August 15, 2005

KEITH STRANGE
VICE PRESIDENT, SUPPLY MANAGEMENT

WALTER O'TORMEY
VICE PRESIDENT, ENGINEERING

SUBJECT: Audit Report – Postal Automated Redirection System's Contract Incentives (Report Number CA-AR-05-003)

This report presents the results of our self-initiated audit of the Postal Automated Redirection System's (PARS) contract incentives (Project Number 04XR009CA000).

Our overall objectives were to determine whether the Postal Service effectively managed the PARS performance incentive pools and properly exercised equitable adjustment contract provisions. We evaluated the incentive pool structure and payment computations and attempted to determine whether the Postal Service sought appropriate recoveries for contractor nonperformance.

Postal Service officials awarded a performance incentive contract to speed the development, maturation, and fielding of independently developed vendor technology with the potential for a high return on investment (ROI). Postal Service officials said PARS has achieved about a 15 percent ROI. However, we found opportunities to improve management of the PARS contract. Specifically, the PARS Phase 1 incentive pool structure allowed the contractor to earn all available performance incentives, although the system did not meet all key performance requirements. Also, while not contractually obligated, Postal Service officials increased the contract value by $1,525,100 to compensate the contractor for improved system performance which the cost model projected would produce additional savings. Additionally, Postal Service officials did not validate PARS performance in accordance with contract provisions. Finally, we could not determine whether the equitable adjustment for the contractor's nonperformance was appropriate.

We made four recommendations to Postal Service management addressing these issues. Management agreed with the recommendations and has initiatives planned addressing the issues in this report. Management's comments and our evaluations of these comments are included in this report.

We appreciate the cooperation and courtesies provided by your staff during the audit. If you have any questions or need additional information, please contact Judy Leonhardt, Director, Supply Management, or me at (703) 248-2300.

/s/ John M. Seeba

John M. Seeba
Deputy Assistant Inspector General
for Financial Operations

Attachments

cc: William P. Galligan, Jr.
Richard J. Strasser
Steven R. Phelps

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EXECUTIVE SUMMARY

Introduction

This report presents the results of our self-initiated audit of the Postal Automated Redirection System's (PARS) contract incentives. Postal Service officials awarded a performance incentive contract to speed the development, maturation, and fielding of independently developed vendor technology with the potential for a high return on investment (ROI). Postal Service officials said PARS has achieved about a 15 percent ROI. We determined whether the Postal Service effectively managed the PARS performance incentive pools and properly exercised equitable adjustment contract provisions. We evaluated the incentive pool structure and payment computations and attempted to determine whether the Postal Service sought appropriate recoveries for contractor nonperformance.

Results in Brief

The Postal Service can improve the PARS incentive contract. Specifically, the PARS Phase 1 incentive pool structure allowed the contractor to earn all available performance incentives, although the system did not meet all key performance requirements. Also, while not contractually obligated, Postal Service officials increased the contract value by $1,525,100 to compensate the contractor for improved system performance which the cost model projected would produce additional savings. Additionally, Postal Service officials properly computed earned performance incentives based on PARS First Article Test results; however, they did not validate PARS performance in accordance with contract provisions. Finally, we could not determine whether the equitable adjustment for the contractor's nonperformance was appropriate because Postal Service officials did not fully document the basis for determining that the adjustment was fair and reasonable.

Summary of Recommendations

We made recommendations to management to improve the incentive pool structure, conduct required validation testing, and fully document the basis for determining future equitable adjustments.

Summary of Management's Comments

Management agreed with the recommendations. Management's comments, in their entirety, are included in Appendix B of this report.

Overall Evaluation of Management's Comments	Management's actions taken or planned are responsive to the recommendations and should correct the issues identified in the findings.

INTRODUCTION

Background

The Postal Automated Redirection System (PARS) revises the method to process undeliverable-as-addressed letter mail by identifying and redirecting it at the point of origin as opposed to destination. PARS is expected to generate significant savings to the Postal Service through a reduction in sort passes and the processing time for handling redirected mail. Postal Service officials said PARS has achieved about a 15 percent return on investment (ROI).

In April 2002, the Postal Service's Board of Governors approved the PARS Phase 1 Decision Analysis Report (DAR) authorizing $307.6 million to deploy PARS at 52[1] processing and distribution facilities, install Change of Address Forms Processing System (CFPS) scanners at 86 Computerized Forwarding System units, and install related equipment at affected locations.

During contract negotiations, the Postal Service and the contractor agreed to a cost model for calculating potential savings associated with implementing PARS nationwide. Early estimations indicated that, fully deployed, PARS would save the Postal Service about $428 million per year. Contract negotiations resulted in an overall program price of $610 million for both phases (not including another $80 million for nonrecurring engineering costs to be paid in Phase 1).[2]

On June 11, 2002, the Postal Service awarded a sole-source, firm fixed-price performance incentive contract for approximately $241 million to implement PARS Phase 1. They awarded a performance incentive contract to speed the development, maturation, and fielding of independently developed vendor technology with the potential for a high ROI. Using performance data from the Dulles Processing and Distribution Center (Dulles)[3] to forecast savings expected for Phase 1, Postal Service officials and the contractor agreed to a Phase 1 contract price of over

[1]The original contract called for 52 sites; however, 4 sites were rescheduled from Phase 1 to Phase 2 (Pasco, Washington; Waldorf, Maryland; Bloomington, Indiana; and Terre Haute, Indiana) and 1 site (Salt Lake City, Utah) from Phase 2 to Phase 1. As a result, only 49 sites were deployed in Phase 1.
[2]Fully deployed PARS were priced at 1.426 times greater than 1 year's anticipated savings ($610 million divided by $427,831,956).
[3]The demonstrated base performance for the PARS technology occurred at the Dulles Processing and Distribution Center.

$198.3 million.[4] By improving technical performance beyond the performance data demonstrated at Dulles, the contractor could earn up to about $43 million in performance incentives for a total Phase 1 contract price of about $241.3 million.

The contract also included a Phase 2 option to acquire 229 additional PARS for about $439 million, with over $154 million allocated to a performance incentive pool.

As of February 2005, the Postal Service had paid the contractor about $228 million, including over $30 million in incentive payments.

Objectives, Scope, and Methodology

Our objectives were to determine whether the Postal Service effectively managed the PARS performance incentive pools and properly exercised equitable adjustment contract provisions. We evaluated the incentive pool structure and payment computations, and we determined whether the Postal Service sought appropriate recoveries for the contractor's nonperformance.

Our review was limited to the Postal Service's administration of the PARS Phase 1 performance incentive pool and the enforcement of equitable adjustment contract provisions.

We reviewed the Postal Service's Purchasing Manual and DAR and the PARS contract files. We also interviewed the PARS program manager, contracting officer, and other personnel in Postal Service Engineering and Supply Management. Finally, we obtained and analyzed program funding data, contractor invoices, and payment information.

This audit was conducted from October 2004 through August 2005, in accordance with generally accepted government auditing standards and included such tests of internal controls as were considered necessary under the circumstances. We did not rely on any computer-generated data to support the opinions or conclusions in this report. We discussed our observations and conclusions with

[4]Phase 1 annual savings of $89,646,307 for Dulles demonstrated performance results times the 1.426 price multiplier equals $127,835,634, plus $80 million (nonrecurring engineering costs) equals $207,835,634. Finally, after subtracting $9.5 million paid for a bridge contract, the Postal Service and contractor arrived at a Phase 1 base contract price of $198,335,634.

appropriate management officials and included their comments where appropriate.

Prior Audit Coverage

The Postal Service Office of Inspector General (OIG) conducted the following three audits of PARS:

Postal Automated Redirection System First Article Testing (Report DA-AR-04-002, dated September 15, 2004). The results of the PARS First Article Test (FAT) Phase 1 disclosed that the intercept rates on the mail processing equipment were all above the technical requirements in the statement of work (SOW), and the mail processing equipment had met expectations. However, there were FAT technical issues for mail processing equipment and CFPS, including the unfavorable CFPS test results and subsequent improvement efforts. In addition, ongoing problems with contract payments, labor savings, documentation, and ZIP Code updates needed to be addressed.

Postal Automated Redirection System, Phase 1 (Report Number DA-AR-03-002, dated February 25, 2003). The expected ROI of 36 percent presented in the PARS Phase 1 DAR was based on assumptions from a statistically unsound study of undeliverable-as-addressed mail. Therefore, the expected ROI may have been incorrect. The OIG recommended Engineering recalculate the ROI using a method that does not rely on the undeliverable-as-addressed mail study and eliminate this study to estimate the ROI for future programs; update the Board of Governors on these results; and compile a test report for the PARS FAT Phase 1 and all future tests conducted by Test Evaluation and Quality personnel.

Postal Service management said they did not plan to use the undeliverable-as-addressed mail study in any future programs to estimate ROI.

Postal Automated Redirection System, Phase 1 (Report Number DA-AR-02-006, dated May 9, 2002). The OIG identified performance issues related to preproduction concept testing. The OIG recommended approving officials consider authorizing the requested $307.6 million contingent on additional testing.

AUDIT RESULTS

Opportunities to Improve PARS Incentive Contract

The Postal Service can improve management of the PARS incentive contract. Specifically, the PARS Phase 1 incentive pool structure allowed the contractor to earn all available performance incentives, although the system did not meet all key performance requirements. In addition, while not contractually obligated, Postal Service officials increased the contract value by $1,525,100 to compensate the contractor for improved system performance which the cost model projected would produce additional savings. Also, Postal Service officials did not validate PARS performance in accordance with contract provisions. Finally, Postal Service officials sought recovery for contractor nonperformance; however, we could not determine whether the equitable adjustment was appropriate because they did not fully document the basis for the amount received.

As a result, the current Phase 1 incentive pool structure may not effectively motivate the contractor to meet and exceed PARS key performance requirements specified in the SOW. In addition, when management pays more incentive than contractually obligated, they increase the potential for future contractor disputes about incentive pool amounts and the availability of funds. Also, by not performing timely validation testing, management has no assurance that deployed PARS are performing as demonstrated at FAT and all payments made for the system were correct. Finally, the Postal Service may not have received a fair and reasonable equitable adjustment for contractor nonperformance.

Incentive Pool Structure

The Postal Service could improve the PARS incentive pool structure. Specifically, the Phase 1 incentive pool structure allowed the contractor to earn all available performance incentives, although the system did not meet all key performance requirements. Additionally, Postal Service officials increased the contract value to compensate the contractor for improved performance, although no contractual obligation existed. This occurred because Postal Service officials agreed to pay performance incentives based on savings projected by the cost model attributable to overall improvements in the system's performance.

Although CFPS did not comply with the SOW error rate requirement, the cost model showed increased savings to the Postal Service. Postal Service officials paid all incentives indicated by the cost model, but withheld 20 percent of the contract price for CFPS components. In addition, Postal Service officials are considering modifying the contract to establish an at-risk amount if PARS does not meet three critical technical performance elements in Phase 2.

Postal Service officials also modified the contract and increased the Phase 1 performance incentive pool by $1,525,100[5] to compensate the contractor for increases in system performance. Although no contractual obligation existed to pay more than the established incentive pool amount, Postal Service officials said increasing the incentive pool amount was in the Postal Service's best interest.

As a result, the Phase 1 incentive pool structure may not effectively motivate the contractor to meet and exceed key performance requirements for PARS as specified in the SOW. By paying more than the contractually obligated amount, management increases the potential of future disputes about incentive pool amounts and the availability of funds.

Recommendation

We recommend the vice president, Engineering, in coordination with the vice president, Supply Management, direct the program manager and contracting officer to:

1. Modify the Phase 2 contract provisions to clearly define the extent of the Postal Service's obligation in the event the incentives earned exceed established performance amounts in the incentive pool.

Management's Comments

Management agreed with the recommendation and will include specific language in the Phase 2 contract modification to limit the Postal Service's liability to the value of the incentive pool. Management plans to modify the contract in August 2005.

[5] Modification 9, dated March 1, 2005.

Recommendation

2. Revise the Phase 2 incentive pool structure to reduce performance incentive payments when Postal Automated Redirection System components do not meet all key performance requirements.

Management's Comments

Management expressed concern that the finding may lead to an incorrect conclusion that the Postal Service did not obtain the full incentive value from the contractor's performance. Management stated testing showed the contractor exceeded PARS performance objectives, but did not meet the agreed-to requirements for CFPS. Since the PARS system generated the vast majority of Postal Service savings, the contractor more than earned the value of the incentive pool.

Although management expressed concern with the finding, they agreed with the recommendation and will establish an at-risk amount or pool within the Phase 2 contract modification to withhold value from the supplier if it does not meet contract performance requirements. Management plans to modify the contract in August 2005.

Evaluation of Management's Comments

Management's comments are responsive to recommendations 1 and 2, and actions planned should correct the issue identified in the findings.

Incentive Payment Computations

Postal Service officials properly computed earned performance incentives based on PARS FAT results. Specifically, they computed and paid $30,065,596[6] in earned performance incentives on delivered and accepted systems. However, they did not perform validation testing of deployed PARS performance according to contract provisions due to technical considerations.

According to paragraph F.5 of the PARS contract:

> *If FAT performance exceeds Dulles demonstration standards, payment will be equal to the Dulles results plus 80 percent of the performance incentive payment ordinarily allowable based on the test results. After 20 systems are deployed, an additional test shall be completed that will serve as the validation test for PARS performance. Upon completion of this test, the Postal Service will pay 100 percent of the validation test documented and authorized payments to the contractor.*

Twenty PARS were deployed as of September 2004. However, as of April 2005, Postal Service officials had not performed validation testing even though all 49 Phase 1 PARS had been deployed. Postal Service officials did not perform validation testing as scheduled because of longer than anticipated time requirements for image collection activities related to testing. Validation testing was originally scheduled for completion in May 2005; however, it was not completed at that time.

By not performing timely validation testing, the Postal Service has no assurance that PARS was performing as demonstrated at FAT and that incentive payments were correct.

Recommendation

We recommend the vice president, Engineering, in coordination with the vice president, Supply Management, direct the program manager and contracting officer to:

[6]Program manager approved payment on 80 percent of the earned performance incentive ($37,581,995 earned incentive times 80 percent = $30,065,596).

3. Conduct validation testing and adjust incentive payments, as necessary.

Management's Comments	Management agreed with the finding and recommendation and planned to complete validation testing by the end of July 2005. Subsequently, they informed us that validation testing would be completed in August 2005. Management will use the validation test results to establish the baseline for PARS Phase 2 performance and incentive payments.
Evaluation of Management's Comments	Management's comments are responsive to the recommendation, and actions taken or planned should correct the issue identified in the finding.

Equitable Adjustments

We were unable to determine whether the equitable adjustment for contractor nonperformance was appropriate. This occurred because Postal Service officials did not fully document the basis for determining the equitable adjustment was fair and reasonable.

The PARS contract states "The Postal Service reserves the right to require an equitable adjustment of the contract price for any extension of the delivery schedule necessitated by additional first article approval tests." The original contract period of performance was from June 11, 2002, to April 11, 2004.

The contractor did not to meet the delivery schedule because CFPS did not pass FAT. On June 8, 2004, Postal Service officials sent the contractor a letter requesting consideration for late delivery. The letter stated the impact on Postal Service operations was an estimated loss of savings in excess of $400,000 per day. Subsequently, on December 9, 2004, Postal Service officials negotiated a supplemental agreement, modifying the PARS contract to establish a new CFPS delivery schedule ending May 12, 2005.

This agreement entitled the Postal Service to a $5.5 million equitable adjustment, which included a credit of $2.5 million in the form of Engineering Change Requests[7] and a waiver of $3 million[8] in earned performance incentives. However, Postal Service officials did not fully document the basis for determining the equitable adjustment was fair and reasonable. We could not determine if it was fair and reasonable based on the estimated $400,000 daily loss of savings due to deployment delays.

As a result, the Postal Service may not have received a fair and reasonable equitable adjustment for contractor nonperformance.

[7]Engineering Change Requests effect changes to previously agreed-upon contract specifications.
[8]As a result, contractor must achieve a measured performance improvement value of $45,985,089 in order to earn the entire $42,985,089 performance incentive pool.

Recommendation

We recommend the vice president, Supply Management, direct the contracting officer to:

4. Fully document the basis for determining whether future equitable adjustments received in the event of contractor nonperformance are fair and reasonable.

Management's Comments

Management disagreed with the finding and stated the contracting officer used the Postal Service's need for additional requirements and the waiver of earned incentive as a basis for negotiating the equitable adjustment. Also, management noted the contracting officer used the $400,000 daily loss of savings as a negotiating tool and it did not represent a final expectation for consideration. Finally, management indicated the negotiation memorandum fully discussed the negotiation objective values and settlement amounts.

Although management disagreed with the finding, they agreed with the recommendation and will specifically address the basis for establishing negotiation objectives and future equitable adjustment settlements.

Evaluation of Management's Comments

Management's comments are responsive to the recommendation, and actions taken or planned should correct the issue identified in the finding.

APPENDIX A. ABBREVIATIONS

CFPS	Change of Address Form Processing System
DAR	Decision Analysis Report
FAT	First Article Test
OIG	Office of Inspector General
PARS	Postal Automated Redirection System
ROI	Return on Investment
SOW	Statement of Work

APPENDIX B. MANAGEMENT'S COMMENTS

UNITED STATES
POSTAL SERVICE

JUL 1 3 2005

JOHN M. SEEBA

SUBJECT: Draft Audit Report—Postal Automated Redirection Systems' Contract Incentives
(Report Number CA-AR-05-DRAFT)

We appreciate the opportunity to review and comment on the subject draft audit report. The attachment highlights our differing view on some of the report's findings and provides our agreement to the four recommendations addressed to Supply Management and Engineering.

This report does contain proprietary business information and should not be disclosed pursuant to Exemption 4 of the Freedom of Information Act (FOIA). Mark Guilfoil, Manager, Automation Category Management Center, is available to discuss the specific sections that should be withheld from public disclosure and can be reached at (703) 280-7891. Marie Martinez of Supply Management will monitor implementation of applicable report recommendations and can be reached at (202) 268-4117.

Keith Strange
Vice President
Supply Management

Walter F. O'Tormey
Vice President
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Attachment

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COMMENTS ON OIG REPORT FINDINGS

Part II - Audit Results

Incentive Pool Structure and Payments

This section of the report does not accurately represent the actions of Postal Service Engineering and Supply Management staff. The Office of Inspector General (OIG) states that ". . . the Phase 1 incentive pool structure allowed the contractor to earn all available performance incentives, although the system did not meet all key performance requirements." This language may incorrectly lead to a conclusion that the Postal Service did not obtain the full incentive value from the contractor's performance. The incentive pool was established prior to testing of performance improvements and covered the entire Postal Automated Redirection System (PARS) Phase I program. It was established using the best information of likely contractor performance at the time of contract award. Importantly, it represented value to be obtained from two separate components of the PARS Phase I system, PARS and Change of Address Forms Processing (CFPS).

Actual performance testing throughout the Phase I program showed that the contractor exceeded PARS performance objectives, but did not meet CFPS agreed to requirements. Between these two systems, the vast majority of Postal Service savings are generated from the PARS system implementation. As testing showed, the contractor more than earned the value of the incentive pool and it was entirely proper to meet the Postal Service's contractual obligation concerning payment of incentive pool amounts. The contract's cost model when applied to the contractor's results shows exactly the amount and areas of cost savings to the Postal Service. To conclude, as the OIG results indicate, that appropriate value was not received by the Postal Service for incentives paid is inaccurate. Irrespective, the contracting officer withheld a value of twenty percent of the earned incentive until such time that the planned validation testing can be completed in July of this year with live operational image data in lieu of lab related results. At the time of this report, this value is still being withheld and is protecting the Postal Service's financial interest for Phase I performance.

Further, the OIG accurately notes that an additional amount of $1,525,100 was added to the contract value to compensate the contractor for improved system performance as measured by a cost model. What is missing from this statement is testing showed that the contractor's software performed and benefited the Postal Service in the amount of the pool plus the $1,525,100. Adding this funding provided an appropriate incentive to the supplier to provide the most efficient software. The performance of the software indicates that this incentive worked.

Equitable Adjustments

The OIG advised they ". . . were unable to determine whether the equitable adjustment for contractor nonperformance was appropriate." We disagree with this finding. While the PARS Phase I program experienced delays in deployment due to system stability and documented software issues, the Postal Service received appropriate consideration in negotiating an equitable adjustment to the contract including incorporation of a revised delivery schedule for system deployments. In conducting

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that negotiation, the contracting officer used the Postal Service's need for additional requirements and the waiver of earned incentive as a basis to provide for negotiated consideration to the Postal Service. A copy of the prepared negotiation memorandum was provided to the OIG and fully discusses the negotiation objective values and settlement amounts for the modification. Irrespective, future contract file documentation and prepared negotiation memoranda will more specifically address the basis for established negotiation objectives and settlements reached in circumstances of contractor nonperformance caused by delay. The $400,000 value noted by the OIG in this section was provided via letter by the contracting officer as a matter of negotiations. It did not represent the final expectation of consideration for the schedule revision. The $400,000 value, if extrapolated, would equate to an unreasonable request for consideration by the Postal Service given both the contract type and system complexities inherent in installation of the PARS system.

RESPONSES TO OIG REPORT RECOMMENDATIONS

We recommend the vice president, Engineering, in coordination with the vice president, Supply Management, direct the program manager and contracting officer to:

1. *Modify the Phase 2 contract provisions to clearly define the extent of the Postal Service's obligation in the event the incentives earned exceed established performance amounts in the incentive pool."*

Management Response: Management agrees with this recommendation. The Phase 2 contract modification will also provide for an incentive pool in excess of the base contract award value. This incentive pool, similar to the Phase 1 program, will be associated with an incorporated cost model to compensate the supplier for performance in excess of established Decision Analysis Report (DAR) and/or contract performance requirements. Accordingly, specific language will be included in the Phase 2 award to govern and limit Postal Service liability at the value of the incentive pool in order to avoid any potential dispute concerning availability of funds. Should any further incentive amounts be provided during the Phase 2 program, any such added amounts would be provided under formal modification thereby increasing the contract value. The Phase 2 contract modification is scheduled for August 2005.

2. *Revise the Phase 2 incentive pool structure to reduce performance incentive payments when PARS components do not meet all key performance requirements.*

Management Response: Management agrees with this recommendation and has already addressed and directed that an "At Risk" amount or pool be established within any Phase 2 award to withhold value from the supplier if they do not meet the established DAR/contract performance requirements. The contract structure contemplated for the Phase 2 award incorporates this "At Risk" approach which will ensure that the established ROI for the program is maintained as regards supplier performance.

3. *Conduct validation testing and adjust incentive payments, as necessary.*

Management Response: Management agrees with this recommendation. The validation testing of First Article Test (FAT) results was planned prior to award and is still a component part of the Phase I

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program. Validation testing will establish the baseline for PARS Phase 2 performance and is the basis for the Phase 2 incentive payment. This testing activity commenced on May 31, 2005, and is expected to be completed by the end of July 2005. Should supplier performance be shown to be less than FAT performance, appropriate adjustments will be made in all incentives previously paid. Currently the Postal Service is withholding 20 percent of the established incentive pool, consistent with the contract, until the completion of this FAT validation testing.

We recommend the vice president, Supply Management, direct the contracting officer to:

4. *Fully document the basis for determining future equitable adjustments received in the event of contractor nonperformance are fair and reasonable.*

Management Response: Management agrees with this recommendation. Future PARS contract file documentation and prepared negotiation memoranda will specifically address the basis for established negotiation objectives and settlements reached in circumstances of contractor nonperformance.