



ASSOCIATED GENERAL CONTRACTORS OF AMERICA WHITE PAPER ON REVERSE AUCTIONS FOR PROCUREMENT OF CONSTRUCTION

I. INTRODUCTION

The Associated General Contractors of America (AGC) strongly supports full and open competition for the many 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. Today, e-commerce, through the internet and other means, may offer the promise of increasing competition for construction contractors, enabling owners to reach a wider group of potential bidders and to improve the “speed to market” of projects. In fact, many owners are already using the Internet to solicit and receive bids for construction contracts. AGC supports and encourages the use of e-commerce to enhance productivity in the construction industry, including the process of electronic bidding.¹

AGC has found that public and private property owners maximize their results when they require or encourage competition on all of the relevant “fronts,” including but not limited to price, schedule, safety, quality, responsiveness, and past performance. Owners have developed several ways of structuring the competition for construction contracts, enabling them to emphasize the factors they consider most important and, at the same time, requiring or at least encouraging competition on other fronts. When owners consider price and price-related factors to be most important, and have little need to meet with the competitors for the contract, they generally procure the contract through sealed bids, a time-tested method that ensures the integrity of the procurement process. When owners consider non-price factors to be important, or wish to discuss the work with the competitors, they are most likely to engage in some form of negotiation, using an alternative contractor selection process and project delivery system.

Whatever their priorities, owners prefer well thought-out pricing based on the human, financial and material resources necessary to perform the work. They want responsive and responsible contractors to bid for their work. When owners contemplate more than one round of bidding, they typically give bidders adequate time to assess their strategies and to recalculate costs, understanding that this leads to accurate and well-constituted bids that are material to the owners’ articulated requirements. Knowledgeable owners, regardless of the procurement method selected, value healthy and vibrant relationships with their construction contractors, recognizing that each project entails unique variables that require consistent, sustained communication and the willingness of both parties to address and work through project difficulties and issues.

Because owners are considering the use of reverse auctions for the procurement of construction, which treat construction as a commodity, AGC offers the following points for consideration:

II. AGC BELIEVES THAT REVERSE AUCTIONS WILL SELDOM PROVIDE BENEFITS COMPARABLE TO CURRENTLY RECOGNIZED SELECTION PROCEDURES FOR CONSTRUCTION CONTRACTORS.

Among some of the distinguishing features of a reverse auction are that the process may require competitors to disclose their prices to each other, it contemplates multiple rounds of bidding, it is quick, and it expects and even encourages competitors to focus on each other’s bids, submitting new and ever lower bids in an effort to win the competition. While competitors may lower their prices, they normally have only minutes to do so.

¹ (AGC Policy on Electronic Bidding in the Public Sector, 1-12-01)

Software vendors and internet service providers who host reverse auctions typically have designed their processes for the procurement of commodities and other manufactured goods. These vendors promote reverse auctions to companies on the grounds that such processes will dramatically reduce the cost of procuring commodities. Whether electronic reverse auctions have reduced the cost of procuring commodities and manufactured goods is a matter of some debate². Business commentators also point out that these vendors are not telling the complete story about other costs associated with reverse auctions that may negate any savings realized from the auction process itself. “For many companies, the promise of lower unit costs is just an illusion because expenses in other budget categories (i.e. indirect losses) may actually increase. The costs of goods sold will thus be maintained or may even increase.”³ These same vendors now suggest that reverse auctions are a superior way to procure construction. Such a suggestion, however, misapplies 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. Manufactured goods 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. In fact, this distinction was reiterated in a July 2003 memorandum from Office of Federal Procurement Policy Administrator Angela Styles, which 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, advising them not to treat construction as a commodity for government procurement purposes.

Vendors promoting reverse auctions have yet to present persuasive evidence that reverse auctions will generate 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.

A. REVERSE AUCTIONS DO NOT GUARANTEE LOWEST PRICE.

Vendors claim that reverse auctions significantly reduce the cost of construction and save substantial amounts of time. In the context of construction, AGC believes that most of these claims 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. Some reports show savings realized by an owner in the first reverse auction are significantly reduced in subsequent reverse auction events.⁴

On the other hand, sealed bidding ensures that competitors have only one opportunity to price the work, encouraging each bidder to present his or her best price. For this reason, AGC believes that sealed bidding, which encourages intense price competition, will continue to serve the owner better than reverse auctioning when the owner wants to emphasize price alone.

² See Emiliani, M.L. and Stec, D.J., “Aerospace Parts Suppliers’ Reaction to Online Reverse Auctions,” available at http://www.theclbm.com/aero_ora.pdf, accessed June 20, 2003.

³ Emiliani, M.L. and Stec, D.J. of RPI’s Center for Lean Business Management in Hartford, Conn.

⁴ International Housewares Association Reverse Auction Task Force, “Reverse Auctions: An Industry White Paper”, October, 2002

B. 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. There are even reported cases in which buyers actually step in to keep an overzealous supplier from obtaining an order that would potentially jeopardized the business viability of the supplier. “[John] Deere saw that a known supplier was bidding down to its own costs of goods in a reverse auction, “We knew ourselves they were below the point where they should have kept going...so we immediately dispatched a couple of supplier-development engineers. Because of the relationship we had, we kept that business and paid a little more than we would have paid to the bidder next to their lowest. But this was a good supplier. It’s still a good supplier”.⁵ Absent such steps, 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.

C. NEGOTIATED PROCUREMENTS ALLOW THOROUGH EVALUATION OF VALUE.

Where price is not the sole determinant, 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 and other factors that promote greater collaboration among the owner and project team members. These processes also consider quality, 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, to clarify and to better understand each party’s needs for the performance of the project. On the other hand, reverse auctions do not promote communication between the parties. Rather, they promote a dynamic in which parties repeatedly attempt to best each other’s prices. In fact, current studies of reverse auctions between buyers and suppliers have found that reverse auctions often have a deleterious effect on the relationship between buyer and seller. “Even more dangerous is the deterioration of buyer and supplier relationships when reverse auction are used to beat up suppliers on price.”⁶ Moreover, non-price factors that are 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.

D. SEALED BIDDING ASSURES THAT THE SUCCESSFUL BIDDER IS RESPONSIVE AND RESPONSIBLE.

Where price is the sole determinant, the sealed bid procurement process was established to ensure integrity in the award of construction contracts. 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 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 owner’s articulated requirements. These auctions expose 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. The National Electronic Coordinating Council, an alliance of state government associations dedicated to the advancement of electronic commerce within the states, expressed these

⁵ Erison, Jim, “Reverse Auctions: Bad Idea”, Line 56, Thursday, September 20, 2001.

⁶ Sawhney, Mohianbir, “Forward Thinking about Reverse Auctions”, CIO Magazine June 1, 2003; see also Schoenherr, Tobias, “Deciding on the Appropriateness of B2B Reverse Auction Technology Adoption: An AHP Approach Combined with Integer Programming.”

concerns in a December 2000 report on E Procurement Policy Issues, “Anonymity of bidders helps prevent collusion between bidders while sealed bids prevent fraud and favoritism being exercised by bid officials. There is some question as to whether a dynamic, real-time bidding environment prevents these problems.”

E. 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.⁷ In addition, some states, such as Pennsylvania and Kansas, have enacted statutes that prohibit procurement of construction through reverse auctions.

III. CONCLUSION

AGC offers these points on reverse auctions in an effort to facilitate and encourage discussion. AGC does not presume to give direction or to provide guidance to members or any other contractors invited to participate in such auctions. Each construction team member must decide whether to participate in reverse auctions, and each must do so entirely on his or her own. However, AGC believes that reverse auctions are an unproven method for selection of construction contractors, specialty contractors, subcontractors, and suppliers. At best, reverse auctions raise significant issues for owners and construction team members, including the following:

- Reverse auctions do not guarantee the lowest price.
- Reverse auctions may encourage imprudent bidding.
- Negotiated procurements allow thorough evaluation of value.
- Sealed bidding assures that the successful bidder is responsive and responsible.
- Reverse auctions may contravene federal procurement laws and certain state laws.

⁷ See, 41USC § 423 and FAR § 52.203-2. It is also unclear whether FAR § 1.102(d) can be interpreted to permit the practice of reverse bid auction by federal agencies without, at a minimum, a waiver of the requirements of the clause at FAR § 52.203-2.