

March 27, 2001

JOHN E. POTTER  
CHIEF OPERATING OFFICER  
AND EXECUTIVE VICE PRESIDENT

SUBJECT: Audit Report - Postal Service's Ability to Meet Requirements of an  
Electronic Commerce Mailer (Report Number MK-AR-01-001)

This report presents the results of our audit of the Postal Service's efforts to address one of its most significant future challenges--how to serve the mailing needs of electronic commerce companies that market products through the Internet (Project Number 00RA035RG000).

We found that the Postal Service had met the mailing requirements of one of its largest electronic commerce mailers (the Company). However, regulatory constraints prevented the Postal Service from quickly meeting the Company's requests for discount rates and a deferred payment option. As a result, the company signed a three-year agreement with one of the Postal Service's primary competitors to handle a share of its package delivery business that the Postal Service expected to receive. Postal Service officials estimate they may lose about \$25 to \$40 million annually in future revenue because of their inability to meet the Company's requests. Since this report did not contain recommendations, management's comments were not required. Thus, management elected not to provide comments.

We appreciate the cooperation and courtesies provided by your staff during the review. If you have any questions, please contact Larry Chisley, director, Marketing, or me at (703) 248-2300.

Debra S. Ritt  
Assistant Inspector General  
for Business Operations

Attachment

cc: John R. Gunnels

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## EXECUTIVE SUMMARY

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### Introduction

This audit is one in a series of audits we plan to conduct to determine whether the Postal Service has the flexibility to compete in the electronic commerce (eCommerce) parcel delivery market, and the infrastructure and operational capacity to meet the mailing requirements of eCommerce mailers. This report presents the results of our audit of the Postal Service's ability to meet the mailing requirements of one of its largest eCommerce mailers, referred to throughout this report as the Company. Revenues from the Company were expected to exceed \$100 million in FY 2000.

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### Results in Brief

Although the Postal Service was able to meet the basic mailing requirements of the Company, regulatory constraints prevented Postal Service officials from quickly meeting Company officials' requests for discount rates and a deferred payment option.

The Postal Service wanted to provide discount rates as part of a negotiated service agreement;<sup>1</sup> however, it needed the required approval by the Postal Rate Commission, which could have taken up to 10 months. The Company was not willing to go through the process of submitting a request to the Postal Rate Commission.

The Postal Service was also unable to meet the Company's request for a deferred payment option. The Domestic Mail Classification Schedule requires prepayment of postage, and any changes to that schedule would also require Postal Rate Commission approval. After studying the deferred payment issue, the Postal Service also decided it could not make a business case for obtaining approval from the Postal Rate Commission. A Company official told the Postal Service that the lack of a deferred payment option was unacceptable and that renegotiation with competitive carriers would be inevitable.

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<sup>1</sup> Negotiated service agreements are agreements between the Postal Service and an individual mailer that would provide the mailer with customer-specific rates.

Due to these factors, the Company signed a three-year agreement with a Postal Service competitor to handle a share of its package delivery business the Postal Service expected to receive. As a result, Postal Service officials estimate the Postal Service will lose \$25 to \$40 million in future revenues.

## INTRODUCTION

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### Background

The Postal Service projects that electronic alternatives to the mail, such as online bill payment and email correspondence, will cause First-Class Mail volumes to decline at an average annual rate of 2.5 percent from fiscal year (FY) 2003 to FY 2008. The Postal Service also believes that growth in the package delivery market may partially offset declining First-Class Mail volumes. This belief is based on their projection that Internet purchasing will grow to \$108 billion by the year 2003, and shipping revenues from those Internet purchases will be more than \$9 billion. United Parcel Service delivers about 55 percent of all merchandise ordered on the Internet. The Postal Service has the second-largest share of the eCommerce delivery market, with a 32 percent market share; while Federal Express is third with 10 percent.

The Company, one of the largest online retailers, primarily ships Priority Mail, First-Class Mail, and international surface parcels through the Postal Service. The Company originally distributed products from a single distribution center. Currently it ships products from several distribution centers throughout the United States. According to Company officials, the Company shipped about 60 percent of its orders through the Postal Service and almost 40 percent through the United Parcel Service. Postal Service revenues from the Company totaled over \$65 million in FY 1999 and were projected to exceed \$100 million in FY 2000.

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### Postal Rate Commission

The Postal Reorganization Act of 1971 established the Postal Rate Commission as the agency responsible for reviewing and recommending Postal Service rates. No rate for a domestic postal product may be established or changed without a recommendation from the Postal Rate Commission and approval by the Postal Service's Governors.<sup>2</sup> Classification changes are often requested at the same time that changes are requested in postal rates.

Commission rules for new rate requests require testimony and supporting documentation explaining the need for the new rate and how the rate proposal was developed. The

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<sup>2</sup> There are nine Governors appointed by the President with the advice and consent of the Senate. The nine Governors, plus the postmaster general and deputy postmaster general, make up the Board of Governors. While the Board of Governors proposes new rates, the nine Governors alone approve rate and classification changes that are recommended by the Postal Rate Commission.

Postal Rate Commission has ten months in which to recommend a decision to the Board of Governors. During the ten-months, the Postal Rate Commission conducts open hearings through administrative trial proceedings. At these hearings, the Postal Service answers questions from various interested parties such as customers, competitors, and consumer advocates. After considering all of the evidence, the Postal Rate Commission issues an opinion and recommended actions to the Governors.

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**Objective, Scope, and  
Methodology**

Our audit objective was to determine whether the Postal Service had the flexibility to compete in the eCommerce parcel delivery market. We accomplished our objective by reviewing the Postal Service's relationship with one of its largest eCommerce customers, referred to as "the Company" in this report.

We selected the Company for review because it was one of the largest Internet retailers, projected to generate over \$100 million in revenue for the Postal Service in FY 2000. This report presents the results of that audit and is the first of two reports we plan to issue.

To accomplish our audit objective we visited Postal Service mail processing facilities near the Company's distribution centers in Seattle, Washington; New Castle, Delaware; McDonough, Georgia; and Fernley, Nevada. At those locations we interviewed various Postal Service personnel including:

- Business mail entry unit personnel responsible for accepting the mail.
- Processing and distribution center and air mail center managers responsible for processing the Company's mail.
- Transportation and network managers responsible for moving the Company's mail.
- Local postmasters responsible for the account.

We interviewed Postal Service Sales personnel and reviewed all Company information recorded in the Postal Service's Account Management System. We also interviewed the national account manager for the Company and examined reports and records related to the Company.

We did not interview Company officials because they were in on-going negotiations with Postal Service officials.

Our audit was conducted between February 2000 and February 2001 in accordance with generally accepted government auditing standards, and included such tests of internal controls as were considered necessary under the circumstances.

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**Prior Audit Coverage**

There was no prior audit work in this area.

## AUDIT RESULTS

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Although the Postal Service was able to meet the basic mailing requirements of the Company, regulatory constraints hampered the Postal Service's ability to meet the Company's request for discounted rates and a deferred payment option. Postal Service officials estimate the Postal Service may lose about \$25 to \$40 million in future revenue because it cannot provide the Company with customized rates or a deferred payment option in a timely manner.<sup>3</sup> This loss in potential revenue is expected to occur because the Company signed a three-year agreement with a primary competitor to handle a share of its package delivery business that the Postal Service expected to receive.

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### Service Effectiveness

The Postal Service met the Company's basic mailing requirements and considered the Company to be the cornerstone of its pursuit of eCommerce customers. Postal Service officials took extra steps to provide service to the Company, including:

- Dedicating ground and air transportation.
- Providing on-site mail transport equipment.
- Providing customized Priority Mail packaging.
- Providing direct access to senior Postal Service management.

In addition, each Postal Service district serving the Company established an account team that included district and area representatives from Network Operations, Transportation, Manifesting, Acceptance and Processing, Marketing, and Sales. Also, because of the high visibility of the Company's account, a headquarters, national account team was established to interact with top executives from the Company. Team members included the chief operating officer, chief financial officer, treasurer, senior vice presidents from Sales and Operations, and the vice president of eCommerce.

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<sup>3</sup> There is no guarantee that if the Postal Service had provided the Company with customized rates or a deferred payment option, competitors could not have met or exceeded services offered by the Postal Service.



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**Regulatory Constraints**

The Postal Service could not accommodate the Company's requests for discount rates and a deferred payment plan in a timely manner. Under current regulations, the Postal Service is required to request changes to rates and classifications through the Postal Rate Commission, which could take up to ten months. Because the Company was not willing to wait for Postal Rate Commission approval, it signed a three-year agreement with another package delivery company. As a result, the Postal Service may lose \$25 to \$40 million in future revenue.

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**Discount Rates**

Company officials told the Postal Service that it wanted discount rates based on mail volume and mailing efficiencies that would lower the Postal Service's costs. Further, Company officials told the Postal Service that receiving the discounts was a requirement for the Company to continue doing business with the Postal Service. Company officials indicated that delays in providing reduced rates could result in a loss of their business. They also indicated they would be willing to make any sortation<sup>4</sup> or work-sharing efforts to receive the discounted rates.

Postal Service officials wanted to offer customized rates as part of a negotiated service agreement, which required approval of the Postal Rate Commission. Postal Service officials had completed a checklist for customers interested in proposing a negotiated service agreement and were working on a process for reviewing and submitting negotiated service agreement proposals to the Postal Rate Commission. However, because the process of obtaining Postal Rate Commission approval could take up to ten months, the Company decided to pursue alternatives outside of the Postal Service.

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**Deferred Payment Option**

The Postal Service was also unable to meet the Company's request for a deferred payment option. Company officials requested a deferred payment option that would have allowed the Company to defer payments anywhere from 30 to 60 days after the actual mailing. However, because the Domestic Mail Classification Schedule requires prepayment of postage, the Postal Service would have been required to seek approval from the Postal Rate Commission.

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<sup>4</sup> The distribution or separation of mail to route it to its final delivery points.

Postal Service officials wanted to test a 15-day deferred payment option with the Company, however, they were advised by the Postal Service General Counsel that under Title 39 of the United States Code, the Postal Rate Commission would have to approve such a modification to the schedule. The General Counsel also advised that giving a deferred payment option to the Company prior to Postal Rate Commission approval carried a high degree of risk of being found premature and improperly selective, if challenged before the Commission or the courts.

Based on the legal opinion provided by the General Counsel, the Postal Service did not test the deferred payment option with the Company. Instead, in conjunction with PriceWaterhouseCoopers, the Postal Service established a cross-functional team to research the prospective costs and benefits associated with offering special credit terms. An August 18, 2000, PriceWaterhouseCoopers report concluded that although a deferred payment option was feasible, they could not document a strong business case justifying the implementation of such an option. They noted that while a deferred payment option would respond to customer demand and could increase market share, their preliminary financial analysis indicated it was likely a breakeven scenario at best, and would likely constitute suboptimal use of limited capital resources.

The cross-functional team and PriceWaterhouseCoopers recommended that further action should be deferred until product management groups for select mail products presented business cases and were willing to accept the responsibility for the financial impact of providing a deferred payment option to Postal Service customers.

The Company's chief operations officer informed the Postal Service that the lack of a deferred payment option was unacceptable and that renegotiation with competitive carriers was inevitable. Subsequently, the Company signed an agreement with a competitor of the Postal Service, which is expected to divert \$25 to \$40 million in future revenue.

Under existing regulatory constraints, we believe the Postal Service, by establishing negotiated service guidelines, took all actions it could to pursue discount rates. Additionally, we believe the Postal Service's decision to not offer the

deferred payment option was reasonable given the results of the deferred payment option studies. Therefore, we have no recommendations concerning discount rates and deferred payments.