Department of Legislative Services

Maryland General Assembly
2005 Session

FISCAL AND POLICY NOTE
Revised

Senate Bill 324 (Senator Conway)
Education, Health, and Environmental Affairs Health and Government Operations

Procurement - Payment Security and Performance Security

This bill requires contractors to provide payment and performance security for State construction contracts over $200,000 instead of $100,000. A State procurement unit may require contractors to provide a performance bond or other security on a supplies, services, or construction-related services contract over $200,000.

The bill also requires the Department of General Services to report to the Senate Education, Health, and Environmental Affairs and House Health and Government Operations committees by November 1, 2007 on the implementation of the bill.

Fiscal Summary

State Effect: Procurement costs could decrease by a significant amount to reflect the change in threshold for contracts requiring contractor performance and payment security bonds, and increased competition from Minority Business Enterprises (MBEs) and other subcontractors being prompted to participate in State contracting.

Local Effect: None.

Small Business Effect: Potential meaningful. While some small businesses will be encouraged to bid on State contracts based on new contractor bond security requirements, there is increased risk associated with each contract not supported by security.

Analysis

Current Law: A contractor must provide payment and performance security for State construction contracts over $100,000. Additionally, if the circumstances warrant security, the State procurement unit may require for supplies, services, and construction-related services contracts over $100,000, that the contractor provide a performance bond or other security. In this case, performance security is defined as an amount that the public body deems adequate for its protection. Payment security must equal at least 50% of the total value of the contract.

A public body, other than the State or a unit of State government (*i.e.,* local governments) may require payment or performance security for a construction contract valued at $25,000 to $100,000. The security must not exceed 50% of the contract amount.

Background:

Payment Security Bonds

Payment security bonds cover risks to a subcontractor associated with a prime contractor refusing payment to the subcontractor. The protections for subcontractors in these bonds also extend down to "subsubcontractors" tier as well. The presence of payment security bonds provides subcontractors the confidence to bid competitively for portions of State contracts. Without any guarantee of payment by the contractor (or subcontractor), subcontractors (and subsubcontractors) may be inclined to avoid participation in a bid process. The subcontractors know that the risks associated with nonpayment by a prime contractor are eliminated at best, and otherwise mitigated by the bond. The presence of performance and payment security bonds adds an estimated 0.5% premium onto the cost of contracts.

Performance Security Bonds

Performance security bonds cover the risk to awarding units associated with nonperformance by a prime contractor. In that there is no privity of contract between the State and subcontractors, from the State's perspective the nonperformance by a subcontractor is realistically nonperformance by the prime contractor. In that vein, prime contractors are free to impose performance bonds against their subcontractors. However, the decision to impose a performance bond on a subcontractor is driven by market forces (*i.e.,* reputation, experience, contract size) versus a statutory requirement, as is proposed in the bill.

State Fiscal Effect: In fiscal 2003, the State procured $1.2 billion in construction contracts and approximately $2.2 billion in services, supplies, and construction-related services contracts. These procurement costs will decrease due to the following:

- *Security Premiums.* As mentioned, performance and payment security bonds add an estimated 0.5% premium onto contract prices for the State. By increasing the threshold at which a security bond is or may be required, the premium will be imposed on fewer contracts. This will have an appreciable downward effect on State contract costs.

- *MBE Participation.* The increase in the threshold for contracts requiring security may encourage more MBEs to participate as subcontractors. MBEs, like other small businesses, participate most in the State procurement process at the subcontractor level. By increasing the security threshold, a prime contractor is less likely to impose a security requirement on a subcontractor. Otherwise-able firms may be able to participate in the contract if the firm is not required to secure credit from surety companies. As more firms participate in the procurement process, prices decrease from increased competition.

In that the nonconstruction contract performance and payment security bond requirements are discretionary, a reliable estimate of the effect of the change in requirements cannot be discerned. However, the requirement that contractors obtain bond security for construction contracts valued over $200,000 is mandatory and could substantially decrease State procurement costs. As mentioned, the State procured $1.2 billion in construction contracts in fiscal 2003.

The State also faces increased risk of default by a contractor.

Small Business Effect: Small businesses will be required to purchase payment and performance security bonds less often under the bill. Those businesses that could otherwise not afford these bonds will now be able to bid on portions of State contracts.

Additional Information

Prior Introductions: None.

Cross File: None.

Information Source(s): Department of General Services, Board of Public Works, University System of Maryland, Maryland Department of Transportation, Department of Budget and Management, Department of Legislative Services

Fiscal Note History: First Reader - March 2, 2005
mll/hlb Revised - Senate Third Reader - March 28, 2005
Revised - Enrolled Bill - May 5, 2005

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