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FISCAL IMPACT REPORT

SPONSOR Rawson **ORIGINAL DATE** 2/14/2006 **LAST UPDATED** **HB**

SHORT TITLE Securities Requirement of Letter of Credit **SB** 22

ANALYST McSherry

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY06	FY07	FY08	3 Year Total Cost	Recurring or Non-Rec	Fund Affected
Total		($550.0)	($550.0)	($1.100.0)	Recurring	Public Schools Facility Fund

(Parenthesis ( ) Indicate Expenditure Decreases)

SOURCES OF INFORMATION
LFC Files

Responses Received From
Public Education Department (PED)
Regulation and Licensing Department (RLD)
New Mexico Department of Transportation (NMDOT)
General Services Department (GSD)
Energy Minerals and Natural Resources (EMNR)
Public Schools Facility Authority

SUMMARY

Synopsis of Bill

Senate Bill 22, “Securities Requirement of Letter of Credit” proposes to amend the Procurement Code, NMSA 1978, Section 13-1-148, to allow a letter of credit or other security in lieu of bonds for contractors and subcontractors for public works contracts.

The bill proposes that subcontractor bonds be executed by a surety company authorized to do business in New Mexico, and approved in federal circular 570 as published by the U.S. Treasury Department, or from a company approved by the state board of finance or the local governing authority.

FISCAL IMPLICATIONS

According to EMNRD, an irrevocable letter of credit can be issued at lower cost than a perform-

ance bond and, because of the savings, the proposed provision could lower construction costs on public works projects. The Department cites typical fee for performance and payment bonds at 3 percent, and asserts that this cost is passed along to the owner as a construction cost. This savings could be passed along to the agency.

Additionally, EMNRD reports that, depending on the availability of the irrevocable letter of credit, the pool of construction contractors available to public agencies may increase, allowing more competitive bidding on public works projects.

PSFA asserts that the current subcontractor bonding provisions have limited competition and increased the cost of construction for public works contracts, including schools, significantly:

> Of the 32 new contracts that have been awarded with funding from the PSCOC since the effective date of subcontractor bonding requirement, 17 have involved additional bonding of subcontractors at a total cost of $550.0 thousand (see attached). In fact, the cost of subcontractor bonds has exceeded the cost of the 100% payment and performance bonds already being provided by the general contractors. In other words, the bonding cost more than doubled with no benefit to the owner (schools or other public entity).

Estimated additional operational cost is estimated based upon the PSFA savings of $550 on bond costs.

SIGNIFICANT ISSUES

The bill could require the State Board of Finance or local governing authorities to institute standards for bonding companies.

According to the PSFA:

> Bonding of Subcontractors providing work of $50,000 or greater became effective in June 2005 (13-1-148.1). The current statute does not specify who the subcontractor supplies the bonds to or the form, so the majority of public owners have placed the onus on the general contractor to specify the form and sufficiency of the subcontractor bonds. This bill would require the owner (central purchasing authority) to specify and determine the validity of bonds or other securities. The subcontractor bonds are in addition to the bonds required of the general contractor and provide no additional benefit to the owner in case of default.
>
> The provisions of 13-4-18, also known as the "Little Miller Act", require all construction contracts awarded in excess of $25,000 to include a performance bond and a payment bond each equal to 100% of the awarded bid amount. The bonds are primarily intended to protect subcontractors and material suppliers by providing a remedy for recovery of monies due for performing work or providing materials on a state or local construction project. The owner and taxpayers are also protected as a mechanism to guarantee delivery of the contracted work should the awarded contractor fail to perform. This bill will allow the owner to allow other forms or securities to be accepted by the owner.

NMDOT cites the following concerns:

1. Upon the default of a contractor or subcontractor supplying a letter of credit in lieu of a Performance Bond, the agency would be entitled to make claim against the funds on deposit with the institution issuing the letter of credit, but would not be in a position

to demand from a surety that it supply a completion contractor or that it otherwise complete the project itself. The agency gets a pot of money, not a completed project. Under such circumstances the agency cannot tap into the large body of surety law that benefits the project owner in order to obtain a completed project.

2. Due in part to 9/11, there is less bonding capacity now than before, and even when surety bonds are obtainable, premiums may be exorbitant. Sureties are now more careful about what kinds of projects and which contractors they will supply bonding to. Sureties are more likely today to supply bonds on only simple straightforward projects. This militates in favor of adding letters of credit as an option.

3. An irrevocable letter of credit in lieu of a Payment Bond may be problematic. Currently, an unpaid worker or small business on a public works project can make claim against a Payment Bond under the Little Miller Act by contacting the surety, which is required to honor valid and properly documented claims. Sureties have the experience to investigate and deal with such claims—this is what they do. A banking institution issuing a letter of credit, however, may not have such experience. There is no mechanism in SB 22 for how banks are to review claims made by unpaid subcontractors, suppliers, or material men. The procedures set forth in the Little Miller Act, NMSA 1978, Section 13-4-19 only apply to claims against Payment Bonds.

EMNRD asserts that a letter of credit is only as secure as the credit of the issuing company, and that state agencies may need to consider that issue. The Department points out that the bill does not specify qualifications for the issuer of the letter of credit; whereas, under other state laws, only letters of credit from banks authorized to do business in the United States qualify.

DFA reports that:

> A letter of credit, which a is a letter from a bank stating that it has established a credit in the company's favor, is deemed to be just as secure as a bond to professionals in the field. The letter replaces the credit worthiness of the contractor with the credit worthiness of the bank issuing the letter. Therefore, as long as the bank is a reputable, financially sound bank, there shouldn't be an issue. The bill sponsor may want to consider including certain financial requirements (i.e. a certain level of debt rating) for the issuing bank in the bill.

According to GSD, a few contacts noted that a letter of credit could be more expensive than the bond and that these costs, would be passed along to the state.

GSD further asserts that:

- Performance and payment bonds assure that the project will be completed in a timely manner and guarantees against defects. With bonds, a bonding company is responsible to verify the claim and make reimbursements as well as complete any unfinished work.
- A letter of credit is only a monetary assurance. With a letter of credit, it is the agency's responsibility to:
    - Verify the claims and reimburse laborers or material suppliers if the awarded contractor failed to pay; and
    - Get another contractor to finish if the awarded contractor did not complete the project.

PERFORMANCE IMPLICATIONS

Public School Facilities Authority (PSFA) reports that one of their goals is speed of delivery, and to control costs and quality of public school construction. PSFA further reports that the subcontractor bonding requirement has increased the cost of construction of public schools. The Department contends that subcontractor bonding has reduced the pool of available subcontractors and made it more difficult to obtain qualified bids, especially in remote, rural areas of the state. PSFA asserts that bonding capacity has no correlation with quality of construction, and can favor contractor profitability over ability to deliver quality.

ADMINISTRATIVE IMPLICATIONS

According to PSFA, the extent to which subcontractors can obtain bonding is unknown and this provision could limit the number of subcontractors that are able to perform work on projects and be problematic on small rural projects.

GSD asserts that additional administrative time would be required to process documentation necessary to prove to the issuing bank the validity of a claim. The Department cites that this time would not be required in the case of a bond; rules would have to be promulgated stating the required terms and conditions of the letter of credit.

TECHNICAL ISSUES

EMNRD asserts that many state agencies would have to be updated on the terms required in the irrevocable letter of credit to ensure that the State is adequately protected in the event that the irrevocable letter of credit needs to be invoked.

According to DFA, the first part of this bill, section 13-1-1-148.1, is unclear regarding to whom the bond would be provided to. The Department contends that since the section deals with subcontractors, will the bond be provided to the state or to the general contractor.

PSFA asserts that numerous sections of the procurement code and related sections would be affected by this bill and require language changes including the "Subcontractors Fair Practices Act" and "Competitive Sealed Proposals for Construction."

PSFA further asserts that the Subcontractors Fair Practices Act requires each subcontractor submitting a bid to a contractor to submit a payment and performance bond if requested by the contractor. This section also allows the expense to be the responsibility of the subcontractor if the contractor in his written request for subcontract bids states the amount and requirements of the bonds.

OTHER SUBSTANTIVE ISSUES

PSCOA suggests that public owners may need to consult an attorney to review letters of credit for an opinion regarding whether they would actually compensate the owner in case of a default. The process for calling on the letter of credit may, in some cases, be even more cumbersome than trying to collect on a bond.

ALTERNATIVES

NMDOT suggests the following as alternatives to the proposed bill:

1. Give agencies the option to accept irrevocable letters of credit in lieu Performance Bonds, but not give bidders that option. Agencies could be required to make a written determination when such an alternative security mechanism is warranted, and would advertise that alternative in the Invitation For Bids. In the absence of such a determination, bidders would have to furnish Performance Bonds.

2. Permit contractors to furnish irrevocable letters of credit in lieu of Performance Bonds, but continue to require them to furnish Payment Bonds. Unpaid workers or small subcontractors may not have the ability to make claim against an irrevocable letter of credit, and financial institutions may not know how to handle or evaluate such claims. A Payment Bond may offer better protection to small businesses or individuals victimized by a defaulting contractor.

PSCOA suggests:

1. Re-qualification of contractors by public owners; and
2. Requiring general contractors to pre-qualify their subcontractors in order to provide better safeguards and lead to higher-quality projects

WHAT WILL BE THE CONSEQUENCES OF NOT ENACTING THIS BILL

The current language in the Procurement Code and Little Miller Act which mandates performance and payment bonds on public works projects will continue unchanged.

EM/yr