Chapter 4

FSA Procurement Auctions: How the Process Works

Introduction

To understand the issues involved in structuring FSA auctions, one needs to understand how the existing process works. This chapter describes the steps involved in administering an FSA auction, using as an example an auction held by FSA's Kansas City Commodity Office (KCCO) in late March 1996 for products to be delivered to distributing agencies during May 1996. That auction is representative of most FSA auctions, but, at the close of the chapter, we discuss recent auction changes for some commodities.

Table 4-1 summarizes the auction; column 2 defines the key steps in the auction, while column 3 lists the associated dates. Column 4 lists the time remaining, at each step, until the beginning of the delivery month (May 1, in this case). Auctions for other months frequently have slightly different days of the month for the procurement activities, but essentially the same time remaining, after accounting for weekends and holidays, until the beginning of the delivery month. In a typical auction, KCCO aims to schedule dates for each step by working backward from the beginning of the delivery month. For example, KCCO aims to receive bids and select and inform auction winners during a period that is typically 5 to 6 weeks prior to the opening of the delivery month. Actual deliveries can be scheduled for two periods—the first or second half of the delivery month.

KCCO aims to prepare final invitations about 8 weeks (55 days) before the beginning of a delivery month. A final invitation is FSA's notice of intent to purchase products, and is sent to vendors and the trade; it is a list of the tendered contracts for purchasing products. The 55-day span reflects auction experience: a shorter span would result in more failures to complete the remaining steps on time and could increase the cost of completing these activities.

FSA excludes product orders that do not arrive by the deadline. Excluded orders may sometimes be included in a special supplemental invitation and auction, with delivery in the same month as the current auction. Otherwise, late orders are held for the next month's auction.

A supplemental auction includes all the steps in other auctions, but with the time until the beginning of the delivery month compressed for steps 4 through 11. Generally, deliveries for a supplemental auction are in the latter half of the delivery month to ease the scheduling problems caused by missing the 55-day deadline. The current or regular auction has deliveries in both the first and second halves of the delivery month.

The FSA Auction Process

Information and Client Planning

USDA's Food and Nutrition Service (FNS) provides client agencies with a list of products that can be obtained from FSA and AMS auctions along with their expected prices, based on experience and forecast inflation. Client agencies include school systems as well as public and private social service agencies. Each client agency is also provided with a budget for domestic commodity distribution based upon the characteristics of the agency's target population, FNS entitlement rules, and the congressional appropriation for the current fiscal year.

Client agencies use the information to develop purchase plans, which form the basis for commodity and product orders to KCCO and AMS. The distributing agencies coordinate their plans for procurement through USDA auctions with plans for purchases with other funds. For example, school lunch providers will have access to entitlements earmarked for the purchase of FSA and AMS products, but they will also receive direct cash entitlements from FNS, revenues from the sale of lunches, and sometimes additional cash support from States and localities. In considering which FSA commodities to purchase with their food entitlements, clients will consider private sector prices and service quality, as well as menu needs, and aim to concentrate their FSA purchases on those products for which FSA offers the greatest competitive advantage.

Developing an Invitation Worklist

Schools and other distributing agencies work with FNS regional offices to develop orders for USDA products, called "delivery orders." Delivery orders for FSA products are then sent by the regional offices to KCCO (steps 1 and 2 in table 4-1). An order specifies the product desired, order size, package size, and how the product is to be shipped. Order sizes are in truckload units. A truckload unit may be split into two parts, with each part having its own final delivery destination, which is typically a warehouse designated by a coordinating State agency. Since FSA holds auctions monthly, with delivery 60-90 days after an order is placed, clients schedule their FSA purchases with that time frame in mind.

The orders are entered on worklists by KCCO, and arranged by commodity category and product. Worklists for each product are then distributed to KCCO personnel for preparation of the final invitation.

Developing and Distributing Final Invitations

KCCO takes about 1 week to prepare final invitations (step 4), while making several decisions that can influence bid prices. Orders will sometimes be combined into a larger unit if several clients order the same product for delivery to the same location, on the grounds that larger orders may attract lower bid prices. The client agency also specifies a delivery window, either the first or second half of the delivery month, in order to give processors opportunities to spread production loads by having contracts for each delivery period. By spreading production, processors may lower costs and bids, and more processors may bid. But combining orders for the same destination may reduce opportunities for spreading production loads; therefore, judgments must be made about how to combine orders.

Table 4-1: A work schedule for the March 1996 KCCO auction

Step	Activity	Date	Days until (since) May 1
1	Clients submit product orders to FNS regional offices	Ongoing	Ongoing
2	FNS delivers orders to KCCO	March 5	57
3	KCCO completes invitation worklist	March 6	56
4	KCCO completes final invitation	March 7-1	51-55
5	Final invitation is distributed	March 12-14	48-50
6	Vendors prepare and submit bids	March 18	44
7	KCCO evaluates bids and selects winning bids	March 25	37
8	KCCO informs each winning bidder of awarded contracts	March 26	36
9	Awarded contracts are publicized via FSA Internet site	March 27	35
10	"Notices to Deliver" are sent to vendors	March 28-29	33-34
11	Vendors produce, package, and ship products	April 1 - May...	30 - ...
12	Clients receive orders	May 1- May 15	0-(14)
		May 16 - May 31	(15)-(30)

Notes: KCCO is Kansas City Commodity Office, FSA is Farm Service Agency, and FNS is Food and Nutrition Service, all with the U.S. Department of Agriculture.

Some orders are selected as small-business set asides. Set-aside contracts give qualified small businesses a 5 percent bidding advantage; that is, the award will be made to a small firm if its bid is no more than 5 percent greater than the best bid.

A final invitation for a particular commodity group, such as flour, will often cover many specific orders. That is, it will separately list each delivery of a specific product, distinguished by package size and precise characteristics. For each product order, it will list a city or town to which the product is to be delivered (sometimes, two will be listed for a split load). The invitation will specify the quantity being sought for each product and destination, and it will identify any specific transportation or distinctive packaging requirements.

KCCO solicits bids by sending the final invitation for each commodity category to the appropriate vendors (step 5). The agency also publicizes the final invitation to the trade and to the public for each product through mailings and through electronic postings on the Internet. After receiving the solicitation, vendors have about 1 week to prepare their bids and return them to KCCO.

Bid Preparation and Selection

In preparing bids (step 6), vendors account for expected competition as well as product costs. Costs include the expected costs of processing, including labor, energy, and packaging materials, and also must reflect expected prices for the agricultural commodities that will be processed into FSA products. Bidders are generally fairly certain of future agricultural prices because bidding occurs only 1 to 6 weeks before processing and because many FSA products are based on agricultural commodities that have deep futures markets.

Bid prices are FOB destination at the warehouse and processor locations are specified by distributing agencies. Vendors pay transportation costs to receiving locations and, therefore, account for likely transportation costs when preparing bids. Bids also reflect distinctive USDA requirements, such as USDA labels, unusual packaging or product standards, and inspections.

Finally, bidders consider likely capacity utilization when preparing bids. Those who expect to have excess capacity at the time of processing are likely to bid aggressively (low). Since they will need to pay capital and other fixed costs whether they win the bid or not, they will seek to win the bid as long as the revenues from winning exceed only the additional variable costs associated with filling an order. By contrast, firms that expect to be producing near full capacity will bid higher; for a winning bid to be worthwhile, it will have to return more to the firm than the production that it supplants. In short, firms will be more likely to add "capacity charges" to the bid when they are already producing near full capacity.

A vendor can specify a total quantity restriction; that is, the vendor can be awarded contracts only up to the restriction quantity, even if the vendor is the low bidder on other contracts. In addition, a vendor may submit a minimum quantity restriction that specifies the lowest quantity of product the vendor is willing to supply. The minimum restriction means that the vendor chooses not to be awarded any contracts if the total quantity won is less than the specified minimum.

Bids submitted by a vendor can vary among contracts, even among contracts for the same product to the same destination. However, a vendor can bid only one price for an entire contract. Frequently, bidders submit revised bids just before they are opened to reflect the latest market information.

Bid Evaluation and Selection of Winners

KCCO opens all the bids at the same time (step 7). No revised bids are accepted after the envelopes are opened. The bids are evaluated and winners are selected on the day the envelopes are opened so that vendors can be notified the next day. Bids are binding contracts; selection of a winner obligates the winner to fulfill the contract even before being notified.

The bid evaluation is complicated because of the minimum and maximum quantity restrictions and the 5-percent bidding advantage given to small businesses. A search procedure implemented on the KCCO computer, known as linear programming, is used to select the combination of contract winners that yields the lowest total procurement costs while satisfying the restrictions.

Winning bids that are greater than a maximum purchase (constructed) price are reviewed. Constructed prices are based on prior experience and expectations of inflation, and are developed by KCCO commodity analysts prior to bid evaluation. KCCO may decide to accept the bid, or they may approach the winning bidder and attempt to get the bid reduced, or they may reject the bid and cancel the contract. Orders in canceled contracts may be reintroduced in the next auction round, and those orders are delivered late to clients, or KCCO may issue a supplemental invitation to purchase the orders for the same delivery period.

Announcement of Awards

Winning vendors are notified quickly, the day after selection, since those who have not already purchased materials (step 8) may consequently be placed in speculative positions. The price risks from these speculative positions increase in direct proportion to the elapsed time between bid submission and notification of contract awards. Winning bidders then have about 5-7 weeks to fulfill contracts with delivery in the first half of the delivery month, and about 7-9 weeks for contracts with delivery in the second half.

KCCO provides public notice of the auction results 2 days after bid openings and evaluations (step 9). The results revealed include the price and winning bidder on each contract. Releasing this information helps ensure the public that the auction is competitive and provides vendors that did not win with information about how much they must lower their bids to win at the next auction. It is important to release the information quickly because some losing bidders may have purchased materials in anticipation of winning contracts, and quick release allows for easier reallocation of materials. Finally, quick public release via electronic means saves resources for FSA and KCCO; agency personnel no longer have to respond directly to frequent requests for information.

Notices to Deliver

KCCO produces a document for each contract, called the Notice to Deliver, and sends it to the winning bidder (step 10). The notice includes the product description (for example, rice, milled U.S. No. 2 medium), as well as the contract number, invitation number, delivery order number, commodity code, contract size, package size, and shipment mode. Notices also list the name, address, and telephone number of the vendor, the distributing agency, and the designated agency person responsible for receiving the product (the consignee). The notice to deliver provides the vendor with all the information necessary for fulfilling the contract.

Production and Shipping

The vendor produces the product and ships it to the consignee (step 11). Contracts call for USDA inspectors to be on site at the plant during production runs for USDA commodities. Vendors must, therefore, arrange for inspection by personnel from AMS (peanut and dairy products and salad dressing) or GIPSA (all other items), and must generally time production runs for their presence. For remote or small plants, this can sometimes lead to delays. Inspectors monitor production processes and may perform some onsite tests. They certify product type, quality (through lab tests), and weight, and also certify that packaging meets contract standards for information, strength, and sanitary requirements. Most USDA products must be shipped with USDA labels, instead of the processor's normal brands or private labels.

Contracts also require that product samples be sent to USDA-approved labs for testing. Required tests vary with the product. For example, USDA aims for certain nutritional goals in cheese purchases, and also prefers a product that will melt properly when cooked, while stretching across a pizza or hamburger. Precise lab tests for cheese include tests of fat, moisture, salt, and acid content. Inspection procedures can also sometimes lead to delays, and products are sometimes shipped pending receipt of test results, at the vendor's risk.

Delays are not always due to USDA inspection and testing requirements. Sometimes processors will deliberately delay production because an unexpected, more lucrative, order came in. USDA can impose fines for late delivery, and can also suspend contracts for vendors that are chronically late. If USDA does not use the tools at its disposal, vendors can have strong incentives for late delivery, especially when vendors are producing near full capacity.

Distribution

The vendor informs the distributing agency by fax that the product order is being shipped (step 12). This notification must be given on the date the product is shipped. The trucker or a rail employee calls the consignee, at least 24 hours prior to delivery, to schedule delivery. FSA products are often shipped to a manufacturing plant for further processing. For example, school districts often use FSA entitlements to purchase flour and cheese, which are then shipped to nearby processors who make them into frozen pizza or other more highly processed foods.

Title to the product is transferred from vendor to distributing agency at the receiving location when the consignee signs for the product. At this stage, USDA's responsibility for product quality ends. The consignee is then responsible for any further processing, as well as product transportation to client facilities and handling at dining facilities.

Recent Variants on the FSA Auction Process

FSA has altered the typical process in recent auctions for several commodities. The alterations affect the timing of the auction process, the use of USDA labels, and the reliance on USDA inspection.

Commercially labeled items in five product categories—infant formula, evaporated milk, instant nonfat dry milk, ready-to-eat cereal, and rice cereal—are being purchased under a 5-year pilot program. The products are purchased not for the school lunch program but for two smaller programs—the Commodity Supplemental Food Program (CSFP) and the Food Distribution Program on Indian Reservations (FDPIR).

By purchasing commercially labeled products, vendors may supply USDA programs out of existing inventory, thus altering the production process outlined in step 11. Moreover, with commercial labels, FSA now relies on vendor certification of quality, since the vendor's brand is on the package. As a result, USDA inspection (also in step 11) is forgone.

The process outlined in table 4-1 uses a series of monthly auctions to procure products to be delivered to clients 5-9 weeks after the selection of winning bids. In infant formula, KCCO has lengthened the contract to a full year, while at the same time allowing commercial labels on formula. Invitations now specify an indefinite quantity to be delivered throughout the year, instead of specifying precise quantities to be delivered to specific locations each month. Contracts can be less precise in infant formula because bids show no geographic variation. Because of the longer contract duration, the volume at bid is considerably larger, and KCCO hopes that larger volume will induce more competitive bidding among the small number of manufacturers. Similarly, KCCO has lengthened contract durations for ready-to-eat cereal purchases as part of the experiment in purchasing commercially labeled products.

KCCO has altered the bidding process in another way for cheese purchases. It now issues rolling invitations, covering several months, for deliveries of cheese. For example, KCCO will issue an invitation in July to bid on deliveries of cheese in specified 2-week windows from September through December. The August invitation will then include any new school orders for October through January deliveries. In essence, the new cheese process adds certain elements of flexibility: firms can now place bids further in the future than they did under the prior system, and they can achieve more certainty, in that they can commit to USDA production for a quarter of a year at a time instead of a month. Rolling contracts also provide KCCO with the opportunity to reject winning bids that are above constructed prices, and still deliver products on time.

Under the cheese experiment, KCCO enters orders as they come in. Clients now have some reason to enter early orders, since KCCO will act upon them. In addition, KCCO can use rolling contracts to encourage client agencies to shift the temporal pattern of their orders, away from peak and toward off-peak periods, to take advantage of seasonal price fluctuations.