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28 September 2007

MEMORANDUM FOR

Assistant Secretary of the Army (Acquisition, Logistics and Technology)
Commander, U.S. Army Sustainment Command

SUBJECT: Audit of Defense Base Act Insurance for the Logistics Civil Augmentation Program, Audit of Logistics Civil Augmentation Program Operations in Support of Operation Iraqi Freedom (Project A-2005-ALS-0340.000), Audit Report: A-2007-0204-ALL

1. **Introduction.** This report addresses our audit of Defense Base Act (DBA) insurance the contractor provides its employees and subcontractor employees under the Logistics Civil Augmentation Program (LOGCAP) contract. We performed the audit as part of our audit of LOGCAP Operations in Support of Operation Iraqi Freedom. We are performing the audit at the request of the Commander, Multi-National Force - Iraq. The audit is part of a multilocation audit, and we will include these results in a summary report. Audit results are shown in paragraph 5, and our recommendation is in paragraph 6. The recommendation is addressed to the Assistant Secretary of the Army (Acquisition, Logistics and Technology). The Office of the Assistant Secretary didn't fully agree with all parts of the recommendation, but the actions it plans to take do meet the intent of the recommendation. The reply from the Office of the Assistant Secretary represents the official Army position on this report. Verbatim comments on the report from U.S. Army Sustainment Command and the Office of the Assistant Secretary are included in the enclosure.

2. **Objective and Conclusion.** We are reporting on one objective in this report.

a. **Objective.** The objective addressed in this report was to determine whether adequate controls were in place to minimize costs paid for DBA insurance under the LOGCAP contract.

b. **Conclusion.** Overall, we concluded that adequate controls weren't in place to make sure that costs for DBA insurance were minimized under the LOGCAP contract.

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(1) DBA insurance is basically workers' compensation insurance that contractors working under U.S. Government financed contracts must provide to their employees and subcontractor employees working overseas. Because this insurance is required by law, and because the LOGCAP contract is primarily a cost-reimbursable contract, the cost of this insurance is ultimately passed on to the government. Through FY 05, we estimate the LOGCAP contractor paid about \$284.3 million for DBA insurance under the current LOGCAP contract.

(2) For the following reasons, we believe there is a high risk that the Army could be paying more than necessary for DBA insurance provided for contractor and subcontractor employees under the LOGCAP contract.

- Wide swings in the rates insurance companies charged for the insurance over the past 5 years appear excessive, especially considering the nature of the insurance and the good safety record of the LOGCAP contractor. For contractor operations in Iraq and Kuwait, the rates for this insurance ranged from as low as 3.75 percent of payroll costs in FY 03 to as high as 18 percent of payroll costs in FY 04. The rates were set for FY 06 at 8.5 percent of payroll costs of the contractor's labor force and 9.44 percent for subcontractor laborers.
- The cost of DBA insurance substantially exceeded the losses experienced by the LOGCAP contractor. For FYs 03, 04, and 05, the estimated cost of claims (less than \$73.1 million) the insurance carriers expected to incur represented less than 26 percent of the premiums paid (about \$284.3 million).

As a result of these conditions, we believe there's a high risk that the contractor may have been paying more than necessary for this insurance. Army personnel at all levels appear to be aware of and concerned with the high cost of DBA insurance. However, we believe sufficient action hadn't been taken to scrutinize these costs due to the complex nature in which rates are computed and applied, and the difficulty in obtaining information needed to fully evaluate the reasonableness of rates charged. Given the large amount of money paid for this insurance, and the increased risk that the Army could be overcharged, we believe DBA insurance costs warrant an increased level of scrutiny by contract managers.

(3) In addition, although our review concentrated on DBA insurance associated with the current LOGCAP contract, we believe similar problems could exist on other contracts outside the LOGCAP arena. Under a pilot program, the

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U.S. Army Corps of Engineers recently took action to reduce the cost of this insurance on its contracts by consolidating its insurance under a single carrier. Although we believe this is a move in the right direction, we believe additional opportunities exist for the Army to minimize the cost of DBA insurance.

3. Scope and Methodology

a. **Review Criteria.** From May 2005 through August 2006, we reviewed the costs associated with DBA insurance incurred under the current LOGCAP contract. The audit covered transactions representative of operations current at the time of the audit.

b. **Audit Standards.** To answer our objective, we:

- Reviewed applicable Federal, DOD, and Army laws, regulations, and guidance related to DBA insurance.
- Interviewed key personnel assigned to U.S. Army Field Support Command (now known as U.S. Army Sustainment Command), U.S. Government Accountability Office (GAO), Defense Contract Management Agency, Defense Contract Audit Agency, U.S. Department of Labor, U.S. Department of State, Corps of Engineers, and the LOGCAP contractor.
- Reviewed reports from GAO, Defense Contract Management Agency, Defense Contract Audit Agency, and U.S. Army Audit Agency that addressed DBA insurance or LOGCAP operations recently under review.
- Reviewed rough orders of magnitude and contract proposals under the LOGCAP contract to understand how DBA costs were allocated to task orders.
- Compared the information we reviewed from various sources with other available DBA information to evaluate the reasonableness of the data we were provided.
- Reviewed State workers' compensation programs to understand how workers' compensation programs are meant to work.

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For the most part, we performed the audit in accordance with generally accepted government auditing standards and included the tests of internal controls we considered necessary under the circumstances. We didn't, however, conduct any tests on the reliability of computer-based data we received from the contractor. Most of the data we used in this report was obtained from the LOGCAP contractor, and we didn't review the original source for most of this data. We did, however, confirm that the correct DBA rates were used and that underlying formulas in computer spreadsheets reviewed were correct. Because we didn't conduct comprehensive tests to evaluate the reliability of data provided by the contractor, we don't express an overall opinion on the accuracy of costs, accident, and personnel statistics presented. We do, however, believe the data the contractor provided was reliable enough to support the conditions we reported in this report.

4. Background

a. **LOGCAP.** LOGCAP is a program of the U.S. Army to use civilian contractors to provide the Army with additional means to adequately support the current and programmed force on the battlefield by performing selected services in wartime and other contingency operations. The principal objective of the program is to provide combat support and combat service support augmentation to combatant commanders and Army service component commanders, primarily during contingency operations, throughout the full range of military operations to include reconstitution and replenishment within reasonable cost. DA has also authorized the program's services for use in supporting other Military Services, coalition, and/or multinational forces, and other governmental and nongovernmental agencies. The current LOGCAP contract requires the contractor to adhere to functional Army regulations and to gather operational performance data required by regulations and the contract's required list of deliverables. The contracting officer delegated administrative contracting officer authority to the Defense Contract Management Agency.

b. **DBA Insurance.** DBA insurance provides workers' compensation insurance benefits to contractor employees who are injured while working on a contract financed by the U.S. Government and performed outside the United States. DBA insurance also pays benefits to the dependents of a contractor's employee in the event that the employee is killed as a direct result of the employee's service under a U.S. Government financed contract. DBA coverage is required by statute for employees of contractors and subcontractors regardless of the duration of their assignment. In addition, a prime contractor is responsible for ensuring all

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subcontractors carry DBA insurance. If a subcontractor doesn't obtain DBA insurance, the prime contractor will be held responsible for the costs of injuries and deaths to the subcontractor's employees.

c. **War Risks.** DBA insurance also covers war-risks (injury, death, capture, or detention), but no premium is charged for this insurance because, under the War Hazards Compensation Act (WHCA), the U.S. Government will reimburse an insurance carrier for any claims paid that were a direct result of a war-type incident. In effect, the U.S. Government self-insures itself against war-related injuries and deaths, and the DBA insurance provides coverage for injuries or deaths that occur under normal work conditions.

d. **Allowable Cost.** Since the DBA mandates workers' compensation or self-insurance, this mandate makes it an allowable cost under a cost-reimbursable contract. Thus, costs of DBA coverage are passed through to the Army by its contractors on cost-type contracts.

5. Audit Results

a. **Cost of DBA Insurance.** DBA insurance represents a significant and recently increasing cost element under the current LOGCAP contract. As shown in the following chart, the LOGCAP contractor paid about \$284.3 million in premiums for DBA insurance between FYs 03 and 05.

**Cost of DBA Insurance Under the
Current LOGCAP Contract**

Fiscal Year	Premiums Paid
03	\$ 4,671,775
04	114,992,558
05	164,657,004
Total	\$284,321,337

b. **Rate Fluctuations.** DBA insurance rates are based on a percentage of the contractor's payroll costs for both contractor and subcontractor employees. During FYs 03 through 06, the rates ranged between 3.75 percent and 18 percent of payroll costs as shown in the following chart:

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DBA Insurance Rates
(Expressed in Dollars Per \$100 of Payroll)

Fiscal Year	Iraq/Kuwait Contractor Employees	Iraq/Kuwait Subcontractor Employees	All Other Countries Contractor Employees	Afghanistan Contractor Employees
02	\$3.75		\$3.75	
03	\$3.75		\$3.75	
04	\$16.20	\$18.00*	\$3.78	
05	\$13.80	\$15.33	\$4.70	
06	\$8.50	\$9.44	\$5.21	\$7.65

* Beginning 6 July 2004

(1) **Rate Increases.** Significant annual increases insurance companies made to DBA insurance rates don't appear to be consistent with the risk associated with providing the insurance. Because the U.S. Government reimburses insurance carriers for claims directly resulting from war-type incidents, the primary risk to the insurance carriers would be the cost of claims associated with injuries and deaths occurring under normal work conditions. Although some increases in injuries and deaths could be expected due to the increased stress levels of working in a war-time environment, we believe the significant fluctuations shown in the previous table are high and warrant increased attention on the part of the contractor and government.

(2) **Questioning of Rates.** The LOGCAP contractor did question its insurance broker about the approximate four-fold increase in rates between FY 03 and FY 04 for Iraq and Kuwait. According to the contractor's insurance broker:

- First, the broker marketed the account to the two main insurers who would consider, or who were capable of, insuring a risk as large and as complex as LOGCAP's—only one insurance carrier was willing to submit a quote. As an example of what a complicated hazard this is, the government solicited bids from insurers to provide DBA coverage for all operations in Iraq, but no insurers were willing to provide coverage.
- Second, the broker reviewed the potential for loss with their claims group and, based on their experience with the higher level of benefits afforded those under DBA coverage and the increased hazards, the pricing was determined to be in line.

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- Third, their statistical analysis group reviewed the exposures and loss history of the LOGCAP account and, even though they used different underlying assumptions, they arrived at the same pricing.
- Fourth, the insurance broker told the LOGCAP contractor to be assured that they weren't content to let the insurance carrier dictate pricing and wanted to use all tools at its disposal to make sure that the FY 04 rate of \$16.20 was a true and valid reflection of the exposures.

In addition, contractor personnel told us that one of the increased hazards considered by the insurance broker was the possibility of a catastrophic plane crash. High benefits and non-war-risk hazards concerns should have already been considered in DBA rates—this is why there is a difference between a State's workers' compensation rates and the same State's DBA rates. Catastrophic plane crashes caused by war-hazards would be covered by the government, and an insurance company could also use a re-insurer to limit its liability.

c. **Expected Cost of Claims.** The estimated dollar amount of claims expected to be paid as a result of injuries and deaths is substantially less than the premiums charged for the DBA insurance. As shown in the following chart, our review of FY 03 to FY 05 premiums and claims paid and to be paid as of the end of the cited fiscal year shows that less than 26 percent of the premiums paid will be used to pay claims processed—after considering reimbursable war hazard claims.

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	FY 03	FY 04	FY 05	Totals FY 03/FY 05
DBA Insurance Premiums Paid	\$ 4,671,775	\$114,992,588	\$164,657,004	\$284,321,367
Claims Paid	\$ 5,215,201	\$21,204,776	\$14,219,537	\$40,639,514
Claims to be Paid in Future Years	8,126,330	31,356,413	38,533,050	78,015,793
Total Funds Reserved for Payment or Paid	\$13,341,531	\$52,561,189	\$52,752,587	\$118,655,307
Potential Claims as Percentage of Premiums Paid	285.58%	45.71%	32.04%	41.73%
Potential War Hazard - Claims	\$246,878	\$8,614,483	\$2,694,015	\$11,555,376
Potential War Hazard - Claims to be Paid in Future Years	\$3,212,138	\$18,616,886	\$12,152,643	\$33,981,667
Potential Reimbursable War Hazard Claims	\$3,459,016	\$27,231,369	\$14,846,658	\$45,537,043
Adjusted Potential Claims to be Paid by Insurance Carrier	\$9,882,515	\$25,329,820	\$37,905,929	\$73,118,264
Adjusted Potential Claims as Percentage of Premiums Paid	211.54%	22.03%	23.02%	25.72%

We were unable to break out the estimated costs of claims to be paid between those claims associated with the contractor's LOGCAP contract and those claims associated with other contracts the contractor was performing overseas. As a result, the 25.72 percentage shown in the preceding chart is a conservative figure because the expected value of claims represents more than just those claims incurred under the LOGCAP contract. Based on the total premiums the contractor paid for DBA insurance on all of its contracts (about \$312.1 million), the adjusted potential claims as a percentage of premiums paid is about 23.4 percent. We believe the difference between the amount of premiums paid and the estimated cost of potential claims appears high. In addition, the significant reduction in the rates beginning in FY 06 also indicates that the rates charged in FYs 04 and 05 were particularly high. Although the FY 06 rates represent a significant decrease from the FY 04 and FY 05 rates, the FY 06 rates are still high when compared with the FY 02 and FY 03 rates of 3.75 percent.

d. **Contractor's Safety Record.** The LOGCAP contractor has reported safety statistics that show lower injury rates than the U.S. Private industry average. The LOGCAP contractor has a system for reporting and recording injuries and deaths of contractors and subcontractors under the LOGCAP contract. Only the information, financial, professional, and business services industries have generally reported lower injury statistics than the LOGCAP contractor. The contractor has designated certain

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individuals in-country to report injury and deaths immediately by e-mail to the LOGCAP headquarters in the continental United States. Army contracting officer personnel also receive this report. The contractor's injury database shows that there have been 5,190 injuries since the beginning of the current LOGCAP contract. Our analysis of the database based on these reports as of 30 September 2005 showed:

- Work fatality cases 50 (1 percent).
- Non-work fatality cases 24 (½ percent).
- First Aid cases 825 (15.9 percent).
- Lost time cases 1,656 (31.9 percent).
- Medical cases 2,134 (41.1percent).
- Restricted work cases 501 (9.6 percent).

These statistics, when compared with U.S. accident statistics, show that only the information, financial, professional, and business services industries have generally reported lower injury statistics than the LOGCAP contractor—even while operating in countries with daily war-risk hazards occurring. The LOGCAP contractor has also presented these accident statistics in various ways at safety meetings and award-fee meetings to show the effectiveness of its safety procedures and to be rewarded for its safety record. Such a safety record would seem to better support the lower premium rates charged in FYs 02 and 03, rather than the increased rates in subsequent fiscal years—especially considering that war-related injuries should be reimbursed to the insurance carriers under the WHCA.

e. **Reasonableness of Rates.** Recent rates charged for DBA insurance appear unreasonably high based on the significant fluctuations in the rates charged and the expected value of claims to be paid. These indicators create a heightened risk that the companies could have been overcharging the contractor for this insurance. We believe the Army should review the issues discussed in this report to determine whether there may be a basis for further inquiry.

f. **Cause.** Although Army personnel at all levels appear to be aware of and concerned with the high cost of DBA insurance, we believe sufficient action hadn't been taken to scrutinize these costs due to the complex nature in which rates are

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computed and applied, and the difficulty in obtaining information needed to fully evaluate the reasonableness of rates charged.

(1) **Rate Computations.** The application of DBA rates to total payroll costs makes it difficult to determine the reasonableness of premiums paid. As discussed earlier, the premiums are determined by applying a set percentage against the contractor's total payroll costs. This method, however, can be misleading because the benefits under the program are capped and many of the contractor's employees earn wages that exceed the level where they would no longer receive benefits based on wages earned. For example, the LOGCAP contractor pays many of its employees a foreign-service bonus, post differential, and danger pay in order to recruit and retain needed personnel. Most of the workers also work a large number of hours of overtime.

(a) **Statutory Limits on Benefits.** DBA and War Hazards Act disability benefits have a statutory limit. In FY 05, the limit was \$1,047 a week or about \$54,400 a year. The statutory limit is based on the Longshoremen and Harbor Workers' Compensation Act. Under this Act, the maximum rate of compensation shall not exceed 200 percent of the national average weekly wage. Therefore, the maximum compensation rate for total disability and death benefits is \$1,047.16 (200 percent of the \$523.58 national average weekly wage). Compensation for disability subject to this maximum should be paid at 66 2/3 percent of the employee's average weekly wage. The \$1,047 maximum or 2/3 of the employee's average weekly wage means that the employees derive the maximum benefit from a salary of about \$81,680.

(b) **Wage Levels.** LOGCAP employee wages are significantly higher than the national average because of extensive hours worked, foreign-service bonus, post differential, and danger pay paid to recruit and retain needed personnel. For example, our review of the contractor's proposal for one task order showed over 850 of the 1,853 LOGCAP employees would receive wages that exceeded the \$81,680 maximum wages that disability and death benefits are paid on. We estimated the 850 employees would be paid about \$14.2 million in wages above the \$81,680 maximum wage.

(c) **Danger Pay.** The LOGCAP contractor pays many of its employees danger pay as an incentive for working in dangerous areas such as Iraq and Kuwait. Contracting officers are normally allowed to negotiate up to a 25 percent increase (recently increased to 35 percent) in contractor employee base wages for danger pay.

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Contracting officers use Department of State regulations as a guide for danger pay authorizations, but are free to negotiate higher or lower amounts when determining a fair and reasonable price. Danger pay is authorized according to Department of State regulations “only when civil insurrection, civil war, terrorism or wartime conditions threaten physical harm or imminent danger to the health or well being of a majority of employees officially stationed or detailed at the post in a foreign area.” This authorization, which is applicable to Federal employees, is used as guidance when approving danger pay requests by a contractor for its employees.

- **War Hazards Act.** The WHCA provides that an insurance carrier can be reimbursed by the U.S. Government for injury and death claims processed through the DBA if it is determined that the injury or death was caused by a war-risk hazard. However, the insurance carrier can't be reimbursed if the contractor that bought the DBA insurance paid a “premium” to cover war-risk hazards. The government established the WHCA to assume responsibility for, and to self-insure the payment of, compensation for injuries resulting from war-risk hazards to employees within the purview of the DBA as well as those within the purview of the WHCA. It did so because of the difficulty government contractors had in obtaining such coverage for their employees and the problem of determining a fair premium rate. The Federal Acquisition Regulation indicates WHCA is “automatic” when the DBA applies. The purpose of the government’s “self-insurance” for war-hazard risk is to control costs paid to contractors that are required to provide workers’ compensation insurance and to encourage insurers to write policies for danger zones. The government reimburses insurers the full cost of war-risk hazard deaths and injuries, plus 15 percent in administrative fees.
- **Premiums on Danger Pay.** We estimated that the LOGCAP contractor has paid its insurance carrier at least \$23.1 million in DBA insurance premiums based on danger pay between 1 January 2003 and 30 September 2005. Because the insurance carrier may process up to \$45.5 million in claims under the WHCA for claims made as of 30 September 2005, we believe that the premium paid on danger pay was also the “premium” for war-risk hazards. We believe that either the premiums paid on danger pay should be refunded, or the insurance company claims for reimbursement under the WHCA should be denied. We asked the Department of Labor to confirm our belief.

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- **Department of Labor Interpretation.** Personnel of the Department of Labor's Office of Workers' Compensation Programs (OWCP) who are responsible for determining when a premium is paid don't believe that the premium paid on the danger pay portion of employees' salary is a premium. We received the Labor Department interpretation on 11 July 2006. Its reply said the prohibition's focus in 42 U.S.C. section 1704(b) is whether the premium reflects an assessment of risk on the part of the insurance carrier related to war-risk hazards. Thus, if an insurance carrier's rate per \$100 was \$5 before the start of a military conflict and was still \$5 at the end of the conflict, then no premium was charged for war hazards. Whereas, we believe that, if the danger component of payroll was \$500 million during the conflict, a war-hazard premium of \$25 million was paid. The Department of Labor stated:

Danger pay represents recognition by the employer of the risk the employee faces working in a hazardous area where the chances of being killed and injured are increased. It is not an assessment of risk by the insurer. The fact that the risks that form the basis for danger pay are similar but not necessarily identical to the risks the government assumes for workers' compensation liability for war-risk hazards does not mean it falls within the 104(b) prohibitions. Therefore, while danger pay impacts the cost of DBA insurance, its impact on insurance rates does not implicate the issues that the prohibition on premium loading in 104(b) of the WHCA was intended to address. Nothing in the WHCA, OWCP regulations, or legislative history suggests that payment of danger pay or other "premium" pay because of war-risk hazards must be treated as premium loading. For all of the above reasons, OWCP does not equate danger pay as premium loading under 104(b) for the purpose of denying reimbursement claims filed under 104(a).

- **Danger Pay Exclusion.** We believe danger pay needs to be excluded from the definition of remuneration/payroll when determining DBA insurance premiums. The Department of Labor interprets premium as the rate charged per \$100 of payroll. We agree that this is a fair interpretation of the circumstances occurring in 1942, when the WHCA became law. But the implementation of danger pay as a component of pay started 38 years later in 1980 when Congress authorized Federal employees this benefit. We believe a broader interpretation of "premium" is required. We believe the

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Department of the Army should require that danger pay be excluded from payroll computations on which DBA insurance premiums are applied. This exclusion could be implemented by creating a Federal Acquisition Regulation clause that excludes danger pay as a part of payroll when a contractor is determining DBA premiums to be paid to insurance carriers.

(2) **Exposure.** DBA insurance premiums should be based on the exposure on which benefits are based, and the exposure is to represent a measurable physical characteristic of the risk. Workers' compensation uses the employers' total payroll as the risk. The insurance industry believes the total payroll is the most equitable measure to distribute the cost of job-related injuries among similar employers. Even though disability benefits are limited to only part of the payroll, the insurance industry states that using total payroll as the basis of premiums helps to keep rates low. If a limited payroll is used, a higher rate would be necessary for the same amount of losses. Also, there is an additional expense in maintaining records for the limited payroll. In the case of the LOGCAP contractor, we believe the use of total payroll overstates the carrier's workers' compensation exposure due to the high wages a large number of the contractor's personnel earn. In addition, the impact of high salaries for performing the same job due to union versus non-union employee pay scales, but receiving the same benefits, has been recognized in some States. For example, New York changed its workers' compensation program in October 1999 to allow for limited payroll for most construction workers. In addition, computing rates based on premium pay can make the rates appear more reasonable than they really are. For example, if the same amount of premiums were collected, but the rate was based on payroll costs limited to the capped level (\$81,680), the rates charged would be significantly higher and provide a clearer picture of the cost of the insurance in terms of comparing the cost for similar types of insurance provided in the continental United States.

g. **Government Initiatives.** The government has recently taken several actions in an attempt to obtain a better understanding and greater control over DBA insurance costs. Most notable are a recently completed GAO review on DBA costs and the award of a contract by the Corps of Engineers for a single company to provide all DBA insurance for Corps operations.

(1) **GAO Results.** GAO issued a report on DBA insurance in April 2005 that concluded it was difficult to determine if all DBA insurance is purchased in a cost-effective manner or if agencies' implementation challenges hindered their effectiveness in providing workers' compensation coverage under DBA. Lack of

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reliable information on numbers of contractors and cost of DBA insurance restricts the ability of agencies to make informed decisions on purchasing strategies for DBA.

(a) **GAO Recommendations.** GAO reported that Congress should make sure that DBA cost and implementation issues identified by its review are adequately addressed. It recommended that Congress consider requiring the Director of the Office of Management and Budget to determine, in coordination with DOD, the Departments of Labor and State, and the U.S. Agency for International Development, current and future needs, options, and risks associated with DBA insurance.

(b) **Response to Recommendations.** Both the Office of Management and Budget and DOD didn't agree with the GAO recommendation stating that actions taken by the administration and within DOD already address the issues raised by GAO. We support GAO's recommendation for a coordinated effort to understand DBA insurance and the government's need for this insurance given current DBA costs—especially considering the large role contractors have taken in working in hostile environments overseas.

(c) **Legislation.** In addition, we noted that Senate Bill S1042 (authorizing appropriations for FY 06 for military activities of the Department of Defense) directs the Secretary of Defense, in coordination with the Director of the Office of Management and Budget and appropriate officials of the Department of Labor, the Department of State, and the United States Agency for International Development, to review current and future needs, options, and risks associated with the DBA insurance.

(2) **U.S. Army Corps of Engineers Initiative.** The Corps of Engineers recently instituted a program to reduce the costs of DBA insurance related to its contracts by consolidating the insurance under a single insurance carrier. DOD had previously studied DBA insurance in 1966 to determine if a single-insurer should issue DBA insurance to DOD contractors and subcontractors. At that time, DOD concluded such a program wouldn't lead to cost savings. However, the significant increases in rates after the start of the Iraqi War in March 2003 resulted in DOD authorizing the Army to test the one-insurer program.

(a) **DBA Insurance Pilot Program.** The Corps of Engineers obtained approval from DOD to establish a pilot program for centralized DBA insurance to assess whether it might be advantageous for DOD through reductions in rates and

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greater small business participation in overseas procurements. The Corps of Engineers emphasized to all offerors that DBA insurance rates proposed shouldn't reflect the risk associated with war hazards because the U.S. Government will reimburse the insurance companies for injuries or deaths caused by war hazards.

(b) **Centralized Contract.** On 4 November 2005, the Corps of Engineers established a contractual vehicle that all Corps contractors and subcontractors needing DBA insurance have to use effective 1 December 2005. The FY 06 rates obtained were \$8.50 per \$100 for construction contracts and \$5.00 per \$100 for all other contracts. These rates are applicable to any country overseas and the rates are currently limited to Corps of Engineers contractors. These rates are comparable to those paid by the LOGCAP contractor in FY 06, but significantly less than the high rates the LOGCAP contractor had been paying over the past several years. In addition, the Corps' DBA insurance rates obtained are still 33 percent to 127 percent higher than the LOGCAP DBA rates of \$3.75 used for all countries overseas before the start of hostilities in Iraq. We believe the Corps rates may be acceptable for countries with war-hazards risks given our understanding of the high rates being paid for DBA insurance in countries with war-risk hazards, but not for countries with no war-risk hazards.

h. **Additional Opportunities to Reduce Costs.** Although the Corps took diligent action to reduce its DBA insurance costs, we believe several other alternatives exist for the Army to further reduce the costs for DBA insurance. One alternative is to use retrospective rating plans and the other alternative is to consider self-insuring.

(1) **Retrospective Rating Plans.** Retrospective rating plans could provide reasonable DBA costs because premiums are adjusted to reflect the actual loss experience of the insurer plus a charge to cover the cost of insurer-provided services.

(a) **Definition.** Retrospective rating plans are "cost plus" arrangements. Under these plans, the employer agrees, before the inception of the policy, to pay for its own workers' compensation costs, plus a basic charge which largely covers the cost of insurer-provided services. There can be optional maximum and/or minimum premiums chargeable regardless of how high or how low the actual claim costs turn out to be optional per loss capping is also available.

(b) **Basis for Premiums.** The final premiums for the retrospective plans aren't determined until the end of the coverage period and are based on the insured's

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own loss experience for that same period. DBA insurance carriers should use retrospective rating plans for contractors needing DBA insurance in overseas areas where war-risk hazards are recognized by the Department of State.

(c) **National Defense Projects Rating Plan.** Ordinarily, a retrospective rating plan will result in the lowest net cost for workers' compensation insurance. However, the National Defense Projects Rating Plan described in Defense Acquisition Regulations is intended to provide this insurance to an eligible contract for even lower costs. The plan also applies to all subcontractors performing work at the same location.

- **Risk Pooling Arrangements.** Acquisition regulations allow for establishing risk-pooling arrangements. These arrangements are designed to use the services of the insurance industry for safety engineering and handling of claims at minimum cost to the U.S. Government. The agency responsible shall appoint a single manager or point of contact for each arrangement. The National Defense Projects Rating Plan, also known as the Special Casualty Insurance Rating Plan, is a risk-pooling arrangement to minimize the cost to the government of purchasing liability insurance, such as workers' compensation. The plan should be used when it provides the necessary coverage more advantageously than commercially available coverage.
- **Basis of Premiums.** The National Defense Projects Rating Plan defines premiums by formulas based on average workers' compensation rates throughout the country and adjusted for experience pooled from Defense contractors. This produced premiums without loadings (for example, commission) and eliminated the burden of negotiating premiums every year with the insurance carriers.
- **Implementation.** The risk-pooling plan is implemented by attaching an endorsement to standard insurance policy forms for workers' compensation. The endorsement states the policy is subject to the National Defense Projects Rating Plan. The plan also provides for the return of premium refunds due the prime contractor to the government.

(d) **Current Use of Retrospective Rating Plans.** The U.S. Agency for International Development recognizes the cost savings advantages of retrospective rating plans. The agency requires contractors to use their centralized DBA contract

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unless the Department of Labor has authorized the contractor to self-insure or the contractor has an approved retrospective rating plan for DBA insurance.

(e) **Need for Retrospective Rating Plans.** Retrospective rating plans are needed when insurance carriers' projections of losses significantly increase their DBA rates in areas with war-risk hazards. Because LOGCAP uses civilian contractors to provide additional means of support to our warfighters on the battlefield during wartime and other contingency operations, it follows that retrospective rating plans should be used when determining DBA premiums.

(2) **Army/DOD Self-Insurance.** The Army/DOD, by self-insuring for DBA premiums, may also reduce overall cost for DBA insurance. By self-insuring, the Army/DOD would assume the contractor's liability for all injuries and deaths that occur in a country where war-risk hazards have been recognized by the Department of State and where commercial carrier DBA rates have become unreasonable. The Army/DOD could require all contractors to process injury and death claims through a contractor hired to process the claims. The contractor would process and pay the DBA claims and forward WHCA claims to the Department of Labor. Acquisition regulations provide that the government can, by providing in the contract, in accordance with law, agree to indemnify the contractor under specified circumstances (Federal Acquisition Regulation 28.3 (a)(1)(i)). Although there is no area of fiscal law that prohibits self-insuring, we believe the Army should request DOD to obtain such authority from Congress.

(3) **Conclusion.** Insurance is a form of risk management primarily used to hedge against the risk of potential financial loss and is defined as the equitable transfer of the risk of a potential loss from one entity to another. For property, the Comptroller General has consistently held that, unless otherwise provided by law, activities couldn't use appropriated funds to obtain private insurance, as the government is a self-insurer. The rationale for this rule is grounded on the premise that the U.S. Government is better prepared to carry insurance or sustain a loss than a person, corporation, or legal entity. The Comptroller General further states that "insurance does not provide any added means to actually protect assets but merely transfers the risk of loss." Although these statements primarily apply to insuring property, we see no reason why the same logic wouldn't apply in providing DBA insurance.

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6. Recommendation: For the Assistant Secretary of the Army (Acquisition, Logistics and Technology)

a. **Recommendation 1:** Use more cost-effective means of providing workers' compensation insurance to contractor and subcontractor employees located in countries where war-risk hazards have been recognized by the Department of State. Use one of the following approaches to reducing costs:

- Consider requiring contractors to use insurance carriers that use retrospective rating plans in determining DBA insurance premiums for countries where war-risk hazards have been recognized by the Department of State.
- Consider self-insuring for DBA insurance for countries where war-risk hazards have been recognized by the Department of State. Request DOD to obtain congressional authority for DOD to self-insure. If authorized, modify contracts to show the government, in accordance with the law, agrees to indemnify the contractor under specified circumstances.
- Change the definition of remuneration (payroll) if the Army continues to require the contractor to obtain the DBA insurance. Change the definition of remuneration (payroll) used in computing DBA insurance premiums to exclude danger pay and place a salary cap on an individual's wages that exceed the current Department of Labor approved benefit level. Create a clause in the Federal Acquisition Regulation to accomplish this change.

b. **Command Comments.** The Office of the Assistant Secretary of the Army (Acquisition, Logistics and Technology) partially agreed to the recommendation and provided the following comments.

- It may prove difficult to find insurance carriers who use retrospective rating plans in determining DBA insurance premiums for countries where war-risk hazards have been recognized by the Department of State. The Office stated it will review the results of the U.S. Army Corps of Engineers' (USACOE's) Centrally Managed DBA Pilot Program which will end its 2-year trial in March 2008. The USACOE pilot was included in a Department of Defense DBA study required by Section 1041 of the National Defense Authorization Act for FY 06 (Pub. L. 109-163). Section 1041 required the Secretary of Defense to review current and future needs, options, and risks associated with DBA insurance. The review was conducted in coordination with the

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Director of the Office of Management and Budget and appropriate officials of the Department of Labor, the Department of State, and the U.S. Agency for International Development. This report addressed issues identified in the Government Accountability Office Report, Defense Base Act Insurance: Review Needed for Cost and Implementation Issues, GAO-05-280R, April 29, 2005. In the Section 1041 report, the Office of the Secretary of Defense identified the USACOE pilot program as a cost-effective option for obtaining DBA insurance.

- Since entering Phase II of the DBA pilot program, competition has driven even lower rates than the rates paid under Phase I. The Services Rate was reduced from \$5.00/\$100.00 of employee remuneration in Phase I to \$3.50/\$100.00 of employee remuneration for Phase II; and the Construction Rate was reduced from \$8.50/\$100.00 of employee remuneration in Phase I to \$7.25/\$100.00 of employee remuneration in Phase II. Given the success of the USACOE pilot program, DA will consider developing an Armywide program based on the USACOE pilot program.
- The Office of the Assistant Secretary also stated that the audit recommendation proposes substantive changes to industry standards and practices, most of which would require legislation to effect. Since current legislation mandates DBA applicability, contract managers cannot make decisions opting for self-insurance. Although the report proposes some innovative and potentially cost-saving methods of handling DBA or War Hazard insurance, the Army will plan a course of action based on the results of the USACOE Centrally-Managed Pilot Program which will be completed in March 2008.

The Office of the Assistant Secretary didn't agree to change the definition of remuneration (payroll) used in computing DBA insurance premiums and stated any efforts to change the definition of remuneration must be based on a thorough study of the potential benefits to be derived. As mentioned previously, the Army will develop a course of action based on the USACOE's Centrally-Managed DBA Pilot Program. In the interim, the Office will carefully audit DBA insurance premiums with the assistance of the Defense Contract Audit Agency and Defense Contract Management Agency to ensure that the base used to calculate insurance rates is fair and reasonable. If these examinations indicate that a change is necessary to regulatory language, the Office will take the appropriate steps.

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c. **Agency Evaluation of Command Comments.** The actions proposed by the Office of the Assistant Secretary of the Army (Acquisition, Logistics and Technology) satisfy the intent of the recommendation.

d. **Verbatim Command Comments and the Official Army Position.** The comments provided by the Office of the Assistant Secretary of the Army (Acquisition, Logistics and Technology) represent the official Army position on this report. Verbatim comments and the official Army position are included in the enclosure to this report.

7. **Remarks.** I appreciate the courtesies and cooperation extended to us during the audit. If you have questions, please contact James Johnson at DSN [REDACTED] (e-mail: [REDACTED]@aaa.army.mil or John Vollbracht at DSN [REDACTED] (e-mail: [REDACTED]@aaa.army.mil).

FOR THE AUDITOR GENERAL:

Encl


JOSEPH P. MIZZONI
Deputy Auditor General
Acquisition and Logistics Audits

CF:
Deputy Chief of Staff, G-4
Commander, Multi-National Force - Iraq
Commander, U.S. Army Forces Central Command
Commander, Multi-National Corps - Iraq
Commander U.S. Army Materiel Command



DEPARTMENT OF THE ARMY
OFFICE OF THE ASSISTANT SECRETARY OF THE ARMY
ACQUISITION LOGISTICS AND TECHNOLOGY
103 ARMY PENTAGON
WASHINGTON DC 20310-0103
AUG 16 2007

SAAL-PP

MEMORANDUM FOR DEPUTY AUDITOR GENERAL (ACQUISITION AND MATERIAL
MANAGEMENT), 3101 PARK CENTER DRIVE,
ALEXANDRIA, VA 22302

SUBJECT: Command Comments and Official Army Position to U.S. Army Audit
Agency (AAA) Draft Report: Defense Base Act (DBA) Insurance For
The Logistics Civil Augmentation Program (LOGCAP), Audit of Logistics
Civil Augmentation Program Operations in Support of Operation Iraqi
Freedom (Project A-2005-ALS-0340.000), Audit A-2006-XXXX-ALL

References:

- a. Army Regulation (AR) 36-2, Audit Reports and Followup; and
- b. USAAA Draft Report: Defense Base Act (DBA) Insurance For The Logistics Civil
Augmentation Program (LOGCAP), Audit of Logistics Civil Augmentation
Program Operations in Support of Operation Iraqi Freedom (Project A-2005-ALS-
0340.000), Audit A-2006-XXXX-ALL.

The Deputy Assistant Secretary of the Army (Policy and Procurement)
(DASA(P&P)) has reviewed the subject draft report and provides the enclosed
comments regarding its contents, reported facts, and conclusions.

Should you have any questions, please contact Mr. David Mabee,
[REDACTED]

E. Ballard
Deputy Assistant Secretary of the Army
(Policy and Procurement)

Enclosure

Enclosure

FOR OFFICIAL USE ONLY

COMMAND REPLY

USAAA DRAFT REPORT (Project A-2005-ALS-0340.00), "Report on Defense Base Act (DBA) Insurance for the Logistics Civil Augmentation Program, Audit of Logistics Civil Augmentation Program Operations in Support of Operation Iraqi Freedom"

FINDING: Adequate controls were not in place to make sure that costs for DBA insurance were minimized under the LOGCAP contract.

RECOMMENDATION 1: Use more cost-effective means of providing workers' compensation insurance to contractor and subcontractor employees located in countries where war-risk hazards have been recognized by the Department of State. Cost reducing approach to be considered: Consider requiring contractors to use insurance carriers who use retrospective rating plans in determining DBA insurance premiums for countries where war-risk hazards have been recognized by the Department of State.

ACTION TAKEN 1: Concur in part. It may prove difficult to find insurance carriers who use retrospective rating plans in determining DBA insurance premiums for countries where war-risk hazards have been recognized by the Department of State (DOS). We will review the results of the U.S. Army Corps of Engineers' (USACE) Centrally Managed DBA Pilot Program which will end its two-year trial in March 2008. The USACE pilot was included in a Department of Defense DBA study required by Section 1041 of the National Defense Authorization Act (NDAA) for Fiscal Year (FY) 2008 (Pub. L. 109-163). Section 1041 required the Secretary of Defense to review current and future needs, options and risks associated with Defense Base Act insurance. The review was conducted in coordination with the Director of the Office of Management and Budget and appropriate officials of the Department of Labor, the Department of State, and the United States Agency for International Development. This report addressed issues identified in the Government Accountability Office Report, Defense Base Act Insurance: Review Needed of Cost and Implementation Issues, GAO-05-280R, April 29, 2005.

- (1) Cost-effective options for acquiring Defense Base Act insurance.
- (2) Methods for coordinating data collection efforts among agencies and contractors on numbers of employees, costs of insurance, and other information relevant to decisions on Defense Base Act insurance.
- (3) Improved communication and coordination within and among agencies on the implementation of Defense Base Act insurance.
- (4) Actions to be taken to address difficulties in the administration of Defense Base Act insurance, including matters relating to cost, data, enforcement, and claims processing.

In the Section 1041 report, the Office of the Secretary of Defense (OSD) identified the USACE pilot program as a cost-effective option for obtaining DBA insurance.

Since entering Phase II of the DBA pilot program, competition has driven even lower rates than the rates paid under Phase I. The Services rate was reduced from \$5.00/\$100.00 of Employee Remuneration in Phase I to \$3.50/\$100.00 of Employee Remuneration for Phase II; and the Construction Rate was reduced from \$8.50/\$100.00 of Employee Remuneration in Phase I to \$7.25/\$100.00 of Employee Remuneration in Phase II. Given the success of the USACE pilot program, the Department of the Army will consider developing an Army-wide program based on the USACE pilot program.

RECOMMENDATION 2: Use more cost-effective means of providing workers' compensation insurance to contractor and subcontractor employees located in countries where war-risk hazards have been recognized by the Department of State. Cost reducing approach to be considered: Consider self-insuring for DBA insurance for countries where war-risk hazards have been recognized by the Department of State. Request DoD to obtain congressional authority for DoD to self insure. If authorized, modify contracts to show the Government, in accordance with the law, agrees to indemnify the contractor under specified circumstances.

ACTION TAKEN 2: Concur in part. The AAA proposes substantive changes to industry standards and practices, most of which would require legislation to effect. Since current legislation mandates DBA applicability, contract managers cannot make decisions opting for self-insurance. Although the report proposes some innovative and potentially cost-saving methods of handling DBA or War Hazard insurance, the Army will plan a course of action based on the results of the USACE Centrally-Managed Pilot Program which will be completed in March 2008.

RECOMMENDATION 3: Use more cost-effective means of providing workers' compensation insurance to contractor and subcontractor employees located in countries where war-risk hazards have been recognized by the Department of State. Cost reducing approach to be considered: Changing the definition of remuneration (payroll) if the Army continues to require the contractor to obtain DBA insurance. Change the definition of remuneration (payroll) used in computing DBA insurance premiums to exclude danger pay and place a salary cap on an individual's wages that exceed the current Department of Labor approved benefit level. Create a clause in the Federal Acquisition Regulation to accomplish this change.

ACTION TAKEN 3: Nonconcur. Any efforts to change the definition of remuneration (payroll) used in computing DBA insurance premiums must be based on a thorough study of the potential benefits to be derived. As mentioned in our response to recommendation #1, the Army will develop a course of action based on the USACE Centrally-Managed DBA Pilot Program. In the interim, we will carefully audit DBA insurance premiums with the assistance of the Defense Contract Audit Agency (DCAA) and Defense Contract Management Agency (DCMA) to ensure that the base used to calculate insurance rates is fair and reasonable. If our examination indicates that a change is necessary to regulatory language, we will take appropriate steps.



DEPARTMENT OF THE ARMY
HEADQUARTERS, U.S. ARMY SUSTAINMENT COMMAND
1 ROCK ISLAND ARSENAL
ROCK ISLAND, IL 61299-6500

REPLY TO
ATTENTION OF:

AMSAS-CS

SEP 06 2006

MEMORANDUM FOR US Army Audit Agency, Office of the Deputy Auditor General, Acquisition and Logistics Audits, 3101 Park Center Drive, Alexandria, Virginia 22302-1596

SUBJECT: Report on Defense Base Act Insurance for LOGCAP, Audit of LOGCAP in Support of OIF (Project Code A-2005-ALS.0340.00)

1. The US Army Sustainment Command has reviewed subject report. Our comments are enclosed.
2. The POC is Mr. Dave Sarafin, AMSAS-IA, DSN [REDACTED], e-mail [REDACTED]@us.army.mil.

Encl

Diana L. Balmer
DIANA L. BALMER
Chief of Staff

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**USAAA Draft Report Defense Base Act Insurance
Audit of LOGCAP in Support of
Operation Iraqi Freedom**

Finding: Cost of DBA Insurance

AAA concluded that adequate controls weren't in place to make sure costs for DBA Insurance were minimized under the LOGCAP contract. Because LOGCAP is a cost reimbursable type contract the cost of this insurance is ultimately passed on to the government.

Command Comments for HQ, AFSC:

The report has no recommendations for our command, however, we furnish comments for your consideration.

The LOGCAP contractor accomplished market research with insurers and then sought competition. Offerors had the expectation of competition and would have bid accordingly. The contractor appears to have acted appropriately when a quote was received from only one offeror by entering into negotiations to obtain best value.

The report indicates that the Government "solicited bids from insurers to provide DBA coverage for all operations in Iraq, but no insurers were willing to provide coverage." The speculation that contract managers on LOGCAP could have done better appears contradictory.

AAA proposes substantive changes to industry standards and practices, most of which would require legislation to effect. It is inappropriate to hold LOGCAP contract managers accountable for such changes. Likewise, as current legislation mandates DBA applicability, LOGCAP contract managers cannot make decisions opting for self-insurance. Although the report proposes some innovative and potentially cost-saving methods of handling DBA or War Hazard insurance, essentially these methods were not available to LOGCAP contract managers.

Had the AAA obtained information on DBA rates paid by other contractors in the same theatre of operations and provided appropriate comparisons, the overpricing claims might have merit. But as presented, claims of overpricing appear to

be conjecture. Also, the claim that LOGCAP DBA rates do not reflect the excellent safety record of the contractor are unfounded without adequate evidence such as comparison with rates for other contractors in comparable conditions.

Limited information is included regarding the Army Corps of Engineers recent pilot program (page 3), which cites "consolidation of the insurance under a single carrier". The report does not clarify how items included on page 2 (bullets 1 and 2) were reduced, i.e., how wide swings in the rates could be prevented, or how the cost of DBA insurance would not exceed the claims.

AAA's reliance on information in newspaper articles to be authoritative or auditable raise into question the use of such information in a AAA report.

No exception is taken to recommendations 1 and 2 (reference 6a). However, regarding recommendation number #1, this may prove difficult to find insurance carriers who use retrospective rating plans in determining DBA insurance premiums for countries where war-risk hazards have been recognized by the DOS. Regarding recommendation #3, changing the definition of remuneration (payroll) used in computing DBA insurance premiums may provide minimal effect.

DCAA is currently evaluating the allowability, allocability, and reasonableness of KBR's DBA insurance costs charged and billed to the LOGCAP III contract.

Clarifications:

- KBR does not pay an overtime rate. KBR pays straight pay for any hours over 40 per week. Reference page 12, paragraph (b).
- Not all employees receive separate post differential and danger pay, depending upon location. Reference page 12, paragraph (b).