

Statement of

Mr. Thomas J. Kelleher, Jr., of Smith Currie & Hancock LLP

on behalf of

The Associated General Contractors of America

to the

Subcommittee on Contracting and Workforce

Committee on Small Business

U.S. House of Representatives

For a hearing on

“Building America: Challenges for Small Construction Contractors”

May 23, 2013

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 33,000 firms, including 7,000 of America's leading general contractors, and over 12,000 specialty-contracting firms. Over 13,000 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.

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**Statement of Thomas J. Kelleher, Jr.,
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Subcommittee on Contracting and Workforce
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My name is Tom Kelleher. I am a Senior Partner with the law firm of Smith Currie & Hancock, where I lead our national construction law practice, which is focused on federal construction. I regularly counsel federal contractors on a wide variety of small business issues, including advice on affiliation rules; mentor-protégé programs; small business and set-aside strategy and compliance (8(a) contracting, ANC, NAC, HUBZone, SDVOSB); small business subcontracting plan compliance; and small business size protests. I previously served as Chair of the Federal Acquisition Regulation Committee for the Associated General Contractors of America (“AGC”) and remain active in the leadership of AGC’s Federal & Heavy Construction Division. In addition, I previously wrote and am currently updating AGC’s book on federal government construction contracts that includes an extensive analysis of the federal small business construction program. I testify today before the Committee on behalf of AGC and its members on the topic of small business utilization in federal contracting and potential reforms that may improve the government’s efforts to utilize and develop small businesses.

AGC strongly supports full and open competition for the many contracts necessary to construct improvements to real property. AGC works to foster a business climate that provides opportunities for all small businesses. To succeed, construction firms must focus on price, quality and reliability. Construction is an intensely competitive industry, and we believe that full and open competition properly penalizes any firm that discriminates based upon impermissible factors. Competition energizes and improves the construction industry, which benefits the economy as a whole. Full and open competition is especially important during these trying economic times.

Despite a recent, modest upturn in construction employment, payroll employment in April 2013 was nearly 2 million, or 25 percent, below the peak in 2006, and unemployment in the sector remains deplorably high. The industry’s unemployment rate in April 2013 was 13.2 percent, not seasonally adjusted—the highest of any industry and nearly double the overall unemployment rate, according to data the Bureau of Labor Statistics released on May 3, 2013. Although demand for private nonresidential and multifamily construction has revived modestly, federal construction spending is down 28 percent since August 2011 according to the U.S. Census Bureau. The outlook for public construction remains grim as agencies at all levels of government continue to cut construction spending.

AGC supports procurement reform to improve delivery of federal construction services. Reform of the federal procurement process should recognize construction’s unique blending of diverse industry sectors. It should also recognize the limitations of what the market can provide, as well as consider the cost versus benefit to the public sector and taxpayers.

Our members recognize the potential benefits that federal small business programs – including the 8(a) Business Development Program, HUBZone Program, Veteran Owned and Service Disabled Veteran Owned Small Business Programs, tribally-owned contracting programs, and Woman Owned Small Business Program – provide to contractors who qualify for these programs. However, the programs as currently regulated, do not achieve the important goal of developing successful small companies that can compete and succeed on their own. In AGC’s view, the rules need to be reformed so that contractors may: (1) comply with the rules; (2) reasonably predict what actions are compliant with the rules and (3) meet the requirements of their federal agency customer more efficiently. AGC believes that the current rules encourage firms to structure their performance in a way that technically meets legal requirements yet fails to capture the spirit and real intent of the small business programs.

To help ensure that the small business program works to successfully grow America’s small businesses, AGC proposes:

- (1) Allowing lower tier small business subcontracts to count toward small business prime contractors’ subcontracting goals to improve transparency and provide more accurate data regarding the extent of small business participation in the federal construction program; and
- (2) Prohibiting federal agency procurement of construction services through reverse auctions to ensure that small construction businesses can successfully compete for federal government contracts.

In addition, AGC holds that reforms to design-build procurement and surety bonding requirements can also be made to help allow the program to work as intended.

Count Small Business Subcontracting At All Tiers

The construction industry has historically supported and provided opportunities for small businesses. Construction is usually accomplished under the leadership of a general contractor. It is the job of the general contractor to integrate the work of the numerous trade and specialty contractors to complete the project. It is not unusual to have anywhere from 20 to 50 trade and specialty contractors on a significant construction project. These subcontractors are organized within the project delivery team in tiers so that each subcontractor can deliver its services in a highly integrated process. Small business trade and specialty subcontractors, operating at the appropriate tiers, are critical and essential to the success of construction projects and the construction industry as a whole. The construction industry cannot succeed without a large pool of qualified small business trade and specialty subcontractors.

This industry is proud of its efforts to include small businesses and allow small businesses to develop. However, instead of being rewarded for its efforts, agencies often over rely on the construction industry to shoulder the burden for other industries that have not encouraged small business involvement. Agencies try to meet substantial portions of their goals by limiting competition to small businesses and their subsets in construction.

A consequence of this practice causes another disturbing trend: Massive growth in the percentage of small business construction subcontracting goals. In some cases, our industry has seen small business subcontracting goal requirements exceed 70 percent on large projects. Large general contractors are usually able to meet the strict legal requirements to achieve these goals, but only through a combination of complicated, inefficient project administration maneuvers and substantial use of larger businesses working as subcontractors to small businesses. These techniques, while legal, do not help most small business actually gain the experience to grow and succeed as the federal small business program intends.

Rather than force unrealistic goals on very large projects where an extremely high level of small business subcontracting at the first tier level is simply not feasible, the government should adapt its agency-wide goals and subcontracting goals to be more consistent with what the market can provide. Counting lower tier small business subcontractors can help Congress and federal agencies make more informed decisions to the small business program, thereby ensuring that small businesses gain the experience they need to grow and succeed.

How the Current System Fails to Account for True Small Business Participation

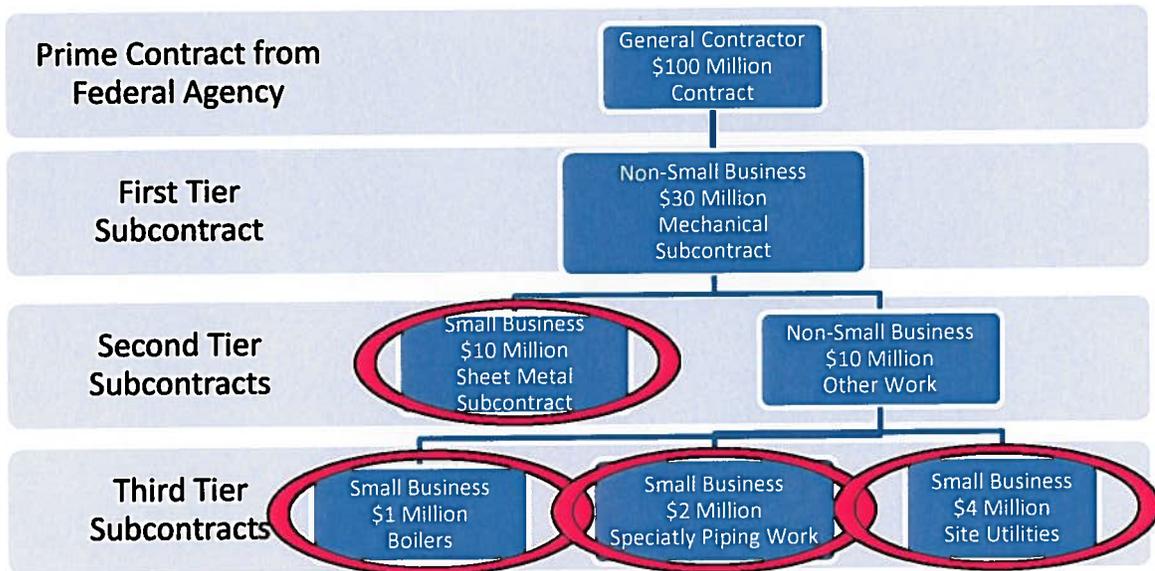
Current rules require set-asides for small business subcontractors, but prohibit general contractors from truly accounting for the total amount of dollars flowing to small businesses. As it stands, if a non-small business is included as a first tier subcontractor, a prime contractor is disqualified from reporting further dollars going to small businesses at lower tiers. Although the rules allow subcontractors to report this information to general contractors, it is the general contractors' experience that subcontractors very infrequently report such information, as there is no incentive for or penalty against the subcontractors to make this effort. As a result, unfortunately, these current counting rules provide an incomplete picture of true small business participation.

Implementing our recommendation can help bring greater transparency to small business subcontracting goals as shown in the following example:

- An agency procures a \$100 million building to be constructed. One of the first tier subcontracts is for all the mechanical trades to be performed in the structure. The prime contractor awards that first tier subcontract valued at approximately \$30 million to a non-small business, as no qualified mechanical small businesses are available to manage that contract. That first tier small business contractor, in turn, subcontracts \$10 million in sheet metal work plus another \$7 million in boilers, piping and utility work to second tier small businesses.
- The current law prevents the general contractor from counting the \$17 million second, third and subsequent tier small business work, as that work is beyond the first tier. If the first tier subcontractors are non-small business contractors, as is the case here, the counting and reporting stops there. That is true even though the sheet metal and other lower tier subcontractors are small businesses. On a typical large construction project there are many qualified specialty trade small businesses operating at lower tiers, but

their participation is not allowed to be counted and the true value and role of small business in federal construction is underrepresented.

- The diagram below depicts the example discussed above. Under the current rules, the small business contracts circled below are not counted towards a general contractor's small business subcontracting goals. In this example, \$17 million in small business subcontracts would not be counted towards the subcontracting goal and the government may have no record of this degree of small business participation. It is our experience that large business subcontractors do not understand or properly complete small business subcontracting reports, since there is no incentive for or penalty against the subcontractors to make this effort.



The Benefits of Counting Small Business Subcontractor Participation at All Tiers

Allowing prime contractors to report small business subcontracting at all tiers would demonstrate true small business participation on a federal contract. Consequently, Congress and federal agencies could determine where small businesses are underrepresented and make informed improvements to the small business program.

In addition, this reform would help ensure that small businesses actually gain the experience the program intends for them to get through the enactment of these goals. As it stands, many prime contractors elevate small business subcontractors that usually work at lower tiers to the first tier to help meet current small business subcontractor goals. Oftentimes, those small business subcontractors then join with non-small businesses, which actually perform a significant amount of the work and have the bonding capacity to guarantee that work. As a result, much of the work experience the small business program intends for a small business subcontractor to gain is actually passed through to non-small business contractors.

Federal agency source selection requirements incentivize prime contractors to allow these pass-through situations to occur because agency small business participation plans, subcontracting plans and past performance evaluations are an important element in the project award process. Small business participation at the subcontractor level noted in these plans is something agencies consider in their determination to make a current award. Additionally, the prime contractor's ability to meet those goals are included in past performance evaluations used in consideration for future federal work. By enabling prime contractors to count lower tier small business contractors towards small business goals, prime contractors can encourage qualified small business subcontractors to participate at a level they are most capable to actually perform the work and succeed by gaining the experience the federal small business program intended them to gain.

The Federal Government Already Uses Tracking Technology That Can Count Lower Tier Subcontractors

The technology for reporting subcontracting data at all tiers is already available and used by the federal government. The system already used to report subcontracting data, the Electronic Subcontractor Reporting System (eSRS), is capable of tracking and reporting small business subcontractor data on multiple tiers. Unfortunately, current rules do not adequately encourage lower tier subcontractors to report their participation. AGC recommends that Congress legislate to allow prime contractors to count small business involvement at all tiers using the eSRS reporting system already in place.

Prohibit Reverse Auctions for Construction Services

AGC has found that certain agencies, like the Department of the Interior and Department of Veterans Affairs, are actively procuring construction services using reverse auction procurement under the unproven conclusion that they save taxpayer dollars. Vendors promoting reverse auctions have yet to present persuasive evidence that reverse auctions will generate real savings in the procurement of construction or will provide benefits of "best value" comparable to currently recognized selection procedures for construction contractors, which have been carefully and specifically tailored for all types of construction.

Manufactured goods—like pens and paper—are subject to little or no variability or change in manufacture or application. Construction projects, on the other hand, are inherently variable. Each is subject to the unique demands of the project, such as the needs, requirements, personnel and budgetary criteria of the owner, site conditions, design features 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 who suggest reverse auctions for construction services misuse a procurement process originally designed for commodities. It ignores the unique nature of construction. 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. In fact, the construction process is fundamentally different from the manufacturing process.

This distinction was reiterated in a July 2003 memorandum from the Office of Federal Procurement Policy (OFPP), which states that "...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, advising them not to treat construction as a commodity for government procurement purposes.

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 successive bids as the auction progresses. As a result, a bidder has little incentive to offer its best price and subsequently may never offer its lowest price. In addition, savings from reverse auctions can be one time occurrences.

Reverse Auctions May 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 may move too quickly for competitors to accurately reassess 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, including the owner. Imprudent bidding may lead to performance and financial problems for owners and successful bidders, which may have the effect of increasing the ultimate cost of construction as well as the cost of operating and maintaining the structure.

Negotiated Procurements Allow Thorough Evaluation of Value

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 needs. These processes recognize the value and quality of project relationships that 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 offers both the owner and contractor the opportunity to discuss and to clarify performance requirements of the project.

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, and unique needs, are deemphasized in the auction. As a result, reverse auctions do not offer owners a good way to evaluate non-price factors.

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 bid is 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's laws, regulations and years of precedent that address these critical factors and ensure the integrity of the process.

Reverse Auctions may Contravene Federal Procurement Laws and Certain State Laws

Federal procurement laws do not specifically address the use of reverse bid auctions to procure construction. The Federal Acquisition Regulation (FAR) and current procurement statutes, however, do reflect a clear policy of not disclosing contractor price information. Price disclosure is often a distinguishing feature of reverse auction processes. Given the restrictions on contractor price disclosure in the U.S. Code and the FAR, it is unclear that any authority exists for the federal government to conduct reverse auctions on fixed-price type contracts or that current law can be interpreted to permit the practice of reverse auctions by the federal agencies. In addition, some states, such as Pennsylvania and Kansas, have enacted statutes that prohibit procurement of construction through reverse auctions.

The Government Experience Does Not Support the Use of Reverse Auctions for Construction

AGC strongly recommends that the Committee closely examine the findings of a reverse auction pilot program report that the Army Corps of Engineers (USACE) issued on July 26, 2004. The findings of the report clearly show that reverse auctions are an inappropriate tool to procure construction and construction-related services. The report further states that reverse auctions fail to realize any additional savings over the sealed bid process.

In its final determinations, USACE found that the acquisition of construction services cannot and should not be equated with commodities for the following reasons:

- Within the operational parameters of Department of Defense contracting regulations, the dynamics are much too diverse between [construction services and commodities]; and
- Virtually all of the USACE construction services...are one-of-a-kind projects under one-of-a-kind conditions with numerous and consistent variables for cost and no-cost factors.

The USACE report stated that there was no proof that reverse auctions provide any significant or marginal edge in savings over the sealed bid process for construction services, noting:

- There was no proof that a consistent, reliable and valid measurement method for projecting savings could be established from reverse auctioning;
- Absent any specific price history for an identical project under identical conditions, there is no practical way to measure or compare any projected savings by reverse auctions over sealed bidding; and
- There is no proof reverse auctions provided any significant or marginal savings in comparison to the government estimate.

Additionally, on March 6, 2008, Major General Ronald L. Johnson, former Deputy Commanding General of USACE, testified before this Committee on this very issue. MG Johnson testified that “The 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.”

For these reasons, AGC supports legislation prohibiting reverse auction procurement for construction and construction-related services.

Design-Build Procurement & Security in Bonding

AGC Supports Two-Step Design Build as the Preferred Design-Build Procurement Process

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. The two-step process involves two rounds of construction and design team selection. Generally, during the first round, a large number of construction and design teams submit their qualifications for the project. Based on those qualifications, the federal agency selects three to five teams to submit full proposals, including extensive and expensive design materials, for final selection in the second round. AGC has long held and supported the limitation of the second round selection to three to five finalist teams.

In the single-step process, on the other hand, there is no qualification first round. Rather, all construction and design teams must submit full proposals, which can cost millions of dollars depending on the size of a project. As a result, competition suffers because many qualified teams, especially small businesses, choose not to incur large costs to participate in single-step design build procurement where perhaps 20 teams or more can compete. 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?

As such, agencies should strive to limit single-step design-build procurement to less complicated and less expensive projects, where very little design work is required. AGC does not support the complete elimination of the single-step design-build procurement by federal agencies, but rather the sensible use of that particular procurement method for smaller construction projects.

AGC Supports “The Security in Bonding Act of 2013” (H.R. 776)

The Miller Act provides statutory surety bond requirements that protect federal project owners by assuring: (1) that interested contractors have been prequalified by a corporate surety to perform a construction contract; (2) that a reputable and knowledgeable corporate surety stands ready to complete the contract in the event of contractor default; and (3) that project subcontractors and suppliers will be paid. Individual sureties, however, may neither be subject to the same regulatory oversight as corporate sureties, nor are they required to relinquish the custody and control of the assets that they pledge to secure their bonds on federal construction projects.

The Security in Bonding Act, H.R. 776, would help eliminate future instances where individual surety bonds are pledged with insufficient or illusory assets. This would help level the playing field for all contractors when it comes to surety choices and better protect the federal government from the risk of default.

Conclusion

Thank you for the opportunity to provide our views on working with the federal market. For the reasons stated above, AGC strongly recommends that Congress reform the federal procurement process to (1) count lower all tier small business subcontractors towards small business subcontracting goals; and (2) prohibit reverse auction procurement for construction services.