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# REPORT TO THE CONGRESS

UNITED STATES  
GENERAL ACCOUNTING OFFICE

AUG 27 1975

LIBRARY SYSTEM

## Extending The Government's Policy Of Self-Insurance In Certain Instances Could Result In Great Savings



Department of Defense

National Aeronautics and Space Administration

Energy Research and Development Administration

Extension of U.S. Government policy of self-insurance is feasible because of (1) the large quantity and geographic dispersion of exposure of Government property to risk and (2) the successful implementation of its policy of self-insurance on inventories under cost-type contracts, new ship construction, and assumption of all losses and damages in excess of \$300,000 to property provided under ship repair contracts.

**BY THE COMPTROLLER GENERAL  
OF THE UNITED STATES**

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AUG. 26, 1975

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COMPTROLLER GENERAL OF THE UNITED STATES  
WASHINGTON, D.C. 20548

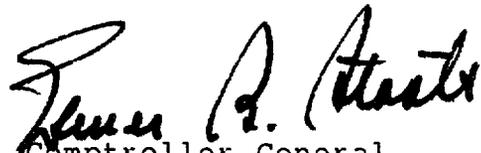
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To the President of the Senate and the  
Speaker of the House of Representatives

This is our report pointing out that reducing Federal expenditures is possible if the Department of Defense, the National Aeronautics and Space Administration, and the Energy Research and Development Administration assume the risk of loss or damage (instead of commercial insurance) to inventories slated to become Government products under negotiated fixed-price contracts and subcontracts thereunder and to Government property in custody of contractors or other users.

Our review was made pursuant to the Budget and Accounting Act, 1921 (31 U.S.C. 53), the Accounting and Auditing Act of 1950 (31 U.S.C. 67), and the authority of the Comptroller General to examine contractors' records, as set forth in 10 U.S.C. 2313(b).

We are sending copies of this report to the Director, Office of Management and Budget; the Secretary of Defense; the Administrator, National Aeronautics and Space Administration; and the Administrator, Energy Research and Development Administration.

  
Comptroller General  
of the United States

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ABBREVIATIONS

<u>1/AEC</u>	Atomic Energy Commission
ASPR	Armed Services Procurement Regulation
DCAS	Defense Contract Administrative Services
DOD	Department of Defense
ERDA	Energy Research and Development Administration
GAO	General Accounting Office
NASA	National Aeronautics and Space Administration
OSHA	Occupational Safety and Health Act

1/As of January 19, 1975, the functions of AEC were assumed by the Energy Research and Development Administration (ERDA) and the Nuclear Regulatory Commission. The activities discussed under ERDA in this report were previously the responsibility of AEC.

COMPTROLLER GENERAL'S  
REPORT TO THE CONGRESS

EXTENDING THE GOVERNMENT'S  
POLICY OF SELF-INSURANCE IN  
CERTAIN INSTANCES COULD RESULT  
IN GREAT SAVINGS  
Department of Defense  
National Aeronautics and Space  
Administration  
Energy Research and Development  
Administration

D I G E S T

The Government could have realized savings of about \$27 million during a 5-year period ended June 30, 1973, if it had extended its policy of self-insurance to

- inventories under negotiated fixed-price contracts and subcontracts thereunder,
- Federal property in custody of commercial shipyards under ship repair contracts, and
- facilities leased to contractors and other users. (See p. 18.)

The Government is already self-insuring a large amount of its property in custody of contractors. (See pp. 9 and 10.)

Extending the Government's policy of self-insurance is feasible and could result in great savings.

GAO recommends that the Secretary of Defense and, where applicable, the Administrators of the National Aeronautics and Space Administration and the Energy Research and Development Administration should extend the Government's policy of self-insurance in selected areas. (See pp. 18 and 19.)

GAO also recommends that the Department of Defense and the Energy Research and Development Administration make a joint agency study on extending the Government's policy of self-insurance to special nuclear material in custody of contractors under fixed-price contracts. (See p. 19.)

The executive branch holds the view that GAO recommendations would be feasible, subject to satisfactory resolution of certain questions, but that the level of savings would not be sufficient to justify its potential cost. (See p. 20.)

## CHAPTER 1

### INTRODUCTION

GAO has completed a study on the feasibility of extending the Government's policy of self-insuring the risk of loss or damage to direct materials, parts, and work-in-process inventories of Government contractors and subcontractors, under negotiated fixed-price supply and research and development contracts, and to Government-owned ships, buildings, and equipment placed in their custody or control. Commercial insurance is currently purchased by contractors and subcontractors to cover this real and personal property. Costs of the insurance are charged to the Government through overhead or in reduced lease or rental payments.

Insurance costs become an important factor when we consider that the prime contractor and the subcontractors obtain insurance coverage on work under end-item contracts and provide for the cost of such coverage in subcontract and prime contract prices. During the 5-year period ended June 30, 1973, the Government incurred insurance costs of about \$27 million (see p. 4) because it required contractors to assume the risk of loss or damage (1) to materials, parts, and work-in-process inventories under competitive and noncompetitive negotiated fixed-price supply and research and development contracts and subcontracts thereunder, (2) to the initial \$300,000 of losses or damages to property provided under master ship repair contracts, and (3) to industrial facilities leased to contractors and other users. High insurance costs are also being incurred by the Government where contractors are held financially responsible under fixed-price contracts for losses of special nuclear material; therefore, they insure themselves against such risks.

### GOVERNMENT'S POLICY OF SELF-INSURANCE

The Government has a long-established policy for self-insuring its property. This policy is based on the theory that the magnitude of the Government's resources, with many exposure units and geographic dispersion, makes it more advantageous for the Government to assume its own risks rather than to insure them through private insurers at rates sufficient to pay all losses and operating expenses together with a profit for the insurer. Although there is no statutory requirement on self-insurance, the Government's policy for self-insurance is expressed in the decisions of the Comptroller General of the United States and is reflected in the official business of various Government departments and agencies. The Congress has recognized this policy in some cases by

specifically prohibiting the expenditure of appropriations for payment of insurance premiums while in other cases it has authorized or required the purchase of insurance by the Government or its contractors.

The Government is already assuming the risk of loss or damage to its property provided to contractors or acquired for its account by contractors under cost-type contracts; new ship construction contracts, as specified in fixed-price contracts; or under the deductible feature of contractors' insurance policies. The Government is also responsible for losses or damages exceeding \$300,000 to property provided under ship repair contracts.

### SCOPE

The study was done at headquarters and field activities of the Department of Defense (DOD); the National Aeronautics and Space Administration (NASA); and the Energy Research and Development Administration (ERDA), formerly Atomic Energy Commission. Our selection of 14 DOD, NASA, and ERDA prime contractors and subcontractors included concerns engaged in aerospace, ships, communications and electronics, ammunition, and nuclear fuel production, with some engaged in more than one of these commodity groups. We included a review of agency, contractor, and subcontractor policies, procedures, practices, and experiences in assigning and assuming the risk of loss for Government property in the custody of contractors and subcontractors, hazard insurance practices and loss or damage experience under insurance coverage, and property safety inspections and claim settlement practices by Government activities and commercial insurance companies.

There is no central source having data on the annual cost to the Government for commercial insurance compared to actual losses reimbursed. Our inquiries of Government agencies, casualty insurance associations, State insurance offices, and State fire marshal offices failed to disclose detailed data on insurance premium costs and loss/damage experience for the industries manufacturing the commodity groups in our study. However, the data was sufficient to reasonably project premium costs to the Government and recoveries for losses or damages from insurance companies.

In evaluating the feasibility of the Government assuming the risk of loss or damage to its property now commercially insured by contractors, we considered not only the relationship of premium expense to loss experience but also what other

essential functions were being done by the insurer and whether such functions could be performed as efficiently by the Government.

Self-insurance denotes the practice of the Government assuming the risk of loss or damage to property and inventories now covered by commercial insurance against fire and other hazards or perils without accumulating a special contingency fund to cover losses or damages.

Inventories in this report include all materials, parts, and work-in-process.

## CHAPTER 2

### POTENTIAL SAVINGS COULD BE REALIZED BY

#### EXTENDING THE GOVERNMENT'S POLICY OF SELF-INSURANCE

Details of the approximate cost savings that could have been realized if the Government had assumed the risk of loss during the 5-year period ended June 30, 1973, follow.

<u>Property category</u>	<u>Estimated insurance costs</u>	<u>Estimated contractors' profit related to insurance costs</u>	<u>Total estimated cost to the Government</u>	<u>Estimated losses recovered from insurance</u>	<u>Approximate savings available to the Government</u>
----- (millions) -----					
Inventories-- prime con- tracts and subcon- tracts:					
DOD (note a)	\$17.4	\$1.8	\$19.2	\$1.4	\$17.8
NASA (note b)	.1	-	.1	-	.1
Ship repair contracts:					
DOD	<u>5.2</u>	<u>.5</u>	<u>5.7</u>	<u>1.2</u>	<u>4.5</u>
	22.7	2.3	25.0	2.6	22.4
Leased facil- ities (note c)	<u>4.7</u>	<u>-</u>	<u>4.7</u>	<u>.4</u>	<u>4.3</u>
Total	<u>\$27.4</u>	<u>\$2.3</u>	<u>\$29.7</u>	<u>\$3.0</u>	<u>\$26.7</u>

a/Excludes inventories under cost-type contracts and contracts for constructing new ships since the inventories are already self-insured by the Government, and inventories of special nuclear material.

b/Estimated profits and losses were less than \$100,000.

c/Government-owned property leased to contractors or other users.

#### BASIS FOR ESTIMATING SAVINGS

Insurance costs to the Government were computed by applying the weighted average of actual hazard insurance premium rates paid by contractors, subcontractors, or lessees to the actual or estimated insured values of Government property or inventories slated to become Government products to arrive at insurance costs. Inventory values were based on unliquidated progress payment balances for DOD prime contracts and subcontracts or on ratios of inventories to amounts of outstanding production contracts at contractors' plants for NASA prime contracts and subcontracts. Insurance costs under ship repair contracts were based on actual or

adjusted actual expenditures by the Navy for repairing or modifying ships by commercial shipyards. Lease data, leased Government property values, and insurance premium data were obtained from the military services and from lessees. However, we were unable to obtain enough information to determine the total premium expense for insuring leased Government facilities. For example, data on leases under title 10 United States Code, section 2667, were obtained for only 8 of 27 leased plants.

Profit was based on the weighted average rate of negotiated profit for fixed-price contracts as reported by contracting officers to DOD for fiscal years 1969-73.

Recoveries from insurance companies for losses or damages to inventories and leased Government facilities were extrapolated from insurance industry statistical publications at an average rate of 8 percent of the estimated cost of insurance premiums. Recoveries for losses and damages under ship repair contracts were projected at 23 percent of the premium costs from replies by 85 of the 119 commercial shipyards.

Comments on savings under the selected property categories follow.

#### MATERIALS AND WORK-IN-PROCESS INVENTORIES

The Government could have realized savings of about \$18 million during a 5-year period if it had assumed the risk of loss or damage to materials, parts, and work-in-process inventories under competitive and noncompetitive negotiated fixed-price prime contracts and subcontracts with progress payment clauses.

Under the progress payment clause, which is included in all fixed-price supply and research and development contracts on which progress payments are authorized, the Government obtains title to all parts, materials, work-in-process, special test equipment, special tooling, drawings, and technical data acquired or produced by a contractor and allocated or properly chargeable to a Government contract. Although title to such property vests in the Government immediately upon its acquisition, production, or allocation to the contract, the clause holds the contractor responsible for risk of loss or damage to the property before its delivery to and acceptance by the Government, unless the Government expressly assumes the risk. A contractor therefore purchases hazard insurance to protect against loss or damage to such inventories and includes the insurance cost in the contract price.

Additional savings could have been realized by extending the Government's policy of self-insurance to all negotiated fixed-price contracts and subcontracts without progress payments. Contractors and subcontractors also obtain insurance coverage on inventories for Government work under such contracts and subcontracts where they bear the risk of loss or damage to such inventories as normal course of manufacturing operations and charge the cost of insurance to contracts through overhead.

We believe that it would be economical for the Government to assume the risk of loss or damage to inventories under competitive and noncompetitive negotiated fixed-price supply and research and development contracts with or without progress payments, negotiated fixed-price first-tier subcontracts thereunder, and other subcontracts awarded to prime contractors.

Estimates of potential savings may be understated because of the pyramiding effect of insurance costs, including profit, on subcontracts. Prime contractors may also insure inventories furnished to subcontractors. The cost of insuring inventories at prime contract level and at the subcontract level is a factor in establishing insurable values of inventories, subcontract prices, and prime contract prices. DOD contractors and subcontractors reported awarding subcontracts totaling about \$57 billion during the 5-year period ended June 30, 1973.

#### Special nuclear material inventories

ERDA holds contractors with fixed-price contracts financially responsible for losses of special nuclear material which includes fissionable plutonium or enriched uranium used principally in fabricating nuclear weapons and as fuel for nuclear reactors. Cost of insurance for protection against such losses is an allowable contract expense.

Our study at one division of a contractor doing work for the Navy under ERDA fixed-price prime contracts indicated that this division charged these contracts with about \$650,000, including profit, for insuring special nuclear material over a 2-year period. During the period, the contractor had no incidents involving loss or damage to Government property, including inventories. We estimate that at this division, the Government could have realized savings of about \$650,000 if it had assumed the risk of loss or damage to nuclear material.

## MASTER SHIP REPAIR CONTRACTS

Savings of about \$4.5 million could have been realized by the Government during the 5-year period ended June 30, 1973, if contractors were not required under the mastership repair contracts with the Navy to obtain insurance on the first \$300,000 of the insured value of each vessel for any losses or damages to Government-owned vessels in their possession for repair, overhaul, alteration, or modification. We estimated that contract prices included costs of insurance and related profit, totaling about \$5.7 million, that could have been avoided if the Government had assumed the full risk of loss or damage to its property in contractors' possession. During the 5-year period, contractors recovered an estimated \$1.2 million, or 23 percent, of premium expense from insurance companies for losses or damages to Government property.

Our inquiries to 119 of the 157 privately owned commercially operated shipyards with Navy mastership repair contracts resulted in replies from 85 shipyards with 21 shipyards reporting a total of about \$868,000 as recoveries for losses or damages to Government ships under ship repair contracts during a 5-year period ended June 30, 1973. We projected the total loss recoveries of \$868,000 to \$1.2 million for 85 to 119 shipyards. Included in the reported recoveries from insurance companies was an amount of \$300,000 for one fire incident in a shipyard shop containing ship assemblies under repair. The total loss for the incident was estimated at \$3 million; the Government assumed the loss of \$2.7 million exceeding the insurance requirement of \$300,000 under the terms of the master ship repair contract.

## LEASED INDUSTRIAL FACILITIES

We could not determine total savings; however, we estimated the Government could have saved at least \$4.3 million during the 5-year period ended June 30, 1973, if contractors or lessees were not required to insure leased DOD industrial plants and equipment.

Although title 10, United States Code, section 2667 does not specifically require lessees to insure Government property which is leased largely for commercial work, DOD officials have construed the law to require hazard insurance coverage. However, under the Armed Services Procurement Regulation contractors may be required to obtain insurance coverage on active Government-owned facilities where commercial work exceeds 25 percent of combined total of Government and

commercial work in a plant. In both instances the Government pays for the insurance cost by reducing gross rentals for leased facilities or through overhead charges to contracts.

Some contractors, who were not required to bear the risk of loss or damage to Government property, insured Government facilities in which they performed their principal contract operations and passed the cost of the insurance to Government contracts. The reason given by contractors' representatives for obtaining the insurance was to make certain that funds would be immediately available to expedite the repair of the damaged Government property and the resumption of plant operations.

In view of the potential savings, the Government should extend its policy of self-insurance to include leased property. Where property is provided to contractors for Government production on a rent-free basis, the Government should also assume the risk of loss or damage to such property. Funding of large losses or damages to Government property is discussed under the claim settlement section of chapter 3.

## CHAPTER 3

### FEASIBILITY OF EXTENDING THE GOVERNMENT'S

#### POLICY OF SELF-INSURANCE

Government and contractor representatives had divergent opinions as to the effect, economic as well as efficiency, of extending the Government's policy of self-insurance on Government and contractor activities and operations.

Several Government and contractor representatives, however, felt that extending the Government's policy of self-insurance would be justified economically since potential savings in contract costs could be realized by reducing premium costs, and administratively, since property controls and accounting practices would be simplified, little or no additional personnel would be required, and reporting requirements would be reduced. These representatives also felt that an in-house capability existed to efficiently and promptly investigate and settle incidents of losses or damages to Government property. Problems may arise if a building or high-dollar value equipment was damaged or lost unless the Congress allows the use of other appropriated funds or unless it passes specific appropriations to finance replacement or repair. Simplified accounting and property safeguarding practices would result when contractors have both cost-type and fixed-price contracts.

Other Government and contractor representatives had certain reservations about the Government extending its policy of self-insurance. The principal concerns were: effect on administrative and accounting activities; delays in claim settlements; little, if any, effect of reducing insurance costs on overhead rates; greater risks of losses with smaller firms; and stricter Government property safety standards. Discussed below are the more important factors and objections considered in determining the feasibility of extending the Government's policy of self-insurance.

#### EXTENT OF PRESENT GOVERNMENT SELF-INSURANCE PRACTICES

The Government is already assuming the risk of loss or damage to property provided to or acquired for its account by contractors and subcontractors under cost-type contracts, new ship construction contracts, ship repair contracts when losses or damages exceed \$300,000 for each vessel, ground flight risk clause under aircraft repair, overhaul,

modification and production contracts, and production facilities provided under various contracts. The extent of the Government's self-insured risks is indicated below:

	<u>Amount</u> (billions)
Cost-type contract awards for supplies, research and development, and plant operations by DOD and NASA (FY 1973) and by ERDA (FY 1972)	\$ 7.3
New ship construction awards (FY 1972)	1.6
Government property in custody of DOD and NASA contractors and subcontractors at June 30, 1973:	
--Production facilities	15.6
--Cost-type contract inventories	3.9

Another form of self-insurance borne by the Government results from the contractors' practice of obtaining insurance with deductible features. The insurance companies pay only losses exceeding the deductibles. To reduce premium costs of commercial insurance, contractors obtain insurance with varying amounts of deductibles for each incident ranging from \$500 to \$150,000 under policies insuring inventories, from \$250 to \$5,000 under ship repair policies, and from \$50 to \$10 million under policies for leased facilities. The Government bears the loss up to the amount of the deductible either as a direct charge to the contracts or through overhead.

Contractors were making few, if any, claims for recoveries for losses or damages from insurance companies because of higher deductible limits. Of the 11 selected prime contractors and subcontractors, who furnished useful data, 9 reported no recoveries involving inventories from insurance companies in the past 5 years. The 11 prime contractors and subcontractors reported premium expenses of \$1.8 million charged to the Government with about \$60,300 recovered from insurance companies for losses. Another contractor with no recoveries from insurance companies was excluded from the above since premium expense allocations did not segregate cost of inventory coverage.

#### IMPACT OF SELF-INSURANCE ON GOVERNMENT AND CONTRACTOR ADMINISTRATIVE ACTIVITIES

Certain Government and contractor representatives claimed that extending the Government's policy of self-insurance would have an adverse effect on administrative activities by requiring increased property controls over inventories under fixed-price contracts; refinement of accounting systems to show and identify Government-owned

inventories at various stages of production, and thereby facilitating identification of losses or damages to such inventories; annual, rather than cyclical, physical inventories; increased number of contracts to be monitored by the Government representatives; increased reporting requirements; and increased investigations involving losses or damages to such inventories.

#### GAO comments

Using various options as provided by the following procurement regulations could simplify or minimize the impact of any extension of Government self-insurance. Under a multicontract cost and material control system, a contractor (1) need not identify the material activity to each contract, (2) may commingle during all performance stages Government and contractor-owned material and work-in-process inventories used in Government production without physical segregation or identification to individual contracts, (3) may continue to use established inventory practices, and (4) may be relieved from certain inventory reporting requirements.

Government administrative contracting activities are presently required to review contractor procedures for controlling and safeguarding Government-owned property in the custody of contractors either under requirements of pre-award surveys or as a continuing review in compliance with ASPR or contract clauses. As of June 30, 1973, more than 1,400 DOD contractors and subcontractors reported holding Government-owned property with a value of \$18 billion. Since a determination of a contractor's ability to perform satisfactorily under a contract is required before the award of the contract and since many of the contractors are now under property control surveillance, it appears that there would be little increase in the Government's contract administration effort if it increased the amount of property being self-insured. The increase in the number of negotiated fixed-price contract awards to a contractor does not automatically increase contract administration since a contractor's accounting, production, and property control procedures are generally reviewed on a systemwide basis.

Certain other laws require the maintenance of many records needed to implement increased self-insurance. For example, Public Law 87-653 (Truth in Negotiations), by emphasizing accurate, current, and complete pricing data, requires a cost accounting system that provides for proper allocations of direct and indirect costs to contracts, while

Public Law 91-379 requires contractors to implement accounting systems in accordance with cost accounting standards as promulgated by the Cost Accounting Standards Board.

CLAIM SETTLEMENT

Several contractors were apprehensive about the capability of Government personnel to make prompt investigation and assignment of responsibility for losses and damages and an equitable settlement of claims involving Government property.

GAO comments

Government employees have the capability to promptly investigate and settle claims involving losses or damages to Government property. Our opinion is based on claim settlement experience with insurance companies and/or Government contract administration personnel for 5 of 14 selected contractors and subcontractors. Seven contractors reported no loss or damage experience during a 5-year period. Data on the remaining two contractors was excluded since they did not report the period required to settle claims or believed the loss experience was not representative of the industry. The following chart shows that, on the average, the Government settled claims more promptly than insurance companies.

<u>Months</u>	<u>Number of months required to settle claims</u>	
	<u>Insurance companies</u>	<u>Government</u>
0-3	1	88
4-6	2	6
7-9	5	1
10-12	1	2
13-16	a/ 1	-
Total	<u>10</u>	<u>97</u>
Weighted average (all claims)	8	1.9
Weighted average (4-12 months)	8	6.6

a/Litigation over amount of damage is still pending.

Investigations by Government personnel into contractors' responsibility for losses or damages to Government property covered inventories, tooling, test equipment, industrial plant equipment, office equipment, and other Government property. Contractors were either relieved of liability or assessed for losses or damages to Government property with settlement of any assessments by reduction in fees or contract prices, adjustments in inventories, or cash reimbursements.

The number of investigations involving losses or damages to Government property including inventories would probably increase under increased Government self-insurance. However, Government administrative contract activities could simplify their claim investigation and settlement effort by holding contractors responsible for all losses under a certain limit, \$1,000 for example, and then checking out in detail claims exceeding the limit. As an alternative, DOD and NASA activities could contract out for investigating and settling claims as is done now by ERDA and by many commercial insurance companies.

Where the Government is held responsible for damage to contractors' facilities or is required to restore its own inventories or facilities used under the contract, the contractor may restore or repair the damaged property and be reimbursed through an adjustment of the contract price. Reprograming of funds might be required for funding certain dollar loss claims.

#### PROPERTY SAFETY SERVICES TO CONTRACTORS WILL CONTINUE

One of the reasons given by contractors' representatives against extending the Government's policy of self-insurance was the availability or preference for services from insurance companies. These services include property safety inspections, settling claims, reviewing construction plans, appraising property, and offering safety guides on materials and equipment.

#### GAO comments

Government contract administration offices perform property safety inspections and investigations to settle claims. To a certain extent, the insurance company property safety services duplicate services now being furnished to contractors by the administrative contracting agencies. As an alternative, the Government could contract out for property

safety services, including inspection and settlement of claims.

PROPERTY SAFETY STANDARDS SHOULD NOT BE  
STRICTER UNDER THE GOVERNMENT'S POLICY  
OF SELF-INSURANCE

Of the 14 contractors 7 believed that the Government property safety standards would not increase or be more stringent than those of insurance companies if the Government assumed the risk of loss instead of commercial insurance. Government and contractors' representatives were concerned, however, with the manner and degree of enforcement and interpretation of the Government property safety standards.

GAO comments

Government and insurance company property safety regulations are based on the same national fire safety codes. Contractors' concern about enforcement and interpretation of Government property safety standards apparently stems from the strict enforcement of the Occupational Safety and Health Act (OSHA). Although this act is oriented toward employee safety, it generally results in measures that protect property.

In some instances, however, stricter Government property safety standards may be justified. For example, a contractor was complying with all of the insurance company's property safety requirements as far as plant facilities and equipment, but, at the same time, it was not questioned about a large concentration of Government-owned aircraft in its plant for repair or modification. In this instance, Government representatives requested that the number of its aircraft in the hangar be kept at a minimum.

We foresee no problems arising from Government property safety standards if contractors comply with nationally acceptable standards which are administered prudently by Government personnel. We also believe that there would be no need for Government property safety standards to exceed present commercial insurance property safety standards since losses or damages to Government property have not been large.

CONTRACTORS' INCENTIVE TO PROMOTE  
PROPERTY SAFETY WOULD CONTINUE

Several Government representatives believed that contractors would have no financial incentive to promote safety or to comply with Government safety recommendations. However, other Government representatives felt that reputable contractors would need to maintain a proper corporate image and to prevent loss of competitive advantage through a series of substantial losses of Government property. One contractor's representatives felt that extensive business interruptions due to an accident or fire might affect contract performance and result in certain intangible costs.

GAO comments

Reputable contractors would continue to promote property safety enabling them to meet contract requirements and avoiding the loss of future business and intangible costs associated with extensive business interruptions. A contractor's incentive to exercise care will not be greatly affected by whether a casualty loss is borne by the Government or by an insurance company.

RISKS NEED NOT BE HIGHER WITH  
SMALLER COMPANIES

One contractor's representative said that smaller firms represent a greater risk because they may be less property safety conscious than larger companies.

GAO comments

We found no evidence that smaller firms are less property safety conscious than larger companies. These firms are also concerned with preventing interruptions in plant operations and failure to meet their contract requirements. Smaller firms undergo property safety inspections by insurance companies and Government activities under the same standards as used for larger concerns. The four subcontractors included in our study reported no loss recoveries from insurance companies.

LARGE COST REDUCTIONS ARE REQUIRED  
TO CHANGE OVERHEAD RATES

At two locations we were told that large reductions in costs would be required to change overhead rates because of rounding off practices. It was contended that, even if

insurance costs were eliminated from the overhead pool, there would be no reduction in the overhead rates because the insurance costs were not high enough and because of the rounding of percentage rates.

#### GAO comments

If several costs are excluded from the overhead pool, the overhead rates would eventually be reduced. Also, we have seen instances where relatively small items of overhead have been disallowed. For example, at one contractor's location where the above position was put forth, the Defense Contract Administration Services (DCAS) disallowed and excluded from the overhead pool a special insurance cost of \$11,000, which covered a sales show.

#### IMPORTANT SYSTEM REVISIONS REQUIRED TO ELIMINATE UNALLOWABLE INSURANCE COSTS QUESTIONED

Two contractors maintained that much reprogramming or revision to their cost accounting systems would be required to develop separate overhead rates or to eliminate unallowable insurance costs to the Government.

#### GAO comments

Effective April 1, 1974, the Cost Accounting Standards Board issued a standard which requires contractors and subcontractors to identify unallowable costs in their cost accounting systems.

Before this date, unallowable costs could have been readily excluded from contract costs. For example, an amount representing unallowable insurance costs could have been eliminated from total costs charged to a Government contract in the same ratio as the overhead pool costs were allocated to the contract.

#### SUBCONTRACTS

Subcontractors may be held liable for any loss or damage to Government property which is provided to them under subcontracts unless relief is obtained from the contracting officer. Generally, subcontractors obtain insurance coverage as protection against this potential liability. Under present insurance practices, both the prime contractor and subcontractor may insure concurrently the same Government property since the prime contractor is also liable for any property provided to the subcontractor.

At present, subcontractors holding Government property must maintain a property control system which is approved by the prime contractor or by the contracting officer. One contractor told us that DCAS makes about 99 percent of the reviews required under prime contracts of subcontractors' property administration. This contractor believes that its administration of subcontractors would be reduced if the Government self-insured the property.

The Government should extend its policy of self-insurance to all DOD, NASA, and ERDA negotiated fixed-price first-tier subcontractors. Regardless of tier, all subcontract work performed by a prime contractor should be self-insured by the Government. It would be inexpedient to relieve a prime contractor from responsibility for loss or damage to Government work under prime contracts and first-tier subcontracts while holding it liable for Government property provided under lower tier subcontracts. We have included inventories under subcontracts on NASA and ERDA prime contracts because many DOD contractors do NASA and ERDA work. Operations under the extended policy of self-insurance would be simplified.

## CHAPTER 4

### CONCLUSIONS AND RECOMMENDATIONS

#### CONCLUSIONS

Extending the Government's policy of self-insurance is feasible because of the large quantity and geographic dispersion of exposure of Government property to risk and because of the successful implementation of its policy of self-insurance on inventories under cost-type contracts, new ship construction, and assumption of all losses and damages exceeding \$300,000 to property provided under ship repair contracts.

It would be economical and feasible for the Government to assume the risk of loss or damage:

- To materials, parts, and work-in-process inventories in selected Federal Supply Classifications under competitive and noncompetitive negotiated fixed-price supply and research and development contracts with or without progress payment clauses, negotiated fixed-price first-tier subcontracts thereunder, and other subcontracts awarded to prime contractors.
- To the initial \$300,000 of possible losses or damages to property provided under ship repair contracts.
- To industrial facilities leased to contractors and other users.

In addition, our review at one division of an ERDA prime contractor suggested the desirability of DOD and ERDA considering the feasibility of extending the Government's policy of self-insurance to special nuclear material provided to contractors under fixed-price contracts.

#### RECOMMENDATIONS

We recommend that the Secretary of Defense and, where applicable, the Administrators of NASA and ERDA, revise procurement regulations to show that the Government is assuming the risk of loss or damage to, and that the cost of hazard insurance will not be allowed on:

- Materials, parts, and work-in-process inventories in selected Federal Supply Classifications under competitive and noncompetitive negotiated supply and research and development fixed-priced prime contracts with or

without progress payment clauses, negotiated fixed-price first-tier subcontracts, and other subcontracts awarded to prime contractors.

--Government property in custody of commercial shipyards under ship repair contracts.

--Facilities leased to contractors and other users.

Contractors and subcontractors, however, should continue to be held liable for any losses or damages due to willful misconduct or lack of good faith by their managerial personnel.

In addition, we recommend that DOD and ERDA consider the feasibility and economy of extending the Government's policy of self-insurance to special nuclear material in custody of contractors under fixed-price contracts.

## CHAPTER 5

### AGENCY AND GAO COMMENTS

NASA and ERDA generally agreed with our recommendations for extending the Government's policy of self-insurance subject to satisfactory resolution of certain questions. DOD was not convinced that the savings would be enough to justify its potential cost.

DOD and ERDA expressed willingness to cooperate in a study of the need for allowing contractors to insure special nuclear material in their custody under fixed-price contracts.

Although some points raised by the agencies required clarification by us, we believe not enough consideration was given to current agency procedures and practices and/or to our comments in the report concerning the extent of current Government (1) self-insurance practices, (2) surveillance of Government property, (3) reviews of operations of prime contractors and subcontractors, and (4) regulations allowing simplifications of inventory, property, and production controls. Also, consideration should be given to continuing underwriting services by insurance companies and using insurance industry national property safety standards. The above listed practices provide some of the controls needed for self-insurance and thus do not represent additional expenditures.

Although much of our discussion deals specifically with DOD and its regulations, it applies equally to NASA, whose procurement regulations follow closely those of DOD. In addition, DOD components provide contract administration support for many NASA contracts since contractors often hold contracts with both agencies. A discussion of the major DOD, NASA, and ERDA comments to our report follows.

#### DOD

##### Impact of extending Government self-insurance on contract administration

DOD felt that there would be an increased need for contract administration by extending the Government's policy of self-insurance. DOD, however, did not furnish any specific cost study to support its opinion. DOD estimated that potential savings could be offset by additional costs of administration. DOD pointed out that over 24,000 contractors were awarded contracts during fiscal year 1974 with the number of subcontractors

running to tens of thousands, implying that it would be necessary for the Government to self-insure inventories at all of these firms and incur increased administrative costs. NASA also felt that there would be an increase in contract administration. Likewise, it did not furnish a cost study.

#### GAO comments

Assuming large numbers of additional contract administration personnel would be required if the Government self-insured additional property is unwarranted because

- much of the property that we believe should be self-insured is located where the Government has other self-insured property and/or has staffs at contractors' plants and was therefore providing the required contract administration, including property safety inspections, investigations, and settling of claims;
- regulations currently require determining a prime contractor's responsibility to perform under a proposed contract before the award of the contract, prime contractors have a similar responsibility with respect to subcontractors;
- procurement regulations allow Government property administrators and contractors to simplify inventory, property, and production controls;
- our recommendation deals exclusively with contractors awarded negotiated fixed-price contracts and, consequently, there are noticeably fewer contractors than the number quoted by DOD; and
- property control and safety inspections continue after the Government property is leased to a contractor.

#### Reviews of contractor's operations include insurance-related activities

DOD procurement regulations already require contracting officers to make an affirmative determination of a company's responsibility to perform satisfactorily under the proposed contracts. This determination includes evaluating the company's integrity, organization, operational controls, and insurance-related technical skills including accounting systems, inventory controls, production controls and practices, property safety practices, and Government property controls. DOD has about 27,000 personnel, excluding its contract audit staff,

in its field offices and at contractors' plants. They perform contract administration, including preaward contract determinations and monitoring of contractors' performance under the contracts.

DOE, through its evaluation of contractor's operations, prior to contract award and during contract operations, is also evaluating the same operations which have a bearing on the proper execution of the Government's policy of self-insurance. These operations include the contractor's compliance with property safety requirements and the adequacy of the inventory, production, and property controls to insure proper allocation of fiscal responsibility for any losses involving Government and commercial work.

In our report we mention several options in procurement regulations which could simplify or minimize the impact of extending the Government's policy of self-insurance. We pointed out that an increase in the number of negotiated fixed-price contract awards does not automatically increase contract administration since a contractor's accounting, production, and property control procedures are generally reviewed on a systemwide basis.

Number of prime contractors and subcontractors  
under the extended policy of self-insurance

DOD stated that over 24,000 contractors were awarded contracts during fiscal year 1974, with the number of subcontracts running to tens of thousands, and that extending the Government's policy of self-insurance to all these firms would cause a vast increase in the workload of contract administration activities.

Our computer analysis of contracts awarded by DOD during fiscal year 1974 disclosed that about 7,300 of the 24,000 large and small contractors received only negotiated fixed-price type contracts for supplies and research and development. All of the other contractors received cost-type contracts (already self-insured) or cost/fixed-price contracts, advertised contracts (not appropriate for self-insurance), and foreign military sales contracts.

Further analysis disclosed that many of the 7,300 contractors were apparently supplying DOD with items of a commercial nature or items not readily susceptible to self-insurance. These items included lumber, petroleum products, office supplies, cleaning equipment and supplies, rope, live animals, subsistence, ores, and minerals. Therefore, extending the Government's policy of self-insurance would be limited to inventories for selected Federal Supply Classifications. These items would be primarily the major hard good

items, such as aircraft, missiles, and space systems. Appendix I lists the Federal Supply Classifications and research and development procurement programs which appear susceptible to self-insurance. Additional research by DOD, NASA, and ERDA may be warranted to refine or expand the list of items appropriate for self-insurance.

Our final computer analysis disclosed that about 3,300 of the original 24,000 DOD large and small contractors had only negotiated fixed-price supply and research and development contracts for supplying items in the selected Federal Supply Classifications and research and development procurement programs and therefore would be covered by our recommendation for self-insurance. Similarly, it is reasonable to expect that the number of subcontractors subject to the Government's extended policy of self-insurance would also be less than stated by DOD.

#### Extent of surveillance of leased Government facility

Surveillance is now being done by DOD personnel at Government facilities leased by contractors or other users. For example, DCAS personnel make property safety inspections of Government property whether leased to contractors or to other users, even though the lessee obtains commercial insurance coverage. Government contract administration personnel may be situated at or near Government facilities leased by contractors. Except for investigating and settling any incidents involving loss or damage to the leased Government property, we believe that no additional workload would be placed on administrative activities.

#### Inconsistent application of the Government's policy of self-insurance

We believe that DOD is following an inconsistent policy of self-insurance. DOD self-insures all losses or damages to new ships under construction with a risk exceeding a hundred million dollars while holding a contractor liable for losses or damages up to \$300,000 to Government property under ship repair contracts being done in the same shipyard. For losses exceeding \$300,000 on ship repair contracts, the Government reverts to the rule of self-insurer. Contract administration services, including property safety inspections, are performed regardless of whether the contract is for repair or new ship construction. We recognize that additional work may be required by DOD contract administration personnel to investigate and settle claims now done by the insurance companies. In our opinion, there should be no

important impact on present workload because of the infrequency of such claims.

If DOD believes the burden of settling claims to be excessive, it can contract out this activity, as some insurance companies do, for a very small fraction of the cost of commercial insurance premiums. For example, one risk management firm we contacted quoted rates ranging from 3-1/2 to 5 percent of estimated insurance premiums for investigating and settling claims and from 2 to 2-1/2 percent of estimated premiums for property safety inspection services. ERDA does contract out for investigating and settling claims. Other Government agencies, including one DOD activity, also contract out for risk management services.

Availability of services from insurance companies at reasonable costs

DOD contended that its acceptance of commercial insurance was predicated on its availability at a reasonable cost and the effectiveness of services provided by insurance underwriters.

GAO comment

With the potential savings that would accrue to the Government by extending its self-insurance policy, it appears doubtful that services provided by insurance companies are being obtained at the lowest cost to the Government. Since contractors will still purchase commercial insurance coverage on their own buildings and facilities used entirely or partially on Government work, these services will continue to be provided: property safety inspections, engineering services, and investigating and settling claims involving contractor-owned property. Consequently, Government contract work would indirectly benefit from the property safety services on contractor-owned facilities rendered by commercial insurance companies.

Savings could be eliminated by a single loss

DOD stated that the loss or damage that might have occurred at one of the Government's contractor plants in the 5-year period could have easily wiped out the savings.

GAO comment

Insurance companies exist on a calculated risk spread over long periods and many exposures with geographic dispersion. Insurance premiums must normally be sufficient to (1) set up reserves to cover losses of the insured, (2) cover

selling, administrative, and other expenses, and (3) provide a reasonable profit to the insurer for the risk. Insurance rates are generally increased when losses impair reserves. Thus the potential catastrophic loss if it incurred could very likely serve as a basis for increased commercial insurance rates that would ultimately be passed on to the Government. Conversely, the Government now bears a share of any catastrophic losses in the non-Government sector as long as the property is in the same insurance rating classification.

Under the above insurance principle, savings under the policy of Government self-insurance should exceed any casualty losses.

#### NASA

##### Legality of Government self-insuring contractor-owned property

NASA questioned (1) the legality of a Government agency assuming with possible violation of the Anti-Deficiency Act, an unlimited liability for contractor-owned inventories under fixed-price Government contracts without progress payment clauses, and (2) whether it was a necessary expense for the Government to use appropriated funds for loss or damage to contractor-owned property for which it had no current interest and which property may also be used in commercial work. NASA also felt that it may be necessary to create a reserve of appropriated funds to insure that the Anti-Deficiency Act will not be violated.

##### GAO comment

The NASA point on legality of the Government assuming the risks of loss or damage to contractor-owned inventories is appropriate. We believe, however, that the question of unlimited liability and the need to create a reserve of appropriated funds to avoid violating the Anti-Deficiency Act is not the problem as envisioned by NASA. First, the Government would self-insure only those contractor-owned inventories that are slated to become Government products. Secondly, NASA funding techniques should greatly reduce possible violations of the Anti-Deficiency Act.

In a recent decision, the Comptroller General ruled that a Government agency may assume the risk of loss of contractor-owned property, which is used solely or for the most part in performance of a Government contract, where the maximum liability is apparently determinable and that indemnity payments would not exceed available appropriations. Accordingly, contracts, which provide for assumption of the risk by the Government for contractor-owned property, must clearly show that indemnity payments could not exceed available appropriations and that nothing in the contract should be considered as implying that the Congress would appropriate funds to meet a deficiency. Otherwise, the agency should obtain legislative exemption from the application of statutory prohibitions against obligations exceeding appropriations.

We believe that the maximum liability for inventory losses is determinable. The contingent liability would be limited to materials and work-in-process inventories purchased for, set aside, or identified with work under negotiated fixed-price supply and research and development prime contracts and under negotiated fixed-price first-tier subcontracts and other subcontracts awarded to prime contractors. No problems would occur in determining extent of losses where Government work is done in segregated facilities. We also believe that there would be no great problems in assessing fiscal responsibility for losses or damages when (1) a contractor commingles materials and work-in-process inventories under Government and commercial contracts, (2) inventories are peculiar or identifiable with Government work, or (3) a contractor maintains proper inventory records, job order cost systems, or production control systems. For example, unidentifiable inventory losses on a common assembly line can be allocated in the exact ratio of inventories placed in work-in-process for Government and commercial work as recorded in production control or job order cost records. Because our recommendation would relate primarily to major hard goods items, there should be less of a problem of identifying inventories under Government contracts since many of the system components being purchased are peculiar to Government end items and probably will be identified to such work.

NASA follows basically the same procedures as DOD without establishing a special fund to finance unprogramed increases in contract costs or losses or damages to its property in custody of contractors. DOD has developed reprogramming measures in consultation with congressional committees for providing a timely device for achieving

flexibility in the execution of defense programs and thereby avoid any violations of the Anti-Deficiency Act. Under the DOD procedures certain reprogramming actions require approval only within DOD while others require prior approval or notification to congressional committees. DOD must report semiannually to the Congress on all reprogramming actions.

We believe that it would be appropriate for the Government to self-insure contractor-owned inventories slated to be included in Government products because the potential savings will reduce contract prices. The Government also has interest in the inventories because of costs incurred in quality assurance surveillance and, in case of a contract termination, it will be required to purchase any remaining inventories. We are not advocating that the Government self-insure any inventories slated for commercial work.

Additional factors need  
consideration in extension of  
Government's policy of self-insurance

NASA felt there should be no diminution or waiver of a contractor's liability for loss or damage to Government property resulting from fraud, willful misconduct, or lack of good faith.

GAO comment

Under current DOD and NASA procurement regulations, when the Government assumes the risk of loss or damage to its property the contractor is still held responsible for any losses or damages to the property due to willful misconduct or lack of good faith on the part of its directors, officers, and management personnel. Our recommendation is revised to emphasize continuing this policy.

NASA was of the opinion that Government self-insurance should not apply in cases where loss or damage to property is covered by contractors' existing general insurance coverage.

GAO comment

Contractors obtain commercial insurance coverage because they are required to bear the risk of loss or damage to the covered property. We believe contractors would no longer obtain such coverage on property or inventories slated to become Government products if they no longer bore the risk for such property, even though title to such property passes to the Government upon delivery. The Cost

Accounting Standards Board recently issued a standard which requires contractors to identify unallowable costs in their cost accounting systems.

NASA suggested that precautions must be taken to discourage carelessness or negligence by contractors.

GAO comment

Precautions must be taken to discourage carelessness or negligence by contractors. We suggest that contractors could be held responsible for all losses under \$1,000 to discourage contractors' carelessness or negligence and to simplify claim investigation and settlement.

Specific details desired on implementing Government property safety standards

NASA felt that the report did not give enough detail on (1) the Government's authority for prescribing "nationally acceptable" property safety standards, (2) any concept or plan for assuring implementation of such standards, (3) assessment of contractors' compliance, or (4) categories of Government personnel that would be expected to "prudently administer" such standards.

GAO comments

Our report does not advocate that the Government establish new "nationally acceptable" property safety standards. We stated that the Government and insurance company property safety standards are based on the same national fire safety codes. The property safety requirements being imposed on contractors by either Government or insurance company inspectors should be very similar. For example, we found that the NASA safety manual requires as a minimum that fire prevention and protection standards must follow insurance industry national fire codes.

Review of the NASA safety manual indicates a well-defined safety program and includes guidelines, instructions, and requirements for promoting a responsible approach to safety matters. Also included are the organizational responsibilities and personnel training guidelines for carrying out the safety program as well as procedures to be followed in assuring implementation of property safety standards by contractors. Although contractors are expected to be responsible and responsive in safety matters, their

compliance with NASA safety requirements will be dependent on contractual agreements. NASA procurement regulations set forth the requirements for inserting safety provisions in contracts. Provisions can be established for halting work when safety considerations warrant such action where provided for in NASA contract.

When a contract prescribes a general safety clause, NASA requires that the contractor's safety program and performance are to be evaluated during the initial stages of contract work and subsequently, at least annually, throughout the life of the contract.

We believe it is an agency's responsibility to designate organizational responsibilities and types of personnel required to carry out its programs. The NASA safety manual provides for the type of organization required to carry out its safety program. Notwithstanding the available skilled property safety personnel, we still believe that property safety standards must be prudently administered and that they should not result in property safety requirements stricter than those levied by commercial insurance inspectors.

NASA also raised the question whether the self-insurance program should be handled by individual agencies or by a central agency. Since our study did not address this area, we are not in a position to comment thereon.

#### ERDA

#### Contracting officer should have option to allow a vendor to insure risk of loss under contract

ERDA agreed with and supported the concept of Government self-insurance if more beneficial and economical than coverage under private insurance company. However, ERDA felt that a contracting officer should have the latitude of allowing a vendor to assume the risk of loss or damage to inventories and properties under fixed-price prime contractors and subcontractors if the savings under the self-insurance policy were offset by reduced contractors' incentive for careful handling and care of materials and in-process work.

### GAO comments

It would not be practical to grant such latitude to a contracting officer because his decision would be based on circumstances involving a local situation without considering the relationship of benefits-versus-costs under the overall self-insurance policy. Self-insurance is justified on the theory that the magnitude of the Government's resources with many exposure units and geographic dispersion makes it more advantageous for the Government to assume its own risks rather than insuring them through private insurers.

Reputable contractors would continue to be motivated to promote property safety regardless of whether they are privately insured. Also, making contractors financially responsible for all incidents up to \$1,000 would be an added incentive to promote property safety practices.

Furthermore, inclusion of a contract clause holding contractors liable for any losses due to willful misconduct or lack of good faith should make them more careful in maintaining property safety standards.

### Recommending a joint study to determine feasibility of self-insuring special nuclear materials

ERDA felt that the reference to DOD should have been instead to its Division of Naval Reactors. However, it expressed its willingness to review the feasibility of such a policy extension.

### GAO comment

The entire production at the contractor's location selected for the study was for the Department of the Navy under ERDA prime contracts. All costs, including the cost of insuring special nuclear material, was charged to the production contracts. ERDA holds contractors with fixed-price contracts financially liable for losses of special nuclear material. In addition, DCAS and the Defense Contract Audit Agency furnished certain contract administration and audit services under these contracts. For these reasons, we suggested and both DOD and ERDA agreed to participate in the study to determine the feasibility of extending the Government's policy of self-insurance to special nuclear material under fixed-price contracts. We expect to be advised as to the result.

DOD agreed to the joint study even though it felt that its procedures under Public Law 85-804 provided for

indemnification of contractors where nuclear risk is involved. Our review of the background for the law and the implementing procurement regulations disclosed that the indemnification clause under fixed-price contracts protects contractors against loss or damage to Government-owned special nuclear material, but only to the extent that such loss or damage arises out of or results from an unusually hazardous or nuclear risk which the use of the nuclear material may create.

LIST OF SUGGESTED FEDERAL SUPPLY CLASSIFICATIONS  
AND PROCUREMENT PROGRAMS UNDER WHICH  
INVENTORIES APPEAR SUSCEPTIBLE TO  
GOVERNMENT'S POLICY OF SELF-INSURANCE

SUPPLIES AND EQUIPMENT

<u>FSC</u>	<u>Description</u>
10	Weapons
12	Fire control equipment
13	Ammunition and explosives
14	Guided missiles
15	Aircraft and airframe structural components
16	Aircraft components and accessories
17	Aircraft launching, landing, and ground handling equipment
a/ 19	Ships, small craft, pontoons, and floating docks
20	Ship and marine equipment
23	Motor vehicles, trailers, and cycles
28	Engines, turbines, and components
29	Engine accessories
42	Fire fighting, rescue, and safety equipment
44	Furnace, steam plant, drying equipment, and nuclear reactors
58	Communication equipment
59	Electrical and electronic equipment components
66	Instruments and laboratory equipment
69	Training aids and devices
84	Clothing and individual equipment

RESEARCH, DEVELOPMENT, TEST, AND EVALUATION  
PROCUREMENT PROGRAMS

Airframes and related assemblies and spares  
Aircraft engines and related spares and spare parts  
Other aircraft equipment and supplies  
Missile and space systems  
Ships (note a)  
Tank-automotive  
Weapons  
Ammunition  
Electronics and communication equipment

a/New ship construction is already under the Government's policy of self-insurance.



ASSISTANT SECRETARY OF DEFENSE  
WASHINGTON, D.C. 20301

29 JAN 1975

## INSTALLATIONS AND LOGISTICS

Mr. R. W. Gutmann  
Director, Procurement and  
Systems Acquisition Division  
U.S. General Accounting Office  
Washington, D.C. 20548

Dear Mr. Gutmann:

This is in reply to your letter of September 25, 1974, to the Secretary of Defense forwarding for comment a draft report entitled, "Study on the Feasibility and Economies Obtainable Through Extension of Government's Policy of Self-Insurance," (OSD Case #3911).

The report indicates that as a result of reviews at fourteen prime contractors and subcontractors of the Department of Defense (DoD), National Aeronautics and Space Administration (NASA), and Atomic Energy Commission (AEC), and replies from eighty-five commercial shipyards to a questionnaire, the Government could have realized a savings of about \$27 million during a five-year period if it had extended its self-insurance policy to certain areas presently covered by commercial insurance.

The report recommends that:

1. The Secretary of Defense revise procurement regulations to show that the Government is assuming the risk of loss or damage to, and that the cost of hazard insurance would not be allowed on:

- Inventories and property under competitive and non-competitive negotiated fixed-price prime contracts with or without progress payment clauses, on first-tier subcontracts, and on other subcontracts awarded to prime contractors.

- Government property in custody of commercial ship-yards under ship repair contracts.
- Facilities leased to contractors and other users.

2. DoD and AEC consider the feasibility and economy of extending the policy of Government self-insurance to special nuclear material in custody of contractors under fixed-price contracts.

3. Contractors be required to comply with Government property safety regulations.

Your report presents some thoughtful arguments for extending the Government's self-insurance policy to other areas. The potential gross savings developed in the report, if they could realistically be achieved, warrant careful consideration of the recommendations in light of the current budget demands. However, there are several matters that are not adequately addressed in the report which cast some doubt on the advisability of adopting the recommendations.

While the potential savings opportunity as presented in the report is attractive, there are administrative costs associated with its achievement which would make the probable net savings considerably less. Although we are unable to determine precisely what additional contract administration resources would be needed to implement the report's recommendations, we are certain that additional Government personnel would be required.

The report estimate of a five-year savings of \$27 million is equivalent to annual savings of \$5.4 million. The cost, in terms of salary, benefits (including retirement, insurance, etc.), travel, and physical plant required to support an incremental man-year of contract administration effort is approximately \$25,000. Therefore, DoD could hypothetically afford to dedicate only 216 man-years ( $\$5,400,000 \div \$25,000$ ) of additional effort before exhausting the annual gross savings at \$5.4 million.

The issue then to be examined is what approach is most cost effective. The report concludes that there would be little increase

in the Government contract administration effort if we increased the amount of property being self-insured. Our experience indicates the opposite when DoD assumes additional management responsibility. In FY 1974, DoD had over 24,000 contractors with procurement transactions of \$10,000 or more. The number of subcontractors would run to tens of thousands. Any additional manpower requirements on a business volume of this magnitude and complexity would inevitably generate further costs which would be significant by any standard of measure. We are persuaded that the probable manpower cost of the additional workload required by the report recommendations would consume all or nearly all of the savings identified.

As a general rule the Government acts as a self-insurer, especially for Government-owned property. However, contractors have obtained commercial insurance for their inventory. DoD acceptance of commercial insurance costs is predicated on its availability at a reasonable cost and on the effectiveness of services provided by insurance underwriters in reducing the Government's administrative burden associated with identifying and processing claims and performing other insurance functions (hazard prevention, etc.). The report does not state that insurance costs in the areas examined were unreasonable, rather, only that losses were less than costs. On the other hand, the loss/damage that might have occurred at any one of the large Government contractor plants in that five-year period could have easily wiped out any such savings. On balance, we have found that the overall insurance costs questioned in the report are both reasonable and prudent given the magnitude of the risks and the over-all administrative burden, though we will continue to examine these costs carefully on a contract-by-contract basis.

Thus, we are not convinced that your first recommendation offers a level of savings sufficient to justify its potential costs. As to the second recommendation, a joint DoD and AEC study of self-insurance involving special nuclear material, we already have procedures pursuant to Public Law 85-804 to provide indemnification to contractors where nuclear risk is involved. It is thus not clear to us exactly what problems led to this recommendation

APPENDIX II

APPENDIX II

as far as DoD is concerned. Should AEC desire to study the matter, we would be pleased to participate. The third recommendation concerns compliance with Government property safety regulations. We propose to review this matter further and will keep you apprised of our progress.

We appreciate your efforts to lay out the problems and potential savings in these areas. Thank you for the opportunity to comment on your draft report.

Sincerely,

*A. I. Mendolia*

ARTHUR I. MENDOLIA  
Assistant Secretary of Defense  
(Installations & Logistics)



NATIONAL AERONAUTICS AND SPACE ADMINISTRATION  
WASHINGTON, D.C. 20546



NOV 19 1974

REPLY TO  
ATTN OF

D

Mr. R. W. Gutmann, Director  
Procurement and Systems Acquisition  
Division  
United States General Accounting Office  
Washington, DC 20548

Dear Mr. Gutmann:

Thank you for the opportunity to review and comment on your draft report entitled "Study on the feasibility and economies obtainable through extension of Government's policy of self-insurance".

In general, NASA concurs with the concept of extending the Government's self-insurance policy, as proposed in your draft report, subject to the satisfactory resolution of the specific matters discussed hereinafter. We believe such approach is consistent with experience under the existing Government policies regarding self-insurance of its own property and with the potential savings that could be realized by avoiding commercial insurance premiums (with contractors' related profits), as illustrated in your draft report.

However, some aspects of GAO's proposal need to be clarified with regard to intent and/or coverage. And, in other respects, it needs to be established that, because of various correlative issues not discussed in the draft report, GAO's proposal can be implemented under present law. As mentioned in the following pages, these matters should be fully considered in connection with any extension of the Government's self-insurance program.

GAO Recommendation 1(a): That the Government assume the risk of loss or damage to, and provide for the disallowance of the cost of hazard insurance on, "inventories and property under competitive and non-competitive negotiated fixed-price prime contracts with or without progress payment clauses, on first-tier subcontracts, and on other subcontracts awarded to prime contractors".

Government-owned and contractor-owned material and work-in-process inventories may be and are often commingled without physical segregation or identification to individual contracts. Also, the Government does not have title to direct materials and work-in-process inventories under fixed-price contracts that do not provide for progress payments to the contractor. Two significant legal problems are therefore inherent in this GAO recommendation, viz:

1. May NASA or another Government agency assume a contingent liability in an unlimited amount for loss or damage to the contractor's property?
2. May NASA or another Government agency pay appropriated funds to reimburse a contractor for the loss or damage to the contractor's property in which the United States has no current property interest and which property is not used or held by the contractor solely for any Government purposes but may be used by the contractor for Government or commercial work or both?

Answers to these questions are prerequisite to any implementation of this recommendation. They have not been answered in Comptroller General's decisions to date, to our knowledge.

However, Comptroller General decisions which are somewhat related to the above first question emphasize that there must be no violation of the anti-deficiency act (31U.S.C. 665(a) and (h)). Where a ceiling could be ascertained for a contingent liability (for example, the value of a specific cargo), it may be necessary for the Government agency to create a reserve of appropriated funds to ensure that the anti-deficiency act will not be violated (45C.G.565 and compare 42C.G.708). In contrast, GAO's draft report would apparently recommend that the Government practice self-insurance "without accumulating a special contingency fund to cover losses or damages," (page 4 of the draft report). This apparent inconsistency should be resolved when the above first question is answered. The use or non-use of contingency funds could have a significant effect on an agency's activities, if a building or high-dollar value equipment was damaged or lost, for example.

Regarding the above second question, concerning use of appropriated funds to discharge a liability for the loss or damage to non-Government property, the ultimate question appears to be whether the payment is a necessary

expense of a Government program. (42C.G.392 and id.708). It is difficult to understand how the Government's payment of a liability for the loss of inventories which have not been segregated and which could have been used for commercial purposes could be construed as a necessary expense of a Government program.

It is stated on page 2, Chapter 1, of the draft report, "... Although there is no statutory requirement on self-insurance, the Government's policy for self-insurance is expressed in the decisions of the Comptroller General of the United States and is reflected in the conduct of official business by various departments and agencies of the Government. ..." Since none of the Comptroller General's decisions is in point with regard to the above two basic questions, we recommend that these questions be answered for the guidance of all Federal agencies possibly by the issuance of new Comptroller General decisions or by GAO requests for appropriate legislation to obviate these questions.

Also, NASA recommends that the following related matters be considered in any extension of the self-insurance program:

- a. There should be no diminution or waiver of a contractor's liability for loss or damage to property resulting from fraud, or from gross mistakes as amount to fraud, or from willful misconduct or lack of good faith on the part of any of the contractor's directors, officers, or key personnel.
- b. Government self-insurance should not apply in cases where loss or damage to property is covered by the contractor's existing general insurance coverage, which applies both to commercial and Government work, or its established reserve for self-insurance.
- c. When the necessary contract clauses or regulations are developed to implement the extended Government self-insurance procedures, additional precautions must be taken to discourage carelessness or negligence on the part of contractors.
- d. It appears that GAO's foregoing recommendation applies only to supply contracts and not to research and development and construction contracts although the term "supply" is not contained in the recommendation; GAO's intent should be clarified.

- e. GAO should also clarify whether or not the foregoing recommendation is intended for application only to first-tier subcontracts that are fixed-price.

While the draft report summarizes divergent opinions as to the administrative effect of extending the Government's policy of self-insurance as proposed by GAO, the report does not support the GAO conclusion that savings in administrative costs can be attained. To the contrary it appears more likely that an adverse impact on administrative activities will result, due to increased property controls, refinement of accounting systems to facilitate identification of losses or damages to Government-owned inventories, etc. (Also, see the following comment on recommendation 3.)

GAO recommendation 1(b): Self-insurance of Government property in custody of commercial shipyards under ship repair contracts.

GAO recommendation 1(c): Self-insurance by the Government of "facilities leased to contractors and other users."

Since recommendation 1(b) and 1(c) pertain to Government property only, we have no specific comment.

GAO recommendation 2: A joint DOD and AEC study to determine the feasibility and economy of extending the policy of Government self-insurance to special nuclear material provided to contractors under fixed-price contracts.

No comment.

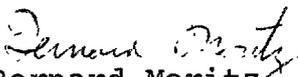
GAO recommendation 3: Government Agencies should require contractors to adhere to Government property safety regulations.

The draft report presentation of this subject is so nebulous and inconclusive that it provides no basis for a realistic evaluation of GAO's conclusion relating to this recommendation. Aside from recommending revision of DOD procurement regulations, there is no indication as to such matters as: (1) the Government's authority (statutory or otherwise) for prescribing "nationally acceptable" property safety standards, (2) any concept

or plan for assuring implementation of such standards, (3) assessment of contractors' compliance, or (4) the categories of Government personnel (by functional types, by individual agencies, by centralized agency, etc) that would be expected to "prudently administer" such standards. Obviously such factors will affect the relative Government-wide and/or agency costs of extending the Government's self-insurance policy.

We believe these and related matters should be more thoroughly explored before the contractors' concerns are dismissed and it is concluded that "we foresee no problems arising from Government property safety standards ..." (pages 19-21).

Sincerely,

  
Bernard Moritz  
Associate Administrator for  
Organization and Management

GAO note: Page references in this appendix refer to the draft report and do not necessarily agree with the page numbers in final report.



UNITED STATES  
ATOMIC ENERGY COMMISSION  
WASHINGTON, D.C. 20545

NOV 18 1974

Mr. Henry Eschwege, Director  
Resources and Economic  
Development Division  
General Accounting Office  
441 G. Street, N. W.  
Washington, D. C. 20548

Dear Mr. Eschwege:

COMMENTS ON GAO DRAFT REPORT TITLED "STUDY ON THE FEASIBILITY AND ECONOMICS OBTAINABLE THROUGH EXTENSION OF GOVERNMENT'S POLICY OF SELF-INSURANCE"

We have reviewed the subject report transmitted by your letter of September 30, 1974, and have discussed certain of its aspects with Mr. Janku of your staff.

We generally agree with and support the concept of self-insurance by the Federal government when the benefits to be derived, costs and other factors considered, outweigh the costs of private insurance coverage. However, there may be instances where it is distinctly advisable for the vendor to retain full responsibility for inventories and property under fixed-price prime contracts and subcontracts. The contracting officer must weigh such factors as the potential reduction in the contractor's incentive for careful handling and care of materials and in-process work, and potential impact on delivery dates, against the estimated cost savings which may be possible through self-insurance. The procurement regulations, if amended, should provide necessary latitude to the contracting officer.

The report recommended that the DOD and AEC consider the feasibility and economy of extending the policy of Government self-insurance to special nuclear material in custody of contractors under fixed-price contracts. From discussions with your staff, we understand that the reference to DOD in this recommendation meant the AEC Division of Naval Reactors. This should be clarified in the final report. The Division of Production and Materials Management, Naval Reactors and other AEC Divisions having an interest in this matter have expressed a willingness to review the feasibility of such a policy extension.

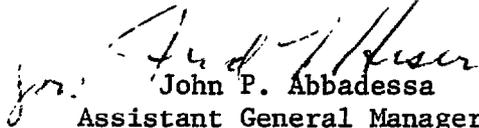
We presume the statistics on Page 13 of the report are not meant to be complete but rather illustrative of the extent of present Government self-insurance practices. The AEC also has a sizeable investment of

Mr. Henry Eschwege

facilities and inventories in the custody of cost-type contractors. We understand that the \$7.3 billion cited in Item 1 on Page 13 includes \$2.1 billion of AEC cost-type contract awards. This amount includes awards for research and development as well as for supplies and plant operations.

The references to mandatory contractor compliance with "Government property safety regulations" should be clarified. We were given to understand that the reference is not to any specific new safety regulations but rather is a general statement that Federal agencies should enforce existing regulations concerning (1) proper care and handling of property and (2) design and construction of new facilities.

Very truly yours,

  
John P. Abbadessa  
Assistant General Manager,  
Controller

GAO note: Page references in this appendix refer to the draft report and do not necessarily agree with the page numbers in final report.

PRINCIPAL OFFICIALS RESPONSIBLE  
FOR ADMINISTRATION OF ACTIVITIES  
DISCUSSED IN THIS REPORT

	Tenure of office	
	From	To
<u>DEPARTMENT OF DEFENSE</u>		
SECRETARY OF DEFENSE:		
James R. Schlesinger	July 1973	Present
William P. Clements, Jr. (acting)	May 1973	June 1973
Elliot L. Richardson	Jan. 1973	Apr. 1973
Melvin R. Laird	Jan. 1969	Jan. 1973
Clark M. Clifford	Mar. 1968	Jan. 1969
SECRETARY OF THE ARMY:		
Howard H. Callaway	May 1973	Present
Robert F. Froehlke	July 1971	Apr. 1973
Stanley R. Resor	July 1965	June 1971
SECRETARY OF THE NAVY:		
J. William Middendorf	June 1974	Present
J. William Middendorf (acting)	Apr. 1974	June 1974
John W. Warner	May 1972	Apr. 1974
John H. Chafee	Jan. 1969	May 1972
Paul R. Ignatius	Sept. 1967	Jan. 1969
SECRETARY OF THE AIR FORCE:		
John L. McLucas	May 1973	Present
Robert C. Seamans, Jr.	Jan. 1969	Apr. 1973
Harold Brown	Oct. 1965	Jan. 1969
DIRECTOR, DEFENSE SUPPLY AGENCY:		
Lt. Gen. Wallace H. Robinson, Jr.	Aug. 1971	Present
Lt. Gen. Early C. Hedlund	July 1967	July 1971

NATIONAL AERONAUTICS AND SPACE ADMINISTRATION

ADMINISTRATOR:		
James C. Fletcher	Apr. 1971	Present

<u>Tenure of office</u>	
<u>From</u>	<u>To</u>

NATIONAL AERONAUTICS AND SPACE ADMINISTRATION (cont'd)

ADMINISTRATOR:

George M. Low (acting)	Sept. 1970	Apr. 1971
Thomas D. Paine	Oct. 1968	Sept. 1970
James C. Webb	Feb. 1961	Oct. 1968

ENERGY RESEARCH AND DEVELOPMENT ADMINISTRATION

ADMINISTRATOR:

Robert C. Seamans, Jr.	Dec. 1974	Present
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ATOMIC ENERGY COMMISSION

CHAIRMAN:

Dixy Lee Ray	Feb. 1973	Jan. 1975
James R. Schlesinger	Aug. 1971	Feb. 1973
Glenn T. Seaborg	Mar. 1961	Aug. 1971

GENERAL MANAGER:

John A. Erlewine	Jan. 1974	Jan. 1975
Robert E. Hollingsworth	Aug. 1964	Jan. 1974

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