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Introduction

One of the current "hot topics" in the construction industry is bidding through "reverse auctions." Before contractors proceed in this manner, they must understand the pros and cons of this type of contracting.

This *Contracts Bulletin* will briefly introduce the concept of "reverse auctions," discuss some of the advantages and disadvantages, and provide some brief "pointers" for those determined to proceed with "reverse auction" bidding.

What is a "Reverse Auction?"

A reverse auction is often simply described as "e-Bay™ in reverse." This means a Request for Proposal (RFP) is placed on the Internet and anonymous bidders make consecutively lower bids over a set period of time. This contrasts with e-Bay™ where the price goes *up*; here, in a "reverse auction" the price goes *down* as contractors steadily underbid each other in an open process. (Open process means everyone on the Internet sees the bids as they occur.)

Who is Using Reverse Auctions?

The Internet enables an increasing number of public and private organizations to use reverse auctions to buy products. For example, many government agencies and major companies, like Target and Home Depot, purchase commodities through reverse auctions. Indeed, the United States' Navy, as early as the spring of 2000, used reverse auctions to buy materials. More recently, government agencies and corporations have considered using reverse auctions to solicit bids for construction services.

Advantages of Reverse Auctions

Advocates of reverse auctions argue that buyers save money. In fact, the State of Minnesota believes that it has saved millions with reverse auctions since they began in 2001. See "State Buying More Goods Through Online Auctions," *Star Tribune*, February 16, 2004.

Proponents further argue that reverse auctions represent the purest form of the free market capitalism. Reverse auctions prevent a small group of insiders from rigging bidding by merely going through the motions of public bidding. In a reverse auction, the project is presented on a public Web site and is open to

anyone who can satisfy the terms of the RFP. This lowers barriers to entry, allows free exchange of information, reduces costs, and lowers the price to the buyer.

Disadvantages of Reverse Auctions

Many construction industry trade groups and associations have been very critical of reverse auctions for construction services. For example, the Associated General Contractors of America (AGC) opposes reverse auctions for bidding construction projects. In fact, SMACNA has endorsed AGC's white paper on this topic through the Associated Specialty Contractors (ASC). (*AGC White Paper on Reverse Auctions for Procurement of Construction*)

The AGC has played a central role in opposing efforts to expand reverse auctions to construction services in both the public and private sectors. As an early user of public reverse auctions, Minnesota has been a battleground for evaluating reverse auctions. The AGC's Minnesota president has written articles critical of reverse auctions. See D. Semerad, "Reverse Auction Bidding – Hot Topic, Cold Reception," *Commercial Builder*, Summer 2003. The reasons the AGC and others contend that reverse auctions present substantial disadvantages to both contractors and the public include the following:

1. **Claims That Reverse Auctions Lower Costs in the Construction Contracts are Unproven.** In a traditional "sealed bid," a bidder is forced to put forth its best proposal. In contrast, parties in an "open auction" can hold back their "best bid" based on the progression of the competition. For example, Mr. Semerad of AGC argued that sealed bids are proven to be cost effective:

As part of the initiative to oppose reverse auctions in Minnesota during the 2003 session, the reverse auction opponents studied five years of state highway and bridge projects to compare the engineers' estimates to low bids. It was felt that there was enough data in five years and over \$2 billion of projects to gauge the effectiveness of the sealed low-bid system. Minnesota DOT projects during the period 1998–2002 were studied. . . . The data showed that out of 1,154 projects totaling \$2.3 billion, 792 or 68.6% of the low bids beat the engineers' estimate.

Could reverse auctions improve this performance or would the experienced contractors elect not to participate, resulting in fewer bidders and higher prices from the contractors willing to take the risk? After these numbers were presented to several legislative committees, it became clear that Minnesota's current sealed low-bid system is working effectively for transportation projects and reverse auctions would not add the value contended by the advocates. It was argued convincingly that, based on the data presented, the contractors were indeed providing cost-effective transportation construction services to Minnesota taxpayers. Although data for analysis of building projects was not readily available, it could be a reasonable inference that other types of projects would follow this same pattern.

Some argue that while reverse auctions may initially lower prices, in the long term they may drive out small competitors who are unable to take the risks of participating in reverse auctions, thus decreasing competition and ultimately increasing pricing.

2. **Reverse Auctions May Encourage Imprudent Bidding.** Because reverse auctions create an environment in which bidding decisions must be made in a short and specified period of time, parties do not necessarily engage in the useful and balanced assessment, which characterizes the "sealed bid" process. The reverse auction may move too quickly for some competitors and result in rash or imprudent bids, which can be detrimental to everyone – including owners. That is, if

contractors underbid projects, they may be unable to adequately serve the owner or complete the projects.

3. **Negotiated Procurements Also Allow for a Better Evaluation of Value.** A reverse auction focuses exclusively on price and ignores other determinants of value. The reverse auction process is, by its very nature, anonymous and, therefore, parties are less able to assess the relative strengths and weaknesses of the parties making bids. Negotiated projects allow parties to establish and evaluate the quality of prior relationships and collaborations in evaluating the strength of bids. Moreover, a negotiated contract permits the contractor and owner to discuss the project in depth and address and identify issues, which may not be identified in the RFP.
4. **Sealed Bids Assure the Bidder is Responsive and Responsible.** Sealed bidding includes a consideration of past relationships and success. Sealed bidders, as discussed above, have proven track records that demonstrate accountability to the buyer. On the other hand, the reverse auction focuses on price and excludes all other considerations.
5. **Reverse Auctions May be Illegal.** Federal procurement laws do not specifically address the use of reverse auctions in construction. While some agencies, including the Departments of Defense and Navy, have used reverse auctions for commodity procurement, Federal Acquisition Regulations (FAR) may not permit such acquisitions for construction contracts. Indeed, a number of states, including Pennsylvania, Kansas, California, North Carolina, and Texas, have barred procurement of construction contracts through reverse auctions.

Bidding in Reverse Auctions

For those contractors, who decide to participate in reverse auctions, reading the fine print in the RFP is of crucial importance. As discussed above, reverse auctions are not viewed as a “relationship transaction,” but are viewed rather as a commodity exchange. Therefore, both parties will be subject to the strict terms of the RFP. It is extremely important that the contractor understands all of its rights and interests under the contract.

Additionally, contractors need to determine to what extent, if at all, parties are able to negotiate business terms apart from the actual price. For example, does the RFP require the bidder to accept all terms and prohibits negotiation relating to: change orders, time of completion, force majeure, limitation on damages, work stoppage, job site control, etc.? If there is no further ability to negotiate, the contractor needs to understand the legal and practical ramifications of the contract contained in the RFP.

Some builders have effectively used reverse auction bidding in a profitable way. However, bidders must be wary and fully understand the transaction.

Conclusion

Reverse auctions are now an integral part of commodity bidding for most government entities and many large corporations. Reverse auctions are an effective tool in commodity purchasing and they are here to stay.

The use of reverse auctions for construction in the public and private sector, however, remains unsettled. Reverse auctions are barred in some states, being considered in others, and are perfectly legal in many states. Those bidding in reverse auctions must be especially vigilant in understanding the terms of the RFP. Reverse auctions are turning construction services, which have traditionally been highly personal, and “relationship transactions” into just another commodity sold on the Internet.

SMACNA wants the Contracts Bulletins to serve our members. Your feedback or topic suggestions are welcomed by contacting Steve Yoch (e-mail: syoch@felhaber.com; telephone 651 312 6040) or Tom Soles (e-mail: tsoles@smacna.org; telephone: 703 803 2988).

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