



February 26, 2004

KEITH STRANGE
VICE PRESIDENT, SUPPLY MANAGEMENT

DONNA M. PEAK
VICE PRESIDENT, FINANCE, CONTROLLER

SUBJECT: Audit Report - Use of Reverse Auctions – Headquarters
(Report Number CA-AR-04-001)

This report presents the results of our self-initiated audit of the Postal Service's use of reverse auctions under the FreeMarkets, Inc., contract (Project Number 03XG028CA000).

The use of reverse auction events conducted by FreeMarkets, Inc., met user requirements, and successfully maintained supplier relations. In addition, the Postal Service identified cost savings for the reverse auction events; however, to date, the criteria for calculating supply chain management savings is not complete and is not published as a formal policy. Furthermore, subsequent to completion of the reverse auction pilot program, Postal Service officials awarded a noncompetitive contract to the FreeMarkets and did not perform a cost or price analysis or provide documentation of price reasonableness. As a result, Postal Service management could be relying on incorrect supply chain management reported savings when making project and budget decisions and selecting commodities for purchase through the reverse auction process. In addition, recognitions and awards based on claimed supply chain management savings could be inaccurate. Finally, price or cost analyses are necessary to validate price reasonableness for future efforts.

Management was pleased to receive confirmation that the reverse auction process added value and that the tool was successfully meeting client requirements and maintaining sound supplier relations. To clarify, the conclusions in this report relate only to the reverse auction events conducted by FreeMarkets, Inc. from June 2001 through May 2003. Management agreed with our recommendations and has initiatives in progress, completed, or planned addressing the issues in this report. Management's comments and our evaluation of these comments are included in the report.

The Office of Inspector General (OIG) considers recommendation 2 significant, and therefore requires OIG concurrence before closure. Consequently, the OIG requests

written confirmation when corrective actions are completed. These recommendations should not be closed in the follow-up tracking system until the OIG provides written confirmation that the recommendations can be closed.

We appreciate the cooperation and courtesies provided by your staff during the review. If you have any questions or need additional information, please contact Lorie Siewert, director, Supply Management and Facilities, at (651) 855-5856, or me at (303) 925-7429.

/s/ Colleen A. McAntee

Colleen A. McAntee
Deputy Assistant Inspector General
for Financial Management

Attachment

cc: Richard J. Strasser, Jr.
Craig D. Partridge
Susan M. Duchek

INTRODUCTION

Background

Supply chain management institutionalizes new business practices, supplier relations, and organizational design and deployment to reduce overall costs and increase customer satisfaction. The Postal Service's initial projected supply chain management cost reduction goal for fiscal year 2003 was \$200 million. Innovations such as reverse auctions are designed to contribute to cost reductions.

Reverse auctions are live online bidding processes (also known as downward price auctions) designed to reduce overall costs and increase customer satisfaction.

Objectives, Scope, and Methodology

Our overall objective was to determine whether the Postal Service's use of reverse auctions is effectively achieving supply chain management cost reductions and customer satisfaction. Specifically, we evaluated reported savings, effectiveness of reverse auctions in satisfying user requirements and efforts to maintain successful supplier relations through the reverse auction process.

We interviewed Supply Management and Finance personnel regarding reverse auction policies, procedures, future plans, and specific reverse auction events. We also reviewed all FreeMarkets, Inc., contracts and related modifications, reviewed contract files for 9 of 16 reverse auction events,¹ and analyzed the methodology for computing cost savings. The scope of our review was limited to 16 reverse auction events conducted by FreeMarkets, Inc., from June 2001 through May 2003.

This audit was conducted from June 2003 through February 2004 in accordance with generally accepted government auditing standards. We reviewed internal controls related to reverse auction events to the extent necessary under the circumstances. We discussed our conclusions and observations with appropriate management officials and included their comments, where appropriate. We did not rely on computer-generated data for this audit.

Prior Audit Coverage

We did not identify any prior audits or reviews related to the objectives of this audit.

¹We did not review reverse auction events for electricity, strapping machines and materials, industrial and automotive batteries, natural gas, custodial rental items, maintenance, repair, and operating supplies, or belts.

AUDIT RESULTS

We found the use of reverse auction events conducted by FreeMarkets, Inc., met user requirements, and successfully maintained supplier relations. Specifically, the reverse auction events we reviewed added value to the Postal Service by enhancing competition, reducing cycle time for contract award, increasing cost savings, and improving strategic efforts to identify vendors. Additionally, when the purchasing teams conducted post-award briefings requested by the supplier, we found no evidence of dissatisfaction.

The Postal Service used reverse auctions to purchase 16 commodities or services² and identified savings of about \$54 million as shown.

Reverse Auction Events with Supply Chain Management Savings ³		
	Commodity	Reported Savings ⁴
1	Plastic Pallets	\$ 1,805,000
2	Personal Computers	714,105
3	Labels and Forms	5,697,072
4	Contact Center Network Solution	13,520,618
5	Truckload Transportation	500,000
6	Software Testing and Validation	1,010,711
7	Temporary Labor	547,200
8	Plastic Hampers	292,950
9	Commercial Air	0 ⁵
10	Electricity	3,251,849
11	Strapping Machines and Materials	402,750
12	Industrial and Automotive Batteries	409,961
13	Maintenance, Repair, and Operation Supplies	14,958,434
14	Natural Gas	710,922
15	Custodial Rental Items	8,561,039
16	Belts	1,991,088
	Total	\$54,373,699

²Reverse auction events conducted by FreeMarkets, Inc., from June 2001 through May 2003.

³We reviewed the process for calculating savings except for electricity, strapping machines and materials, industrial and automotive batteries, natural gas, custodial rental items, maintenance, repair, and operating supplies, or belts.

⁴Reported savings reflect the first performance year of the contract.

⁵ Postal Service did not award the Commercial Air contract based on reverse auction results.

However, to date the criteria for calculating supply chain management savings is not complete and is not implemented as a formal policy. Additionally, subsequent to completion of the reverse auction pilot program, Postal Service officials awarded a noncompetitive contract to the same contractor and did not perform a cost or price analysis or provide documentation of price reasonableness.

As a result, Postal Service management could be relying on incorrect supply chain management reported savings when making project and budget decisions and selecting commodities for purchase through the reverse auction process. In addition, recognitions and awards based on claimed supply chain management savings could be inaccurate. Finally, price or cost analyses are necessary to validate price reasonableness for future efforts.

Criteria for Calculating Supply Chain Management Savings Not Complete or Implemented as a Formal Policy

To date the criteria for calculating supply chain management savings is not complete and is not implemented as a formal policy. Specifically, Postal Service officials did not establish relevant baseline criteria when historical spend data was not available. In addition, procedures did not exist to reduce total verified savings, as a result of the use of reverse auctions, by the amount paid to FreeMarkets, Inc., to conduct reverse auction events. Additionally, as of January 2004, Postal Service officials had not finalized or published a draft instruction to calculate savings as a formal policy.

Draft Administrative Instruction SM 2003-008, Managing Supply Chain Management Value, dated April 8, 2003, defines net savings as the difference between prior year spend and current year spend for the same or comparable products, services, or activities. However, the draft instruction did not establish relevant baseline criteria when prior year spend data was not available and did not include guidance for reducing savings by the cost to conduct reverse auction events.

When prior year spend data for commodities or services purchased through reverse auctions were not available, Postal Service officials used initial bids as a substitute. In these instances, Postal Service officials computed savings by taking the difference between the successful supplier's

initial and final bid.⁶ However, this practice was not contained in the draft instruction.

Also, Postal Service management advised us that difficulties establishing criteria for calculating savings when historical and market prices are not available, and other specific user needs, resulted in delays in finalizing draft Administrative Instruction SM 2003-008.

On October 9, 2003, we briefed Postal Service officials on our observations regarding the draft instruction. Consequently, Postal Service officials are revising the draft instruction to expand the guidance on calculating net savings. The proposed changes define net savings as “the difference between baseline spend (historical or current market, or other relevant baseline) and spend achieved through supply chain management actions for the same or comparable products, services, or activities.” The other relevant baseline provision does not preclude using initial bids in calculating savings.

The total contract amount for FreeMarkets, Inc., to conduct reverse auction events through December 31, 2003, was about \$5.66 million. However, total verified savings resulting from the use of reverse auctions were not reduced by the cost to conduct these reverse auctions, and the draft management instruction does not require an offset.

Establishment of relevant baseline criteria ensures consistent supply chain management value calculations and increases the accuracy and reliability of reported savings. Additionally, reducing total verified identified savings by the cost to conduct reverse auction events will provide a more precise assessment of supply chain management impact.

Recommendation

We recommend the vice president, Supply Management, in conjunction with the vice president, Finance, controller:

1. Enhance draft Administrative Instruction SM 2003-008, Managing Supply Chain Management Value, to include procedures for reducing total verified savings resulting from the use of reverse

⁶For temporary labor, the percentage difference in each labor rate was then applied to an estimate of prior year spend.

auctions by the amount paid to conduct reverse auction events.

Management's Comments	Management agreed with the intent of the recommendation. Management stated that the current process does not require a reduction to total verified savings for fixed costs associated with supply chain management efforts; they would prefer a net-based calculation. Management defers action until completion of our upcoming review of the methodology for reporting supply chain management impact. Management's comments, in their entirety, are included in the appendix of this report.
Evaluation of Management's Comments	Management's comments are responsive to the recommendation. While management defers action, our review of supply chain management value methodology used by Supply Management and Finance will examine a net-based calculation to be applied uniformly to all supply chain management initiatives when cost effective.
Recommendation	<p>We recommend the vice president, Supply Management, in conjunction with the vice president, Finance, controller:</p> <ol style="list-style-type: none"> 2. Finalize and implement draft Administrative Instruction SM 2003-008, Managing Supply Chain Management Value, to include procedures to define relevant baselines for computing supply chain management savings when historical or current market spend data is not available.
Management's Comments	Management agreed with our recommendation and is in the process of finalizing the draft administrative instruction to include establishing baselines when historical or current market spend data is not available. Postal Service is targeting quarter 3, fiscal year 2004 to finalize the administrative instruction.
Evaluation of Management's Comments	Management's comments are responsive to the recommendation, and actions taken or planned should correct the issues identified in the report.
Fair and Reasonable Determination of Contract Price Not Documented	On April 5, 2000, the Postal Service awarded a noncompetitive contract to FreeMarkets, Inc., for a pilot project to provide online reverse auction services. Subsequently, on January 3, 2001, the Postal Service

continued the reverse auction program by awarding the same contractor a noncompetitive commercial ordering agreement that expired December 31, 2003.

According to Postal Service officials, a cost or price analysis was not prepared before awarding the commercial ordering agreement. During a later noncompetitive extension (April 2002), the contracting officer prepared a business case and performed a market analysis. However, the contract file did not include sufficient documentation to support a fair and reasonable negotiated price. Additionally, Postal Service officials informed us that they will extend the existing contract for another six months and they will prepare a business case that includes a determination of price reasonableness. Postal Service management explained that seeking competition for this short extension period would be time consuming, cost prohibitive, and otherwise not in the best interests of the Postal Service. Postal Service officials informed us that after the extension period, they will migrate from full service to an in-house desktop reverse auction environment, and currently efforts are underway to solicit competitive offers.

Purchasing Manual, Section 5.1.1.b, General Responsibilities, requires the purchase team to perform a price or cost analysis to evaluate initial contract prices and for pricing modifications to ensure that prices are fair and reasonable.

Performance of and documentation of a cost or price analysis will ensure future prices are fair and reasonable.

Recommendation

We recommend the vice president, Supply Management, direct the manager, Supply Management Strategies:

3. Perform and document a price or cost analysis or obtain adequate competition before awarding future contracts or modifications for reverse auction events.

**Management's
Comments**

Management agreed with the recommendation and stated that the contract file now contains price reasonableness documentation for final extension of the reviewed contract.

**Evaluation of
Management's
Comments**

Management's comments are responsive to the recommendation, and actions taken should correct the issues identified in the report.

APPENDIX A. MANAGEMENT'S COMMENTS



February 6, 2004

COLLEEN MCANTEE

THRU: KEITH STRANGE *for Harry Guy Lee* FEB 06 2004

SUBJECT: Draft Audit Report—Use of Reverse Auctions—Headquarters
(Report Number CA-AR-04-DRAFT)

Thank you for the opportunity to review and comment on the subject audit report. We were pleased to receive confirmation that the reverse auction process does add value through enhanced competition, cycle time reduction, increased monetary savings, and sourcing identification. Since this is a relatively new process, it was valuable for us to learn that the reverse auction tool is also successfully meeting client requirements and maintains sound supplier relations.

The following responds to the report's three recommendations.

1. Management agrees with the intent of the recommendation; however, the current process for capturing, reporting, and verifying savings does not require assessing and reducing savings based on fixed costs, such as postal or contract provided labor, services, materials associated with our Supply Chain Management (SCM) efforts. Rather, *SCM Impact* is currently defined as the net savings between baseline spend and spend achieved. While the current process was agreed to by Finance, and will continue, we would prefer a net based calculation that deducts appropriate direct and indirect costs. We encourage the OIG to investigate this and other options during their upcoming review of our methodology for reporting *SCM Impact*. We welcome any recommendations that have been verified, can be applied uniformly, are cost effective, and are consistent with world-class supply management organizations. No further action with regards to this recommendation is planned at this time.
2. Management agrees with the recommendation. Supply Management's Administrative Instruction covering managing supply management value is in the process of being finalized and will include a requirement to work with SCM Projects and Finance to establish baselines when historical or current market spend data is not available. Completion is targeted for Postal quarter 3, fiscal year 2004.
3. Management agrees with the recommendation. Price reasonableness, whether achieved through price or cost analysis, should be sufficiently documented in the contract file. The file does contain appropriate price reasonableness documentation covering the final extension of the reviewed contract (December 31, 2003 through June 30, 2004). Since no further extensions are anticipated, additional actions in response to this recommendation are not necessary.

We do not believe that this report contains any proprietary or business information and may be disclosed pursuant to the Freedom of Information Act (FOIA). Marie Martinez, of Supply Management, will monitor implementation of report recommendation two. She can be reached at (202) 268-4117.

A handwritten signature in black ink that reads "Juanda J. Barclay".

Juanda J. Barclay, C.P.M., A.P.P.
Manager
Supply Management Infrastructure

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