CONTRACTING AND THE INDUSTRIAL BASE

HEARING

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UNITED STATES
HOUSE OF REPRESENTATIVES

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CONTENTS

OPENING STATEMENTS

WITNESSES

APPENDIX

CONTRACTING AND THE INDUSTRIAL BASE

THURSDAY, FEBRUARY 12, 2015

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The Committee met, pursuant to call, at 10:30 a.m., in Room 2360, Rayburn House Office Building. Hon. Steve Chabot [chairman of the Committee] presiding.

Present: Representatives Chabot, Gibson, Radewagen, Velázquez, Chu, Hahn, Meng, Adams and Lawrence.

Chairman CHABOT. Good morning. While I am beginning my 19th year as a member of the Small Business Committee, this is my first hearing as chairman. In that capacity, I look forward to working with my friend and colleague, the ranking member, Ms. Velázquez, and all of my colleagues on both sides of the aisle in an effort to improve the plight of American small businesses. I am particularly pleased to see that we will begin that endeavor today by discussing a subject that has much promise for small businesses and taxpayers alike, federal contracting reform.

As you know, the government has a goal of awarding at least 23 percent of federal prime contract dollars to small businesses, and in Fiscal Year 2013, we met that goal for the first time in many years. Early indications are that we met the goal again last year. However, it is not enough to simply meet the goal; we have to focus on why Congress created those goals in the first place.

The goals exist as a tool. They are intended to make sure we have a broad spectrum of small businesses working with the government across industries. Having a healthy small business industrial base means the taxpayers benefit from increased competition, innovation, and job creation. It also means that we can securely support programs crucial to our national defense. The percentage of dollars awarded to small businesses is a good measure of success, but it is not the only measure. Indeed, it appears that over the last four years, while the percentage of dollars being awarded to small businesses was increasing, the number of contract actions with small businesses fell by almost 60 percent. At the Department of Defense, the number fell by almost 70 percent. The size of the average individual small business contract action increased by 230 percent during that same period, and by nearly 290 percent at DoD. These statistics are all alarming in their own way, but one of the more clear cut and disturbing figures is that there are over 100,000 fewer small businesses registered to do business with the Federal Government than there were in 2012. These data points suggest we have a problem with our small business industrial base.

Today's witnesses are going to address specific recommendations to improve the competitive viability of our small business contractors. This is only the first of a series of Full Committee and Subcommittee hearings we will be having on this topic. As chairman, I expect that the Committee will actively pursue ways to increase opportunities for small businesses to access capital and contracts, while removing barriers to small business success. And I am quite confident that our Subcommittee chair, Mr. Hanna, and his Subcommittee on Contracting and Workforce, will be thoroughly exploring this issue in the very near future. And I look forward to working with each of you and want to welcome our witnesses here this morning.

I now would yield to the ranking member for the purpose of making an opening statement.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

For several decades now, the federal government has looked to the private sector to provide services and supplies for its day-to-day operations. As such, a vibrant industrial base has become essential to the U.S. economy and our national security. It comes as no surprise to those in this room that small businesses are at the heart of the supply chain. With a strong presence in a variety of different industries, from construction to manufacturing, small businesses continue to play a vital role in providing our government with goods and services. In order for this sector to continue its resurgence, we need to ensure that small businesses are able to compete both globally and here in America.

Here at home this means ensuring that small firms can gain access to the nearly $500 billion federal procurement marketplace. Numerous policies and protections have been put in place to ensure their continued participation in this arena. This includes goals, set-aside programs, and the assignment of federal personnel to work on behalf of small contractors. Many of these initiatives have evolved over the years to reflect the changing needs of small firms. In many regards, these efforts have paid off as small businesses last year won nearly $100 billion in awards. However, it appears that we have stalled, and in many ways the goal is becoming a ceiling rather than a floor.

And with regard to set-aside programs, we continue to see over and over again non-small businesses gaining access to small business awards, whether it is HUBZone, service disabled veterans, or 8A awards, we need stronger protections to keep bad actors out of the federal marketplace or trying to gain access to federal contracts that were designed for small businesses in the first place.

Another trend is occurring that may also impact small contractors. Data shows that the average contract size is increasing. On first take, this appears to be promising as larger contracts might be more profitable for small companies. However, it might suggest that more contracts are being consolidated, resulting in fewer opportunities for small businesses. I am particularly interested in the witnesses' perspective on this during today's hearing.

What is important for this committee to keep in mind is that these developments are part of a bigger picture, which is that the federal procurement marketplace is always evolving. Whether it is sequestration, reductions in federal procurement staff, or the rise

of multiple award contracts, there will always be new issues for small businesses to overcome. And against this backdrop, we must ensure small businesses are not left behind and that procurement laws evolve with this changing landscape.

During today's hearing, I look forward to learning about the challenges facing small contractors and possible solutions. Doing so is not only essential for small firms and our nation's industrial base, but the economy overall. Small firms bring new ideas to the table which in turn generate new jobs and even new industries. Taken together, this is a key part of what has made the U.S. the leader in today's economy.

I thank all the witnesses for being here today, and I yield back the balance of my time. Thank you, Mr. Chairman.

Chairman CHABOT. Thank you. The gentlelady yields back. And if Committee members have opening statements prepared, I would ask that they submit them for the record.

And I would like to take just a moment to explain the time rules that we operate under here, which is the same that the other Committees do. It is the five-minute rule. You will have five minutes to testify. We will have five minutes, each of us, to ask questions. We even have a lighting system set up for that. The green light will come up. You can talk for four minutes. The yellow light comes on to let you know you have one minute to wrap up. When the red light comes on, we would ask that you try to terminate your testimony as close to that as possible. So we give you a little leeway, but not much. I appreciate your cooperation.

And I will now introduce our first witness, who is Randall Gibson—or Randy Gibson, our son's name; not Gibson, but Randy—who is president of Whitesell-Green, Inc., a general contractor in Pensacola, Florida. He is also the chairman of the Associated General Contractors (AGC), Naval Facilities Engineering Command Committee, and a member of the United States Army Corps of Engineers Committee. He is testifying today on behalf of AGC.

We thank you for being here, and you are recognized for five minutes.

STATEMENTS OF RANDALL D. GIBSON, PRESIDENT, WHITESELL-GREEN, INC.; JAMES P. HOFFMAN, PRESIDENT, SUMMER CONSULTANTS,, INC.; JOHN MCNERNEY, GENERAL COUNSEL, MECHANICAL CONTRACTORS ASSOCIATION OF AMERICA; ANDREW HUNTER, DIRECTOR, DEFENSE-INDUSTRIAL GROUP AND SENIOR FELLOW CENTER FOR STRATEGIC AND INTERMNATIONAL STUDIES

STATEMENT OF RANDALL D. GIBSON

Mr. GIBSON. Chairman Chabot, Ranking Member Velázquez, and members of the Committee, thank you for inviting the Associated General Contractors of America to testify on reforms to the Federal Government's contracting laws important to our industry.

My name is Randy Gibson. I am president of Whitesell-Green, Incorporated, a small business based in Pensacola, Florida, providing general contracting and design-build service to Department of Defense and other federal agency clients throughout the Southeastern region of the United States.

Since our founding in 1970, my company has constructed over 400 heavy commercial projects, resulting in nearly one billion dollars in completed contracts.

While my written testimony covers all the topics for today's hearing, I will use the time allotted today to address the need for Congress to (1) prohibit all federal agencies from procuring construction services through reverse auctions; and (2) encourage sensitive consideration of past performance records in joint venture and teaming context.

AGC strongly supports full and open competition for construction contracts; however, reverse auctions for constructions services have the effect of turning away qualified and experienced contractors, especially small business firms like mine, for a host of reasons. Procurement of construction services is different than for manufactured goods like pens and paper. Construction services are complex, most often requiring the participation of numerous trade subcontractors and vendors in lower-tier arrangements with the general contractor. They are project-specific and inherently variable. And they require a large degree of professional expertise.

In a reverse auction, nonprice factors of consequence to the owner, such as quality of relationship, past performance, scheduling, long-term maintenance, and unique needs are deemphasized by the process. In a reverse auction, a bidder has no incentive to offer its best price. Winning bids may simply be an established increment below the second lowest bid, not the lowest responsible and responsive price. In a reverse auction, discipline is difficult to maintain. General contractors can underbid the contract simply to win the award, putting the government at significant risk to receive lower quality construction and even contractor default. This also exposes subcontractors to risk for nonpayment.

It is my belief that AGC's position on reverse auctions is shared by other important stakeholders to the procurement process. The U.S. Army Corps of Engineers, the White House Office of Federal Procurement Policy, and even the largest reverse auction vendor to the Federal Government, FedBid, have all publicly stated that reverse auctions for construction are not appropriate. Yet, agencies like the Department of Veterans Affairs, the Department of the Interior, and the General Services Administration continue to conduct them. Considering this inconsistency, AGC urges members of this Committee and Congress to enact a law that prohibits reverse auction procurement for construction services government-wide.

Turning to the joint venture and teaming issue, AGC and its members are increasingly finding that federal agencies will disqualify small businesses from competition when they seek to partner with another business for the first time. In an environment where agencies are bundling contracts worth upwards of $100 million, and specifically setting them aside for small business, it is often beyond the capacity of a small business alone to bond and perform such large-dollar projects. Consequently, small businesses, like my firm, often seek to partner with other small or nonsmall businesses to win such awards.

Some federal agencies are not allowing small businesses and their partners to submit the relevant past experience of each individual company to prove qualification for the contract. Rather,

agencies demand that the small business and partner submit only past experience that they have performed together, or otherwise be disqualified from consideration. This limitation often prevents the governments from receiving the benefit of project-specific experiences and resources which the first-time collaboration of these teams may offer.

AGC strongly supports a sensible legislative solution to ensure that federal agencies reasonably consider the individual past performances of construction contractors seeking to joint venture or team, even if they are teaming for the first time.

Thank you again for the opportunity to testify. I look forward to answering your questions to the best of my abilities.

Chairman CHABOT. Thank you very much. And thank you for staying within the time constraints.

Our next witness is James Hoffman, who is president of Summer Consultants, Inc., in McLean, Virginia. Prior to starting with Summer over 22 years ago, Mr. Hoffman served as a platoon leader and company executive officer in the 317th Engineer Battalion in the United States Army. He is testifying on behalf of the American Council of Engineering Companies.

We thank you for being here today. We thank you for your service, and you are recognized for five minutes.

STATEMENT OF JAMES P. HOFFMAN

Mr. HOFFMAN. Chairman Chabot, Ranking Member Velázquez, and members of the Committee, I appreciate the opportunity to testify before you today about the issues surrounding contracting and the industrial base.

My name is James Hoffman, and I am the president of Summer Consultants, a consulting mechanical, electrical, and plumbing engineering firm located in McLean, Virginia. Summer Consultants is a small business with 30 employees. Our practice focuses on the federal market for the past 50 years. My firm is an active member of the American Council of Engineering Companies, the voice of America's engineering community. ACEC oversees over 5,000 member firms, represents hundreds of thousands of engineers and other specialists throughout the country, are engaging a wide range of engineering works that propel the nation's economy, and enhance and safeguard America's quality of life. Almost 85 percent of these firms are small businesses.

Design build is a type of construction where engineers team with industry professionals. There are two forms of design build—two-step and one-step. Two-step requires the team submit qualification packages to the contracting officer in the first round. The contracting officer reviews them and notifies the teams if they are selected for the second round. At this point, the design build team develops expensive and detailed plans for the contractor to bid, generally without any reimbursement. Industry best practice has three to five finalists in the second round. In the recent years, there have been more than 10 finalists at some competitions as current law allows the contracting officer to increase the number of finalists without limitation. This causes problems for both the industry and for the government. My firm's marketing risk is inversely correlated to the number of finalists, and the contracting of-

ficer must review all the proposals and give feedback to each team member that does not win the project, which is time-consuming. This issue has driven many, including small businesses, out of the federal market.

One-step design build creates an even more precarious environment. One-step allows the owner to solicit complete proposals from the construction market without a qualifications review. This forces out small businesses as they cannot spend dollars on projects where there are too many competitors, many of which may not have the qualifications for the project. It is an inefficient process for the Federal Government as it asks the contracting officer to review multitudes of proposals. This Committee has been a strong supporter of this issue, and we ask the Committee to continue to improve the design build market by supporting the reintroduction of H.R. 2750.

The second issue, the Court of Federal Claims ruling on the nonmanufacturer rule, poses a challenge for the construction industry, as it is a service industry that typically did not have to address this rule in the past. The rule exists to ensure that a contract for goods is restricted to small businesses, rather than act as a pass-through for large entities. The course interpretation would require that any firm who is a prime contractor be responsible for their subcontractors' use of small business products, and potentially, the many different tiers of subcontractors as is undefined at this time.

The burden on this rule is staggering as I, as a business owner, would have to take the most conservative view to make sure that I am complying with the law. We have concerns that due to the unknown nature of this rule, that we can be penalized by an overbroad court ruling. ACEC asks the Committee to work with SBA on language to make sure that construction services and products continue to be excluded from the rule.

I urge Congress to reintroduce H.R. 2750 and enact it into law. I also encourage Congress to work with the SBA to limit the scope of the nonmanufacturing rule on service industries. These bills can help my firm and other engineering firms to serve our clients' needs and thrive.

Thank you for the opportunity to participate in today's hearing, and I would be happy to respond to any questions from the Committee members.

Chairman CHABOT. Thank you very much for your testimony.

I would now like to introduce our next witness, John McNerney, who is general counsel of the Mechanical Contractors Association of America, the MCAA. The MCAA represents about 2,500 firms involved in heating, air conditioning, refrigeration, plumbing, piping, and mechanical service. We thank you for your testimony here that you will be giving this morning, and you are recognized for five minutes.

STATEMENT OF JOHN MCNERNEY

Mr. MCNERNEY. Thank you, Mr. Chabot. Good morning, Ms. Velázquez.

On behalf of the 2,500 members of MCAA, thank you very much for the opportunity to be here. I am general counsel, and I have been involved in the work of this Committee for several years now,

as have our members. We testified here several times on the old 3 percent withholding tax on Federal Government contracts, and we commend your work on that. You were persistent, and we hope it does not come back again. That was a big threat to cash flow and prompt payment for all our members.

We also would commend you for your recent activity having a naming rule for small businesses in prime contract, small business contracting plans, and allowing those firms some assurance that they will be selected or have recourse to the contracting officer if they are not.

Having said that, we also admire your persistence on the reverse auction rule. The Federal Government lags the private sector in recognizing just how bad that practice is. So we hope this time we can pursue that until we get it where it should be.

The Corps of Engineers Pilot Study on Reverse Auction came in more than 10 years ago. They studied nine projects, and they came out with a conclusion in about a 95-page report that said it was totally unacceptable for low bid awards. But since then it has been fitful by getting this Congress to do something about it. Our statement on it is attached to my written statement. In summary, it says simply this. There is a strong discipline in the sealed bid, low bid process that protects the project owner's best interest in well-considered judgments by its bidders, and all that discipline is lost in the publicly disclosed price auction with hasty and frenzied judgments imperiling careful offers and awards.

You know, back in 2004, when this started, a lot of private sector industries took this up. Most of them have given up the project, and those who have not have been fired by customers, fired by the contractors as their customers. And we think that the persistence of some government agencies to do this is impairing competition.

So in all, I think there are three problems with the reverse auction. Number one, it shows that some bad ideas, like the 3 percent withholding tax, for example, have a habit of recurring. Projects that are mischaracterized as commodity purchases then are subject to the lack of discipline of the sealed low bid, and when construction projects are misclassified as commodity purchases, the government and the contractor are deprived of protections and benefits of the many standards for construction contract clauses that serve to allocate risk fairly. The unforeseen conditions cause, the equitable change clause, the prompt payment clause, and some of the warranty clauses, too.

So in summary on that point, we commend the Committee for pursuing this and trying to finally implement the Corps' categorical assessment that this is a bad practice. Nothing has changed since then that would mitigate that conclusion, so we look forward to your reintroduction of that bill.

We would also suggest when you do that, that you consider expanding it Part 15, Negotiated Procurement. And Part 14, Sealed Bid, is where we are looking at it now, but we understand that many agencies are going to a species of negotiated procurement, low priced technically acceptable where once the team is evaluated it becomes a low bid process. So we need to legislate those kind of controls into that process. Our members are having anecdotal evidence that there are selection abuses in LPT awards as well.

On the individual surety reform, we are fully in support of the industry consensus. There is no harm and only benefit to closing the individual surety loophole where there can be elusory assets and fraud and bad practice there. Your reform preserves the possibility of individual surety but protects against the abuses, so we think that can only increase competitiveness in that market.

And on the nonmanufacturing rule, I talked to my members and they said they cannot buy a tiller from a small business company or an air handling unit or mechanical equipment. It is entirely inapt for our industry.

So with that, sir, I will stop and look forward to your questions.

Chairman CHABOT. Thank you very much. I appreciate your testimony.

I would like to yield to the ranking member.

Ms. VELÁZQUEZ. I guess that you started out on the wrong track today.

Mr. Chairman, it is my pleasure to introduce Mr. Andrew Hunter. Mr. Hunter is the director of the Defense-Industrial Initiatives Group and a senior fellow for the International Security Program at the Center for Strategic and International Studies here in Washington, D.C. He focuses on issues affecting the industrial base, including sequestration, acquisition policy, and industrial policy. Prior to joining CSIS, Mr. Hunter served as a senior executive at the Department of Defense, including as chief of staff to Ashton B. Carter and Frank Kendall, while each was serving as under-secretary of defense for Acquisition, Technology, and Logistics.

Welcome, Mr. Hunter.

STATEMENT OF ANDREW HUNTER

Mr. HUNTER. Well, thank you, Chairman Chabot, and Ranking Member Velázquez. Thank you for the opportunity to testify to you today about contracting and the industrial base.

I am Andrew Hunter from CSIS, and as mentioned, prior to being at CSIS, I worked at the Department of Defense under two undersecretaries of defense for Acquisition. And prior to that, I spent 17 years working in various capacities in the House of Representatives. So this is a little bit of a homecoming, and a happy one.

A major focus of my work at CSIS involves understanding the evolving partnership between the Federal Government and the industrial base. This partnership is critical to the successful execution of the more than $400 billion in federal contracting that occurs annually. I have a particular focus on how this partnership is evolving between industry and the Department of Defense; however, CSIS performs in-depth analysis on data from all federal agencies, and I will try to keep that hat on today.

The industrial base is important because without it the Federal Government cannot function. The health of the industrial base, therefore, is of critical importance to the nation as a whole. While federal contracting is only a small portion of the overall economy, it is nonetheless very important to certain sectors of the economy and the industrial base, especially those that focus on government-intensive areas, such as defense, transportation, and healthcare, not least of great importance to many small businesses.

Contract obligations represent the overwhelming majority of the federal spending that is received by industry, and examining the contracting data is essential to understanding what is happening in the industrial base.

I will briefly summarize some of the chief findings of the analysis that CSIS has done on this data and try to provide some context for the discussion today and hopefully for the Committee's work in this Congress.

Our first central finding is that sequestration is currently the dominant force in federal contracting. With repercussions that have been particularly severe in defense contracting, but also across the board. We are in the midst of a significant reduction in federal contract obligations that are affecting every sector of the contracting world in the industrial base.

Within that overarching story, secondly, there is an important dynamic going on specific to research and development. Federal contracting for research and development performed by industry is particularly challenged under sequestration, potentially impacting the historical role that small businesses have played in technology innovation that Ranking Member Velázquez referred to in her opening statement. A great deal of the cutting-edge innovation has its source in small business. They are frequently incentivized to pursue innovative technologies that larger businesses do not have the same incentive to pursue. And that has been important to the nation over many years.

R&D contract obligations are declining much more rapidly than overall contract obligations, and we have not reached the bottom yet, even though we are likely approaching the bottom for contract obligations overall.

Third, small business contracting is highly sensitive to changes in the overall federal contracting environment. Small businesses are likely to be significantly affected therefore by return to sequestration levels, spending levels in 2016. Contract obligations with small businesses plunged in the first year of sequestration, 2013, then happily, but somewhat unexpectedly, recovered very well in 2014. I believe the reality for small business in truth is somewhere between the crisis picture that the 2013 data presents and the relatively healthy picture that the 2014 data presents. But I suspect that a return to full sequestration would send us, again, in a sharply downward directly.

And then lastly, the composition of small businesses participating in federal contracting has been significantly reshaped since 2000, which is when a lot of the federal data started to become widely publicly available contracting data. And much of this has been the result of policies established in the Small Business Act. And I mention this to point out that the future direction chosen by this Committee will shape the future of small business contracting over the next 10 to 15 years, so it is very important. The work of this Committee is very important.

And lastly, I just want to emphasize that the continuing, in some cases increasing complexity of the federal contracting process referenced by many of my colleagues here, remains the most significant barrier to entry for firms of all sizes in the industrial base, particularly small business. And small businesses are challenged to

absorb the overhead required to successfully navigate through this vast complexity. And I would say when you are making these decisions, I would suggest that you tend to err as much as possible on the side of reducing complexity in all of these approaches.

So thank you, and I stand ready to address your questions.

Chairman CHABOT. Thank you, Mr. Hunter. We thank all the panel members for their excellent testimony here this morning. And I will begin with myself with five minutes of questioning.

How can we get more small business construction companies to compete for federal work as either prime contractors of subcontractors? And Mr. Gibson, if you do not mind, I will start with you. And anybody else that would like to weigh in is welcome to do so.

Mr. GIBSON. Taking from my own experience, sir, as a small business, I would say the way to invite more firms to get interested and involved in federal contracting would be to hopefully take some of the regulations away that sometimes deter firms from entering the marketplace. And also to enhance the teaming and partnering ideas that we have been talking about in my testimony today. Lots of times a firm needs a mentor or somebody who has been in the federal construction process. Allowing them to team, show their own qualifications, share the qualifications of their partner, get involved, learn the ropes, that would be an opportunity for them to ease their way into the marketplace.

Chairman CHABOT. Thank you very much.

Mr. Hoffman, did you want to weigh in on that?

Mr. McNerney?

Mr. MCNERNEY. My members would agree with that ability to partner and team more. My very small members, of which I have many, do that and they would like to do more of it. And the idea that all the team members would be evaluated is a good idea. Any more discerning selection criteria is highly favored by my members because they prosper when the selection criteria is high.

Chairman CHABOT. Okay. Thank you.

Mr. Hunter, did you want to weigh in?

Mr. HUNTER. I would just say I think this gets a little bit to the design build discussion that happened earlier; that the more you can make it easier for companies to get in the front door and participate, the better. I think having more companies engaged in the front end of the process is a good thing, and it is true that the bid and proposal costs can be one of the major barriers to entry. I think the trick a little bit in that is for the government having to evaluate based on a list of qualifications makes it a little bit hard on the contracting officer to withstand bid protests. And bid protests are something that we are seeing has a very pervasive influence throughout the contracting process. It is driving many more of the decisions that get made than I think it was ever really intended to be driving. And so I think sort of that larger story is playing out in the design bid and the construction context.

Chairman CHABOT. Okay. Thank you.

Let us see, Mr. Hoffman, I think I will start off with you on this one. Some would argue that by only having five teams submit full bids on a design build project we are limiting competition. Could you explain why the two-step process is actually pro-competition? Arguably pro-competition?

Mr. HOFFMAN. Yes, sir.

First of all, the first phase of competition is open to everyone. So everyone is able to participate. And then with respect to the second step, what we are going to find is that the most experienced architect, engineers, and construction contractors are going to step out if there are more than five construction contractors. So we are going to have less qualified people participating in federal projects because the opportunity to win that project with significant investments is dramatically diminished once you go beyond the three to five recommended in industry practices.

Chairman CHABOT. Thank you.

And then I will have each of you just address this very briefly, if you would. If you could just tell us legislatively what you would like to see us do; if there were one or two things that we could do that would really make a difference? Maybe I will start with Mr. Hunter this time and go in the opposite direction.

Mr. Hunter, if you want to suggest one or two things.

Mr. HUNTER. Yeah. I am going to make a suggestion that may be slightly hard to implement. But as I mentioned, I think trying, wherever you can, to reduce complexity in the system is the way to go.

Chairman CHABOT. I would go with Mr. Gibson's reducing the regulations basically.

Mr. HUNTER. Yes. And of course, you have to be careful. Many of these regulations have a history. They exist for a reason, but I think there are frequently less complex ways to implement the statute and regulations and to get the same job done.

Chairman CHABOT. Okay. Mr. McNerney?

Mr. MCNERNEY. Mr. Hunter's comment about the roadblocks and the complications from bid protests is a good one. And I do not know how you would legislate that, but our members prefer a more robust evaluation, a past performance evaluation on completed contracts, more robust than exists now. If you had that and more widespread use of the federal awarded past performance information system, I think would help bolster selection criteria, exclusions, if you will. Again, I think that our members on the main would like to see the selection process be more discerning, and I think that would increase competition. Some of my members say they will not compete in the federal market because of not so careful selection procedures.

Chairman CHABOT. In order to enforce my five-minute rules against myself, I am going to cut it off at that point. And I will either talk with you briefly or in a second round or we will get back to it. But I now recognize the ranking member for five minutes.

Ms. VELAZQUEZ. Thank you.

Mr. Hunter, in evaluating the awards to small businesses over the last few years, there seems to be a trend in which the dollar value of small business contracts has increased. What effect does this concentrated dollar value have on the small businesses' industrial base?

Mr. HUNTER. It is a very interesting point. As someone who spends a lot of time analyzing contract data, it would be great if we could dig deeper into that and understand. Is it because the locus of where the awards are happening within the space of fed-

eral contracting? In other words, is it because it is more construction happening and less in the world of supplies? Because that can affect contract size. Construction projects are going to be bigger than most commodity purchases.

But having not carefully analyzed it at this point, my suspicion is that it is not that; that it is, in fact, that the average awards are growing bigger across the board, because our data shows that small businesses are generally succeeding in the areas where they have always succeeded in the contracting process. And I do not know if that is being driven by the way the government is putting out solicitations and proposals. That would generally probably be the first place to look.

Ms. VELAZQUEZ. Do you think that bundling has a lot to do with that?

Mr. HUNTER. It certainly could. It could also be that some of the smaller purchases which may have historically been done with small businesses, if they are now being done with a purchase card at Walmart, you know, that may be driving some of that. Smaller business and directions away from small businesses. And I think if it is an issue of interest, having someone take a deeper look at that, those trends, would be good.

Ms. VELAZQUEZ. Thank you. Thank you.

Mr. McNerney, during its pilot program of reverse auction, the Corps found that the process might move too quickly for competitors to actually reassess their costs or the way they will actually do the work. There have even been reports in which the buyer had to step in to prevent a supplier from meeting a price that would harm the company. Do you believe that contractors are actually able to perform the contract at the price they beat or are some of them putting the viability of their company at risk?

Mr. MCNERNEY. All of that, Ms. Velázquez. I read the report on the subway down here and the Corps of Engineers says all of that very empathically. And I talked to some of my members yesterday who were involved in—the pharmaceutical industry was a big adopter of this back in 2002–2003. I will not name the company, but I asked him, I said, " Did you continue to bid that work as either prime or sub?" And he said, " No, I fired that customer." Because when the hasty judgments—the first Corps of Engineer Pilot Study ended up in a bid protest because the prime contractor who won said he did not mean to push the button the last time, ironically. So that tells you, what is that, an error in judgment or a clerical error?

Ms. VELAZQUEZ. Do you believe then that some of the same concerns that we see in construction reverse auctions will exist in other industries?

Mr. MCNERNEY. I think it is very likely. You know, the Corps of Engineers report said that for commodities it can be done well and it can help you find the lowest price. But the hearing you held last year with the VA did not prove that out.

Ms. VELAZQUEZ. Right. Okay, thank you.

Mr. Hunter, the contribution of small businesses to R&D has long been recognized as critical to our economy and national security as these firms have developed some of the most innovative technology. You noted in some areas of your testimony the decline

in R&D contracting at the Department of Defense, indicating that this is a worrisome trend that is incompatible with achieving national objectives. Can you explain this statement and what this trend means for the industrial base?

Mr. HUNTER. Yes. What we found is that the magnitude of the reduction in contract obligations for R&D is much greater than what you see overall. I think that is a result of the fact that for many—for the Department of Defense for certain, and for many federal agencies, there is a lot of rigidities within their budget that make it very hard to cut in other areas. And obviously, in the case of the Department of Defense, there is a strong desire to avoid cuts to things like military compensation. And so then the cuts have to be taken elsewhere. And R&D is inherently something that can be rescheduled and retasked fairly quickly because you are inventing things and you cannot invent on a schedule. The contracts are all designed to reflect, to be rewritable or adjustable as work proceeds. And that is good in a R&D context, but it also means it is very easy to, when the budget cut comes, to take money out of that contract.

Ms. VELAZQUEZ. But let me ask you a last point. Given the fact that when it comes to R&D spending, the agency has so much flexibility. How can we reverse that trend?

Mr. HUNTER. I think it is making it clear that this remains a priority. And I mentioned in my testimony that the goals and objectives that have been set in statute have actually reshaped the way that contracting is being performed. And so I think continuing to emphasize the importance of research and development and innovation is a key thing.

Ms. VELAZQUEZ. Thank you.

Chairman CHABOT. The gentlelady's time has expired.

The gentleman from New York, Mr. Hanna, is recognized for five minutes.

Mr. HANNA. Thank you, Chairman.

Boy, there is a lot to talk about. The 3 percent rule is gone. Relax. I cannot imagine it coming back.

In the last Congress, we worked on some of the subjects you mentioned, Mr. Gibson, in particular, reverse auctioning is, I mean, you all stated it one way or another, but it is a race to the bottom. I think we worked with the Department of Defense. I think with the chairman's permission, we can—I would like to continue on that path because I could not agree with you more. When all you have to do is click a button to be lower than the guy a moment before you, it does add, as you said, a degree of irrationality, and everyone wants to work. So everyone always thinks they can do a little bit better than they thought. So I get that.

And in terms of the overall conversation though about bidding in general, one of the problems with the whole process is, and one of the reasons for bid protests is the very subjective nature of everything you do, which feeds back to the conversation over reverse auctioning and why it is such a bad thing. But how do you protect the interest of the public and at the same time limit the number of bidders? How do you take out those elements that cause people to protest bid? Because it is easy to do and it is easy to find a reason to do that.

I personally was in that business for many years, so I have seen a lot of that. I guess it is hard to have everything. Like, with Mr. Hunter, how do you have a vibrant industrial base, have sequester, and have an efficient R&D, an effective R&D, and still have the right to cut back on the cost of doing business? I mean, you cannot just fund an industrial base because you always want them to be there. You cannot just pay people to manufacture things because someday you may need them, although you could argue that you might. I wonder how you balance all that.

Mr. Hoffman, maybe you would like to say something about it. And anyone else.

Mr. HOFFMAN. With respect to competition, the issue for us would be the design build piece. So everyone has the opportunity through sources—and small businesses can participate in that and it can be set aside. Irregardless of whether it is small business or it is unrestricted, small businesses can participate as part of larger teams, and everyone would benefit and the standard to follow the best practices of three to five bidders so that we can go ahead and make sure the best qualified teams are pursuing things.

Mr. HANNA. So really what you are saying is you need a better way to qualify bidders, limit the number of bidders, and frankly, let the government have a more thoughtful and deliberate process for deciding not just how many, but how and what.

I am interested though, Mr. Hunter, what do you think of—how do you maintain all that?

Mr. HUNTER. Well, I would say, you know, I think this issue of how does the government basically arbitrate amongst proposals, and if it is a list of qualifications, it may be a case that everyone has great qualifications and it is very difficult to discern the difference. Or it may be the case that it defaults to whoever has the longest history of past performance, which again, is not going to necessarily get new entrants into the process. I know the Department of Defense and in the R&D context, a lot of times they use an approach that is referred to as a " white paper." And so you are asking folks to give you at a relatively low cost, something that is fairly short, but some description of what the approach that they would take to the problem would be. And that at least can provide a middle ground. I am not sure how well it works in the construction contracts because how far can you go into talking about a construction project before you are into some significant expense? In other contexts that can provide I think a way for the government to distinguish and to kind of call out the best folks to do the more expensive proposal.

And I would say on your question about innovation, I think prototyping can be something that is a good middle ground, if you will, that allows for you to do work on innovative technologies without going to the expense of, again, designing an entire system that the government probably does not have the funding to actually purchase.

Mr. HANNA. Thank you.

Chairman CHABOT. The gentleman's time has expired.

The gentlelady from California, Ms. Chu, is recognized for five minutes.

Ms. CHU. Well, this question is for anybody on the panel, and it has to do with reverse auctions. You have all been pretty vociferous in being against reverse actions for the construction industry, and you have said that it does not guarantee the lowest price, may encourage imprudent bidding, does not allow for a thorough evaluation of value, and does not ensure that the successful bidder is responsive and responsible and may, in fact, go against federal procurement laws. And in fact, the Army Corps of Engineers study found that it did not even offer marginal savings over a sealed bid process. I find that very interesting because the reason for reverse auctions in the first place was to get to the lowest price. So I would like your comments on any of these factors that have come out because of the reverse auctions.

Mr. GIBSON. Yes, ma'am. As a construction contractor, I can tell you that you might have what you think is the lowest price at time of award but it is the price you pay at the outcome that determines the real price of the job. If you have losses, if you have under proposals in there, they are going to come to life during the performance of that contract, and they are going to cause the government buyer a lot of problems. So I think it is putting up a smokescreen as to what real cost is when you invite that type of imprudent bidding.

And I will give you one example. As a construction contractor, most typical jobs I bid involve about 30 to 50 crafts, other companies coming to me to offer their services, 5 to 10 offers in each craft. There are several hundred people offering prices on bid day. Sixty percent of those prices come in within the last two hours prior to the bid deadline. So in the reverse auction process, how does the contractor have the opportunity to go back to those people and say, " Can you do better?" He is making a guess, and those guesses end up costing the government in the long run.

Mr. HOFFMAN. I might add that with respect to engineering services, reverse auctions, they do not look at lifecycle cost analyses and total cost of ownership. So the lowest cost is not necessarily the best cost. So if we look at construction in facilities, that cost is a small fraction of the total ownership costs once you go ahead and look at ongoing operation and maintenance. And I would urge the Committee to consider that, and I think you can only focus on first cost reverse auctions. I have no idea how you are able to understand what the total cost is of ownership when you do that.

Mr. MCNERNEY. I would just emphasize what Mr. Gibson said. Reverse auction is the antitheses of a best value selection process, which I think is also the answer to Mr. Hanna's question. You know, the government has gone to design build best value to get away from the problems that existed in contract claims and dispute and defense of contract administration back when all projects were low bid, before 1994 Competition and Contracting Act.

So I think Mr. Hanna, the answer to your question is, too, you have got to, you know, you have got to allow the CO to have governed discretion. He has the contracting warrant. He has to make discretionary judgments, and the bid protest agencies have to back him up.

Ms. CHU. If I may change topics, Mr. Gibson, the SBA has two surety bond guarantee programs that guarantee 70 to 90 percent

of the bonds up to $6.5 million in value to assist small businesses. However, many construction companies are not using the program and the individual sureties have filled the void. Why do you believe construction companies are not utilizing the program, and what are the steps that could make this program more attractive? Like, for instance, if they were guaranteed by 100 percent or if the total guaranteed value is increased from $6.5 million?

Mr. GIBSON. Ma'am, I have to tell you that I am not a surety expert. I have had the relationship with my same surety for 40 years, one surety. So I know very little about their operations. I trust the solid company that I have been working with for 40 years, and I would prefer to defer to somebody else on the panel that might be able to talk about those distinctions.

Ms. CHU. Okay. Anybody else on the panel?

Mr. HUNTER. Well, I would just say about surety bonds, I think it is reflective of another issue in federal contracting, which is access to capital. And I think historically, when the Federal Government was sort of a bigger part—federal procurement was a bigger part of the overall economy, there was always just an assumption that it was a gold standard; that the private sector would always be willing to front the capital to make a federal contract work, and what we are finding is that that is not as true anymore. The margins to be made on government business are not as attractive in many cases as what companies can find in the tech sphere. So it is just not as attractive to a lot of companies to engage in this business, and it takes a little more effort on the part of the government to get companies involved.

Chairman CHABOT. The gentlelady's time is expired.

The gentleman from New York, Mr. Gibson, is recognized for five minutes.

Mr. GIBSON. Well, thanks, Mr. Chairman.

Just to start off, to both chairman and ranking member, I am excited to join the Committee. Looking forward to our work together. Small business, a huge part of upstate New York. And so to get this opportunity to provide a voice for our small business owners is a real privilege.

Good session here. I am learning quite a bit and I appreciate the comments. Definitely taking notes here with regard to reverse auction, the bidding process, and how we are proceeding with protests, insights that you are providing for improvements.

I am going to make a couple of observations of things that I have heard in my time moving around the 19th Congressional District and somewhat informed by the 29 years I had in uniform before I came to Congress. I would be interested in your commentary or perhaps policy recommendations that may be able to address some of these things. I do not think there will be anything surprising about what I am going to mention here. Just given your expertise, I would love to hear if you have some thoughts on how we could change law or insights on regulation to do better.

The first is, I had a company in Kingston that I thought was really doing excellent work with regard to protection for our troops. Body armor and protection of both people and equipment. But they were having a hard time getting the attention of the DoD. And so sort of the first phenomenon, is there something about the proc-

esses, RFP and whatnot, that would cast a net a little wider and allow for small businesses who are doing really creative stuff, to make sure that they knew what the government was looking for, and for the government to get a better appreciation or even situational awareness on what small businesses are doing; number one.

And number two is somewhat related. I have, and I do not think this is an epiphinal comment, but one of the value added of small businesses is that you really see agility. You see responsiveness and you see boldness in terms of pulling things together. Then the issue becomes one of scale. You go ahead and you really hit it and you hit it well, but then how do you compete? What I saw in my time in the military is it almost seemed like the DoD would rather safe side it and go to a bigger company, even if they might have been impressed with some of the ideas of a smaller company, because they did not want to take on the risk. And so there was this issue of scale. I do not know, maybe there is a finer point on design build on this score, but I would be interested in anyone from the panel commenting on those two general points. And then if you have any policy recommendations, I would love to hear them.

Mr. GIBSON. I can just speak from personal experience on your scale issue. As a small business contractor, I have observed an inclination over the past several years for the purchasing agencies of the government to prefer the larger contractors. I actually had it said to me by agency representatives that they think they are buying down risk when they hire the larger contractors. And we have had to be creative to work—as a small business, to work around that. We have had to go outside of our marketplace, our custom marketplace to find work.

Mr. HOFFMAN. Actually, with respect to scale, I think if we talk to the various agencies, it is interesting. Many times the contracting officers and some of the project managers appear to be willing to embrace the utilization of small businesses, but then they also need to sell it to their customers, and their customers can be more risk adverse. Certainly, we have seen a good many sources sought and a good many opportunities for small businesses, at least in our sector, to participate, and we appreciate that.

With respect to policy changes, again, in our testimony, we would suggest the reintroduction of H.R. 2750 and the clarification of the nonmanufacturing rule.

Mr. HUNTER. I think your example actually about troop protection is a really great case. Because that is one where the government tends to want to take a low-risk approach for very understandable reasons that you can certainly appreciate. And it is expensive to test some of the items and to prove out that they meet the specs that the government is looking for which are fairly stringent.

Interestingly enough, there is a program at the Department of Defense called the Foreign Comparative Test Program that exists for a similar reason, to allow the department to test out equipment from overseas that may be something that we do not have here, and to pay for the testing just so that it can show what its capabilities are. And I think having some small amount of budget to sort of demonstrate, allow small companies to demonstrate what their products can do so that the buyer then does not have the fear that

a smaller firm may not have designed something that is going to stand up over time or meet the spec. And the Army has done good work on this with field testing, essentially, of articles in the electronics realm that has really expanded the envelope of people able to participate. I think in troop protection that could be a very valuable example.

Chairman CHABOT. The gentleman's time has expired. Thank you, gentleman.

We will go to a second round at this time, and I will recognize myself for five minutes. I am not sure if I am going to take the whole five minutes.

But my last question in the previous round, I had asked what legislatively would you like us to do, and we heard from Mr. Hunter and Mr. McNerney, so I would like to give Mr. Hoffman and Gibson an opportunity to suggest what maybe legislatively you would like to see us take up. I will prompt you by giving a couple of bills that I know that we are considering now, and I think you may be somewhat familiar with. One is Chairman Hanna's bill relative to surety bonds. And another is H.R. 2750, which is a design build bill; H.R. 2751, which has to do with reverse auctions. These were in the last Congress introduced, and I am sure we will be working on them this Congress as well. Another was the nonmanufacturing rule and also teaming and joint venture legislation. So those are some of the things. So you can either comment on those if you would like to or other things if you would like to bring to our attention, what you would actually like to see us do. And maybe I will begin with either one of you.

Mr. Hoffman, do you want to go?

Mr. HOFFMAN. Thank you.

Actually, each one of those rules are in our written testimony, and we would encourage the Committee to pursue and pass those proposed reforms. And that would be what we would be looking for, sir.

Chairman CHABOT. Okay. You cannot be much more specific than that. Thank you.

Mr. Gibson?

Mr. GIBSON. Absolutely the same. We support all of those, and have added that to our testimony as well today.

Chairman CHABOT. Okay. Thank you very much.

I think I am going to stop there. I got the answer I wanted, so thank you.

I will now yield to the gentlelady from New York, the ranking member, Ms. Velázquez.

Ms. VELAZQUEZ. Yes, I would like to go back to Mr. Hunter. We are now reviewing the budget for Fiscal Year 2016. In your testimony you mentioned that your data shows small business contracting numbers increased in the last fiscal year, despite the cuts imposed by sequestration. Can you give us an explanation as to why that happened? What can you tell us regarding the spending levels that are proposed for Fiscal Year 2016 and whether they represent a significant risk for small business growth?

Mr. HUNTER. I will do my best. The same answer would be to say we need more data. What we have seen in several areas, and I will try to maybe highlight a little and not be cryptic. For exam-

ple, we saw big differences between the military services and the way that their contracts were playing out. So the Army's contract obligations have sort of fallen off a cliff. The Navy showed surprisingly little variation in their contract obligations. And then the Air Force was somewhere in the middle and it was very hard to understand how you could have three such different outcomes when they are all facing relatively the same level of cuts. The 2014 data has now come in. We find that, in fact, it is the Navy whose contract obligations have gone down now quite a bit in 2014, much more so than 2013, and the other services not as much. And I think what is happening is that things are shifting around. So there is a semi-artificial barrier there which is the end of the fiscal year—one fiscal year, the start of another. And to some extent the appropriations in terms of when they go on contract can be fungible across that boundary. And so I think there is a lot of shifting that is going on. And so I think work from 2013 got shifted essentially into 2014, partly probably due to the uncertainty when sequestration kind of came down in the middle of the fiscal year, and partly because of strategies that different agencies adopted. And so I suspect that if you were to sort of take the two years and average them out, that might be—and assume that in reality sort of that, there was more of a steady state trend line there and that those two numbers are extremes and the reality is somewhere in the middle, I suspect that is the case.

So taking you then to 2016, this question of does it go back down to the full sequester levels and another drop? Or does it now start to go in a positive direction in terms of the total federal obligations? It is going to, I think, again, kind of, you know, it will be—in some ways it surprised agencies whichever outcome occurs because they have budgeted now for what the president's level is, which is higher, and if it ends up going back to sequestration, there is going to be that surprise again. And that is why I think it will be a sharp drop if that happens.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

Chairman CHABOT. The gentlelady yields back.

The gentleman from New York, Mr. Hanna, is recognized.

Mr. HANNA. Thank you.

Surety bonding. You know there was a bill in the last Congress that almost made it. It died but for one person in the Senate. You are familiar with that. Basically, it meant that bonding had to be backed by real assets. It is not that complicated and it is not that much to ask. We know that it has not always been that way. I would just like to give you a chance to talk about that, Mr. McNerney and Mr. Gibson. You are both in that racket, so.

Mr. MCNERNEY. There are those notorious cases that you have all heard from the NASBP and the surety and fidelity, the individual surety who pledged coal waste as the security for a bond. If there were a claim made on that, my contractor would have been out of luck. He would have been on the hook for all his payroll and everything else when the prime failed. So I just think it is a very good government abuse. It is just a transparently bad loophole in the law. The contracting officers do not deal with it properly. It is more prevalent than you would think, I am afraid. What I hear

from NASBP, it is just—I do not think you lose the virtues of independent——

Mr. HANNA. Bonding has always been based on a zero loss ratio. As soon as you factor in any loss at all, you are degrading the contractor and you are degrading the process.

Mr. MCNERNEY. Right.

Mr. HANNA. You would agree with that, Mr. Gibson?

Mr. GIBSON. Yes. And I would say that we are here talking about small businesses. That loophole is very dangerous for small businesses who are thinking about getting into the Federal Marketplace. You do not want to step into the Federal Marketplace without a solid surety behind you, and you cannot get a solid surety unless you are solid yourself financially. So this Committee should help protect small businesses by closing that loophole.

Mr. HANNA. Mr. Hunter, implicit in your statement—and I will just admit, just for myself, that sequestration is pretty ham-fisted and not nearly as discriminate as any thoughtful person would want it to be. But knowing that and knowing the other issues with the debt and the deficit and the way people feel about all that, and I agree with that, how do you maintain research and development and how do you maintain these companies without just throwing money at them to make sure they are in business when you need them? Because that is implicit in your statement, and yet, that is not logical necessarily to everyone, and certainly not to me.

You have got two minutes. I mean, I would kind of like to know about that dynamic because we have, in my district, companies that are deeply invested in doing work for the government and find themselves through sequestration in trouble right in the middle of things that they are doing that everybody thinks are important. It is an interesting problem.

Mr. HUNTER. It is. And I think the government needs to be very discriminating about how it approaches and how it invests its R&D dollars. And so I think that is kind of the answer in both directions to your question I would argue.

Mr. HANNA. But you would agree; you just cannot throw money at the problem.

Mr. HUNTER. You cannot throw money at the problem, and we do not need to be investing government dollars where the private sector is going to invest its own dollars. And generally, they are probably going to, I mean, history shows they are going to be successful in that in enough cases to make it not worth the government investment. So I think the government then needs to focus. When R&D budgets are declining and the government has to focus very hard, there is a tendency to say, well, we are going to invest in an area because we invested in it last year. We thought it was good then, it must still be good now. At a time like this, you really need to revisit those assumptions and say maybe the world has moved on. And in some cases it has. And in communications technology, the advancements on the commercial side are so rapid, it is highly unlikely the government investment is ever going to——

Mr. HANNA. So do you mind, can I speculate and say that sequestration is not all bad because it has made some people more thoughtful about how they do things and how they manage their total budgets?

Mr. HUNTER. I would say the government should be thoughtful without sequestration.

Mr. HANNA. But maybe it helped?

Mr. HUNTER. And part of the problem with sequestration is it does not allow a lot of thought. So we end up cutting everything, even the things that are critical and necessary, and yes, we may have cut some of the things that are less critical and necessary, but we cut them exactly 10 percent, not 100 percent as maybe we should have. And so I think it is those rigidities and that mechanism.

Mr. HANNA. Except in the last, they did allow for discretion in terms of that. That was the original way it went. But that changed, so.

Mr. HUNTER. Well, but there are still rigidities within the budget process that tend to drive the cuts to certain areas, R&D in particular, more so than places where we maybe should be cutting.

Mr. HANNA. Thank you. My time is expired. Thank you, Chairman.

Chairman CHABOT. Thank you very much. The gentleman's time has expired.

We want to thank all of the witnesses for their participation here this morning. It has been very helpful I think to the Committee. The testimony we heard I believe shows that there are changes this Committee can make to improve the competitive viability of small construction and A&E contractors and improve the health of our industrial base. We look forward to working closely I think on this issue and all issues.

And I want to ask unanimous consent that members have five legislative days to submit statements and supporting materials for the record.

Without objection, so ordered. And if there is no further business to come before the Committee, we are adjourned.

Thank you.

[Whereupon, at 11:45 a.m., the Committee was adjourned.]

APPENDIX

Statement of

Randall D. Gibson of Whitesell-Green, Inc.

on behalf of

The Associated General Contractors of America

to the

U.S. House of Representatives

House Committee on Small Business

For a hearing on

"Contracting and the Industrial Base"

February 12, 2015

AGC of America
THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA
Quality People. Quality Projects.

The Associated General Contractors of America (AGC) is the largest and oldest national construction trade association in the United States. AGC represents more than 25,000 firms, including America's leading general contractors and specialty-contracting firms. Many of the nation's service providers and suppliers are associated with AGC through a nationwide network of chapters. AGC contractors are engaged in the construction of the nation's commercial buildings, shopping centers, factories, warehouses, highways, bridges, tunnels, airports, waterworks facilities, waste treatment facilities, dams, water conservation projects, defense facilities, multi-family housing projects, site preparation/utilities installation for housing development, and more.

THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA
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Statement of Randall D. Gibson
Whitesell-Green, Inc.; Pensacola, Florida
House Committee on Small Business
United States House of Representatives
February 12, 2015

Chairman Chabot, Ranking Member Velázquez and members of the Committee, thank you for inviting the Associated General Contractors of America (AGC)—of which I am a member—to testify on reforms to the federal government's contracting laws relating to the industrial base, including the construction industry.

My name is Randy Gibson. I am president of Whitesell-Green, Inc. (WGI)—a small business construction contracting firm based in Pensacola, Florida that services the Southeast region. Since WGI's founding in 1970, we have constructed over 400 heavy/commercial projects—public and private—resulting in nearly one billion dollars of completed contracts. On the federal government side, WGI has completed numerous projects for the U.S. Army Corps of Engineers, Naval Facilities Engineering Command, the Air Force Civil Engineer Center, and Department of Veterans Affairs.

Today, I will discuss the need for Congress to:

I. Prohibit all federal agencies from procuring construction services through reverse auctions;

II. Reform design-build contracting government-wide;

III. Encourage sensible consideration of past performance records in the joint venture and teaming context;

IV. Prevent unintended consequences of misinterpretation of the nonmanufacturer rule; and

V. Help prevent fraud in the surety bond market;

I. Prohibit All Federal Agencies from Procuring Construction Services through Reverse Auctions

AGC strongly supports full and open competition for contracts necessary to construct improvements to real property. This includes competition among general contractors, specialty contractors, suppliers and service providers. Over the years, it has been established that such competition energizes and improves the construction industry to the benefit of the industry and the nation as a whole, especially taxpayers. As Congress considers changing the federal procurement landscape, we offer the following points for consideration during your evaluation of reverse auctions.

a. The Problems with Reverse Auctions for Construction Services Contracts and How Reverse Auctions Limit Competition

i. Reverse Auctions Do Not Provide Benefits Comparable to Currently Recognized Selection Procedures for Construction Contractors

Vendors promoting online reverse auctions are selling technology for which there may be legitimate economic justifications for some types of procurements. However, those vendors have neither presented persuasive evidence that reverse auctions generate real savings in the procurement of the design or construction of a project, nor have they adequately explained how reverse auctions generate the benefits of "best value" comparable to currently recognized selection procedures for design and construction contractors. Such selection procedures have been carefully tailored to meet industry standards that generate competitive procurements for the benefit of taxpayers. In fact, reverse auction vendors have said themselves that reverse auctions for design and construction services are not appropriate. [1]

Unlike manufactured goods and commodities—i.e., pens, paper, so forth—construction services are project-specific and inherently variable. Each construction services contract is subject to the unique demands of the project, including: the geography—including but not limited to site conditions, the seasonality of certain construction activities, project proximity to major suppliers, and site ingress and egress in conjunction with other landowners—the needs, requirements, personnel and budgetary criteria of the owner, specific and unique design features, construction requirements and parameters, and the composition of the project team.

Federal procurement laws recognize that construction stands apart from commodities or manufactured goods. AGC contends that vendors promoting reverse auctions for construction services misuse a procurement process originally established for commodities and ignore the unique nature of construction. Designers, construction contractors, specialty contractors, subcontractors and suppliers offer and provide a mix of services, materials and systems. They do not "manufacture" buildings, highways, or other facilities.

ii. Reverse Auctions Do Not Guarantee Lowest Price

In the context of construction, AGC believes that most of the claims of savings are unproven and that reverse auction processes may not lower the ultimate cost of construction. For example, "winning" bids may simply be an established increment below the second lowest bid, not the lowest responsible and responsive price. Moreover, in reverse auctions, each bidder recognizes that he or she will have the option to provide successively lower bids as the auction progresses. As a result, a bidder has no incentive to offer its best price and subsequently may never offer its lowest price—as opposed to during low price technically acceptable procurements and other contracting approaches. In addition, savings from reverse auctions can be one time occurrences.

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[1] Joe Jordan, former Office of Federal Procurement Policy Administrator and now FedBid reverse auction company employee, has noted that reverse auctions are not appropriate for procuring design and construction services. James Best, Jr., *Reverse Auctions Draw Scrutiny*, NEW YORK TIMES, April 6, 2014 *available at:* http://www.nytimes.com/2014/04/07/business/reverse-auctions-draw-scrutiny.html?_r=0.

iii. Reverse Auctions Encourage Imprudent Bidding

Reverse auctions create an environment in which bid discipline is critical yet difficult to maintain. The competitors have to deal with multiple rounds of bidding, all in quick succession. The process can move too quickly for competitors to accurately assess either their costs or the way they would actually do the work. If competitors act rashly and bid imprudently, the results may be detrimental to everyone: designers, prime contractors, subcontractors, sureties and especially federal agencies. For prime construction businesses, imprudent bidding can lead to project default. In the case of subcontractors, imprudent bidding means they may be pushed to unrealistically lower their prices, which will jeopardize the quality of the supplies, materials and services those subcontractors can provide. The risk of and actual default can increase surety bond costs. All these problems have the effect of increasing the ultimate cost of construction as well as the cost of operating and maintaining the facility to the federal agency and the taxpayer.

During reverse auctions, small construction businesses are most likely to fall victim to such imprudent bidding and experience the greatest harm. Small construction businesses have less cash flow and reduced ability to handle risk than non-small construction businesses. Some small business contractors may simply bid a job below cost to maintain some form of cash flow to remain in business. Additionally, some may fall victim to the auction's time restraints and consequent knowledge gap. Under pressure to win the job, a small business may unwittingly underbid, thinking that the subcontractors it has lined up would perform at that low of a price. Unable to have subcontractors perform the work, the prime small business may not have the capability to actually perform all of the work on its own and default. And, to add insult to injury, the federal government can even file a claim against the contractor when it underbids a contract under the False Claims Act.[2]

iv. Reverse Auctions Do Not Allow Thorough Evaluation of Value, Unlike Negotiated Procurements

Where price is not the sole determinant, federal owners increasingly have utilized processes focused on negotiation to expand communication between the owner and prospective contractors for the purpose of discussing selection criteria such as costs, past performance and unique project needs. These processes recognize the value and quality of project relationships that share expertise to promote greater collaboration among the owner and project team members. These processes also consider quality, safety, system performance, time to complete and overall value that can, in fact, outweigh the lowest price to arrive at the best value for the owner. Such an approach also offers both the owner and contractor the opportunity to discuss and to clarify performance requirements of the project.

[2] In the case of *Hooper v. Lockheed Martin Corp.*, the U.S. Court of Appeals for the Ninth Circuit ruled for the first time that underbidding or making false estimates in bids or proposals submitted in response to federal government solicitations may constitute violations of the False Claims Act. In a situation where a bidder needs a contract to maintain cash flow, the reverse auction can serve as an easy way for some contractors to do that. However, as this case reflects, there can now be legal liability for doing so that could further endanger the company. For more information see http://www.mckennalong.com/media/site_files/1979_FCA%20Article.pdf

On the other hand, reverse auctions do not promote communication between the owner and bidders. Rather, they promote a dynamic in which bidders repeatedly attempt to best each other's prices. In fact, reverse auctions between buyers and suppliers often have a deleterious effect on the relationship between buyer and seller. Non-price factors of consequence to the owner, such as quality of relationship, past performance, scheduling, long-term maintenance and unique needs, are deemphasized in the auction. As a result, reverse auctions do not offer owners a sufficient opportunity to evaluate non-price factors.

v. Sealed Bidding Assures that the Successful Bidder is Responsive and Responsible

Where price is the sole determinant, the sealed bid procurement process is well-established to ensure integrity in the award of construction contracts. Under sealed bid procurement each proposer offers its best price and bids are evaluated through the use of objective criteria that measure responsiveness of the bid to the owner's articulated requirements and the responsibility of the bidder. In this manner, sealed bidding ensures fairness and value for the federal owner. On the other hand, reverse auctions ignore this tradition. The pressure and pace of the auction environment removes any assurance that initial and subsequent bids are responsive and material to the federal owner's articulated requirements. These auctions expose federal owners to the real possibility that they may award contracts to what would otherwise be non-responsive bidders. In addition, reverse auctions ignore the protections of the sealed bid procurement laws, regulations and years of precedent that address critical factors and ensure the integrity of the process.

vi. Reverse Auctions Limit Competition

My company—as well as many AGC members of all sizes—choose not to participate in reverse auctions for all of their risks and faults articulated above. Again, AGC strongly supports full and open competition for contracts necessary to construct improvements to real property. We contend that reverse auctions create an environment where competition is unnecessarily limited to the detriment of the federal government and taxpayers. In fact, we contend that no objective study on the issue has provided persuasive evidence that reverse auctions generate the cost, or best value for the procurement of construction services.

b. Federal Agency Experience, Reports and Policy on Reverse Auctions

Federal agency experience and reports support AGC's position that Congress should prohibit reverse auctions for design and construction services contracts. Those sources include the U.S. Army Corps of Engineers, the White House Office of Federal Procurement Policy, and the Government Accountability Office.

i. The U.S. Army Corps of Engineers' Experience & Findings

The U.S. Army Corps of Engineers (USACE) published a 2004 study entitled "Final Report Regarding the U.S. Army Corps of Engineers Pilot Program on Reverse Auctioning."[3] The

[3] U.S. ARMY CORPS OF ENGINEERS, FINAL REPORT REGARDING THE U.S. ARMY CORPS OF ENGINEERS PILOT PROGRAM ON REVERSE AUCTIONING, 2004 *available at:* http://docs.house.gov/meetings/VR/VR08/20131211/101557/HHRG-113-VR08-Wstate-CaryN-20131211.pdf

report determined that although reverse auctioning had potential in the purchase of "simple commodities" where variability is exceedingly small or nil (identical products under identical conditions), its use for the purchase of construction services where the dynamics and variables are just too diverse "should be the very rare exception and not the rule – if used at all." The USACE report further states that on the rare occasion reverse auctioning may be considered as an acquisition method, such consideration should only be made after sealed bidding has failed.

On March 6, 2008, Major General Ronald L. Johnson, former Deputy Commanding General of USACE, testified before the House Committee on Small Business on this very issue. MG Johnson testified that "[t]he Corps, through our pilot study, found no basis to claim that reverse auctioning provided any significant or marginal savings over a traditional contracting process for construction or construction services." MG Johnson also testified that "[w]hile this tool may be appropriate and beneficial in more repetitive types of acquisition, we did not find it to be a useful tool for our construction program and do not currently utilize it today to any great extent."

Most recently, on May 23, 2013, USACE Engineering and Construction Chief James C. Dalton, P.E., also testified before the House Committee on Small Business on a similar topic. Mr. Dalton noted that reverse auction procurement "provides a benefit when commodities or manufactured goods procured are of a controlled and consistent nature with little or no variability. Construction is not a commodity." He went on to state that "procuring construction by reverse auction neither ensures a fair and reasonable price nor a selection of the most qualified contractors." As a result of its experiences, USACE does not procure construction services using reverse auction procurement.

ii. White House Office of Federal Procurement Policy Findings

Furthermore, the federal government has elsewhere acknowledged that construction services stand apart from commodities or manufactured goods. In a July 3, 2003, memorandum from Office of Federal Procurement Policy Administrator Angela Styles, the government states that "[n]ew construction projects and complex alteration and repair, in particular, involve a high degree of variability, including innumerable combinations of site requirements, weather and physical conditions, labor availability, and schedules." This memorandum was sent to all federal procurement executives to encourage them not to treat construction as a commodity for government procurement purposes.

iii. Government Accountability Office

In December 2013, the Government Accountability Office issued a report[4] that reviewed reverse auction procurement in four agencies: the Army, Department of Homeland Security, Department of the Interior, and the Department of Veterans Affairs. The report notes that reverse auction procurement increased over 175 percent between fiscal years 2008 and 2012 and that agency officials are increasingly using reverse auctions to acquire services and for more complex contracting actions.

[4] GOVERNMENT ACCOUNTIBILITY OFFICE, REVERSE AUCTIONS: GUIDANCE IS NEEDED TO MAXIMIZE COMPETITION AND ACHIEVE COST SAVINGS, DEC. 2013 *available at* http://www.gao.gov/products/GAO-14-108.

Furthermore, the report finds that agencies have awarded a significant number of contracts when there was only one bidder or a lack of interactive bidding. Specifically, the selected agencies conducted 3,617 reverse auctions where only one vendor participated and submitted one bid. Agencies paid $1.7 million in fees for these auctions and were unlikely receiving the best price, as there was no competition. And, counter to the claims of reverse auction vendors, the GAO report finds that "it is unclear whether savings due to reverse auctions are accurate because target prices may be set too low or too high."

c. Reverse Auctions in the Department of Veterans Affairs and the General Services Administration

Over the years since USACE's first-hand insight on reverse auction procurement of construction services, AGC has found that some agencies—including the Department of Veterans Affairs (VA) and the General Services Administration (GSA)—continue to use or push this acquisition tool for construction. By no means are these two agencies alone. AGC has also brought the inappropriate use of reverse auctions to the attention of the National Parks Service and other agencies within the Department of Interior. For the purposes of today's hearing, we will address our concerns with the VA and GSA.

i. Department of Veterans Affairs

The VA construction program separates into two appropriation accounts: (1) minor construction, for projects of $10 million or less; and (2) major construction, for projects over $10 million. Similarly, the VA structures its construction program into two organizations, one where the 22 regional Veterans Integrated Services Network (VISNs) offices procure minor construction contracts and the other in the Office of Construction and Facilities Management (CFM) that handles major construction contracts.

In AGC's experience, the inappropriate use of reverse auction rests with the VISNs and not with CFM. AGC has tried to reach out to VISNs that utilize this acquisition tool to inform them of prior federal agency experience and the inherent risks they bring. However, they have not been responsive. As such, AGC reached out to CFM about minor construction project awards procured through the reverse auction process since 2011. Those awards included the following 14 examples:

1. VA261-13-B-0854, Renovation Support – Facility Space Realignment, San Francisco VA Medical Center, California; Award: $888,508.80
2. VA247-13-R-1355, Floor Maintenance and Repair, Central Alabama Veterans Health Care System (CAVHCS), Montgomery and Tuskegee, Alabama; Award: $727,924.10
3. VA247-13-Q-1567, Place Ductwork and Equipment, Atlanta VA Medical Center, Decatur, Georgia; Award: $283,250.00
4. VA247-13-B-1655, Auditorium Upgrades, Ralph H. Johnson VA Medical Center, Charleston, South Carolina; Award: $224,540.00
5. VA2417-13-R-0228, Stairwell Repairs, Carl Vinson VA Medical Center, Dublin, Georgia; Award: $208,352.52

6. VA247-13-R-1560, Fall Protection Installation, Atlanta VA Medical Center, Decatur, Georgia; Award: $101,053.30
7. VA262-12-Q-0950, Construct Concrete Slab Parking Pad with Security Fence, VA Medical Center, North Las Vegas, Nevada; Award: $86,700.66
8. VA262-13-Q-0514, Install/Replace Flooring, VA Medical Center, North Las Vegas, Nevada; Award: $82,297
9. VA247-12-R-1390, Floor Restoration Building 802, Charlie Norwood VA Medical Center in Augusta, Georgia; Award: $81,267.00
10. 542-11-4-5306-0076, Retaining Wall Repair, VA Medical Center, Coatesville, Pennsylvania; Award: $75,639.08
11. VA247-12-R-1396, Floor Restoration, Charlie Norwood VA Medical Center in Augusta, Georgia; Award: $52,009.85
12. VA247-13-Q-1348, Medical Air Compressor Installation, VA Medical Center, Fort McPherson, Georgia; Award: $51,685.40
13. 561-13-4-503-0021, Remodel of Homeless Services Domiciliary, Lyons, New Jersey; Award: $47,728.71
14. VA247-13-Q-0604-01, Roof Repairs, Carl Vinson VA Medical Center, Dublin, Georgia; Award: $25,000

All of the solicitations previously mentioned were small business set-aside projects, many of which were for Service-Disabled, Veteran-Owned small businesses. AGC holds that the VA should not jeopardize the financial stability of these veteran small businesses, whose development and well-being is within the VA's mission, for a short-sighted and unproven construction services procurement method already abandoned by the largest federal construction agency.

Additionally, these VA contract awards were for the procurement of professional construction services and not for the purchase of a simple commodity, commercial item or mere maintenance. AGC holds that the VA misclassified these contracts, often as some form of simple maintenance rather than as professional construction services. For example, the VA Northern California Health Care System awarded a nearly $900,000 contract (VA261-13-B-0854) for "numerous interior renovations throughout multiple buildings at the San Francisco VA Medical Center. . . [for which] [t]he contractor shall provide all labor, materials, and equipment."

Here, the VA sought to solicit construction services under the guise of simple maintenance of structures and facilities. However, under no circumstance were the tasks equivalent to cleaning bathrooms. In fact, the solicitation called for over 20 rooms to be renovated in some fashion, including but not limited to work on flooring, plumbing, mechanical and electrical installation. The solicitation also included construction services calling for the use of fire-stopping construction practices and construction operations occurring during business hours in a hospital facility. Additionally, construction services contractors were responsible for worksite safety for the contractor workforce and the VA facilities employees and patients.

For another example, the Carl Vinson VA Medical Center in Dublin, Georgia, awarded a $25,000 "roof repair" contract (VA247-13-Q-0604-01) as a simple "repair or alteration of structures and facilities." However, this project was not merely a roof repair; it appears to be a

complete roof replacement. Roof replacement is a complex construction service. It should not be procured through a game-like, online reverse auction process in which price is the only factor.

Whatever the cost of the total project, construction requires professional expertise. It is subject to, among other things, weather conditions, rapidly changing diesel fuel and material prices, as well as conditions that introduce an extreme degree of variability to construction, like changing labor supply, workforce safety, and equipment costs and time. Additionally, construction projects can include unforeseen site issues, such as the existence and necessary safe removal of hazardous materials that were not disclosed to the contractor or known to the owner.

The complexities of these processes simply do not compare to the purchase of an off-the-shelf commercial item or mere maintenance. The reverse auction process ignores the expertise of the contractor or the unique nature of construction. Construction contractors, specialty contractors, subcontractors and suppliers offer and provide a mix of services, materials and systems. Again, they do not "manufacture" buildings, highways, or other facilities.

ii. General Services Administration

In 2013, GSA launched an online reverse auction platform (http://reverseauctions.gsa.gov/) that enables any federal agency to procure construction services through a reverse auction. AGC notified GSA that it should remove from its Reverse Auction Platform the construction services options outlined in Schedule 56—noted below.

Specifically, the Reverse Auction Platform enables federal agencies to procure "Buildings and Building Materials, Industrial Services & Supplies" through Schedule 56. Schedule 56 includes "Ancillary Repair and Alteration requiring minor construction (includes Davis Bacon and construction clauses); and Installation and Site Preparation requiring Construction, which is necessary for Roof Repair or Replacement, to install a Pre-Engineered or Prefabricated Building or Structure, to install an Above Ground Storage Tank or to Install Alternative Energy and Power Distribution Solutions (includes Davis Bacon and construction clauses) " and construction of foundations.[5]

While GSA may intend for the procurement of what is misclassified as "simple," "ancillary" or "preparatory" construction services through a reverse auction, in practice, such undefined terms could allow for federal agency misuse of the Reverse Auction Platform, costing the federal government—and taxpayers—more in the long run. Determining which contractor is the most qualified at the lowest price to clear and improve land for construction, construct a building foundation, install prefabricated buildings, and repair roofs, among other things in Schedule 56, demands that a procurement agency evaluates a host of source selection factors together, which reverse auctions do not consider. For example, installation of prefabricated buildings can require a degree of design-build project delivery expertise that varies among contractors. However, a reverse auction only evaluates price, whereas established federal procurement practices allow for the consideration of this expertise.

[5] GENERAL SERVICES ADMINISTRATION, BUILDINGS AND BUILDING MATERIALS, INDUSTRIAL SERVICES AND SUPPLIES SCHEDULE 56: FREQUENTLY ASKED QUESTIONS (FAQS), *available at*: http://www.gsa.gov/graphics/fas/FAQs-Buildings-Schedule56.pdf

AGC fears that misclassification of major construction services as merely maintenance or repair jeopardizes the quality of construction an agency may receive through a reverse auction. Congress should not allow each agency to make its own mistakes when using reverse auctions, but rather learn from the experiences of the past.

d. Congress Must Prohibit the Use of Reverse Auctions for Construction Services Contracts

In 2014, Congress passed and the President signed into law a reverse auction provision as part of the Carl Levin and Howard P. 'Buck' McKeon National Defense Authorization Act for Fiscal Year 2015. The provision prohibits the Department of Defense from conducting single bid reverse auctions and reverse auctions for design-build military construction projects. While the law enacted last year is a step in the right direction, it neither addresses the vast majority of construction services reverse auctions for which small business would otherwise compete, nor does this law address all federal construction agency use of reverse auctions for construction. In fact, AGC is not aware of any agency ever conducting or having considering conducting a reverse auction for the construction of a design-build military construction project.

As our testimony and the record evidence, the experiences of one federal agency do not necessarily mean another federal agency will learn from them. Rather, we find that each federal agency learns the mistake of construction services reverse auction procurement on its own. This will neither benefit competition and the construction industry—especially small businesses—nor the American taxpayer. As such, AGC holds that the only solution is for Congress to enact a law that prohibits reverse auction procurement for construction services government-wide.

II. Reform Design-Build Contracting

Federal agencies have a number of different options in how they can procure design and construction services that will, in turn, affect who performs the different stages of a project. One of those options is design-build. Under design-build procurements, a single entity—the construction and design team—submits proposals for both the design and construction of the project.

Design-build is different from the traditional construction procurement method: Design-Bid-Build. Under design-bid-build, the design work, i.e., final construction drawings and specifications, is completed under a separate contract for design. These separate design contracts are most often competed for and awarded to architect-engineer (AE) firms. The federal agency will then ask contractors to compete for the construction contact, based on the design documents completed under the prior, separate design contract.

AGC recommends that owners—both public and private—select the project delivery systems that best fit their particular needs but with due regard for their independent interest in an open and competitive construction industry. As such, AGC is project delivery system "neutral" and merely recommends the project delivery system that fits each owner and project's particular and unique

needs. Many federal agencies have come to prefer design-build for a number of reasons, including the improvements in time of delivery and efficiency inherent in reducing the number of "steps" in the procurement process. Also, as design-build has become established in the federal contracting industry, agencies, designers and contractors have learned to use the close-working relationships inherent with this contracting method to better address the particular project needs of the federal end-user client.

a. One-Step versus Two-Step Design-Build Procurement

i. Congress Should Reasonably Limit One-Step Design-Build Procurements to Ensure Robust Competition

In general, there are two major types of design-build procurement:

1. Two-step design-build; and
2. One-step design-build.

AGC supports federal agency use of the two-step design-build procurement method as the preferred method over single-step design-build procurement for construction projects.

1. Two-Step Design-Build Procurement Explained

Generally, during the first step of the two-step design-build option, the issuing federal agency limits the proposal submission requirements to the qualifications of the offering design-build "teams." These qualification criteria are most often evidence of past experience with the specific facility type; client performance evaluations for that past work; and sometimes other performance criteria such as safety ratings, bonding, etc. Design-build teams are inclined to submit proposals for these relatively simple first-step opportunities, because this information is readily available in their company records and inexpensive to gather and present. As a result, the federal agency obtains a good quantity of qualified proposals to choose from and can be confident that they can select the best qualifiers for "second-step." Furthermore, the first-step review effort by the federal agency is similarly inexpensive, as they can quickly and easily judge the submitted qualification information.

In the "second step" of the two-step procurement the federal agency generally selects three to five teams to submit much more detailed technical proposals, including extensive and expensive design information. This step is sometimes referred to as the "short-list." When design-build teams know that they will be competing against a reasonable, limited number of other teams in step two, they can justify the significant technical proposal expense by weighing the risk of submitting such a proposal with the odds of winning the contract. This provides a degree of certainty and acceptable business risk that encourages more robust competition and design innovation. From this short list, the federal agency selects one design-build team for contract award.

2. One-Step Design-Build Procurement Explained

In the single-step design-build option, in contrast, there is no qualification "first round." Instead, all interested design-build teams must submit full proposals, requiring extremely large costs necessary for each team to prepare the technical and design documents (described in step two of the two-step option above). Design-build teams considering pursuit of a "single-step" proposal have no way to judge their prospects for success, as no team can be sure how many teams are pursuing the project. As a result, competition suffers because many qualified teams, especially small businesses like mine, choose not to incur these large costs to participate where perhaps 20 teams or more can offer. Why spend those proposal dollars for a 1 in 20 chance, when you can enter a two-step procurement, reach the second round and have a 1 in 5 or better chance of winning the award? Also, how does the government benefit from spending significant time and resources thoroughly evaluating all 20 proposals, some of which may be from unqualified teams?

AGC holds that agencies should strive to reasonably limit single-step design-build procurement to less complicated and less expensive projects, where very little design work is required for submission with the proposal.

ii. Recent Contractor Examples of Inappropriate One-Step Design-Build Projects

As my own anecdotal example of this dilemma, my company teamed with a large business firm to pursue a one-step aircraft maintenance hangar proposal (approximately $40 million in size). The technical submission requirements emphasized energy efficient design as the main selection criteria. Our team made sense, because my firm has extensive hangar experience and our joint-venture partner had extensive experience in high-efficiency energy system design and construction. Our team expended in excess of $100,000 in design and proposal costs, but our offer was not selected based in part on the government rating our qualifications lower than our competition. We later learned that more than 20 firms offered, meaning that if our expense was "typical," this proposal generated at least $2 million of industry expense, most of which went unrewarded. The agency could have dismissed my team, and perhaps many others, on this analysis of our qualifications by way of a two-step approach, saving all of us much expense and wasted time, and saving themselves a lot of source selection review effort. In my case, this unsuccessful expenditure limited my opportunity to pursue other projects, both while working on this offer and afterwards as a result of the impact on our company budget for proposal "pursuit."

In addition, AGC has received anecdotal complaints from members over the years on this issue. Most recently, AGC members were particularly concerned about two expensive and complex projects: one at the U.S. Military Academy at West Point, New York and another at Fort Carson, Colorado. At the West Point project, the U.S. Army Corps of Engineers (USACE) issued a request for proposal for a $170 million project under one-step design-build procurement. Similarly, at Fort Carson, USACE solicited a $100 million barracks project under the one-step process. In both cases, AGC alerted USACE that the prohibitive cost of entry into such high dollar, complex one-step design-build competitions in conjunction with low odds of winning awards can serve to decrease the number of qualified teams, often eliminating small business participation in total.

To the credit of the USACE Headquarters, in response to industry concerns at the Fort Carson project in particular, the agency issued an Engineering and Construction Bulletin[6] in August 2012 to serve as agency-wide guidance for when the one-step design-build process could be used. However, AGC recognizes and respects that USACE implementation of reasonable and consistent policies across an agency with such a wide scope is a challenge. USACE is tasked with ensuring the safe, secure and efficient construction of the nation's military and civil works infrastructure and facilities at home and abroad across 38 District offices within 8 Divisions. In the case of this particular guidance, AGC members have seen some inconsistency between the USACE Districts in policy implementation.

b. Final Round of the Two-Step Design-Build Procurement:

i. Congress Should Reasonably Limit the Final Round to Three to Five Construction and Design Teams

As previously noted, during the two-step design-build procurement process, a federal agency selects a limited number of finalists to enter the second-step of the competition and to submit full proposals with more complete—and more expensive—design materials and cost estimates. AGC has long held and supported the reasonable limitation of the second-step selection to three to five finalist construction and design teams. Such a range of finalists still allows for a sufficient and reasonable competition, allowing federal agencies and taxpayers to realize the benefits of robust competition without driving away qualified competition. As with the example of 20 proposals in the one-step design-build process, the less predictable the competition and the odds of success, the more likely qualified teams do not compete.

Like AGC, I strongly support full and open competition for the many contracts necessary to construct improvements to real property. I recognize that the reviewer might ask how AGC and I can still support full and open competition while arguably advocating for limiting competition during this second-step of design-build procurement. I respectfully submit that by limiting the finalists in the final round of the two-step procurement, federal agencies will help ensure that they receive pre-proposal packages from any and all interested and qualified construction and design teams, including small businesses like mine. Such predictability allows businesses to consider the odds of participating in an expensive proposal process, as opposed to the one-step procurement process. As a result, this defined competition certainty with less risky odds for success encourages greater competition in the first-step of the two-step design-build process.

c. Congress Must Reform Design-Build Contracting Government-Wide to Encourage Small Business Participation

As with reverse auctions, Congress in 2014 passed a design-build reform provision as part of the Carl Levin and Howard P. 'Buck' McKeon National Defense Authorization Act for Fiscal Year 2015. The provision effectively limits the second-step of design build procurement to no more than

[6] U.S. ARMY CORPS OF ENGINEERS, LIMITATIONS ON THE USE OF ONE-STEP SELECTION PROCEDURES FOR DESIGN-BUILD, ENGINEERING AND CONSTRUCTION BULLETIN, AUG. 6, 2012 *available at:* http://www.wbdg.org/ccb/ARMYCOE/COECB/ARCHIVES/ecb_2012_23.pdf

5 teams on projects over $4 million. However, the head of the contracting activity, i.e., the head of the Army Corps or Naval Facilities Engineering Command, may approve a contracting officer's written justification to include more than 5 teams when it is in the government's interest.

While this provision is an excellent start, it only applies to the Department of Defense, and not to civilian construction agencies within the federal government. Congress should extend that provision to civilian construction agencies. In addition, Congress has not addressed the issue with regards to one-step design-build. Consequently, AGC strongly urges Congress to support passage of legislation that reasonably limits one-step design-build procurements to ensure robust competition, especially for small business.

III. Encourage Sensible Consideration of Past Performance Records in the Joint Venture and Teaming Context

AGC and its members find that federal agencies continue to bundle and consolidate construction contracts, including in the small business set-aside context, despite statutes and regulations meant to counter these practices. Many of these set aside projects are valued well above the $36.5 million small business general contractor threshold set by the U.S. Small Business Administration.[7] As a result, the only way a small general contractor business can bond and have the capacity to complete the work is to joint venture or team with a larger general contractor or another small business. However, federal agencies have set up procurement road blocks preventing or limiting joint ventures.

Specifically, federal agencies are not allowing small businesses and their joint venture/teaming partners to submit their individual companies' past relevant experience to prove their qualifications for the project. Rather, agencies demand that the small business and joint venture/teaming partner use past relevant experience that they have performed **together** or otherwise be disqualified from consideration. In most cases, these companies have not worked together in a joint venture/teaming context, but perhaps in a more traditional prime and subcontractor relationship. Even so, under the federal agencies requirements, many small businesses are being turned away from the competition.

a. Background on Past Performance and Relevancy

[7] For example, in 2013, the Naval Facilities Engineering Command set aside for small business a $70 million design-build project for the construction of a communication information systems operations complex at Camp Pendleton, California (Solicitation Number: N6247312R5015; https://www.fbo.gov/?s=opportunity&mode=form&id=3e089d706e24de811567b36e70599518&tab=core&_view=0). Small businesses in the San Diego area vehemently complained that they could not objectively perform the work alone as a general contractor. The Department of Veterans Affairs is currently seeking to set-aside for small business a $98 million design build project for the construction of a new bed tower at the VA Medical Center in Tampa, Florida (Solicitation Number: VA10115N0051; https://www.fbo.gov/index?s=opportunity&mode=form&id=52271f630cd090b5729d8e5abc2be503&tab=core&_view=0). Again, small businesses note that they cannot perform this work alone as a general contractor and must joint venture or team with a larger general contractor.

Federal agencies must record and submit contractor performance evaluations during and at the conclusion of a project. Agencies then use these evaluations when considering contractors for future projects during the procurement process. During construction procurement, federal agencies require general contractors interested in winning a contract award to submit evidence of relevant past experience. To be relevant, the past project must have been completed generally within the last 5 or 6 years and be similar in scope to the currently solicited project. The past experience portion usually relates back to the past performance evaluations on other federal projects.

b. Background on Teaming Agreements and Joint Venture Agreements

When two businesses pool their resources, they can often achieve goals that each company could not reach as individual entities. A joint venture agreement allows two companies to work together on a specific project as partners. A teaming agreement functions as a contractor/subcontractor relationship in which a larger company subcontracts out specific tasks to smaller companies.

Many small general contractor businesses are not capable of performing or bonding a significant percentage of the procurements set aside for small businesses by themselves. Similarly, many larger business concerns acting alone are ineligible to compete for small business set-asides because of their size. These realities make it desirable for small business contractors to team with other small businesses or with large businesses to enable the small business contractor to successfully compete for and perform small business set-aside contracts. The most common working arrangements are joint venture agreements and teaming agreements.

Joint ventures are generally considered to be independent legal entities separate and distinct from the entities that form them. Joint ventures have the ability to compete for and receive federal contract awards as prime contractors, to subcontract work to other contractors, and to receive work as subcontractors on federal contracts.

Teaming agreements are essentially contracts between a potential prime contractor and one or more potential subcontractors in which the prime contractor agrees to subcontract a designated portion of the contract work to its potential subcontractor should it receive the prime contract award. Teaming agreements are extremely flexible tools for prime contractors and subcontractors to form binding cooperative relationships to compete for federal contracts.

c. Hypothetical of What's Occurring Regarding this Issue

Jack Small Business Construction ("Jack") and Jill Small Business Construction ("Jill") have worked successfully for decades in the federal construction market. However, they have never joint ventured or teamed on any construction projects in the past. Both businesses' gross revenues are $10 million annually and fall within the small business dollar thresholds allowing them to compete for small business set-aside contracts.

A federal agency sets aside a $20 million construction project. Neither Jack nor Jill have the capacity to individually bond or perform that construction project. But, together, they could do so.

Jack and Jill form a joint venture for the purposes of bidding on and performing the work for federal agency's $20 million project. The federal agency requires that Jack and Jill submit examples of past experience on similar and relevant projects which they have performed together in the joint venture. Jack and Jill have never worked together in a joint venture. As a result, they offer the outstanding and relevant past performance records their companies have amassed individually.

The federal agency does not accept Jack and Jill's individual past performances records as relevant to their work as a joint venture. As a result, Jack and Jill cannot compete for the $20 million contract. These small businesses miss an opportunity to compete and perform as a joint venture because the federal agency will not even give them a chance to work as a joint venture.

d. Congress Must Legislate that Federal Agencies Sensibly Consider Past Performance Records in the Joint Venture and Teaming Contexts

The example above represents a problem that is increasingly occurring across federal construction agencies. AGC questions how small businesses, and even non-small businesses, can compete or work as joint ventures when the federal government is not willing to give them an opportunity. As such, AGC strongly supports a sensible legislative solution to ensure that federal agencies reasonably consider the individual past performance records of construction contractors seeking to joint venture or team, even if they have not ever done so.

IV. Prevent Unintended Consequences of Misinterpretation of the Nonmanufacturer Rule

Under the Nonmanufacturer Rule (NMR), small businesses contracting with the federal government for goods must ultimately receive such goods from a small business. The purpose of the NMR is to prevent pass-through situations under which small businesses act as a front for larger businesses in the federal procurement of goods through small business-set aside contracts. The NMR has not traditionally applied to federal contracts for services in the small business context.

Recently, the Court of Federal Claims (COFC) in *Rotech Healthcare, Inc., v. U.S.*, struck down Small Business Administration regulations that limit the NMR only to procurements that have been assigned a manufacturing North American Industry Classification System (NAICS) code, or to the supply component of a manufacturing or supply contract that also has a services component. Thus, the court found that the NMR applies to all contracts for goods. Consequently, services contracts through which the procurement of goods may be necessary could fall under the NMR. The result of such an interpretation when applied to the construction contracting industry would be far reaching and extreme. Under such an interpretation, small business construction contractors would have to purchase materials and supplies through small businesses.

Let's take an example of a small business contractor building a hospital wing for the U.S. Department of Veterans Affairs through a small business set-aside contract. Building a portion of a hospital is not a simple task. Contractors will often have to build facilities that require the installation of medical equipment, bedroom materials, and kitchen or cafeteria equipment. To treat our nation's veterans, the VA may require medical equipment that is not produced by a small business or not at the same standards. Should the contractor find replacement medical equipment that may be suitable, but all be less so, to satisfy the court's new interpretation of the NMR? Should our nation's veterans and their doctors have a smaller, and perhaps lower standard choice in the medical equipment—x-ray machines, scanners? Additionally, what if there is no steel, concrete or other small business building material suppliers located within 100 miles of the VA hospital location? Should the VA have to pay a premium to receive these materials from a remote small business to ship them to the site? Would not the money be better spent on caring for the medical needs of the nation's veterans?

The court's ruling would also place small business general contractors in another precarious position as a result of the False Claims Act. Under the court's interpretation of the NMR, when a small business general contractor purchases materials or supplies they would have to be from a small business at the time of purchase. The difficulty many AGC members encounter is either: (1) businesses intentionally misrepresent their small business status; or (2) businesses are unaware that they have graduated from the small business program but continue to represent themselves as small businesses. A general contractor does not have the ability to affirmatively determine whether or not the financial statements of its suppliers merit their certification as a small business at the time of purchase. All a general contractor can do is rely on the word of that small business supplier that it is such. However, in the event that small business supplier is not in fact a small business, the general contractor would be held liable by the federal government under the False Claims Act, as well as the court's interpretation of the NMR.

In short, AGC believes the Court of Federal Claims decision would place the entire small business construction industry and the federal owners it services in an incredibly difficult position to the detriment of all parties. AGC strongly supports this Committee's endeavor to draft reasonable legislation to address this new NMR rule interpretation, before it is too late.

V. Help Prevent Fraud in the Federal Surety Bond Market

a. Background on the Suretyship and the Miller Act in Federal Construction

Suretyship is a very specialized line of insurance that is created whenever one party guarantees performance of an obligation by another party. There are three parties to a surety agreement:

1. The principal (i.e., general contractor) is the party that undertakes the obligation.
2. The surety (i.e., an insurance company) guarantees the obligation will be performed.
3. The obligee (i.e., the federal agency) is the party who receives the benefit of the bond.

A surety bond is a written agreement that usually provides for monetary compensation in case the principal fails to perform the acts as promised. The Miller Act of 1935 (41 U.S.C. Section 3131

et. seq.) generally requires general contractors on federal public works projects to post two surety bonds as a condition of awarding the contract:

1. A performance bond guaranteeing performance of the work; and
2. A payment bond guaranteeing payment of subcontractors and suppliers.

While the burden is on the prime contractor on a federal project to provide Miller Act bonds, the bonds do not protect the general contractor. Rather, the bonds are for the benefit and protection of the United States government owner—i.e., a federal agency—and subcontractors and suppliers. For instance, if the general contractor defaults in the performance of its work or is terminated, the federal government may turn to the surety to step in and take over the general contractor's obligations under the prime contract. The Miller Act also benefits subcontractors and suppliers. Subcontractors and suppliers cannot assert a lien against federal property. The Miller Act protects eligible subcontractors and suppliers against nonpayment by providing them with an alternative means of recovery should the general contractor fail to make payment on federal projects. Under the Miller Act, qualifying subcontractors and suppliers may bring a civil action on the payment bond for any unpaid amounts.

Under current federal law and regulations, construction contractors for the federal government have three options for securing their surety obligations:

1. They can obtain a surety bond from an insurance company that is vetted and approved by the U.S. Department of Treasury and licensed by a state insurance regulator.
2. General contractors can pledge and deposit assets with the federal government until the contract is complete. Only assets backed by the federal government can be pledged.
3. Individuals, real flesh and blood people, can pledge their personal assets to back the contractor's obligations. Such individuals are called "individual sureties." Only individual sureties are permitted to pledge assets that are NOT backed by the federal government. In fact, individual sureties are allowed to pledge stocks, bonds, and real property, and also are not required to deposit such assets with the federal government for the duration of the contract. All that individual sureties need to give federal contracting officers is a document listing the assets and their value, representing that they are pledged in an escrow account to secure the contractor's obligations.

b. Individual Sureties can be the Bernie Madoffs of the Federal Construction Industry

Individual sureties are approved directly by federal agencies contracting officers on a project-by-project basis. Federal contracting officers are not immune from deception since they do not have the resources necessary to carefully vet individual sureties. Contracting officers are used to relying upon the Treasury Department to perform the legwork necessary to assess surety insurance qualifications. Neither the Treasury Department nor state insurance commissioners rate individual sureties. Federal contracting officers are simply on their own to verify the value and integrity of pledged assets that are hard to determine ownership and value as well as liquidate in the event of default. The reality, though, is that contracting officers are not equipped to act as appraisers, underwriters and risk mangers. The window for fraud is gaping; and there are hosts of examples of such fraud.

In *United States ex rel. JBlanco Enterprises Inc. v. ABBA Bonding, Inc.*,[8] an individual surety submitted bonds on a federal project in Colorado supported by an affidavit that the surety had a net worth of $126 million. No assets were placed in escrow, but the U.S. General Services Administration accepted the bonds. Shortly thereafter, the individual surety filed for bankruptcy and it was clear that most of the $126 million never existed.

In 2014, an AGC member acting as a subcontractor on a U.S. Army Corps of Engineers project at Ft. Hood fell victim to an individual surety's false assets. The individual surety at issue was IBCS Fidelity owned by Edmond C. Scarborough. Mr. Scarborough and his company are widely known throughout the construction industry. He—and other notorious individual sureties like him—run their businesses like Ponzi schemes. They back federally required surety bonds with hard-to-value and often difficult to liquidate assets, like real estate—homes or land—and personal property—like stamp collections. They collect revenue from bond fees and, more often than not, do not have to pay out on the bonds as the general risk of contractor default is low. However, when a default does occur and indemnification is sought on the bonds, these individuals often go bankrupt, leaving the federal government—on performance bonds—and subcontractors—on payment bonds—without means of payment.

In the case of Mr. Scarborough, the *Engineering News Record* (ENR) magazine published a series of stories on him. He backed his bonds with about 15 million tons of Kentucky and West Virginia usable coal waste.[9] He valued that coal waste at $190 million. However, his recent bankruptcy filings report those assets to be worth $120,000.[10] When the economy turned for the worse and Bernie Madoff's clients sought to cash in their assets, the reality that there was no value in those assets became apparent. Similarly, when contractors defaulted and the government and subcontractors needed payment from Mr. Scarborough, the assets pledged did not meet the obligations for which they were required. And, as with Bernie Madoff, the people that relied on Mr. Scarborough and their small businesses were left holding an empty bag. The AGC member subcontractor who relied on Mr. Scarborough's bonds for payment may get pennies on the dollar for the work it completed on the USACE project.

c. Congress Must Adopt Legislation Preventing Fraud in the Individual Surety Market

The problem of individual sureties using illusory assets to back their bonds to the "benefit" of U.S. Government and to subcontractors and suppliers is real. The solution is simple. Congress must require that individual sureties use real, liquid assets backed by the full faith and credit of the U.S. Treasury when posting their bonds. To fail to do otherwise will allow the Bernie Madoffs and Edmond Scarboroughs to continue to open shops in the federal construction market.

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[8] *See* No. 07-cv-01554-REB-CBS, 2009 WL 765875, at *1-2 (D. Colo. Mar. 20, 2009).

[9] Richard Korman, *A Bold Individual Surety Claims His Coal-Backed 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

[10] Richard Korman, *Controversial Individual Surety Files for Bankruptcy Protection*, ENGINEERING NEWS-RECORD, Aug. 5, 2014, *available at*: http://enr.construction.com/business_management/finance/2014/0805-outspoken-individual-surety-files-for-bankruptcy-protection.asp

In conclusion, I again thank the Committee for inviting AGC and me to testify before you on these critical industrial base issues the construction industry faces. The association and I look forward to working with you on achieving legislative progress on these issues.

Testimony of James Hoffman, P.E
President, Summer Consultants, Inc.

Before the House Committee on Small Business,
February 12, 2015

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A C E C

AMERICAN COUNCIL OF ENGINEERING COMPANIES

Introduction

Chairman Chabot, Ranking Member Velázquez, and members of the committee,

The American Council of Engineering Companies (ACEC) appreciates the opportunity to testify before you today about the issues surrounding *Contracting and the Industrial Base* and specifically about the unique considerations within engineering services and construction more broadly. ACEC believes that small businesses can flourish in the federal market, but there must be continued oversight by this and other committees to reduce barriers to market entry. There must be a focus on improving the marketplace for design and construction services by eliminating wasteful spending by both the federal government and contract participants during the procurement process. ACEC will address issues that are present in federal design-build procurement, the potential issues with the implementation of a new court decision in the Nonmanufacturer Rule, the use of reverse-auctions, federal agency use of joint venture and teaming qualifications and surety improvement.

My name is James Hoffman and I am President of Summer Consultants, a consulting mechanical, electrical, and plumbing engineering firm located in McLean, Virginia. Summer Consultants is a Small Business with 30 employees. We are committed to providing our clients sound engineering designs for various sized projects. Our practice focuses on the federal market and we have worked on many federal projects in the past 50 years.

My firm is an active member of ACEC - the voice of America's engineering industry. ACEC's over 5,000 member firms employ more than 380,000 engineers, architects, land surveyors, and other professionals, responsible for more than $500 billion of private and public works annually. Almost 85% of these firms are small businesses. Our industry has significant impact on the performance and costs of our nation's infrastructure and facilities.

We are at a critical juncture in our nation's history as the risk to the public is growing at an alarming rate, as there has been ongoing neglect of the nation's infrastructure. At the same time, we are coming out of the largest economic crisis that affected all professional engineering firms. The construction industry, which bore the brunt of the recession, is finally coming back to fiscal health. Procurement improvements that facilitate greater efficiency for both the industry and the government will help these entities create better public infrastructure while increasing good paying jobs.

Design-Build Improvement

Design-build is a method of construction where engineers team with other industry professionals on proposed work. It requires the design team, comprised of engineers and architects, to develop de-

tailed drawings and specifications for the contractor so that construction suppliers can submit detailed prices for the final proposal. This method has become popular in recent years and the federal government has moved to expand its use in construction.[1]

There are two forms of design-build procurement: two-step and one-step. Two-step design-build requires that teams submit relatively inexpensive qualifications packages to the contracting officer in the first round. The contracting officer reviews the qualifications and notifies the teams if they are selected for the next phase. In the second round, the design team develops expensive detailed and extensive plans for the contractor to use in their bidding. The design group develops these plans, generally without any reimbursement by the federal government or other participants, resulting in firms risking funds to participate in the project.[2]

It is the industry standard for three to five finalists to be in the second round. However, in recent years, industry has reported often more than 10 finalists in that round. The current civilian statute states that the federal contracting officer should follow the industry standard, but the officer, at her or his own discretion, may increase the number of finalists when it is "in the Federal Government's interest and is consistent with the purposes and objectives of the two-phase selection process."[3] This exception causes issues for both the industry and for the contracting officer. Industry is risking greater exposure as more firms; small, medium, and large, are spending valuable resources developing expensive plans and specifications that have a lower chance for a successful bid. The contracting officer must review each of the plans and be prepared to give feedback to each team that does not win the project. With the increase in finalists, the government spends more time on proposal review, and introduces greater opportunity for errors or underbidding which impacts the project later. This issue has driven many, including small businesses, to stay out of the federal market. This makes the market less competitive and drives down industry participation.

One-step design-build creates an even more precarious environment for the industry as the qualifications step is eliminated. ACEC is staunchly opposed to this form of procurement as it eliminates the qualifications process, increases cost for all participants, and reduces market participation for engineers. One-step design-build allows the owner to solicit complete proposals from the construction market without a review of the team's past performance and qualifications. This mechanism forces teams to compete in large pools without any focus on technical capability, quality, or savings within the design. Due to this type of unqualified competition, many firms cannot justify the expenditures to compete against an unknown pool of applicants. This selection forces out small firms as they cannot spend valuable marketing dollars on projects

[1] Press Release, H. Comm. on Small Bus, Graves, Hanna Introduce Bipartisan Legislation to Benefit Small Construction Contractors. (July 19, 2013) (on file with author).

[2] *Building America: Challenges for Small Construction Contractors: Hearing Before the Subcomm. on Contracting & Workforce of the H. Comm. on Small Bus 113th Cong. 113–109 (2013).* (statement of Helene Combs Dreiling, President, the American Institute of Architects).

[3] 41 U.S.C. 3309(d).

where there are too many competitors—many of which that may not have the qualifications for the project. It is an inefficient process for the federal government as it asks contracting officers to review multitudes of proposals without the framework of qualifications to focus the evaluation. The U.S. Corps of Engineers has taken steps recently to limit one-step design-build, requiring high level, advanced approval for any projects over $750,000.[4] When the government's largest construction agency implements limits on the process, other agencies should follow their precedent.

Chairman Hanna held a haring on this issue on May 23, 2013 and the House Oversight and Government Reform Subcommittee on Federal Workforce, US Postal Service and Census, also held a hearing on this issue on December 3, 2013. Former Small Business Committee Chairman Graves sponsored H.R. 2750, the Design-Build Jobs and Efficiency Act of 2013, which was amended into the National Defense Authorization Act (NDAA) of 2015. The NDAA implemented a limitation on military design-build procurements over $4 million whereby the contracting officer must ask for permission to expand the finalist pool in a two-phase procurement beyond five finalists. However, the limitations including the prohibition on one-step design-build, reporting on any exceptions to the five finalists, or any limitations for either single or two-step design build were not extended to the federal civilian market. The Congressional Budget Office (CBO) found that H.R. 2750 "would not have a significant net effect on the federal budget"[5] in their analysis of the bill. CBO determined that it would help to "analyze fewer construction bids"[6] which would balance any additional costs that may be involved in the bill. We ask the Committee to continue to pursue the proposed efficiencies found in H.R. 2750, which will help small businesses compete in the federal market, while also harmonizing the language between military and civilian design-build construction.

Proposed Nonmanufacturer Rule Changes

The updated interpretation of the Nonmanufacturer Rule (NMR) poses a challenge for the construction industry as it is a service industry that typically did not have to address this rule in the past. The NMR exists to ensure that when competition for a contract for goods is restricted to small businesses that the good ultimately purchased was from 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. In a recent Court of Federal Claims ruling on Rotech Healthcare, Inc. v. United States[7], the Court changed the common understanding of the rule. The Court found that the Small Business Act references "any procurement for goods" and

[4] James Dalton, PES, Limitations on the Use of One-Step Selection Procedures for Design-Build, Directive No. 2012–23 (2012) (on file with the author).
[5] MATTHEW PICKFORD, CONG. BUDGET OFFICE, H.R. 2750 DESIGN-BUILD EFFICIENCY AND JOBS ACT OF 2014 (2014), *available at* http://www.cbo.gov/sites/default/files/hr2750.pdf.
[6] Id.
[7] CASE NO. 14–502C (SEPTEMBER 19, 2014)

that the SBA must apply that interpretation broadly across both services and commodities [8].

ACEC has grave concerns with this interpretation. Currently, over 85 percent of all construction dollars are subcontracted to third parties.[9] The Court's interpretation would require that any firm who is a prime contractor be responsible for their subcontractors' use of small business products. The paperwork burden on this concept is staggering. An example of the unintended result of this rule could require that engineering firms use paper made by small businesses to print out their correspondence for a federal construction job. Many businesses do not know who made their paper nor do firm owners concern themselves with the small business aspect of its production. The interpretation could require that the ink and any other materials, like specialized seismic machinery, that are not exempted through the regulations, must be obtained through a small business. The result of this ruling cannot be implemented without great cost to the businesses who work on and the taxpayers who fund federal construction projects.

Second, in many instances, specific items may be manufactured in a foreign country. If an engineer specifies a part that has a foreign origin, or is made by a large manufacturer, it is most often because of necessary performance specifications that are essential to the project's long-term success. This ruling would have the engineer concerned with minutiae that is not relevant the responsibilities outlined above. This decision will result in the inefficient and wasteful use of taxpayer funds. ACEC asks the Committee to work with the SBA on language to make sure that construction services and products continue to be excluded from the NMR.

Reverse Actions

Reverse auctions are on-line sales where the bidders compete for work by lowering their price against other competitors in a specified time.[10] Typically, agencies pay a variable fee, "which is no more than 3 percent of the winning bid" [11] to the reverse action contractor. Reverse auctions force design professionals to bid on price, which is strictly prohibited by the Brooks Act and by many state professional licensing standards. It also fails to encourage any participant in the design and construction industry to focus on providing innovative and strategic solutions to the nation's infrastructure. It forces the competitors to focus solely on lowering their price. This often leads to errors or underbidding during the auction, without the ability to verify costs with subcontractors, who are often small businesses. The potential damage to a construction project and firms involved can be significant as project costs may increase beyond the bid or businesses could go out of business due to a mistake in the frenzy of bidding. Also of consideration is the fact that over "a third of the...2012 reverse auctions...had not inter-

[8] Id. at 6–8.
[9] 13 C.F.R. § 125.6.
[10] U.S. Gov't Accountability Office, GAO-14-108 Reverse Actions_Guidance Is Needed to Maximize Competition and Achieve Cost Savings 6 (2004).
[11] Id. at 19.

active bidding"[12] which means that no other vendor drove down the price. In short, the competition was sole-sourced out to a single bidder.

Reverse actions have been used by the federal government in the past with commodities, with a noted lack of success in construction. The U.S. Corps of Engineers conducted a year-long study whereby they found that reverse auctions "offered not even marginal edge in savings over the sealed bid process for construction service projects"[13]. The Corps found that sealed bids for construction, typically the domain of contractors, was a better method than reverse auctions.[14] Moreover, former OFPP Administrator Mr. Joseph Jordan, who is the current FedBid CEO stated, "An agency might want to use FedBid to find a contractor to paint a wall, he said, but not to construct an office building."[15] It is telling that both the Corps and the third-party vendor for reverse auctions do not advocate their use in construction.

H.R. 2751, the Commonsense Construction Contracting Act of 2013, introduced by Rep. Richard Hanna (R-NY), sought to restrict the use of so-called reverse auctions as a means of procuring construction and design-related services. Like H.R. 2750, it was incorporated into the NDAA, but the prohibition was limited to the use of reverse auctions in design-build procurements. At this time, there are no programs that can be found by the industry that used this procurement method. While federal procurement law already prohibits the use of reverse auctions for engineering activities, we view the full legislation as necessary to protect firms of all sizes in our industry when they provide services in support of construction efforts. ACEC asks the committee to reintroduce H.R. 2751, to build stronger prohibitions against the use of this commodities based program for construction services.

Joint Venture Rules

Joint ventures and teams are important to construction and small businesses in the federal market.[16] Teams are important to the design-build process as each discipline works together to compete on construction projects. Joint ventures allow for organizations new to federal procurement to work with experienced partners to gain entry to the market. It is important for teams to add or change firms to enhance their qualifications, to offer the best services for a particular project in the pre-competition phase. These practices allow the federal government to obtain innovative private sector talent while also increasing capable competition on federal projects.

Current law states that small businesses may "submit an offer that provides for the use of a particular team of subcontractors for

[12] Id. at 26.
[13] USACE, FINAL REPORT REGARDING THE USACE PILOT PROGRAM ON REVERSE AUCTIONING 34–37 (2004).
[14] ACEC advocates for qualifications based selection (QBS) in the selection of the architect and engineer, but that is not the subject of this hearing.
[15] Danielle Ivory, *'Reverse Actions' Draw Scrutiny,* N.Y. Times, April 6, 2014 at B1.
[16] Joint ventures and teams are used interchangeably in this submission. Joint ventures are contractual relationships between entities while teams are groups of professionals working together towards a single project. They are very similar in nature, but differ in the legal sense.

the performance of the contract"[17] and that requires the contract be evaluated, "in the same manner as other offers, with due consideration for the capabilities of all proposed subcontractors."[18] There are recent reports that some agencies are requiring joint ventures or teams to present joint past performance in their qualification. This practice demonstrates that some contracting officers do not understand the rationale and benefit of teaming. Some agencies require that "an [o]fferor must have proven experience and performance as an existing CTA (Contractor Team Arrangement) in the form of a Partnership or Joint Venture in accordance with the proposal submission requirements'[19], or that past performance may only be considered if it is that of "a parent company, affiliate, division, and/or subsidiary."[20] Under present statute, the contracting officer must look at the qualifications of the individual organizations comprising a team rather than the past performance of the group as a whole. Requiring that the team have common past performance reviews discourages the use of new teams, new partners, and the inclusion of new small businesses in the federal market.

ACEC strongly encourages the Committee to amend the Small Business Act to protect the development of joint ventures and teams. Federal agencies are losing their opportunity for innovation and small business participation when contracting rules are not followed by federal agencies.

Surety Improvements

A surety is a third party product that guarantees payment if one party defaults on the agreement. In federal construction, there are two key bonds—payment bonds and performance bonds. The Miller Act requires that the contractor must provide a surety for payment and performance bonds on contracts greater than $150,000. This provides performance protection to the federal government that the taxpayer will not be damaged if the contractor fails to complete a project, while also guaranteeing payment to subcontractors if the contractor defaults. H.R. 776, the Security in Bonding Act of 2013, was introduced by Chairman Hanna to address the issues of bonding availability for small businesses and problems with individual surety guarantees. The bill increases the guarantee rate for the Preferred Surety Bond Program, which will help more small business obtain a bond at a reasonable rate, and requires verifiable collateral for the issuance of surety bonds. While ACEC members typically do not obtain surety bonds, with the exception of some of our larger members who are also construction contractors, we recognize the importance of this product for the taxpayer and the subcontractors. ACEC asks the Committee to reintroduce H.R. 776 in this Congress.

Conclusions and Recommendations

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[17] Id.

[18] Id. at § 15(e)(4), 15 U.S.C. § 644(e)(4).

[19] GSA OASIS REQUEST FOR PROPOSAL (2013) *available at http://www.fbo.gov/?s=opportunity&mode=form&tab=core&id=df05de3d9c9cafle7943d278094eefbl&_cview=1.*

[20] HCaTS RFI APPENDIX 3 - DRAFT RFP SECTION L (2015) (on file with author).

The engineering services industry is unique in how firms are established, perform work, selected for the project, and work with each other. Most firms in the industry are small, specialized, and have a business plan to remain that way to assure performance and reputation. These factors result in the need for special considerations when trying to ensure appropriate small business participation in federal procurements.

We ask that the committee consider the following actions for the 114th Congress:

- Reintroduce H.R. 2750 and enact it into law.
- Work with the SBA on appropriate language to limit the scope of the NMR on service industries.
- Reintroduce H.R. 2751 and enact it into law.
- Strengthen the Joint Venture and teaming past performance rules.
- Reintroduce H.R. 776 and enact it into law.

ACEC and I thank the Committee for the privilege and opportunity to address engineering and construction industry issues with current federal procurement and I am pleased to answer any questions.

Statement on the record

Mechanical Contractors Association of America

to the

Committee on Small Business

U.S. House of Representatives

For the hearing on

"Contracting and the Industrial Base"

February 12, 2015

Mechanical Contractors Association
MCAA
of America

The Mechanical Contractors Association of America (MCAA) serves the unique needs of approximately 2,500 firms involved in heating, air conditioning, refrigeration, plumbing, piping, and mechanical service. We do this by providing our members with high-quality educational materials and programs to help them attain the highest level of managerial and technical expertise. MCAA includes the Mechanical Service Contractors of America, the Plumbing Contractors of America, the Manufacturer/Supplier Council, the Mechanical Contracting Education and Research Foundation and the National Certified Pipe Welding Bureau.

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February 12, 2015

The Honorable Steve Chabot, Chairman
House Small Business Committee
United States House of Representatives
Washington DC 20515

Subject: MCAA's Statement for the Record on the hearing, *Contracting and the Industrial Base*, House Small Business Committee, February 12, 2015

Dear Chairman Chabot and Members of the Committee:

Please accept this letter and accompanying attachments as the formal MCAA statement for the record for the hearing today referenced above.

The Mechanical Contractors Association of America (MCAA) represents over 2,500 specialty construction businesses nationwide that operate across the full spectrum of mechanical construction industry, serving public and private sector clients nationwide. MCAA members are engaged in heavy industrial, institutional, public facility, commercial and residential new construction, service and maintenance, and energy efficiency retrofit projects of all types. MCAA members perform mechanical systems construction, plumbing and hvac system installation, and mechanical and plumbing service and maintenance projects of all types.

MCAA member companies perform those types of projects variously as either prime contractors with public and private project owners, or as subcontractors to primes contractors on various projects. MCAA member firms provide mechanical new construction and hvac/refrigeration system services and energy efficiency retrofit projects with a great many Federal Defense and Civilian agency facilities across the country. Moreover, MCAA's membership is comprised primarily of small business firms, but a substantial number also have progressed from small business status to larger annual dollar volume operations, in many cases thanks to various Small Business Administration programs. In all, MCAA member firms understand the broad purpose of the Small Business Committee's mission with respect to Federal construction contracting from both the prime contractor and subcontractor perspectives, andrespectfully commends the committee for its work in recent years in enacting several constructive, good-government reforms in the Federal construction market.

The topics of this hearing emphasizing the importance of a sustainable and expanding small business contracting infrastructure to maintain the Nation's industrial base is consistent with that effort. MCAA notes that many of the issues on the docket for the February 12, 2015 hearing also are consistent with related goals to promote market equity for small business, while achieving direct Federal contracting procedural reforms that aid those goals and simultaneously Federal purchasing agency construction program effectiveness.

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MCAA fully supports further Committee action on all the topics on the hearing docket today as noted in the enumerated points below. In summary, MCAA's position is that Federal contracting procurement, prime and subcontractor selection, and contract administration reforms at all tiers that enhance the sustainability of small business competitiveness, also bolster the industrial base aims of the committee. Construction industry employers of all types, and especially those in the high-skill specialty contracting segment of the industry, train and provide the skilled worker base on the industry, which is among the largest and most technically adept workforce in the goods producing sector of the economy. Our sector of the industry leads the technical skill sector of the industry with employer and worker training in the latest building information modeling (BIM) design and production improvements, modular and off-site construction prefabrication facilities, along with other constant high technology developments, like high purity welding, automated welding and building automation control technology, and ever smaller facility energy efficiency technology improvements, such a small facility gas burning micro turbine combined heat and power systems. Our training programs themselves are models of high technology adaptation, with widespread use of distance learning tools, on-line technical courses, and use of on-line virtual training tools, where building facilities, tools and equipment are worked on virtually over the internet with technical interaction online.

1. ***The Security in Bonding Act of 2013*, H. R. 776** - MCAA joined with the great many other construction prime contractor and subcontractor groups in the 113th Congress in commending Representative Hanna for recognizing that the procedures under the Miller Act that permit individual surety bonds should be reformed to prevent loss to the Government and injury to subcontractors and suppliers in the event that a non-corporate surety bond is accepted and not backed by sufficient assets to meet the bond obligation. MCAA agrees with the broad industry consensus that the integrity of the surety bonds on a Federal project is key to taxpayer and agency protections and prevention of loss and competitive impairment for subcontractors and suppliers on those projects, who don't have the protections of mechanics' liens and must rely on the assets backing the bonds to prevent losses in the event of prime contractor defaults. This is a good-government reform that strengthens the Federal construction procurement process for all stakeholders, and in that way supports the sustainability of the small business infrastructure in building the skill base for the National industrial competitiveness resurgence in the goods producing economy.

   Mechanical contractors are specialty trade contractors which often participate on federal construction projects at the subcontractor level. As a subcontractor, the mechanical contractor must rely on the solvency of the prime contractor for payment. Should the prime contractor become insolvent, the mechanical contractor's only payment remedy is the payment bond required of the prime contractor under the federal Miller Act, as the mechanical contractor cannot place a mechanics lien against public property and cannot sue the government as it has no direct contract with the contracting agency. It is precisely these reasons that Congress enacted the Miller Act in 1935 to provide payment protections to downstream entities furnishing labor and materials on federal construction projects. Currently, the federal Miller Act requires performance and payment bonds from

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prime contractors awarded construction contracts exceeding $150,000, and payment securityfor contracts between $30,000 and $150,000.

Unfortunately, in recent decades--especially pronounced during the recent recession--these payment protections proved illusory in many instances where the payment bond was issued by an individual surety, rather than from a US Department of Treasury approved surety company, which undergoes a rigorous review and certification process to assess financial wherewithal and to gain approval to write bonds on federal contracts. Under the Federal Acquisition Regulation (FAR), individuals, natural persons, can act as a surety for a prime contractor seeking award of a federal construction contract without being licensed as an insurer in any state or territory of the US or reviewed by the US Department of the Treasury. Such persons merely have to pledge certain prescribed assets under the FAR, such as stocks or real property, and are not vetted with respect to criminal records, tax liens, or personal insolvency. Only the agency contracting officer, as part of his or her myriad duties, determines the acceptability of the individual surety and the pledged assets for each procurement. Not surprisingly, worthless bonds with non-existent assets have been accepted on numerous federal contracts, costing millions and millions of taxpayer dollars and jeopardizing the viability of many downstream businesses. This has been and continues to be a serious and vexing problem. I know that the Committee is aware of testimony by the National Association of Surety Bond Producers (NASBP) and the complementary position of The Surety and Fidelity Association of America in past Congresses that document such problems.

Mechanical contractors, like all subcontractors, rely on the efficacy of the payment bond for their payment remedy in case of nonpayment. Working on federal construction projects is made more attractive by virtue of the Miller Act requirement for payment bonds to be in place, and the federal government likely receives better pricing as a result of having payment bonds in place for subcontractors. However, under the current requirements allowing individual sureties to pledge a broad class of assets which are not placed in the direct care and custody of the federal government, worthless individual surety bonds will continue to be accepted. Such individual bonds subvert, if not, destroy the Miller Act payment remedies given to subcontractors, undermining our confidence that our payment bond remedy is real and available in the case of bonds issued by individual sureties.

One worthless payment bond can spell financial disaster for the many businesses acting as subcontractors on any given federal construction project. MCAA urges the Committee to act to close this loophole that permits chicanery, gamesmanship, and fraud at the expense of taxpayers and construction businesses. MCAA supports the reintroduction and support in this Congress of such measures as H.R. 3534 in the 112th Congress and H.R. 776 in the 113th Congress. Such measures enjoy the broad support of prime contractors and subcontractors alike. The legitimate use of individual surety will be bolstered and fraud and abuse by questionable providers will be substantially curtailed.

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2. ***Two-step design/build procurement methods*** - MCAA also commends the Committee for continuing to look into ways to address the growing use of design/build procurement, and to continually monitor the growing use of alternative contractor selection methods to make sure that small businesses and government agencies are both being well served by procurement procedures in the interests of the agency programs overall and small business and the taxpayers in general. MCAA supports the Committee's proposal to make sure that agencies adhere to the two-step design/build procedures, and short list no more than 5 design/build teams after the initial responses to the request for qualifications, unless there is a specific justification for short-listing more teams, as proposed in H.R. 2750 in the 113th Congress. The significant shift of direct Federal construction procurement from low-bid selection (generally now approximately only 10% of dollar volume) to negotiated selection procedures – design/build chief among those (now fully 90% of overall dollar volume – perhaps more for some agencies) should be a continual subject for examination for the committee's procurement jurisdiction. Also, MCAA would encourage the committee to look into whether and how the design build reform in Far Part 15 selection procedures should specifically apply to both low-price/technically-acceptable (LPTA) award methods and multiple award task order contracting (MATOC) as well. It may be that in some cases, agencies are turning back from full scale design-build procedures, to a streamlined LPTA procedure- in some cases to address agency acquisition/procurement workforce issues. MCAA would support reintroduction of H.R. 2750 to expand that consideration and in that way improve the sustainability of the small business industrial base.

3. ***Ban internet reverse auctions for construction prime contractor low-bid selection*** - MCAA commends the Committee for its persistence in attempting to enact the full U.S. Army Corps of Engineers' recommendation, after the USACE pilot study conducted in 2004, that agencies should be foreclosed altogether from using internet reverse auctions for direct Federal construction prime contractor low-bid selection decisions. The USACE pilot study was called for in the regular order of Congressional business more than several years ago. Its pilot study was comprehensive, and detailed. USACE's conclusion was unambiguous – internet reverse auctions for direct Federal prime contractor low-bid selection are not advantageous to the government. The virtually unanimous industry view at the time was that the USACE was 100% correct on the issue. There is nothing but potential problems in the use of low-bid internet bid shopping selection methods for prime contracts. That process forsakes all the business discipline of the sealed, low-bid process – and thereby transfers a large bundle of project risk and jeopardy that devolves right down to problems for the agency project, its mission, and the taxpayers.

   Nothing has changed since then to rebut the USACE's categorical opposition to the practice. Yet since then, still some few agencies attempt occasionally to use the process by categorizing some small scope construction projects as commodity procurement.

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Most recently, the joint Small Business/Veterans Affairs Committee hearing on construction projects last year on the occasion of a negative General Accountability Office (GAO-14-108, 2013) report on the inapt use of reverse auctions by the VA turned up several such efforts by the VA in recent years. Similarly, occasionally GSA has undertaken initiatives to define some types of construction projects (roofing projects, and building equipment replacements) as commodity contracts and apply commodity purchasing techniques to those projects.

MCAA fully support reintroduction of the Commonsense Construction Act (H.R. 2751 in the 113th Congress), as MCAA fully supports the USACE work product that duly noted after comprehensive study, there are no provable project cost advantages from reverse auctions (a form of open electronic bid shopping of the prime contractor's initial bid), exposing the agency to significant project drawbacks from an exposed bid shopping system that forfeits all the beneficial discipline of the sealed, low- bid system. Imprudent bidding is engendered by open bid shopping at the prime contract level, and the agency and prime contractors and subcontractors alike, small business and otherwise, are detrimentally exposed to predatory prime bidders that would buy the job too low in an internet reverse auction, and then make up for the lack of discipline in poor project performance, disputes, and claims.

Virtually all construction prime contract and subcontractor groups join in supporting the USACE and now the Committee's recurrent proposal to ban internet reverse auctions for construction low-bid prime contractor selection procedures. MCAA also would strongly suggest that H.R. 2751 be redrafted to also extend to FAR Part 15 price-only selection procedures in use under LPTA and MATOC awards as well, in addition to FAR Part 14 (not sealed), low-bid award procedures. Attached is MCAA's policy statement against low bid auction procedures, which is typical of many industry group statements. (Attachment 1).

4. ***Use of Small Business in Joint Venture and Team Projects*** - MCAA would support consideration of reforms the committee would propose to remove barriers to past performance and financial evaluation of small business joint venture and project team businesses that may be excluded from evaluation in favor of only prime contract past performance evaluations and financial resources evaluations under current procedures. To the extent necessary, such proposed reforms would open up opportunities for greater use of small business, serving the interest of maintaining the industrial base those firms supply. Likewise, this broader type of business review for all team members is in line with MCAA policy promoting greater screening of all primes and subcontractors in the contract award process. If all project team or joint venture firms are named and evaluated at the inception of award, then the full credit of past performance records and financial stability can be known and evaluated – strong performance recognized and encouraged, and past problem projects disclosed and evaluated too early enough to avoid predictable problems.

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5. ***The non-manufacturer rule*** - MCAA also supports the Committee's potential consideration of the misapplication of the non-manufacturer rule (NMR) by the courts, and the impediments that misapplication may present for small business utilization in the future. If the courts and agencies are to apply the non-manufacturer rule for goods purchasing to construction services contracts, the unintended consequences could be very great. Under the non-manufacturer rules, small business contract awards for commodities restrict pass though of goods manufactured by large businesses through the small business firm. That rule cannot readily be transferred to small business construction firms, as many of the equipment and systems provided for construction projects are not the product of small business manufacturing. In the mechanical industry for example, major heating, ventilating, air conditioning and refrigeration systems, and large energy efficiency systems such as combined heat and power micro turbines, are not made by domestic small businesses. Yet, the small business firms that purchase and install those systems do so as legitimate small business construction firms. MCAA commends the Committee for looking for ways to stem this misapplication of the non-manufacturer rule.

Respectfully submitted,

John McNerney, General Counsel MCAA

Attachments:
1. MCAA ***Statement on the Use of Internet Reverse Auctions for Construction Services***

MCAA Statement on the Use of Internet Reverse Auctions for Construction Services

MCAA considers the use of Internet reverse auctions for procurement of construction services to be *problematic for owners and contractors alike.*

While most applications of various e-commerce and Internet use (project websites, for example) have demonstrated or hold great promise for productivity and service improvements for owners and the industry at large, the same cannot be said for Internet reverse auctions. MCAA considers them to be little more than a form of *electronic bid shopping;* that is, disclosing the proprietary bid price of a competitor to all others for the purpose of obtaining even lower bids.

While reverse auctions may be judged appropriate by some owners for certain well defined projects on a case-by-case basis, an across-the-board policy dictating reverse auction, price-only selection for all projects would be just as short sighted as dictating a single type of project delivery system for projects of all types.

MCAA, along with the industry overall, long ago recognized the long-term detrimental impact of an across-the-board policy of low-bid, price-only selection criteria, and the bid shopping and chopping practices that are inherent in that system and undermine project success, such as: fragmented scopes of work and scope disputes, unnecessary changes and inordinate delays, and overhead waste relating to defensive contract administration, claims, disputes and lawsuits.

In fact, many of the innovations in construction procurement, contracting and project administration over the past 20 years have been in direct response to the inefficiencies that stem from low-bid, price-only selection criteria. Those innovations include value-based selection criteria, careful past performance evaluations, prequalification screening of competitors, project partnering, integrated project contracting and delivery systems, design-build services delivery, and other positive contract administration procedures, including dispute avoidance mechanisms and measures to reduce project dispute overhead costs. Overall, these developments have represented a better investment in overall project quality and life-cycle cost effectiveness.

Unfortunately, Internet reverse auctions can be seen as a way to adapt new technology to return to many of the problems of the past and give back the project efficiency gains that have resulted from innovative, value-added contracting procedures. Nevertheless, given recent experience with reverse auctions, MCAA members have encountered certain approaches that tend to ameliorate the more difficult aspects of the process as discussed below.

> Well-defined scope of work - Reverse auctions are least likely to lead to problem jobs in those cases where the owner has firm,

detailed design drawings and specifications. Recent studies strongly indicate that project planning up front is the best predictor of project success and problem avoidance.

> Use of best-value prequalification criteria - Best-value prequalification criteria should be rigorously applied. The criteria should include demonstrated superior past performance related to project performance overall, including cost and schedule delivery, project safety experience, workforce training and development investments, and project management and site supervision expertise relating to equipment purchasing and other aspects of contract administration.

> Transparency of auction procedures - The reverse auction procedures should provide maximum transparency in the interest of fairness for all competitors. The identity of all participants should be disclosed, as well as the dollar amount and ranking of all bids. Similarly, the owner should disclose the existence and amount of any reserved price above which the project would not be let. Just as laws pertaining to the auctions of goods are designed to protect fairness in the process and prevent fraud and abuse, the owner and Internet service provider for reverse auctions of construction contracts should make sure that all competitors are extended the same privileges under the auction rules.

> Provide adequate procedures for redress of errors - The auction procedures should provide careful safeguards against both imprudent and administrative mistakes in bidding, as overall project success is strongly compromised by mistakes in selection decisions. Even at this early stage, it is widely recognized that the reverse auction process often tempts hasty and imprudent bidding given the tight time frame and competitive context of the auction procedure. The industry recognizes that selection based on competitive frenzy as opposed to more discerning judgment is a high risk factor for project success. Bid decrements and the time intervals for bid adjustments should be appropriate for the scope and size of the project. Clerical mistakes also should be excused in the auction process in the manner of treatment of those mistakes in the sealed bidding context. Overall the owner should not design the process as though construction service auctions can be conducted in the same way as commodities procurement.

> Provide adequate safeguards against other abuses - The reverse auction procedures should also contain adequate safeguards against fraud and abuse, including express warranties against fictitous ("phantom bidders") bidders and other conditions that would constitute fraud in the inducement of the contract award. Moreover, any procedure for post-bid negotiated awards should be disclosed up front so competitors can fairly judge whether they can afford to compete. Similarly, if post-bid price increases are to be permitted, that too should be disclosed up front.

> Policy reservations - Notwithstanding adherence to the suggestions listed above, MCAA member experience suggests that reverse auctions remain a relatively new, untested and unproven method to actually lower construction costs without compromising project success.

MCAA contractor experience with Internet reverse auctions suggests that the last bid in a reverse auction is not always the lowest and best price that may have been submitted even under sealed bidding procedures. Owners should be aware that a comparison of the opening bid with the last bid is not a valid indicator of actual cost savings on the project. Moreover, while open competition is good policy generally, even with careful prequalification screening, the auction process prompts fast and furious competitive judgments more than prudent decision-making. Negative experiences could significantly shrink the pool of willing competitors, and deliver negative project outcomes.

In conclusion, early experience suggests that the risks of mistakes, misjudgments and the added costs of Internet services may well in many cases outweigh the *perceived costs savings* realized through the use of reverse auctions.

MCAA will continue to monitor experience with reverse auctions for a continuing factual assessment of their costs and benefits and effect on project outcomes.

Footnote - This statement does *not* address the many ways that public and private contracting practices vary with respect to contractor selection rules and procedures generally and reverse auctions in particular. In the main, Federal, state, and local open competition/sealed bidding rules prohibit reverse auctions for construction. The Federal procurement policy is to continue to use sealed bidding/competitive negotiations without price disclosure for construction services, even though one agency has Congressional authorization to test pilot reverse auctions. Another agency is attempting to categorize some construction/repair/alteration projects as "commercial items" to avoid construction procurement rules. At the state level, a growing number of states are amending procurement laws to permit reverse auctions for commodities, but are careful to rule out reverse auctions for construction services.

Approved by the MCAA Board of Directors, February 28, 2004

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U.S. House of Representatives Committee on Small Business

"U.S. GOVERNMENT CONTRACTING AND THE INDUSTRIAL BASE"

A Statement by:

Andrew Hunter

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Senior Fellow, International Security Program
Center for Strategic and International Studies (CSIS)

February 12, 2015

2360 Rayburn House Office Building

Chairman Chabot and Ranking member Velazquez, thank you for the opportunity to testify before you today about contracting and the industrial base. I am Andrew Hunter, Director of the Defense-Industrial Initiatives Group at the Center for Strategic and International Studies (CSIS). A major focus of my work at CSIS involves understanding the evolving partnership between the federal government and the industrial base. This partnership is critical to the successful execution of the more than $400 billion in federal contracting that occurs annually. As my title indicates, I have a particular focus on how this partnership is evolving between industry and the Department of Defense, however, CSIS performs in-depth analysis on data from the Federal Procurement Data System including contracting data from all federal agencies. While there are some important differences in trends for defense and non-defense contracting that I will highlight where appropriate, since defense contract obligations are roughly twice the total of non-defense contract obligations, overall trends in federal contracting tend to mirror those in defense contracting.

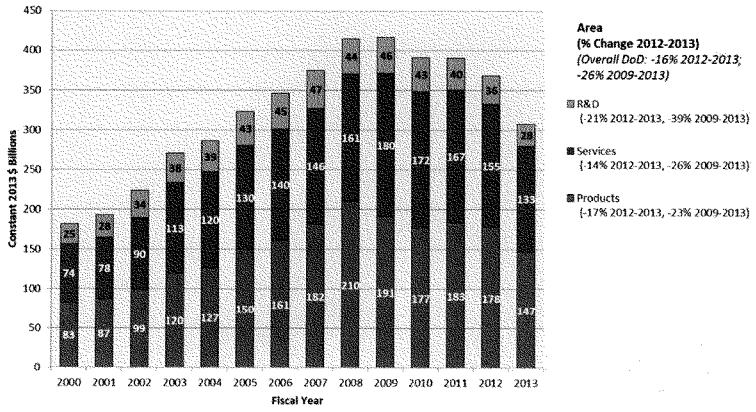
Contract obligations represent the overwhelming majority of the federal spending received by industry, and examining federal contracting data is essential to understanding many things currently happening in the industrial base. Today I intend to share with you some central insights arising from CSIS's analysis of contracting data to inform the committee's approach to the industrial base and particularly small businesses. To briefly summarize these insights, they are: 1) sequestration is currently the dominant force in federal contracting with repercussions that have been particularly severe for defense contracting; 2) federal contracting for R&D performed by industry is particularly challenged under sequestration potentially impacting the historical role that small business have played in technology innovation; 3) small business contracting is highly sensitive to changes in the overall federal contracting environment caused by sequestration and small businesses are likely to be significantly affected by a return to sequestration level spending levels in 2016; and 4) policies adopted by Congress are substantially reshaping the composition of small businesses participating in federal contracting. Separate from CSIS's data analysis, I would also like to emphasize my belief that the continuing, and in some cases increasing, complexity of the federal contracting process remains the most significant barrier to entry for firms of all sizes. It presents a particular obstacle for small businesses which are challenged to absorb the overhead required to successfully navigate this complexity. My testimony builds on the work of several of my colleagues at CSIS, especially Greg Sanders, Jesse Ellman, Rhys McCormick and Madison Riley, as well as my predecessor, David Berteau. Wherever possible, it has been updated to reflect data on 2014 contract obligations. CSIS does not take policy positions. All positions expressed to you as part of this testimony are my own.

The most apparent dynamic in federal contracting today is the effect of sequestration-level discretionary spending caps on contract obligations. It is worth noting that these caps have served to continue and accelerate a downward trend initiated by two other recent events: the sharp reduction in spending associated with the ending of the wars in Iraq and Afghanistan, which has primarily affected defense contract obligations, and the

completion of significant expenditures associated with the American Recovery and Reinvestment Act of 2009, better known as the stimulus bill, which has primarily affected non-defense contract obligations. As a result of these two factors that predate sequestration, defense contract obligations actually peaked in 2009 and have been declining since, while non-defense contract obligations peaked in 2010. In the case of DOD, sequestration significantly accelerated the pace of the decline in obligations in 2013. In the case of non-defense contract obligations, the first year of sequestration in 2013 continued the existing downward trend but contract obligations bounced back in 2014.

As illustrated in the figure below, defense contract obligations have declined 26% from their peak of $417 billion in the period from 2009 to 2013 in constant 2013 dollar terms. More than half of this decline, 16%, occurred in 2013 alone as result of the accelerated decline required by the mechanics of sequestration. Defense contract obligations for R&D purposes are considered separately from services in this analysis. R&D contract obligations have declined much more steeply, by 39% since 2009 and by 21% in 2013 alone.[1] CSIS is beginning to assess defense contract obligation data for 2014 which recently became available. Early analysis of this data show that the decline in defense contract obligations continued in 2014, falling by an additional nine%.

Figure 1: DoD Contract Obligations by Area, 2000-2013

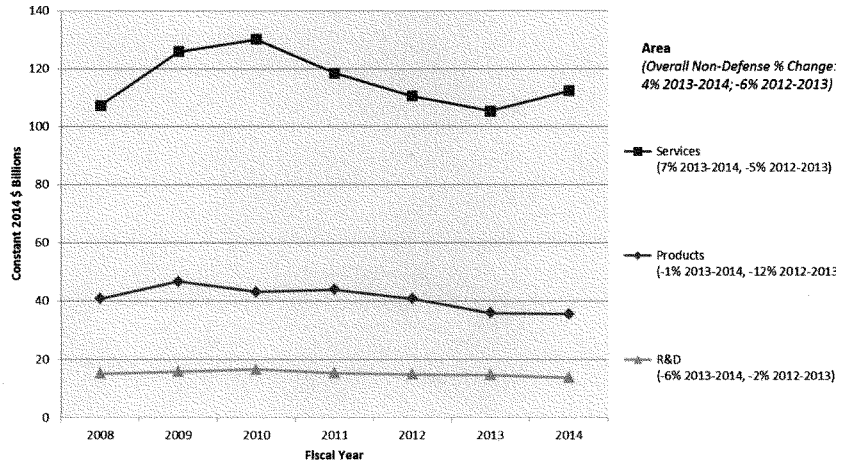


Source: FPDS and CSIS analysis.

[1] Figure 1 and the related analysis is derived from the CSIS Report "U.S. Department of Defense Contract Spending and the Industrial Base, 2000-2013" by David Berteau, Jesse Ellman, Gregory Sanders, and Rhys McCormick and can be found at http://csis.org/files/publication/140929_Ellman_DefenseContractSpending2013_Web.pdf. CSIS developed a measure of R&D contract obligations that reflects the vast majority of unclassified funding that actually makes it to industry for what is normally considered R&D purposes. For additional information about the CSIS contracting data analysis methodology, see https://csis.org/program/methodology.

Federal non-defense contract obligations have been trending steadily downwards since their peak of $190 billion in 2010, declining by six percent in each of the subsequent two years. Interestingly, overall federal non-defense contract obligations declined at that same rate, six percent, under sequestration in 2013, to $156 billion. The data show a small but broad-based rebound across the non-defense federal contracting agencies in FY2014, approaching FY2012 obligation levels in most cases. Most notably, while federal products contract obligations were nearly steady in 2014, and services contract obligations increased moderately, non-defense research and development (R&D) contract obligations declined three times as steeply in 2014 as they did in 2013. Coupled with the significant decline in defense R&D contract obligations in 2013, this data point lends credence to concerns that federal R&D contracting is being disproportionately impacted under sequestration.[2]

Figure 2: Non-Defense Contract Obligations by Area, 2008–2014



Source: FPDS; CSIS analysis

Non-defense services contracts, which had been declining steadily since their peak in 2010, declined by 5 percent under sequestration from 2012 to 2013, slightly less than the overall decline in non-defense contracts. Between 2013 and 2014, services contract obligations increased by seven percent, rising to $112 billion, exceeding the 2012 obligations level. Non-defense products contract obligations, which represent a much smaller share of overall contracting activity than in DoD, declined sharply under

[2] This analysis of non-defense contract obligations is taken directly from the work of Jesse Ellman in the CSIS Report "Sequestration Plus One: Early Indicators of the Federal Contracting Environment in the Era of Sequestration" which can be found at http://csis.org/publication/sequestration-plus-one-early-indicators-federal-contracting-environment-era-sequestratio.

sequestration (-12 percent), and failed to rebound in 2014 (-one percent). Non-defense R&D contract obligations, which declined by only two percent in 2013, fell by six percent in 2014. The overall picture for non-defense federal contracting agencies in 2014 shows a broad rebound for services contracts, a leveling off for products after a steep decline in 2013, and an acceleration of decline in R&D.

It is worth noting that the sharp reduction in contract obligations for R&D, occurring in both defense and non-defense contracting, presents specific concerns for the industrial base and for innovative small businesses. Federal investment in R&D has historically allowed small firms with limited financial resources to develop innovative technologies that larger firms may not be incentivized to pursue. The ongoing reductions in R&D put this important source of innovation at risk. The disproportionate reductions to defense R&D contract obligations are driven to a large extent by the mechanics of sequestration, which has largely excluded reductions in military pay and benefits and couldn't significantly address locked in costs in the defense budget such as civilian pay other than through furloughs. In addition, Congress' reluctance to fully support reductions in military compensation and force structure over the 2010-2013 period further constrained the areas where budgetary savings could be taken. These rigidities in several areas of the defense budget essentially transmitted the effects of the draw down and sequestration to areas such as R&D where they were more easily absorbed. The relatively uncertain nature of R&D means that R&D contracts are designed to be inherently flexible. Work can be relatively rapidly rescheduled to reflect the pace of technology development, or in the case of sequestration, to rapidly absorb unexpected budget reductions. Similar dynamics may be in play at non-defense agencies.

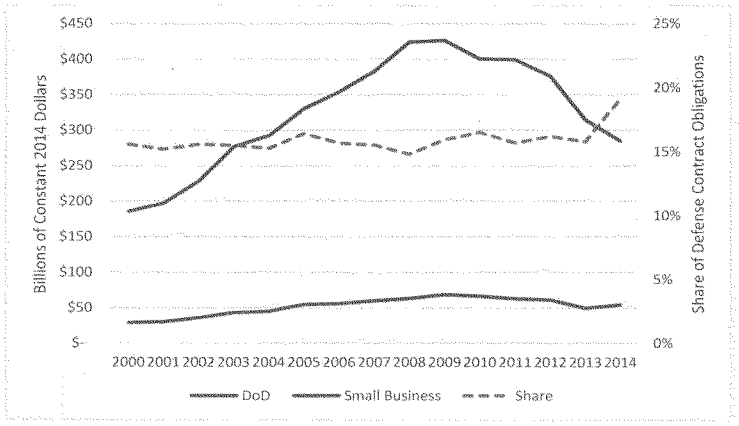
CSIS has done specific analysis on small business contracting with the Department of Defense to identify the effects of sequestration on small business, examine trends in competition, and explore areas of success and challenge for small business.[3] Given the demonstrated differences between defense and non-defense contracting trends, further analysis would be required to determine whether the trends in small business contracting with DoD also apply to non-defense contracting. However, given the volume of defense contracting, it is safe to conclude that these trends apply to the bulk of small business contracting.

In 2013, small business contracting with DoD declined 17%, roughly equivalent to the overall reduction of defense contract obligations of 16%. In 2014, however, after modest relief from sequestration provided by the Murray-Ryan budget agreement, small business contracting with DoD actually bounced back by 11% even as defense contract obligations overall declined by a further nine%. This surprising result, illustrated in Figure 3 below, explains how DoD was able to meet its small business contracting goals in 2014 for the first

[3] These issues will be examined in greater depth in a forthcoming CSIS paper building on work done by Madison Riley.

time in 8 years.[4] Given the highly stable share of contract obligations going to small businesses over the previous 13 years and based upon other data reviewed by CSIS that has indicated that sequestration in 2013 may have led to a shifting of contract obligations between 2013 and 2014, it is premature to conclude that the small business share of defense contract obligations is likely to continue at the level achieved in 2014. Rather, I believe that this data demonstrates that small business contracting has been highly reactive to changes in spending levels under sequestration and that a return to full sequestration spending levels in 2016 presents a significant risk of decline in small business contracting both in absolute terms and as a share of all contracts.

Figure 3: Small Business Contract Obligations as a Share of Defense Contract Obligations



Source: CSIS analysis of FPDS data

Parsing the small business contracting data further between products, services, and R&D, as illustrated in Figure 4, shows that services contracts for small business rebounded by $3.9 billion dollars in 2014, 14 percent above 2013. Products rebounded by $972 million or 5.9 percent, but remains substantially below peak levels. R&D contracts did not significantly rebound in 2014. It is notable that R&D contract obligations for small business exhibited much less fluctuation over time than services or products, but has dropped $1.35 billion dollars below the 2010 peak. Again, this raises concerns about the ability of small businesses to continue to play their historical role as a source of defense innovation.

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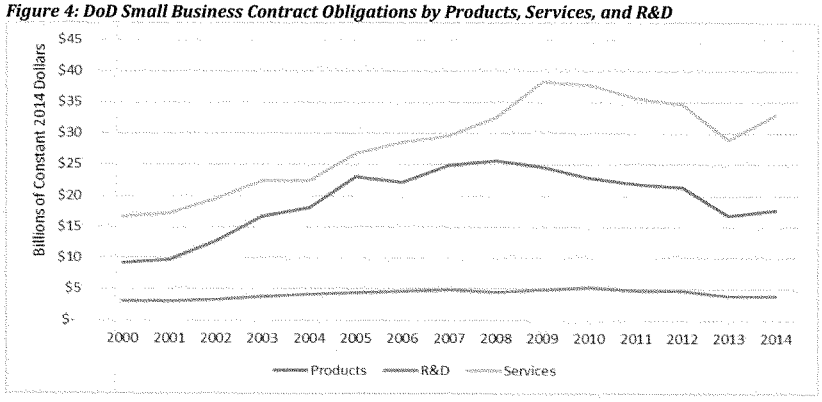
[4] Our analysis of small business contracting includes firms identified as small businesses in contract data and compares these firms' contract obligations with total contract obligations. This differs from the calculation of small business contracting for purposes of meeting Small Business Administration established contracting goals, which exclude certain contract obligations from the overall total. Also, in our analysis, we immediately remove companies from classification as a small business as soon as they are labeled as a subsidiary of a large business. We take no issue with the SBA's method for calculating compliance with its targets. The complexity of that calculation, however, is not necessary for CSIS to achieve its analytical objectives.

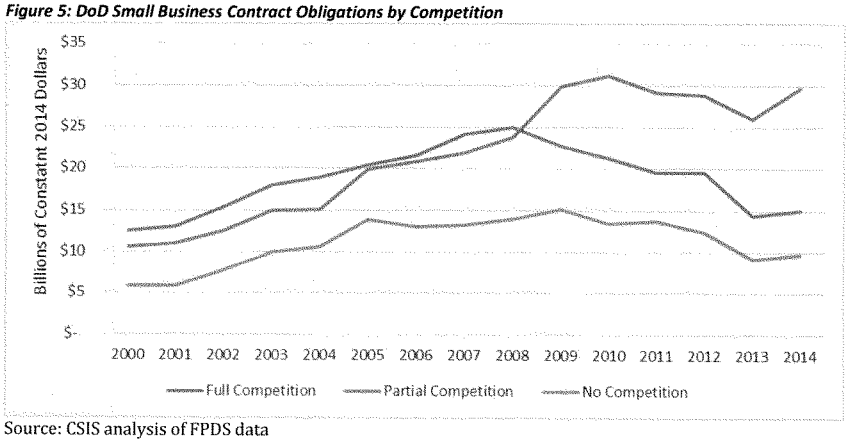
Figure 4: DoD Small Business Contract Obligations by Products, Services, and R&D



Source: CSIS analysis of FPDS data

The data on competition show that defense small business contracting is highly competitive, particularly by DoD standards, and that the share of small business contracts resulting from either full or partial competition has grown significantly over time, marked by particularly dramatic growth in partial competition.[5]

Figure 5: DoD Small Business Contract Obligations by Competition



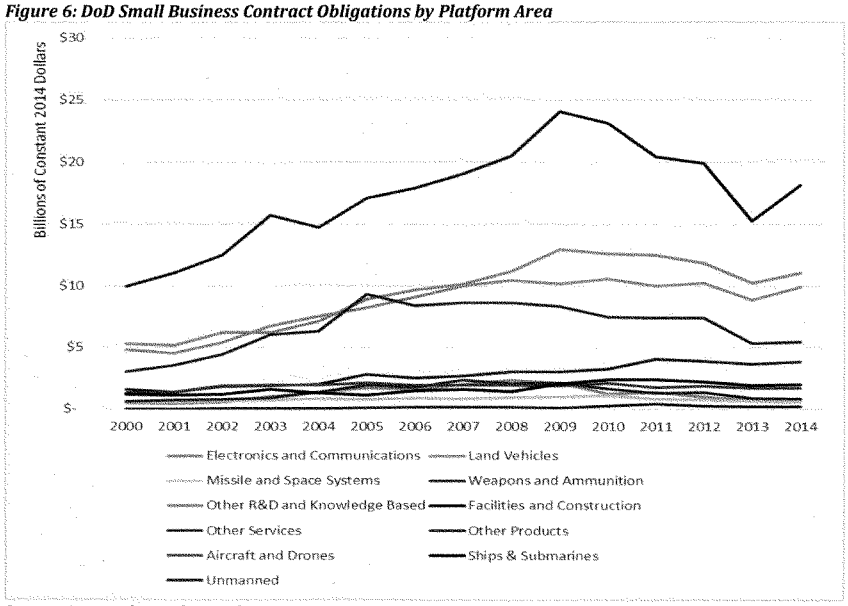
Source: CSIS analysis of FPDS data

Continuing past trends, the areas that had the greatest value of small business contract obligations were Facilities-Related Services and Construction (FRS&C),

[5] Partial competition represents competitive delivery orders, full and open competition with the exclusion of sources, and contracts competed under Simplified Acquisition Procedures. Full competition is defined as full and open competition only.

Professional Administrative and Management Support (PAMS), other R&D and Knowledge-Based Services, and Electronics & Communications (E&C). These areas are also among the ones that rebounded most strongly in 2014. By contrast, areas such as Missile and Space Systems, Weapons and Ammunition, Aircraft and Drones, and Unmanned have had little participation from small business and all continued to fall in 2014.[6]

Figure 6: DoD Small Business Contract Obligations by Platform Area

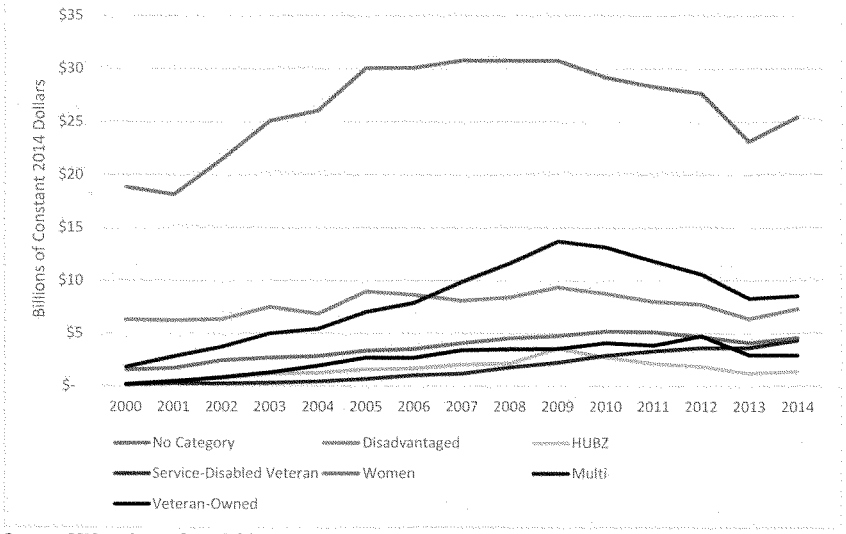


Source: CSIS analysis of FPDS data

An important shift has occurred in the composition of small businesses participating in federal contracting. CSIS analysis shows that the adoption of specific contracting goals for four targeted small business categories: small disadvantaged businesses, HUBZone businesses, women-owned businesses, and service-disabled veteran-owned businesses has had a significant impact. Since 2005 all of the growth in DoD small business contracting has happened within these targeted categories as shown in Figure 6 below. It does not currently appear that sequestration will alter this fundamental shift in small business contracting.

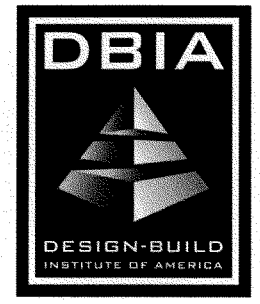
[6] As an aid to researchers seeking to reproduce or build on CSIS's work, our full Product Or Service Codes classifications are available through a GitHub repository (https://github.com/CSISdefense/Lookup-Tables).

Figure 6: DoD Small Business Contract Obligations by Category



Source: CSIS analysis of FPDS data

The challenges facing small business contracting under sequestration are substantial, but the 2014 contracting data show that small business can confront these challenges and compete and win if properly supported. I recommend that the committee continue to closely observe these issues, particularly the decline in R&D contract obligations which has not yet shown signs of abating. This worrisome trend is fundamentally incompatible with achieving national objectives. I also urge the committee to review the significant complexity in the federal contracting process confronted by small businesses as well as other firms and do what you can to combat it. I look forward to addressing your questions.



THE DESIGN-BUILD INSTITUTE OF AMERICA

U.S. House of Representatives
Committee on Small Business

Hearing on
Contracting and the Industrial Base

February 12, 2015
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INTRODUCTION

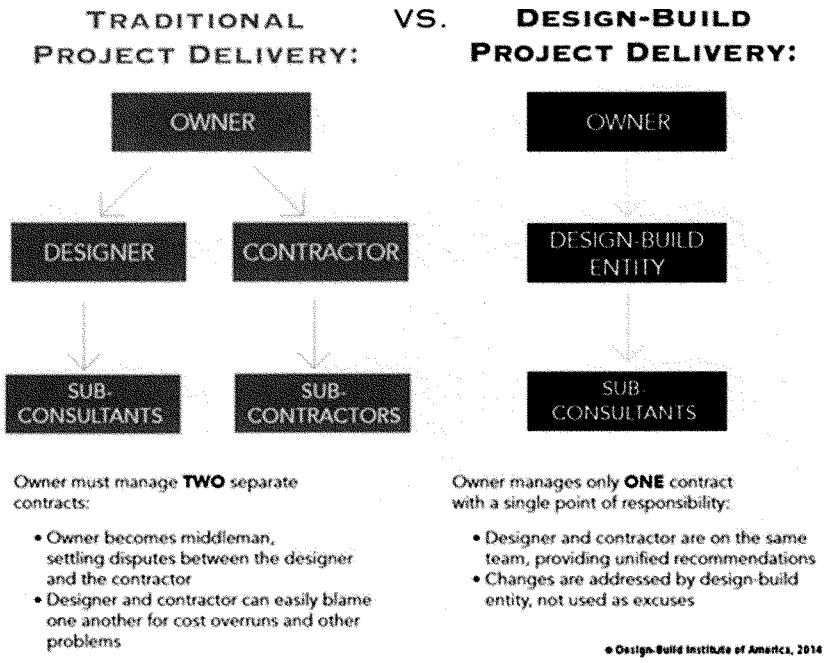
Chairman Chabot, Ranking Member Velázquez and members of the committee, thank you for holding this hearing examining contracting and the industrial base. Further, thank you for the opportunity for the Design-Build Institute of America (DBIA) to submit the following testimony.

DBIA is an institute representing leaders in the design and construction industry utilizing design-build and integrated project delivery methods to achieve cost and time savings on high performance projects. DBIA promotes the value of design-build project delivery and teaches the effective integration of design and construction services to ensure success for owners and design and construction practitioners in the delivery of projects from all sectors in communities across the country. Since we are design-build professionals focused on defining and teaching best practices, we will limit our comments today to the "failure to properly use a two-step procurement process for design-build contracts", as indicated in the February 5, 2015 hearing announcement.

WHAT IS DESIGN-BUILD?

Design-Build is a method of project delivery in which one entity - the design-build team - works under a single contract with the project owner to provide design and construction services. With design-build there is one entity with a single point of responsibility, one contract, one unified flow of work from initial concept through completion - thereby integrating the roles of designer and constructor.

Design-build is a more efficient and better quality alternative to the traditional design-bid-build project delivery method. Under the traditional approach, design and construction services are split into separate entities, separate contracts, and separate work.



Design-build project delivery provides benefits for both owners and practitioners. Owners experience faster delivery, cost savings and better quality than with other contracting methods. **Research**

shows costs can be six percent lower with project delivery speed increased by as much as one-third [1].

Further, dealing with a single entity decreases owners' administrative burden and allows them to focus on the project, rather than managing separate contracts. The approach also reduces their risk and results in fewer litigation claims for all parties involved.

Practitioners reap the benefits of a higher profit margin since an integrated team is fully and equally committed to controlling costs. Like owners, the design-builder benefits from a decreased administrative burden because the communication between designers and builders is streamlined.

The advantages of design-build have become clear in recent years which is why today nearly **40% of all non-residential construction in the U.S. is done design-build,** with the **military using it for more 80% of its construction [2].**

SINGLE-STEP VS. TWO-STEP DESIGN-BUILD

Federal regulation allows for the use of design-build project delivery, including both a single-step process and a two-step process. In the single-step process, a request for proposals (RFP) is issued for a project. It is issued to an unlimited number of participants and any and all parties can respond with a proposal. A selection process is then used to determine the proposal that is best from both a cost and technical perspective.

In a two-step process a request for *qualifications* (RFQ) is first issued, and any and all participants then respond with a statement of qualifications. The RFQ response is a relatively simple and inexpensive procedure where the design-build teams submits, for example, documents detailing their past performance, staff resumes, and examples of similar projects they've completed. Based on these statements a short list of three to five of most qualified respondents is determined. The RFP is then issued only to these "shortlisted" firms which then develop full proposals including cost, schedule, and technical response.

Small Business Are Far Better Served By the Two-Step Process

In a single-step process, all design-build teams are asked to spend time and resources creating detailed proposals immediately, as opposed to simply submitting their qualifications. Due to the high costs of this first step - often reaching hundreds of thousands of dollars or even millions - many design-build teams decide not to apply since their chances of final selection are so low. Small businesses in particular do not have the luxury to spend limited resources to apply for a project when the chance of being chosen may be less than ten percent.

If small businesses were only required to initially provide their qualifications under the two-step process, as opposed to a full pro-

[1] Construction Industry Institute (CII)/Penn State 1999
[2] Design-build Project Delivery Market Share and Market Size Report, RS Means, May 2014

posal under the single-step process, many more would be able to participate. This is not only good for American small businesses, it also benefits the federal government and the American taxpayer who can be sure the most qualified design-build teams were not scared away from a project simply due to the costs and risks of applying.

Consider and Pass the Design-Build Efficiency and Jobs Act

During the 113th Congress, legislation endorsed by DBIA, the Design-Build Efficiency and Jobs Act (H.R. 2750) was introduced by Congressman Graves and a version passed the House of Representatives. This bill was written to limit the use of single-step design-build procedures, and assure the proper use of two-step procedures as originally mandated by Congress. That legislation should be reintroduced, considered and passed into law.

H.R. 2750 would have done two primary things:

1. To limit the use of single-step, H.R. 2750 would have limited its use to projects that are less than $750,000. This threshold is based on U.S. Army Corps of Engineers guidance which was issued in August 2012. Further, it will assure that for larger more complex projects risks for all firms are held in check, thus allowing small firms a greater chance to compete in the marketplace.

2. H.R. 2750 also would have encouraged better use of the preferred two-step procedures and by requiring agencies to better justify and report when their agencies short-list more than five finalists on a specific project in the two-step process.

CONCLUSION

Thank you again for the opportunity to submit this statement. We look forward to working with this committee on improving design-build procedures so the advantages of design-build delivery can be more fully realized and American small business can thrive.

We are ready to answer any questions you may have.

Statement of:

THE NATIONAL ASSOCATION OF SURETY BOND PRODUCERS (NASBP)
&
THE SURETY & FIDELITY ASSOCIATION OF AMERICA (SFAA)

To the U.S. House of Representatives
Committee on Small Business
RE: Hearing on
"CONTRACTING AND THE INDUSTRIAL BASE"

February 12, 2015

The National Association of Surety Bond Producers (NASBP) is a national trade association of firms employing licensed surety bond producers who place bid, performance, and payment bonds throughout the United States and its territories.

The Surety & Fidelity Association of America (SFAA) is a District of Columbia non-profit corporation whose members are engaged in the business of suretyship. SFAA member companies collectively write the majority of surety and fidelity bonds in the United States. The SFAA is licensed as a rating or advisory organization in all states, as well as in the District Columbia and Puerto Rico, and it has been designated by state insurance departments as a statistical agent for the reporting of fidelity and surety data.

Our written statement begins with a brief description of the important role surety bonds play in the federal procurement arena. Our statement then addresses our support of three bills introduced in the 112th and 113th Congresses, H.R. 3534 and H.R. 776, and H.R. 838. H.R. 838 was introduced in the 114th Congress on February 10, 2015, by Representative Richard Hanna, and cosponsored by the Chairman of the House Small Business Committee, Steve Chabot and Representative Grace Meng. These bills concern the use of individual surety bonds on federal construction projects and reforms to the Small Business Administration's (SBA) Surety Bond Guarantee Program, and are representative of needed legislation on small business matters that NASBP and SFAA wish to bring to the attention of the Committee on Small Business for support.

The Importance of Surety Bonds: Sound Public Policy

Corporate surety bonds are three-party contract agreements by which one party (a surety company) guarantees or promises a second party (the obligee/federal government) the successful performance of an obligation by a third party (the principal/contractor). In deciding to grant surety credit, the surety underwriter conducts in-depth analysis, also known as prequalification, of the capital, capacity, and character of the construction firm during the underwriting process to determine the contractor's ability to fulfill contractual commitments. Surety bonds are an essential means to discern qualified construction companies and to guarantee contracts and payments, ensuring that vital public projects are completed, subcontracting entities are paid, and jobs are preserved.

The federal government has relied on surety bonds for prequalification of construction contractors and for performance and payment assurance since the late nineteenth century. In 1894, the U.S. Congress passed the Heard Act which codified the requirement for surety on U.S. government contracts and institutionalized the business of surety. In 1935, the Heard Act was superseded by the Miller Act, which required the continuation of these vital assurances so that U.S. taxpayer funds were protected and subcontractors and suppliers would receive payment for their labor and materials. Currently, the federal Miller Act requires performance and payment bonds from prime contractors awarded construction contracts exceeding $150,000.00, and payment security for contracts between $30,000.00 and $150,000.00.

Types of Surety Bonds

The bid bond assures that the bed has been submitted in good faith and the contractor will enter into the contract at the bid price and provide the required performance and payment bonds. A performance bond protects the project owner from financial loss should the contractor fail to perform the contract in accordance with its terms and conditions. The payment bond protects subcontractors and suppliers, which do not have direct contractural agreements with the public owner and which would be unable to recover lost wages or expenses should the contractor be unable to pay its financial obligations. Often, small construction businesses must access the federal procurement marketplace at subcontractor and supplier levels, and the payment bond is their primary recourse and protection in the event of prime contractor nonpayment or insolvency.

The Construction Industry Supports of H.R. 3534 (112th Congress) H.R. 776 (113th Congress) and H.R. 838 (114th Congress)

NASBP and SFAA along with many other organizations such as: the American Council of Engineering Companies (ACEC), the Associated General Contractors of America (AGC), the American Institute of Architects (AIA), the American Subcontractors Association (ASA), the Mechanical Contractors Association of America (MCAA), the Sheet Metal and Air Conditioning Contractors' National Association (SMACNA), the Construction Financial Management Association (CFMA), and the American Insurance Association (AIA), view H.R. 3534, H.R. 776, and H.R. 838 as critical means (1) to protect taxpayers, federal contracting entities, and construction businesses by assuring the integrity of surety bonds on federal contracts when issued by unlicensed individuals using a pledge of assets and (2) to provide additional opportunities for small and emerging construction contractors, which otherwise do not qualify for surety credit in the standard market, to utilize the Surety Bond Guarantee Program of the US Small Business Administration, so that such businesses will receive surety credit from regulated markets.

Enact legislation to protect taxpayers, and small businesses

Every contractor that bids and obtains a federal construction contract must secure its obligations under that contract. The most common form of security is a surety bond from a certified and approved surety insurance company. As noted earlier, the Federal Miller Act requires contractors to furnish surety bonds on federal construction projects to ensure that prospective contractors are qualified to undertake federal construction contracts and that bonded contracts will be completed in the event of a contractor default, thereby protecting precious U.S. taxpayer dollars and subcontractors and suppliers, many of which are small businesses. The financial strength and stability of the surety is the key to the success of the surety bonding system.

Presently, there are three methods construction firms may use to furnish security on a federal construction project:

1. By securing a bond written by a corporate surety, that is vetted, approved, and audited by the U.S. Department of Treasury and listed in its Circular 570;

2. By using their own assets to post an "eligible obligation," i.e. a U.S.-backed security, in lieu of a surety bond. The security is pledged directly and deposited with the federal government until the contractor is complete; or

3. By securing a bond from an unlicensed individual, if the bond is secured by an "acceptable asset," which includes stocks, bonds, and real property owned in fee simple.

It is this third alternative that has proven consistently problematic to the financial detriment of contracting authorities and of subcontractors and suppliers performing on federal projects. NASBP, SFAA, along with the other organizations supporting these bills, believe, based on substantial evidence and past testimony, that the current regulations pertaining to use of individual sureties on federal construction projects are fundamentally flawed, allowing gamesmanship by unlicensed persons acting as sureties. Such existing requirements need to be superseded by the statutory approach delineated in H.R. 3534/776/838.

Federal Acquisition Regulation (FAR) 28.203–2(b)(3) permits federal contracting officers to accept bonds from natural persons, not companies, if the bond is secured by an "acceptable asset," which includes stocks, bonds, and real property. These individuals neither are subject to the same scrutiny and vetting given to corporate sureties nor are they required to provide physical custody of the asset to the government that they pledge to secure their bonds to the contracting authority.

This lack of thorough scrutiny of individual sureties and control over their pledged assets has resulted in a number of documented situations where assets pledged by individual sureties have proven to be illusory or insufficient, causing significant financial harm to the federal government, to taxpayers, and to subcontractors and suppliers, many of whom are small businesses wholly reliant on the protections of payment bonds to safeguard their businesses.

Federal requirements do mandate a level of documentation and information from individual sureties. Individual sureties are required to complete, sign, and have notarized an affidavit of individual surety (SF 28), which is a standardized form for the purpose of eliciting a description of the assets pledged and the contracts on which they are pledged. SF 28, however, does not elicit other pertinent information, such as that about the character or fitness of the individual acting as surety, like criminal convictions, state insurance commissioner cease and desist orders, outstanding tax liens, or personal bankruptcies.

Under FAR requirements, the pledged assets also are supposed to be placed in an escrow arrangement by the individual surety, subject to the approval of the contracting officer. The individual surety, however, is not required to turn the assets over to the phys-

ical care and custody of the contracting authority. Each contracting officer, not the Department of Treasury, shoulders the entire burden of determining the acceptability of the individual surety, its documentation, the escrow or security arrangement, and the value and adequacy of pledged assets, and must do so in relatively short order to progress the contract procurement. A missed, incorrect, or forsaken step may mean the acceptance of a fraudulent or insufficient bond, rendering its apparent and much needed protection worthless.

This burden of assessing individual sureties is added to the already considerable responsibilities of contracting officers. They are required to determine the authenticity of the documentation of the assets pledged to support the individual surety's bond obligations and to verify that the pledged assets actually exist, are sufficient, and are available to the federal government. They have to know that a particular financial document is what it purports to be and to understand and to assess the different types of collateral, such as stocks and real estate located anywhere in the United States.

It is not clear if and how often federal contracting officers receive specific training to understand and to perform the needed tasks of examination concerning individual sureties. Documents of federal agencies suggest that there are occasions when federal contracting officers may not have a complete understanding of what is required of them to safeguard taxpayers and small businesses from individual surety fraud. The Financial Management Service of the U.S. Department of Treasury issued a "Special Informational Notice to All Bond-Approving (Contracting) Officers" [1] on February 3, 2006, still posted at http://www.fiscal.treasury.gov/fsreports/ref/suretyBnd/special_notice.pdf. This informational notice was directed to federal contracting officers to remind them of the applicable FAR requirements governing individual sureties. Specifically, the notice, a copy of which is attached to this testimony, states in part:

> *"Although FMS is not substantively responsible for approving individual sureties, we believe it prudent to issue this Special Informational Notice on a FYI basis to Agency Bond-Approving (Contracting) Officers who do have that responsibility under the FAR.*
>
> *Recently, FMS has been made aware of instances where individual sureties are listing corporate debenture notes and other questionable assets on their 'Affidavit of Individual Surety', Standard Form 28. In some instances, the individual sureties used a form other than the Standard Form 28 as their affidavit."*

Likewise, the U.S. Department of the Interior issued a notice to its contracting officers in 2009 to remind them of FAR requirements associated with acceptance of individual surety bonds. This notice, titled "Department of the Interior Acquisition Policy Release (DIAPR) 2009–15," states that the Department of the Interior Of-

[1] United States Treasury Department. Financial Management Service. "Special Informational Notice to All Bond-Approving (Contracting) Officers". February 3, 2006.

fice of Inspector General conducted an investigation of contracting personnel practices concerning individual sureties and found concerns.[2] Specifically, the release, a copy of which is attached to this testimony, states in part:

> *"The investigation identified several areas of concern that require our attention. There is concern that Contracting Officers (COs) are: (1) unfamiliar with the FAR requirements for individual surety; (2) accepting individual surety bonds without knowing or verifying the assets backing the bonds; (3) not vetting questions about individual surety bonds through the DOI Office of the Solicitor; and (4) not verifying individual sureties against the General Services Administration's Excluded Parties List System."*

If a contracting officer fails to perform adequately the necessary investigation of an individual surety, and the individual surety pledges assets that do not exist, are insufficient, or are not readily convertible into cash to pay the obligations of the defaulted general contractor, everyone on the project from the contracting agency on down is left unprotected and at risk for financial loss. If the assets pledged to support the bonds are uncollectible, unpaid subcontractors and suppliers protected by the bond, many of which typically are small businesses, will suffer financial hardship and could, in turn, default and become insolvent.

Examples of Improper Individual Surety Activity

There is no one place to go to find statistical data on individual surety problems because individual sureties typically operate outside of state insurance regulatory structures, despite the fact that they are required under almost all state insurance codes to obtain certificates of authority to act as a surety insurer from state insurance commissioners. Moreover, the federal government does not require individual sureties writing bonds on federal contracts to furnish proof of licensure or authority to operate in a state jurisdiction as a surety insurer. Consequently, little or no regulatory oversight may ever be exercised over persons acting as individual sureties on federal projects apart from the modicum of scrutiny undertaken, if at all, by the federal contracting officer.

Nonetheless, in recent years, illustrations of individual surety problems abound. These situations usually involve individual surety bond assets that turned out to be inadequate, illusory, or unacceptable. One illustration is *United States ex rel. JBlanco Enterprises Inc. v. ABBA Bonding, Inc,* where, in spite of a March 11, 2005 cease and desist order from the Alabama Insurance Department, Mr. Morris Sears, doing business as ABBA Bonding, was able to submit bonds on a federal contract in Colorado supported by an affidavit (Standard Form 28) stating that ABBA Bonding had assets with a net worth of over $126 million. Although no assets were placed in escrow for the benefit of the government, the U.S. General Services Administration accepted the bonds anyway.

[2] United States. Department of the Interior. "Department of the Interior Acquisition Policy Release (DIAPR) 2009–15". September 8, 2009.

JBlanco Enterprises, a small business 8a subcontractor performing work on federal contracts, nearly was forced to declare bankruptcy as a result of a deficient individual surety bond placed by Mr. Sears on a federal project that later proved to have no assets to support the bond. Ms. Jeanette Wellers, a principal of JBlanco Enterprises, provided oral and written testimony [3] about this situation during a hearing on H.R. 3534.

Sears eventually sought bankruptcy protection against numerous creditors (100+) arising from defaulted bond obligations, including protection against bond debts owed to three federal contracting agencies. Chief Bankruptcy Judge Margaret A. Mahoney, U.S. Bankruptcy Court, Southern District of Alabama held that Sears had "knowingly made misrepresentations regarding collateral he pledged in support of surety bonds." [4] Judge Mahoney also found that Sears falsely stated that the real estate had not been pledged to any other bond contract within three years prior to the execution of any Affidavit and that Sears made misrepresentations to numerous agencies. Thus, the Bankruptcy Court determined that the Sears' debts to the government were nondischargeable. His false statements then formed the basis of a criminal indictment against Sears, who died while undergoing criminal prosecution in the U.S. District Court for the South District of Alabama.

In another example, Edmund Scarborough, the owner of IBCS Fidelity, another individual surety, filed for bankruptcy in Tampa, Florida. IBCS issued countless individual surety bonds on federal, state, and private construction projects using suspect assets. In his bankruptcy petition, Scarborough listed $4.5 million in assets and $16.2 million in liabilities; IBCS had used a speculative commodity, mined coal waste, which it valued at $191 million, to back its individual surety bonds. That mined coal waste was valued at $120,000 in the bankruptcy filing.[5]

The above individuals operated nationally and across state boundaries, victimizing public and private entities, small construction businesses, and businesses of all sizes. These examples, unfortunately, are not isolated instances. Other examples exist, both past and present, showing where individual surety bond assets proved illusory, uncollectible, or deficient. More businesses, many of whom are likely to be small businesses, will be victimized unless Congress acts to correct these flawed requirements, which permit unscrupulous individuals, many with criminal, personal insolvency, and tax lien histories, to issue worthless surety bonds on taxpayer-funded federal construction contracts.

Common-Sense Legislative Solution

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[3] Wellers, Jeanette. Written Testimony before U.S. House Committee on the Judiciary Subcommittee on Courts, Commercial and Administrative Law. March 5, 2012.

[4] United States. Department of Justice. US Attorney's Office. Southern District of Alabama. "Pennsacola Man Indicted in Government Contract Survey Bond Fraud Scheme". June 28, 2012.

[5] Richard Korman, *Controversial Individual Surety Files for Bankruptcy Protection,* ENGINEERING NEWS-RECORD, August 5, 2014 *available at:* http://enr.construction.com/business_management/finance/2014/0805-Outspoken-Individual-Surety-Files-for-Bankruptcy-Protection.asp?

Legislation like H.R. 3534, H.R. 776, and H.R. 838 are simple, common-sense legislative solutions that will eliminate opportunities for fraud by mandating that real assets be placed in the care and custody of the contracting authority. These bills require individual sureties to pledge solely those assets defined as eligible obligations by the Secretary of the Treasury. An eligible obligation is a public debt obligation of the U.S. Government and an obligation whose principal and interest is unconditionally guaranteed by the U.S. Government, such as U.S. Treasury bills, notes, and bonds, certain HUD government guaranteed notes and certificates, and certain Ginnie Mae securities, among other federally guaranteed securities. These safe and stable assets then are provided to the federal contracting authority, which will deposit them in a federal depository designated by the Secretary of the Treasury, ensuring that pledged assets are real, sufficient, convertible, and in the physical custody and control of the federal government. This is nothing more than what now is statutorily required of contractors who wish to pledge collateral as security on a federal contract in lieu of a surety bond.

If enacted, it would eliminate the gamesmanship and opportunities for fraud endemic in the current regulatory system governing individual surety bonds and pledged assets and will remove a considerable administrative burden from federal contracting officers. Federal contracting officers no longer will need to assess a range of pledged assets, as all pledged assets will be limited to assets unconditionally guaranteed by the federal government; they simply will need to gain custody over the asset to deposit the asset in a federal depository, such as the Federal Reserve Bank, St. Louis. The asset will be released upon successful performance of the bonded obligation, with any accrued interest inuring to the benefit of the individual surety pledging the government-backed asset.

Construction businesses working on a construction project—either as subcontractors, suppliers, or workers on the job—have no control over the prime contractor's choice of security provided to the federal government, but they suffer the most harm financially if the provided security proves illusory. The impact is particularly acute on small construction businesses, which may not have the strength to weather a significant disruption to their cash flow. Passage of legislation like such as H.R. 838 will mean that contracting agencies and the numerous subcontractors and suppliers on federal construction projects, in the event of a performance or payment default will know that adequate and reliable security is in place to guarantee that they will be paid for their valid claims.

Increase the Guarantee to 90% for Surety Companies in SBA Program

Background

The U.S. Small Business Administration's (SBA) Surety Bond Guarantee Program (Program) was created to ensure that small and emerging contractors who do not qualify for surety credit in the standard market have the opportunity to bid on public construction work, grow their businesses and remain a viable part of

the U.S. economy. Small businesses must have access to these bonds to obtain federal construction contracts after a certain dollar threshold, and the Program assists them in obtaining these bonds.

As the Program has evolved, there are two plans under which sureties can participate in the Program. The Prior Approval Program (Plan A) was the original SBA bond guarantee program. In this Program, the surety must obtain SBA approval for each bond prior to writing the SBA guaranteed bond. The SBA maximum indemnification of the surety's loss as a result of a bond claim in Plan A is 80%, and 90% for bonds written for socially and economically disadvantaged contractors and bonds written for contracts under $100,000. The second program is the Preferred Surety Bond Program (Plan B). Under this plan, sureties apply to participate, submitting information up front on their underwriting practices and financial strength. Once a surety becomes a participant in Plan B, it is given an aggregate limit of bonds that it can write within the Program. As long as the surety complies with all of the requirements of Plan B, all bonds written within the Program qualify for reimbursement of losses. The SBA does not review or approve each individual bond before it is written and the guarantee attaches. In Plan B the surety receives a maximum 70% indemnification.

Enhancements to Program

Over the years, the Program has gone through several enhancements to increase participation and remove burdensome regulatory requirements. For example, a provision in the 2013 National Defense Authorization Act (NDAA) increased the guarantee limit from $2 million to $6.5 million to align the Program with the simplified acquisition threshold and with the needs of other SBA small business contracting programs, such as the 8a Minority Small Business and Capital Ownership Development Program. Additional reforms will provide greater enhancement opportunities for small businesses and to ensure participation from sureties.

Legislative Recommendation

NASBP and SFAA recommend amending Section 411(c)(1) of the Small Business Investment Act of 1958 (15 U.S.C. 694b(c)(1)) by increasing the guarantees afforded to surety companies that participate in the Program from 70% to 90%. This revision will likely stimulate greater corporate surety and surety bond producer participation, providing access to the corporate surety markets to small businesses which otherwise do not qualify for surety credit in the standard market. These small businesses are often the ones that may turn to unlicensed individual sureties, where they can be duped by unscrupulous persons seeking vulnerable businesses and offering surety credit to anyone, regardless of the firm's qualifications, financial wherewithal, or experience, and at rates many times higher than the filed rates charged by corporate surety markets.

No Added Cost to the Government or Risk to Taxpayers

According to the 2014 House Small Business Committee Report (REPT. 113–462, Part 2, pgs. 5–6) the Congressional Budget Office (CBO) "estimates that implementing this change would not have a significant effect on discretionary spending because we expect the agency would raise fees to cover any additional costs arising from the higher guarantee percentage. Enacting such legislation would not affect direct spending or revenues; therefore, pay-as-you-go procedures would not apply."

According to the SBA Office of Surety Guarantees, increased liability to the government does not seem to be a significant issue. Under the 2009 American Recovery and Reinvestment Act (ARRA), the SBA issued 218 final surety bonds for a contract value of $663 million, which resulted in only two defaults. The National Defense Authorization Act for Fiscal Year 2013 increased the eligible contract amount to $6.5 million, and up to $10 million with a Federal contracting officer's certification that the guarantee is necessary for the small business to obtain bonding. Since the increase in contract size amount, SBA has guaranteed over 170 total bonds with a contract value of over $500 million, which have resulted in no defaults.

Conclusion

NASBP and SFAA appreciate the opportunity to provide the Committee with information about the compelling need to enact legislation such as H.R. 838: (1) to protect taxpayer funds and construction businesses performing as subcontractors and suppliers on federal construction contracts and (2) to provide small businesses with greater access to regulated surety markets through the SBA Surety Bond Guarantees Program. NASBP and SFAA hope this statement proves beneficial and welcomes any inquiries from the Committee on the points raised in this written testimony or on other matters pertinent to small businesses and surety bonding.

○