

RULES ON UNBALANCED PRICING HAVE CHANGED SIGNIFICANTLY*

By Joseph J. Petrillo

It is time to relearn the concept of "unbalanced bidding." At one time a prohibited practice, new rules are more liberal. The watered_down strictures on unbalanced bidding provide offerors more flexibility in pricing, and in some cases even may permit interest_free use of Government funds.

What is "Unbalanced Bidding"?

Unbalanced bidding can arise whenever the Government is ordering more than one separately priced item. Individual unit prices can be overstated or understated. Since it can occur in all kinds of contracts, unbalanced pricing is a more accurate description. Unbalanced pricing arises most frequently in two contexts.

The first context is where there is uncertainty about how many individually_priced items the Government will actually order during contract performance. This happens regularly in the context of indefinite_quantity and requirements contracts, which contemplate future orders by the Government. During the solicitation phase, the Government uses estimated quantities for bid and offer evaluation purposes. The actual quantities ordered, however, can and often do vary from the estimates used for price evaluation.

The second context is where the contract includes options for increased quantities or for additional periods of performance. For instance, service contracts are usually awarded initially for a term of one year or less, followed by a succession of options for additional periods of performance, each lasting no more than one year. Another example are supply contracts where only a portion of the items are awarded initially, and the balance are subject to the placement of orders. Since the Government is not obligated to exercise options or place orders, there is a degree of uncertainty about how many of each priced item the contractor will supply. In this second context as in the first, the Government provides estimated quantities to be used for evaluation purposes.

In either of these situations, bidders and offerors have some latitude in distributing their total price among the various contract line items. "Unbalanced bidding" refers to cases where there is an unusual or discrepant distribution of price among the line items. For instance, if performance of a services contract is expected to cost roughly the same from year to year, a price for one period which is much higher or lower than for the others might be unbalanced.

Early Response to Unbalanced Bidding.

The law regarding unbalanced bidding developed in bid protest decisions of the General Accounting Office, which inspired coverage in the procurement regulations. As the traditional rules evolved, a bid or offer could be rejected if it was both "mathematically" and "materially" unbalanced.

Mathematical unbalancing means that some prices are significantly less than cost whereas others are significantly overstated. If a bid or offer was unbalanced, however, it did not need to be rejected unless the unbalancing was "material." This usually equated to a calculation of the chance that the bid would not remain low if actual conditions varied from the evaluation model.

GAO also expressed an additional concern regarding "front_loaded" bids, i.e., those where the payments are shifted to the early part of a contract, and away from the later periods. Front_loaded prices were to be rejected when they were "tantamount" to an illegal advance payment.

The Gordon Critique.

In 1994, Dan Gordon, a lawyer at GAO published a seminal article on unbalanced bids in a journal of the American Bar Association. Gordon, "Unbalanced Bids," 24 Pub. Cont. L. J. 1 (1994). Gordon thoroughly analyzed years of bid protest decisions by GAO in this area. He criticized the decisions as being occasionally inconsistent, and as establishing legal tests which were difficult to apply.

Gordon proposed a different approach to handling unbalanced bids. Rather than the traditional analysis of mathematically and materially unbalanced prices, he proposed that the Government review unbalanced bids as a matter of risk. If the risk were acceptable, then the bid or offer could be accepted.

New Rules in FAR Part 15 rewrite.

In the mid 1990's, the Government undertook a complete rewrite of Part 15 of the Federal Acquisition Regulation, governing negotiated procurements. This rewrite adopted Gordon's proposed approach to unbalanced bidding, and made it effective in October, 1997.

In the current regulation, the old concepts of material and mathematical unbalancing are gone. The critical issue is now an assessment of risk. The new regulation continues to define an unbalanced price as one where one or more contract line items is significantly overstated or understated. When an offer is unbalanced, the contracting officer must consider the risks which would result and determine whether award "will result in paying unreasonably high prices for contract performance" If the contracting officer determines that the risk is "unacceptable," then the bid or offer can be rejected. Gone from the revised regulation is any mention of "material" unbalancing or the possibility that an unbalanced bid can constitute an advance payment.

Impact of the New Rules on GAO Bid Protests

A priori, one might expect there to be fewer successful bid protests of unbalanced bids under the new rules. The new test of "unacceptable risk" seems more vague and subjective than the old rules of mathematical and material unbalance. What degree of risk is "acceptable" is a matter of judgment. Thus, prevailing in a bid protest would seem to depend, not upon a numerical analysis of prices, but instead on overcoming the discretion of the decisionmaker.

Indeed, that has been the case. There have been a dozen GAO bid protest decisions under the new FAR language. They show an interesting trend. In none of them has a protester won.

In three decisions, GAO determined that there was no unbalanced bidding. In the remaining decisions, GAO has always affirmed the agency's risk analysis. It has not yet found an agency's risk analysis to be inadequate. In every case save one, the agency decided to accept the unbalanced price.

The GAO has cited various factors in upholding agency determinations to accept an unbalanced price. They include: confidence in the estimates used for bid evaluation; the relatively small amount of the total price which was unbalanced; the fact that the alleged unbalanced prices would net out because items would be ordered in pairs; other bids included a similar degree of risk; and a special payment provision in the solicitation which protected the Government from paying an excessive price early in the contract.

It also appears to help if the agency discusses the unbalanced pricing with the prospective contractor. In *Red River Service Corp.*, B_282634, July 15, 1999, the agency asked the offeror about unbalanced prices. It responded that the prices were based on "its own competitive pricing strategy, and its many years of experience" performing similar contracts. The agency accepted this explanation, and GAO did not gainsay it.

In a noteworthy case, Citywide Managing Services of Port Washington, Inc., B_281287.12, Nov. 15, 2000, the agency conducted no risk analysis at all, because it did not view the awardee's prices as unbalanced. GAO disagreed, and concurred with the protester that those prices were in fact unbalanced. However, GAO denied the protest, because there was no showing that the agency's estimates were unreliable. Specifically, the protester failed to show what GAO considered to be a convincing scenario under which it, and not the awardee, would be the low bidder.

In one decision, the agency determined not to accept an unbalanced bid, and GAO upheld this determination. Industrial Builders, Inc., B_283749, December 29, 1999. In that case, the bidder had failed to allocate the cost of an expensive dewatering measure among the priced work items relating to dewatering, and had instead included it in a lump_sum line item price for a relatively minor and apparently unrelated work element. As a result, its price for that line item was many multiples higher than the government's estimate or the other bids. Since the Government would have to pay for this item without any assurance that it would be completed, the agency decided that the unbalanced bid posed an unacceptable risk. Given GAO's other decisions in this area, it is possible that, if the agency had decided instead to accept the unbalanced bid, GAO still would have ruled in its favor.

GAO decisions under the new version of the FAR seem to have retreated from its prior rule that front_loaded unbalanced prices are potentially illegal advance payments. One decision notes that the language about advance payment was removed from the rewritten FAR provision, and goes on to suggest that if the risk is not unacceptable, there is no advance payment problem. GAO reaches this result by equating a determination of acceptable risk with a finding that "the government is paying a reasonable price for each of the various line items" From here, it is only a short step to conclude that "the government is not paying more than the value of the good or service being provided under each of the line items," and therefore is not making an advance payment. It is not clear, however, that contracting officers are making a separate determination of price reasonableness for each line item, as opposed to the overall contract price.

Impact of the New Rules on Bidding Strategy.

Bidders need to take into account the apparent laxity of the new rules in assessing their competitive environment. There is less chance that a competitor's bid will be rejected because it appears to be unbalanced. Similarly, bidders can put forth more aggressive bidding strategies under the new rules.

There are several ways in which a bidder can seek an advantage using an unbalanced bid. The most common way is where the bidder perceives an error in the estimated quantities used for bid evaluation. It can inflate its prices for those items where the quantities may be underestimated, and perhaps offset this with lower prices for items where the quantities appear overestimated. Thus, it can hope to achieve a bid which will be an artificially low in the evaluation but just as profitable, if not more so, during performance.

Another method which a bidder can use is to "front_load" its bid. As noted, the new regulations no longer mention this explicitly as a type of unbalanced bidding. In a front_loaded bid, the contractor will, in effect, receive advance payment for later contract work. This results in the interest_free use of money, with obvious benefits for contract financing. However, advance payments continue to be illegal, although the rules have been liberalized somewhat.

An example of front_loaded pricing allowed under the new rule appears in the Court of Federal Claims's decision in CCL Service Corp. v. United States, et al., No. 00_361, (COFC, Oct 24, 2000). That case involved a five_year contract for computer hardware maintenance in four separate geographic regions. The winning offeror proposed a first year price which was about 40% of the total price, but a fifth year price which was only about 5% of the total price. An unsuccessful offeror's protest that this amounted to improper unbalanced bidding was rejected both by the GAO in an advisory opinion and by the court. They each

concluded that the agency had made a proper assessment of risk before accepting this front_loaded price proposal. They also rejected the argument that this pricing amounted to an illegal advance payment, because there was "no showing that agency payments to [the awardee] in one year were to be applied to another year"

Thus, offerors have more ability to front load prices today than they probably had in the past.

ENDNOTES

1. "Bids" refer to procurement by sealed bidding (formerly called "formal advertising"), and "offer" is the term used in other forms of contracting, such as negotiated procurements. However, unbalanced pricing is not usually considered a problem in procurements where the source selection is not primarily based on price.

2. This structure results from funding by annual appropriations.

3. FAC 97_2, 62 Fed. Reg.51224 (Sept. 30, 1997).

4. FAR 15.404_1(g)(1). FAR 14.404_2 applies the rules in FAR 15.404_1(g) to bids.

5. FAR 15.404_1(g)(2)(i)&(ii).

6. FAR 15.404_1(g)(3).

7. Ranco Constr., Inc., B_281579, Mar. 2, 1999; Joppa Maintenance B_281579, Mar. 2, 1999; MG Industries., Inc., B_283010.3, January 24, 2000.

8. J&D Maint. & Svc. B_282249, Jun. 18, 1999; So. Atlantic Constr. Co.; Neals Janitorial Service, B_279633, 98_1 CPD ¶ 156)

9. Kellie W. Tipton Constr. Co., B_281331.3, March 22, 1999 (10%); So. Atlantic Constr.Co., B_286592.2, Apr. 13. 2001.

10. Beldon Roofing Co., , B_283970, Jan. 28, 2000.

11. So. Atlantic Constr. Co., supra.

12. Enco Dredging B_284107, Feb 22, 2000; Reese Contracting, Inc., B_285666, Aug. 21, 2000.

13. Reece Contracting, Inc., supra, citing Duke Eng'g & Sons, Inc., B_284605, May 17, 2000.

14. Slip opin. at n. 20.

15. Id. at 14.

16. Id. at n. 21.

* This article appeared in *Government Contract Audit Report*, July/Aug. 2001, page 16. Publisher is The Lyman Group, Suite 600, 1775 I St., NW, DC 20006