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

RELEASED

72-0351
JUN 21 1972

B-114811

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Dear Mr. Chairman:

Your letter of April 26, 1972, referred to recent testimony by Admiral R. G. Freeman III, Deputy for Procurement and Production, Naval Material Command, regarding the ground and flight risk clause contained in defense contracts. In his testimony Admiral Freeman stated that this clause resulted from an investigation by the General Accounting Office in the mid-1950's. You requested further information about that investigation and raised certain questions about the application and effects of the Government's policy of self-insuring its risks.

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Enclosed is a copy of our "Report of Survey of Fire and Extended Coverage Insurance on 'Airplanes in Open' under Contracts with the Department of the Air Force and the Department of the Navy" (B-114811, Nov. 6, 1953), which, we believe, is the General Accounting Office report referred to in Admiral Freeman's testimony.

The ground and flight risk clause referred to by Admiral Freeman, contained in Armed Services Procurement Regulation 7-104.10 and 10-404, is used by all the armed services in negotiated fixed-price-type contracts for the production, modification, maintenance, or overhaul of aircraft. Under the provisions of this clause, the Government assumes all risk of loss or damage to such aircraft in flight or during certain other operations, except that the contractor is responsible for the first \$1,000 of loss or damage resulting from each separate event.

Other circumstances under which the Government acts as a self-insurer in connection with military supply contracts include (1) risk of loss or damage to Government-owned property and equipment in the possession of contractors, (2) risk of loss or damage to vessels over 200 feet in length while under construction, and (3) risk of loss 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 third circumstance, a contractor is also relieved of liability for loss or damage to major contract items of high unit cost, such as missiles, aircraft, tanks, ships, and aircraft engines.

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The Government's general policy of self-insurance derives from the fact that the Government is financially able to absorb its maximum probable loss and the fact that its 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. It should therefore be less costly for the Government to assume the risk of loss than to purchase insurance, since the cost of insurance premiums must normally be sufficient, in the long run, not only to cover policyholders' losses but also to cover the insurer's selling, administrative, and other expenses and to provide a reasonable profit to the insurer for its risk and services.

We believe the principle of self-insurance by the Government is sound. We believe it is also appropriate to apply self-insurance to Government property in the possession of contractors and, in some circumstances, to property being manufactured by contractors for the Government, where the cost of insurance would be passed to the Government through the contract price.

You have raised a pertinent question, however, regarding the possibility that relieving the contractor of certain risks may reduce its incentive to be careful and efficient. It would be difficult, if not impossible, to determine conclusively the effect of the Government's policy of self-insurance on contractors' attitudes and practices, but certain logical assumptions may be made.

The care and protection of Government property in the possession of a contractor cannot be isolated from the care and protection of the contractor's own property. Both are dependent upon the contractor's overall programs to provide safe working conditions and to instill in its work force an attitude of safety consciousness. The incident that can result in loss or damage to Government property can also imperil the contractor's own property as well as the lives and health of its employees.

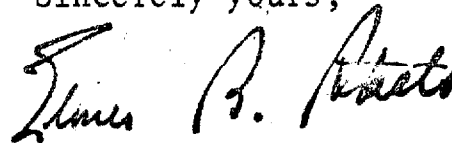
Moreover most contractors are not financially able to self-insure the risks involved; they purchase insurance and pass the cost of the premiums to the Government as part of the contract price. We doubt that a contractor's incentive to exercise care would be significantly affected by whether a casualty loss is borne by the Government or by an insurance company. In neither case would the contractor bear the loss.

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Because of the widespread use of the ground and flight risk clause and the number of contractors involved, it would be difficult and time consuming to assemble the data needed to estimate the costs incurred by the Government as a self-insurer. In addition, for such an estimate to be meaningful, we believe it would be necessary to develop, for comparative purposes, an overall estimate of the premium costs which the Government has saved by self-insuring the risks involved.

Enclosed is a copy of our report to the Congress on our Government-wide "Survey of the Application of the Government's Policy on Self-Insurance" (B-168106, June 14, 1972). Chapter 3 of the report discusses bonds and insurance paid for indirectly by the Government through contracts and may provide additional information to you in connection with the questions raised in your letter.

Sincerely yours,



Comptroller General
of the United States

Enclosures

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The Honorable William Proxmire
Chairman, Joint Economic Committee
Congress of the United States