Surety Bonding for Public Entity Outsourcing – A White Paper

A project of the NASBP Commercial Surety Committee

Purpose

The purpose of this document is to educate stakeholders about the opportunities and benefits of public entity outsourcing as a tool to contain costs, improve services, and streamline the management of public infrastructure. In addition, it outlines the many benefits and peace of mind that bonding can provide when public entities outsource. From prequalification of potential outsourcing partners to ensuring continuity of services when outsourcing partners fail to perform or fail to pay their subcontractors in a timely fashion, surety bonds are a critical tool in managing the risk associated with outsourcing.

Background

Surety bonds are used for public entity contracts to transfer risk and fulfill statutory requirements. Since 1893, the federal government has required contractors to obtain bonds for federal public works projects to assure performance of the contract and payment to certain laborers and materials suppliers. The federal law mandating surety bonds on federal construction contracts is the Miller Act of 1935. Most states and local jurisdictions have similar legislation, commonly referred to as "Little Miller Acts," which vary greatly from jurisdiction to jurisdiction.

Under applicable federal procurement regulations and to protect government and taxpayer interests, surety bonds may be require in federal procurement contexts other than for construction. Contracting authorities may require contractors to furnish bonds contracted to perform, e.g., demolition or removal of an improvement. In non-construction situations, federal contracting officers may consider use of annual performance bonds. Other types of bonds may be appropriate when federal contracting authorities acquire particular supplies or services. Examples of such bonds include advance payment bonds and patent infringement bonds.

A surety bond is a risk transfer mechanism where the surety company assures the obligee – the government entity requiring the bond - that the principal, the entity hired to fulfill the work (vendor), will perform a contract. A surety bond is based on an underlying agreement, such as a service contract, a purchase agreement, a maintenance agreement, a statute, or a settlement agreement.

Surety bonding shares some characteristics of bank credit; in that the surety company's financial resources back the vendor's commitment to complete the contract. This backing enables the vendor to enter into a contract with an obligee. Surety bonds are three-party agreements among the obligee, principal, and surety. The premium is a fee for service and is not based upon expected loss.
Vendor companies are not guaranteed a surety bond, but rather must qualify for them. That process is called prequalification or underwriting. Like traditional insurance, surety is a risk transfer mechanism and is licensed and regulated by state insurance departments.

Prequalification is an important part of the surety bonding process. The surety agents and underwriters take an in-depth look at the principal's entire business operations. The principal must demonstrate to

the surety that it is capable of completing the contract. The surety company will bond only those principals who can demonstrate that they have the capital, capacity, and character to perform the specific contract. Prequalification is done to determine if the principal can handle the scope of work in the contract, to verify a company's financial strength, and to determine if the principal can meet current and future obligations. In order to judge the financial strength of the principal, some of the areas that a surety company will investigate include: annual and interim financial statements, investment strategies, cost control mechanisms, cash flow, net worth, working capital, and bank and other credit relationships. Surety professionals go beyond the simple acquisition of financial reports to determine the capital available for the applicant to perform. The underwriter analyzes financial trends and tracks gross profits on open and completed contracts to determine the validity of the financial reports. The surety also is interested in what a principal does to keep his or her capital, and scrutinizes investment strategies, and cost control and reporting mechanisms.

The surety also wants to make certain the principal has the capacity, or ability, to perform the contract. The surety looks at the principal's: business plan, with growth and profit objectives, how work is obtained, contract size and scope, bidding practices, and geographic areas in which work is performed, organizational structure, key employees and their qualifications, established systems to schedule and control work flow, and a detailed continuity plan. Surety professionals have the expertise, experience, and objectivity to effectively prequalify a company's performance.

The prequalification process, while extensive, does not exclude small and emerging companies from qualifying to perform work. In many ways, the process educates them and prepares them to be more successful business owners by introducing them to a comprehensive view of their companies. The surety industry has developed a number of programs to educate and provide guidance to small and emerging companies about the bonding process.

This process of prequalification of vendors/service suppliers is an added assurance for public procurement officers that the suppliers/vendors they will enter into contracts with are qualified and financially sound enough to perform the vital services that are being outsourced.

While surety bonding is traditionally associated with construction projects, it is also a risk transfer tool that has been used extensively and successfully to bond all types of commercial contractual arrangements. The use of a bond ensures that qualified vendors bid on outsourced public work, and that public entities, and taxpayer dollars, are protected in the event that the outsourcing provider (or principal) is unable to perform (or fulfill) its obligations under the contract and that there is not an interruption in the delivery of vital public projects, services, and resources. Additionally, surety bonds provide assurance that the outsourcing provider's subcontractors will be paid in a timely fashion, alleviating potential risk and burden to suppliers down the chain.

How Bonds Work

The underlying agreement is the primary instrument to establish the risk associated with the guarantee. Just as the endorsement of the loan stands as a guarantee of the fulfillment of the terms and conditions of the loan agreement, a performance bond for a service contract guarantees the fulfillment of that contract.

Contract documents contain the requirements of the underlying agreement. For example, the sales-tax bond requirement is a direct result of a statute that places this obligation on the principal. Therefore, the statute is the underlying agreement being guaranteed by the sales-tax bond. Performance bonds can be utilized for various types of service contracts. One example would be a local printer bidding on a contract to supply the state with income-tax forms. Some of the contract requirements might include a very tight time schedule, large liquidated damages, the need for absolute accuracy and quality control, and/or an amount of "printer's liability insurance coverage." The surety prequalifies the printer by looking at the requirements contained in the underlying agreement. The performance bond assures the fulfillment of the underlying agreement and makes a strong representation to the owner that the contractor is fully capable of fulfilling the contract agreement, and that the surety stands behind that report with its financial guarantee.

The competitive bidding process has become the primary means of allocating public funds to contract procurement. A surety bond: assures the integrity of the competitive bidding process for project distribution, enhances "on time performance" by matching the right service contractors to the right contracts, saves tax dollars by enhancing competition and by reducing the work load of public officials in letting and managing public works projects, and protects tax payer dollars in the event of non-performance of the contract.

In summary, surety bonds provide:

- More qualified vendors
- More competitive pricing
- Timely contract performance
- Quality products and services
- Protection of tax payer dollars in the event of non-performance of outsourcing supplier/vendor
- Financial recourse for subcontractors in event of a principal's financial insolvency
- Continuity of outsourced service and protection from contract-related reputational risk to the public entity
- Provides more efficient management of public works administration for outsourced functions

Outsourcing Defined

Outsourcing is often a cost-effective and efficient alternative for public entities to provide essential public services without having to directly manage the personnel, resources, equipment, and supplies required to provide the service. It has the added benefit of aligning core capabilities of vendors with needed public services and reducing the burden of managing the service from the public entity.

Wikipedia defines outsourcing as "***the process of contracting an existing business process which an organization previously performed internally to an independent organization, where the process is purchased as a service. This practice of purchasing a business function--instead of providing it internally--is a common feature of any modern economy…"***.

Outsourcing in the public arena has grown significantly over the past decade. The Surety and Fidelity Association of America added a new class code (500) to its statistical report to represent this class of business. Based on the statistics from this class code, bonded public outsourcing has more than doubled between 2006 and 2010.

Government Opportunities

The Office of Management and Budget issued OMB Circular No. A-76 to establish improved program performance to citizens and lower costs for taxpayers. In addition OMB is making significant revisions to the processes and practices for determining whether a commercial activity will be performed by a public or private source. The expectations of OMB A-76 includes

- Increasing visibility into government management
- Ensuring effective agency planning for public-private competitions
- Promoting better service to our citizens
- Closing loopholes that diminished the return on taxpayer investments
- Ensuring commercial activities are performed by the best source at the lowest possible cost

There have been specific contracts awarded to private security forces during and after the Iraq War and new aircraft and weaponry contracts are awarded with competitive bids.

Health Care and other Social Services have created numerous opportunities for software contractors. Energy providers as well as security and educational providers have seen an increase in opportunities as well. Federal Mandates in this arena include:

- Federal health-care reforms require state administrators to finally integrate health and human services programs

- Integrated systems can realize efficiencies for States and better customer service for families. At the same time, States have a short timeframe to accomplish the eligibility system changes needed to implement Affordable Care Act health insurance changes that take effect in 2014.

States are encouraged to consider the benefits of interoperable systems, and how system development might be staged to ensure that the Affordable Care Act timeframes are met.

- A new Renewable Electricity Standard (RES) bill, sponsored by Sen. Tom Udall (D., New Mexico), requires utilities to generate 6% of energy from renewables by 2012, rising to 25% by 2025. Thirty states have renewable energy portfolio standards (three of which are voluntary). Oregon, Minnesota, and Illinois set the same 2025 target as the President's agenda and Sen. Udall's bill. Other states have more aggressive targets: California has a 20% target in effect now, rising to 33% by 2020; New Mexico targets 20% for 2020.

Various states are eagerly striving to get their data bases aligned to meet the standards that will determine their eligibility to continue receiving funds from the Federal level. There is a "carrot on the stick" that will force many states to overhaul their current software systems. This creates an opportunity for software companies. Independent software companies can bring a more global experience to the limited scope of some states experience in software engineering.

Many states have implemented renewable energy programs. We see greener residential waste companies assisting cities in recycling programs. Wind farms have cropped up in many areas. Refineries have been rebuilt to more efficient, cleaner standards brought on by federal and state mandates.

State Opportunities

Mandates trickle down. Municipalities are under tremendous pressure to maintain budgets while providing services to their communities. Federal support has decreased will also adds pressure find new and creative ways to do more with less and outsourcing is often one of the strategies employed. For example, to cut costs South Carolina, Florida, and some cities outsource school transportation. Education is a high budget item in most states. Any improvement there will help with the overall fiscal restrictions.

Some examples of outsourcing initiatives currently underway include:

- In South Carolina, the General Assembly introduced bill number H.4610 called the South Carolina School Bus Privatization Act of 2012. The bill will require local school districts to own and operate their own school buses or to contract with third-party transportation providers beginning with the 2013 school year. Florida is also seeing some of these changes. The state legislature is currently considering the Cost Comparison Bill. The bill would require Florida's 65 school districts that own and operate their own fleets to put school transportation contracts out for RFP every three years. ***Information Research Center – March 2012***

- In the town of Mamaroneck, New York, school officials have decided not to shift private-school students onto public transportation next year, but are moving ahead with plans to fully outsource the district's own bus routes. The district has been studying transportation as a way to trim costs, and expects privatization to save more than $800,000 next year. School board

members opted not to have some private-school students take public buses and trains after parents blasted the plan over logistics and safety concerns. ***April 1, 2012 – Lower Hudson Valley News (lohud.com)***

- The City of New York had an RFEI on parking technology vendors that finds open parking spots in the City (green for both the city and the vendor).
- The Virginia Department of Transportation is turning to the private sector to modernize and integrate their transportation operations centers. VDOT is very progressive in this arena. They have outsourced many other projects to outside vendors.

The Outsourcing Movement

The interest in outsourcing will only continue to grow in the public arena. As pressure to cut or contain costs increases and public expectations for efficiently administered and high quality services continue to rise, public entities will continue to explore outsourcing options.

The American City and County Special Report of December 2011[1] provided the following information on the three most important reasons why they have or will contract services:

Saves money	65.20%
Provides professional expertise	58.90%
Saves management time	33.10%
Improves operations	31.60%
Improves service quality	22.50%
More accountable	14.50%
Provides better equipment	12.60%
Improves infrastructure	11.40%
Public approval	9.70%
Improves labor relations	3.10%

Saving money is extremely important in our government offices. The majority of those surveyed see where the operations will improve and they will receive the professional expertise that is limited in their organization today.

The report provided the following satisfaction rates for those who currently outsource:

Very satisfied	18.6%
Satisfied	72.1%
Dissatisfied	7.9%
Very dissatisfied	1.4%

More than 90% of those surveyed that have outsourced are satisfied with the results.

The report asked the municipalities, "How can contractors win your business?" and the respondents said:

Guaranteed performance	63.4%
Performance standards/metrics	52.9%
Revenue or cost sharing	24.6%
Guaranteed employment of staff	13.4%
Signing bonus	2.5%
Construct new community bldgs	2.2%

Conclusion

Many of the objections to public entity outsourcing that arise could be alleviated through the use of surety bonds. The reputation of local governments for providing reliable and quality services to the public would be most effectively insured by bonding outsourced services. The prequalification process, along with performance and payment guarantees, sets the stage for outsourcing success.

[1] The survey results are printed with permission from Penton Media. The complete survey is available from *American City and County* at their website: http://americancityandcounty.com/administration/privatization-outsourcing