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BID CUTTING: AN EMPIRICAL STUDY OF PRACTICE IN SOUTH EAST QUEENSLAND

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ABSTRACT

The nature, status and role of bid cutting in construction bidding are examined from economic, legal, ethical and management perspectives. Some possible means of countering its negative effects are considered including its prohibition by legislation, the use of bid depositories, earlier formalisation of subcontracts, withdrawal of subcontract prices and through alternative procurement methods.

An empirical survey of bid cutting practice is described involving a sample of main contractors (MCs) and subcontractors (SCs) in SouthEast Queensland. The practice of bid cutting was found to be widespread. All the MCs considered the practice to be ethical and all the SCs considered it to be unethical. In some cases, MCs awarded contracts elsewhere, even after telling SCs they had the job. Most of the SCs had tried individually to counteract bid cutting but were unable to continue this while others were complying with MC bid cutting attempts. SC bid withdrawals are very rare and litigation is never applied by either MCs or SCs. Mainly as a result of incomplete project documentation, MCs disliked the idea of making the subcontract binding at the time of main contract bid subject to its success, although it was generally recognised that it would reduce bid-cutting by the MC – view that was also shared

by half the SCs. Most respondents thought the construction management procurement option might reduce bid cutting but none had sufficient direct experience to be sure.

Keywords: Bid cutting, bid shopping, bid peddling, bidding, tendering, subcontracting, practice, economics, law, ethics.

INTRODUCTION

The construction contract market contains many sellers and buyers, even for the same construction project. The principal 'sells' the main contract to the main contractor (MC)[1], the MC 'sells' subcontracts to subcontractors (SCs), SCs 'sell' further contracts for the supply of materials, etc, and so on down the line.

In theory at least, bid cutting can take place at any point in the project delivery process and can be exercised by any of the contract 'sellers' involved. Sellers may hunt for the best deals available from buyers by any means at their disposal. This can be either passive, by simply asking buyers for prices, or active, by negotiation on the basis of either an original buyer's price ('bid-peddling'), competitors' prices ('bid-shopping') or a seller budget figure which may be a purely arbitrary figure, based on factual or fictitious competitors' prices, or standard prices from published lists such as the Cordell or Rawlinson cost guides.

[1] It is more fruitful here to treat principals as 'selling' contracts in return for construction services and MCs 'buying' contracts with their services in return for money, in contrast with the usual line where MCs are taken to

In economic terms, there seems to be little wrong with this, the price of contracts depending on the level of demand for contracts. As long as the contract market is freely accessible and buyers are free to choose the contracts they wish to pursue, an efficient economic behaviour is maintained.

From a MC's point of view, once tenders for the main contract have closed, the intention to bid cut SCs' prices can be justified due to lack of time in the bidding period, a lack of enthusiasm from SCs, difficulty in obtaining prices from SCs etc. If the intention, however, is purely to enhance the MC's own profits, that intention, though economically rational, may be seen as unethical. From a principal's viewpoint, for example, bid cutting by a MC might be regarded as improper if the lowered costs of subcontracting are not passed on to the principal in some way (eg by an equivalent reduction in the MC's bid or through the terms of the contract itself). Similarly, a SC in this situation could feel exploited. In both cases, the accusation would be that of greediness of the MC because of an overly short-term view and at the expense of potentially valuable long-term relationships. In contrast, a MC might claim with some justification that the extra profits are needed to compensate for the disproportionately high levels of risks involved in main contracting compared with subcontracting and for which the competitive bidding system fails to adequately provide (risk values being regularly underestimated, especially by those contractors new to the field, leaving most construction projects insufficiently resourced).

According to Runeson and Uher (1985) however, greed is not the likely motive for bid cutting. "One can probably quite safely say that it is the pressure of competition and the potential for

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sellers, and principals the buyers, of construction services.

lower bids which leads to bid cutting, rather than the more simplistic view that bid cutting will lower cost without affecting the cost to the client and therefore be reflected in higher profits to builders" (p 42). It may therefore be fair to seek a reduction in a buyer price if the seller honestly believes that the buyer has overpriced the contract, especially if the seller has a preference towards a regular 'customer' or the contract involves work of a specialist nature. The cheapest price will not necessarily provide the best value for money, so preferred buyers should be given the opportunity to lower a price for other reasons (eg quality of workmanship, time on job, loyalty, etc). Another possible method of obtaining cheaper prices from experienced and preferred buyers would be to arrange bulk deals, which would ensure that their services were produced at a lower rate.

One of the most iniquitous aspects in the MC-SC relationship is the potential for MCs to exploit SCs' ignorance. A particular example of this is in legal issues concerning the construction contract itself, where detailed knowledge is of a specialised nature and sometimes available only at a cost affordable by the MC and not the SC. In such cases, the superior technical knowledge of the MC may be used at the unfortunate SC's expense. With bid cutting, the opportunity exists for unscrupulous sellers to use this as a means of achieving a covert part of a longer-term strategy to lower buyers' prices by pretending that the prices are needed for a current contract they are trying to buy. The seller can then treat these prices as a precedent when compiling a future bid by reminding the buyers of these prices later.

To counter this, buyers have several strategies available: insisting on the one-off nature of the reduced price; trying to ensure that sellers have a genuine intention to employ them on the current contract; refusing to quote prices to known or suspected bid cutters or withdrawing

quoted prices before their acceptance. At post tender stage, however, MCs are in an even stronger position to pressurise SCs and suppliers into reducing their prices, as there is a greater certainty of the MC, and therefore the SCs, actually doing the work and therefore less risk of underemployment. Therefore, MCs should be able to reduce SCs' prices by simple unilateral action.

Another potential problem associated with the means involved in bid cutting is that of disclosure. A buyer may feel that his best prices are being regularly abused if the seller freely distributes his price around. To counter this though, buyers can adopt an eleventh hour strategy by quoting prices only at the last possible moment.

A product of bid cutting is that buyers can come to depend on sellers for their work, placing the sellers in what is essentially a monopolistic position. The effect of this, as with any monopolistic situation, will be to weaken the buyers' strategies by creating the potential for sellers to jeopardise the buyers' future workload. A further problem is that if buyers have to reduce their prices too far, they may not be able to avoid making a loss and ultimately go out of business. For a MC to get 'burned' in this way seems to be to neither the MC nor SCs' advantage. Indeed, the interdependence of main and SCs could lead to the situation where the insolvency of one causes the insolvency of the other.

The extent of bid cutting in the construction industry is not known. Despite a considerable folklore, there is a dearth of previously published work on the topic. In this paper we consider some possible means of countering its negative effects including its prohibition by legislation, the use of bid depositories, earlier formalisation of subcontracts, withdrawal of subcontract prices

and through alternative procurement methods. An empirical survey of bid cutting practice is also described involving a sample of main contractors and subcontractors in SouthEast Queensland. All respondents agreed that the practice is very common. The groups differed, however, on its ethical status. Most accepted it as a necessary aspect of business practice and doubted whether improvements would be possible or practicable in the absence of corrective legislative.

POSSIBLE IMPROVEMENTS

Legislation

According to Creason (1967), “it is important to give legal effect to the factual realities of the bidding process in the construction industry, thereby eliminating the evils of bid cutting without unnecessarily restricting the general’s freedom” (p1747). In California this is manifested in the form of a statute preventing bid cutting in state government contracts. The statute is designed to prevent bid cutting that occurs *after the award of the main contract*. The view taken by the legislators in this case seems to be that bid cutting prior to award “may foster the same evils, but at least they have the effect of passing reduced costs onto the public in the form of lower prime bids” (Keating, 1990:121).

No such legislation exists in Australia. Instead, what does exist are codes of ethical practice that are intended to benefit industry by, among other things, "... the elimination of malpractice" (Standards Australia, 1993:4). The most relevant of these codes is the Interim Australian Standard Code of Tendering, AS 4120 (Int), which is designed to delegate responsibilities to

both competing bidders and the principal (client, owner). The code is very general however, the most relevant injunction being that "[Bidding] at all levels in the industry shall be conducted honestly and in a manner that is fair to all parties involved". No specific mention is made of the practice of bid cutting.

Timing of subcontract formation

The timing of the subcontract formation is clearly a crucial issue as this is the point when no further price negotiations need be tolerated by either party and should therefore obviate possible bid cutting attempts. The traditional position is that a binding contract comes into existence upon the formal acceptance by the MC of the SC's quoted price. In law, such acceptance can be formally transmitted in writing of just be mere verbal notification, although this latter method is a rather 'grey area', especially in construction bidding where discussions often occur between MC and SC before entering into a formal contract. These discussions may involve such things as programming, specifications, timing of work, payments, retentions, etc. The question therefore arises as to whether these issues are crucial before a contract can be formed, or whether they are only a mere formality to the contract.

An alternative is for the contract to become binding at the time of notification by the MC that it has used, or intends to use, the SC's price in the main contract bid. This should effectively fix the subcontract price as well as preventing the MC from going to another SC later. Empirical research by Runeson and Uher's (1985) Australian survey found a large majority of the MCs in support of this approach. Creason's USA survey also found support from the majority of SCs

and just over half the MCs surveyed, while Lewis' survey produced the same results but with only half of the SCs agreeing. One of the problems with this proposal is that, to be enforceable in law, of proving reliance on a particular SC's price. This reliance could only be determined if the MC was to disclose its proposed SCs at tender stage or with 'bid depositories'.

The method of 'bid depositories' has been used in the USA to some extent to control the problem of bid cutting. In essence, the system involves the subcontract prices being quoted to either the architect or the quantity surveyor for the project. The MCs then nominate in their bid their proposed SCs for each trade, which then contractually binds the two if the MC is subsequently awarded the main contract. The purpose of submitting the subcontract prices to an independent body is simply to prevent bid cutting after the award of the contract.

The use of bid depositories has, however, only been on a relatively small scale in the USA, with still many courts objecting to its use because it violates anti-trust laws, in that it restricts competition among MCs and SCs. In Australia and UK, bid depositories have not been used to date to control bid cutting of subcontract prices.

Withdrawal of subcontract quoted price

One rather drastic means of avoiding bid cutting is by SCs withdrawing their quoted prices before their formal acceptance for

> "According to classical ideas of freedom of contract, an offer is by its nature revocable until it is accepted, so that an offerer is not to be kept to his promise if he has indicated in good time that he will not be bound by it" (Lewis, 1982:156).

With no consideration passing (eg. in the form of an option or making the contract conditional upon award of the main contract), the MC has no legal remedy other than by the rather restrictive doctrine of promissory estoppel (Anon, 1991:8-500). The threat of withdrawal thus creates a situation coined by Schultz (1952) as "The Firm Offer Puzzle", in which the MC is dependent on the SC standing by his price, from the time it is received until the time the subcontract is awarded, matched by the dependence of the SC on the MC ultimately accepting the price without further negotiation. In theory, this should temper exploitative action by the MC. Shultz's empirical work, however, found that "... contractors in general are neither aware nor significantly influenced by the law in this area [as evidenced by] not only the almost total failure by contractors to consider serious use of contractual protective devices, but also by their complete unconcern with legal sanctions against contractors who frustrate their expectations" (Shultz, 1952:283). This was endorsed in later work by Lewis (1982) who also found how little people rely on or are interested in legal action as a method of guaranteeing the expectations which arise from a promise made in the course of business.

Alternative procurement methods

The traditional main contract system involves the principal contracting directly with one head contractor who in turn contracts with a multitude of SCs. An alternative is the Construction Management arrangement in which the principal's agent, the *construction manager*, enters numerous head contracts with the various SCs. These SCs under this system are normally called *trade contractors*. For simplicity's sake, however, we shall refer to trade contractors as SCs.

Crucially, under the Construction Management system the construction manager is paid a fee that includes a margin for head office overheads. The fee may be a lump sum, a percentage of construction costs or a combination of the two. In addition to the fee, the construction manager is reimbursed for any direct construction costs (Plant and Wilson, 1989). Thus, the principal becomes the direct beneficiary of any bid cutting activities.

Whether this method generates more or less zealous bid cutting depends on the personnel involved but it is thought that construction managers in general, with less personal interest than MCs, would be less inclined to be exploitative.

EMPIRICAL STUDY

Data collection

A series of interviews were used to examine the nature and extent of bid cutting practices, and possible areas of improvement, in the Brisbane area of SouthEast Queensland. Potential MCs and SCs involved in both traditional and Construction Management contracting were contacted. The SCs were selected from a broad range of trades representing the construction industry in total. These comprised formworkers, electricians, plumbers, curtain wall installers and ceiling SCs. Ten MCs and ten SCs agreed to take part in the survey. Six and seven responses were received from the MCs and SCs respectively.

Results

SC quoted prices

SCs usually quote their prices within two days of the main contract bid depending on the level of contract documentation, the time given to quote and the MC to whom they were quoting. SCs indicated that they deliberately submitted their quotes late in the process in order to limit the MC's opportunity to shop for lower prices. Similarly, if more than one MC wanted a price for the contract, the different submission dates were ignored and the quote was sent to each MC simultaneously.

SCs usually deliver their quotes in written form. The majority of MCs indicated that they sometimes use orally quoted subcontract prices in compiling their bids. This mainly applies to supply prices, ie. concrete, sand or fill materials. One MC indicated it never would use orally quoted prices, commenting that "We insist on a fax. If they can't afford a fax, they can't afford to pay wages". A MC who "sometimes" used orally quoted prices had compiled

a form for use in such situations, which has a list of 15 questions to ask the SC. He noted however that "problems occur when prices are quoted orally to the receptionist (due to the boss or estimator being unavailable), who cannot administer the questionnaire. Then is becomes a builder's risk decision whether to utilise the price".

SC selection

All the MCs stated that, due to the current competitive conditions in the industry, they would usually use the lowest subcontract price. One MC stated that "if other bidders are using a low price we cannot afford to ignore it". However, half of the MCs also indicated that they would check this low price with the SC to ensure it conformed to the specification and drawings before using it.

The majority of MCs indicated that they would often end up using the SC whose price they had relied upon. However, as one MC stated "due to the very competitive market, administrators usually recall prices for contracts and sometimes add additional SCs to those that tendered". In addition, another MC mentioned that the site team chooses which SC to use, and that may not be the SC upon whom the estimator has relied. This is because the site team may consider that a SC is not capable of doing the job. One MC also objected to the term 'reliance' stating "we rarely solely rely on a SC's quote to compile our own bid".

Half the MCs felt ethically bound to using a SC upon whose price they had relied in the main bid, while the other did not. One of the MCs who did went on to say, "the ethics are subject to the site team agreeing to his ability to do the work". Another MC who objected to being ethically bound stated that "due to the very competitive market, most private clients are currently screwing down builders, usually in a Dutch Auction[2] to obtain the best possible price". The MC went on to state that if the client was not bound to the MC, then he should not be bound to a SC.

Notification

The respondents generally intimated that SCs were rarely notified that their prices were being used in the main contract bid. This was recognised by MCs and SCs alike to enable MCs to retain their bargaining strength. As one MC stated, by notifying SCs "you then lose the edge to negotiate a contract price with him' although admitting that "we do indicate to SCs if asked, and tell them they are competitive or possibly in the lowest group at main bid stage".

Counter-measures

Most of the SCs had tried taking measures to counteract bid cutting. One SC said that "I tried to inflate the price, but generally that does not work as you ultimately miss out on the job". Another comment was that "when one has been used a number of times it is wise to

[2] Though not the dictionary definition of the term, this is usually interpreted by practitioners as meaning the incremental 'bidding-down' of competitors - the reverse of the incremental 'bidding-up' observed in conventional chattel-type auctions.

cease assisting those concerned". One who had not attempted any counter measures commented that "it would be very hard to stop [succumbing to bid cutting practices] ... if our competition is silly enough to do it, so be it, our company is here for the long term", implying the futilityof making any resistance.

The majority of SCs felt that they were free to withdraw their quoted prices before the main contract bid because the MC would not be disadvantaged by withdrawal at this time. Once the main contract bid was made, however, only half of the SCs said they felt free to withdraw their quoted prices. Of these, one said that "it depends on the relationship, size of error and reason for the error; we would be loath to do it, but bear in mind the price would probably be shopped around anyway". The general feeling among the MCs was that SC late withdrawals are completely unacceptable at any time. All the MCs however indicated that the practice occurred only rarely, due mainly to their taking precautions to ensure the subcontract prices are reliable. As described by one MC "where possible we contact the SC and discuss with them prior to tenders closing and if it appears that they are in error, we suggest they withdraw and inform all the other bidders they quoted to, of their withdrawal prior to tender closing". None of the respondents had ever experienced legal action being taken against a SC to bind him to its price. As one MC stated "there is no point – 99% of SCs have no financial substance, and money spent trying to recover monies would be wasted". Another MC responded by saying "we feel if its pricing is wrong, by legally binding it to its price, it will obviously not perform satisfactorily and may even go bankrupt during the contract, both of which are detrimental to the MC". The general feeling among the MCs was that the use of legal sanctions would be a waste of time and money and it would be better to simply not use that particular SC again.

Incidence of bid-cutting

Half of the SCs admitted to having lowered their prices after discussions with the MC *before* submission of the main contract bid. The reason given for lowering the prices was not to undercut other SCs but as one SC stated because of "buildability issues and design alternatives that affect cost". All SCs however had lowered their prices because of discussions with MCs *after* the award of the main contract. Some of the responses included "this is the normal procedure, contactors always put the squeeze on after they win the contract" and "Dutch Auction techniques are rampant through this industry by head contractors". One SC also commented that "it is almost unknown to be awarded a subcontract at the quoted price, even if the contractor used your price, or yours was the only price it had".

Ethics

The majority of SCs regarded the practice of lowering subcontract prices prior to the main contract bid as unethical, one SC commenting that "where a contractor uses the lowest price regardless of if the SC is capable of doing the job, and then discounts this price further, which is what is happening, then yes I consider this to be unethical". A similar viewpoint was expressed for the practice of lowering subcontract prices after the award of the main contract. However, even though SCs considered this practice to be unethical, they still went

along with it with comments such as “if you don’t negotiate then you don’t have much chance of getting the job” and “it was unethical, but through common usage it is the standard procedure, just as SCs must now screw their suppliers etc.”

All the MCs, on the other hand, considered the reducing of subcontract prices before tendering the main contract bid to be an acceptable practice. As one MC stated “if we approach a SC to lower its price, it is entirely up to him whether he reduces it or not”. Regarding ethics, one MC felt that “ethics has got nothing to do with this; this is the way the industry works; from a contractor’s perspective we would be better off if SCs did not ‘discount’ before or after tendering the main bid”. Looking at the problem from a different viewpoint, another MC stated that “a bid is a contractor’s best offer to construct a project, and however it estimates that price is its responsibility. In today’s market usually the best price wins and there is nothing for second or third, so contractors need to be very competitive”.

The MCs also did not consider it unethical to reduce subcontract prices even after the award of the main contract. Changes in circumstances were considered a major reason for this. One MC did consider it unethical if it had made a commitment to a particular SC before the main contract bid. However, this certainly would be a rare occasion.

Legal position

The respondents considered the MC's acceptance to be the point at which the subcontract becomes legally binding. For most, this meant the formal order of acceptance as, in the words of one SC "several contractors had awarded contracts elsewhere, even after telling us we'd have the job". For MCs this appears to be reasonable for, as one MC stated, "the MC is in the same boat, he doesn't have a contract either these days until a letter of intent or contract is in place. Very few clients these days accept a gentlemen's agreement (as was the case in the past), and usually take time in awarding the contract". Another MC added that "a contract is subject to too many negotiations and changes in specification to be formal until finally signed ... bid documentation would have to be fully detailed to ensure that the extent of work is totally self explanatory and this is certainly not the case at tender stage these days". For similar reasons, all the MCs and a half of the SCs disliked the idea of making the subcontract binding at the time of main contract bid subject to its success, although it was generally recognised that it would reduce bid-cutting by the MC

All the MCs stated that the principal would rarely encourage them to bid-cut when construction management arrangements were being used and most did not consider the principal to have sufficient experience and skill to do it himself. The responses by the SCs were mixed, with many of the SCs having insufficient experience of the construction management option to be able to comment. The general feeling though was that construction managers usually accept higher price levels than do MCs.

CONCLUSIONS

This paper has examined the nature, status and role of bid cutting in construction bidding from an economic, legal, ethical and management perspective. Some possible means of countering its negative effects have been considered including its prohibition by legislation, the use of bid depositories, earlier formalisation of subcontracts, withdrawal of subcontract prices and through alternative procurement methods. An empirical survey of bid cutting practice is described involving a sample of main contractors and subcontractors in SouthEast Queensland. The practice of bid cutting was found to be rampant. In the words of one SC, "it is almost unknown to be awarded a subcontract at the quoted price, even if the contractor used your price, or yours was the only price it had". All the MCs considered the practice ethical and all the SCs considered it unethical. In some cases, MCs awarded contracts elsewhere, even after telling SCs they had the job.

Most of the SCs had tried individually to counteract bid cutting but were unable to continue this while others were complying with MC bid cutting attempts. SC bid withdrawals are very rare and litigation is never applied by either MCs or SCs. Mainly as a result of incomplete project documentation, MCs disliked the idea of making the subcontract binding at the time of main contract bid subject to its success, although it was generally recognised that it would reduce bid-cutting by the MC – view that was also shared by half the SCs. Most respondents thought the construction management procurement option might reduce bid cutting but none had sufficient direct experience to know.

Bid cutting then is clearly here and looks like staying that way. But should it be so? Providing there is no deception involved, it is a both lawful and economically sustainable practice. From a client/owner point of view, it seems to be highly successful too as each layer of project participants seek to find their lowest cost solution – the bidding system ensuring that the benefits are ultimately passed on to the client in the form of reduced main contact bids. But are practices justifiable on the sole criterion of 'success'? Many believe this to be true. 'Reaganomics' is an obvious example. Its continued success rendering impossible what Westmoreland-White terms the USA's "struggle for economic justice".

The interviews revealed a predominance of self-interest of those involved. That all the main contractors believed to be ethical something that all of the subcontractors believed to be unethical is indeed a sign of the times in which we live. Perhaps the most salutary and saddest aspect of this however was the comment that the days of the 'gentlemen's agreement' are now firmly departed. There is little room for trust in a world where competitive 'edge' is everything.

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