

White Paper on Performance Bonding

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Performance Bonding in Correctional Health Care Contracts

Recent developments in the surety markets have begun to have a major impact on the cost and availability of performance bonds that may be required in correctional health care contracts. Contributing factors, implications for RFP/contract development and alternative performance guarantee measures for these contracts are discussed below.

FUNCTION

The use of performance bonds has its origins in protecting the buyer's need to secure and insure the delivery of large construction or capital-intensive projects (e.g. bridges, buildings) where default of the contractor has obvious consequences. Over time, their use has been broadened to encompass performance under service-based contracts such as correctional health care providers. Specialized commercial entities known as Surety Companies attract capital that is then used to underwrite a surety bond which covers the risk of a contractor default. These companies charge a premium for this 'insurance' as well as requiring collateral for a percentage of the bond value written.

Should a contractor default on performance under its contract to the extent that another contractor and/or monetary compensation to the client is required to meet contract commitments, the commercial surety company is responsible for making such payments.

CURRENT ENVIRONMENT

Reflecting turmoil similar to that currently surrounding the medical malpractice/professional liability market, the surety industry is into its fourth year of increasing levels of loss, having been severely impacted by the events of September 11 and the Enron collapse. In 2001, the surety industry lost roughly \$1.35 for every dollar of premium generated. The results of such mounting losses are predictable:

- Less capital available to fund surety bonds
- Consolidation of the industry with fewer companies providing this product - months ago there were 16 surety reinsurers; today there are seven
- Increasing premiums - rate increases of 30-70% are not uncommon
- Diminished capacity of companies to provide performance bonds.

Typically, performance bonds are set as a percentage of the annual contract amount. This amount is not necessarily related to either a particular client's potential exposure for non-performance or the risk associated with industry-wide exposure.

As a correctional health care provider, PHS finds itself 'caught in the middle' between our clients' desire for some form of perform-

ance guarantee and the commercial market's increasingly limited and expensive premium and collateral requirements to underwrite surety coverage. Since the actual costs of purchasing and securing this coverage from commercial carriers is added directly to the proposed contract price, clients end up paying for this increasingly expensive coverage, when it is available.

NEED FOR BONDING IN CORRECTIONAL HEALTH CARE

Unlike medical malpractice insurance, it is very rare for a performance bond to be threatened or a claim filed in the performance of medical services. In fact, the frequency of vendor default in this field is quite rare. PHS has never had a claim filed against a performance, bid or other surety bond of any kind for any reason in its 23-year operating history.

As noted above, the impetus for performance bonding came primarily from large construction or capital projects where default had long-term, tangible and 'hard' costs. In contrast, the nature of a correctional health care contract means that vendor default primarily entails locating another provider through an RFP process or bringing management of these services back in-house, either of which may be accomplished within a one to three month time frame. The costs of default are basically those of time and management required during the transition period since much of the actual health care costs themselves will be incurred providing a constitutionally required level of care.

Current industry-standard ranges for performance bond requirements in correctional health care are from 10-20% of annual contract revenues; virtually no RFP's are being written or responded to by providers with performance bond requirements exceeding

these levels. However, as surety companies now seek to reduce their actual exposure on performance bonding, correctional health care providers are finding their capacity to bid new projects increasingly limited. The net result becomes a reduction in the number of RFP's to which providers can respond and a subsequent reduction in the number of competing bids that clients receive from otherwise qualified providers.

IMPLICATIONS FOR RFP'S AND CONTRACTS

While the desire for some form of performance guarantee is understandable, within the current environment, corrections clients end up paying significantly more costs for this coverage while limiting the potential number of competing bidders. For these reasons, RFPs are increasingly being written with minimal or no performance bond requirement. The added costs, limited availability and relatively low risk/low cost associated with correctional health care contract performance is driving this trend.

However, the important element of contractor accountability for performance can be obtained more cost-effectively through several other provisions including:

- Financial qualifications and due diligence
- Experience and qualifications performing under similar contracts
- Contract default provisions
- Extensive reference checks
- Operational and clinical performance measures incorporated into the contract that under defined parameters may trigger financial deductions if not met.

A final option and cost saving consideration for current clients is to progressively reduce and eliminate the bonding requirement

where PHS has established a track record of performance and contract accountability. For example, if the contract has an initial 20% bond requirement, reduce this to 10% after 2 years, to 5% in year 3 and then eliminate the bond in the following year. All savings from this process accrue directly to the client, significantly reducing total costs over the life of the contract.

SUMMARY

The market for performance/surety bonds will continue to constrict in supply and rise in cost for the foreseeable future. Correctional systems can obtain enforceable provisions for contractor performance through a number of alternatives that deliver similar protections at lower cost while maximizing the likelihood of receiving proposals from otherwise qualified bidders.