

Date of Hearing: April 30, 2014

ASSEMBLY COMMITTEE ON JOBS, ECONOMIC DEVELOPMENT AND THE ECONOMY

Jose Medina, Chair

AB 2278 (Weber) – As Introduced: February 21, 2014

SUBJECT: State agency contracts: small business

SUMMARY: Increases the maximum financial value of an individual small business bid preference and the aggregate value that may be applied to a bid package that includes more than one preference. The bill also modifies the base of that calculation from being the lowest responsible bidder to the lowest responsible non-small business bidder. Specifically, this bill:

- 1) Increases the maximum financial value of the 5% small business procurement preference from \$50,000 to \$350,000.
- 2) Increases the maximum financial value of all combined preferences from \$100,000 to \$400,000 for any bid that includes a small business preference.
- 3) Modifies the calculation of the small business 5% preference by basing it on the bid of the lowest responsible non-small business bidder rather than just the lowest responsible bidder. A responsible bidder is a bid that is fully compliant with all contract requirements.

EXISTING LAW:

- 1) Designates the Department of General Services (DGS) as the administrator of the state Small Business Procurement and Contract Act (Small Business Act), which includes certifying and implementing targeted preference programs for certified small businesses, microbusinesses, and disabled veteran owned business enterprises (DVBEs).
- 2) Authorizes a 5% preference for state contract bidders that are either a certified small or microbusiness or a larger business that commits to using a certified small or microbusiness in effecting the contract. This 5% is calculated based on the bid of the lowest responsible bidder, which may be a small or non-small business.
- 3) Authorizes a 5% preference for a state contact bidder that agrees to perform the contract work in a designated "distressed area" and 1% to 4% workforce bidding preference in specified state service and commodity contracts valued in excess of \$100,000.
- 4) Authorizes contracting departments to offer a DVBE incentive. The application of an incentive varies from that of the small business and Target Area Contract Preference (TACPA) both when it is incorporated into competitive solicitations and how the incentive percentages are determined and calculated. Unlike preferences where there is a 5% standardized value included to competitive solicitations, discretion is left to departments to determine incentive percentages for a particular transaction based upon a business strategy to achieve their annual goal.
- 5) Defines a small business as independently owned, not dominant in its field of operation, domiciled in California, employing 100 or fewer employees, and earning \$10 million or less in average annual gross revenues for the three previous years.

FISCAL EFFECT: Unknown

COMMENTS:

- 1) Author's Purpose: According to the author, "Small businesses are the lifeblood of the economy in California. According to the Public Policy Institute of California, small businesses comprise more than 98.3% of all businesses, and are responsible for employing more than 57.9% of all workers in the state.

Currently, California small businesses get a 5% preference when bidding on state contracts. However, currently the ceiling for the preference is \$50,000. This means that the preference starts losing its value for contracts valued over \$1 million. E.g., at \$1,000,000 a small business could beat a nonsmall business with a bid of \$1,050,000. At \$3,000,000, the small can win with a bid of \$3,050,000 and so on. California small businesses have less-and-less benefit from the preference in higher value contracts, which are more difficult to prepare bids for, and where small businesses need the help most. AB 2278 increases the ceiling to \$350,000. This gives California small businesses a fighting chance at contracts up to \$7 million; a good size contract for a small business."

- 2) Framing the Policy Issue: This bill increases the maximum dollar value of the 5% small business preference from \$50,000 to \$350,000 and adjusts the current aggregate value of all preferences to reflect the increase. In proposing this change three policy issues are raised.
- The first issue is whether the current financial limit allows small businesses to successfully compete for state contracting opportunities as either a prime or as a subcontractor? Evidence and commentary by DGS suggests that the \$50,000 limitation is too low given the increasing size of state contracts.
 - The second issue flows from the first, in that, if the current \$50,000 financial limit is too low for small businesses to compete, wouldn't the same be true for the financial caps on other 5% procurement preferences, including the 5% preference for bidders undertaking contracts in low-income areas and hiring economically disadvantage individuals?
 - The third issue is perhaps an unintended consequence of the measure, but a core public policy issue none the less. Does the Legislature wish to change the current level playing field among preferences and give some groups of bidders a greater advantage? And, in making this policy choice, should small businesses be raised above contracting in high poverty areas and hiring targeted populations, or using recycled content in state purchases.

The analysis includes additional discussion on these policy areas. Comment 8 includes amendment recommendations.

- 3) The Role of Small Businesses within the California Economy: California's dominance in many economic areas is based, in part, on the significant role small businesses play in the state's \$2 trillion economy. Among other advantages, small businesses are crucial to the state's international competitiveness and are an important means for dispersing the positive economic impacts of trade within the California economy. California small businesses comprised 96% of the state's 60,000 exporters in 2009, which accounted for over 44% of total exports in the state. Nationally, small businesses represented only 31.9% of total exports. These numbers include the export of only goods and not services.

Businesses with no employees make up the single largest component of businesses in California, 2.8 million out of an estimated 3.5 million firms in 2010. As these businesses grow, they continue to serve as an important component of California's dynamic \$2 trillion economy. Microenterprises, meaning businesses with less than five employees represent approximately 93% of all businesses in the state, or approximately 3.2 million of all businesses.

State procurement law defines a small business as being independently owned and operated with a principle office in California, having less than 100 employees, and having had average annual gross receipts over the previous three years of less than \$10 million. According to the U.S. Census Bureau, businesses in California with less than 100 employees comprise nearly 98% of all businesses and employ approximately 38% of all workers.

California's non-employer and small employer firms create jobs, generate taxes, and revitalize communities. In hard economic times, smaller size businesses often function as economic engines. In this most recent recession the trend continued, with the number of nonemployer firms increasing from 2.6 million firms (\$137 billion in revenues) for 2008 to 2.8 million firms (\$138 billion in revenues) for 2010. In the post-recession economy, small businesses are expected to become increasingly important due to their ability to be more flexible and better suited to meet niche market needs.

Their small size, however, results in certain challenges in meeting regulatory requirements, accessing capital, and marketing their goods and services.

- 4) Small Business Procurement Act: The Small Business Procurement Act, administered through DGS, was implemented more than 30 years ago to establish a small business preference within the state's procurement process that would increase the number of contracts between the state and small businesses. A DBVE component was added in 1989.

The Small Business Procurement Act states that it is the policy of the State of California that the state aid the interests of small businesses in order to preserve free competitive enterprise and to ensure that a fair portion of the total purchases and contracts of the state be placed with these enterprises. The statute further states that DVBE participation is strongly encouraged to address the special needs of disabled veterans seeking rehabilitation and training through entrepreneurship, and to recognize the sacrifices of California's disabled military veterans. Statute sets an annual 3% DVBE participation goal, and a 25% goal for small and microbusinesses (through executive order).

Unfortunately, participation rates have not been as high as desired, with state agencies meeting the 25% small business goal and DVBE 3% goal, in only four out of the last 11 years. In the most recent report on procurement, 2011-12, DGS reported that the state had entered into \$7.4 billion in contracts with \$1.8 billion (24.16%) being awarded to small businesses and \$337 million (4.67%) to DVBEs.

- 5) How State Procurement Preferences Work: In order to assist agencies in reaching state participation goals, bidders for state contracts may include 5% procurement preferences. The value of any single 5% preference is limited to \$50,000 and the combined value of one or more preference cannot exceed 15% or \$100,000, whichever is lower.

The state currently recognizes two preferences based on the type of business and one preference based on the location of the business. Business type preferences include a 5% preference for bids that include a small business or microbusiness as either a prime or subcontractor. The geographically-based

TACPA provides a 5% preference for completing the contract in an economically distressed area and up to an additional 4% for hiring economically disadvantaged workers.

The state also offers a DVBE business incentive, which is similar to a preference, but the exact percentage value is determined by the contracting entity on a per bid basis and applied at a different point in the bid review process than the 5% procurement process. It is not uncommon for a bidder to apply a combination of preferences and the DVBE incentive in his or her bid package.

When a small business preference is claimed, it is calculated as 5% of the net bid price of the lowest responsible bidder. As an example, Bidder A is the lowest responsible bidder with a \$5 million bid and does not qualify for the small business preference. The contracting agency would multiply $\$5 \times 0.05 = \$250,000$. Because of the financial cap, the preference would be limited to \$50,000. Bidder B is a certified small business and submits a \$5.2 million bid. In evaluating Bidder B's bid price, the contracting department would subtract the preference adjustment from the net bid price ($\$5.2 \text{ million} - \$50,000 = \$5.15 \text{ million}$). In this example, under existing law, the nonsmall business bidder, Bidder A, would be awarded the contract.

AB 2278 proposes to change the procurement process by increasing the financial cap of the small business preference to \$350,000. Applying the AB 2278 proposed change to the example above, Bidder B would now be awarded the contract because the full benefit of the 5% preference would be calculated. More specifically, Bidder B's adjusted bid would be \$4.95 million, which is lower than Bidder A's \$5 million bid ($\$5.2 \text{ million} - \$250,000$).

While a 5% preference was sufficient to have the small business be awarded the contract, sometimes the differences between bids are larger and existing law allows for the combining of preferences. Applying the TACPA preference would provide for an additional 5% preference. AB 2278 does not change the financial value for applying an additional preference.

Please note the preference does not change the actual bid price, the calculations are performed in order to compare and rank bids.

- 6) Challenges in Meeting Procurement Goals: If small businesses are so important to the California economy, why has it been so hard for state agencies to meet the small business and DVBE procurement goals (85% of DVBE are small)? Every year, Members craft a range of bills to improve outreach, increase preferences, and use their bully pulpit to help increase small business and DVBE participation rates. Over the years, direct and innovative approaches have been added including mandating small business and DVBE liaisons at every agency, establishing official state-level Small Business and DVBE Advocates, and requiring the state join a national on-line contracting platform (BidSync).

The 2011-12 Statewide Consolidated Annual Report offers some interesting insights. As an example, only 86% of the mandatory reporting entities actually reported their contracting activity to DGS. Of those that did report: mandatory reporters awarded 24.16% of their contracts to small businesses (failed to meet the goal) and 4.67% to DVBEs (met the goal).

The DGS report suggests that part of the challenge in increasing small business and DVBE participation lies with helping the state's largest contracting agencies have more outreach and be more effective. In 2011-12, 62% of all state contracts were awarded by the Department of Corrections, the Department of Transportation, the Franchise Tax Board, and the Department of Health Care Services (DHCS). The top 10 agencies were awarded 80% of all contracts by dollar amount. This means that regardless of the

efforts of the Department of Education (76.23%) and Labor and Workforce Agency (40.59%), the state's largest contracting entities must do a better job in contracting with small and microbusiness if the state is going to reach its goal. The chart below shows the top 10 contracting departments.

Top 10 Contracting Agencies in 2011-12				
Departments	Total Contact Dollars	Percentage of Statewide Contracting	Small Business and Microbusiness Participation Percentage	DVBE Participation Percentage
All Mandatory Reporters	\$7,434,297,407		24.16%	4.67%
Corrections and Rehabilitation	1,960,625,290	26%	22.34%	5.32%
Transportation	1,872,767,028	25%	23.53%	4.04%
Franchise Tax Board	442,705,911	6%	21.11%	4.57%
Health Care Services	397,931,111	5%	5.41%	0.97%
State Hospitals	320,585,676	4%	36.27%	4.46%
Water Resources	295,652,449	4%	29.26%	8.98%
Finance (primarily the FISCAL)	217,578,977	3%	26.06%	5.48%
General Services	187,246,007	3%	38.54%	9.64%
Parks and Recreation	163,909,725	2%	36.06%	2.82%
Motor Vehicles	116,203,306	2%	24.46%	5.97%
Top 10 Total	\$5,975,205,480		23.65%	3.7%

Source: 2011-12 Statewide Consolidated Annual Report prepared by DGS

According to DGS, the state's inability to reach its small business procurement goal in 2011-12 is directly attributable to DHCS' poor performance. In the report year, DHCS issued a multiyear contract for Medi-Cal Dental Services worth \$300 million per year without any small business or DVBE participation. Had the agency met their small business goals on this one contract, DHCS would have had a 21% small business participation rate, instead of the reported 5%. DGS suggests that DHCS focus on certifying the individual dentists that will be subcontracting under the master Delta Dental contract, otherwise this single contract will continue to hold down the state's overall participation rates for years to come.

- 7) Using State Procurement Dollars for Community Reinvestment: As noted above, the small business preference is one of several preferences and incentives authorized under California law. Another important preference is TACPA, which provides a preference to businesses that undertake the contract in high poverty areas and hire targeted populations including the formally incarcerated, disadvantaged youth, and veterans.

Given that both the TACPA and small business preferences have the same percentage and financial cap, changing only one of the financial caps creates a confusing procurement policy that lacks transparency to the public who may wish to use the 5% preferences in obtaining state contracts.

More importantly, from a community development perspective, AB 2278 changes an unbiased policy between supporting small businesses and encouraging reinvestment in low income neighborhoods to asking policy makers to move the support for small businesses ahead of the pursuit of employment opportunities for disadvantaged individuals. This is a problematic policy choice.

- 8) Technical Amendments: AB 2278 increases the maximum financial value of the small business preference including the higher preference value to bids that use more than one preference that includes the small business preference.

Technical amendments are needed to make similar changes to other state preferences that can be combined with the small business preference. These amendments would result in the maximum value of all preferences in a bid package to be \$400,000 i.e. \$350,000 maximum value for 5% small business preference and \$50,000 for the maximum value of any other 5% preference.

- 9) Related Legislation: Below is a list of related legislation. While there has been an abundance of effort by the Legislature to increase small and microbusiness participation in state contracting, a majority of the measures fail to advance from the fiscal committees.
- a) *AB 31 (Price) Public Contracts: Small Business Procurement and Contract Act*: This bill increased the maximum contract threshold amount for awards to small businesses (SME), including microbusiness, and disabled veteran-owned business enterprises (DVBE) under the states streamlined procurement process, from \$100,000 to \$250,000, as specified. It required contractors to report the contract amount allocated to SMEs and DVBE 's with which they made contract commitments. Status: Signed by the Governor, Chapter 212, Statutes of 2009.
 - b) *AB 172 (Weber) State Contracting Microbusiness*: This bill would have increased the microbusiness procurement preference from 5% to 7% for state contracts to purchase goods, services, information technology, and construction of state facilities, and allowed the preference to be awarded to either a microbusiness bidder or a non-microbusiness bidder that uses a microbusiness subcontractor. Status: Held on the Suspense File of the Assembly Committee on Appropriations, 2013.
 - c) *AB 550 (Brown) State Procurement Procedures for Small Businesses*: This bill would have made key changes to state procurement procedures for the purpose of increasing small business, including microbusiness, and disabled veteran-owned business enterprise participation rates. Status: Held on the Suspense File of the Assembly Committee on Appropriations, 2013.
 - d) *AB 1734 (Jones-Sawyer) Public Contracts and Small Business and DVBE Participation*: This bill requires each state agency to establish and achieve a 25% small business participation goal and increases the annual procurement participation goal for disabled veteran business enterprises (DVBEs) from 3% to 5% of the value of state contracts: Status: Scheduled to be heard in the Assembly Committee on Accountability and Administrative Review.
 - e) *AB 1783 (Perea) Streamlining Small Business Certification*: This bill required the Department of General Services to publish on the department's website, and make available to local agencies, a list of small businesses and microbusinesses that have been certified as such by the department. Status: Signed by the Governor, Chapter 114, Statutes of 2012.
 - f) *SB 67 (Price) Small Business Participation in Public Contracts*: This bill would have authorized the Department of General Services to direct all state entities to establish an annual goal of achieving no less than 25% small business participation in state procurement contracts, as specified. Status: Held in the Assembly Committee on Appropriations, 2011.
 - g) *SB 733 (Price) High Speed Rail*: This bill would have required the California High-Speed Rail Authority (HSRA) to include in its January 1, 2012 business plan a strategy for ensuring California-certified small business participation in contracts awarded with state and federal funds during all phases of the high-speed rail project. It also required the HSRA to have a strategy for working with

the Employment Development Department to ensure that at least 25% of the project workforce at each worksite is from the local workforce. Status: Held in Senate Committee on Appropriations, 2011.

REGISTERED SUPPORT / OPPOSITION:

Support

California Association for Micro Enterprise Opportunity
California Small Business Association
The American Federation of State, County, and Municipal Employees

Opposition

None Received

Analysis Prepared by: Toni Symonds / J., E.D. & E. / (916) 319-2090