C.F.R. § 28.203.

³¹ 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.

and their acceptable assets.³² 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.³³

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. 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. This legislation passed the House of Representatives in 2014, but was not acted upon by the Senate. Therefore, the hearing will provide the Committee 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

³² 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."

³³ *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).

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.³⁴

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.³⁵

The use of reverse auctions for construction services has been denounced by most of the construction-related trade associations.³⁶ 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.³⁷ When 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.³⁸ 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.³⁹

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.⁴⁰ 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.⁴¹ Specifically, they are being awarded as commercial item contracts, in direct contravention of Office of Management and Budget Guidance.⁴²

³⁴ 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.

³⁵ While the use of reverse auctions for commercial goods itself remains controversial, it is outside the scope of this memorandum.

³⁶ 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://docservr.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).

³⁷ AGC WHITE PAPER.

³⁸ 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.

³⁹ H.R. 2067, 109th Cong. (2005).

⁴⁰ USACE STUDY at 34-37.

⁴¹ 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).

⁴² 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.

In response, the Small Business Committee favorably reported on H.R. 2751, the Commonsense Construction Contracting Act of 2013 during the 113th Congress. The legislation exempts any contract for design and construction services that is deemed suitable for award to small business from being awarded using a reverse auction methodology. After that report, additional improprieties in the use of reverse auctions came to light, specifically that they were being used in a manner that did not ensure adequate competition or savings.⁴³ Consequently, an expanded provision passed the House in 2014 that would have also restricted the use of reverse auctions on all service contracts and on contracts that required technical evaluations. The Senate rejected the language, but ultimately agreed to some limitation on reverse auctions for DoD contracts.⁴⁴ The hearing will discuss whether the Committee should pursue legislation on reverse auctions during the 114th Congress, and whether there are ways to improve the approach advocated by the prior legislation.

V. 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.⁴⁵ Further, these B&P costs are not isolated to the prime contractor, but also apply to the subcontractor. Considering 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.⁴⁶

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 technical qualifications for any given job.⁴⁷ 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

⁴³ GAO, *GUIDANCE IS NEEDED TO MAXIMIZE COMPETITION AND ACHIEVE COST SAVINGS*, GAO-14-108, (2013); *Hearing Before the Subcomm. on Contracting and Workforce, House Comm., and Subcomm. on Oversight and Investigations, Comm. on Veterans' Affairs*, 113th Cong. (2013).

⁴⁴ § 824, Pub. L. No. 113-291, the Carl Levin and Howard P. "Buck" McKeon National Defense Authorization Act for FY 2015 (*hereinafter* FY15 NDAA) (2014).

⁴⁵ 13. C.F.R. §121.201.

⁴⁶ 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>.

⁴⁷ 41 USC § 3309(c).

submit a full proposal.⁴⁸ 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.⁴⁹ 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.⁵⁰ 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, during the 113th Congress, this Committee examined draft legislation which attempted to address the imperfect application of the two-step process, a version of which was ultimately reported on favorably by the Committee on Oversight and Government Reform, and which passed the House as part of the FY15 NDAA, but only a small portion of which ultimately became law.⁵¹ The preferred version of the legislation during the 113th Congress, H.R. 2750, the Design-Build Efficiency and Jobs Act, adopted the \$750,000 threshold from the USACE Directive and implements it governmentwide. Further, the bill required 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, but more contractors will be induced to offer initial bids in all cases. The Committee will now examine whether the legislation remains an important tool to improve the health of the industrial base.

VI. Joint Ventures and Teams

In order to address the problems small businesses face when competing for bundled and consolidated contracts, Congress has repeatedly acted to increase opportunities for small businesses to team and joint venture. This is particularly important for construction and A&E contractors, as subcontracting can frequently account for up to 85 percent of the work contracted.⁵² Therefore, the fact that some agencies are treating joint ventures and teams punitively could adversely affect these industries.

The Act is very clear that small business teams and joint ventures are to be encouraged. For example, the Act requires that “[e]ach Federal agency shall include in each solicitation for any multiple award contract above [\$2 million] a provision soliciting bids from any responsible source, including responsible small business concerns and teams or joint ventures of small business concerns.”⁵³ Likewise, the Act has required that the Federal Acquisition Regulation (FAR) be updated to include “a Government-wide policy regarding contract bundling, including regarding the solicitation of teaming and joint ventures,” and then federal agencies were required to publish this policy on their websites.⁵⁴ Additionally, the Act requires that in any

⁴⁸ *Id.* at 13. § 3309(d).

⁴⁹ 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).

⁵⁰ *Id.* at 2.

⁵¹ § 814 of the FY15 NDAA ultimately included a provision limiting the number of offers on a design building contract at the DoD if the contract is using a two step process and the contract exceed \$4 million.

⁵² 13 C.F.R. § 125.6.

⁵³ § 15(q)(1), 15 U.S.C. § 644(q)(1).

⁵⁴ *Id.* at § 15(q)(2), 15 U.S.C. § 644(q)(2).

bundled or consolidated contract, small businesses may “submit an offer that provides for the use of a particular team of subcontractors for the performance of the contract” and that requires the contract be evaluated, “in the same manner as other offers, with **due consideration for the capabilities of all proposed subcontractors.**”⁵⁵ Finally, in the FY13 NDAA, the Act was amended to allow teams of small businesses to work together to meet the limitation on subcontracting rules.⁵⁶

SBA has fully implemented all but the limitation on subcontracting rules, and has established protocols promoting Small Business Teaming Arrangements (SBTA) and to preapprove joint ventures for the award of up to three contracts.⁵⁷ SBA has a proposed rule pending to implement the limitation on subcontracting rules, and to make it easier for small businesses to joint venture.⁵⁸ Unfortunately, its sister agencies have been less diligent.

While the change to the FAR was required in 2010, it has never been executed, so contracting officers are not encouraging or supporting teaming and joint venturing. Indeed, no federal agency has a policy supporting teaming on its website. Instead, some contracting officers are hostile to teams and joint ventures, requiring that “an [o]fferor must have proven experience and performance as an existing CTA in the form of a Partnership or Joint Venture in accordance with the proposal submission requirements”⁵⁹ or past performance may only be considered if it is that of “a parent company, affiliate, division, and/or subsidiary.”⁶⁰ Unheard of five years ago, these provisions are becoming more common in large contracts, even contracts set aside for small businesses. These encourage small businesses to behave in a way that will cause them to be considered affiliated, but pursuant to SBA rules; two affiliated companies must combine the size and receipts of each before determining if the firm is a small business.⁶¹ Therefore, for a small business to compete in the manner preferred by the contracting agency, it must risk its status as a small business – this provision effectively negates any small business teams or joint ventures.

Therefore, the Committee will consider whether the Small Business Act needs to be amended to protect joint ventures and teams. One possible solution would be to allow the parties to a joint venture the ability to use their own past performance and experience for purposes of evaluation. Another would be to allow a small business team to rely on the experience and expertise of its team members. However, a question arises as to how far down a team should reach for past performance.

VII. Nonmanufacturer Rule

As previously discussed, the NMR exists to protect taxpayers – it ensures that a small business is not simply acting as a front for a large business in order to receive a contract through restricted competition. Specifically, the Act requires that a small offeror “represent that it will supply the product of a domestic small business manufacturer or processor, unless a waiver of such requirement is granted.”⁶² This requirement has historically been applied only to contracts for supplies, and SBA has proposed a rule to further clarify that this is the intent of the NMR.⁶³

⁵⁵ *Id.* at § 15(e)(4), 15 U.S.C. § 644(e)(4) (emphasis added).

⁵⁶ § 46(b), 15 U.S.C. § 657s(b).

⁵⁷ *See*, 13 C.F.R. § 121.103(b)(9), 13 C.F.R. § 125.1(u) (SBTA); 13 C.F.R. § 121.103(h) (preapproval of joint ventures).

⁵⁸ Proposed Rule: *Small Business Government Contracting and National Defense Authorization Act of 2013 Amendments* 79 Fed. Reg. 77,955 (2014).

⁵⁹ GSA OASIS Request for Proposal (2013) available at

<https://www.fbo.gov/?s=opportunity&mode=form&tab=core&id=df05de3d9c9caf1e7943d278094eefb1&cvview=1>.

⁶⁰ HCaTS RFI APPENDIX 3 - DRAFT RFP SECTION L (2015) (on file with Committee).

⁶¹ 13 C.F.R. § 121.103.

⁶² § 8(a)(17)(B)(iv); 15 U.S.C. § 637(a)(17)(B)(iv).

⁶³ *Supra* note 58, 79 Fed. Reg. at 77,967.

However, the Court of Federal Claims (COFC) recently issued a decision in Rotech Healthcare, Inc. v. United States that invalidated SBA's current regulations limiting the NMR to the procurement of goods.⁶⁴ The COFC found that as the Act references "any procurement for goods" SBA may not interpret the statute to find that Congress only intended that the NMR apply to purchases that are primarily for goods.⁶⁵

The Rotech decision could have particularly dire consequences for construction and A&E companies. If the NMR were applied as suggested by the COFC, a builder would have to use steel, concrete, and other construction materials manufactured by a small business. Indeed, the opinion could be read to suggest that an architect's design would need to be provided on paper manufactured by a domestic small business, using ink manufactured by a domestic small business. This is an inefficient, and irrational application of the rule, and nearly impossible to comply with given that contractor still must comply with the limitation on subcontracting rules. Consequently, even the SBA has asked for legislative intervention by this Committee.

VIII. 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.

⁶⁴ Case No. 14-502C (September 19, 2014).

⁶⁵ *Id.* at 6-8.