August 2, 2007

SUSAN M. BROWNELL
VICE PRESIDENT, SUPPLY MANAGEMENT

SUBJECT: Management Advisory – Commodity Sourcing Activities Within the Automation Category Management Center (Report Number CA-MA-07-005)

This report presents the results of our review of commodity sourcing activities within the U.S. Postal Service's Automation Category Management Center (CMC) (Project Number 06YG026CA000). This review was self-initiated based on the Postal Service Board of Governors' questions about the Automation CMC awarding contracts to a limited number of suppliers, often noncompetitively.

Background

The Automation CMC is part of Supply Management's Mail Equipment Portfolio (MEP) and provides contracting support to Engineering by soliciting proposals, negotiating terms and conditions, and awarding and managing contracts for automated mail processing equipment and enhancements. Recent contracts include procurements for the Automated Flat Sorting Machine-Automatic Induction, the Automated Package Processing System (APPS), the Flat Recognition Improvement Program, and the Intelligent Mail Data Acquisition System. The Automation CMC spends approximately $800 million each year and the total award value of its open contracts as of August 16, 2006, was approximately $1.5 billion.

The Postal Service is not subject to the Federal Acquisition Regulation (FAR), the primary rules governing all federal executive agencies in their acquisition of goods and services with appropriated funds. Rather, the Postal Service is required to follow the rules contained in Title 39, Code of Federal Regulations.

In addition, the Postal Service developed and adopted Supplying Principles and Practices that provide internal advice and guidance for performing supply chain management (SCM)[1] functions. The Supplying Principles and Practices are not binding regulations, but are intended to assist the Postal Service in obtaining the best value and efficiently conducting its SCM functions.

Objective, Scope, and Methodology

Our objective was to determine whether the Postal Service took action to effectively identify, develop, and maintain an adequate automation supplier base consistent with its policies and business objectives. To accomplish this objective, we reviewed Postal Service policies and procedures and discussed commodity sourcing and source selection practices with the MEP and Automation CMC managers. Additionally, we reviewed the Automation CMC's Commodity Sourcing Strategy Plans (CSSPs)[2] for fiscal years (FY) 2005 and 2006.

In addition, we reviewed the 11 highest dollar value contracts the Automation CMC awarded from October 1, 2004, to August 16, 2006, representing approximately $587 million of the $776.2 million in contract award actions during the period. We reviewed the associated contract file information to identify the contract purpose, award amount, unsuccessful offerors, and award type (competitive vs. noncompetitive). The Automation CMC awarded nine of the 11 contracts reviewed noncompetitively. Also, we reviewed the contract files to determine the existence of best value determinations and price negotiation memoranda.

We reviewed Defense Contract Audit Agency (DCAA) audit reports to determine whether Automation CMC personnel used DCAA cost analyses when negotiating automation contracts. Additionally, we reviewed unsolicited proposals the Automation CMC received between October 1, 2002, and November 9, 2006, to identify any other potential mail automation suppliers. We also reviewed all Supplier Ombudsman[3] decisions the Postal Service issued between August 1, 2005, and December 19, 2006, to identify possible impediments to competition, as well as other potential mail automation suppliers. Finally, we obtained feedback from four international posts, four unsuccessful suppliers, two international suppliers, and one pre-sort equipment supplier. This feedback allowed us to better understand their acquisition practices

[1] SCM focuses on coordination, integration, and control measures to efficiently and effectively fulfill the end customer's needs with the delivery of high-quality products and services. It seeks to remove and reduce unnecessary costs incurred throughout the entire supply chain and is driven by the overall goal of providing best value to the end user.
[2] Each CMC team is required to develop and maintain a written supply strategy (including advice from applicable clients) for each major spend category for which they are responsible. The strategy should focus on planned objectives, as well as the tactics and resources necessary to achieve client satisfaction and business success in the supply category in the coming year.
[3] The Supplier Ombudsman resolves business disagreements that arise during the purchasing process and that the supplier and the Postal Service contracting officer cannot resolve.

and/or role in the mail automation equipment market and to validate assumptions contained in the Automation CMC's CSSP.[4]

We conducted this review from July 2006 through August 2007 in accordance with the President's Council on Integrity and Efficiency, *Quality Standards for Inspections*. We discussed our observations and conclusions with management officials on May 9, 2007, and included their comments where appropriate. To perform the review, we relied on computer-processed data contained in the Contract Authoring Management System. We used system data to identify contract types, award amounts, and supplier names, and compared the information to that contained in associated contract files. For the period reviewed, we believe the data were sufficiently reliable to form our conclusions and recommendations.

Prior Audit Coverage

We did not identify any prior audits or reviews related to the objective of this review.

Results

In general, the Postal Service took action to effectively identify and maintain a mail automation supplier base consistent with its policies and business objectives. Specifically, Postal Service officials adopted an acquisition strategy and established strategic partnerships with key suppliers to acquire automated mail processing equipment and enhancements. In addition, they took action to mitigate risks associated with contracting with a few key suppliers. For instance, officials modified contract clauses to better protect the Postal Service's intellectual property rights, justified noncompetitively awarded contracts, and took action to ensure contract price reasonableness. However, in light of the limited automation equipment supplier market, the Postal Service should explore options for developing alternative mail automation supply sources and include appropriate technology protection clauses in mail automation contracts to better protect its investments. Additionally, the Postal Service should obtain contractor cost or pricing data when noncompetitively awarding share-in-savings, incentive-type mail automation contracts.

Limitations in the Postal Service's Mail Automation Supplier Base

Inherent risks exist in the Postal Service's automation equipment acquisition process because its supplier base is limited to a small number of companies. The FY 2006 CSSP identified five major suppliers of mail automation equipment worldwide – Siemens Energy and Automation (Siemens), Lockheed Martin Corporation (Lockheed Martin), Northrop Grumman Systems Corporation (Northrop Grumman), NEC Corporation, and Elsag. The CSSP concluded the existing supplier base was sufficient

[4] We contacted an additional two pre-sort service providers, two international posts, two unsuccessful suppliers, and one pre-sort equipment provider, but were unable to obtain feedback from them.

and the mail automation equipment market could not support additional suppliers. It detailed that the Postal Service established strategic relationships with Siemens, Lockheed Martin, and Northrop Grumman for machinable letter and letter-size advertising mail, parcel processing, and flats automation platforms, respectively. Also, the Postal Service currently relies on Siemens and Lockheed Martin for mail recognition technology improvements.

Our review of unsolicited proposals and Postal Service Ombudsman decisions did not disclose any impediments to competition or other potential sources of mail automation equipment. Likewise, feedback received from international posts, unsuccessful suppliers, international suppliers, and pre-sort equipment suppliers during this review validated assumptions contained in the FY 2006 CSSP and did not reveal any other potential sources of mail automation equipment.

Although we did not identify any impediments to competition or other potential sources of mail automation equipment, the limitations in the supplier base pose concerns. Postal Service officials recognized risks inherent in such a small supplier base, to include limited competition and the unexpected loss of a key supplier. To document and address these risks, Postal Service officials:

- Prepared and submitted CSSPs in FYs 2005 and 2006 that included descriptions of the CMC's support mission, the supplier marketplace, and the Postal Service's supplier base.

- Adopted an acquisition strategy and established strategic partnerships with key suppliers to acquire mail automation equipment and enhancements.

- Met semiannually with Siemens, Lockheed Martin, and Northrop Grumman to discuss business strategies and mail automation technological development.

- Rewrote standard contract clauses to provide more intellectual property rights to the Postal Service.

- Negotiated technology protection clauses for incorporation into future contracts with Siemens, Lockheed Martin, and Northrop Grumman[5] to grant technology rights for mail automation equipment under certain circumstances. These circumstances include a key supplier that ceases performing Postal Service work, declines or refuses to perform Postal Service work, and/or does not transfer its technology rights to a capable successor.

The Postal Service's Supplying Principles state its supplying professionals should seek methods to optimize the Postal Service's supplier base in line with the specific

[5] On February 23, 2007, the Postal Service awarded Northrop Grumman a $874,639,000 contract to produce the Flats Sequencing System. The contract included the updated technology protection clause.

characteristics of the market, the goods or services supplied, and the goals of the Postal Service. The principles state that, in many cases, optimizing the supply base will include efforts to consolidate purchases among a smaller group of more capable and strategic suppliers to reduce costs (including transaction costs) and to improve quality and performance.

Other federal agencies, such as the Department of Defense, recognize there may be exceptional circumstances in which they need to act to increase the supplier base to maintain future competition. Actions may include engaging in leader company contracting. This is an extraordinary acquisition technique where a developer or sole producer of a product or system is designated to be the leader company and to furnish assistance and know-how under an approved contract to one or more designated follower companies so they, too, can become a source of supply.

Postal Service officials have not developed procedures, such as leader company contracting, to increase the mail automation supplier base to maintain future competition. Development of such procedures would likely increase the Postal Service's short-term acquisition costs, which Engineering would have to fund. However, increasing the mail automation supplier base should enhance competition in the long term, reducing the total cost of ownership, generating innovation and efficiency, and assuring a supply and quality consistent with the Postal Service's needs and market strategy.

Additionally, action the Postal Service has taken to improve its intellectual property rights may not address all contingencies. Specifically, when developing the FY 2006 CSSP, Postal Service officials recognized control of intellectual property rights as a weakness associated with a small supplier base; however, the modified contract clauses do not provide the Postal Service with technology rights for mail automation equipment in the event it debars or suspends[6] a supplier. Because of the limited mail automation supplier base, it is critical to Postal Service operations that it has mail automation technology rights in the event a supplier is debarred or suspended.

Recommendations

We recommend the Vice President, Supply Management, direct the Manager, Automation Category Management Center, to:

1. Explore options for developing alternative sources for mail automation equipment, such as leader company contracting, and coordinate with Engineering on required funding.

[6] Debarred or suspended suppliers are excluded from receiving contracts and contracting officers may not solicit proposals or quotations from, award contracts to, or (when the contract provides for such consent) consent to subcontracts with such suppliers, unless the Vice President, Supply Management, determines in writing there is a compelling reason for such action in the interest of the Postal Service.

2. Within the scope of existing and new technology protection clauses, negotiate mail automation technology rights that protect the Postal Service in the event of supplier debarment or suspension while staying within the scope of existing and new technology protection clauses.

Management's Comments

Management agreed with the recommendations and stated they will use the annual market research and CSSP process to continue exploring available options for developing alternative sources of technology supply to meet the Postal Service's mail processing needs. They agreed to provide updated CSSPs within 30 calendar days following issuance of the final report. In addition, management agreed to pursue revised technology protection clauses, but noted that negotiations may or may not result in the incorporation of revised technology protection clauses. They agreed to provide the outcome of the negotiations by the end of FY 2007. Management's comments, in their entirety, are included in the appendix.

Evaluation of Management's Comments

Management's comments are responsive to the recommendations and actions planned should correct the issues identified in the finding.

Risks with Noncompetitively Awarded Share-in-Savings Contracts

Postal Service officials justified noncompetitively awarded contracts and took action to ensure contract price reasonableness. Specifically, in accordance with Postal Service Supplying Principles, Automation CMC personnel prepared justifications and obtained proper approvals for eight of the nine noncompetitively awarded contracts included in our review and obtained appropriate approvals prior to their award.[7] Additionally, Automation CMC personnel obtained a DCAA cost or price analysis[8] for three contracts and performed separate cost or price analysis for four other contracts included in our review.

However, for the remaining two noncompetitively awarded contracts reviewed, the Automation CMC did not perform price analysis or obtain cost or pricing data because both were share-in-savings, incentive-type contracts. The prices for these contracts were based on projected Postal Service savings and were unrelated to the suppliers' costs. Per the FY 2006 CSSP, the Automation CMC developed a rough standard of paying 1 year of savings to suppliers in return for their improvements.

[7] The Postal Service noncompetitively awarded a contract to Lockheed Martin to remove Small Parcel Bundle Sorter (SPBS) machines from sites to which it recently deployed APPS machines. This occurred because SPBS machine removal was an unexercised option item on the original APPS development and production contract with Lockheed Martin.

[8] Price analysis is the process of examining and evaluating a proposed price against reasonable price benchmarks without evaluating its separate cost elements and profit that make up the price.

Section 210 of the E-Government Act of 2002 authorized the federal government[9] to use information technology share-in-savings contracts until September 30, 2005. However, for a variety of reasons,[10] their use was limited and the rule expired when Congress did not reauthorize the act. In the FY 2006 CSSP, the Automation CMC recognized that, in the few circumstances where other federal agencies used share-in-savings, incentive-type contracts, they obtained cost or pricing data from suppliers and competitively awarded the contracts. The Automation CMC concluded that additional review was necessary before determining if it should modify its use of share-in-savings, incentive-type contracts.

Although Postal Service Supplying Principles encourage the use of share-in-savings contracts, they require it perform a price analysis or obtain cost or pricing data from the supplier before awarding a contract noncompetitively. Without conducting price analysis or considering supplier costs, share-in-savings, incentive-type contracts may not be fair and reasonably priced, and may unduly enrich suppliers.

Recommendation

We recommend the Vice President, Supply Management, direct the Manager, Automation Category Management Center, to:

3. Obtain cost or pricing data when negotiating noncompetitive, share-in-savings, incentive-type contracts for mail automation equipment.

Management's Comments

Management agreed with the intent of the recommendation as it concerns the need for a finding of price reasonableness, but disagreed as it relates to optical character reader address encoding incentive contracts. Management stated that a small number of companies, each with substantial intellectual property investments in their encoding software, provides recognition system improvements to world posts. A supplier generally offers its software based on a value which it calculates for the Postal Service or prices it on a per piece processed basis.

In subsequent discussions with management, they advised that in FY 2008, the Automation CMC will conduct market research activities with other world posts to obtain information about the prices paid on recognition system address interpretation improvements. They stated they will include this information, together with Postal Service's historical pricing, in future negotiation memorandums to improve the price analysis coverage for contract file documentation. Additionally, they will continue to use

---

[9] The Act did not include the Postal Service.

[10] Government Accountability Office (GAO) Report Number GAO-05-736, *Share-in Savings Contracts*, dated July 26, 2005, reported reasons including the absence of implementing regulations, the difficulty of determining baseline costs, and concerns that the return on investment may be too low to attract potential contractors.

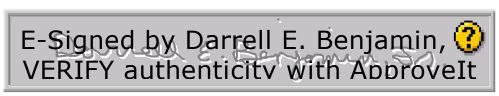
value analysis to determine cost reasonableness. They plan to complete the market research activities by September 2008.

Evaluation of Management's Comments

Management's comments are responsive to the recommendation and actions planned should correct the issue identified in the finding. Their plans to strengthen price analysis for noncompetitively awarded share-in-savings contracts through benchmarking and documenting historical pricing should help ensure that contracts are fair and reasonably priced and suppliers are not unduly enriched. We may review the price analysis documentation during future audits of noncompetitively awarded share-in-savings contracts.

The OIG considers recommendations 1, 2, and 3 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. If you have any questions, or need additional information, please contact Judy Leonhardt, Director, Supply Management, or me at (703) 248-2100.



Darrell E. Benjamin, Jr.
Deputy Assistant Inspector General
for Support Operations

Attachment

cc: H. Glen Walker
Walter O'Tormey
Marie K. Martinez
Rowena C. Dufford
Katherine S. Banks

APPENDIX MANAGEMENT'S COMMENTS

SUSAN M. BROWNELL
VICE PRESIDENT, SUPPLY MANAGEMENT

UNITED STATES
POSTAL SERVICE

June 28, 2007

TAMMY L. WHITCOMB

SUBJECT: Draft Management Advisory – Commodity Sourcing Activities Within the Automation Category Management Center (Report Number CA-MA-07-DRAFT)

We appreciate the opportunity to respond to the subject advisory report. As your team learned through this review effort, Supply Management and Engineering maintain an effective collaborative working relationship, which includes continual review and update of our automation sourcing and acquisition strategies. Central to these strategies is mitigating and managing risks associated with a very specialized global product market served by a small number of suppliers. I was pleased to learn that your review provided confirmation of several key components of current plans, did not disclose any impediments to competition, and that actions taken by the Postal Service are effectively identifying and maintaining a mail automation supplier base consistent with postal purchasing policies and our Supplying Principles and Practices.

The attachment to this response addresses the report's three recommendations and, as applicable, provides our planned actions concerning implementation. We do not believe that this report contains any proprietary or business information and may be disclosed pursuant to the Freedom of Information Act. You may contact Marie Martinez if you have any questions regarding this response or actions taken to satisfy the report's recommendations. She can be reached at (202) 268-4117.

Susan M. Brownell

Attachment

cc: H. Glen Walker
Walter O'Tormey
Marie K. Martinez
Katherine S. Banks
Mark Guilfoil

475 L'Enfant Plaza SW
Washington, DC 20260-0200
202-268-4040
Fax: [illegible]
www.usps.com

ATTACHMENT
Supply Management Response
OIG Report CA-MA-07-DRAFT
Page 1 of 2

We recommend the Vice President, Supply Management, direct the Manager, Automation Category Management Center, to:

1. *Explore options for developing alternative sources for mail automation equipment, such as leader company contracting, and coordinate with Engineering on required funding.*

Supply Management agrees with this recommendation and through our annual market research and Commodity Sourcing Strategy Planning (CSSP) process, we are and will continue to explore available options for developing alternative sources of technology supply to meet the Postal Service's mail processing needs. An important factor in developing acquisition approaches will continue to be maximizing the return on investment within implemented capital programs. The Automation CMC is currently updating each of its five commodity specific CSSPs, which will be provided to your office within 30 calendar days following issuance of this final report to serve as documentation supporting implementation of this recommendation.

While we can confirm that we will continue to review alternatives, the approach of leader company contracting will not likely be determined to be an economically viable strategy for the Postal Service. This acquisition approach requires significant identical quantities of production to be acquired year over year to yield competitive based savings. The nature of advancing technology typically mandates that there are significant improvements and configuration upgrades developed between production requirements. Having non original equipment manufacturers produce complex equipment stemming from others' technology is a very risky approach, and not one which can be sustained without significant out year requirements. Further, the length of time required in obtaining funding approvals and awarding our capital automation programs already requires suppliers to assume large levels of risk in supporting necessary resources. Finally, our most recent market research did not reveal this method to be used by other world posts in satisfying their technology needs. However, during our future planning efforts, we will keep this option in mind.

2. *Within the scope of existing and new technology protection clauses, negotiate mail automation technology rights that protect the Postal Service in the event of supplier debarment or suspension while staying within the scope of existing and new technology protection clauses.*

Supply Management agrees with this recommendation with the understanding that negotiations may or may not result in incorporation. Prior to the close of this fiscal year, we will provide your office with the text of a revised clause and any variation necessary for a particular supplier, and will relay outcomes from negotiations to implement this recommendation.

3. *Obtain cost or pricing data when negotiating noncompetitive, share-in-savings, incentive-type contracts for mail automation equipment.*

Supply Management does understand and agrees with the intent of this recommendation as it concerns the need for a finding of price reasonableness in negotiated instruments; however, we disagree as it relates to optical character reader (OCR) address encoding incentive contracts based on commodity specific commercial practices.

Recognition system address interpretation improvements are provided to world posts by a small number of companies, each with substantial intellectual property investments in their encoding

ATTACHMENT
Supply Management Response
OIG Report CA-MA-07-DRAFT
Page 2 of 2

software. This software is constantly being further developed by its owner through additional research and development in an attempt to further its ability to deliver higher performance levels within individual mail streams and in different markets. Within this commodity area, the focus is on product performance and the contracting method is based on incentivizing the supplier to deliver the greatest benefit in the shortest period of time. Setting the price on value to the Postal Service instead of cost and pricing data accomplishes that objective. Additionally, the Automation CMC has performed benchmarking activities with mail OCR suppliers concerning the structure of other world post acquisitions. In no known case have we found that recognition systems improvements are acquired by other world posts using traditional cost analysis techniques based on cost and pricing data to determine a contract value. Instead, we found that it is customary to either competitively obtain improvements, as the Postal Service has done through prior competitions, or to obtain a price for a level of performance with built in penalties if that performance is not obtained. In most cases, a supplier offers its software based on a value which it has calculated that the applicable post would benefit from its use, or prices it on a per piece processed basis.

As this is an unusual contracting type, the Automation CMC has in the past used value analysis within non-competitive recognition incentive contracts to ascertain price reasonableness. The Postal Service's methodology for handling these types of contracts has proven to be very successful in its results using such analysis and is consistent with the commercial model. We will continue to document the file regarding the determination of price reasonableness in recognition system improvement incentive contracts. Additionally, the Automation CMC Manager will provide for specific discussion with his staff concerning purchasing practices related to the use of cost and pricing data in non-competitive acquisitions. This action will be taken and completed within 30 calendar days following receipt of your final report.