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REPORT TO THE CONGRESS

Survey Of The Application Of The Government's Policy On Self-Insurance B-168106

BY THE COMPTROLLER GENERAL OF THE UNITED STATES

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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 on our survey of the application of the Government's policy on self-insurance.

Our survey was made pursuant to the Budget and Accounting Act, 1921 (31 U.S.C. 53) and the Accounting and Auditing Act of 1950 (31 U.S.C. 67).

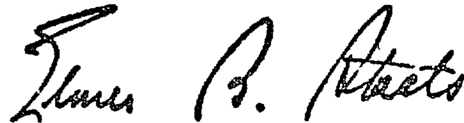
The report presents the results of our study made to evaluate the application of the Government's policy on self-insurance and to identify significant insurance costs which the Government bears but which it could avoid through self-insurance. It was not our objective to make final determinations as to the appropriateness and feasibility of self-insuring each of the types of risks for which the Government was currently procuring insurance but rather to identify those which appeared to warrant further consideration for self-insurance.

As time and resources permit, we expect to review in greater depth those types of insurance which appear to have the most potential for substantial savings to the Government through self-insurance. We will report to you later on the results of such reviews. In the meantime the information developed in our survey and included in this report should be of interest and value to the Congress. So far as we are aware, this is the first time that such a comprehensive Government-wide survey has been made of the types of insurance that are being procured directly, or paid for indirectly, by the Government.

The results of our survey are summarized in Chapter 1, Introduction, which includes a listing of the types of bonds and insurance studied. Chapter 2 discusses the types of bonds and insurance being purchased directly by the Federal Government, and chapters 3 through 6 similarly discuss bonds and insurance being paid for indirectly by the Government through contracts, grants, leases, and other means.

We have not obtained the comments of the agencies, contractors, and other organizations which are mentioned in the report.

Copies of this report are being sent to the Director, Office of Management and Budget; the heads of the departments and major independent agencies; and the congressional committees concerned with the programs and expenditures of those departments and agencies.



Comptroller General
of the United States

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ABBREVIATIONS

ADP automatic data processing

AEC Atomic Energy Commission

AFLC Air Force Logistics Command

ASCS Agricultural Stabilization and Conservation Service

ASPR Armed Services Procurement Regulation

CCC Commodity Credit Corporation

CONUS continental United States

CSC Civil Service Commission

DOD Department of Defense

FEGLI Federal employees' group life insurance

FHA Federal Housing Administration

FHWA Federal Highway Administration

FNMA Federal National Mortgage Association

GAO General Accounting Office

GOCO Government-owned contractor-operated

GSA	General Services Administration
HUD	Department of Housing and Urban Development
LHA	local housing authority
MAC	Military Airlift Command
MSC	Military Sealift Command
MSFC	George C. Marshall Space Flight Center
NALC	National Association of Letter Carriers
NASA	National Aeronautics and Space Administration
NSF	National Science Foundation
OEO	Office of Economic Opportunity
OMB	Office of Management and Budget
P&I	protection and indemnity
TVA	Tennessee Valley Authority
VA	Veterans Administration

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CHAPTER 1

INTRODUCTION

A study of self-insurance in the Government was initiated by the General Accounting Office (GAO) for the purpose of evaluating the application of the Government's policy on self-insurance, identifying significant insurance costs which the Government currently bears but could avoid through self-insurance, and establishing an order of priorities for manageable segments or types of insurance for further consideration in determining the feasibility or merits of self-insurance.

PURPOSE OF INSURANCE

The general purpose of insurance is to spread the risk of loss or extraordinary expense among those who share a similar risk through the technique of payments into a fund, administered by an insurer, out of which payments are made to cover the actual losses or extraordinary expenses of the participants. The premiums paid into the fund must normally be sufficient, in the long run, not only to cover the losses of the participants but also to cover the selling, administrative, and other expenses of the fund and to provide a reasonable profit to the insurer for his risk and services in administering the fund.

It is apparent, therefore, that an insured who is financially able to absorb his maximum probable loss, or whose risks are spread so widely as to result in a minimal statistical probability that losses will exceed insurance premiums over a reasonable period of time, will find it less costly to assume the risk of loss than to purchase insurance. It is also apparent that the Federal Government meets both of these criteria.

GOVERNMENT POLICY ON SELF-INSURANCE

The Federal Government has generally followed a policy of self-insurance and currently self-insures, in almost all cases, the risks of loss or damage to Government-owned property, workmen's compensation for Government employees, and liability for property damage and bodily injury as a result

of the actions of the Government or its employees. Certain other types of insurance are procured by the Government, however, and a number of types are paid for indirectly by the Government through contracts, grants, leases, or other means.

The Government's policy of self-insuring its risks does not involve a statement of positive law. The policy has been enunciated in decisions of the Comptroller General of the United States and of predecessor officials and reflected in the conduct of official business by the various departments and agencies of the Government. Although the Congress has recognized the policy in some cases by specifically prohibiting the expenditure of appropriations for the payment of insurance premiums, it has in other cases made exceptions to the policy by authorizing or requiring the purchase of insurance by the Government or its contractors.

STUDY OBJECTIVES

The three basic objectives of the self-insurance study have been to:

- --identify all types of risks against which the Government was procuring insurance coverage, either directly or indirectly, in substantial amounts;
- --evaluate each risk so identified as to whether it might be appropriate and feasible for self-insurance by the Government; and
- --establish an order of priorities for further study of those types of insurance which appeared to be appropriate and feasible for self-insurance.

APPROPRIATENESS

Because of the wide variety of situations involved, we did not find it practicable to establish one overall set of criteria for evaluating the extent to which each type of insurance covered a Government risk that was appropriate for self-insurance. Instead, we made our evaluations on a case-by-case basis, considering such factors as (1) whether the Government had title to the insured property and, if not,

whether the property was being constructed or manufactured for the Government, (2) whether the property was physically under the control of the Government or its employees, (3) whether the insurance was being procured under a Government-sponsored program established by law, (4) the extent to which the probability of loss or injury was dependent on the care and competence of Government officials or employees on the one hand, or of non-Government personnel on the other hand, and (5) the possibility that assumption of the risk by the Government would reduce the incentive of Government contractors to exercise due care in carrying out their contractual responsibilities.

FEASIBILITY

In evaluating the feasibility of self-insuring each risk for which insurance was being procured, we considered not only the relationship of premium expense to loss experience but also what other essential functions were being performed by the insurer and whether such functions could be performed by the Government as efficiently as by the commercial insurer. In this connection, Bureau of the Budget Circular A-76 contains criteria for determining when it is in the national interest for the Government to provide directly the products and services it uses rather than following the general policy of relying upon the private enterprise system to supply its needs.

We did not evaluate the functions performed by insurers in terms of the criteria of Circular A-76. We believe, however, that further consideration should be given to these criteria, particularly where, as in the case of the Federal Employees' Health Benefits Program, important functions other than indemnification of losses are performed by the insurers (p. 12).

PRIORITY A

In fulfilling our third objective, we established three categories of priorities and labeled them Priorities A, B, and C. In Priority A we included those risks which appear to be both appropriate and feasible for self-insurance by the Government and for which significant potential savings may be available through self-insurance. Following is a list of types of insurance to which we assigned Priority A, indexed to the pages in the report where they are discussed in greater detail.

1. Federal Employees' Health Benefits Program (p. 12).

2. Federal employees' group life insurance (p. 16).

3. Insurance procured directly and indirectly by the Commodity Credit Corporation (CCC):

   --blanket insurance policy purchased by CCC (p. 22); and

   --hazard insurance on CCC-owned and loan-collateral grain, beans, and rice stored in commercial warehouses (pp. 128 and 130);

4. Bonds and insurance purchased by the Department of Labor:

   --workmen's compensation on enrollees in the Work Incentive Program (p. 27); and

   --fidelity bonds covering certain individuals seeking employment (p. 29).

5. Hazard insurance purchased by contractors on materials and work-in-process inventories (p. 44).

6. Bid and performance bonds purchased by Postal Service star route contractors (p. 49).

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PRIORITY B

We assigned Priority B to those risks which appear to have sufficient potential to warrant further consideration but for which either (1) there are important questions regarding appropriateness or feasibility of self-insurance which could not be resolved in the survey or (2) the potential savings through self-insurance do not warrant the highest priority. Following is a list of the types of insurance to which we assigned Priority B, indexed to the pages in the report where they are discussed in greater detail.

1. Fidelity bonds on Federal employees (p. 32).

2. Liability insurance on Government-owned aircraft (p. 34).

3. Bid, performance, and payment bonds under:

   --contracts for construction of public works (p. 51);

   --contracts for construction and repair of vessels (p. 62);

   --contracts for ships chartered by the Military Sealift Command (p. 63);

   --contracts for construction of highways partially financed by Federal grants (p. 91);

   --contracts for construction of facilities partially financed by Federal grants (p. 96);

   --contracts for construction of low-rent public housing (p. 98); and

   --lease-construction agreements (p. 112).

4. Hazard and liability insurance on shipments of Government-owned property by common carrier (p. 65).

5. Hazard insurance purchased by contractors constructing Government facilities (p. 67).

6. Hazard insurance purchased by contractors on Government-owned property:

   --hazard insurance on Government-owned aircraft under repair or modification (p. 69);

   --hazard insurance on Government-owned contractor-operated plants (p. 71); and

   --hazard insurance on Government-owned equipment operated by contractors (p. 79).

7. Product liability and catastrophic accident insurance purchased by contractors (p. 74).

8. Ship repairer's legal liability insurance purchased by contractors on Navy and Coast Guard vessels under repair (p. 77).

9. Hazard insurance purchased by grantees on facilities and equipment (p. 100).

10. Hazard and liability insurance purchased by lessors on property leased by the Government:

    --hazard and liability insurance on leased buildings 100 percent Government occupied (p. 116);

    --hazard and liability insurance on leased automobiles (p. 120); and

    --hazard insurance on leased automatic data processing equipment (p. 124).

11. Bonds and insurance procured in connection with the management of acquired properties (p. 138).

12. Insurance costs included in the ship construction-differential subsidy (p. 141).

PRIORITY C

We assigned Priority C to those risks which do not appear to have potential for self-insurance by the Government

under present conditions. This category includes not only those risks which do not appear to be appropriate or feasible for self-insurance but also certain types of risks which are already self-insured (item 4 below) or which were placed under self-insurance during our study (item 5 below). Following is a list of the types of insurance to which we assigned Priority C, indexed to the pages in the report where they are discussed in greater detail.

1. Nuclear liability insurance purchased by the Tennessee Valley Authority (p. 34).

2. Liability insurance on certain D.C. Government vehicles (p. 38).

3. Liability insurance on Government-owned vehicles operated in foreign countries (p. 38).

4. Hazard insurance on shipments of valuables (p. 39).

5. Collision damage insurance covering first $100 damage to rented automobiles (p. 42).

6. Liability insurance purchased by contractors constructing Government facilities (p. 67).

7. Liability insurance purchased by contractors operating Government-owned equipment (p. 79).

8. Protection and indemnity insurance purchased by contractors operating Government-owned ships (p. 82).

9. Hazard and liability insurance purchased by contractors on chartered ships and aircraft (p. 84).

10. Other types of insurance paid for indirectly under contracts (p. 88).

11. Liability insurance purchased by grantees on facilities and equipment (p. 100).

12. Fidelity bonds covering grantee employees (p. 106).

13. Liability insurance purchased by grantees' contractors (p. 107).

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14. Hazard insurance purchased by grantees' contractors on facilities under construction (p. 108).

15. Bid, performance, and payment bonds required by lessors and/or financial institutions in connection with the construction of facilities under lease-construction agreements (p. 114).

16. Liability insurance purchased by lessors of automatic data processing equipment (p. 124).

17. Hazard and liability insurance purchased by contractors constructing facilities under lease-construction agreements (p. 127).

18. Hazard insurance paid for indirectly by CCC on loan-collateral cotton stored in commercial warehouses (p. 130).

19. Insurance costs included in the ship operating-differential subsidy (p. 144).

TITLE INSURANCE

At the time the self-insurance study was initiated, two reviews of title insurance on acquired property were under way by GAO site audit staffs at the Department of Justice and the Department of Housing and Urban Development. Reports on these two reviews had not yet been issued at the time the self-insurance study was completed. To avoid duplication we did not include title insurance in our self-insurance study.

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ISOLATED MINOR CASES

In a few instances, we found that Government agencies were purchasing insurance in small amounts to cover certain unique risks. Although we were not completely satisfied as to the justification for the purchase of insurance in these cases, we did not pursue them further or comment on them in this report in view of the nominal cost involved and the fact that each instance appeared to be an isolated case.

ESTIMATES OF SAVINGS

In assigning priorities for further consideration of the various types of insurance, it was desirable to have some idea of the significance of each type in terms of the potential savings to the Government through self-insurance. Although in a few cases information as to premium costs and loss or claims experience was readily available, in most cases accurate estimates could not be developed without considerably more detailed audit work than was appropriate in a survey. In such cases we made a rough estimate of the costs or savings on the basis of the best data that could be obtained within reasonable time limits. In a number of cases, no data was available regarding claims expense, and we therefore included estimates of premium costs only.

We have called attention to instances where it appeared that self-insurance might result in additional expense to the Government because of the in-house performance of functions that are now performed by the insurers. Another cost factor which we recognized as significant but which was not practicable to include in our estimates was interest. Investment income on funds retained by insurance companies for reserves and other purposes is a significant item of revenue to these companies, and to the extent that these funds come from premiums that have been paid for by the Government, the interest thereon is an item of expense to the Government which would be saved under a self-insurance program. Our survey did not generally develop data of sufficient accuracy and detail to provide a sound basis for estimating interest costs to the Government; however, we believe this matter should be given further consideration.

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Because of the wide variance in the degree of accuracy of our estimates, as well as the wide variance in the degree of appropriateness and feasibility of self-insurance of the various types of risks we identified, we did not consider that a Government-wide total of our estimates would be meaningful.

To assist us in estimating the significance and feasibility of self-insurance of various types of risks for which the Government is now paying for insurance indirectly through contracts, we mailed questionnaires to 89 contractors who were operating Government-owned plants, to 222 contractors who were performing major Government contracts in their own plants, and to 200 construction contractors. The results of these questionnaires were useful in identifying the types of insurance being paid for indirectly through contracts as well as in estimating insurance costs, claims, and potential savings.

THE GOVERNMENT AS AN INSURER

There are many areas in which the Government now acts as an insurer of the risks of others. One of the better known examples is insurance of mail by the Postal Service. We did not consider insurance by the Government of the risks of others to be within the scope of our survey except in two cases where the Government is reinsuring the risk through the purchase of commercial bonds or insurance (pp. 27 and 29).

PRODUCT WARRANTIES

We did not consider product warranties to be within the scope of our survey. A warranty ordinarily provides for repairing or replacing a defective product or for returning the purchase price, and this risk is normally not covered by commercial insurance. On the other hand, product liability, involving possible extensive liability for consequential property damage and personal injury, is normally covered by commercial insurance and was therefore included in the scope of our survey (p. 74).

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PRIOR GAO REPORTS

In performing our survey, we attempted to identify those GAO reports issued within the past 10 years which dealt with the Government's policy on self-insurance. A listing of such reports is included as appendix I.

CHAPTER 2

BONDS AND INSURANCE PURCHASED

DIRECTLY BY THE GOVERNMENT

FEDERAL EMPLOYEES' HEALTH BENEFITS PROGRAM--PRIORITY A

The Federal Employees' Health Benefits Program was established by the Federal Employees' Health Benefits Act of 1959 (P.L. 86-382, approved September 28, 1959) and became effective on July 1, 1960. In commenting on S-94 (a predecessor bill to S-2162 on which the act was based) in April 1959, the Comptroller General suggested that the Senate Committee on Post Office and Civil Service consider the Government's policy of self-insurance in its consideration of the bill.

During the hearings on S-94, members of the Senate Committee on Post Office and Civil Service questioned officials of the National Association of Letter Carriers (NALC) as to the desirability of self-insurance of the program. Mr. William Doherty, President of NALC stated that:

> "*** since our Government is big enough and capable enough to operate our own retirement plan and have been doing so since 1920 and since we have the same capabilities in the case of our compensation bureau, it would not be a bad idea for the committee to study the feasibility of the Government operating its own plan. I think you would save untold thousands and ultimately millions of dollars."

Mr. Jerome Keating, Vice President of NALC stated that self-insurance would be more economical but that the insurance underwriters and the American Medical Association were opposed to such a program. He added that:

> "Medical people are frightened to death of socialized medicine and anything that moves in that direction is generally opposed by people in that

particular field. So, for that reason, and with the hope of getting legislation that could be enacted, the proposal was presented in the way it has been presented."

So far as we could determine, no further consideration was given by the Congress at that time to self-insuring the program.

In calendar years 1968 and 1969, subscription income[1] to the 27 experience-rated health benefits plans amounted to $1,424,999,566. During this period benefits of $1,409,523,204 were paid and the following overhead costs were incurred by the carriers or allowed by the Civil Service Commission (CSC):

Administrative costs	$57,679,049
Risk charges	15,222,336
Premium taxes	10,267,038
Total	$83,168,423

During the same period, subscription income to the 10 community-rated plans amounted to $74,747,282. Benefits paid and administrative costs incurred totaled $74,463,203 and premium taxes totaled $22,529.

Enrollment contributions to all plans totaled about $1.5 billion during calendar years 1968 and 1969, of which Federal agencies contributed about $452 million or about 30 percent. Effective January 1971, the Federal contribution was increased to an amount equal to 40 percent of the average high option premiums for the six largest plans for self-only or family enrollments, not to exceed 50 percent of the premium for an option under any plan (P.L. 91-418, approved September 25, 1970; 84 Stat. 869).

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[1]Subcription income is the amount received by the insurers and consists of the enrollment contributions by Federal employees and agencies, less the amounts deposited in the U.S. Treasury as administrative and contingency reserves, plus amounts received by the insurers from the contingency reserves.

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Pursuant to the act, about 1 percent of all enrollment contributions are deposited in the U.S. Treasury as an administrative reserve, and about 3 percent of the contributions to each plan are deposited in the U.S. Treasury as a contingency reserve for the plan. The administrative reserve is used for the payment of CSC's administrative expenses. Funds may be transferred from the administrative reserve to the contingency reserves of the plans when CSC considers it appropriate to do so.

When the reserves held by a carrier fall below a minimum level agreed to by CSC, or when certain other conditions are met, the carrier is entitled to receive payment from the contingency reserve in an amount equal to the lesser of (1) the difference between the total of the last 5 months' subscription charges paid from the fund to the carrier for the plan and the total of the reserves held by the carrier for the plan, or (2) the excess, if any, of the contingency reserve over 1 month's subscription charges.

Indemnity Benefit Plan

The Indemnity Benefit Plan is the second largest health benefits plan for Government employees. Since inception of the plan in 1960, the Carrier--Aetna Life Insurance Company--has reinsured with other insurance companies pursuant to 5 U.S.C. 8902(c), which requires the carrier to reinsure with other companies which elect to participate. During the policy period ended December 31, 1970, there were 121 companies participating as reinsurers.

Also, since inception of the plan, CSC's contract with Aetna has provided for annual risk charges and reinsurers' expense allowances based on percentages of the subscription charges. The risk charge has been equal to 1 percent or 1.3 percent of subscription charges, and the reinsurers' expense allowances have been equal to 0.2 percent of subscription charges. From inception of the plan through December 31, 1970, risk charges totaled $14,116,474 and reinsurers' expense allowances totaled $2,376,053. Of the total risk charges and reinsurers' expense allowances, the reinsurers have received about $15 million although they have had no operating responsibility under the plan, and Aetna has retained the balance of about $1.5 million.

According to Aetna officials, the purpose of the risk charge is to compensate Aetna and the reinsurers for the underwriting risks involved and provide a fee or profit. In testimony on July 20, 1971, before the Subcommittee on Retirement, Insurance, and Health Benefits, House Committee on Post Office and Civil Service, the Director of CSC's Bureau of Retirement, Insurance and Occupational Health stated that the term "risk charge" meant "profit."

In connection with a GAO review of the Indemnity Benefit Plan, officials of three of the major reinsurers informed GAO that the costs associated with being a reinsurer of the plan usually consisted of the costs of making entries in the accounting records.

Issues for further consideration

The risk charges and premium taxes would be eliminated if the Government acted as the insurer for the Federal Employees' Health Benefits Program. On the basis of the costs cited above for the 1968-1969 period, and the current Federal contribution level of about 40 percent, we estimate annual savings of at least $5 million to the Federal Government and at least $7.5 million to Federal employees through elimination of these costs. Because premium rates have increased substantially since 1969, it is possible that these estimates may be quite conservative.

Also, if the Government assumed full responsibility for the risk and administration of the health benefits program, instead of buying insurance from outside sources, it seems likely that there could be considerable simplification of the program through reduction of the present number of 38 separate plans, which could result in some savings in administrative expense.

Further study will be required to develop an accurate estimate of potential savings and to demonstrate the feasibility of the Government assuming the role of insurer of the Federal Employees' Health Benefits Program rather than buying insurance from outside sources. We believe that the study should consider the possibility of contracting out the claims settlement services rather than establishing a nationwide organization to provide these services.

FEDERAL EMPLOYEES' GROUP LIFE INSURANCE--PRIORITY A

Group life insurance policy with Metropolitan Life Insurance Company

The Federal employees' group life insurance (FEGLI) program was established by the Federal Employees' Group Life Insurance Act of 1954 (5 U.S.C. 8701). Pursuant to the act, as amended, the regular insurance coverage is equal to the larger of $10,000 or the current rate of an employee's compensation rounded to the next higher $1,000, plus $2,000 additional insurance, not to exceed a total of $45,000. Partial or full benefits, as prescribed by law, are paid for loss of limb or eyesight, and double indemnity is provided if death is accidental. The Federal Government pays one third of the cost of the insurance and the employee pays the remainder.

Pursuant to authority contained in the act, CSC agreed to a group policy with Metropolitan Life Insurance Company effective August 29, 1954, under which Metropolitan became the prime insurer under the FEGLI program. The policy was amended effective December 16, 1967, to include the optional group life insurance coverage of $10,000 authorized by Public Law 90-206 (5 U.S.C. 8714a). The total cost of the optional insurance is paid for by the employee.

In accordance with the act, the group policy with Metropolitan provides that Metropolitan reinsure portions of the total insurance under its policy. The act requires that the amount of reinsurance of each participating reinsurer be based on the total amount of each reinsurer's group life insurance in force in the United States at the end of the most recent calendar year. At June 30, 1968, there were 332 life insurance companies participating as reinsurers.

Of the premiums collected from the employees and the employing agencies, CSC pays 99 percent to Metropolitan and retains 1 percent to pay its administrative expenses. From the beginning of the program in August 1954 through June 30, 1968, Metropolitan received premiums of $1,975,876,150 and paid mortality and other claims of $1,451,071,054. During the same period the following expense and risk charges were charged against the policy:

Taxes	$35,693,689
Risk charges	9,902,051[a]
Other expenses	5,789,414[a]
Expense of maintenance and operation of the Office of FEGLI	4,805,853
Total	$56,191,007

[a]Of the risk charges and other expenses of $15,691,465, the reinsurers received $12,850,513 and Metropolitan retained $2,840,952.

The amount shown in the tabulation above for taxes consists of the following:

State taxes on insurance premiums	$34,755,431
State and local jurisdiction fees, licenses, and assessments	791,019
Federal taxes on insurance premiums (eliminated after 1957)	147,239
Total	$35,693,689

Taxes on life, accidental death, and dismemberment insurance premiums are paid by Metropolitan to the 50 States, the District of Columbia, Puerto Rico, and certain Canadian provinces on the basis of the geographical distribution of the annual compensation of the Federal employees within the taxing jurisdictions. Fees, licenses, and assessments of certain State insurance departments and local jurisdictions are also paid by Metropolitan and charged to the FEGLI program.

The current annual risk charge is an amount equal to 0.4 percent of the first $190 million of gross premiums, plus 0.2 percent of the gross premiums in excess of $190 million. The current annual allowance for other expenses is an amount equal to 0.3 percent of the first $190 million of gross premiums, plus 0.06 percent of the gross premiums in excess of $190 million.

The charges of $4,805,853 shown above for Metropolitan's expense of maintenance and operation of the Office of FEGLI

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include (1) expenses incurred directly by the Office of FEGLI in connection with, among other things, performing the functions of approving and paying mortality and dismemberment claims, (2) expenses incurred by other organizational units of Metropolitan considered attributable to the operations of the Office of FEGLI, and (3) fees paid for independent legal and other services related to the settlement of claims.

The act also provides for the retention of an interest-bearing contingency reserve by Metropolitan, in an amount to be determined by CSC. (Effective July 1, 1968, CSC reduced the amount of the contingency reserve from $300 million to $200 million.) Funds in excess of the maximum contingency reserve are paid by Metropolitan to CSC for deposit in the Employees' Life Insurance Fund in the U.S. Treasury. For the 14 policy years ended June 30, 1968, funds paid by Metropolitan to CSC in excess of the authorized amount of the contingency reserve totaled about $334 million.

Public Law 90-206 amended the act to require that the contribution rate for regular insurance cover the level cost of the insurance as determined by CSC (5 U.S.C. 8707). Level cost equals the constant premium for each $1,000 of insurance which, when supplemented by interest earnings on a fund created by the excess of premiums over insurance benefits and other costs, will pay for the benefits in perpetuity.

Therefore, it appears that Metropolitan and the reinsurers are assuming very little risk under the group life insurance policy and that there is little, if any, justification for payment of the risk charge, because of the level cost basis of setting premiums and the amount of the contingency reserve maintained by Metropolitan. Also, there seems to be little, if any, justification for payment to the reinsurers of the amounts for other expenses, since they apparently are incurring no expenses and providing no services under the policy.

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Group life insurance policy with Shenandoah Life Insurance Company

The Federal Employees' Group Life Insurance Act of 1954, as amended by the Act of August 11, 1955 (Public Law 84-356, 69 Stat. 676), authorized CSC to arrange with certain employees' beneficial associations for the assumption by the Employees' Life Insurance Fund of life insurance agreements which were provided by the associations for their members. Pursuant to this authority, CSC and the Shenandoah Life Insurance Company agreed to a group life insurance policy, effective January 1, 1956, to provide life insurance coverage to employees holding policies with employee beneficial associations at August 11, 1955.

Association members pay to CSC the same premiums they were paying to the beneficial associations prior to assumption of the life insurance agreements by CSC. They are also eligible, if otherwise qualified, for regular and optional insurance under the FEGLI program.

Effective January 1, 1968, Shenandoah started receiving an annual allowance of 2.25 percent of premiums in lieu of former amounts charged for expenses and risk charges. During fiscal year 1970 CSC collected premiums of $2,661,686 from members and paid premiums of $6,571,212 to Shenandoah. The expense and risk charge allowance for fiscal year 1970 therefore amounted to about $148,000. The policy also provides for reimbursement to Shenandoah of the actual amount of premium taxes incurred. Such taxes averaged about $39,000 a year during the 12 policy years ended December 31, 1967.

The annual premiums and allowance to Shenandoah should gradually decrease over the years, because the group policy is limited to members who had beneficial association policies at August 11, 1955. The number of members covered by the policy had declined from about 136,000 at the time the beneficial association insurance was assumed by CSC to about 96,000 at June 30, 1968.

At the time the assumption of the beneficial association insurance by CSC was authorized, it was recognized that the insurance obligations of the associations substantially

exceeded the sum of their assets and anticipated future premiums. A report of the Senate Committee on Post Office and Civil Service (S. Rept. 686, 84th Cong., 1st sess., dated June 28, 1955) indicated that no additional appropriations to cover the loss under the beneficial association insurance operations were then required and that the added cost of the insurance could be financed from the Employees' Life Insurance Fund as then constituted. In a 1970 GAO report to the Congress on "Administration of Federal Employees' Group Life Insurance Program by the U.S. Civil Service Commission" (B-125004, February 3, 1970), it was estimated that the deficit in the beneficial association insurance operations would amount to about $91 million over the estimated 35-year remaining life of the beneficial association operations.

It appears that Shenandoah is assuming little or no risk under this policy because, to the extent that the assets of the program and the future premiums paid by the association members are inadequate to cover claims and expenses, the deficit will have to be financed by appropriations or by the Employees' Life Insurance Fund applicable to the regular insurance program.

Issues for further consideration

It appears that the costs applicable to the risk charges, other expenses allowed reinsurers, and premium taxes would not be incurred if the Government were to assume responsibility, as the insurer or self-insurer, for the group life insurance provided under the policies with Metropolitan and Shenandoah. It appears also that the expense of adjudicating and paying death claims under the life insurance program could be reduced if CSC were to assume complete responsibility for the program, because CSC already maintains records and performs similar services on behalf of current and retired employees in connection with lump-sum and survivor annuity benefit payments under the Civil Service Retirement System.

On the basis of the first 14 years' experience under the program, it appears that such action could result in savings of about $1.2 million to the Government and about $2.4 million to Federal employees.

Further study will be required, however, to develop an accurate estimate of potential savings and to demonstrate the feasibility of the Government assuming responsibility for the group life insurance provided under the policies with Metropolitan and Shenandoah Life Insurance Companies. In this regard, our review of the legislative history of the Federal Employees' Group Life Insurance Act of 1954 revealed no indication that consideration was given to providing group life insurance to Federal employees under a self-insurance program at the time the act was enacted.

BLANKET INSURANCE POLICY PURCHASED BY THE COMMODITY CREDIT CORPORATION--PRIORITY A

The Commodity Credit Corporation purchased a blanket insurance policy at an annual cost of $596,250 for the period December 1, 1969, through December 1, 1972. The policy generally covers any and all claims that CCC might have against a warehouseman storing CCC-owned or loan-collateral grain, beans, or rice. Similar policies have been purchased since July 1, 1963. The policy provides that:

> "Except as otherwise provided herein, the insurer shall pay CCC any and all amounts for loss, or shortage of or damage to any commodities subject to the terms of the [Bean Storage, Uniform Grain Storage, and Uniform Rice Storage] Agreements*** and such other amounts of any kind and character whatsoever which CCC shall be entitled to recover from a warehouseman as a result of storage or handling of any such commodities under the terms of such Agreement or a warehouseman's failure to perform any other of his obligations as a warehouseman***."

The policy provides coverage of $250,000 annually for each warehouse with a maximum annual coverage of $5,000,000 for all warehouses.

The "Exclusions" section states, in part, that the policy does not apply to loss or damage caused by or resulting from:

> "Failure of the warehouseman to obtain insurance required by CCC in the Agreement, or insolvency or bankruptcy of any warehouseman's insurance company, or companies which have issued a policy or policies to a warehouseman in accordance with the agreement."

An official of the Claims Branch, Fiscal Division, of the Agricultural Stabilization and Conservation Service (ASCS) informed us that the Department of Agriculture's Office of General Counsel and the Department of Justice were pleased with the results obtained by purchasing the blanket

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insurance coverage, because such coverage eliminated considerable work and litigation normally involved in the collection of claims against warehousemen or their insurance or surety companies. He added that the insurance policy provides a claims settlement service for CCC. We noted, however, that the policy has not been entirely successful in this respect, in view of the number and amount of old claims pending in the Department of Agriculture's Office of General Counsel and in the Department of Justice, as indicated in the table on page 24.

Regarding the service provided by the underwriter of the policy in collecting claims against warehousemen or their insurers or sureties, the policy states that:

> "***the insurer is assigned and subrogated, to the full extent permitted by law, to all rights of CCC against the warehouseman, any surety or insurer on any warehouse bond or insurance policy, and any other persons with respect to the losses for which payment is made under this insurance policy. The parties intend that the insurer will thus be fully subrogated and substituted in place of CCC with respect to all its rights against any person to the same extent as if CCC were pursuing such rights. ***."

With regard to the settlement of claims, the policy states that:

> "All claims shall be paid to CCC within 60 days after presentation at the office of the insurer of proof of claim. ***. Prior to filing a claim against the insurer CCC shall make reasonable efforts, by offset or otherwise short of litigation, to collect amounts due from the warehouseman except in cases where CCC believes such collection efforts would be of no avail, including but not limited to, any cases where the warehouseman is insolvent or is in bankruptcy or receivership. ***."

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A blanket insurance policy was first purchased by CCC covering the period July 1, 1963, through June 30, 1964, in lieu of requiring warehousemen operating under the Uniform Grain Storage Agreement to furnish CCC a performance bond. The premium cost of $742,765 was allocated to the warehousemen operating under the Agreement and they were required to reimburse CCC for such costs.

Effective July 1, 1964, CCC assumed the cost of the blanket insurance policy, and coverage under the policy was extended to warehousemen operating under the Bean Storage Agreement and the Uniform Rice Storage Agreement. The premiums paid for the blanket insurance coverage and various claims data as shown in a report of claims activity as of November 1, 1970, prepared by the Claims Branch of the Fiscal Division, ASCS, are summarized below.

Period of coverage	Claims paid	Claims pending	Claims withdrawn	Premiums paid
7/1/63 - 7/1/64[a]	$ 487,770	$ 111,838[b]	$ 328,387	$ 742,765
7/1/64 - 7/1/68	2,904,106	271,839[c]	1,114,693	2,039,826
7/1/68 - 12/1/69	1,172,262	88,824	23,544	915,062
12/1/69 - 12/1/70[d]	388,976	567,875	4,444	596,250
Totals	$4,953,114	$1,040,376	$1,471,068	$4,293,903

[a]This policy covered only the Uniform Grain Storage Agreement. The premium was paid by the warehousemen.

[b]This represents two claims which were pending in the Department of Justice.

[c]This represents six claims, five of which had been referred to the Office of General Counsel or were pending in the Department of Justice.

[d]Claims data are through 11/1/70 only. The premium amount is the first-year premium for a 3-year policy.

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The above data on claims paid by and pending against the insurance companies in relation to premiums paid for the blanket insurance coverage is somewhat deceiving, because the insurers are subrogated to all rights of CCC and are entitled to recover from the warehousemen or their insurance and surety companies the amount of claims paid to CCC. In this regard, the Chief, Claims Branch of the Fiscal Division, ASCS, in an internal memorandum dated November 25, 1970, stated, in part, that:

> "We do not know the amount of recoveries against sureties and warehousemen made by the underwriters on these policies, but from the limited information available to us they appear to be substantial."

Although CCC apparently purchases the blanket insurance policy in lieu of requiring warehousemen to furnish a performance bond, most of the warehousemen covered by the policy are still required by State statute or by the U.S. Warehouse Act to furnish a performance bond guaranteeing fulfillment of their obligations to depositors of commodities as a condition to receiving a license to operate. For example, of the CCC-owned and loan-collateral grain stored in commercial warehouses as of June 30, 1970, about 90 percent was stored in 20 States which, as of March 1968, required a warehouseman to furnish a performance bond as a condition to receiving a license to operate. Of the remaining 20 States in which such grain was stored, some of the warehousemen in 17 were operating voluntarily under the U.S. Warehouse Act which requires a warehouseman to furnish a performance bond. As of March 1968 the total amount of the performance bonds furnished by warehouses covered by the blanket insurance policy was about $598 million.

Therefore, it appears that CCC would be able to recover the majority of its losses, other than casualty losses, from the surety companies of the warehousemen when it is unable to recover such losses from the warehousemen, the same as the underwriter of the blanket insurance policy is apparently now doing.

While undoubtedly it could be said that CCC is paying indirectly for the cost of performance bonds furnished by

WORKMEN'S COMPENSATION INSURANCE PURCHASED BY THE DEPARTMENT OF LABOR FOR ENROLLEES IN THE WORK INCENTIVE PROGRAM--PRIORITY A

Section 633(f)(4) of 42 U.S.C. provides that the Secretary of Labor shall have reasonable assurance that "appropriate workmen's compensation protection is provided to all participants" in the Work Incentive Program. To meet this statutory provision, with respect to enrollees participating in institutional or work experience training, the Department of Labor has purchased workmen's compensation insurance coverage under a commercial insurance policy.

From July 12, 1968, through July 31, 1970, the Department of Labor paid premiums of $673,774 to the insurer for the workmen's compensation insurance coverage. Reports submitted to the Department by the insurer for the 2 policy years showed that paid and pending claims totaled about $65,000, representing 120 claims. The reports showed also that an additional 31 claims were rejected but the dollar amount of such claims was not shown. The Department did not have information as to the disposition of pending claims. In view of the small amount involved, we did not attempt to obtain this information from the insurer.

The final premium pursuant to the terms of the policy is to be determined at termination of the policy (retrospectively rated) on the basis of (1) claims paid and reserves for unpaid claims, plus a factor of one third of such amounts, apparently for administrative expenses and profit, and (2) allocated claims costs, subject to a minimum and maximum premium. The cumulative minimum premium through the 2 elapsed policy years ending July 31, 1970, totaled $489,803. The policy contains no provision for payment of interest to the Department on the reserves held by the insurer.

An official of the Manpower Administration, Department of Labor, informed us that, prior to soliciting bids for providing the workmen's compensation coverage, he had estimated that it would cost about $500,000 a year, exclusive of the payment of claims, to establish and maintain an effective organization to handle the claims generated, if workmen's compensation coverage were provided to the

FIDELITY BONDS PURCHASED BY THE DEPARTMENT OF LABOR COVERING CERTAIN INDIVIDUALS SEEKING EMPLOYMENT--PRIORITY A

Section 105 of the Manpower Development and Training Act of 1962, as amended (42 U.S.C. 2572c), required the Secretary of Labor to establish a program to aid individuals seeking employment through public employment offices, who were otherwise qualified but could not obtain employment because of their inability to obtain bonding. The act authorized the Secretary to make payments to or contracts with employers or institutions authorized to indemnify employers against losses from the infidelity, dishonesty, or default of such persons.

In March 1966 the Department of Labor entered into a contract with an insurance company to provide fidelity bonds for those individuals attempting to obtain employment through public employment offices who were unable to obtain fidelity bonding coverage. Between March 1966 and December 31, 1970, the Department purchased 280,000 bonding units costing about $350,000. A bonding unit is $500 coverage for one person for 1 month. During this period 2,645 individuals were bonded under the program and only 35 claims totaling $21,610 were paid by the bonding company. According to information furnished to us by the Department, 57 claims were submitted, but many were not covered by the bonds and a few were still pending as of December 31, 1970.

In December 1970 the contract was amended to provide for the purchase of 243,000 additional bonding units at a cost of $170,100, and the period of performance was extended through October 31, 1971. The contract was also amended to provide for acceptance by the bonding company, for standard coverage at comparable commercial premium rates, of all bondees who have been covered for a minimum of 18 consecutive months under the program without a paid default, if the employer is still unable to obtain commercial bonding coverage. The period of performance was later extended through June 30, 1972.

With regard to consideration given to self-insurance of the bonding program, an official of the Manpower Administration, Department of Labor, stated that:

--Because of the demonstration aspects of the program, the decision was made to purchase the bonds from a commercial source rather than indemnify an employer directly for a fidelity loss.

--No estimate was made of the cost of providing the bonding coverage under a self-insurance program at the time the program was initiated.

--The feasibility of self-insurance of the program was not reconsidered when the program was expanded nationwide.

--The feasibility of self-insurance of the program may be reconsidered prior to submission of the fiscal year 1973 budget.

Initially, the program was implemented on a pilot basis in four cities. It was gradually expanded to 51 cities in 29 States and to six other States on a Statewide basis. Also, the bonding coverage was made available under all of the prisoner training projects under the Manpower Development and Training Act. In January 1971 the bonding coverage was made available nationwide as a part of the placement process in all local State employment service offices.

The specific authority for conducting the bonding program, as provided in section 105 of the Manpower Development and Training Act of 1962, as amended, expired on June 30, 1970. The Manpower Administration official informed us that subsequent to that date the program had been conducted under the general authority contained in section 102(6) of the act, as amended. In this regard, during hearings before a Subcommittee of the House Committee on Appropriations on the Department of Labor's fiscal year 1971 appropriations, the Assistant Secretary for Manpower stated as follows:

> "Offsetting the increases is a program decrease of $931,000. Of this amount $391,000 is for the Labor Mobility Demonstration Program and the Trainee Placement Assistance (Bonding) Demonstration Program. Authority for these programs expires in June 1970***."

Also, during hearings before a Subcommittee of the Senate Committee on Appropriations on the Department's fiscal year 1971 appropriations, the following statement was included in the Department's general statement regarding reorganization of the Manpower Administration:

> "In 1971, there is no request for funds for the mobility and bonding programs as authority for these two programs expires in June 1970."

In a letter dated October 6, 1971, our Office of General Counsel requested the Secretary's views as to the authority for continuing the bonding program in the absence of congressional action extending the authority contained in section 105 of the act beyond June 30, 1970. On January 26, 1972, the Assistant Secretary for Manpower forwarded the Solicitor's opinion on the matter which is currently under consideration by our Office of General Counsel.

Issues for further consideration

It appears that the specific authority for conducting the bonding program gave the Secretary of Labor the option of either purchasing fidelity bonds from a commercial source or indemnifying employers directly for fidelity losses resulting from the employment of individuals who were unable to obtain fidelity bonds. With regard to the demonstration aspects of the program, we believe that the feasibility of bonding such individuals could have been demonstrated through a self-insurance program.

Because of the small amount of claims paid by the bonding company in relation to the premiums received and because the program is now nationwide, it appears that a potential exists for significant savings through self-insurance of the risks involved, if it is determined that authority exists to continue the program. Further study will be required, however, to develop an accurate estimate of the potential savings and to determine the feasibility of indemnifying employers directly rather than purchasing fidelity bonds.

FIDELITY BONDS ON FEDERAL EMPLOYEES--PRIORITY B

The bonding of certain employees of the Federal Government against fidelity losses is required or authorized by various statutes, some of which apply to Government agencies in general while others apply to specific agencies. For example, 31 U.S.C. 82c requires that certifying officers be bonded in such amounts as may be determined by the head of the agency concerned, and 12 U.S.C. 3 requires that the Comptroller of the Currency be covered by a $250,000 bond.

Prior to January 1, 1956, the cost of fidelity bonds was borne by the employees. Since that date, the bond premiums have been paid by the Government pursuant to 6 U.S.C. 14. The same section requires the Secretary of the Treasury to transmit to the Congress on or before October 1 of each year, a comprehensive report of operations under the bonding program during the preceding fiscal year.

The reports submitted to the Congress by the Secretary show that, during the 14-1/2 year period ended June 30, 1970, the premiums paid by the judicial, legislative, and executive branches of the Government (about $4.2 million) and the total administrative costs of the bonding program (about $700,000) exceeded the claims filed against the surety companies (about $3 million) by about $1.9 million, or an average of about $130,000 a year. The reports show that about $2.7 million, or 64 percent of the total premiums, was paid by the Post Office Department. The data on claims and administrative costs are not broken down by agency, but if it is assumed that these items are divided in approximately the same ratio as the premiums, about $83,000 of the net annual cost is applicable to the Post Office Department and about $47,000 is applicable to all other Government agencies.

The General Accounting Office has issued two reports to the Congress (B-8201, March 29, 1962, and B-8201, December 30, 1964) in which it recommended that, in furtherance of the Government's general policy of assuming its own insurable risks, the Congress enact legislation to repeal the mandatory requirements for fidelity bonding of Federal employees and require each agency to absorb any fidelity losses incurred. No action was taken at the time, although a

proposed bill to accomplish the objectives of the recommendation was attached to each of the reports.

During calendar year 1971, however, the Post Office Department and its successor, the Postal Service, discontinued the bonding of all postal officials and employees. Moreover, on February 16, 1972, a bill (H.R. 13150) was introduced in the House of Representatives to provide that the Federal Government shall assume the risks of its fidelity losses. The bill was reported out by the Subcommittee on Manpower and Civil Service, Committee on Post Office and Civil Service, on March 20, 1972, and was passed by the House of Representatives on April 17, 1972.

Issues for further consideration

If H.R. 13150 is passed by the 92d Congress, the Government will become a self-insurer of the risks now covered by fidelity bonds, and no further consideration of this matter will be needed. Should H.R. 13150 fail to become law during the current session of the Congress, however, we believe that further consideration should be given to the feasibility of eliminating the mandatory requirements for such bonds.

LIABILITY INSURANCE ON GOVERNMENT-OWNED AIRCRAFT--PRIORITY B

The Corps of Engineers owns four aircraft, of which three are operated and maintained by the Corps and one is operated and maintained by Page Airways under a contract with the Corps. The aircraft are assigned to the Washington, D.C., Fort Worth, Omaha, and Vicksburg districts. The Corps purchases liability insurance (personal injury and property damage) on three of the aircraft at an annual cost of $4,030 (of which $1,100 is for insurance on the aircraft operated by Page Airways). No insurance is procured on the fourth aircraft.

National Aeronautics and Space Administration (NASA), Coast Guard, Federal Aviation Administration, Forest Service, and Atomic Energy Commission (AEC) informed us that they do not purchase liability or hull insurance on their aircraft. (However, see page 79 for comments on liability insurance purchased by contractors operating aircraft owned by NASA and AEC.) Other agencies, such as Bureau of Reclamation, Bonneville Power Administration, and Tennessee Valley Authority (TVA), also have Government-owned aircraft, but we did not inquire about their insurance practices.

Issues for further consideration

The procurement of liability insurance on aircraft owned, operated, and maintained by the Corps of Engineers appears to be unnecessary and uneconomical. Although the premium cost is relatively small, it nevertheless appears to represent a needless expense, a large part of which might be saved through self-insurance. We therefore believe that the Corps should give consideration to assumption of the risks covered by such insurance.

NUCLEAR LIABILITY INSURANCE PURCHASED BY TENNESSEE VALLEY AUTHORITY--PRIORITY C

An official of TVA informed us that TVA currently has two nuclear power plants under construction and that TVA, like other AEC licensees, has the option of purchasing the

maximum commercial nuclear liability insurance available (currently about $82 million) or showing that it is capable of absorbing a loss equal to the amount of insurance available. He stated that TVA had recently purchased the first phase of nuclear liability insurance--the $1,000,000 coverage required when nuclear fuel is delivered to the site--at a cost of about $5,000. He stated also that TVA would probably purchase the maximum nuclear liability insurance available when the nuclear power plants under construction are placed in service.

An AEC official informed us in October 1971 that he thought TVA had definitely decided to purchase commercial nuclear liability insurance coverage for the two plants. He informed us also that the annual cost of insurance coverage generally ranges from about $200,000 to $300,000 per nuclear unit, depending on the size and type of reactor and location of the power plant. The first of the three nuclear units at TVA's Browns Ferry nuclear power plant is scheduled to begin operation in April 1972, the second in January 1973, and the third in October 1973. The two nuclear units at the Sequoyah power plant are scheduled to begin operation in April and December 1974. When all five units are placed in service, nuclear liability insurance coverage could cost between $1 million and $1.5 million a year.

Section 2210 of Title 42, United States Code provides that each license issued by AEC for a nuclear facility designed to produce electricity shall have as a condition of the license a requirement that the licensee have and maintain financial protection to cover public liability claims. If such a facility has a rated capacity of 100,000 electrical kilowatts or more, the amount of financial protection required shall be the maximum available from private sources. The financial protection required by section 2210 may include private insurance, private contractual indemnities, self-insurance, other proof of financial responsibility, or a combination of such measures.

According to 10 CFR 140.51, Federal agencies which are holders of AEC licenses are not required to furnish financial protection. Section 140.52 of 10 CFR states that AEC will execute and issue agreements with Federal agencies having AEC licenses, which provide that AEC will indemnify

and hold the agencies harmless from public liability (10 CFR 140.94, Appendix D). A Federal agency is defined in 10 CFR 140.3(c) as "*** a Government agency such that any liability in tort based on the activities of such agency would be satisfied by funds appropriated by the Congress and paid out of the United States Treasury."

An AEC official informed us that since TVA's power operations are supposed to be self-supporting and TVA does not receive appropriated funds for such operations, AEC's Office of General Counsel and TVA officials agreed that TVA would provide financial protection in accordance with 42 U.S.C. 2210 for its nuclear power plants.

Observations

We believe that, for purposes of determining risk exposure and ability to absorb maximum probable loss, the Federal Government should be considered as a single entity, including all its departments and independent agencies and those Government corporations which are supported by appropriated funds. However, Government corporations such as TVA, which conduct self-supporting operations, pose a unique problem with regard to self-insurance. To the extent that such corporations purchase insurance, the cost is passed to the users and does not increase the expenditures of the Federal Government. If, on the other hand, a corporation's risks were to be pooled with other Government risks and the corporation's losses were to be indemnified from appropriated funds, the corporation's activities would be subsidized by the Government and the Government's expenditures would be increased, rather than decreased, through self-insurance.

A possible solution might be for the Government to agree to indemnify a corporation for those losses which are beyond the corporation's capacity to absorb and to charge a reasonable premium for this service. We are inclined to believe, however, that the most practical solution to the problem is for TVA and other corporations which conduct self-supporting activities to self-insure their risks to the extent of their capacity to absorb losses and

to purchase insurance coverage on risks which exceed that capacity. It is our understanding that this is essentially the course which TVA is following.

LIABILITY INSURANCE ON CERTAIN D.C. GOVERNMENT VEHICLES--PRIORITY C

In fiscal year 1971, the D.C. Government purchased liability insurance ($100,000/$300,000 bodily injury and $10,000 property damage) covering 73 school buses, 32 carryalls, 30 driver training cars, and 1 truck at an annual cost of about $22,000. Information included in the invitation for bids for the 1971 contract indicated that the D.C. Government had been purchasing similar insurance since at least September 1967.

The legislative histories of recent D.C. Government appropriations acts indicate that it was the intent of both the Congress and D.C. Public School authorities that the education appropriation be available for procuring insurance on certain public school vehicles.

Observations

Because of the apparent intent of purchasing the insurance for the protection of students, teachers, and other public school employees, no further consideration of self-insurance of the risks covered seems warranted at this time.

LIABILITY INSURANCE ON GOVERNMENT-OWNED VEHICLES OPERATED IN FOREIGN COUNTRIES--PRIORITY C

The Secretary of State and the Secretary of Agriculture are authorized by law (22 U.S.C. 2670 and 7 U.S.C. 2262, respectively) to purchase liability insurance on Government-owned vehicles operated in foreign countries. The legislative history indicates that the primary purpose in granting authority for the purchase of such insurance was to provide for compliance with the laws and policies of foreign countries and to protect employees while operating United States vehicles in foreign countries.

Also, the act making appropriations available to the Department of Defense for fiscal year 1971 (84 Stat. 2020), authorized the expenditure of funds for insurance of official motor vehicles in foreign countries when required by the laws of such countries.

Observations

Because the purpose in granting legal authority for the purchase of insurance on Government-owned vehicles operated in foreign countries was to enable compliance with the laws and policies of such countries, we believe that no further consideration of self-insurance of the risks covered is warranted.

HAZARD INSURANCE ON SHIPMENTS OF VALUABLES--PRIORITY C

The Government Losses in Shipment Act, approved July 8, 1937 (40 U.S.C. 721 and 31 U.S.C. 528 and 738a), prohibits Federal agencies from purchasing insurance on shipments of valuables, except as specifically authorized by the Secretary of the Treasury. The act permits the Secretary to authorize agencies to purchase insurance on such shipments when he finds that the risk of loss, damage, or destruction thereof cannot be adequately guarded against by the facilities of the United States or that adequate replacement cannot be made under the act. Section 262.1 of 31 CFR states that valuables include money of the United States and foreign countries, private and public securities and certain other instruments or documents, precious metals and stones, and works of artistic, historical, scientific, or educational value.

The act also established a revolving fund in the U.S. Treasury from which agencies may receive reimbursement for losses of valuables in shipment. All recoveries and repayments on account of loss, damage, or destruction to valuables for which payment has been made from the fund are credited to the fund, and sums are appropriated by the Congress as necessary to replenish the fund.

In 1939 the act was amended to authorize charges to the fund for losses arising from Post Office Department operations, as an agent of the Treasury, such as the sale of U.S. Savings Bonds and internal revenue stamps (40 U.S.C. 724). General authority was later provided for charges to the fund of any losses resulting from payments made in connection with redemptions of U.S. Savings Bonds (31 U.S.C. 757c(i)).

BEST DOCUMENT AVAILABLE

From inception of the fund in July 1937 through fiscal year 1970, net charges against the fund [illegible]unted to $2,784,548. During hearings before the [illegible]e Subcommittee on Departments of Treasury and Post Offi[illegible] nd Executive Office Appropriations, in February 1968, [illegible]Treasury official stated that about $70 million in comm[illegible]rcial insurance premiums had been avoided from the inception of the fund to sometime in 1956 when the calculations were stopped.

The Assistant Comptroller (Depository Analysis), Bureau of Accounts of the Treasury Department, who is responsible for administration of the Government losses in shipment fund, informed us that, to his knowledge, no agency had been granted authority in recent years to purchase commercial insurance on a shipment of valuables. He stated that the costs of administering the program consisted of about 5 percent of his time and about 15 to 20 percent of his secretary's time. He added that additional administrative costs are incurred by agencies submitting claims for reimbursement from the fund. He stated, however, that the costs incurred by an agency in investigating a loss and submitting a claim would be comparable to the costs of investigating a loss and submitting a claim to an insurance company if shipments of valuable were covered by commercial insurance.

An order issued by the Secretary of the Treasury in 1937 and amended in 1938 (3 F.R. 2281; 31 CFR 260) states generally that any shipment of gold and silver coin or bullion to, from, between, or within foreign countries is excepted from the prohibitions in the Government Losses in Shipment Act if, and to the extent that, adequate insurance at satisfactory rates can, in the opinion of the Secretary of the Treasury, be obtained to cover such shipment.

An official of the Treasury Department informed us that, in recent years, no shipments of silver had been made to, from, between, or within foreign countries. He stated that most of the gold transfers between countries were handled at the Federal Reserve Bank of New York by simply transferring the gold bullion from one vault to another. He informed us also that in 1968 a shipment of gold had been made to a foreign country by an Air Force plane but that no insurance had been purchased.

Observations

Since in recent years no Government agencies have apparently been granted authority to purchase insurance on shipments of valuables, and no insurance has apparently been purchased on shipments of gold and silver coin and bullion to, from, between, or within foreign countries, no further study of this area seems necessary at this time.

COLLISION DAMAGE INSURANCE COVERING FIRST
$100 DAMAGE TO RENTED AUTOMOBILES --PRIORITY C

In a report to the Director, Bureau of the Budget (B-158712, June 30, 1970), GAO stated that there was a lack of uniformity in the car rental practices and procedures of the Department of Defense and other Federal agencies related to the purchase of collision damage insurance on automobiles rented from commercial firms. The report stated, in part, that:

"--The Department of Defense has issued instructions encouraging its travelers, both military and civilian, to buy collision damage insurance when renting cars for official use. Some subordinate commands apparently have issued conflicting instructions and are either discouraging or prohibiting the practice. Others seem to be following a permissive policy; some travelers buy the coverage and others do not.

"--Similar inconsistencies were found in other Federal agencies. Several allow their personnel to buy the coverage; others refuse on the basis that it is more economical for the Government to assume the risk of loss; others have not established any policy."

The report concluded that a determination should be made as to whether it would be more economical for the Government to assume the risk for collision damage losses of $100 and under than to procure collision damage insurance and that existing regulations should be revised in accordance with such determination so that they could be applied uniformly throughout the Government.

Most of the major car rental companies accept responsibility for collision damage losses in excess of $100 and include the insurance cost in their rental fees. Individuals who rent cars are held liable for losses of $100 or less, but they may obtain full insurance coverage by purchasing a collision damage waiver which the rental companies currently provide for an additional charge of $2 a day. Our Office has previously issued decisions allowing reimbursement to

employees for the cost of collision damage insurance and for losses of $100 or less when such insurance was not purchased. (See 35 Comp. Gen. 553, April 5, 1956, and 47 Comp. Gen. 145, August 30, 1967, respectively.)

In another decision (B-162186, January 7, 1970), the Secretary of the Air Force was advised that we had no legal objection to the Joint Travel Regulations for members of the uniformed services being amended to provide for reimbursement to a member for personal funds spent in paying the first $100 of damage sustained by a vehicle properly rented in the performance of official business, provided that the regulations, as amended, specifically excluded the cost of collision damage insurance as a reimbursable item of expense.

Effective November 17, 1970, the Joint Travel Regulations for members of the uniformed services were amended to prohibit reimbursement to a member for the purchase of collision damage insurance and to provide for reimbursement not to exceed $100 for personal funds paid to rental car agencies for damage sustained by an automobile properly rented in the performance of official business. Also, effective October 10, 1971, the Office of Management and Budget revised the Standardized Government Travel Regulations, similarly, in response to our June 1970 report.

Observations

Because of the revisions made to the Joint Travel Regulations and to the Standardized Government Travel Regulations, no further study of this area seems necessary at this time.

CHAPTER 3

BONDS AND INSURANCE PAID FOR INDIRECTLY UNDER CONTRACTS

HAZARD INSURANCE ON MATERIALS AND WORK-IN-PROCESS INVENTORIES--PRIORITY A

Under the provisions of Armed Services Procurement Regulation (ASPR) 7-203.21, the Government takes title to all property acquired by a contractor under a cost-reimbursement-type supply contract, including parts, materials, and work in process, and assumes the risk of loss, except where any losses are the result of willful misconduct or lack of good faith of the contractor's directors, officers, or managers. Accordingly, a contractor's need for insurance is reduced. In the event a contractor purchases insurance to protect against loss or damage to inventories and other Government property under a cost-reimbursement-type contract, the cost is not allowable under section 15 of ASPR.

The same types of items acquired by a contractor under a Government fixed-price supply contract are treated differently. Our review of contracts during the study indicates that a contractor generally is held responsible for any loss under a fixed-price contract until the finished product is accepted by the Government, even though title may have previously passed to the Government under the standard progress payment clause (ASPR 7-104.35). Under this clause, which is included in all fixed-price supply 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 prior to its delivery to and acceptance by the Government unless the Government expressly assumes the risk.

A contractor therefore purchases fire and extended coverage insurance to protect against loss or damage to such inventories. The effect is that a contractor does not insure inventories under cost-type contracts but generally does insure the same types of inventories under fixed-price contracts even when title to the inventories has passed to the Government. The cost of such insurance would normally be included in the contract price.

This inconsistency could be corrected by revising ASPR 7-104.35 to provide for Government assumption of the risk of loss or damage to all direct materials and parts acquired by a contractor and charged to a contract containing the standard progress payment clause. We believe, however, that additional savings may be realized by extending the Government's policy of self-insurance to all negotiated supply contracts rather than limiting it to those contracts containing the standard progress payment clause.

We therefore believe that consideration should be given to the feasibility of treating all direct materials and parts acquired by contractors and charged to negotiated fixed-price supply contracts as having been procured for the account and risk of the Government and therefore subject to the Government's traditional policy of self-insurance, without regard to the passage of title or inclusion of a progress payment clause. If the Government assumed this risk, the cost of any insurance procured by contractors on direct materials and parts should be excluded from contractors' price proposals and from consideration in the negotiation of contract prices. Such a policy should result in substantial savings to the Government and should simplify the problem of adjudicating claims when a loss occurs in a plant where both cost-type and fixed-price contracts are being performed.

Our projections based upon the questionnaire replies that we received from contractors and related information indicate that insurance costs on inventories applicable to Department of Defense (DOD) contracts during a recent 12-month period amounted to about $4.2 million and that claims for loss or damage amounted to about $1.3 million. We believe the insurance costs projected are considerably understated because purchased parts and materials inventories--

which in some cases exceed the value of the contractors' work-in-process inventories--were not covered by many contractors in their replies to our questionnaire.

GAO has previously made a review of potential savings in this area. In a prior report to the Congress (B-146926, September 15, 1964), covering a review of four major contractors for 5-year periods ended in 1961, GAO reported that the Government had incurred unnecessary costs of $1,237,500 for insurance and related profit because DOD required the contractors to bear the risk of loss or damage to parts, materials, work in process, and special tooling, title to which had passed to the Government under fixed-price contracts which provided for progress payments. During the 5-year periods, amounts received by the contractors for losses on this property amounted to only $12,500. The report also pointed out that the Government had avoided costs of $295,800 during a comparable 5-year period at another major contractor's plant by assuming the risk of loss or damage to such property.

GAO recommended that the Secretary of Defense take action to provide for Government assumption of risk of loss or damage to all Government-owned parts, materials, work in process, and special tooling in the possession of contractors under negotiated fixed-price contracts unless the contracting officials could show in individual cases that assumption of risk by a contractor would be less costly. GAO also recommended that when the Government assumed the risk of loss, the contractor be required to represent that no costs for insurance on such property are included in the prices established for negotiated fixed-price contracts. DOD disagreed with GAO's position and did not adopt the recommendations.

In some instances, however, DOD has assumed the risk on work-in-process inventories under fixed-price contracts. For example, the Navy has a longstanding practice of assuming the risk of loss or damage to vessels over 200 feet in length while under construction. More recently, as the result of a GAO report to the Congress (B-114851, August 12, 1970), the Coast Guard advised GAO that it would adopt the Navy's policy of self-insurance on vessels under construction. Also, we noted that the Air Force, Navy, and Coast Guard have assumed the risk of loss or damage to work in process

under certain fixed-price contracts for fixed-wing aircraft and helicopters.

The Government also incurs insurance costs on subcontractors' inventories. Subcontractors with fixed-price contracts generally are required by Government prime contractors to assume the risk of loss or damage to inventories destined for Government products. The cost of insurance purchased by a subcontractor as protection against this risk is a factor in establishing the subcontract price, which is in turn included in the prime contract price.

The dollar volume of subcontracting is substantial. In fiscal year 1970, 934 large DOD prime contractors reported that they had subcontracted $11.9 billion under their prime contracts. This probably includes only the first level or tier of subcontracts. If all tiers were considered, the overall cost of insurance would be increased, because many subcontractors issue subcontracts of their own. We did not attempt to determine the overall cost of insurance purchased by subcontractors, but our survey work indicates that it could be significant. We believe that consideration should be given to the feasibility of Government assumption of the risk of loss or damage to subcontractors' work-in-process inventories under negotiated prime supply contracts.

Views of contractor and agency officials

A number of contractors indicated that it would be feasible for the Government to assume the risk of loss or damage to inventories under fixed-price prime and subcontracts. Some contractors indicated that Government self-insurance of inventories would alleviate their problems in obtaining sufficient commercial insurance to meet their needs.

Some contractors opposed or had reservations about the Government assuming this risk, contending that (1) problems would arise in settling claims where Government and commercial work are commingled, (2) insurers provide valuable safety and engineering services, and (3) insurance companies probably could handle the claims more promptly and economically than the Government. Others indicated that extension

of Government self-insurance to subcontractors' inventories could become unwieldy and difficult to control.

Certain agency officials advised us in informal discussions that extension of Government self-insurance to inventories of fixed-price prime contractors would be feasible, but others expressed opposition or mentioned problems that could result. These potential problems were generally similar to those mentioned by contractor representatives. In addition, officials of one agency indicated that contractors might be required to meet higher safety standards under a Government self-insurance program than under commercial insurance, thereby increasing contract costs. On the other hand, they stated that the incentive for contractors to improve safety conditions in order to reduce commercial insurance costs would not exist under Government self-insurance.

The objections raised by contractor and agency officials merit further consideration. The strongest rebuttal to these objections appears to be that the Government already assumes the risk of loss or damage for inventories under cost-type prime contracts and has extended this practice to fixed-price contracts for certain naval vessels and certain aircraft.

We contacted representatives of the Navy and the Defense Contract Administration Services, Defense Supply Agency, to determine their experience in settling claims involving Government-owned property under cost-type contracts where Government and commercial operations are performed at the same plant. These representatives advised us that to their knowledge there had been no problems in settling claims involving loss or damage to Government property where a contractor's operations included both commercial and Government cost-type work.

Issues for further consideration

Further study will be needed to demonstrate the feasibility of extending the Government's policy of self-insurance to assumption of the risk of loss or damage to direct materials and work-in-process inventories of Government contractors and subcontractors under negotiated fixed-price supply contracts, and to develop a more precise estimate of the potential savings to the Government from such action.

BID, PERFORMANCE, AND PAYMENT BONDS

A bid bond, which accompanies a bid or proposal, provides assurance that the bidder will not withdraw his bid within the period specified therein for acceptance and will execute a written contract and furnish such bonds as may be required within the period specified in the bid.

A performance bond executed in connection with a contract secures the performance and fulfillment of all the undertakings, covenants, terms, conditions, and agreements contained in the contract.

A payment bond executed in connection with a contract ensures payment to all persons supplying labor and material under the contract.

Postal Service star route contracts--Priority A

The Postal Service awards contracts for intercity highway transportation of mail (star routes). The contracts are awarded to trucking firms and private individuals through competitive bidding and can include box delivery, collection, and other services normally furnished by rural carriers. Star route contracts normally cover periods of 4 years and may be renewed for an additional term of 4 years without advertising.

The Post Office Department, predecessor of the Postal Service, required each bidder on a star route contract to provide a combined bid and performance bond to insure that the bidder would execute a contract and that service would be performed in accordance with the contract terms. The Postal Service is continuing this requirement but has reduced the amount of the bond required from 50 percent to 25 percent of the bid amount, with a minimum bond of $1,000. We estimate the total cost of these bonds in fiscal year 1971 to be about $1 million, and we believe it is logical to assume that this cost is included in the contract prices. The cost should be somewhat lower in future years because of the reduction in the required amount of the bond.

The Postal Service Manual provides that, after a surety assumes responsibility for a star route upon default or

removal of a contractor, the surety may be released from responsibility by claiming financial hardship when the cost to the surety for operating the route exceeds the compensation received. In one postal region during an 8-month period, a surety company was released from its responsibility on 11 star routes because of claimed financial hardship.

In a letter to GAO dated October 5, 1971, the Postmaster General stated that the bid and performance bonds guaranteed maintenance of a standard of service, protected against losses caused by default of the contractor, and acted as a policing device to eliminate excessively low bids by unqualified bidders. He said that the bond exercised a discipline over contractors and bidders that would not otherwise be possible without high administrative costs and possible deterioration in the quality of service.

Issues for further consideration

The protection afforded by the bonds on star route contracts appears to be minimal and is further reduced by the provisions of the Postal Service Manual whereby surety companies may be relieved of responsibility in the event of financial hardship. In view of the fact that star route contracts are awarded for a 4-year period and may be renewed for another 4-year period, it should be possible for the Postal Service to perform the function of screening out unqualified bidders without incurring excessive administrative costs.

Further study of this matter will be needed to demonstrate the feasibility of eliminating the requirement for bid and performance bonds on Postal Service star route contracts and to develop a current estimate of potential savings through self-insurance of this risk.

Construction of public works--Priority B

The Miller Act (40 U.S.C. 270a) requires that any contracts over $2,000 awarded by the Federal Government for construction, alteration, or repair of any public building or public work be covered by performance and payment bonds furnished by the contractor. The act permits waiver of this requirement for cost-type contracts awarded by certain agencies. Generally, all Government fixed-price contracts over $2,000 for direct construction of buildings, dams, reservoirs, and test facilities, and for alteration or repair of public works, must be covered by performance and payment bonds. Also, performance and payment bonds are sometimes required by contracting agencies under other types of contracts.

Although the Miller Act does not specifically require bid bonds, in practice most Government agencies require bid bonds in those cases where performance and payment bonds are required. The additional cost of a bid bond is nominal, and it provides assurance that the successful bidder will be able to furnish the required bonds when he is awarded the contract.

The Federal budget for fiscal year 1972 provides $5.2 billion for construction of civil and defense public works. Outlays amounted to $3.7 billion in fiscal year 1970 and were estimated to be $4.6 billion in fiscal year 1971.

We estimate that the cost of bonds on such construction was between $16.5 million and $20.5 million in fiscal year 1970, and between $20 million and $24.5 million in fiscal year 1971. Bonding costs in fiscal year 1972 could amount to between $23 million and $28 million. These estimates do not include bonding costs on contracts for alteration or repair of Government buildings but do include some cost-reimbursement-type contracts awarded by the Corps of Engineers and the Navy that would not require bonding. Construction outlays by TVA are not included in our estimate of bond costs since TVA performs virtually all of its own construction and therefore does not require bonds.

During our survey, we contacted several of the agencies having major construction programs. Generally, the depth

of our survey was dependent upon the availability of records at the agencies' headquarters in Washington, D.C., from which summary information could be obtained. For example, actual costs of bonds and data on contractor defaults were available at the Veterans Administration (VA) and Postal Service, but such information was not available at the Corps of Engineers or General Services Administration (GSA) because of decentralized operations.

We obtained actual costs of bonds on selected contracts awarded in fiscal years 1970 and 1971 to derive a basis for estimating such costs overall. Data on contractor defaults was obtained where available to determine if bonding requirements have conferred economic or other benefits on the Government. We could not generally obtain accurate information on the extent of the economic benefits to the Government, however, because in most cases of default the surety takes over and completes the construction project using a different contractor, and the surety's records are not ordinarily available for GAO inspection.

Corps of Engineers

The Corps of Engineers contracts for military construction of the Army and Air Force and for civil public works such as flood control and navigation projects. In compliance with the Miller Act, the Corps requires bid, performance, and payment bonds on all fixed-price contracts for construction. On cost-reimbursement-type contracts, however, the Corps can waive the bond requirements. Corps officials informed us that cost-type contracts are rarely used.

The Corps of Engineers fulfills its construction responsibilities through the operation of district offices that are relatively autonomous. The district offices are responsible for the award and administration of the construction contracts.

Our Cincinnati and Dallas Regional Offices had previously performed survey work in 1968 and 1969 on the bonding practices of the Corps of Engineers' district offices at Huntington, West Virginia, and Fort Worth, Texas. The bond costs identified by the surveys for fiscal years 1967 and 1968 are shown in the tabulation below.

	1967	1968	Total
Huntington	$ 61,546	$165,938	$227,484
Fort Worth	298,179	330,610	628,789
Totals	$359,725	$496,548	$856,273

Huntington experienced two contractor defaults in fiscal year 1966 on which the surety companies incurred costs of $174,425 in excess of the contract price. These were the only defaults that occurred from fiscal year 1959 through October 1968, while the estimated costs of performance bonds during this period amounted to $1.9 million.

The Fort Worth District experienced two defaults from fiscal year 1962 through January 1969. One default in fiscal year 1962 resulted in costs to the surety of about $12 million in excess of the contract price. The other default occurred in 1964; however, the surety company refused to complete the project or to pay the costs of completing the project in excess of the contract price. The Government has filed suit against the surety in the amount of $12,240, plus interest.

On the basis of our survey at the Corps' New Orleans District Office, we estimate that bond costs of the district amounted to about $165,000 and $169,000 in fiscal years 1970 and 1971, respectively. Since 1962 the New Orleans District has experienced four defaults. Data on one of the defaults was not available because the records had been retired. On the other three defaults, the Corps collected $66,694 from the surety, $116,183 was written off as uncollectible, and $59,250 is pending.

New Orleans District officials advised us that a more intensive preaward survey or prequalification of bidders could be used in lieu of the present bond requirements. The district offices currently conduct preaward surveys even when bonds are required.

Based on outlays by the Corps of Engineers, we estimate that the cost of bid, performance, and payment bonds amounted to between $5.9 million and $7.3 million in fiscal year 1970, and between $7.3 million and $8.9 million in fiscal year 1971,

and could amount to between $8.3 million and $10.1 million in fiscal year 1972. Default data for the other Corps districts would have to be obtained from the individual district offices.

Postal Service

In fiscal year 1970 the Postal Service awarded four contracts for direct construction of major facilities at an estimated cost of $29.9 million. The estimated cost of bid, performance, and payment bonds required on these four contracts was $157,000. We estimate that the cost of bonds on contracts awarded in fiscal year 1971 was about $1.4 million and will be about $1.2 million in fiscal year 1972. It should be noted that construction of federally financed facilities was sharply curtailed in fiscal year 1970 as a result of a Presidential order.

To evaluate any tangible benefits derived from bonding, we reviewed the Postal Service's files and found that there had not been a default by a contractor constructing a major facility since fiscal year 1966.

It should be noted that the Corps of Engineers has been given responsibility for awarding and administering contracts for buildings constructed for Postal Service ownership. The Postal Service will continue to determine its space requirements and location of the desired sites.

Procurement regulations of the Post Office Department applied, with some modification, the requirements of the Miller Act to contracts for installation, alteration or modification of fixed mechanized systems for handling mail. The systems consist of equipment such as conveyors, towveyors, chutes, and other mechanized equipment installed in postal facilities for use in handling mail. This requirement has been continued by the Postal Service and by the Corps of Engineers. We estimate the cost of bonds on such contracts at about $135,000 a year for fiscal years 1971 and 1972.

Tennessee Valley Authority

TVA had outlays for construction amounting to $348 million, or 15.8 percent of total Federal construction outlays, in fiscal year 1970 and will account for about 18 percent of total outlays in 1971 and 1972. However, TVA performs almost all of its construction with its own work force, and therefore bonds are not required. TVA officials estimated that only 2 percent of its construction program is carried out by private contractors.

TVA has a unique policy on the bonding of supply contracts. When TVA believes a bond may be needed, its invitation for bids requires each bidder to provide a letter from a surety company stating its willingness to furnish a performance bond in the event the bidder is awarded the contract. The estimated cost of the performance bond is stated as a separate item in the bid and may be deducted from the contract price if TVA elects not to require the bond.

The flexibility provided by this bonding procedure permits TVA to require a performance bond when a contract is awarded to a bidder who is not well known to TVA or when the procurement is for essential commodities such as coal. On the other hand, if the contractor is well known and past performance has been satisfactory, the bond requirement can be waived at a savings in contract cost. While this method could not be used for construction contracts subject to the Miller Act, it seems worthy of consideration if any proposal is made to amend the Miller Act to eliminate the mandatory bonding requirement.

Veterans Administration

VA Headquarters maintains files on all construction contracts in excess of $300,000, while files on contracts of less than $300,000 are maintained at the 166 VA field stations. Based on construction outlays by VA, we estimate that the cost of bid, performance, and payment bonds was about $210,000 and $820,000 in fiscal years 1970 and 1971, respectively, and will be about $845,000 in fiscal year 1972.

We reviewed all of the files on contractor defaults provided by VA Headquarters officials and found only two

defaults--one on a contract of about $2 million, which occurred in November 1956, and another on a contract of about $180,000, which occurred in January 1959. We also contacted officials of seven VA hospitals to determine their default experience and their knowledge of any instance where a surety provided assistance to a contractor. These officials could not recall any defaults within the last 5 years. Six of the seven officials had no knowledge of any instances where the surety company provided assistance to a contractor. The seventh official recalled one case in the last 5 years where VA notified the surety company that the contractor was falling behind schedule, and after that there was no problem.

General Services Administration

We estimate that the cost of bonds on contracts awarded by GSA for construction, repair, improvement, conversion, or extension of Government buildings would be about $363,000, $746,000, and $1,246,000 for fiscal years 1970, 1971, and 1972, respectively.

GSA officials informed us that since January 1, 1966, GSA has experienced defaults on five contracts for new construction with contract prices totaling $15.7 million. Three of the defaults involved the same contractor. Information was not available as to the percent of completion at the time of default or the cost to the surety of completing each project.

Atomic Energy Commission

AEC requires bid, performance, and payment bonds on formally advertised fixed-price prime construction contracts and on fixed-price subcontracts awarded under cost-type prime contracts for construction of facilities.

We estimate the cost of bonds on contracts awarded by AEC at $1.2 million, $1.3 million, and $1.1 million for fiscal years 1970, 1971, and 1972, respectively. AEC officials advised us that there had been no contractor defaults in the last 3 years. These officials were reluctant, however, to express an opinion regarding the feasibility of eliminating the requirement for bonds because they had not given previous consideration to the matter.

Views of agency officials

Agency officials were nearly unanimous in their opinions that, in addition to the Miller Act requirements, the bonds are necessary for the following reasons:

1. Surety companies screen out marginal contractors and thereby provide assurance that the bidders are technically and financially competent. Without performance bonds it would be very difficult for a Government agency to disqualify a low bidder on the basis of agency officials' opinions as to his competence. Disqualification of the low bidder could result in a bid protest that would delay construction.

2. The Government would find it costly and difficult to provide the same protection to subcontractors and suppliers that is now afforded by payment bonds.

3. Sureties perform a valuable service by exerting pressure on contractors who are behind schedule. When a contractor is in difficulty the surety will sometimes provide him with managerial and even financial assistance to help avoid a default.

4. When a default occurs, the surety relieves the Government of a tremendous administrative burden by taking over the project; settling the claims of laborers, subcontractors, and suppliers; and obtaining another general contractor to complete the construction. Because the surety is not constrained by Government procurement regulations, it can complete the project faster and usually cheaper than the Government could.

Industry views

We solicited the views of The Associated General Contractors of America, an organization with 9,100 members who do about 80 percent of all the construction work performed in the United States. Officials of the association stated that they believed Government assumption of the risks covered by bonds was feasible provided there were adequate

prequalification procedures and lists of qualified bidders. They offered to distribute a questionnaire to obtain the opinions of the membership. The questionnaire, which we prepared, was sent to the association's 200 directors, who are also construction contractors. Responses were received from 150 directors.

About 80 percent of the directors who responded said that they would not favor elimination of bid, performance, and payment bonds. However, only 53 percent of these directors indicated that they generally required their subcontractors to provide bonds. Sixty-seven percent stated that the surety companies perform a valuable function in eliminating marginal contractors.

The questionnaire requested the directors' comments regarding the practicability of the Government assuming the role of self-insurer. A number of directors suggested the use of prequalification procedures as an alternative to the present bonding requirements. Prequalification procedures generally require contractors to provide statements on their financial resources, equipment, workload, and experience. Most of the unfavorable comments expressed doubt that the Government could match the efficiency, effectiveness, or objectivity of the surety companies in screening out marginal contractors. The directors also expressed concern that elimination of bond requirements would result in more defaults and increased Government red tape.

Examples of some of the comments, both favorable and unfavorable, are presented below.

1. "There should be a tremendous saving in the Government becoming self-insured providing appropriate self-protecting procedures are adopted."

2. "We think that the Federal Government could eliminate a very chaotic situation by handling this function. Provided it is handled properly."

3. "The practice of using bid bonds and surety bonds on all public work is a sound one. The entire construction industry has grown in stature and prospered by reason of requiring a surety to guarantee the

contractor's performance. Private owners have the privilege, and usually exercise this privilege, to prequalify bidders. Private owners have the right, and frequently do, to select for their construction a bidder other than a low bidder. Public awarding authorities have little or no right of prequalification and if prequalification is attempted by public awarding authorities the influence of politics will certainly play a large part. The use of bid bonds and surety bonds prevents many of the undesirable bidders and contractors from muddying the water of the construction industry."

4. "Really the only thing a bond in our world amounts to is a payment to a bonding company (approved by the awarding authority) for no service rendered."

5. "I do not feel that the Government or other agencies should waive present bonding requirements (1) the bond is a protection to the agency as well as to all tiers of subcontractors furnished by an independent entity; (2) as independent businessmen the surety companies are far better qualified to appraise the contractors current financial condition as well as his capability to perform the work contemplated. In this capacity, he also protects the Government and all tiers of subcontractors from the undue optimism of an unqualified contractor."

6. "Use of the technique of 'pre-qualification' to weed out unstable contractors."

In contrast to the directors of The Associated General Contractors of America, a majority of the members of the National Constructors Association favored the elimination of bonding requirements. The National Constructors Association is an organization of 35 member companies which are designers and erectors of oil refineries, chemical plants, steel mills, and power plants. Upon learning of our study, an official of the Association polled the membership and provided us with the results of the poll. Of the 26 members that expressed opinions, 18 favored the elimination of the requirements for bonds. No comments were provided on the reasons the members favored or opposed self-insurance by the

possible that a recent change in DOD's procedures for making progress payments to contractors can provide such assurance without the need for payment bonds. Defense Procurement Circular No. 94 provides, with respect to new solicitations after January 1, 1972, that progress payments are to be based on actual payments by the contractor rather than on costs incurred, except when the contractor is a small business concern. Such procedures have been in effect in Great Britain for many years. Although the primary purpose of the new procedure--the elimination of progress payments in excess of a contractor's actual needs under a contract--is unrelated to payment bonds, we believe the effect will be to eliminate much of the need for such bonds on construction contracts.

Agency officials and representatives of sureties provided us with several specific examples of assistance given by sureties to contractors who were in difficulty. We have no basis, however, for estimating the percentage of contracts on which such assistance is given, or the effectiveness of such assistance in avoiding defaults. Additional work will be needed to explore this matter further.

With regard to the last argument of the agency officials, it is undoubtedly a big help to agencies to have a responsible surety take over a defaulted project and complete it for the Government. Whether such a service, in the few cases where it is provided, justifies the amounts being expended for performance bonds depends on a number of factors, such as (1) the number of defaults in relation to the total number of contracts, (2) the percentage of completion of each contract at the time of default, (3) the excess, if any, of the cost to complete the project over the contract price, and (4) the amount of administrative effort required to settle claims, obtain another contractor, and complete the project.

In view of the significant cost of the bonds and the limited number of defaults that have been experienced, it appears that there might be a net advantage to the Government through accepting the occasional inconvenience, disruption, and expense of an uninsured default in order to save the substantial amounts now being expended for bond premiums.

Construction and repair of vessels--Priority B

Although the Secretaries of the Army, Navy, Air Force, Transportation, and Commerce are authorized to waive the Miller Act bond requirements when contracting for ship construction and repair, the waiver authority is not always exercised. The Navy generally assumes the bonding risk in contracting for construction of vessels over 200 feet in length and for repair of vessels but requires bid, performance, and payment bonds for construction of vessels under 200 feet.

The Coast Guard, as a result of a GAO report (B-114851, August 12, 1970) no longer requires bonds on vessel construction contracts but does require bonds on vessel repair contracts in excess of $2,000.

The Maritime Administration, also as a result of a GAO review and report (B-118779, November 29, 1966), waives the requirement for bonds on ship construction subsidy contracts when the shipbuilder demonstrates sufficient financial capability. Maritime has received authority under the Merchant Marine Act of 1970 to waive the bonding requirements under contracts for repair of Government vessels. We understand that such vessels would be those of the National Defense Reserve Fleet and that repair activity has been negligible since the act became effective because of the inactive status of the Reserve Fleet.

Although the Navy generally assumes the bonding risks on construction of vessels in excess of 200 feet in length, it required Lockheed Shipbuilding and Construction Company, Seattle, Washington, to furnish bonds at a cost of about $244,000 on two contracts for construction of five amphibious transport docks. These are seagoing craft over 400 feet in length for use in transporting troops, equipment, and small landing craft to seashore landing areas. However, the Navy did not require Lockheed to provide bonds on a concurrent contract for construction of destroyer escorts which are over 200 feet long.

Also, the Navy required Rohr Corporation, Chula Vista, California, to furnish bonds at an estimated cost of $17,000 on a contract for 61 mechanized landing craft which are under 200 feet in length.

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We have no overall statistics as to the cost of such bonds, the number of defaults, the amount of surety losses, or the number of vessel construction and repair contracts on which bonds have been required. The estimated costs noted above for the landing craft contracts at Lockheed and Rohr indicate that total bonding costs for vessels under construction could be substantial. It is reasonable to assume that such bonding costs are included in the contract price.

Issues for further consideration

Further study will be needed to determine the magnitude of the bonding of vessel construction and repair contracts and to demonstrate the feasibility of Government assumption of the risks covered by such bonds.

It appears that the need for such bonds might be eliminated by the use of appropriate evaluation of the financial condition and technical capability of contractors, as is now apparently being done in the case of contracts for the construction of Coast Guard vessels and of most Navy vessels in excess of 200 feet in length. The present bond requirements can result in unnecessary costs to the Government and create a situation in which the same shipbuilder provides bonds on some contracts but not on other contracts with the same agency.

Ships chartered by the Military Sealift Command--Priority B

The Military Sealift Command (MSC) requires an owner of ships chartered by it to provide a performance bond if his financial condition is considered marginal. We noted that in one case a ship owner was required to provide a $75,000 performance bond under a charter agreement for a single ship for a period of 2 to 4 months. An MSC official estimated the cost of the bond at about $60. A schedule of rates published by the Surety Association of America indicated that the cost of a $75,000 bond for a period of 4 months could be as high as $375. Using MSC's estimate of $60 for a 4-month period or $180 for 12 months, the annual bond cost for the 110 ships under charter at August 1, 1971, would be $19,800. Using the higher figure of $375 for 4 months (or $1,125 per year), the annual bond cost for the 110 ships would be $123,750.

These estimates probably are high because the number of chartered ships has been decreasing and MSC does not require a bond on each charter agreement.

Issues for further consideration

The risk covered by performance bonds on chartered ships appears to be one which could be economically self-insured by the Government. Although it appears that the total cost of the bonds may be relatively small, the cost may nevertheless represent a needless expense which might be saved through self-insurance. We therefore believe that MSC should review its need for requiring owners of chartered ships to furnish performance bonds, with a view toward eliminating such requirements.

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HAZARD AND LIABILITY INSURANCE ON SHIPMENTS OF GOVERNMENT-OWNED PROPERTY BY COMMON CARRIER--PRIORITY B

Survey work performed by our Seattle Regional Office and our Transportation Division indicates that substantial annual savings in transportation costs might be possible if the Government assumed the risk of loss or damage to Government property being shipped and, on dangerous items such as explosive ammunition, the risk of loss of life or injury to persons and of damage to the property of the carrier or others.

This survey primarily involved large-volume carload and truckload ammunition shipments within the continental United States (CONUS). Shipments of household goods were not included in the survey because the carrier is responsible for packing, crating, and loading such shipments, and his liability for risk of loss is an incentive for his exercise of care. Less than carload shipments also were excluded because the carrier is responsible for loading such shipments, which are highly susceptible to loss or damage. Shipments outside CONUS, which are mainly by sea, were not covered. The bulk of ammunition and explosives are shipped overseas on ships chartered by MSC.

Freight costs of shipments of ammunition and explosives during fiscal year 1969 for military agencies totaled $629 million. Of this amount, $307 million was mainly for ocean shipments and $322 million was for shipments within CONUS. Losses and damage claims of the military services in fiscal year 1969 on CONUS shipments of ammunition and explosives totaled only $706,000. This amount, however, does not include the claims, if any, of the carriers or of third parties because of damages or injuries resulting from the hazardous nature of the Government shipments. Such claims would have been paid by the carriers' insurance companies or out of the carriers' self-insurance funds.

The survey did not develop an overall estimate of the cost to the Government of insurance on shipments of dangerous materials. Such an estimate would be extremely difficult to develop because the costs of insurance (or of self-insurance by carriers) are buried in the freight rates and

there are many other factors--value, density, competition, etc.--which cause wide variations in the freight rates of different types of shipments. There is also some uncertainty as to whether the Government could capture, through lower freight rates, the full savings in insurance costs resulting from Government assumption of the risks related to the shipment of Government property.

Issues for further consideration

Further study will be needed to resolve the many difficult questions regarding the economy and feasibility of self-insurance of shipments of Government-owned property.

HAZARD AND LIABILITY INSURANCE DURING CONSTRUCTION OF GOVERNMENT FACILITIES--PRIORITY B (HAZARD) AND C (LIABILITY)

Risk of loss or damage to facilities being constructed for the Government under fixed-price contracts, and risk of bodily injury and damage to property of others during construction, generally are the contractual responsibility of the construction contractors. As protection against such risks, contractors may purchase builders risk insurance and general liability insurance voluntarily or as required by contract terms, sources of financing, or State and local law.

Data was not readily available on the actual cost of such insurance included in construction contract prices paid by the Government or on the related claims against the insurers. On the basis of estimates of average insurance rates in the Washington, D.C., area which we obtained from GSA, and estimated total outlays for Government construction for fiscal year 1972, we computed a rough estimate of $6 million as the cost of builders risk insurance (fire and extended coverage) on public works construction.

Insurers of facilities under construction perform an important function by inspection of construction sites and enforcement of safe practices on the part of contractors. However, the Government has resident engineers at some construction sites who could probably perform this function. To accomplish this, the resident engineers might require increased staff and possibly the development of additional expertise in the field of safety engineering, the cost of which would partially offset any savings in construction costs resulting from Government assumption of the risk of loss or damage to facilities during construction.

We obtained the views of members of two associations of construction contractors regarding Government assumption of the risk of loss or damage to Government facilities during construction. (See pp. 57 and 59.) Of the 150 directors of The Associated General Contractors of America who responded to our questionnaire, 75 indicated that they preferred commercial insurance to Government assumption of the risk. On the other hand, 19 of the 26 members of the National

Constructors Association who expressed an opinion favored Government assumption of this risk.

Agency officials with whom we discussed this matter generally were opposed to Government assumption of this risk because of additional administrative work that would be required and the loss of inspection services provided by insurers.

Issues for further consideration

We believe that the Government has an insurable interest in the facilities under construction. Such facilities are usually built on Government-owned land and are therefore the property of the Government from the outset of construction. In any event, they become Government property upon completion or as progress payments are made. Also, the Government can, and in some cases does, exercise a degree of surveillance over the construction activities. Further study will be needed to determine the feasibility of Government assumption of the risk of loss or damage to Government facilities during construction.

It does not appear to be appropriate, however, for the Government to assume the risks that are now covered by liability insurance during construction of Government facilities. We believe that these are essentially contractor risks which are dependent upon the competence and care of the contractor and his employees. Also, because contractor employees and equipment may be utilized within short periods of time on both Government and non-Government construction projects, contractors generally carry one liability policy which covers them on all projects rather than a separate policy for each project. It would probably be impractical, therefore, for the Government to assume this risk on Government construction projects.

HAZARD INSURANCE ON GOVERNMENT-OWNED AIRCRAFT UNDER REPAIR OR MODIFICATION--PRIORITY B

Under ASPR 10-404 (ground and flight risk clause used in negotiated fixed-price contracts for the modification, maintenance, or overhaul of aircraft), a contractor is responsible for the first $1,000 loss or damage for each incidence to Government aircraft undergoing repair or modification, except when an aircraft is in flight. Damages in excess of $1,000 are assumed by the Government.

The ASPR Committee, however, authorized the Air Force for a 2-year period beginning in April 1968 to increase the amount of risk assumed by a contractor from $1,000 up to $50,000 on certain contracts for repair or modification of aircraft. The authority to deviate from ASPR was extended an additional year which ended in April 1971. The reason for the increase in the amount of risk assumed by a contractor was to allow the Air Force to test its effect on contractors' prices for performing the work and to determine whether it would result in fewer accidents involving Government aircraft.

The ASPR Committee did not extend the deviation authority beyond April 1971 because it believed the Air Force had not fully justified its position that contractors' management of the maintenance, modification, or overhaul work had improved or that fewer accidents had resulted. The Air Force Logistics Command (AFLC) disagreed with the decision by the ASPR Committee and on a case-by-case authorization has continued to hold contractors responsible for varying amounts ranging up to as much as $100,000 for loss or damage to aircraft, under the the provisions of ASPR 1-109.2 which permits such deviation.

The Air Force reported that the number of accidents causing significant damage to Government aircraft under the repair and modification programs had dropped from 10 in 1968 to four in 1969. Headquarters, AFLC indicated that the reduction was due largely to the increased emphasis placed on contractor liability for damages to Government aircraft. An Air Force representative said that reductions in such accidents resulted in other benefits such as expediting both overhaul and maintenance work, quicker

return of aircraft to the active fleet, and delivery of other aircraft for overhaul as scheduled, thereby reducing unscheduled downtime of active fleet aircraft.

An AFLC summary showed that the cost of insurance covering the increased risk assumed by contractors for bailed aircraft amounted to $185,000 for 512 aircraft. The period to which this cost data was applicable was not identified. The summary also showed that two contractors had assumed liability for the first $100,000 damage to aircraft at no charge to the Government. On the other hand, an Air Force official told us that some contractors were refusing to accept liability for the higher amounts of damage.

Issues for further consideration

It is apparent that there are divergent opinions within DOD on the merit of the Air Force's practice of increasing the amount of risk assumed by a contractor for aircraft undergoing repair or modification. Further study will be needed to evaluate the Air Force's justification for deviating from the Government's policy of self-insurance.

HAZARD INSURANCE ON GOVERNMENT-OWNED CONTRACTOR-OPERATED PLANTS--PRIORITY B

Contractors operating Government-owned plants sometimes purchase hazard insurance (fire and extended coverage) on such facilities because of the Government's requirements or to provide for prompt repair of damaged facilities and resumption of operations in the event of a serious casualty loss. The contractors may charge all or a portion of the cost of such insurance to the Government through allocations of overhead to contract costs or treat the costs as an offset against the rentals due the Government for use of the facilities.

Under the provisions of ASPR 13-607, contractors leasing Government facilities for use in both Government and commercial work may be required to insure the property when commercial sales exceed 25 percent. For example, Air Force plants equipped with heavy presses are used by some contractors for substantial amounts of commercial work. A representative of one of the contractors leasing such a plant advised us that his company was required by the contracting officer to obtain fire and extended coverage insurance on the facility at an annual cost to the Government of about $6,000. He questioned the need for this insurance. The Air Force reportedly has six such plants leased to contractors.

In another instance a contractor performing substantial commercial work in an Air Force plant was required by the terms of the lease to buy fire and extended coverage insurance at an annual cost of $52,000 to the Government.

We noted other instances where contractors had voluntarily insured Government facilities and apparently recovered the costs from the Government. Two DOD contractors allocated $68,700 to Government work for the cost of fire and extended coverage insurance on Government facilities in which the contractors performed their principal contract operations. The reason given by the contractors' representatives for obtaining the insurance was to make certain that funds would be immediately available to expedite the repair of damaged Government property and the resumption of plant operations in the event of damage.

We also noted that the Government may allow a contractor to insure Government facilities against natural hazards which could result in significant damages. For instance, we were advised by a Department of the Navy representative that a contractor leasing a naval industrial reserve plant was allowed to buy insurance protection against tornado damage to the facility because of the frequency of tornados in the area. In one instance, a tornado tore the roof off the plant, causing damages in excess of $3 million. The Government-owned plant and equipment had an insured value of about $38.1 million and were insured at an annual cost of $29,818.

Air Force officials stated that the requirement for insurance on Government facilities used for both Government and commercial work was necessary in order to prevent the contractors from gaining a competitive advantage and to protect the Government against loss or damage arising from commercial operations.

Issues for further consideration

It does not appear to be necessary to procure insurance on Government facilities in order to avoid giving contractors a competitive advantage. In fact, the present practice of requiring the purchase of insurance on certain Government-owned contractor-operated (GOCO) plants when the level of commercial work exceeds 25 percent appears to allow the contractor a competitive advantage on commercial work below that level. There should be no competitive advantage to contractors who rent Government facilities if the rentals charged for commercial use of such facilities are comparable to the rates charged by commercial lessors for similar facilities and include factors for insurance, taxes, and any other expenses normally incurred by a commercial lessor. If this is done, the contractor will not obtain a competitive advantage at any level of commercial use of the facility, and it will not be necessary to procure insurance.

While the prompt repair or replacement of damaged Government facilities may be a highly desirable objective, it does not appear to justify procurement of insurance on a GOCO plant any more than on a Government-operated facility.

Further study will be needed to identify the full extent of the practice of procuring insurance on GOCO plants and to demonstrate the feasibility of self-insuring all Government facilities operated by contractors.

PRODUCT LIABILITY AND CATASTROPHIC ACCIDENT INSURANCE--PRIORITY B

Contractors purchase product liability insurance protection against the risks of liability for bodily injury, death, and property damage resulting from defects in their products. For example, aircraft manufacturers purchase insurance to cover injuries and property damage that could result from a crash of one of their aircraft caused by a defect in design or manufacture.

Product liability coverage for an individual contractor may range up to $100 million. The premium costs can be substantial as indicated by one major aircraft and missile contractor which in responding to our questionnaire reported annual product liability insurance costs of $866,000 allocated to Government contracts.

In a 1963 review of product liability insurance obtained by DOD aircraft and missile contractors under an industry-wide plan, GAO found that liability insurance premiums from 1955 through 1961 had amounted to $10.6 million and that the plan had incurred losses of only $786,000. In addition, GAO found that the Government had paid third-party claims in a number of instances where material failure had been established as the cause of the accidents, but that the Government had taken no action to recover damages from the contractors or their insurers in these cases. At that time the matter was brought to the attention of the Secretary of Defense by letter from GAO. So far as we know, no action was taken by DOD.

The liability insurance procured by contractors generally does not cover loss of or damage to the military products of the insured contractor. We understand that for many years it has been the unwritten policy of DOD not to hold contractors liable for loss of or damage to its products or other property of the Government resulting from a defect in a contract item if the loss occurs after final acceptance of the contract item.

During the past year, this policy was formalized in writing by the issuance of Defense Procurement Circular No. 86, which was later incorporated as ASPR 1-330. This

section provides generally that a contractor shall not be liable for loss of or damage to Government property, with the exception of the contract item itself, resulting from defects or deficiencies in the contract item when the loss or damage occurs after final acceptance of the contract item by the Government. In the case of major items of high unit cost, such as missiles, aircraft, tanks, ships, and aircraft engines, a contractor is relieved of liability for loss of or damage to the contract item.

We understand that the Commission on Government Procurement is considering recommending the extension of this policy to all Government agencies and its expansion to make the Government a self-insurer of all contract items, not just major items, after final acceptance. In view of the recent change in ASPR and the interest of the Commission, we see no need for further consideration at this time of damages to Government property resulting from product defects.

In February 1971 the Aerospace Industries Association of America, Inc., proposed a bill for consideration by the Commission on Government Procurement whereby the Government would assume liability for claims resulting from catastrophic accidents in excess of $10 million up to a maximum of $500 million for each occurrence. Liability for the first $10 million would continue to be the responsibility of the contractor. We understand that the reason for industry's interest in having the Government enter this field as an insurer was that many contractors were finding it difficult or impossible to procure sufficient commercial insurance coverage to provide adequate protection for themselves and the general public. Contractors questioned on this subject during our study generally favored Government assumption of product liability risks. The Commission was considering the merits of this proposed bill at the time our study was completed.

Government assumption of the risk of liability for catastrophic accidents resulting from contractor operations or product defects does not appear to involve self-insurance of a Government risk but rather insurance by the Government of a contractor risk in order to protect the general public and Government contractors at levels of liability that exceed the capacity of the insurance industry.

Issues for further consideration

With regard to the lower levels of product liability, we question whether it would be appropriate for the Government to assume such risks so long as insurance companies are able and willing to provide adequate coverage. However, the 1963 GAO review disclosed some indications that the Government was at that time absorbing a substantial portion of the losses resulting from product defects while continuing to bear the cost of product liability insurance premiums.

Further study will be necessary to determine the extent to which Government agencies are currently bearing the cost of third-party claims for personal injury and property damage resulting from defects in products procured by the Government. If the amount is significant, we believe that the agencies involved should consider taking action to recover the amount of such claims from the contractors and their insurers where appropriate.

Regarding the broader question of Government assumption of product liability and catastrophic accident risks, we suggest that further consideration of this matter be deferred until the Commission on Government Procurement has issued its report.

SHIP REPAIRER'S LEGAL LIABILITY INSURANCE ON NAVY AND COAST GUARD VESSELS UNDER REPAIR--PRIORITY B

In contracting for the repair of vessels, the Navy and Coast Guard require commercial shipyards to carry ship repairer's legal liability insurance. This insurance covers the shipyards' liability to the Government for physical damage to the vessels and their liability to third parties while the vessels are under the shipyards' care, custody, and control. Required coverage is $300,000 for any one accident or vessel. Shipyards purchase similar insurance, sometimes with higher coverage, to cover their commercial ship repair work.

We have no information as to the overall cost of ship repairer's legal liability insurance or related claims. A Navy official estimated that the cost would amount to about 1 percent of a shipyard's gross receipts from ship repairs. The Navy's budget for fiscal year 1972 includes an item of $443 million for ship overhaul costs. Even if the bulk of this work is done in naval shipyards, the cost of insurance on the work done under contract could be significant.

A Coast Guard official expressed the view that ship repairer's legal liability insurance could be eliminated because the coverage of $300,000 is not significant when compared to the cost of a vessel. A Navy official indicated that he would not favor Government assumption of all risks covered by this insurance because of the poor experience of insurance companies with this type of insurance and because of the Government's lack of expertise in the settlement of third-party claims. He indicated further, however, that the Government received little benefit from the policy provisions relating to damage to vessels undergoing repair because the Government had to prove negligence on the part of a shipyard in order to collect damages. He therefore saw no objection to Government assumption of the risk of damage to vessels while undergoing repairs.

Issues for further consideration

In other sections of this report we have concluded that it would not be appropriate for the Government to assume a

contractor's risk of liability to third parties, even when the risk is incurred in the operation of Government-owned equipment in the performance of Government contracts and when the cost of the insurance is passed to the Government as a part of the contract price. We believe, therefore, that no question should be raised regarding the shipyards' purchase of third-party liability insurance and the inclusion of the premium expense as an allowable contract cost.

However, a portion of the coverage provided by ship repairer's legal liability insurance may be considered, from the Government's standpoint, as hazard insurance on Government property under the control of the contractor. Further study will be needed to determine what portion of the insurance premiums is applicable to this coverage and to demonstrate the feasibility of Government self-insurance of this risk.

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HAZARD AND LIABILITY INSURANCE ON GOVERNMENT-OWNED EQUIPMENT OPERATED BY CONTRACTORS--PRIORITY B (HAZARD) AND C (LIABILITY)

The Government generally assumes the risk of damage to Government-owned property operated by contractors. However, there are various exceptions as discussed below. Also, the Government sometimes requires contractors to purchase liability insurance on such property.

Barges

Corps of Engineers

The New Orleans District Office, Corps of Engineers, awards three or four contracts each year under which the Corps provides the contractor with rent-free use of Government-owned barges. Each contract usually involves three or four barges which are valued at about $20,000 each.

It is the Corps' policy to require the contractors to purchase hull insurance coverage equal to the full value of the barges. Information as to the extent of this practice at other Corps districts, the cost of the insurance, and the experience on losses and damage to barges was not developed during our study.

New Orleans District officials were of the opinion that this risk could be assumed by the Government.

National Aeronautics and Space Administration

NASA is providing Government-owned barges to a contractor under contract terms which require the contractor to carry hazard and liability insurance. The estimated annual cost of such insurance is about $28,000.

Aircraft

Atomic Energy Commission

AEC owns nine aircraft that are assigned to the Albuquerque and San Francisco offices. The aircraft are

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operated by the Ross Aviation Company under a cost-type contract. Ross purchases liability insurance on the aircraft at an estimated annual cost of about $110,500.

National Aeronautics and Space Administration

One contractor is operating three NASA-owned aircraft and is required by NASA to carry liability insurance thereon. The cost of the liability insurance is about $18,000 a year. The contractor also purchases hull insurance on the three aircraft although it is not required by NASA to do so. We did not obtain data on the cost of the hull insurance, but a contractor official informed us that insurance costs are allocated to contracts through the general and administrative overhead account.

In addition, insurance coverage on NASA-owned aircraft is provided under the general liability policy of Jet Propulsion Laboratory, California Institute of Technology. We were unable to determine the cost applicable to NASA-owned aircraft.

Special tooling and test equipment furnished to subcontractors

Under the provisions of ASPR 13-102.2, a subcontractor is required to assume the risk of loss or damage to Government property in his possession provided by prime contractors unless the subcontract provides relief from such liability. This is in contrast to the Government's policy of generally assuming the risk for its property in the hands of prime contractors.

We found instances where subcontractors were held responsible for risk of loss or damage to Government-owned special tooling and test equipment and were procuring insurance thereon. Rohr Corporation was insuring about $25 million of Government-owned special tooling at an annual cost of about $15,000 under a subcontract awarded by Lockheed Aircraft Corporation under the C-5a aircraft program. Thiokol Chemical Corporation was insuring about $2 million of special tooling provided by a prime contractor at an annual cost of about $8,000.

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Issues for further consideration

It does not appear that further consideration should be given to Government assumption of the risk of liability on Government-owned aircraft and other equipment operated by contractors. It would probably not be practicable to separate the risk applicable to Government ownership from the risk applicable to actions of contractor employees. The latter might constitute the major portion of the total risk and would not, we believe, be appropriate for Government self-insurance.

Although the cost of hazard insurance procured by contractors on Government-owned property in their possession does not appear to be significant in any one agency, it nevertheless appears to be an unnecessary expense, a large part of which might be saved through Government self-insurance. We therefore believe that NASA should consider disallowing, for contract pricing or reimbursement purposes, the cost of hazard insurance voluntarily procured by any contractor on Government-owned aircraft; that NASA and the Corps of Engineers should consider eliminating their requirements for contractors to procure hazard insurance on Government-owned barges in their possession; and that DOD should consider eliminating its requirement for subcontractors to insure special tooling and test equipment in their possession.

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PROTECTION AND INDEMNITY INSURANCE ON GOVERNMENT-OWNED SHIPS OPERATED BY CONTRACTORS--PRIORITY C

Military Sealift Command tankers

MSC owns a fleet of tankers which are manned by commercial operators under contract. The tankers are used for transporting Government cargo on routes and to ports as directed by MSC. The operators purchase marine protection and indemnity (P&I) insurance to cover injury to the crews and liability to third persons that may result from operation of the ships. We believe it is reasonable to assume that a factor for insurance is included in the operators' contract prices.

The number of such tankers ranged from 11 to 21 during the period July 1, 1965 to March 31, 1970. For the same period, P&I insurance premiums on these MSC tankers totaled about $5.8 million as compared to losses of about $4.8 million--a difference of about $1 million or about $200,000 a year. Savings to the Government through self-insurance of these risks would probably be somewhat less than this amount, depending upon the amount of administrative and legal expenses incurred in the settlement of claims. MSC had 18 tankers in operation on April 8, 1971.

MSC officials have opposed Government self-insurance on contractor ship activities in general because of the possibility that large claims would eliminate any savings. MSC officials also indicated that funding for such claims could be a serious problem.

Navy and Coast Guard ships under construction

The Navy and the Coast Guard require shipbuilders to carry P&I insurance on ships under construction. The amount of insurance required is 80 percent of the sum of the contract price for each ship and the value of Government-furnished material, or $2 million, whichever is less. Losses in excess of such insurance coverage are assumed by the Government.

The insurance covers injury to the commercial crews and bodily injury and damage to property of third parties during launch, trial runs, and operation of a ship until it is delivered to the Government.

We did not develop overall statistics as to premium costs and claims. Because this insurance requirement appears to be a standard provision in shipbuilding contracts of the Navy and Coast Guard, the costs probably are significant. Shipbuilders indicated that the cost of such insurance ranges from $4,200 to $6,000 per ship. An official of one shipbuilder stated that losses covered by the insurance were virtually non-existent. An official of another shipbuilder stated that in 10 years his firm had experienced only one claim which amounted to $1,500.

Observations

Although the MSC tankers are owned by the Government and carry Government cargo over routes and to ports specified by the Government, the actual operation of the ships is under the control of contractor employees. The Government has little opportunity to exercise control over the conditions which could result in liability. Under these circumstances, we believe it would be inappropriate for the Government to assume a contractor's risk of liability to his employees and to third parties. Similar circumstances apply to ships under construction.

HAZARD AND LIABILITY INSURANCE ON CHARTERED SHIPS AND AIRCRAFT--PRIORITY C

Ships

MSC charters ships from commercial ship operators who purchase hazard and liability insurance on the ships and include the cost in the contract rates charged to MSC.

The number of ships under charter to MSC has ranged from 41 in March 1965, prior to the Vietnam buildup, to a peak of 226 in January 1969. By August 1, 1971, the number had decreased to 110 ships and probably will continue to decrease.

The types of insurance purchased include hull and machinery insurance protection against damage or loss of the ship, and P&I insurance for damage caused by the ship and for illness and injury to the officers and crews.

Since July 1968 the Maritime Administration has provided, without charge, war-risk insurance covering the officers and crews of chartered ships during periods when the ships were in designated war-risk areas. However, war-risk insurance covering hulls and machinery has been purchased commercially by the operators and the cost has been reimbursed by MSC.

In a report to the Congress (B-172699, November 9, 1971), GAO recommended that war risks on hulls and machinery of ships chartered by MSC be self-insured and that, if feasible, the coverage be obtained from the Maritime Administration, as authorized by the Merchant Marine Act of 1936. In commenting on the report, DOD stated that the Navy had completed a study of this matter, at DOD's request, and concluded that the financial problems involved in establishing a policy of Government self-insurance for war risks were such that adoption of such a policy was not recommended.

Data on overall costs of insurance on ships chartered by MSC is not readily available. Based on information on 18 MSC-owned tankers operated by commercial crews, the P&I insurance could amount to about $6 million annually for the 110 ships under charter at August 1, 1971. The cost of hull and machinery insurance on chartered ships would

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probably be substantial. We had no basis for estimating such costs, however, because hull insurance is not purchased on MSC tankers.

Observations

We believe that the risks, other than war risks, covered by hull and machinery insurance and P&I insurance on chartered ships are essentially contractor risks and would not be appropriate for self-insurance by the Government since the ships are operated by officers and crews in the employ of the contractors. The provision of war-risk insurance on chartered ships by Maritime can be justified on the basis that the extra risks involved in transporting men and materiel in a war zone are peculiar to the Government and are very costly to cover with commercial insurance.

Aircraft

Military Airlift Command

The Military Airlift Command (MAC) utilizes commercial airlines to supplement its fleet in the transportation of men and materiel. Total obligations by MAC for overseas airlift by commercial airlines were $449.8 million and $372.1 million in fiscal years 1970 and 1971, respectively, and are estimated at $150.1 million in fiscal year 1972.

The airlines may carry MAC passengers and cargo on their regularly scheduled commercial flights and may also provide aircraft, with crews, for exclusive use by MAC for airlift services. The Government through the Federal Aviation Administration provides war-risk insurance on chartered aircraft covering loss or damage to the hull as the result of hostile action during service in a war zone. The charter rates include the cost of liability insurance which is required by MAC and hull insurance to cover losses not involving hostile action.

Atomic Energy Commission

An AEC contractor owns and operates one aircraft for AEC's Richland Operations Office and purchases hazard and

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liability insurance to cover the aircraft. Another AEC contractor owns, operates, and probably insures two aircraft used in monitoring AEC test sites.

National Aeronautics and Space Administration

NASA contracts for airlift services and requires the contractor to purchase insurance covering all risks attendant to the use of three aircraft. The estimated annual insurance cost is about $125,000.

Forest Service

The Forest Service annually contracts for 1,000 to 1,200 contractor-owned and operated aircraft primarily for fire-fighting purposes. The contracts provide for a fixed-fee retainer so the aircraft will be available when needed, and an hourly rate for flight time. The hourly rates presumably include the contractors' costs for hazard and liability insurance.

Postal Service

The Postal Service contracts for transportation of mail by air taxi service utilizing contractor-owned multi-engine aircraft. Postal Service officials informed us that most air taxi operators utilize their aircraft 100 percent of the time in the transportation of mail, primarily because there is no other type of business available to these operators. The Postal Service does not restrict the air taxi operators as to the use of their aircraft and, in fact, encourages them to obtain other business since this would provide a larger base for allocating expenses.

The Civil Aeronautics Board establishes the insurance requirements which air taxi operators must meet. Generally, the operators carry liability and hull insurance. Based on our review of Postal Service files on three air taxi routes selected at random, we estimate that the annual cost to air taxi operators for insurance would total about $262,000, of which hull insurance would be about $161,000.

Observations

We do not believe it would be appropriate or feasible for the Government to assume contractors' risks, other than war risks, that are attendant to operation of chartered aircraft. Because the aircraft generally may be used interchangeably for commercial operations and Government contracts, the practical problems of adjusting commercial insurance coverages might prevent the Government from realizing significant savings from assumption of the contractors' risks.

OTHER TYPES OF INSURANCE PAID FOR INDIRECTLY UNDER CONTRACTS--PRIORITY C

Government contractors carry other types of insurance such as hazard and liability insurance on their plant and equipment, automobile hazard and liability insurance, workmen's compensation insurance, life and health insurance on employees, fidelity bonds on employees, and general liability insurance. The premiums for such insurance generally are allowable items of costs in establishing Government contract prices.

Observations

The above types of insurance do not generally involve Government property or Government employees, and although a portion of the premium cost is passed to the Government, it appears that the risks are contractor risks, except for war risk insurance on contractor employees (see GAO report B-172699, November 9, 1971). Where a contractor's operation involves both Government and commercial work, it would be quite impracticable to cover contractor employees and equipment with insurance only while they are being used on commercial work. Even when a plant is being utilized solely for work on Government contracts, there can seldom be complete assurance that fluctuations in the Government contract work load or other conditions will not result in a significant influx of commercial work within a short period of time.

We believe, therefore, that it would not be appropriate for the Government to assume the above types of contractor risks.

CHAPTER 4

BONDS AND INSURANCE PAID FOR INDIRECTLY THROUGH GRANTS

The Federal Government provides grant funds to State and local units of government, nonprofit institutions, individuals, and other institutions for various purposes. In fiscal year 1970 the estimated obligations for 528 project and formula grant programs, administered by 30 departments and agencies, totaled about $23.4 billion. The amount of a Federal grant is usually based on a percentage of the total cost of an eligible project. The percentage may be uniform for all eligible projects or it may vary depending on such factors as population and financial ability of the grantee.

On October 19, 1971, the Office of Management and Budget (OMB) issued OMB Circular No. A-102 to establish uniform administrative requirements for grants-in-aid to State and local units of government. The effective date of the Circular is to be "as soon as practicable but not later than July 1, 1972." The requirements set forth in the Circular are based on a study made by an interagency task force under the direction of OMB. The Circular provides that, except for grants involving contracts for construction or facility improvement exceeding $100,000, Federal grantor agencies shall not impose bonding and insurance requirements over and above those normally required by the State or local units of government. For grants involving contracts exceeding $100,000, the Circular provides that:

--each bidder must furnish a bid guarantee equivalent to 5 percent of the bid price; and

--a contractor must furnish a performance bond for 100 percent of the contract price and a payment bond for 100 percent of the contract price.

The Circular provides also that, when the Federal Government guarantees the payment of money borrowed by a grantee which is a State or local unit of government, the agency involved may, at its own discretion, require adequate bonding and insurance if the bonding and insurance requirements

of a grantee are not considered sufficient to protect the Federal Government's interest.

An OMB official informed us that OMB also plans to make a study of Federal requirements, including bonding and insurance requirements, under grants-in-aid to nonprofit institutions and community action agencies, apparently for the purpose of establishing uniform requirements for such grants.

Prior to the issuance of OMB Circular A-102, Federal agencies, except the Federal Highway Administration (FHWA), generally required recipients of grant funds for construction to have contractors furnish certain types of bonds and carry certain types of insurance coverage. Under the highway construction grant program, FHWA permitted the States to follow their own bonding and insurance requirements. For other types of grant programs, Federal agencies required that employees of grantees who were authorized to sign or countersign checks or make cash disbursements be bonded.

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BID, PERFORMANCE, AND PAYMENT BONDS--PRIORITY B

Highway construction grants

The Federal Government currently provides 90 percent of the funds for construction of interstate highways and 50 percent of the funds for construction and improvement of primary and secondary roads and streets. In addition, the Federal Government provides 100 percent of the funds for construction or improvement of highways in or adjacent to national forests and in certain locations in States with large areas of public lands. Also, Federal funds may be provided for 50 to 100 percent of the cost of repair or replacement of Federal-aid highways damaged by floods and other natural disasters.

The Federal-Aid Highway Act of 1970 increased the amount of Federal funds to be provided for primary and secondary roads and streets from 50 percent to 70 percent, beginning with fiscal year 1974. All 50 States and the District of Columbia require contractors to furnish bid, performance, and payment bonds or some variation of such bonds under highway construction contracts. The bonding requirements of the District of Columbia and 45 of the 50 States are based on statutory provisions.

Based on Federal outlays of $4.3 billion in fiscal year 1970 and estimated annual outlays of $4.6 billion in fiscal year 1971 and 1972 for highway construction grants, we estimate the annual cost to the Government for bid, performance, and payment bonds at about $20 million.

Based on FHWA estimates of about $26.4 billion for the Federal portion of the cost to complete the interstate highway system beginning with the fiscal year 1972 authorization, we estimate that the Federal share of the cost of bid, performance, and payment bonds for completion of the interstate system will be about $116 million.

Our estimates are based on an average cost for bid, performance, and payment bonds of about 1/2 of 1 percent or $5 per $1,000 of contract amount, which we computed during our study from data on a sample of contracts awarded by the

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District of Columbia and the States of Kansas, Missouri, Nebraska, and Ohio. The State of Ohio requires bidders to include the cost of such bonds as a separate line item in their bids.

During our study we discussed with FHWA and State highway department officials the possibility of the Federal and State Governments assuming the risks now covered by bid, performance, and payment bonds. Some of these officials were in favor of the proposal for the following reasons:

1. The elimination of such bonds would result in considerable reduction in costs.

2. There is a certain amount of duplication of work between the surety companies and the States in making financial and managerial investigations of the contractors when the States have a contractor prequalification procedure.

Other FHWA and State highway department officials were not in favor of the Federal and State Governments assuming such risks for the following reasons:

1. It would be necessary to change the States' statutes regarding such bonds.

2. Contractor defaults would increase since unqualified or marginal contractors would not be prevented from bidding on or receiving contracts because of their inability to obtain bid, performance, and payment bonds.

3. The completion of defaulted contract work would be delayed up to 3 months during which time the project could deteriorate because the State would be required to draw up new specifications and readvertise for bids for completion of the work. A surety company could proceed immediately with completion of the defaulted contract work.

Although one of the principal benefits of bid, performance, and payment bonds is said to be the prevention of unqualified or marginal contractors from bidding on, or

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receiving, highway construction contracts, 42 of the 50 States have specific contractor prequalification procedures for the same purpose. Those States which have contractor prequalification procedures generally require a contractor to submit annually to the State highway department a financial statement (usually signed by a Certified Public Accountant), an outline of work experience, a listing of equipment owned or otherwise available, and other pertinent data including the current status of his uncompleted work. Also, some States require a contractor to submit data regarding the current status of his uncompleted work each time a bid is submitted to enable the State to determine if the contractor's current work commitments might preclude him from performing.

Prequalification of a contractor is illustrated by the procedures followed by the State of Ohio which are discussed below.

The Revised Code of Ohio requires that, in order to bid on highway construction work, a contractor must prequalify on an annual basis or at least 10 days prior to submitting a bid, by filing with the Department of Highways a Confidential Financial Statement and Experience Questionnaire. The financial statement must be prepared and attested to by an independent Certified Public Accountant or a Registered Public Accountant.

Each prequalified contractor is issued a "Certificate of Qualification," which states the type and amount of construction work he is qualified to bid on. The amount of work a contractor is qualified to bid on is based on the contractor's net current assets (working capital) multiplied by 10 to arrive at a maximum rating. A contractor is prequalified to bid on contract work equivalent to his maximum rating if he meets certain criteria of the Department of Highways with regard to his organization, plant and equipment, credit relations, and past experience and performance. This amount is reduced at the time of bid by the total contract amount of all uncompleted work, including non-highway work, which the bidder has under contract at that time. However, any work the bidder has subcontracted and for which his subcontractor has provided performance and payment bonds is considered as completed work.

A bidder may qualify for a contract that either exceeds the amount stated on his Certificate or contains work he is not qualified for on his Certificate if he submits a letter of agreement from another prequalified contractor which commits him to perform, as a subcontractor, the portion of work which the bidder is not qualified for, provided the work to be subcontracted does not exceed 50 percent of the bid amount.

Each time a contractor submits a bid, he must submit a supplemental questionnaire which contains data regarding:

--subcontractors needed to qualify for the contract and a letter of commitment from each;

--equipment acquired or disposed of since the issuance of the Certificate of Qualification;

--equipment which will be purchased or rented if the contract is received;

--all incomplete contracts and subcontracts (highway and non-highway), including the status and required date of completion; and

--any substantial changes in his financial status since the filing of his last financial statement.

When a contractor who has not prequalified submits a bid, the Ohio Department of Highways simply returns his bid to him unopened.

The number of contractor defaults in the four States visited during our study have been relatively small. For example, data developed by the Ohio Department of Highways shows that, of the approximately $2.9 billion in highway construction contracts awarded by the State during the period 1960-1970, only nine contracts totaling about $4.7 million, or about .2 of 1 percent of the value of all contracts awarded, were affected by contractor defaults.

Issues for further consideration

As stated earlier, all 50 States require bid, performance, and payment bonds, and 42 of the 50 States have

prequalification procedures. We have considerable doubt as to the need for both prequalification procedures and bonding requirements; however, it will be difficult to compare the effectiveness of these two control devices because there is currently no State which does not require bid, performance, and payment bonds.

Nevertheless, in view of the annual cost to the Federal Government of about $20 million for bonds under highway construction contracts, the apparent duplication between prequalification and bonding requirements in most States, and the fact that there have apparently been very few defaults, we believe there may be a potential for significant savings through self-insurance of the risks covered by bid, performance, and payment bonds. Further study will be required, however, to determine the feasibility of the Federal and State Governments self-insuring the risks covered and to explore alternatives to such bonds.

There appear to be four principal alternatives to requiring highway construction contractors to furnish bid, performance, and payment bonds, each of which has certain disadvantages:

1. The States could be encouraged to revise their statutes to eliminate the bonding requirements, and to join with the Federal Government in self-insuring the risks. We have considerable doubt, however, as to whether many States would voluntarily join in such a self-insurance program.

2. The States could be required to join with the Federal Government in self-insuring the risks. There would probably be considerable objection by the States, however, to the elimination of their requirements for bid, performance, and payment bonds as a condition to receiving Federal grant funds for highway construction.

3. The Federal Government could self-insure 100 percent of the risks while generally saving only 70 to 90 percent of the premium costs. Although this alternative would undoubtedly result in net savings to the States, it might easily result in a net increase

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in cost to the Federal Government. A possible variation of this alternative might be for the Federal Government to assume 100 percent of the risks and to make an appropriate reduction in the percentage of Federal participation in highway costs.

4. The Federal Government could self-insure the Federal portion of the contracts and the States could purchase bonds to cover their portion of the contracts. Two surety companies informed us, however, that they would not be interested in such a co-insurance arrangement and that, in any event, they could not make a commensurate reduction in the premium cost since their investigative and claims settlement costs would not be reduced because of Government assumption of a portion of the risk.

Other types of construction grants

Federal agencies provide grant funds to State and local units of government, nonprofit institutions, and other institutions for the construction of various other types of facilities such as hospitals, educational facilities, airports, and waste treatment facilities. The amount of a Federal grant for such construction generally ranges from about 30 to 100 percent of eligible project costs. Federal agencies administering these construction grant programs have generally required grantees to obtain bid, performance, and payment bonds from construction contractors.

According to the fiscal year 1972 Federal budget, Federal outlays for construction grants, excluding highways, totaled $1.8 billion for fiscal year 1970 and were estimated at $2.4 billion and $3.1 billion for fiscal years 1971 and 1972, respectively. Based on the average cost of bid, performance, and payment bonds under selected construction contracts awarded directly by Federal agencies, we estimate that the cost of such bonds related to construction grants will increase from about $9-$11 million in fiscal year 1970 to about $15-$19 million in fiscal year 1972.

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Issues for further consideration

The arguments raised by agency officials against eliminating the bonding requirements on construction of public works (p. 57) would apply equally to construction under Federal grants, and unless these arguments can be refuted in that area, it would appear to be useless to attempt to demonstrate the feasibility of self-insuring these risks in the grant area.

There is an additional problem in the grant area because of the fact that the Federal Government usually bears less than 100 percent of the project cost, and most grantees probably do not have a wide enough risk exposure to self-insure their share of these risks. The Federal Government might, therefore, be in the position of assuming the entire risk in order to save a portion of the premium cost. This problem is similar to the one discussed on page 95 in connection with bonds on highway construction, although the average percentage of Federal participation on highway construction is probably greater than the average on other types of construction. We believe the probability is remote that the Federal Government would realize an overall saving on projects on which the Federal participation is less than 70 percent.

Nevertheless, because of the significant costs being incurred for bid, performance, and payment bonds under other types of construction grants, we believe there may be some potential for savings through self-insurance of these risks under grants for the construction of facilities on which Federal funding amounts to 70 percent or more of the cost. Further study will be needed to determine the feasibility of the Federal Government self-insuring such risks.

Construction of low-rent public housing

The United States Housing Act of 1937, as amended (42 U.S.C. 1401), authorizes a low-rent public housing program to help provide safe and sanitary dwellings within the financial reach of low-income families. The development and administration of this program is primarily the responsibility of local housing authorities (LHAs), which are independent legal entities established pursuant to State legislation to develop, own, and operate low-rent public housing projects.

Federal financial assistance is provided to LHAs by the Department of Housing and Urban Development (HUD) in the form of preliminary loans for surveys and planning and in the form of payments under annual contribution contracts with LHAs. The annual contribution contracts are entered into pursuant to 42 U.S.C. 1410. The HUD annual contributions, at their maximum allowable amounts, are intended to be sufficient to pay the principal and interest on bonds and notes sold by LHAs (debt service requirements) to obtain funds for financing the low-rent housing projects. HUD's maximum allowable contributions are reduced by the amount of residual receipts from project operations.

The provisions of the annual contribution contracts between HUD and the LHAs require that each bidder for a construction or equipment contract furnish a bid bond or equivalent guarantee of not less than 5 percent of his bid amount, and that for each construction or equipment contract for $2,000 or more the contractor furnish either a combined performance and payment bond in an amount not less than 100 percent of the contract price or separate bonds each in an amount not less than one-half of the contract price. We believe it is reasonable to assume that the anticipated cost of such bonds is included in contractors' bids and thus passed on to the LHAs in the form of higher contract prices.

Although HUD does not provide grant funds directly for construction of low-rent public housing, it ultimately pays, almost in total, for the cost of such construction through its annual contributions to LHAs to meet their debt service requirements on funds borrowed to finance the construction.

The debt service requirements of all LHAs totaled about $464.8 million in fiscal year 1970, of which HUD paid about $441.4 million or 94.9 percent. According to the Budget of the United States Government for fiscal year 1972, the debt service requirements of all LHAs eligible for assistance were estimated to be $607 million and $749.5 million in fiscal years 1971 and 1972, respectively, of which HUD expects to pay 95.8 and 95.3 percent, respectively.

Based on the average cost of bid, performance, and payment bonds under selected construction contracts awarded directly by Federal agencies, we estimate that the cost of such bonds, including interest, related to HUD's annual contributions to LHAs for debt service requirements would be about $2.1 million, $2.8 million, and $3.4 million in fiscal years 1970, 1971, and 1972, respectively.

Issues for further consideration

The costs incurred for bid, performance, and payment bonds under contracts for construction of low-rent public housing are significant, and we believe that the major part of any savings resulting from self-insurance of the risks involved would accrue to the Federal Government in the form of lower annual contributions to LHAs. Further study will be required, however, to determine the feasibility of Government assumption of the risks covered by such bonds and to develop an accurate estimate of the potential savings.

HAZARD AND LIABILITY INSURANCE PURCHASED BY GRANTEES--PRIORITY B (HAZARD) AND C (LIABILITY)

Insurance purchased by local housing authorities under the low-rent public housing program

The provisions of the annual contribution contracts between HUD and LHAs (see p. 98) require LHAs participating in the federally aided low-rent public housing program to maintain the following types of insurance coverage:

--fire and extended coverage on all insurable property and equipment;

--owners', landlords', and tenants' public liability, excluding property damage;

--manufacturers' and contractors' public liability, excluding property damage;

--workmen's compensation;

--automobile property damage and bodily injury liability;

--burglary and inside robbery;

--outside robbery, unless armored car service is used for the transportation of cash;

--boiler insurance, if steam boilers have been installed;

--war damage insurance, if prescribed by the Government.

The contracts also require LHAs to provide fidelity bond coverage on their officers, agents, and employees authorized to handle cash, sign checks, or certify vouchers. (See p. 106 for comments on fidelity bonds covering grantee employees.)

When the provisions of OMB Circular A-102 are implemented, HUD's requirement for LHAs to purchase such insurance will be eliminated. We believe, however, that the

LHAs will probably continue to purchase some of the above types of insurance coverage for their own protection.

Although current data was not available on insurance costs incurred by LHAs, a May 1969 HUD report showed that annual insurance costs applicable to 628,961 housing units totaled about $5.8 million, or an average of $9.15 per unit, based on data for the LHAs' fiscal years ended in 1967. According to data prepared by the HUD San Francisco Regional Office in August 1970, the annual cost of bonds and insurance purchased by LHAs in the region totaled $504,743, of which $409,986, or 81.2 percent, represented the cost of fire and extended coverage insurance. On the basis of this data, we estimate that about $4.7 million of the 1967 insurance costs of $5.8 million was for fire and extended coverage insurance.

Our estimate of the cost of such insurance for fiscal years 1970, 1971, and 1972, based on the actual and estimated number of dwelling units eligible for assistance as shown in the Budget for fiscal year 1972, is shown in the tabulation below.

Fiscal year	Dwelling units	Total insurance costs	Estimated cost of fire and extended coverage
1970	830,000	$7,594,000	$6,167,000
1971	936,000	8,564,000	6,954,000
1972	1,028,000	9,406,000	7,638,000

In addition to the contractual payments to LHAs for debt service requirements, HUD may make payments to LHAs (special family subsidies) pursuant to 42 U.S.C. 1410(a), not to exceed $120 per annum per dwelling unit occupied by an elderly, large, unusually low-income, or displaced family if such displaced family was displaced by an urban renewal or low-rent housing project. Section 212 of the Housing and Urban Development Act of 1969 (42 U.S.C. 1410(b)) provided authority for HUD to make additional annual contributions to LHAs. The Conference Report on the Act indicates that such contributions are intended:

--to cover existing operating deficits of LHAs and enable them to maintain adequate operating and maintenance services and adequate reserve funds, and

--to make up the amount by which the proportionate share of operating and maintenance expenses attributable to a dwelling unit exceeds 25 percent of the tenant's income, provided the tenant is paying 25 percent of his income for rent (rental assistance subsidy).

Although insurance costs are charged to project operations and are not paid for directly from HUD's annual contributions, any savings in insurance costs should reduce HUD's annual contributions because such savings would:

--increase the LHAs' residual receipts (the amount by which operating receipts exceed operating expenditures) which are applied to the debt service requirements, thereby reducing HUD's contribution; or

--decrease the LHAs' operating deficits, which would lower the amount of HUD subsidies needed by the LHAs.

According to the Budget of the United States Government for fiscal year 1972, HUD's annual contributions to LHAs to assist in meeting their debt service commitments totaled about $441.4 million in fiscal year 1970 and represented 94.9 percent of the maximum allowable amount. The special family subsidies and rental assistance and operating subsidies for fiscal year 1970 and the estimated amounts for fiscal years 1971 and 1972 are shown in the tabulation below.

Fiscal year	Special family subsidies	Rental assistance and operating subsidies	Total subsidies
1970	$24,490,000	$ 6,974,000	$ 31,464,000
1971	35,000,000	38,000,000	73,000,000
1972	35,000,000	75,000,000	110,000,000

For fiscal year 1972, HUD estimated that 846 of the 2,350 LHAs would require financial assistance in the form of operating subsidies.

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Issues for further consideration

Further study will be needed to determine the feasibility of the Government assuming the risks presently covered by hazard insurance (primarily fire and extended coverage) purchased by LHAs and to develop an accurate estimate of the potential savings. It does not appear to be appropriate, however, for the Government to assume the LHAs' risks presently covered by workmen's compensation and the various types of liability insurance.

Insurance purchased by other grantees

Other grantees purchase various types of insurance, such as hazard insurance (generally fire and extended coverage) on facilities and equipment, automobile liability insurance, general liability insurance, employees' health and life insurance, workmen's compensation insurance, and medical and legal malpractice insurance. The premiums for these types of insurance are generally considered to be allowable items of project cost under the terms of the grant agreements.

In some instances, one or more Federal agencies provide grant funds to cover 100 percent of the cost of construction or acquisition of facilities or equipment of a grantee. Generally, however, the Government provides funds to cover only a portion of such costs. Also, in some instances, one or more Federal agencies may provide grant funds to cover the total cost of research or other operations conducted by a grantee, while in other instances grant funds are provided to cover only a portion of such costs.

Although we do not know the extent to which Federal agencies provide 100 percent, or almost 100 percent, of the funds to grantees for construction or acquisition of facilities or equipment and for subsequent operating costs, we were able to identify from the Catalog of Federal Domestic Assistance a number of grant programs under which grant funds are provided to cover 100 percent of the cost of construction or acquisition of facilities or equipment. For example:

--under eight grant programs, 100 percent of the funds are provided for construction of facilities;

--under 22 grant programs 100 percent of the funds are provided for acquisition of equipment; and

--under three grant programs 100 percent of the funds are provided for construction of facilities and acquisition of equipment.

However, we were unable to identify from the Catalog, instances in which two or more Federal agencies combined, provide 100 percent of the funds to grantees for construction or acquisition of facilities or equipment.

In a report to the Congress on "Need for Improved Administration of Federal Support of Shore Facilities and Vessels for Research Activities at Oceanographic Institutions" (B-169941, September 23, 1970), GAO stated that because of the National Science Foundation's (NSF) policy of transferring title to oceanographic research vessels to grantee institutions, the premiums for hull insurance on the vessels were borne by the Federal agencies which financed the operating costs of the vessels. GAO estimated that, during calendar years 1963-67, such insurance premiums totaled about $550,000 on 10 research vessels for which NSF had financed all or substantially all the construction or conversion costs. The report pointed out that the Office of Naval Research, as a matter of policy, retained title to research vessels it provided to oceanographic institutions. GAO recommended that the Director, NSF present the question of ownership of oceanographic research vessels to appropriate coordinating bodies in the executive branch for consideration in establishing a Government-wide policy regarding title to such vessels when purchased with Federal funds.

Issues for further consideration

Further study will be needed to develop an estimate of potential savings and to determine the feasibility of the Government assuming the risks covered by hazard insurance on facilities and equipment of a grantee when the construction or acquisition thereof is financed in total or almost in total by Federal funds and when the operations of the grantee related to the use of such facilities and equipment are financed in total or almost in total by Federal funds.

It does not appear to be appropriate, however, for the Government to assume the grantees' risks covered by workmen's compensation and the various types of liability insurance.

FIDELITY BONDS COVERING GRANTEE EMPLOYEES--PRIORITY C

Federal agencies have generally required that grantee employees who are authorized to sign or countersign checks or make cash disbursements be covered by fidelity bonds. When the provisions of OMB Circular A-102 are implemented, however, such requirements with regard to grants to State and local units of government will be eliminated. Also, OMB plans to make a study of Federal requirements, including bonding and insurance requirements, under grants-in-aid to nonprofit institutions and community action agencies, apparently for the purpose of establishing uniform requirements for such grants.

We did not determine the cost of fidelity bonds covering grantee employees. Federal agencies administering grant programs do not maintain such cost data and, therefore, the data would have to be obtained from individual grantees. In 1968, however, the Department of Housing and Urban Development reported on a study of the cost of bonding grantee employees under its urban renewal and housing assistance programs. According to the report, the cost of such bonds totaled about $642,000 over a 3-year period ($214,000 annually), while the amounts recovered from the bonding companies totaled only about $2,800 during a 1-year period.

Observations

Since OMB Circular A-102 will eliminate the Federal bonding requirements under grants to State and local units of government and since OMB plans to make a study of the bonding and insurance requirements under grants-in-aid to nonprofit institutions and community action agencies, no further study of this area seems warranted at this time.

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LIABILITY INSURANCE PURCHASED
BY CONTRACTORS--PRIORITY C

Under construction grant programs, Federal agencies have generally required that contractors carry certain types of liability insurance coverage such as automobile liability and general liability insurance. When the provisions of OMB Circular A-102 are implemented, such requirements with regard to grants to State and local units of government will be eliminated. It is probable, however, that many grantees will continue to require such insurance and that most construction contractors will carry liability insurance in any event.

Contractors do not generally purchase insurance to cover work on individual contracts but carry one liability policy which covers them on all their construction activities. A copy of the policy may be furnished to the grantee as evidence of the contractor's compliance with the insurance requirements of the grantee and the Government. We did not consider it practicable, therefore, to obtain an estimate of the total cost of such insurance paid for through grants.

Another type of liability insurance sometimes purchased by contractors under construction grant programs is "railroad protective liability" insurance. Railroad companies require a contractor to carry such insurance, covering bodily injury and property damage and naming the railroad company as the insured when construction activities, such as highway construction, involve railroad property. The cost of such insurance was about $178,000 on highway construction contracts awarded by the State of Ohio during calendar year 1970.

Observations

We believe that it would be inappropriate for the Government or the grantees to assume the contractors' risks of liability for bodily injury and property damage on construction projects supported by Federal grants. Also, we have considerable doubt that assumption of such risks by the Government or the grantees would result in lower contract prices.

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HAZARD INSURANCE PURCHASED ON FACILITIES UNDER CONSTRUCTION--PRIORITY C

Under construction grant programs Federal agencies have generally required that contractors carry hazard insurance (fire and extended coverage) on facilities under construction with the exception of highway construction. Some agencies have required such coverage for 100 percent of the value of completed work while others simply require that adequate coverage be provided. Neither FHWA nor the States require highway construction contractors to carry such insurance coverage, but the States generally hold a contractor liable for damage to work-in-process. The insurance requirements of Federal agencies, with respect to grants to State and local governments, will be eliminated by OMB Circular A-102, but it seems probable that most grantees will continue to require construction contractors to carry hazard insurance.

We did not attempt to determine the cost of hazard insurance on facilities under construction under the various construction grant programs. Such cost data is not maintained by Federal agencies and would have to be obtained from individual grantees or contractors.

Observations

It appears that it would not be appropriate or feasible for the Federal Government or the grantees to assume the risk covered by hazard insurance because:

--the Federal Government is not generally a party to the construction contract and would not be in a position to exercise any controls over safety practices at the construction site to ensure minimization of risk;

--most grantees would probably not have a wide enough risk exposure to self-insure their share of the risk; and

--under most grant programs the Federal share of the construction cost would not be sufficient to make it economical to assume all of the risk in

order to save the Federal share of the premium expense.

OTHER STUDIES OF BONDS AND INSURANCE PAID FOR INDIRECTLY THROUGH GRANTS

In addition to the studies by OMB for the purpose of establishing uniform grant requirements (see p. 89) and the Department of Housing and Urban Development's study of fidelity bonding of grantee employees (see p. 106), the Office of Economic Opportunity (OEO) is currently making a study of the insurance purchased by and the insurance needs of OEO grantees.

In June 1971 OEO awarded a contract to Control Systems Research, Inc., for the purpose of:

--determining the present insurance coverage purchased by OEO grantees, the cost of such insurance, and the loss experience;

--determining the insurance needs of OEO grantees and the risks that should be self-insured;

--developing minimum insurance standards and guidelines for grantees and their delegate agencies; and

--developing a model insurance program which could be made available to grantees on a national, regional, or local basis or some variation of these.

In the background section of the request for proposals for making the study, OEO stated that the significance of the need for the study was evident because its grantees spend an estimated $8-$16 million annually for insurance coverage, or about 1 to 2 percent of their budgets. OEO stated also that, although it required grantees to maintain only (1) fidelity bonding coverage of $25,000 for persons authorized to sign or countersign checks or disburse cash and (2) automobile liability insurance on vehicles acquired from Government sources, many grantees obtained other types of insurance. Examples of other types of insurance purchased by grantees included workmen's compensation, general liability, fire, theft, medical and legal malpractice, and accident and health insurance.

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In June 1971 OEO awarded a contract to Control Systems Research, Inc., for the purpose of:

--determining the present insurance coverage purchased by OEO grantees, the cost of such insurance, and the loss experience;

--determining the insurance needs of OEO grantees and the risks that should be self-insured;

--developing minimum insurance standards and guidelines for grantees and their delegate agencies; and

--developing a model insurance program which could be made available to grantees on a national, regional, or local basis or some variation of these.

In the background section of the request for proposals for making the study, OEO stated that the significance of the need for the study was evident because its grantees spend an estimated $8-$16 million annually for insurance coverage, or about 1 to 2 percent of their budgets. OEO stated also that, although it required grantees to maintain only (1) fidelity bonding coverage of $25,000 for persons authorized to sign or countersign checks or disburse cash and (2) automobile liability insurance on vehicles acquired from Government sources, many grantees obtained other types of insurance. Examples of other types of insurance purchased by grantees included workmen's compensation, general liability, fire, theft, medical and legal malpractice, and accident and health insurance.

OEO furnished the contractor a list of about 200 grantees, selected on a random sample basis, from whom the contractor was to obtain certain data through the use of a questionnaire. The results of the OEO study were not available at the time our survey was completed. The contract price for the study is $29,500 plus an estimated $10,000 for travel and per diem.

CHAPTER 5

BONDS AND INSURANCE PAID FOR

INDIRECTLY UNDER LEASES

BID, PERFORMANCE, AND PAYMENT BONDS UNDER LEASE-CONSTRUCTION AGREEMENTS

Bonds required by Government agencies--Priority B

The Postal Service's requirements for facilities to conduct postal operations are met primarily by construction of major facilities for Government ownership and lease-construction of small and medium size facilities whereby a private developer constructs a facility according to postal specifications under an agreement providing for its lease to the Postal Service for a fixed term, usually between 5 and 20 years.

Although the bonding requirements of the Miller Act (40 U.S.C. 270a) apply only to the construction, alteration, or repair of Government-owned buildings and public works, the Post Office Department and the Postal Service have applied these requirements to lease-construction agreements for facilities in excess of 3,000 square feet. This policy is in sharp contrast to the GSA policy which, since November 1965, has not required performance bonds on lease-construction agreements.

The GSA policy resulted from a study report dated November 8, 1965, which concluded that the expense of performance bonds did not provide an equitable value to the Government or timely completion of the facility. The study disclosed that GSA had not received any financial benefit from the bonds which it had obtained on lease-construction contracts from June 1963 to November 1965. The study disclosed also that GSA regional counsels were hesitant to recommend initiation of suits for damages caused by construction delays because of the difficulty in assessing responsibility for the delays. All GSA regional offices agreed that the causes of delay usually originated with the Government rather than the lessors.

In a prior report to the Congress (B-145650, September 30, 1963) GAO questioned the need for performance bonds on agreements involving construction of postal facilities by private developers for lease to the Government. GAO recommended that the Post Office Department make greater use of the statement of bidder's qualification and give greater consideration to the use of the liquidated damages clause to discourage construction delays. The recommendation was not adopted.

We estimate that the cost to lessors for bid, performance, and payment bonds on lease-construction agreements for postal facilities was about $276,000 in fiscal year 1970 and about $1 million in fiscal year 1971, and will be about $1 million in fiscal year 1972. The cost of these bonds would be included in the total costs, which each lessor would expect to recover in rentals over the life of the lease. It would be expected, therefore, that the Government would bear at least a portion of the bonding cost, plus interest thereon, depending on the length of Government occupancy of each building.

We found that there had been only four defaults on lease-construction agreements for postal facilities during the period July 1965 to April 1971 and that the Post Office Department had not collected damages from the sureties or received any other financial benefit from the bonds in any of these four cases.

Postal officials with whom we discussed this matter were opposed to elimination of the bid, performance, and payment bond requirements on lease-construction agreements, primarily because of the function performed by the sureties in screening out irresponsible bidders. They said that the screening function was particularly important on lease-construction contracts because bidding on such contracts is not limited to construction contractors. Anyone with sufficient financial backing can submit a bid and, if he is the successful bidder, contract with someone else to construct the building. The postal officials also said that sureties often perform a valuable function by exerting pressure on contractors who fall behind on construction schedules.

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Issues for further consideration

Because the Post Office Department collected no damages during a recent 6-year period, and since GSA has found it unnecessary to require bid, performance, and payment bonds on lease-construction agreements, there appears to be potential for significant savings to the Postal Service through elimination of its requirements for such bonds. Further study will be needed, however, to demonstrate the feasibility of Government assumption of the risks now covered by such bonds on the lease-construction of postal facilities and to develop an accurate estimate of the potential savings to the Government.

Bonds required by lessors and/or financial institutions--Priority C

Although GSA does not require its lessors to provide bonds under lease-construction agreements, GSA analyses prepared on each lease-construction project indicate that the successful bidder normally provides a bond to the institution providing the construction financing and that the construction contractor may also be required to provide a bond to the lessor. GSA appraisers estimated the cost of such bonds to be about $749,500 on lease-construction contracts awarded in fiscal year 1971.

A postal official advised us that similar bonds may be procured in some cases by construction contractors and lessors under lease-construction agreements for postal facilities but that he did not believe this was a general practice.

Observations

Although the procurement of such bonds probably results in some increase in rental costs to the Government, we do not believe it would be appropriate or feasible for the Government to assume the risks covered by the bonds. The procurement of such bonds is not a Government requirement but is a matter for negotiation between the lender, the lessor, and the construction contractor in connection with contracts to which the Government is not a party. Also, to eliminate the cost of bonds on those contracts where they

are now required, the Government would probably have to assume the risk on all similar contracts, including those for which bonds are not now being required. We believe such a practice might easily result in a net additional cost rather than a saving to the Government.

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HAZARD AND LIABILITY INSURANCE ON LEASED BUILDINGS 100 PERCENT GOVERNMENT OCCUPIED--PRIORITY B

Postal Service

In fiscal year 1970 the Post Office Department was leasing 27,722 facilities to satisfy a large percentage of its space requirements. The facilities were leased under lease-construction arrangements or rental agreements. Cleaning and building maintenance generally were performed by the lessor.

Facilities acquired under lease-construction arrangements include small and medium size buildings leased for 5 or more years and larger facilities leased for 10 or more years. There were 11,985 such facilities with over 70 million square feet of space under lease to the Department in fiscal year 1970. We estimate that the annual cost of hazard and liability insurance on these facilities totaled between $3.5 million and $5 million.

Rental agreements are used for small facilities with an annual rent of $2,000 or less, which are occupied on a month-to-month basis or for a fixed term not exceeding 60 months. In fiscal year 1970 the Department was occupying 15,737 facilities providing 12.5 million square feet of space under rental agreements. We did not compute the insurance costs for facilities acquired under rental agreements because the short lease periods probably would make Government self-insurance impracticable in most cases.

Personal injury and property damage statistics related to leased facilities are collected by the Postal Service, but are not compiled separately from other damage and claim statistics. To segregate data on leased facilities, the Postal Service would have to reprogram its present data processing system for a special printout. In view of the time and expense involved, we did not request the Postal Service to provide the information.

Industrial accident losses, including fire but excluding vehicle losses, for the entire Post Office Department totaled $10,078,870 in fiscal year 1970, of which $9,447,556

applied to injuries and death to Government and non-Government personnel. Property damage for all postal facilities in fiscal year 1970 totaled $631,314, of which $393,326 represented fire losses.

Postal Service officials stated that they were not in favor of self-insuring leased facilities for the following reasons:

1. There is no assurance that rent would be reduced.

2. Additional administrative costs would be incurred for inspection, investigation, and adjudication of claims.

3. The lessor would no longer be under pressure from the insurance company to maintain the facility in good repair.

General Services Administration

GSA awarded five lease-construction contracts in fiscal year 1971. GSA appraisers estimated that the annual cost of insurance on the completed facilities would total about $150,000.

GSA indicated in its fiscal year 1972 budget request that it would propose legislation authorizing the award of 45 lease-construction contracts during the fiscal year. The legislation was introduced as H.R. 10488 and S. 2479. As of April 7, 1972, final action had not been taken on the proposed legislation, and therefore we do not know how many of these facilities, if any, will be constructed. We estimate roughly that the annual cost of insurance on the 45 facilities, if they are constructed, will be about $500,000.

GSA also leases a number of existing buildings which are occupied 100 percent by the Government. The leases are for various periods ranging from 5 to 15 years. We estimate roughly that the annual cost of insurance on these facilities would be between $130,000 and $285,000. GSA did not have statistics available on total losses or damage claims on Government-owned or leased facilities. However, it should be possible to develop this information from records available at the various GSA regional offices.

GSA officials with whom we discussed the matter stated that there might be merit in considering Government self-insurance of leased buildings but emphasized that this would be practicable only where there is 100 percent Government occupancy and the Government has the responsibility for building maintenance. One official questioned whether financial institutions which lend money to the lessors would be willing to accept a Government guarantee of indemnification in lieu of commercial insurance. Another official stated that he would not want the Government to be stuck with a lease and the responsibility for rebuilding a burnt-out building rather than canceling the lease and finding new space, as it can now do.

Issues for further consideration

Further study will be needed to determine the feasibility of Government assumption of the risks covered by hazard and liability insurance on leased facilities with 100 percent Government occupancy.

We believe it is reasonable to assume that there is a direct relationship between bidders' proposals and the costs which they expect to incur in leasing facilities to the Government. It follows, therefore, that elimination or substantial reduction of an expense such as insurance should result in a corresponding reduction in the rental amount proposed in a bid. This proposition could be easily tested by soliciting alternate proposals with and without Government assumption of the hazard and liability risks. Alternate proposals have sometimes been solicited in the past on lease-construction contracts with and without lessor maintenance of the facilities.

We agree that some additional administrative costs would be incurred for inspection, investigation, and adjudication of claims. We see no reason to assume, however, that performance of these functions by the Government would be substantially more expensive than by the insurance companies. This matter should be given further study.

We agree that 100 percent occupancy and Government responsibility for building maintenance are prerequisites for Government self-insurance of leased buildings. Since most

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leased facilities are now maintained by the lessors, this might impose an additional problem in renegotiating the lease agreements to provide for Government assumption of these risks in return for a reasonable reduction in rental rates. If it were found to be impracticable to renegotiate existing leases, it might still be possible to realize substantial savings in the long run by providing for Government self-insurance and building maintenance in all new lease-construction agreements.

The advantages and disadvantages of Government maintenance of leased buildings, as opposed to lessor maintenance, will need further study. If a net disadvantage is determined for Government maintenance, it will be necessary to consider this as an offset against the potential savings estimated through self-insurance. The question of the acceptability to financial institutions of a Government self-insurance program will also need further study.

Although a self-insurance program would require the Government to accept the risk of occasionally having to restore a destroyed or badly damaged leased building--a risk which it already bears with regard to Government-owned buildings--or to compensate a building owner for such a loss, we doubt that such a situation is likely to occur often enough to negate the financial advantages of self-insurance.

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HAZARD AND LIABILITY INSURANCE ON LEASED AUTOMOBILES--PRIORITY B

Postal Service

As of November 1971 the Postal Service was leasing about 34,000 vehicles. The Postal Service's vehicle lease agreements include a clause stating that the Government is responsible for loss or damage to the vehicles caused by the act or negligence of Government employees. This clause would appear to make the lessor responsible for any damage from a collision in which the Government driver is not at fault, as well as any loss from fire, theft, or other hazards, which does not result from Government negligence. It is possible that many of the lessors are carrying insurance on their vehicles to protect themselves from these risks.

Another clause in the leases requires the lessor to furnish the Postal Service a copy of any liability insurance policy he may have covering the leased vehicles. The Postal Service reimburses the lessor for the cost of the insurance when such a policy is furnished.

The policy of the Postal Service, therefore, permits a lessor to purchase liability insurance, if he elects to do so, and receive reimbursement. On the other hand, if a lessor elects not to purchase insurance, the Postal Service self-insures the risk of liability to third parties resulting from operation of the vehicles.

During our survey, Postal Service officials informed us that they were reviewing their policy to determine whether the risk of liability on all leased vehicles should be assumed by the Postal Service or whether all lessors should be required to carry liability insurance on their vehicles. On February 23, 1972, a Postal Service official informed us that a decision had not been reached on this matter.

Air Force

As of September 1971, the Air Force was leasing about 500 vehicles for use in recruiting activities. Under the provisions of ASPR 7-1501.4, a lessor is responsible for damage in excess of the first $100 to the leased vehicles

and is required to maintain bodily injury and property damage liability insurance.

The Air Force was leasing 89 of the vehicles under a multi-year procurement, planned for 2 1/2 years. The lessor provided comprehensive and collision damage insurance, as well as bodily injury and property damage liability, covering both the lessor and the Government. According to data compiled by a Special Subcommittee of the ASPR Committee, the insurance premiums on the 89 vehicles will total about $74,760 over the 2 1/2-year period, or an average annual cost of $336 for each vehicle. Of the average annual cost, $156 represented the cost of comprehensive and collision damage insurance and $180 represented the cost of bodily injury and property damage liability insurance. The Subcommittee indicated that many more such leases would be awarded by the military departments.

In May 1971 the Special Subcommittee submitted to the ASPR Committee a proposed revision to ASPR which would:

--limit the liability of the lessor for damage to leased vehicles to instances in which such damage was caused by his negligence;

--require the Government to assume the risk of other physical damage to the vehicles; and

--require the contractor to insure only his third-party liability, excluding any coverage for the Government or its employees.

This proposal does not appear to represent full self-insurance by the Government, since it leaves with the lessor the risk of loss or damage to his vehicles as a result of his negligence (presumably deficiencies in manufacture or maintenance) as well as the risk of liability to third parties emanating from his ownership of the vehicles.

The ASPR Committee did not accept the proposed revision. However, the Committee later authorized the Air Training Command of the Air Force to self-insure leased vehicles for a 3-year period beginning July 1971, apparently for the purpose of accumulating data on the costs of self-insuring leased

vehicles. The Air Training Command had previously developed data on insurance costs and claims related to leased vehicles.

If the feasibility of self-insuring leased vehicles is demonstrated by the experimental program, we believe it could result in a change in ASPR, which would require self-insurance of all vehicles leased by DOD. It could also result in self-insurance of leased vehicles by NASA, which generally adapts its procurement regulations to ASPR.

National Aeronautics and Space Administration

As of October 1971 NASA was leasing 117 vehicles which were used by NASA personnel and contractor employees. We visited the George C. Marshall Space Flight Center (MSFC) which was leasing 88 of the 117 vehicles. Under the terms of the lease agreement, MSFC requires the lessor to carry liability insurance on the vehicles.

MSFC officials estimated the annual cost of insurance on the 88 vehicles to be about $12,000. If their estimate is accurate, the annual insurance costs on all 117 vehicles would be about $16,000.

MSFC officials advised us that the insurance was required because the vehicles were operated by both contractor employees and NASA personnel. A NASA official stated that NASA had not considered self-insuring leased vehicles because the potential savings were relatively small and could be offset by additional administrative costs.

Issues for further consideration

Further study of this matter will be needed to determine the feasibility of the Government assuming the risks covered by hazard and liability insurance on vehicles leased by the Postal Service, DOD, NASA, and any other Government agencies which do not self-insure leased vehicles. At the time our survey work was completed, however, the Postal Service was reviewing its policy to determine whether it should assume the risk of liability on all leased vehicles or require lessors to carry liability insurance, and the Air Training Command of the Air Force was experimenting

with a self-insurance program that may eventually be adopted by DOD. It may be desirable, therefore, to defer further consideration of self-insurance of such risks in these agencies until these studies have been completed.

HAZARD AND LIABILITY INSURANCE ON LEASED AUTOMATIC DATA PROCESSING EQUIPMENT-- PRIORITY B (HAZARD) AND C (LIABILITY)

Government leases for automatic data processing (ADP) equipment provide that the lessor is responsible for loss or damage to the equipment, with certain exceptions such as loss or damage resulting from war, civil strife, nuclear activity, and fault or negligence of the Government. Lessors are also responsible for the risk of injury to persons and damage to property of others resulting from fault or negligence of the lessor or caused by the equipment. Commercial insurance generally is purchased by lessors as protection while the equipment is in the possession of the Government and other lessees.

During fiscal year 1969, the Government leased ADP equipment valued at $1.2 billion at an annual rental of $344 million. Using rates obtained from an insurance rating bureau for fire and extended coverage insurance, we estimate that the annual lease costs paid by the Government included hazard insurance premium costs of about $2.5 million. We could not obtain meaningful estimates of the cost of insurance coverage for personal injury and damage to property of others.

Although we could not obtain information on overall losses or damages to leased ADP equipment, such instances appeared to be extremely rare. Only two cases came to our attention. These involved fire damage to leased ADP equipment at the Pentagon and at an Air Force base. Representatives of the lessors told us that the Pentagon loss was covered by the lessor's insurance, and that the lessor of the equipment at the Air Force base filed a claim against the Government because a defective sprinkler system had contributed to the loss.

Actual costs of insurance included in the lease rates negotiated by the Government with lessors of ADP equipment were not available. Several major lessors whom we contacted during our study would not make such information available to us. Moreover, GSA, which negotiates the leases, did not have this type of information in its files.

Lessor officials with whom we discussed the question generally were not receptive to Government assumption of the risk of loss or damage to the equipment. One lessor official stated that his firm preferred to insure the equipment and would prefer to deal with its insurance company in settling claims rather than with the Government. He also said that insurance coverage was provided under blanket policies which covered equipment leased to commercial lessees as well as to the Government, and that the amount of potential savings to the Government might not be significant.

A GSA official informed us that he would not be opposed to negotiating a self-insurance arrangement. He stated, however, that he did not believe the lessors would provide any information on the cost of such insurance. He also questioned whether an equitable reduction in lease costs could be effected.

Issues for further consideration

We believe that the feasibility of Government assumption of the risk of loss or damage to leased ADP equipment in its possession deserves consideration because of the significant insurance costs involved. Moreover, the lease provisions making the Government liable for damages due to its fault or negligence raise a question as to the value the Government is receiving from insurance costs included in the rental payments.

If the insurance costs applicable to ADP equipment leased to the Government can be approximated, it would seem that the potential reduction in lease costs resulting from Government assumption of risk of loss or damage to the equipment would be a matter for negotiation with the lessors. One method of obtaining such an approximation would be for GSA to obtain proposals from each prospective lessor on the basis of (1) lessor assumption of risk of loss or damage resulting from covered hazards, regardless of fault or negligence, other than willful misconduct, by the Government or its employees, and (2) Government assumption of risk of loss or damage resulting from such hazards.

Further study will be needed to determine the feasibility of Government assumption of the risk of loss or damage to leased ADP equipment. We believe, however, that it would be inappropriate for the Government to assume the risk of personal injury and damage to property of others resulting from the lessor's fault or negligence or caused by his equipment, because this would relieve the lessor of responsibility for his actions and product.

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HAZARD AND LIABILITY INSURANCE DURING CONSTRUCTION UNDER LEASE-CONSTRUCTION AGREEMENTS--PRIORITY C

In an earlier section of this report (p. 68), we indicated that further study would be needed to determine the feasibility of the Government assuming the risk of loss or damage to Government facilities during construction. We noted that Government facilities are generally constructed on Government land and are therefore the property of the Government from the outset of construction, and that it appears to be practicable for the Government to exercise a reasonable degree of surveillance over the safety practices of contractors at the construction sites.

These conditions are not present in the case of construction of facilities for lease to the Government. Facilities to be leased to the Government are usually constructed on privately owned land and do not become the property of the Government at any time during or after construction. The Government is not usually a party to the construction contract and is not, therefore, in a good position to exercise adequate surveillance over the safety practices of the construction contractors.

The arguments previously stated (p. 68) against Government assumption of liability risks during construction of public works apply equally to construction under lease-construction agreements.

Observations

For the above reasons, we believe that Government assumption of hazard and liability risks during construction under lease-construction agreements would not be appropriate or feasible.

CHAPTER 6

OTHER TYPES OF INSURANCE

PAID FOR INDIRECTLY

HAZARD INSURANCE ON CERTAIN CCC-OWNED COMMODITIES AND ON COMMODITIES HELD AS LOAN COLLATERAL

Insurance on CCC-owned grain and grain held as collateral for extended loans stored in commercial warehouses--Priority A

The Commodity Credit Corporation requires commercial warehousemen to carry hazard insurance (fire, lightning, explosion, windstorm, cyclone, and tornado) covering the market value of grain owned by CCC or held as collateral for price-support loans, regardless of whether the grain is stored commingled or identity preserved. During the initial loan period the producer pays the storage charges which include the cost of insurance. On grain under extended loan (a loan extended beyond the initial loan period), CCC pays the storage and insurance charges for the extended period of the loan, regardless of whether the grain is ultimately redeemed or forfeited by the producer.

At June 30, 1970, CCC was paying storage charges, which included the cost of insurance, on 831,530,000 bushels of CCC-owned grain stored in commercial warehouses. According to a March 1971 report on a cost study (ERS-475) made by the Economic Research Service of the Department of Agriculture, the estimated average annual cost of insurance on grain stored in various types of commercial warehouses was .205 cents a bushel. Based on this rate, the estimated annual cost of insurance on the CCC-owned inventory of grain would be about $1,700,000.

Also, at June 30, 1970, CCC was paying storage charges, including the cost of insurance, on 298,500,000 bushels of grain held as collateral for extended loans, which was stored in commercial warehouses. Based on the estimated annual insurance cost of .205 cents a bushel, the annual cost of insurance on such grain would be about $600,000.

According to data furnished to us by the Deputy Director-Management of CCC's Kansas City Commodity Office, CCC received insurance settlements of $611,249 during fiscal year 1970 for fire and windstorm damage to CCC-owned grain and grain held as collateral for extended loans stored in commercial warehouses. Therefore, the amount of insurance settlements was about $1.7 million less than the estimated costs of $2.3 million for insurance on such grain.

We did not attempt to determine the administrative costs that would be incurred if CCC were to self-insure the risks now covered by hazard insurance on grain. We believe, however, that the estimated $1.7 million excess of insurance costs over insurance settlements indicates a potential for significant savings if CCC were to self-insure its own grain and grain held as collateral for extended loans stored in commercial warehouses.

Grain under extended loan which is stored on farms

At June 30, 1970, about 800 million bushels of grain held by CCC as collateral for extended loans was stored on farms. CCC pays the farmers for storage of grain under extended loan, but the farmers bear the storage costs during the initial loan period.

CCC pays farmers the same storage rates as it pays to commercial warehousemen, although it does not require the farmers to insure their grain and it assumes any casualty losses that are incurred on the grain. CCC's accounting records show that it assumed losses of about $721,000 on farm-stored grain under loan in fiscal years 1969 and 1970.

Based on the average annual cost of insurance on grain stored in commercial warehouses (.205 cents a bushel) and on the inventory of about 800 million bushels of farm-stored grain under extended loan as of June 30, 1970, it appears that potential annual savings of about $1.6 million could be realized by reducing the storage rates paid to farmers to reflect the fact that they are not required to insure such grain.

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Insurance on CCC-owned beans and rice stored in commercial warehouses--Priority A

CCC's requirements with regard to warehouse-stored CCC-owned beans and rice are essentially the same as for grain except that insurance is not required on CCC-owned beans or rice when they are stored identity preserved. Annual insurance costs on these products are very low compared with grain, however. On the basis of June 30, 1970, inventories, we estimate maximum annual insurance costs of about $11,000 on rice and probably even less on beans.

Insurance on cotton held as collateral for loans--Priority C

CCC requires commercial warehousemen to carry fire insurance covering the market value of cotton stored in their warehouses as collateral for CCC price-support loans. If a producer redeems cotton held by CCC as loan collateral, the producer pays the storage charges, which include the cost of insurance. If the producer forfeits the cotton, CCC acquires title and pays the storage charges. The cotton must be either redeemed or forfeited by the end of the loan period, as CCC does not extend the loan period on cotton. When CCC acquires title to loan-collateral cotton, it requires the warehouseman to cancel the insurance by the last day of the month in which title is acquired and to make an appropriate reduction in the storage rate for subsequent months to reflect the cost of insurance.

During fiscal year 1970, loans on 2,514,808 bales were repaid by producers, who paid the storage charges, including insurance. During the same year CCC acquired 2,784,391 bales of loan-collateral cotton on which it paid the storage charges, including insurance. According to an April 1971 report on a cost study (ERS-469) made by the Economic Research Service of the Department of Agriculture, the estimated cost of insurance on loan-collateral cotton was

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1.7 cents a bale per month. The Deputy Director, Transportation and Warehouse Division of the Agricultural Stabilization and Conservation Service, informed us that the average cotton loan period was about 9 months during fiscal year 1970. Based on the estimated cost of insurance of 1.7 cents a bale per month and an average loan period of 9 months, the cost of insurance would be about $426,000 on the 2,784,391 bales of loan cotton acquired by CCC during fiscal year 1970.

We did not obtain data on insurance settlements for losses on loan-collateral cotton, because a detailed analysis would have been required to obtain such information. The Chief, Fiscal Division, New Orleans Commodity Office, informed us that all insurance claims on cotton are handled for CCC under a contract with Underwriters Salvage Company, which determines the extent of a fire loss and the amount of cotton that can be reconditioned, and files the claim against the insurance company.

If CCC were to self-insure loan-collateral cotton, it probably would have to assume the risk of fire loss or damage on all cotton placed under loan because, at the time a loan is made, CCC does not know whether the producer will redeem or forfeit the cotton and CCC pays the storage and related insurance costs only on the cotton it acquires. Therefore, in order for the Government to realize a net savings on self-insurance of loan cotton, it would be necessary that the insured losses on all cotton placed under loan, plus the cost of administering a self-insurance program for such cotton, be less than the insurance premium costs on loan cotton acquired by CCC.

In a year in which most of the loan cotton was forfeited, there would likely be a net savings, since CCC would save the premium on almost all of the cotton under loan, which might well exceed the losses and the administrative costs of the self-insurance program. On the other hand, in a year in which most of the loan cotton was redeemed, the chance of a net savings under self-insurance would be remote, because CCC would save very little in premium costs and would

bear any losses on the cotton in storage. For fiscal year 1971, for example, only about 1.1 million bales of cotton were forfeited, compared with about 2.6 million bales redeemed.

It appears highly uncertain, therefore, whether a self-insurance program for loan-collateral cotton would result in a net saving or a loss in any given year or over a period of years.

Prior consideration of self-insurance of CCC-owned and loan-collateral commodities

On January 10, 1964, the Department of Agriculture announced that CCC would assume the risk of loss from fire, windstorm, and other causes then covered by casualty insurance on commodities owned by the Government or pledged as collateral for price-support loans, which were stored in commercial warehouses. The announcement stated that (1) the wide distribution of CCC's commodity holdings would accomplish the same spreading of risks which individuals obtain from insurance and (2) assumption of the risks was in line with the policy of the General Accounting Office regarding insurance on Government property. The policy was to take effect July 1, 1964, on grain and August 1, 1964, on cotton and other commodities.

In justifying the change in policy, CCC stated that:

--information compiled for fiscal years 1962 and 1963 showed that for every dollar paid to commercial warehousemen for insurance on grain (apparently CCC-owned), only 27 cents was paid to CCC as a result of insured losses;

--the estimated average annual gross savings by self-insuring CCC-owned grain during fiscal years 1962 and 1963 would be about $4.5 million, without considering either the administrative, investigative, and other overhead costs that would be incurred by CCC in assuming its own risks or the amounts that might be realized from salvage of damaged grain;

--estimated net savings of about $3.6 million had been realized during the 5 years ended June 30, 1963, or an average of about $714,000 a year, by not requiring insurance on CCC-owned cotton; and

--estimated annual net savings of about $590,000 could have been realized by not requiring insurance on loan cotton acquired from the 1961 and 1962 crops (an average of 3,982,756 bales a year).

During the Department of Agriculture's appropriation hearings on March 10, 1964, before the Subcommittee on Department of Agriculture and Related Agencies Appropriations, Agriculture officials were questioned extensively about the self-insurance policy announced on January 10. Most of the questions and criticisms of the policy, however, were directed to CCC's assumption of risks on loan-collateral commodities and protection of the producers' equity when the market price of loan-collateral commodities goes above the price-support level.

The Chairman of the Subcommittee urged Agriculture officials to hold a hearing on its policy of self-insuring CCC-owned and loan-collateral commodities to determine whether or not money would be saved and American agriculture would be served. An Agriculture official promised that the Chairman's recommendation would be considered respectfully and expeditiously, but apparently the hearing was never held since CCC reversed its self-insurance policy 14 days later.

In a letter to the Deputy Administrator, Commodity Operations, ASCS, dated March 16, 1964, the Director, Inventory Management Division, ASCS, stated that public reaction to the January 10 announcement of CCC's self-insurance policy was "instantaneous and overwhelming." He added that:

--the Division had made replies to over 165 congressional letters protesting CCC's action, some of which had as many as 15 attachments from constituents;

--the general tone of the letters was one of "outrage and indignation alleging unwarranted intrusion by the Government into private business and private enterprise," and

--the protests alleged that loan collateral was not Government property and CCC was not obliged to comply with the Government's policy on self-insurance.

The Director concluded that, because of the many complexities involved, CCC's policy on self-insurance should be reappraised. He recommended that insurance be continued on loan collateral and dropped on CCC-owned commodities.

On March 24, 1964, the Department of Agriculture reversed the policy announced on January 10, 1964, and stated that CCC would continue to require commercial warehousemen to carry casualty insurance on CCC-owned grain and on grain and other commodities pledged as collateral for price-support loans.

The official document (Docket CZ 153, Revision 2, approved by the CCC Board of Directors on March 26, 1964), which reversed the self-insurance policy, justified the action on the basis that:

--a self-insurance policy would be impracticable in the administration of farm price-support programs;

--a reappraisal of the storage programs had disclosed substantial complexities, particularly as the policy would apply to warehousemen and to the long-established practices prevailing in the industry with regard to insurance;

--cotton and grain warehousemen and insurance firms and brokers had made strong and convincing representations that the policy was an infringement upon a long and well-established trade custom; and

--State legislatures and State warehousing authorities had protested that CCC's plan to eliminate insurance on stored commodities would create a serious conflict with State laws and regulations, particularly in grain-producing States, most of which required warehousemen to carry insurance on all grain in storage as a condition to receiving a State license. (The

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General Counsel of the Department of Agriculture ruled on December 20, 1963, that, pursuant to section 4(g) of the Commodity Credit Corporation Charter Act, such State laws would not be applicable to CCC operations as long as the storage contracts with warehousemen were amended to state that no insurance shall be provided.)

The General Accounting Office received two inquiries from members of the Congress regarding the Department of Agriculture's proposed policy of self-insurance. In response to these inquiries (B-151876, April 24, 1964), the Comptroller General stated, in part, as follows:

> "As previously pointed out, exceptions have been made to the Government's policy as self-insurer of its property. Inasmuch as we view that policy as equally applicable to commodities held as security on price-support loans, the standards for exception to such policy apply as well. Those standards for exception are repeated here as follows:
>
> (1) Where the economy sought by self-insurance is defeated.
>
> (2) Where sound business practice indicates that a savings can be effected, or
>
> (3) Where services or benefits not otherwise available can be obtained by purchasing insurance.
>
> "It is apparent from the findings made by the Department of Agriculture that neither of the first two reasons for exception apply in this consideration. We are not aware of any basis for applying the third reason for exception in this matter.

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"Consequently, we believe that the Department of Agriculture's decision as stated in the press release of January 10, 1964, that the Commodity Credit Corporation would assume its own risks on Government-owned commodities and commodities held by it as security on price-support loans, was in accord with the Government's policy to self-insure."

In May 1964 GAO received a letter from the National Cotton Compress & Cotton Warehouse Association, which took exception to the conclusions in the letter to one of the Congressmen, and which stated that "the Government cannot become a self-insurer of property which it does not own." In his reply dated August 6, 1964, the Comptroller General stated:

"***there is no question but that a mortgagee has an insurable interest on mortgaged property to the extent of the debt secured (44 C.J.S., Insurance, sec. 187b, p. 884), and we are aware of no law which would require a mortgagee to insure his interest. Thus, the Government, may, if it so desires, assume the risk of loss of any interest it may have in cotton pledged to it as security for a loan, and be a self-insurer to that extent."

Apparently no further action was taken by GAO to encourage CCC to adopt a policy of self-insurance on CCC-owned and loan-collateral commodities.

Issues for further consideration

There appears to be a potential for substantial savings through self-insurance of CCC-owned grain, beans, and rice, and of grain held as collateral for extended loans. Based on the inventories of these commodities as of June 30, 1970, we estimate that gross annual savings of about $3.3 million, exclusive of increased administrative costs, could be realized by adopting a policy of self-insurance and by reducing the storage rates paid to commercial warehousemen and farmers to reflect the cost of insurance. Further study will be required, however, to develop an accurate estimate of potential savings and to demonstrate the feasibility of self-insurance of these commodities.

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With regard to cotton held as collateral for loans, we believe that it is not possible to demonstrate the feasibility of self-insurance at this time, because CCC would have to assume the risk of loss on all cotton under loan in order to avoid the payment of insurance costs on the cotton it acquires. Should there be any change, however, at some future date in CCC's policy which affects the incidence of storage and insurance costs between the Government and the producers, we believe that this matter should be reevaluated to determine whether the change affects the feasibility of self-insurance.

BONDS AND INSURANCE PRO[illegible]RED IN CONNECTION WITH THE MA[illegible]MENT OF ACQUIRED PROPERTIES--[illegible]TY B

In administering [illegible] mortgage insurance programs, the Federal Housing Adminis[illegible]ation (FHA) of the Department of Housing and Urban Development acquires title to various types of housing through mortgage default. After title to a property is acquired, FHA places it with a broker who, under the terms of a contract, is responsible for managing the property until FHA is able to sell it. At June 30, 1970, brokers managed 165 multifamily properties containing 23,600 units and 23,335 single-family properties that had been acquired through mortgage default.

FHA requires brokers with contracts for management of multifamily properties to obtain (1) comprehensive general liability insurance with bodily injury limits of $200,000 for each person and $600,000 for each accident and property damage liability (except automobile) of $100,000 for each accident, (2) nonownership automobile public liability insurance with the same coverage limits as the comprehensive general liability insurance, and (3) workmen's compensation insurance, when a broker is authorized to hire project employees. The property management contracts between FHA and the brokers require that the liability insurance be in the name of the contractor for his protection and that the Government be covered thereunder as a party insured. During fiscal year 1970 the cost of comprehensive general and automobile liability insurance totaled about $255,000, while workmen's compensation insurance costs amounted to about $97,000.

FHA also requires brokers managing either multifamily or single-family properties to furnish surety bonds. Premiums on such bonds totaled about $73,000 for fiscal year 1970.

The Veterans Administration, which acquires single-family properties through mortgage default, does not require its property management brokers to furnish surety bonds.

Other types of insurance may be purchased by brokers with multifamily property management contracts at the discretion of the broker and the local FHA insuring office based on their knowledge of local conditions. For example, during fiscal year 1970 brokers purchased various types of

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hazard insurance such as boiler and machinery, plate glass, dishonesty-destruction-disappearance, and money and securities, at a total cost of about $57,000.

Premiums for bonds and insurance are considered operating expenses of the property and are paid by the brokers from property revenues when the revenues are sufficient or are paid by the brokers and reimbursed by FHA when the property revenues are insufficient.

In 1968 FHA asked brokers who were managing or had recently managed FHA-acquired multifamily properties whether they would continue to purchase the liability insurance coverage if it were no longer required by FHA. The overwhelming majority of brokers who replied stated that they would continue to purchase the coverage and that they would increase their bids to cover the cost of this insurance. FHA concluded that the results of this inquiry argued against discontinuing the policy of purchasing liability insurance on multifamily housing projects, in that, if the insurance requirement were discontinued, a large part of the premium expense would continue as an indirect cost without providing protection against the contingent liability of FHA. FHA concluded also that additional costs for investigation, settlement, and litigation of claims would be incurred.

During the past 10 years, GAO has issued two reports to the Congress in which it questioned FHA's practice of purchasing certain types of insurance covering property acquired through mortgage default. One of the reports (B-114860, March 30, 1962) dealt with the purchase of hazard insurance and the other (B-114860, August 15, 1966) dealt with the purchase of liability insurance.

Issues for further consideration

A broker's risk of liability to third parties appears to be a contractor risk which should not be assumed by the Government. Also, it does not appear to be appropriate for the Government to assume the risk covered by workmen's compensation insurance, because the broker, not the Government, is the employer and the insurance is required in most cases by State law.

It appears, however, that FHA's policy of requiring brokers to furnish surety bonds and permitting them to charge against property revenues the cost of such bonds and the cost of various types of hazard insurance on FHA-owned multifamily properties is generally uneconomical and is inconsistent with the Government's policy of self-insuring its risks. Although the premium cost involved is relatively small, it nevertheless appears to represent a needless expense, a large part of which might be saved through self-insurance. We therefore believe that FHA should give consideration to assumption of the risks covered by such bonds and insurance.

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INSURANCE COSTS INCLUDED IN THE SHIP CONSTRUCTION-DIFFERENTIAL SUBSIDY--PRIORITY B

The Merchant Marine Act of 1970 declares that the national policy for development and maintenance of a merchant marine requires the authorization and appropriation of such sums as necessary to construct 300 ships. The act requires that the ships be constructed in shipyards of the United States and provides for a Government subsidy to cover the higher costs of construction in American shipyards as compared to foreign shipyards. Shipyards purchase builder's risk insurance to protect themselves against loss or damage from fire, windstorm, and other hazards during construction. The cost of insurance is a factor in establishing the contract price for construction of a ship.

A substantial portion of the cost of ships constructed under the construction-differential subsidy program will be provided by the Government. The Maritime Administration, an agency of the Department of Commerce, is responsible for administration of this program. For contracts awarded in fiscal year 1971, the subsidy rate goal is 45 percent of construction costs exclusive of National Defense features which are paid for in total by the Government. This will be reduced at the rate of 2 percent each year until it reaches 35 percent in 1976. However, the subsidy could be as high as 50 percent of construction costs if the Secretary of Commerce finds it necessary.

The cost of builder's risk insurance ranges from $140,000 to $240,000 per ship. Using an estimated average of $200,000 per ship, insurance costs could amount to about $60 million for the 300 ships. The Government's share, using an estimate of 40 percent for the average subsidy, could be about $24 million.

The shipyards on the Gulf Coast suffered heavy losses during Hurricane Betsy in 1965. For example, losses on two ships being built in New Orleans under the construction subsidy program in effect at that time amounted to about $18 million. As a result of such losses, premium rates for builder's risk insurance on the Gulf Coast have increased substantially since 1965.

Maritime officials did not favor Government assumption of the risk of loss or damage on ships being constructed under the subsidy program, largely because a repetition of Hurricane Betsy could result in heavy losses.

An official of a major Gulf Coast shipyard stated that he believed that the Government should assume the risk of loss or damage on ships being constructed under the subsidy program and indicated that his firm had absorbed substantial increases in builder's risk insurance premiums under fixed-price contracts for ship construction. Also, the high cost of builder's risk insurance on the Gulf Coast because of greater risk of hurricane damage could place shipyards in that area at a competitive disadvantage.

There does not appear to be any provision in the act or in its implementation by the Maritime Administration for Government assumption of the risk of loss or damage to ships being constructed under the subsidy program. We noted that the Navy and the Coast Guard have adopted the practice of assuming these risks on large ships under construction. However, the Government pays 100 percent of the cost of these ships in comparison to 45 percent or less of the cost of ships constructed under the subsidy program.

Issues for further consideration

A possible alternative to Government assumption of 100 percent of the risk of loss or damage on ships being constructed under the subsidy program could be an arrangement whereby the shipyards would insure only the unsubsidized portion of the construction cost and the Government would agree to indemnify the shipyards for the portion of the losses equal to the construction subsidy percentage. Insurance industry representatives have advised us that this could be done provided the insurance policies clearly stated the method of allocating losses. They pointed out, however, that the reduction in insurance premiums would not be in proportion to the reduction in coverage because their costs of administration, handling and settling claims, and inspection of safe practices would be about the same regardless of the percentage of risk assumed by the Government.

A more practical alternative might be for the Government to assume 100 percent of the risk and reduce the subsidy that would otherwise be paid by an amount approximating the shipowner's share of the commercial insurance premiums. We believe that this alternative is the one most likely to result in savings to the Government.

Further study will be needed to determine the feasibility of Government assumption of the full risk of loss or damage to ships being constructed under the subsidy program, with an appropriate reduction in the amount of the subsidy to compensate for the added risk assumed by the Government.

INSURANCE COSTS INCLUDED IN THE SHIP OPERATING-DIFFERENTIAL SUBSIDY--PRIORITY C

The Maritime Administration is responsible for administration of the operating-differential subsidy program designed to achieve parity of operating costs between a ship operating under the American Flag and its foreign competitor. Under subsidy contracts between Maritime and the American flag ship operators, the Government pays to the operators the fair and reasonable excess cost of certain items of expense over the estimated fair and reasonable costs to foreign competitors for the same items of expense.

Maritime requires the ship operators to carry hull and machinery insurance and protection and indemnity insurance and provides a subsidy to the operators averaging about 15 and 60 percent, respectively, of the costs of the coverage. During fiscal year 1970, operating subsidy payments by Maritime totaled about $205.7 million of which about $16.4 million was applicable to these two types of insurance coverage.

Observations

It appears that it would not be appropriate or feasible for the Government to assume the risks covered by the above types of insurance. To do so, the Government would probably have to assume 100 percent of the risks in order to save from 15 to 60 percent of the insurance costs. This would not only be more costly to the Government, in all probability, but would go beyond the intent of the operating-differential subsidy program by subsidizing the full cost of insurance rather than the difference between insurance costs to American flag vessels and foreign flag vessels.

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GAO REPORTS CONTAINING

FINDINGS RELATED TO THE

GOVERNMENT'S POLICY ON SELF-INSURANCE

B-8201, March 29, 1962--Review of Bonding Program for Employees of the Federal Government

B-8201, December 30, 1964--Potential Savings to the Government if Bonding of Federal Employees is Discontinued

B-114824, January 31, 1963--Review of Warehousing Operations Under the 1959 and 1960 Cotton Purchase Programs, Commodity Credit Corporation, Department of Agriculture (Failure of CCC to promptly cancel fire insurance on acquired cotton)

B-114824, January 31, 1964--Audit of Commodity Credit Corporation, Department of Agriculture--Fiscal year 1962 (Reiterates finding contained in January 31, 1963, report)

B-114851, August 12, 1970--Opportunity for Coast Guard to Reduce Cost of Vessel Construction by Not Requiring Shipbuilders to Buy Insurance and Performance and Payment Bonds, Department of Transportation

B-114860, March 30, 1962--Review of Management and Disposition of Acquired Properties, Federal Housing Administration, Housing and Home Finance Agency--March 1961 (Purchase of hazard insurance on properties acquired through mortgage default)

B-114860, August 15, 1966--Possible Savings by Discontinuing the Purchase of Public Liability Insurance Covering Acquired Property, Federal Housing Administration, Department of Housing and Urban Development

B-114860, August 26, 1968--Savings Available Through Discontinuing Purchase of Title Insurance on Sales of Houses Acquired by the Federal Housing Administration, Department of Housing and Urban Development

B-118660, June 21, 1966--Review of the Purchase of Title Insurance on Properties Acquired in the State of Florida Under the Loan Guaranty Program, Veterans Administration

B-118660, August 9, 1966--Savings Available by Canceling Hazard Insurance Policies on Properties Acquired Upon Default of Housing Loans, Veterans Administration

B-118779, November 29, 1966--Review of Policy and Practices Relating to Requirements for Performance and Payment Bonds on Certain Ship Construction Contracts, Maritime Administration, Department of Commerce

B-133102, July 29, 1960--Review of Capehart Housing Program of the Department of Defense (Unnecessary costs should no longer be incurred for title search and title insurance on Government land used for Capehart housing because of recently approved legislation.)

B-133338, December 14, 1967--Opportunities for Improvement in Administration of the Contract for Operation of the Kitt Peak National Observatory, Tucson, Arizona, National Science Foundation (Contrary to normal Government policy, title to vehicles used in operation of the Observatory is vested in the contractor, and the cost of insurance is borne by the Government through the cost-reimbursement contract.)

B-136209, June 26, 1970--Costs of Operating the Nuclear Merchant Ship Savannah, Maritime Administration, Department of Commerce (Savings available by discontinuing the purchase of protection and indemnity insurance)

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B-146804, April 3, 1964--Excessive Costs Incurred in Transporting Saturn Launch Vehicles, National Aeronautics and Space Administration (Contrary to the Government's policy of assuming its own risks, NASA required a contractor to purchase insurance, over and above the contractor's normal coverage, which provided for recovery of up to $5 million in the event of damage in transit to Government-owned barges and cargo of Saturn launch vehicle stages.)

B-146876, October 2, 1964--Uneconomical Leasing of Motor Vehicles for use in Assembly and Checkout Operations at Minuteman Missile Launch Sites and Avoidance of Congressional Controls Relating to Acquisition of Motor Vehicles, Department of the Air Force (The report points out that the computations of the increased costs of leasing rather than purchasing motor vehicles excluded insurance costs averaging about $15 a year per vehicle which were paid separately by the contractor and that these costs were excluded because of the difficulty of comparing the contractor's insurance costs with the costs the Government would have incurred under its policy of self-insurance.)

B-146926, September 15, 1964--Unnecessary Costs to the Government for Insurance on Government-Owned Inventories and Special Tooling Held by Contractors Under Negotiated Fixed-Priced Contracts, Department of Defense

B-158712, June 30, 1970--Report to Director, Bureau of the Budget, on a lack of uniformity in car rental procedures and practices as they relate to the purchase of collision damage insurance by travelers to cover the first $100 of collision damage

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B-169941, September 23, 1970--<u>Need for Improved Administration of Federal Support of Shore Facilities and Vessels for Research Activities at Oceanographic Institutions, National Science Foundation and Department of the Navy</u> (NSF should not transfer title to oceanographic research vessels to grantee institutions, but should retain title and avoid hull insurance costs under the Government's policy of self-insurance.)

B-172699, November 9, 1971--<u>Opportunity for Savings in Providing War Risk Insurance for Contractor Property and Employees, Department of Defense, Department of State, and Department of Commerce</u> (The report recommends that the Government assume the risk covered by war risk insurance on contractor-owned vessels and contractor employees, including third-country nationals--citizens of countries other than the United States and Vietnam.)

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