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DOE/IG-0396

U.S. Department of Energy
Office of Inspector General

September 1996



Report on

Audit of Department of Energy's Contractor Liability Insurance Costs

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memorandum

DATE: September 13, 1996

REPLY TO

ATTN. TO: IG-1

SUBJECT: INFORMATION: "Audit of Department of Energy's Contractor Liability Insurance Costs"

TO: The Secretary

BACKGROUND:

Fifty-four of the Department's major contractors reported expending \$44.3 million in liability insurance costs for the last 3 completed years of operation. This included \$23 million for comprehensive general liability insurance and \$5.6 million for automobile liability insurance. Also, some contractors reported having other types of liability insurance costing \$15.7 million. The purpose of this audit was to evaluate how the Department implemented its policy to assume the risk of losses for its contractors rather than to insure them through commercial insurers.

DISCUSSION:

The Department's general policy is to assume the risk of allowable losses or liabilities for its contractors and it currently has a liability insurance program in place to assume this risk. Contractors are required to use self-insurance if combined annual premiums for commercial insurance exceed \$10,000. However, a review of 18 major contractors showed that the Department was not consistently following its policy and that the contractors which used commercial insurance incurred higher costs. In addition, a separate review showed that required approvals were not always obtained prior to purchasing certain other types of liability insurance. We recommended that the Department's policies requiring self-insurance be fully implemented; that requests for approval for commercial insurance when annual premiums exceeded \$10,000 be fully justified, and, that the commercial insurance policies specifically define the liability coverage prior to approval and payment. We also recommended that the contracts include clauses limiting reimbursements for insurance expenditures to actual losses and administrative costs.

U.S. DEPARTMENT OF ENERGY
OFFICE OF INSPECTOR GENERAL
OFFICE OF AUDIT SERVICES

AUDIT OF DEPARTMENT OF ENERGY'S
CONTRACTOR LIABILITY INSURANCE COSTS

Audit Report Number: DOE/IG-0396

SUMMARY

The Department of Energy (Department) uses contractors to operate its facilities and pays the costs incurred by these contractors. During the last 3 completed years of operation, 54 of its major contractors reported that they incurred and were reimbursed about \$44.3 million for liability insurance costs.

The purpose of the audit was to evaluate how the Department implemented its policy to assume the risk of allowable losses or liabilities for its contractors rather than to insure them commercially.

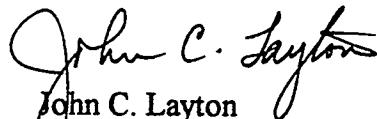
The Department currently has a liability insurance program to assume the risk of allowable losses for its contractors. A review of 18 major contractors, for the last 3 completed years of operation, showed that the Department was not consistently following this policy. As a result, the contractors which used commercial insurance incurred higher costs. In addition, a separate review showed that required approvals were not always obtained prior to purchasing other types of liability insurance. If contracting officers had required contractors to follow Department policies during the last 3 completed years of operation, the Department could have avoided expenditures of about \$14 million.

We recommended that the Department follow its policies to assume the risk of allowable losses or liabilities for its contractors and that contractors be required to obtain approval from Headquarters for commercial insurance when annual premiums exceeded \$10,000. We also recommended that the contracts include clauses that limited reimbursements for insurance expenditures to actual losses and administrative costs.

Management generally concurred with the audit finding and recommendations.

Office of Inspector General
Office of Inspector General

The Deputy Assistant Secretary for Procurement and Assistance Management generally concurred with the finding and recommendations, and provided a series of actions that were planned.



John C. Layton
Inspector General

Attachment

cc: Deputy Secretary
Under Secretary
Assistant Secretary for Human Resources and Administration
Deputy Assistant Secretary for Procurement and Assistance Management
Director, Office of Contractor Human Resource Management
Director, Office of Resource Management and Services

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U.S. DEPARTMENT OF ENERGY
OFFICE OF INSPECTOR GENERAL

AUDIT OF DEPARTMENT OF ENERGY'S
CONTRACTOR LIABILITY INSURANCE COSTS

Report No.: DOE/IG-0396
Date of Issue: September 13, 1996

Capital Regional Audit Office
Germantown, Maryland 20874

**AUDIT OF DEPARTMENT OF ENERGY'S
CONTRACTOR LIABILITY INSURANCE COSTS**

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PART I

APPROACH AND OVERVIEW

INTRODUCTION

The Department of Energy uses contractors to operate its facilities and reimburses all costs except those which are specifically unallowable or determined to be unreasonable. In keeping with a long established policy of minimizing these contractor costs, the Department's general policy is to assume the risk of allowable losses or liabilities for its contractors. This policy is based on the theory that the magnitude of the Government's resources, with its many facilities and a wide geographic dispersion, makes it cost advantageous for the Government to assume its own risks rather than to insure them commercially.

Throughout this report we refer to Departmental policies that require its contractors to either self-insure or use self-insurance to protect against certain losses. This is intended to mean that the contractors should use one of the options described in this report in which the Department assumes the risk of allowable losses.

We did not, as part of this audit effort, evaluate the current status of the Department's policy regarding assumption of risk by its contractors. Rather, our focus was on determining how the Department implemented an appropriate system of self-insurance once it had opted to accept certain risks. During the last 3 completed years of operation, 54 of its major contractors (management and operating, major environmental restoration, construction management, and support service contractors) reported that they incurred and were reimbursed liability insurance costs totaling about \$44.3 million. Our objective was to determine if the Department self-insured its contractors.

SCOPE AND METHODOLOGY

To accomplish our objective, we obtained and reviewed applicable Federal and Departmental regulations and correspondence related to contractor liability insurance. We also reviewed related reports issued by the Office of Inspector General and the General Accounting Office. We held discussions with staff from the Office of Contractor Management and Administration on policies designed to provide oversight and control over liability insurance expenditures.

Using a questionnaire, we obtained information on the types of liability insurance, premium amounts, losses, and refunds, where applicable, from the operations/field offices for 54 of the Department's major contractors for the last 3 completed years of operation. The last 3 completed years were calendar, fiscal, or insurance policy period and were determined by the available records of each contractor. These contractors reported liability insurance costs including premiums, losses, and deductibles of about \$44.3 million. Forty-five of the contractors reported having comprehensive general liability insurance at a cost of \$23 million, and 48 reported having automobile liability insurance costing \$5.6 million. Also, 15 contractors reported having other types of liability insurance costing \$15.7 million.

We judgmentally selected 18 of these 54 contractors for a more detailed review. The review was limited to comprehensive general liability and automobile liability insurance. We verified the data provided by these contractors by obtaining and analyzing available supporting documentation.

Our analysis of the 18 contractors included:

- Determining if contractors had commercial or self-insurance liability coverage.
- Verifying the amount reimbursed to the contractors for insurance premiums and losses for liability insurance for the last 3 completed years of operation.
- Determining if contracts contained clauses that limited reimbursements for insurance expenditures to actual losses and administrative costs.

We also selected for review all 15 of the 54 contractors which reported having other types of liability insurance. Our analysis included determining the types and amounts of other liability insurance and determining if required approvals were obtained prior to procuring this insurance. The other types of liability insurance reported included fidelity/crime, fiduciary, medical malpractice, directors' and officers', and pollution.

In addition to obtaining information and conducting telephonic discussions with responsible officials, we made site visits to three contractors. These contractors and locations were: Mason and Hanger in Amarillo, Texas; Kaiser-Hill in Golden, Colorado; and Lockheed-Martin in Oak Ridge, Tennessee.

The audit was made in accordance with generally accepted Government auditing standards for performance audits and included tests of internal controls and compliance with laws and regulations to the extent necessary to satisfy the audit objective. Accordingly, we assessed internal controls regarding expenditures for liability insurance. Because our review was limited, it would not necessarily have disclosed all internal control deficiencies that may have existed.

The audit was performed between October 1995 and February 1996. We did not rely on computer-processed data to accomplish our audit objective. A formal exit conference was waived by the Director, Office of Contractor Management and Administration, on July 23, 1996.

BACKGROUND

The Department's contractors do not operate in the competitive environment which is typical of most private-sector firms. In general, the Department reimburses all costs incurred under the contracts unless they are specifically unallowable or determined to be unreasonable.

DOE Order 3890.1A defines self-insurance as a method of dealing with losses, with or without advance funding, and with no transfer of risk to a third party (i.e. an insurance company). The Order defines two methods of self-insurance. Under the first method, contractors self-insure using their own personnel to service claims and they do not incur costs unless there is a claim. Under the second method, contractors use a plan commonly referred to as retrospective insurance where the final premium is based on actual losses paid during the year. The retrospective plan includes an amount for estimated losses based on prior claim experience, an administrative processing fee, and a fixed amount for profit. If the estimated premiums are more than actual losses, the Department receives a refund. However, if actual losses exceed estimated premiums, the difference will be paid by the Department.

The Order prescribed that the contractor would procure and maintain bonds and insurance as required by the written direction of the contracting officer. The Order also required contractors to use self-insurance if the combined annual premiums for commercial insurance exceeded \$10,000. Departures from this self-insurance requirement required justification to and approval by the Headquarters, Office of Contractor Management and Administration.

In March 1996, the Department engaged the services of a Third Party Administrator (TPA) to handle and administer contractor liability claims. The TPA would service all cost-type contractors and others as directed by a contracting officer and would charge a fixed cost per claim. Use of the TPA is advocated by the Office of Contractor Management and Administration. The Department expects savings to be achieved if its contractors use the newly initiated TPA mechanism to administer claims.

This report contains a finding that addresses liability insurance coverage that should be considered by management in preparing the yearend assurance memorandum on management controls. Part II of this report provides details on our finding and recommendations. Part III of this report includes detailed management and auditor comments.

PART II

FINDING AND RECOMMENDATIONS

Liability Insurance Coverage

FINDING

The Government has a long established policy of insuring itself against losses or liabilities. By applying the practice of self-insurance to its major contractors, the Department only reimburses the cost of allowable losses arising out of contractor operations and related administrative costs. The Department was not consistently self-insuring its contractors and the contractors which used commercial insurance incurred higher costs. Specifically, the Department did not: (1) implement its policies requiring contractors to be self-insured; (2) always require contractors to justify and obtain approval from Headquarters prior to purchasing commercial insurance or other types of liability coverage; (3) require the terms of the liability insurance policy coverage to be specifically defined; and (4) include clauses in its contracts that limited reimbursements for insurance expenditures to actual losses and administrative costs. During the last 3 completed years, if contracting officers had required contractors to use self-insurance and enforced Department policies, about \$14 million in expenditures could have been avoided.

RECOMMENDATIONS

We recommend the Deputy Assistant Secretary for Procurement and Assistance Management, in conjunction with the managers of the Department operations offices and other field or site offices:

1. Implement DOE Order 3890.1A by requiring contractors to use self-insurance when total annual premiums exceed \$10,000, unless justified as cost effective and approved in writing by the Office of Contractor Management and Administration.
2. Require contracts to include clauses that limit reimbursements for insurance expenditures to actual losses and administrative costs, unless the Office of Contractor Management and Administration has approved the use of commercial insurance.
3. Ensure that commercial insurance policies clearly define liability coverage prior to approval and payment.
4. Require contracting officers to review and determine if the other types of liability insurance coverage, as defined in DOE Order 3890.1A, are allowable and take appropriate action to recoup any unallowable costs.

MANAGEMENT REACTION

The Deputy Assistant Secretary for Procurement and Assistance Management generally concurred with the recommendations.

DETAILS OF FINDING

INSURANCE POLICIES

The Government has a long established policy of self-insuring itself against losses or liabilities. This policy of self-insurance is based on the theory that the magnitude of the Government's operations and its resources, makes it cost advantageous for the Government to assume its own risks rather than to insure them through commercial insurers. Currently, the Department has an insurance program where it assumes the risk of allowable losses for contractors who manage and operate the Department's facilities.

Although there is no statutory requirement for the Government to self-insure its contractors, the Government's policy for self-insurance is embodied in Congressional and Comptroller General decisions. Comptroller General decision B-7067 prescribes that the Government assume its own risks. The decision also prescribes that it is difficult to conceive of a person, corporation, or legal entity better prepared to carry insurance or sustain a loss than the United States Government.

Federal Acquisition Regulation (FAR) 28.3 entitled, "Insurance" requires contractors to purchase liability insurance or self-insure for the risk to which they are exposed. According to the Department of Energy Acquisition Regulation (DEAR) Subpart 950.71-General Contract Authority Indemnity, the Department is authorized general contract authority to enter into indemnity agreements with its contractors to relieve them of risk. Under the authority, Department contractors are protected against risk of liability and covered for the costs of allowable losses, which are limited to the amount of funds appropriated to the Department.

These acquisition regulations are reinforced by DOE Order 3890.1A which prescribes that the Government assumes the risk of loss arising out of contractor operations. The Order also requires contractors to use self-insurance if combined annual premiums for commercial insurance exceeded \$10,000. Any deviations from this self-insurance requirement must be justified and approved by the Office of Contractor Management and Administration.

The Order prescribes that certain other liability insurance coverages including professional, directors' and officers', business interruption and "extra expense" liability insurance are unallowable. Exceptions to this policy also must be justified and approved by the Office of Contractor Management and Administration.

CONTRACTOR INSURANCE COVERAGE

The Department did not consistently enforce the requirement that its contractors self-insure. We reviewed insurance coverage at 18 of the 54 major contractors. The review showed that 13 had comprehensive general liability insurance costing \$6.8 million. Of these 13 contractors, 9 had self-insurance and 4 had procured commercial insurance policies. Also, 16 of the 18 contractors had automobile liability insurance costing \$1.1 million. Eleven of the 16 contractors had self-insurance and 5 procured commercial insurance policies. Audit results showed that contractors which procured commercial insurance incurred significantly higher costs.

In addition, a separate review was performed for 15 of the 54 contractors which reported procuring other types of liability insurance costing approximately \$15.7 million. The necessary approvals were not always obtained prior to purchasing some of this insurance. All of the above costs were for the last 3 completed years of operation.

Comprehensive General Liability Insurance

Comprehensive general liability insurance typically covers third party bodily injury and property damage. For the last 3 completed years, premium and loss reimbursements for the 13 contractors totaled \$6.8 million as shown below.

Comprehensive General Liability Insurance

<u>Type of Insurance</u>	<u>Number of Contractors</u>	<u>Cost of Insurance</u>
Self	9	\$ 500,000
Commercial	<u>4</u>	<u>6,300,000</u>
Totals	<u>13</u>	<u>\$6,800,000</u>

For the last 3 completed years, the contractors which purchased commercial policies did not report any losses. The above chart shows that contractors which purchased commercial insurance incurred significantly higher costs than those who self-insured.

Furthermore, through discussions with contracting officers, we determined that 3 of the 4 contractors did not prepare justifications that included a cost benefit analysis when premiums exceeded \$10,000 or did not have the proper approval to purchase commercial comprehensive general liability insurance.

Automobile Liability Insurance

Automobile liability insurance included coverage for third party bodily injury and property damage. The policy was usually written to cover all motor vehicles, regardless of ownership, used in contract operations when use was not limited exclusively to the premises on which the

work was performed. For a 3-year period, 16 contractors reported costs of about \$1.1 million for automobile liability premium and loss reimbursements as follows.

Automobile Liability Insurance

Type of Insurance	Number of Contractors	Cost of Insurance
Self	11	\$ 242,000
Commercial	<u>5</u>	<u>858,000</u>
Totals	<u>16</u>	<u>\$1,100,000</u>

For the 5 contractors that procured commercial policies, reported losses were about \$528,000. Therefore, taking these losses into account, the Department could have avoided \$330,000 in automobile liability insurance. Moreover, only 2 of the 5 contractors received the required approval from the Office of Contractor Management and Administration to purchase commercial automobile liability insurance.

Other Liability Insurance

The Department reimbursed contractors for costs incurred in procuring liability insurance other than comprehensive general and automobile. Fifteen of the 54 contractors reported procuring other liability insurance and were reimbursed about \$15.7 million in premium costs.

DOE Order 3890.1A prescribes that directors' and officers' liability, professional liability, business interruption, and "extra expense" insurance were unallowable except if authorized by the Office of Contractor Management and Administration. Only 5 of the 15 contractors reported procuring other liability insurance that required Headquarters approval. None of the five contractors had approval from the Office of Contractor Management and Administration to procure other types of liability insurance. For the last 3 completed years, the five contractors were reimbursed \$7.4 million in premiums.

CONTRACT ADMINISTRATION

The Department did not always implement its policies requiring contractors to be self-insured or to justify and obtain Headquarters approval for commercial insurance when premiums exceeded \$10,000. Contractors were allowed to obtain insurance without waiting for comment or approval from the Office of Contractor Management and Administration. Further, commercial insurance was being procured without having the coverage specifically defined. In addition, contracts did not include clauses that limited reimbursements for insurance expenditures to actual losses and administrative costs.

Approval of Insurance

At one of the sites we visited, the contractor was allowed to procure a commercial liability insurance package with annual premiums of \$5.6 million without proper approval from

Headquarters. This package required justification and approval by the Office of Contractor Management and Administration prior to purchase. After a review of this policy, the contracting officer was informed that, unless the contractor had already been directed in writing to purchase the insurance, the insurance package should not be approved. However, the contracting officer did not wait for comment or approval before allowing the contractor to purchase this insurance package.

Defined Insurance Coverage

The Department allowed the same contractor, discussed above, to procure commercial insurance without having the liability coverage specifically defined. In June 1995, the contractor had acquired pollution/professional liability insurance at a cost of \$3.8 million annually. When the original policy was issued, it did not specifically define what was covered. As of March 1996, there had been no resolution of these issues. However, the contractor was reimbursed the \$3.8 million by the Department even though there was no agreement as to what the coverage included. There were no claims against this policy during this period.

Contract Clauses

DEAR 950.71, General Contract Authority Indemnity, and FAR 28.3, Insurance, permit the Department to limit insurance reimbursements to the cost of actual losses and administrative costs, up to the availability of appropriated funds. However, none of the 18 contracts reviewed included these clauses to limit reimbursements to contractors. If the Department had limited these reimbursements the contractors would, in effect, have been self-insured. Instead, the contracts included clauses allowing contractors to procure and maintain insurance as required by the written direction of the contracting officer. The cost implications of these decisions were significant. For example, our review of 18 contractors showed that they were reimbursed \$7.2 million in premiums for commercial comprehensive general and automobile liability insurance policies. However, reported losses were only \$528,000. Therefore, the Department could have avoided about \$6.7 million in expenditures if these contracts had included the appropriate clauses that limited reimbursements to actual losses and administrative costs.

Through discussions with the Office of Contractor Management and Administration, it was determined that contracting officers were interpreting Federal and Department regulations to mean all insurance costs are allowable. A cognizant official stated that since insurance is not one of the unallowable costs per the DEAR and FAR, contractors could be reimbursed for insurance costs.

IMPACT OF CURRENT INSURANCE ADMINISTRATION

Based on the results of the audit, contractor insurance costs could have been reduced by about \$14 million if contracting officers had extended the Government's policy of self-insurance to its major contractors. Five of the 18 contractors reviewed, purchased commercial comprehensive general and automobile liability insurance. The Department could have avoided \$6.7 million in expenditures (excluding losses incurred) if these contractors had been required to self-insure and had the contracts included the required clauses that limited reimbursements to actual losses and

administrative costs. The Department could have avoided expending an additional \$7.4 million in other liability insurance costs if contracting officers had enforced compliance with Department regulations.

PART III

MANAGEMENT AND AUDITOR COMMENTS

In response to this report, the Deputy Assistant Secretary for Procurement and Assistance Management generally concurred with the recommendations. A summary of management's comments and our response follows.

Recommendation 1. Implement DOE Order 3890.1A by requiring contractors to use self-insurance when total annual premiums exceed \$10,000, unless justified as cost effective and approved in writing by the Office of Contractor Management and Administration.

Management Comments. Concur. The Deputy Assistant Secretary for Procurement and Assistance Management will issue a Headquarters letter to all field element directors that will emphasize use of the Department's new Third Party Administrator (TPA) support services contract when commercial insurance premiums exceed \$10,000. The letter will highlight the policy in DOE Order 3890.1A and emphasize the documentation required for approval of commercial insurance. The field offices will be required to notify the Office of Contractor Management and Administration in writing or by E-mail that they have policies and/or procedures in place to ensure commercial insurance purchase reviews are made and properly documented before approvals are given.

Auditor Comments. Management's comments are responsive to the recommendation.

Recommendation 2. Require contracts to include clauses that limit reimbursements for insurance expenditures to actual losses and administrative costs, unless the Office of Contractor Management and Administration has approved the use of commercial insurance.

Management Comments. Concur. The Office of Contractor Management and Administration will work with the General Counsel and other field element offices to draft contract language that will limit the cost of self-insurance to approved claim expenses plus administrative costs. The new contract language will be included in all appropriate Requests for Proposal when it is complete.

Auditor Comments. Management's comments are responsive to the recommendation.

Recommendation 3. Ensure that commercial insurance policies clearly define liability coverage prior to approval and payment.

Management Comments. Concur in principle. Management stated that commercial insurance companies normally use standard industry clauses, and it is unlikely that the Department would have any success at dictating changes to these standard clauses. The soon to be released order, DOE Order 350.1, will stipulate that the Head of Contracting Activity is responsible for ensuring that commercial insurance policies, when allowed, clearly define the liability coverage and are documented as cost effective prior to approval and payment. In the interim, the Head of

interim, the Head of Contracting Activity will be directed to comply with the spirit and intent of the new Order as a good business practice. The Head of Contracting Activity will be required to notify the Office of Contractor Management and Administration of the policy and/or procedures they put in place to satisfy this new requirement.

Auditor Comments. Management's comments are responsive to the recommendation.

Recommendation 4. Require contracting officers to review and determine if the other types of liability insurance coverage as defined in DOE Order 3890.1A are allowable and take appropriate action to recoup any unallowable costs.

Management Comments. Concur. The Deputy Assistant Secretary for Procurement and Assistance Management will establish a requirement for the Head of Contracting Activity to direct their responsible contracting officers to conduct a review of their contractors commercial insurance programs to determine if any of the commercial insurance is unallowable under the terms of the contract. Contracting officers will be directed to take appropriate action to recoup any unallowable costs. The Head of Contracting Activity will be required to notify the Office of Contractor Management and Administration in writing or by E-mail that the review has been completed and provide results of the review.

Auditors Comments. Management's comments are responsive to the recommendation.

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