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Subcommittee on Contracting and Workforce,  
Committee on Small Business  
Before the Committee on Armed Services  
Statement for the Record  
April 14, 2015

Good morning, Chairman Thornberry, Ranking Member Smith, and Members of the Committee. I appreciate the opportunity to testify before you on the National Defense Authorization Act for Fiscal Year 2016 (FY16 NDAA). Let me begin by thanking the Committee for its longstanding collaboration with the Small Business Committee, including work on surety bonds and reverse auctions. I am here today to ask that we complete the work we started last Congress on these two issues. As a former construction contractor, I am very familiar with the challenges facing small contractors. Let me start by giving you an overview of the role of small construction contractors in the federal marketplace, then address surety bonding, then reverse auction issues that apply specifically to construction contractors, and finally I will discuss other abuses of reverse auctions that I have during my three years as Chairman of Subcommittee on Contracting and Workforce of the Committee on Small Business.

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

Construction and architectural and engineering (A&E) contracts account for about eight percent of federal prime contract dollars, these segments account for over 17 percent of the awards to small businesses.<sup>1</sup> Therefore, issues affecting construction and A&E contracts have a disproportionate effect on small business opportunities.<sup>2</sup> Of the contracts awarded by the federal government annually, approximately eight percent is spent on federal construction and A&E projects.<sup>3</sup> However, within the dollars awarded to small businesses, the percentage is over twice as high, exceeding 17 percent for federal construction and A&E work.<sup>4</sup> In FY 2012, the majority of those dollars were expended by the Department of Defense (DoD),<sup>5</sup> with nearly 60 percent of DoD's

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

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

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

<sup>4</sup> FPDS.

<sup>5</sup> *Id.*

spend coming through USACE.<sup>6</sup> Among civilian agencies, the General Services Administration (GSA) and the Department of Veterans Affairs (VA) were responsible for a major share of the work.<sup>7</sup> In each case, small businesses were well represented, with over 40 percent of total construction spend, and over 23 percent of A&E work. The federal sector is a significant and growing portion of the construction market, accounting for 40 percent of the value of ongoing overall private and public sector construction activity in 2010, compared to about 20 percent in the prior decade, with a special focus on industrial/heavy construction.<sup>8</sup> Unfortunately, the number of small businesses registered to compete for federal contractors is only 17,782 concerns,<sup>9</sup> out of 273,072 small businesses registered to compete for federal contracts.<sup>10</sup> To further highlight this contrast, in FY2014, there were 753,590 private construction companies in the United States.<sup>11</sup>

**Table 2. FY 2012 Federal Contracts for Construction and A&E<sup>12</sup>**

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

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

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

<sup>7</sup> Prime Award Spending Data, List View, USASpending.gov, available at <http://www.usaspending.gov>.

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

<sup>9</sup> Data retrieved from the Dynamic Small Business Search (DSBS) site available at [www.dsbs.sba.gov](http://www.dsbs.sba.gov) (last accessed January 28, 2015).

<sup>10</sup> Data retrieved from the System for Award Management available at [www.sam.gov](http://www.sam.gov) (last accessed January 28, 2015). This number is down by over 100,000 small businesses from 2012, when DSBS reported a 382,092 active small businesses.

<sup>11</sup> Bureau of Labor Statistics, Construction NAICS 23, available at <http://www.bls.gov/iag/tgs/iag23.htm>. This does not include A&E contractors, nor does it distinguish between the size of companies.

<sup>12</sup> FPDS ad hoc report, available at <https://www.fpds.gov> (last accessed May 9, 2013). Copy on file with the Committee.

## **II. Surety Bonds**

Surety bonds protect the government and small businesses alike by providing a third party guarantee that the prime contractor will complete construction, commonly call a performance bond, and that the prime contractor will pay its suppliers and subcontractors, commonly called a payment bond. Under federal law, to bid on most federal construction and A&E projects above \$150,000, the prime contractor must provide the contracting officer with a surety bond, and both the performance and payment bonds become binding upon contract award.<sup>13</sup> Thus, when bonds are issued by a surety, the surety vouches for the creditworthiness and capacity of the contractor, protects the government against uncompleted projects and liens, and protects subcontractors against unscrupulous or over extended prime contractors. However, bonding itself creates problems if qualified small businesses cannot obtain the necessary bonding, or if the guarantor of the bond is not willing or able to meet its obligations, and then will discuss proposed legislation seeking to address these issues.

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

The first challenge posed by bonding is that if a small construction company cannot provide the necessary level of bonding, a contracting officer will not accept their proposal no matter how technically well qualified the firm. The Small Business Investment Act (SBIA) sought to provide an avenue for small business bonding by creating two surety bond guarantee programs within the Small Business Administration (SBA).<sup>14</sup> Pursuant to the SBIA, SBA can use one of two programs to guarantee bonds for contracts up to \$6.5 million: the Prior Approval Program (PAP)<sup>15</sup> or the Preferred Surety Bond Program (PSBP).<sup>16</sup> Pursuant to the PAP, SBA provides sureties with up to a 90 percent guarantee, meaning that if the small business fails to fulfill its obligations and the bond is called upon to pay subcontractors or the agency, SBA will reimburse the surety up to 90 percent of its cost. To obtain the guarantee, sureties must seek prior approval from SBA before issuing the bonds, and such approval is typically granted in three days. In contrast, the PSBP only

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<sup>13</sup> 40 USC § 3131(b).

<sup>14</sup> 15 U.S.C. § 692 *et seq.*

<sup>15</sup> 15 U.S.C. § 694b(a).

<sup>16</sup> 15 U.S.C. § 694b(a)(3). The caps were increased from \$2 million to \$6.5 million pursuant to the National Defense Authorization Act of 2013, PUB. L. NO. 112-239 (2013). These provisions also made it possible for SBA to provide proportional coverage if notice requirements were not met.

pays a 70 percent bond guarantee, but sureties are preauthorized to issue bonds and audited every three years, and are not required to seek approval before issuing individual bonds.

To fund both programs, SBA charges the small business receiving the bond 0.729 percent of the contract price for the bond guarantee, and the surety company 26 percent of the fee the surety charges the small business. As of May 2013, there are approximately 7,494 active bonds with an actual bond liability of \$2.9 billion.<sup>17</sup> Each program is operating at a zero subsidy from taxpayers.<sup>18</sup> Despite the different guarantee amounts and the differing levels of review, both the PAP and PSBP have similar levels of default. However, over the years, the PSBP program has become less effective for small businesses since only four sureties currently participate in the program because the guarantee rates are no longer competitive enough to encourage commercial sureties to participate.<sup>19</sup>

The second issue regarding bonding occurs when the surety cannot back its bonds, thereby exacerbating the very risks the bond is intended to mitigate. This problem is usually tied to a lack of assets associated with the surety. There are two types of surety-provided guarantees: corporate and individual. Corporate sureties are incorporated entities (often subsidiaries of insurance companies) that are certified to write surety bonds in one or more states in the United States, licensed and regulated by the state(s) where the surety does business, and approved by the Department of the Treasury, each of which ensure that sufficient assets exist to back the bonds.<sup>20</sup> However, this is not always the case with individual sureties. Individual sureties are not: 1) incorporated and usually are a single individual or a group of individuals who own or control a large amount of cash or other liquid assets; 2) licensed or regulated by state agencies; and 3) listed on the Department of the Treasury's list of approved corporate sureties. The assets serve as collateral to the project owners guaranteeing the project's completion. However, pursuant to the Federal Acquisition Regulation (FAR), an individual with surety needs only to pledge assets to the government, it does not need to allow the government to hold the assets.<sup>21</sup> In addition, an individual surety may pledge more volatile assets such as stocks and bonds traded on an exchange or rights in real property.<sup>22</sup> Thus, while the FAR does permit contracting officers (COs) to accept

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<sup>17</sup> E-mail from Frank Lalumiere, Director, SBA Surety Bond Program to Committee staff (May 13, 2013). (on file with the Committee).

<sup>18</sup> *Id.*

<sup>19</sup> *Id.*

<sup>20</sup> Surety and Fidelity Association, "About Industry" available at <http://www.surety.org/?AboutIndustry>. According to the Surety & Fidelity Association of America, corporate sureties generate \$3.5 billion or more in written premiums annually from surety bonds. Because of their greater access to capital, corporate sureties dominate the industry, and have issued the majority of bid bonds, performance bonds, payment bonds, etc. Corporate sureties provide most of the bonding for federal construction projects and the Department of the Treasury maintains a formal list of federally approved corporate sureties. The Department of the Treasury's Financial Management Service (FMS) administers the surety bond program for the federal government pursuant to 31 U.S.C. §§ 9304-9308. FMS's Listing of Approved Sureties (Department Circular 570), available at [http://www.fms.treas.gov/c570/c570\\_a-z.html](http://www.fms.treas.gov/c570/c570_a-z.html).

<sup>21</sup> 48 C.F.R. § 28.203.

<sup>22</sup> See, e.g. Richard Korman, *A Bold Individual Surety Claims His Coal-Back Bonds are Rock Solid*, ENGINEERING NEWS RECORD, Feb. 27, 2013, available at

individual sureties, the decision as to whether or not the bid bond is acceptable is left to the CO's discretion; and not all government COs are familiar with individual sureties and their acceptable assets.<sup>23</sup> If the CO does not adequately scrutinize the individual surety, and the individual surety pledges nonexistent or insufficient assets, or the assets are not readily convertible into cash to pay the obligations of the defaulted contractor, the federal government's construction project is at risk for failure and financial loss as are any small businesses that acted in reliance upon the bonds. In 2012, a hearing before the Subcommittee on Courts, Commercial and Administrative Law of the House Committee on the Judiciary provided detailed testimony on the risk these types of bonds pose to the government and small businesses.<sup>24</sup>

Last Congress, I introduced H.R. 776, the Security in Bonding Act of 2013, which was included in the House version of the FY 15 NDAA. This Congress, I have reintroduced the legislation as H.R. 838, the Security in Bonding Act of 2015. This legislation addresses both the issue of bonding availability and the problem on unscrupulous individual sureties. First, the legislation increases the guarantee rate on the PSBP to 90 percent, which should attract new sureties to the program. While agency briefings indicate that the program could cover this additional guarantee out of existing authorizations – the current program actually makes money – it is important to note that should the current funding not prove sufficient, SBA has the ability to increase the fees on the bonds to prevent cover additional costs. Both the Congressional Budget Office and the Office of Management and Budget agree that there will be no cost associated with this legislation.

Second, H.R. 776 confronts the problem of underfunded individual sureties by requiring that any asset pledged to back the bonds be reviewed by government officials and then deposited so that the government will have control of the assets should the company fail to meet its obligations. This would prevent sureties from pledging assets of dubious or speculative value, or from pledging the same assets numerous times. This provision also passed the House in 2012, as part of the FY13 NDAA. These issues are even more important in the time of shrinking budgets – we must ensure that the money spent on construction contracting is backed by a reliable bond.

### **III. The Use of Reverse Auctions for Construction and Construction Services**

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

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[http://enr.construction.com/business\\_management/ethics\\_corruption/2013/0225-a-bold-individual-surety-claims-his-coal-backed-bonds-are-rock-solid.asp](http://enr.construction.com/business_management/ethics_corruption/2013/0225-a-bold-individual-surety-claims-his-coal-backed-bonds-are-rock-solid.asp).

<sup>23</sup> Under FAR § 28.203(c), if the contracting officer "determines that no individual surety in support of a bid guarantee is acceptable, the offeror utilizing the individual surety shall be rejected as nonresponsible."

<sup>24</sup> *Security in Bonding Act of 2011: Hearing Before the Subcomm. on Courts, Commercial and Administrative Law of the House Comm. on the Judiciary*, 112th Cong. (2012).

summarize the criticism of this methodology as it applies to construction, and finally discuss proposed legislative solutions.

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

Under this reverse auction methodology, there is an ‘auction’ process whereby [contractors] offer multiple and consecutively lower bids on a rapid ‘auctioning’ basis to eventually arrive at the lowest bid-price of goods or services for the privilege of a standard contract award. In the case of government reverse auctions . . . [t]he government publicly solicits for specific goods and/or services from responsible and responsive contractors to provide these specific goods or services. The reverse auction process simply is the method by which contractors submit their bids and the lowest bid is received. The award is then executed through a standard firm fixed price contract.

Yet, there is a major difference in the operational dynamics of the reverse auction methodology that is unlike anything available in the standard sealed bid process. In the standard sealed bid process, the contractor only gets only one chance to submit a bid. Additionally, the contractor does not know the relative ranking of his bid versus others during the bid process. Hence, in a standard sealed bid process, a contractor cannot bidgame, because he is forced to submit his best bid with only one chance to bid.<sup>25</sup>

Therefore, a reverse auction is a multi-round low-bid process where the lowest bids are disclosed. A typical reverse auction will be conducted for commodities – products that are standardized and where price is the principle differentiator.<sup>26</sup>

The use of reverse auctions for construction services has been denounced by most of the construction-related trade associations.<sup>27</sup> They allege that reverse auctions do not guarantee the

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<sup>25</sup> USACE, FINAL REPORT REGARDING THE USACE PILOT PROGRAM ON REVERSE AUCTIONING 11 (2004) (hereinafter USACE STUDY). Generally, the term “sealed bidding” is used to describe a process where bids are all submitted by a time certain, publicly opened and recorded, with immediate award to the lowest bidder; however, within the construction industry it is commonly preceded by a round when an offeror’s technical capability is evaluated. 48 C.F.R. § 14.

<sup>26</sup> While the use of reverse auctions for commercial goods itself remains controversial, it is outside the scope of this memorandum.

<sup>27</sup> See, e.g., Sheet Metal and Air Conditioning Contractors National Association, REVERSE AUCTIONS (2004), available at <http://www.smacna.org/pdf/ACF6BF7.pdf>; Chuck Scislo, *To the Lowest Bidder*, PROFESSIONAL ROOFING March 2006, available at <http://docserver.nrca.net/technical/8633.pdf> (National Roofing Contractors Association opposes reverse auctions); Associated General Contractors of America, WHITE PAPER ON REVERSE AUCTIONS FOR PROCUREMENT OF CONSTRUCTION 2005, available at

lowest price, may encourage imprudent bidding, do not allow for a thorough evaluation of value, do not assure that the successful bidder is responsive and responsible; and may contravene federal procurement laws.<sup>28</sup> When these auction are conducted by third parties, work that should be reserved for small business is frequently awarded to large businesses, and pricing information that the FAR insists remain private is publicized.<sup>29</sup> Indeed, even the chief legislative proponent of reverse auctions, former Congressman Tom Davis (R-VA), specifically exempted construction from any legislation he introduced promoting the use of reverse auctions.<sup>30</sup>

Industry's assertions are borne out by the only study on the use of reverse auctions for construction services. USACE spent a year studying the use of the procurement methodology and found that, "it offered not even marginal edge in savings over the sealed bid process for construction service projects" and that construction was too variable to be considered a commodity.<sup>31</sup> As a result, USACE no longer uses reverse auctions for construction contracts. However, even though USACE has the most construction contracting of any federal agency, not all federal agencies have followed USACE's example and construction contracts continue to be awarded using reverse auctions.<sup>32</sup> Specifically, they are being awarded as commercial item contracts, in direct contravention of Office of Management and Budget Guidance.<sup>33</sup>

In response to these issues, I introduced H.R. 2751, the Commonsense Construction Contracting Act of 2013 during the 113<sup>th</sup> Congress. The legislation exempted any contract for design and construction services that is deemed suitable for award to small business from being awarded using a reverse auction methodology. The Small Business Committee favorably reported the bill, and this Committee included an expanded version of the bill in the House version of the FY 15 NDAA. However, after H.R 2751 was introduced, additional improprieties in the use of reverse auctions came to light, specifically that they were being used in a manner that did not ensure adequate

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<http://newsmanager.commpartners.com/agcleg/downloads/AGC%20Position%20on%20Reverse%20Auctions%20-%20FINAL.pdf> (hereinafter AGC WHITE PAPER).

<sup>28</sup> AGC WHITE PAPER.

<sup>29</sup> Small businesses win most contracts awarded using reverse auctions; however, given that all of the awards are under the statutory amount reserved exclusively for small businesses, these awards should be exclusively to small companies. Likewise, pricing is frequently disclosed in contravention of FAR § 52.203-2.

<sup>30</sup> H.R. 2067, 109th Cong. (2005).

<sup>31</sup> USACE STUDY at 34-37.

<sup>32</sup> See, e.g., Department of the Interior, *Solicitation P12PS25233* (Jun. 13, 2012), available at [https://www.fbo.gov/?s=opportunity&mode=form&tab=core&id=b55a55a0cc7346ab722e4c4b011c4911&\\_cview=0](https://www.fbo.gov/?s=opportunity&mode=form&tab=core&id=b55a55a0cc7346ab722e4c4b011c4911&_cview=0) (supply and deliver flexible road base); VA, *Solicitation VA24413Q0363*, (Jan. 31, 2013), available at [https://www.fbo.gov/?s=opportunity&mode=form&id=039ef8d115384d0cebef055c25934d07&tab=core&\\_cview=1](https://www.fbo.gov/?s=opportunity&mode=form&id=039ef8d115384d0cebef055c25934d07&tab=core&_cview=1) (testing or poser distribution system); VA, *Solicitation VA24312Q1952* (Jul. 30, 2012), available at [https://www.fbo.gov/?s=opportunity&mode=form&id=8a576e312880690d317f3fc78314f401&tab=core&\\_cview=0](https://www.fbo.gov/?s=opportunity&mode=form&id=8a576e312880690d317f3fc78314f401&tab=core&_cview=0) (complete overhaul of chiller).

<sup>33</sup> Memorandum From Angela Styles, Administrator, Office of Federal Procurement Policy, Applicability of FAR Part 12 to Construction Acquisitions (Jul. 3, 2003) available at [http://www.whitehouse.gov/sites/default/files/omb/assets/omb/procurement/far/far\\_part12.pdf](http://www.whitehouse.gov/sites/default/files/omb/assets/omb/procurement/far/far_part12.pdf).

competition or savings.<sup>34</sup> Consequently, the version of the bill I introduced this Congress provides a more comprehensive reform. I will now discuss what convinced me of the need for greater reforms.

#### **IV. Systemic Problems with the Use of Reverse Auctions**

I will now turn to systemic challenges with reverse auctions regardless of the good or service being purchased.<sup>35</sup> The Subcommittee on Contracting and Workforce previously looked at the misuse of reverse auctions during a December 11, 2013 joint hearing with the House Veterans' Affairs Committee (HVAC) Subcommittee on Oversight and Investigations (O&I).<sup>36</sup> That hearing explored the finding of a Government Accountability Office (GAO) report issued December 9, 2013.<sup>37</sup> We revisited the issue on March 19, 2015, when Dan Gordon, a former OFPP Administrator testified about the need to take corrective action on reverse auctions.

Reverse auctions first gained popularity in the late 1990s, as Internet-based technologies allowed potential vendors to underbid each other in real time. Since then, they have grown to account for nearly one percent of federal prime contract dollars awarded each fiscal year.<sup>38</sup> While the Office of Federal Procurement Policy (OFPP) has been promising guidance on the use of reverse auction procurements since 2000, to date no guidance or regulations have been forthcoming, meaning that over \$828 million in procurements are awarded using a methodology never mentioned in the Federal Acquisition Regulation (FAR) or in statute.<sup>39</sup> Instead, OFPP and the Office of Management and Budget (OMB) have encouraged the use of reverse auctions without offering guidance on how to best use this methodology.<sup>40</sup> OFPP most recently agreed to issue guidance sixteen months ago, in response to the GAO report, but has not yet even opened a FAR case.<sup>41</sup>

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<sup>34</sup> GAO, *GUIDANCE IS NEEDED TO MAXIMIZE COMPETITION AND ACHIEVE COST SAVINGS*, GAO-14-108, (2013); *Hearing Before the Subcomm. on Contracting and Workforce, House Comm., and Subcomm. on Oversight and Investigations, Comm. on Veterans' Affairs*, 113th Cong. (2013).

<sup>35</sup> Memorandum from Committee Staff to the Small Business Committee re: *Contracting and the Industrial Base; Hearing Before the Small Business Committee*, 114<sup>th</sup> Cong. (Feb. 12, 2015) (hereinafter "*Contracting and the Industrial Base I* Memorandum"), available at [http://smallbusiness.house.gov/uploadedfiles/2-12-2015\\_hearing\\_memo.pdf](http://smallbusiness.house.gov/uploadedfiles/2-12-2015_hearing_memo.pdf) (last visited Feb. 27, 2015).

<sup>36</sup> *Contracting Away Accountability – Reverse Auctions in Federal Agency Acquisitions; Hearing Before the House Veterans' Affairs Committee Subcommittee on Oversight and Investigations and the House Small Business Committee Subcommittee on Contracting and the Workforce*, 113<sup>th</sup> Cong. (Dec. 5, 2013).

<sup>37</sup> GAO, *REVERSE AUCTIONS, GUIDANCE IS NEEDED TO MAXIMIZE COMPETITION AND ACHIEVE COST SAVINGS* (hereinafter *GAO REVERSE AUCTIONS*) GAO-14-108 (2013).

<sup>38</sup> GAO, *REVERSE AUCTIONS* at 2.

<sup>39</sup> Colleen O'Hara, "Reverse Auctions Move Forward," *FEDERAL COMPUTER WEEK* (Aug. 3, 2000) available at <http://fcw.com/articles/2000/08/03/reverse-auctions-move-forward.aspx> (last visited Feb. 27, 2015), quoting the OFPP Administrator as planning to "issue guidance to sharpen up the Federal Acquisition Regulation regarding reverse auctions."

<sup>40</sup> See Robert Burton, Acting OFPP Administrator, "Utilization of Commercially Available Online Procurement Services" (May 12, 2004), available at [http://www.whitehouse.gov/sites/default/files/omb/assets/omb/procurement/publications/online\\_procurement\\_051204.pdf](http://www.whitehouse.gov/sites/default/files/omb/assets/omb/procurement/publications/online_procurement_051204.pdf) (last visited Feb. 27, 2015); Paul Denett, OFPP Administrator, "Effective Practices for Enhancing Competition" (Jul. 18, 2008), available at

Based on my review of the issue, I believe there are three issues that need to be addressed. First, how do we maintain adequate competition in reverse auctions. Second, what is the appropriate use of third party service providers. Finally, what types of goods and services should be purchased using reverse auctions.

*a. Competition*

In FY 2012, the last year for which federal data is available, federal agencies awarded \$828 million in contracts using reverse auctions.<sup>42</sup> However, FedBid reports that it conducted \$425 million in transactions for the Department of Defense (DoD) in FY 2013<sup>43</sup> Likewise, another \$1.1 billion in reverse auctions were conducted by FedBid for civilian agencies in FY 2013.<sup>44</sup> While this does not account for reverse auctions conducted by the General Services Administration (GSA) or by other third party providers, it indicates that the amount of reverse auctions dollars nearly doubled in one year to over \$1.525 billion. As such, it is clear that reverse auctions are increasingly important to how the government buys, and from whom those purchases are made.

While competition itself would reasonably be expected to reduce the price paid by the government – this is the foundation of our procurement system – competition is frequently absent or not meaningful in many reverse auctions. In FY 2012, over one-third of reverse auctions conducted for federal agencies had no interactive bidding, defined by GAO as “where vendors engage in multiple rounds of bidding against each other to drive prices lower.”<sup>45</sup> In 27 percent of auctions, there was only one bidder and that bidder received the award.<sup>46</sup> In contrast, the DoD policy in place at that time required that before issuing a contract when only a single bid was received, “[w]hen a solicitation is open for less than 30 days and only a single bid is received, the contracting officer should cancel and re-advertise the solicitation for a minimum of 30 additional days unless a waiver is obtained from the head of the contracting activity. When a solicitation is

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[http://www.whitehouse.gov/sites/default/files/omb/procurement/memo/enhancing\\_competition\\_071808.pdf](http://www.whitehouse.gov/sites/default/files/omb/procurement/memo/enhancing_competition_071808.pdf) (last visited Feb. 27, 2015); Jeffrey Zients, Deputy Director, OMB, “The Accountable Government Initiative” (Sept. 14, 2010) available at

[http://www.whitehouse.gov/sites/default/files/omb/memoranda/2010/AccountableGovernmentInitiative\\_09142010.pdf](http://www.whitehouse.gov/sites/default/files/omb/memoranda/2010/AccountableGovernmentInitiative_09142010.pdf) (last visited Feb. 27, 2015).

<sup>41</sup> GAO, REVERSE AUCTIONS at 30.

<sup>42</sup> GAO, REVERSE AUCTIONS at 6. GAO reported that 99% were conducted by the same contractor, FedBid. FedBid is a Virginia company founded by Ali Saadat in 1999. In 2012, it secured “significant investment from Revolution Growth, a venture capital fund created by Steve Case, Ted Leonsis and Donn Davis.”

<http://www.fedbid.com/about/directors/> (last visited Feb. 27, 2015). Messrs. Case and Leonsis were the cofounders of AOL, and Mr. Leonsis is the owner of the Washington Wizards and Capitals. FedBid’s Board of Directors includes General George Casey, Jr., former Army Chief of Staff, Mr. Leonsis, and Susan Bostrom, former CMO of Cisco. *Id.* Their list of advisors includes former political appointees of Presidents Clinton and George W. Bush, generals, admirals, and Members of Congress. <http://www.fedbid.com/about/advisors/> (last visited Feb. 27, 2015). The current CEO is a former OFPP Administrator.

<sup>43</sup> <http://www.fedbid.com/buyers/departments-of-defense/> (last visited Feb. 27, 2015). It states that 85 percent of these awards are to small businesses. *Id.*

<sup>44</sup> <http://www.fedbid.com/buyers/federal-civilian/> (last visited Feb. 27, 2015).

<sup>45</sup> GAO, REVERSE AUCTIONS at 16.

<sup>46</sup> *Id.* at 16-17.

open for at least 30 days or has been re-advertised and only a single bid is received, the contracting officer should conduct negotiations with the offeror, unless a waiver is obtained by the head of the contracting activity.”<sup>47</sup> No such competitive procedures were followed.

However, additional problems were found with the competition of these awards. In eight percent of awards there were multiple bidders but only one round of offers – essentially, this was a sealed bid procurement.<sup>48</sup> However, agencies paid \$3.9 million in fees for these procurement services.<sup>49</sup> Perhaps even more problematic is the fact that for over 3,600 reverse auctions, \$1.7 million in fees was paid even though only one offer was received from one bidder – thus, in addition to lacking competition for the actual award, the government paid extra to award a sole source contract.

Approximately 80 percent of the dollars awarded using reverse auctions were under \$150,000, and 86 percent of the contracts were awarded to small businesses.<sup>50</sup> According to the Small Business Act, all contracts between \$3,000 and \$150,000 are exclusively reserved for small businesses, provided that there are two or more small businesses able to provide the good or service at a fair and reasonable price.<sup>51</sup> Further, in cases where the contract exceeds \$150,000, if two or more small businesses are able to compete for the contract, it is to be set aside for small business. Therefore, the lack of adequate competition on these contracts was most likely to harm small businesses. Furthermore, given that items purchased using reverse auctions are supposed to be commercially available and not complex, one question is, why are all of these procurements not reserved for small businesses? Indeed, the Chief Counsel for Advocacy of the Small Business Administration (SBA Advocacy) sent a letter to OFPP stating that “some Federal agencies using reverse auctions may not be complying with the simplified acquisition threshold requirements for contracts to be reserved for small businesses.”<sup>52</sup> Thus, the inappropriate use of reverse auctions is harming the small business industrial base.

### ***b. The Use of Third Party Providers***

The inappropriate use of third party providers may also pose a challenge to the industrial base. Before proceeding with this discussion, it is important to note that it is the federal government, and ultimately the contracting officer, that is responsible for the conduct of a third party reverse auction provider under its direction. As the largest third party provider of reverse auctions, FedBid has come under scrutiny as of late. However, while allegations have been made regarding

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<sup>47</sup> Memorandum from Shay Assad, Director Defense Procurement and Acquisition Policy “Improving Competition in Defense Procurements” (2011) available at <http://www.acq.osd.mil/dpap/policy/policyvault/USA002080-11-DPAP.pdf> (last visited Feb. 27, 2015).

<sup>48</sup> GAO, REVERSE AUCTIONS at 16-17.

<sup>49</sup> *Id.*

<sup>50</sup> *Contracting and the Industrial Base* Memorandum

<sup>51</sup> Section 15(j)(1).

<sup>52</sup> Winslow Sargeant, *Impact of Reverse Auctions on Small Businesses* (2012), available at <http://www.sba.gov/advocacy/816/42071> (last visited Feb. 27, 2015).

FedBid’s conduct, the actions the company took in the award of contracts were permitted by the contracting agency, so this memorandum will focus on what the federal contracting agency permits.

Because the federal procurement system is complex and involves obligating the federal government, under the Federal Acquisition Regulation (FAR), an action should be undertaken only by a federal employee if it could “[b]ind the United States to take or not to take some action by contract,” “[d]etermine, protect, and advance United States . . . interests by contract management,” or “[e]xert ultimate control over the acquisition, use, or disposition” of property or funds.<sup>53</sup> While third party providers do not award contracts, the third party is in a position of exercising functions closely associated with inherently governmental activities. For example, according to discussions with FedBid, any questions a vendor may wish to pose to a contracting officer must be submitted through FedBid. Likewise, FedBid states that it keeps independent past performance records on vendors, including information regarding their creditworthiness, which it shares with the government but does not share with the vendors.<sup>54</sup> FedBid also reports that agencies allow it to bar a vendor from receiving an award if FedBid and the vendor are in a dispute over fees the vendor allegedly owes to FedBid.<sup>55</sup> Finally, FedBid states that agencies permit it to tell an offeror that its offer is lagging in order to induce a lower bid, when in fact there is no lower bid.<sup>56</sup>

Each of these statements poses a challenge to the industrial base permitted by the contracting agency. Requiring that vendors speak to contractors rather than the government means that the information they receive regarding the government’s needs is filtered, and that the contracting officer may not learn about the needs of the vendor community. Keeping separate performance and financial responsibility files excludes companies from successfully competing for offers. Barring a company over a private dispute again limits competition on merely the assertion of a contractor. Misleading a vendor over pricing builds distrust in the vendor community and causes businesses to opt out of the federal marketplace. As the testimony before the Subcommittee demonstrated, the fact that the actual award is signed by a contracting officer does not always mitigate the private sector intrusion into all of the inherently governmental aspects of the process. Rather, GAO found only within the last two weeks cases where FedBid’s action violated federal procurement laws.

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<sup>53</sup> FAR § 2.101; *see also* FAR § 7.5.

<sup>54</sup> FAR § 15.306. Further, if a contracting officer determines that a small business’s past performance make it unsuitable for award, it should refer that business to the Small Business Administration for review. FAR § 19.6.

<sup>55</sup> Committee staff conversations with Joe Jordan, CEO of Fed Bid, on November 6, 2014. The Committee has since received documentation of this statement from a third party whose bid was not allowed.

<sup>56</sup> Committee staff conversations with Joe Jordan, CEO of Fed Bid, on November 6, 2014.

*c. Appropriate Goods and Services*

While my interest in reverse auctions began with construction services, I remain convinced that reverse auctions are a good way to save the government money when they are used appropriately. GAO and witnesses all agreed that they can be an efficient way to buy commodities when the only factor we care about is price. However, the more complex the service, the greater the risk of harm. Parts of DoD are currently using reverse auctions to procure body armor, and while some may consider this protective gear a mere commodity, I think we would all agree that factors other than price should be considered when peoples lives are at stake. I think Dan Gordon said it best when he stated that if “you want to do a reverse auction to buy surgery services, make sure you don’t particularly like the patient.”<sup>57</sup>

*d. H.R. 1444*

I believe that H.R. 1444, the Commonsense Contracting Act of 2015, as incorporated into H.R. 1481 the Small Contractors Increase Competition Act of 2015, and successfully marked up by the Small Buisenss Committee, offers a solution to the problems I’ve outlined. First, it requires that reverse auctions be awarded competitively, and that trained contracting officers be responsible for the decisions made during the reverse auction. It also imposes some fair play rules – the government or its agent can’t lie to bidders about the rankings of their offers, or use third party providers to get around statutory requirements on responsibility and past performance. It also keeps disputes between the third party providers and offerors out of the decision making process. Finally, this language restricts the use of reverse auctions on small business contracts to contracts for goods and services, other than construction service contracts, when the basis of award is only price and the goods or services are not purchased to protect Federal employees, members of the Armed Forces, or civilians from bodily harm.

**V. Conclusion**

The language in H.R 1444, H.R. 1481, and H.R. 838 has been supported by the National Defense Industry Association, the Associated General Contractors, the American Institute of Architects, the National Small Business Association, the American Council of Engineering Companies, and many others. It represents a common sense approach to issues undermining federal contracting. I ask that you include this language in the FY 2016 NDAA. Thank you for your time and support. I would be happy to answer any questions.

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<sup>57</sup> [http://www.washingtonpost.com/business/economy/suspension-lifted-fedbid-still-comes-under-fire/2015/03/19/14ddc510-ce47-11e4-a2a7-9517a3a70506\\_story.html](http://www.washingtonpost.com/business/economy/suspension-lifted-fedbid-still-comes-under-fire/2015/03/19/14ddc510-ce47-11e4-a2a7-9517a3a70506_story.html)