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REPORT TO THE CONGRESS

Opportunity For Coast Guard
To Reduce Cost Of
Vessel' Construction
By Not Requiring Shipbuilders
To Buy' Insurance And
Performance And Payment Bonds'

B-114851

Department of Transportation

BY THE COMPTROLLER GENERAL
OF THE UNITED STATES

092548

~~715105~~

AUG 12, 1970



COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D C 20548

B-114851

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

This is our report on opportunity for the U.S. Coast Guard to reduce its vessel construction costs by not requiring shipbuilders to buy insurance and performance and payment bonds. Our review 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).

Copies of this report are being sent to the Director, Office of Management and Budget, and to the Secretary of Transportation

A handwritten signature in cursive script that reads "James B. Stacks".

Comptroller General
of the United States

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D I G E S T

WHY THE REVIEW WAS MADE

The U.S. Coast Guard has a continuing program to replace overage, obsolete, and deteriorated vessels through new construction by private shipbuilders and by the Coast Guard Yard, Curtis Bay, Maryland.

The Coast Guard received appropriated funds in the amount of \$246.4 million for new vessel construction during fiscal years 1964 through 1969 and has plans for future expenditures of about \$740.6 million for the current replacement program. (See p. 4.)

The General Accounting Office (GAO) reviewed the Coast Guard's policy of requiring builders' risk insurance under contracts awarded for vessel construction because it seemed inconsistent with the long-standing Government-wide policy of self-insurance. GAO also reviewed the policy of requiring performance and payment bonds on such construction because the statutory authority to waive this requirement for Coast Guard contracts had never been exercised.

FINDINGS AND CONCLUSIONS

Builders' risk insurance

The Government generally follows a policy of self-insurance. GAO found that the Coast Guard was not following this policy for contracts awarded to commercial shipbuilders. One contractor, concurrently constructing vessels for the Coast Guard and the Navy, was incurring costs to provide insurance under the Coast Guard contracts while the Government assumed the risk of loss under the Navy contracts.

Requiring insurance resulted in an increase of \$918,000 in contract prices during fiscal years 1964-66. If the Coast Guard continues to require such insurance, related premium costs of as much as \$5.15 million could be incurred for currently planned construction. (See p. 7.)

Performance and payment bonds

Although the statutory requirement for performance and payment bonds may be waived on Coast Guard contracts, no waivers had been made up to the

time of GAO's review in April 1969. GAO believes that the Coast Guard could save as much as \$900,000 by waiving the requirement for currently planned vessel construction. (See p 11.)

RECOMMENDATIONS OR SUGGESTIONS

The Secretary of Transportation should:

- Direct the Coast Guard to adhere to the Government-wide policy of self-insurance by adopting the Navy's policy of self-insurance in connection with contracts awarded for the construction of vessels.
- Waive the requirement for performance and payment bonds when a pre-award evaluation shows that the contractor has enough assets to cover its performance and payment obligations.

AGENCY ACTIONS AND UNRESOLVED ISSUES

The Department told GAO that the Coast Guard would adopt the Navy's policy of self-insurance. (See p. 17.) The Department agreed that savings are likely through judicious waiver of the requirement for performance and payment bonds and informed GAO that this requirement had been waived in its latest shipbuilding award. (See p. 19.)

MATTERS FOR CONSIDERATION BY THE CONGRESS

This report informs the Congress of opportunities for substantial reductions in the cost of constructing Coast Guard vessels.

CHAPTER 1

INTRODUCTION

The General Accounting Office reviewed the Coast Guard's policies and practices which require that vessel construction contractors provide builders' risk insurance and performance and payment bonds. Our review was directed toward evaluating the factors underlying the need for Coast Guard's policy of requiring insurance and bonds. We did not make an overall evaluation of the administration of vessel construction contracts.

The scope of our review is described on page 13. The principal Department of Transportation officials responsible for the activities discussed in this report are listed in appendix III.

The Coast Guard is responsible for enforcing or assisting in the enforcement of Federal laws on the high seas and waters subject to the jurisdiction of the United States. The Coast Guard provides search and rescue facilities for marine and air commerce and the Armed Forces. Other functions include promoting the safety of merchant vessels; furnishing icebreaking services; and developing, installing, maintaining, and operating aids to maritime navigation. Also, the Coast Guard has a responsibility for maintaining a state of readiness to function as a specialized service of the U.S. Navy in time of war or national emergency.

To assist in carrying out its responsibilities, the Coast Guard operates a fleet of 347 vessels. In order to maintain its fleet at a required level of effectiveness, the Coast Guard has a continuing program to replace overage, obsolete, and deteriorated vessels through new construction by private shipbuilders and by the Coast Guard Yard, Curtis Bay, Maryland.

In November 1959, the Coast Guard set forth its vessel replacement and augmentation requirements in a Report on the Requirements for Coast Guard Vessels. This report was revised in June 1962 and again in September 1966 by the Cutter Plan, the Coast Guard's most current approved

planning document. During fiscal years 1964 through 1969, the Coast Guard received appropriations amounting to \$246.4 million for new vessel construction. The Cutter Plan indicates additional expenditures of about \$740.6 million through fiscal year 1974 for the construction of 139 vessels.

CHAPTER 2

SAVINGS AVAILABLE BY ADOPTING

A POLICY OF SELF-INSURANCE AGAINST CERTAIN RISKS

DURING CONSTRUCTION OF VESSELS UNDER CONTRACT

The Coast Guard, in awarding contracts for the construction of vessels, requires contractors to provide insurance against risk of loss or damage (1) to materials and properties either purchased by the contractor or furnished by the Government and (2) to vessels while they are under construction. This requirement is inconsistent with the general Government-wide policy of self-insurance and the Navy's policy of self-insurance during construction of its major ships (over 100 feet in length). We found that one contractor, concurrently constructing vessels for the Coast Guard and the Navy, was incurring costs to provide insurance under the Coast Guard contracts while the Government assumed the risk of loss under the Navy contracts.

The Government's long-standing policy of self-insurance is based on the theory that there is so much Government property and it is so widely dispersed that it is less costly for the Government to assume the risk of loss than to obtain insurance with private firms at rates sufficient to cover all losses, operating expenses, and profits of the insurers.

Insurance under vessel construction contracts is of the type known as builders' risk. Builders' risk insurance covers the hazards peculiar to ship construction. The policy coverage extends from the laying of the keel to the acceptance of the ship by the Coast Guard and covers both the structure and materials at the site that are to be used during construction.

The Department of the Navy generally follows a policy of self-insurance for the construction of major ships by commercial shipyards. The Navy establishes resident representatives at each of its major ship construction locations to administer the contracts awarded to private shipbuilders. The responsibilities of these representatives include

administering the self-insurance program; for example, investigating contractors' claims for damages.

Under contracts for the construction of ships or vessels, title to materials and properties furnished by the Government generally remains with the Government; however, for materials and properties furnished by contractors, title passes to the Government when the materials and properties are used in performing contract work or when they are paid for by the Government, whichever occurs earlier. Since the Government makes periodic progress payments to contractors on the basis of materials and properties purchased as well as on the basis of labor expended and construction progress, title to such materials and properties generally passes to the Government soon after being received at contractors' yards.

During fiscal years 1964 through 1966, the Coast Guard awarded contracts for the construction of 16 medium- and high-endurance cutters at prices totaling about \$115.8 million. We estimate that the Coast Guard's policy of requiring contractors to obtain commercial insurance against risk of loss or damage to Government-owned property in the possession of the contractors has resulted in increased prices of about \$918,000, representing insurance premium costs to the contractors. Also, because a substantial portion of the insurance coverage obtained by the contractors has been acquired through foreign underwriters, the Coast Guard's policy may have an adverse effect on the balance of payments of the United States.

The Coast Guard does not consistently follow a policy of requiring loss and damage insurance on its properties in the possession of contractors. For example, in procuring aircraft--both fixed-wing and helicopter--the Coast Guard buys under Navy contracts in which the Government assumes the risk of loss or damage to properties and materials in the hands of contractors. Moreover, the Coast Guard acts as a self-insurer for vessels constructed at its Curtis Bay facilities.

The Coast Guard's Cutter Plan contemplates the acquisition of 139 additional vessels, including such vessels as high-endurance cutters, medium-endurance cutters, and

icebreakers. The Coast Guard has not determined the number of vessels to be constructed at its Curtis Bay facilities; however, we were advised that most vessels will be constructed under contracts with private shipbuilders.

If the Coast Guard continues to follow its present policy of requiring such insurance, related premium costs of as much as \$5.15 million could be incurred for currently planned vessel construction. These premium costs are borne by the Government since the contractors include the cost of insurance in their contract prices.

We believe therefore that, if the Coast Guard would adopt a policy of self-insurance, consistent with the general Government-wide policy, it would achieve significant reductions in future Coast Guard expenditures for the construction of vessels in implementation of the Cutter Plan.

The Coast Guard, like the Department of Navy, stations resident representatives at its major ship construction sites. Our review indicates that there would be no apparent difficulty for resident Coast Guard representatives to administer a program of self-insurance, particularly if they worked in cooperation with resident Navy representatives.

AGENCY COMMENTS AND GAO EVALUATION

We proposed that the Secretary of Transportation direct the Coast Guard to adhere to the Government-wide policy of self-insurance by adopting the Navy's policy of self-insurance in connection with contracts awarded for the construction of vessels.

By letter dated February 27, 1970 (see app. I), the Assistant Secretary for Administration advised us that the Coast Guard would revise its current policy of requiring private shipbuilders to bear the risk of loss or damage to Government-owned property in their possession by adopting the Navy's policy of self-insurance in connection with contracts awarded for the acquisition of vessels over 100 feet in length. The Assistant Secretary also advised us that, in implementing such a program, the Department would reserve the right to evaluate the effects of this policy and make

appropriate exceptions upon any particular project in the best interests of the Coast Guard.

In the implementation of a program of self-insurance, the Assistant Secretary stated that, before agreeing to a change in policy, the record should be clear that, in the event of a major disaster, the reprogramming of funds and, very probably, supplemental appropriations would be required. He further stated that present policy of the Coast Guard was based on the fact that it did not obtain sufficient funds under the Acquisition, Construction, and Improvements appropriation to absorb a large loss without returning to the Congress for additional funds; whereas, the loss of one ship under construction would not really be felt by the Navy. (See app. I, p. 1).

It seems that the loss of a major asset would have an adverse effect on any Government agency involved in a major construction program. It is inherent in a self-insurance program that funds be provided to replace the asset destroyed. Funds are appropriated on the basis of the cost of constructing a specific asset, and therefore the loss of the asset would necessitate returning to the Congress for additional funds. The basis for the Government's policy of self-insurance does not rely on the particular circumstances surrounding a single agency but is established on a base which includes all the Government's assets.

CHAPTER 3

OPPORTUNITIES FOR SAVINGS THROUGH

WAIVER OF REQUIREMENT FOR

PERFORMANCE AND PAYMENT BONDS

Although the authority to waive the statutory requirement relative to performance and payment bonds on Coast Guard contracts was enacted in 1955, no such waiver had been made up to the time of our review in April 1969. The Coast Guard requires private shipbuilders to furnish such bonds under contracts awarded for the construction of vessels while the Department of the Navy does not.

The Miller Act (40 U.S.C. 270a) requires contractors to furnish to the United States performance and payment bonds on any contract exceeding \$2,000 for the construction, alteration, or repair of any public building or public work of the United States. Performance bonds guarantee to the United States the performance of the contract. Payment bonds protect persons supplying labor and materials in the event a contractor does not make prompt payment for all materials and labor used in performing contract work.

The Miller Act, as amended (40 U.S.C. 270e), grants to the Secretaries of the Army, Navy, Air Force, and Treasury authority to waive the bonding requirements on certain contracts, including those for the manufacturing, producing, furnishing, construction, alteration, repair, processing, or assembling of vessels. The waiver authority for Coast Guard contracts was granted to the Secretary of the Treasury in 1955. The powers and duties of the Secretary of the Treasury relating to the Coast Guard were transferred to the Secretary of Transportation by 49 U.S.C. 1655(b)(1). Under present regulations, the Coast Guard is not required to obtain performance and payment bonds on contracts for the construction, alteration, or repair of vessels.

The 1955 amendment to the Miller Act was requested by the Secretary of the Treasury because of difficulties experienced with contractors which declined to perform

services for the Coast Guard differently than for the other armed services. It was recognized that contractors would expect conformity of the basic procurement procedures of the Coast Guard with those of the other armed services because much of its procurement activity is comparable to theirs.

We examined into 12 ship construction contracts awarded by the Coast Guard since fiscal year 1963. These contracts, aggregating \$127 million, were for construction of various types of Coast Guard vessels. Our examination showed that the Coast Guard policy of requiring performance and payment bonds on these contracts resulted in increased vessel costs because contractors included bond costs in their contract prices.

Three of the 12 contracts were awarded to a shipbuilder which at the same time was constructing vessels for the U.S. Navy. One of the Coast Guard contracts, for construction of three high-endurance cutters, was awarded to the shipbuilder in March 1965 at a price of about \$32.7 million. The terms of the contract required the shipbuilder to furnish performance and payment bonds at a cost of about \$62,000.

In July 1964, the Navy awarded a contract to this shipbuilder for the construction of seven ships at a total price of about \$81 million. The Navy, however, did not require the shipbuilder to provide performance and payment bonds under the contract. Our review showed that the Navy made a preaward evaluation to determine the financial responsibility of this shipbuilder and to evaluate the shipbuilder's capability, in terms of financial and technical resources to meet the terms of the contract. As a result of this evaluation, the Navy exercised its authority under the Miller Act, as amended, and waived the requirement for performance and payment bonds.

Federal Procurement Regulations, adopted by the Coast Guard as its procurement regulations, require an evaluation of contractor responsibility prior to the award of a contract. In our review of the Coast Guard's contract administration files, however, we did not find any evidence that

the Coast Guard had inquired into the financial responsibility of the contractors before requiring the performance and payment bonds.

We believe that the appropriate evaluation of a prospective contractor's financial responsibility would permit Coast Guard contracting officials to determine whether performance and payment bonds are warranted. Such a determination, if properly made, coupled with the appropriate use of the authority to waive the requirement for performance and payment bonds, in our opinion, would allow the Coast Guard to realize significant savings in its vessel construction program.

We estimate that, for the 139 vessels planned for construction in the Cutter Plan, the Coast Guard could reduce the construction costs by as much as \$900,000 by exercising its authority to waive the requirement for performance and payment bonds. We believe that the Coast Guard should waive this requirement in those cases where an appropriate evaluation shows that prospective contractors have the financial responsibility to cover performance and payment obligations.

In a draft report dated November 6, 1969, we advised the Department of our findings and proposed that the Secretary of Transportation give consideration to directing the Coast Guard to exercise its authority to waive the requirement for performance and payment bonds where a preaward evaluation determines that the contractor has financial assets of a magnitude sufficient to cover performance and payment obligations. By letter dated December 9, 1969, the Assistant Secretary for Administration informed us that the Department agreed that future savings on ship construction contracts are likely through the judicious waiver of the requirement for performance and payment bonds. (See app. II.) He stated also that the Coast Guard's most recent shipbuilding award for three ships at a price of over \$41 million waived the requirement for performance and payment bonds.

The Assistant Secretary, in commenting on the forecast of Coast Guard vessel construction costs through 1974,

noted that the amount included in our draft report was extremely optimistic. He stated that about \$200 million was more realistic and that our estimate of potential savings should be reduced accordingly.

Our estimate of potential savings is based on the Coast Guard's Cutter Plan, which provided for the expenditure of about \$740.6 million for the construction of 139 vessels through 1974. Unless the Coast Guard reduces its overall vessel requirements or materially revises its vessel modernization program through revision of the Plan, we believe that our estimate is reasonable.

CHAPTER 4

SCOPE OF REVIEW

Our examination of bonding practices covered all vessel construction contracts awarded by the Coast Guard since fiscal year 1963 in implementation of its vessel replacement program. Our examination of insurance requirements covered four contracts awarded during fiscal years 1964 through 1966 for the construction of nine high-endurance and seven medium-endurance cutters.

Our review included an examination of contract documents, procurement regulations, and other data on file at Coast Guard Headquarters in Washington, D.C. We examined selected ship construction contracts awarded by the Department of the Navy and reviewed procurement regulations related to the Navy's insurance and bonding practices. We discussed our findings with Coast Guard and Navy officials in Washington. We made limited inquiries at the Coast Guard Yard, Curtis Bay, Maryland, and at the yards of two private shipbuilders that had constructed vessels for the Coast Guard.

There were no internal audits made of these activities.

APPENDIXES



OFFICE OF THE SECRETARY OF TRANSPORTATION

WASHINGTON, D C 20590

February 27, 1970

ASSISTANT SECRETARY
FOR ADMINISTRATION

Mr. Bernard Sacks
Assistant Director
Civil Division
U. S. General Accounting Office
Washington, D. C. 20548

Dear Mr. Sacks:

This is in reply to your request for our comments on your draft report to Congress entitled "Review of Coast Guard Insurance Policy Relating to Vessel Construction."

The report recommends that the Coast Guard revise its policy of requiring its shipbuilding contractors to bear the risk of loss or damage to Government property in their possession, based upon savings afforded by self-insurance through assumption, itself, of the risk of loss.

The present policy of the Coast Guard of having its contractor use commercial insurance for major ships (over 100 feet in length) was based on the fact that the Coast Guard has a very limited spread of risk in both numbers and locations of projects. It did not have a large enough base in AC&I projects to absorb a large loss without return to Congress for additional appropriations. The loss of one ship under construction would not really be felt by the Navy. However, the loss of one Coast Guard vessel could represent 50 percent or more of the entire building program. A significant delay as a result of the Coast Guard having to drastically reprogram funds following severe damage to a vessel, might result in additional construction costs. Before agreeing to a change in policy, we wish to make the record very clear that, in the event of a major disaster, reprogramming of funds and, very probably, supplemental appropriations will be required on an expeditious basis.

With that understanding, we will adopt your recommendation; the Coast Guard will revise its current policy of requiring private shipbuilders to bear the risk of loss or damage to Government-owned property in their possession by adopting the Navy's policy of self-insurance in connection with contracts awarded for the acquisition of vessels over 100 feet in length. We reserve the right however, to evaluate the effects of this policy upon any particular construction project, and make appropriate exceptions if the best interests of the Coast Guard so require.

It should be noted that the Navy practice in boatbuilding contracts (up to 100 feet in length) is to require the contractor to maintain insurance for damage to or loss of boats including both Government furnished and contract furnished material. (See para. 16-2.2(a) of encl. 1). This practice is of course, the same as that of the Coast Guard. In fact, the majority of the contracts that the Coast Guard awarded over the period from 1965 to the present falls within this category. The administrative costs of self-insurance for these smaller vessels are not justified by the relatively modest prospective savings in insurance premiums. In addition, the boatbuilding yards involved are generally small, and some are precariously financed. This means the risk is greater to both the Government and the contractor.

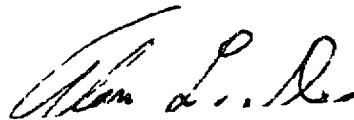
[See GAO note on p. 19.]

In regard to the comment regarding foreign underwriters, it should be noted that domestic insurance is not always available. Discussions with personnel in the Contract Insurance Branch, Naval Material Command, indicates that insurance of this nature is handled by the American Hull Syndicate which is composed of 30 to 40 insurance companies. Many of these companies do not like to underwrite small policies and thus the foreign companies are the only ones available with which to place the insurance.

At the bottom of page 5, the report indicates the Coast Guard would incur costs of as much as \$4.18^[1] million under ship construction contracts expected to be awarded by 1974. It is presumed that this figure was obtained by proportioning the \$750,000^[1] estimated insurance costs versus \$115.8 million in contracts. If so, this presumes that the Coast Guard will award shipbuilding contracts of about \$645 million from the present through 1974. A far more realistic figure is that the Coast Guard will award about \$200 million in contracts through 1974.

We appreciate the opportunity afforded us to comment on your draft report.

Sincerely,



GAO note: Estimates for insurance costs of \$4.18 million and \$750,000 were revised to \$5.15 million and \$918,000, respectively, on the basis of additional information received after completion of the draft report.



OFFICE OF THE SECRETARY OF TRANSPORTATION
 WASHINGTON, DC 20590
 December 9, 1969

ASSISTANT SECRETARY
 FOR ADMINISTRATION

Mr Bernard Sacks
 Assistant Director, Civil Division
 United States General Accounting Office
 Washington, D. C. 20548

Dear Mr Sacks:

As requested by your letter of November 6, 1969, the following comments are offered to your proposed report on the subject of past Coast Guard requirements for performance and payment bonds under vessel construction contracts

- a. Forecasts of Coast Guard vessel construction through 1974 as mentioned on pages 2, 3 and 6 of the draft report are considered to be extremely optimistic. A more realistic estimate would be about \$200 million in ship construction contracts through 1974. Possible savings should be re-evaluated and reduced accordingly.

[See GAO note.]

The above comments notwithstanding, we concur that future savings on ship construction contracts are likely through judicious waiver of performance and payment bond requirements.

The Coast Guard's most recent shipbuilding award for three ships at a price of over \$41 million, waived the requirement for performance and payment bonds.

Sincerely,


 James W. Williams, RADM, USCG
 Acting

GAO note: Comments pertaining to draft report material revised in or not pertinent to the final report have been omitted.

APPENDIX III

PRINCIPAL OFFICIALS OF
THE DEPARTMENT OF TRANSPORTATION
RESPONSIBLE FOR THE ACTIVITIES
DISCUSSED IN THIS REPORT

Tenure of office
From To

DEPARTMENT OF TRANSPORTATION (note a)

SECRETARY OF TRANSPORTATION:

John A. Volpe	Jan. 1969	Present
Alan S. Boyd	Jan. 1967	Jan. 1969

UNITED STATES COAST GUARD

COMMANDANT:

Adm. Chester R. Bender	June 1970	Present
Adm. Willard J. Smith	June 1966	June 1970

^aThe United States Coast Guard was transferred to the Department of Transportation from the Treasury Department, effective April 1, 1967, by Executive Order 11340, dated March 30, 1967.