OFFICE OF INSPECTOR GENERAL

September 24, 1999

SYLVESTER S. BLACK
VICE PRESIDENT, NETWORK OPERATIONS MANAGEMENT

SUBJECT: Audit Report - Priority Mail Processing Center Network (DA-AR-99-001)

This report presents the results of our audit of the Priority Mail Processing Center Network. We found Priority Mail processed through the network cost [redacted] more than Priority Mail processed by USPS without a network. We also found that Priority Mail Processing Center Network [redacted] referenced in the contract.

39 USC 410(c)
b(3)

Management generally agreed with our recommendations. However, management pointed out that differences of opinion remain on some of the findings in the report. In addition, officials pointed out that the Priority Mail Processing Center Network was audited during its pilot phase, and that many of the findings and recommendations in the report may be premature. Management's views are highlighted in the report, and included in their entirety in Appendix B of the 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 [redacted] or myself at (703) 248-2300.

b(6)

Richard F. Chambers
Assistant Inspector General
for Performance

Attachment

cc: John E. Potter
M. Richard Porras
Alan B. Kiel
John R. Gunnels

1735 N LYNN ST
ARLINGTON VA 22209-2020
(703) 248-2100
FAX: (703) 248-2256

TABLE OF CONTENTS

39 USC 410(c)(2), b(3)

EXECUTIVE SUMMARY

Introduction

In April 1997, the United States Postal Service (USPS) awarded a [redacted] contract to establish a network of ten Priority Mail Processing Centers on the east coast of the United States. We conducted this audit to determine if the Priority Mail Processing Center Network was meeting cost and performance standards outlined in the contract.

Results in Brief

The audit disclosed that the same volume of Priority Mail processed through the Priority Mail Processing Center Network cost [redacted] more for end-to-end service than if processed in-house by USPS without a network. In addition, we found [redacted] referenced in the contract.

First, the per piece cost reported by USPS network personnel correctly includes contract volume variable cost. However, attributable USPS volume variable costs must also be considered when determining Priority Mail end-to-end service costs. In fiscal year (FY) 1998, processing Priority Mail through the network cost USPS [redacted] more than the estimated cost of in-house processing without a network. In addition, opportunities existed to reduce the cost of the network in the areas of [redacted] and fuel procurement.

[redacted]

As a result, the additional costs of network operations [redacted]

Summary of Recommendations	We provided the Vice President, Network Operations Management, six recommendations to control costs, capture savings, and improve performance. Additionally, we recommended that management address [redacted] issues identified in this report before any future expansion of the Priority Mail Processing Center Network is undertaken.
Summary of Management's Comments	Management generally agreed with the specific recommendations in the report. However, management pointed out that differences of opinion remain with the Office of Inspector General (OIG) on some of the findings in the report. In addition, management pointed out because the audit was conducted during the pilot phase of the Priority Mail Processing Center Network, many of the findings and recommendations in the report may be premature. Management also pointed out that "establishing the Priority Mail Processing Center Network was one of the most complex projects undertaken by postal management in years." In addition, management noted that [redacted] [redacted]
Evaluation of Management's Comments	Overall, we view management's comments as responsive, and believe that corrective actions taken or planned will meet the intent of our recommendations. We agree that the Priority Mail Processing Center Network was a complex initiative. We also acknowledge that we began the audit prior to the full implementation. However, the objectives of the audit were to determine if the Priority Mail Processing Center Network was meeting [redacted]

39 USC 410(c)(
b(3)

INTRODUCTION

Background

39 USC 410(c)(2)
b(3)

USPS removed the words "two-day" from its packaging and advertising as a result of a 1993 General Accounting Office (GAO) report on service performance. GAO reported that "Postal Service advertisements clearly portray to the public that Priority Mail will be delivered anywhere in the United States within two days; however, Priority Mail was processed and available for delivery within two days about [redacted] of the time, on average, nationwide." In January 1994 USPS chartered the Priority Mail Business Process Reengineering Project to improve delivery time.

USPS developed a project team that included members from both Headquarters and Area Operations. The team's purpose was to study methods for improving Priority Mail delivery rates and to develop, through a Decision Analysis Report, appropriate cost/benefit models for each option. In addition, the team was responsible for creating detailed designs for how the proposed solution(s) would work. The team recommended removing Priority Mail processing from the Processing and Distribution Centers in a limited test area and creating a specialized network of Priority Mail Processing Centers that would handle only Priority Mail.

The Capital Investment Committee approved the Decision Analysis Report on September 6, 1995, and the Board of Governors approved the request for capital and expense investment on November 6, 1995. The Decision Analysis Report estimated that Phase 1 of the Priority Mail Network would have [redacted] and a net cash flow of [redacted] over an [redacted] month period. However, [redacted] in service performance of [redacted] on-time deliveries.

The Decision Analysis Report was validated and approved using internal wage rates. The funding request for the Board of Governors included the provision for contracting out one Priority Mail Processing Center site. Subsequent review indicated that additional benefits could be achieved from contracting out more than one Priority Mail Processing Center operation. On March 4, 1996 the Board of Governors approved the option of contracting out up to ten facilities.

A work group analyzed the possible use of contractor(s), initiated a competitive purchasing process, and developed a statement of work. The work group determined that service benefits could result from contracting for an integrated network including transportation, Priority Mail Processing Center operations, network management, and information services. The contracting strategy included a performance-based contracting approach and a single prime contract for all network operations and information services. The contractor who received the award had the option to use all or part of the design developed by the USPS for internal implementation or to develop an entirely new design. The contractor was required [redacted]

39 USC 410(c)(2)
b3

In April 1997 a comparative analysis (comparing the benefits and the cost of a contractor operation to an internal operation) of the Priority Mail Processing Center Network was completed. After completing the comparative analysis, the USPS awarded a [redacted] contract to establish a network of Priority Mail Processing Centers on the east coast of the United States. [redacted] of the contractor's [redacted] were activated by June 1998.

In a November 1998 presentation to the Board of Governors, Postal representatives outlined the objectives of the network, which included:

- provide consistent and reliable two-day service;
- achieve [redacted] on-time reliability for Priority Mail as measured by the Priority End-to-End measurement system;
- require the contractor to achieve [redacted] on-time reliability as measured by the contractor reliability index;
- serve as a platform for value added features; and
- remain the low cost provider.

Objectives, Scope And Methodology

The objectives of our audit were to determine if: (1) all costs associated with Priority Mail Processing Center operations were identified and reported, (2) the contractor was meeting [redacted]

39 USC 410(c)(2)
b(3)

In completing the audit, we reviewed numerous internal documents and reports relating to the Priority Mail Processing Center Network, independent public accountant's audit reports, [redacted] and comparative analyses prepared by USPS officials. We interviewed USPS officials at USPS Headquarters, the network hub, the ten Priority Mail Processing Centers, and selected Processing and Distribution Centers, as well as contractor personnel and independent public accountants.

The audit was conducted from August 1998 through August 1999 in accordance with generally accepted government auditing standards. We reviewed internal controls related to the Priority Mail Processing Center Network to the extent we considered necessary under the circumstances.

END-TO-END COSTS

39 USC 410(c)(2)
b(3)

In FY 1998 Priority Mail processed through the Priority Mail Processing Center Network cost [redacted] more for end-to-end service than if the same volume of Priority Mail had been processed by the USPS without a network. Specifically:

- Our analysis added the attributable USPS volume variable costs (e.g., acceptance and delivery costs) to the network volume variable costs to reflect the total end-to-end cost of the Priority Mail product and
- Opportunities exist to [redacted] of the network. For example, the contractor used commercial airlines to [redacted]

Background

The USPS has established guidelines for the preparing of cost data for comparison with contracting out proposals. The guidelines require that a comparative analysis be performed to evaluate in-house versus contractor costs for related services. In April 1997 a comparative analysis (comparing the benefits and cost of a contractor operation to an internal operation) for Phase I of the Priority Mail Processing Center Network was completed. Five factors were evaluated with regard to contracting out the Priority Mail Processing Center Network: public interest, cost, efficiency, availability of equipment, and qualification of employees.

The comparative analysis concluded that outsourcing would provide benefits that offered a higher value because:

- [redacted]
- [redacted]
- [redacted]
- [redacted]

[redacted]

39 U.S.C. 410(c)(2)
b(3)

The analysis showed that the total cost of an outsourced network would be [redacted]

Program officials computed cost per piece cost using contract volume variable cost. It is USPS policy when performing a comparative analysis not to report costs that would be the same for in-house and contractor operations. Program officials only identified and reported volume variable cost associated with processing Priority Mail through the network. Costs associated with acceptance and delivery were considered the same for in-house and contractor operations and were not included in cost per piece calculations reported by network personnel. In a November 1998 presentation to the Board of Governors the program manager reported network costs of [redacted] below the approved program plan of [redacted]

However, we believe it is a useful management tool to compute the total end-to-end cost for processing Priority Mail through the network and comparing it to USPS costs without a network. The results of such analysis can then be used when evaluating the performance of the network versus USPS without a network. Our analysis of end-to-end costs follows.

Cost Per Piece

In FY 1998 the end-to-end cost of Priority Mail processed through the network was [redacted] more per piece than the same volume of Priority Mail processed outside the network. The cost per piece computed by network personnel included only the volume variable contract cost, and excluded attributable USPS volume variable costs. When all attributable costs are considered, the USPS paid [redacted] more than if the same volume had been processed in-house without a network. (See Figure 1)

39 U.S.C. 410 (c)(2) b(3)

[redacted]

[redacted]

We met with officials in the Cost Attribution Office, Finance,[2] and determined attributable USPS volume variable costs using cost estimates developed by USPS Network personnel. Adding in the USPS costs to the contractor volume variable costs [redacted] the total network costs for FY 1998 to [redacted] In comparison, the in-house end-to-end costs would have been [redacted] to process the same volume. The Priority Mail Network Manager stated that he has no control over the Priority Mail outside the network. Therefore, he stated the comparison should be limited to intra-network costs [redacted] versus USPS costs. This comparison still showed the network end-to-end costs [redacted] the USPS costs, without a network, [redacted] When all attributable costs are considered, we estimate that the USPS paid an [redacted] to process Priority Mail through the network in FY 1998 than if the same volume had been processed without a network.

[redacted]

[redacted]

In addition to the USPS volume variable costs noted above, costs [redacted] were incurred by the Priority Mail Processing Center Network in FY 1998. Specifically, these [redacted] costs were for track and trace services, security

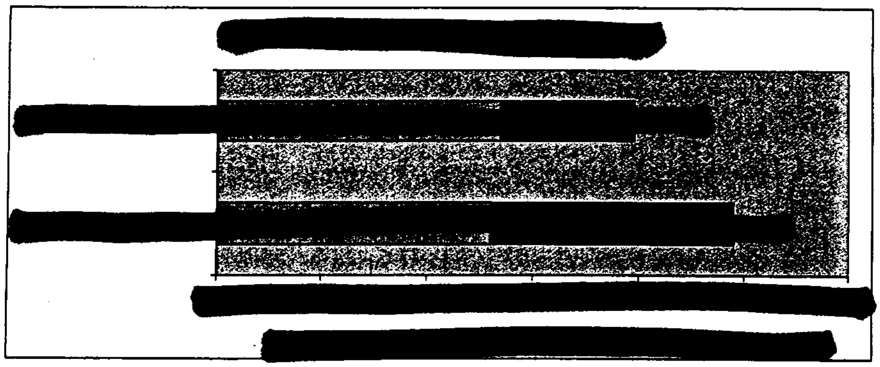
[2] The Cost Attribution Office, Finance is responsible for measuring the cost of individual postal products.

requirements, activation bonuses, and for transporting additional mail containers. These costs, while included in the total reported program costs, were not included in the FY 1998 cost per piece calculation. However, these costs were included in the development of the FY 1998 Cost and Revenue Analysis Report.[3] Network personnel did not include these costs because they considered these to be start-up and non-recurring costs. If these contract costs were treated as volume variable, the contract per piece cost would be [redacted] higher than reported by network personnel.

39 USC 410(c)(2)
b(3)

[redacted]

[redacted]



[redacted]

[3]The report shows the FY revenue and cost of each of the USPS' subclasses of mail. It is prepared as an aid in determining whether the USPS is meeting the statutory requirement under Title 39, Section 3622, U.S. Code, that "each class of mail or type of mail service bear the direct and indirect costs attributable to that class or service."

Diesel Fuel Costs

Network personnel did not provide adequate oversight for the ground transportation fuel invoicing. They used an independent accounting firm to review the accuracy of the contractor's diesel fuel invoices and to monitor the fuel usage and price. Network personnel stated the procedure for monitoring the fuel price was not given the highest priority during implementation because it could be done at a later date. During FY 1998 this procedure was not performed.

39 U.S.C. 410(c)(2)
b(3)

The network contract requires that fuel costs be treated on a [redacted] The contract also directs the USPS to monitor fuel price indices and requires the contractor to acquire fuel at the most favorable prices possible. The contract includes provisions that the contracting officer or a designated representative may require the contractor to adjust or revise its fuel purchasing strategy and/or methods.

In March 1998 the USPS implemented a pilot Fuel Management Program to maximize the utilization of postal and transportation supplier-owned assets by establishing an infrastructure for effective cost-management. USPS pays a large number of surface suppliers for fuel expenses as a pass-through cost and incurred an increase in annual gallons and cost of fuel through the implementation of the Priority Mail Processing Center Network. The Fuel Management Program personnel stated the network could [redacted] The program also helps to ensure the mark-up added by fuel suppliers is consistent.

The USPS reimburses the contractor for diesel fuel as a pass-through cost for actual fuel consumed, [redacted] During our analysis of the diesel fuel costs, we reviewed fuel invoices submitted for FY 1998. Our review found that the diesel fuel costs incurred for FY 1998 totaled approximately [redacted]. We compared the invoiced diesel fuel costs to the Fuel Management Program diesel fuel costs.[8] Based on the implementation of the pilot fuel program, we determined [redacted]

[7] The contractor's [redacted] is in addition to the fuel suppliers' mark-up.
[8] We compared the computed monthly averages to actual compensation (minus federal and state taxes) documented on the fuel invoices.

39 USC 410(c)(2)
b(3)

the life of the contract not including FY 1998. The potential savings over the life of the contract could [redacted] (See Appendix A)

Network officials agreed that there might be an opportunity to achieve [redacted] by participating in the USPS Fuel Management Program. Since no audits of diesel fuel were performed during the course of the contract, network personnel did not determine if other avenues for fuel pricing, such as the USPS Fuel Management Program, were warranted.

Additional Costs

During our review we found that network subcontractors were abandoning Priority Mail destined for Anchorage, Alaska in Seattle, Washington. Subcontractors left Priority Mail at USPS flight staging areas instead of flying the mail directly to Anchorage. The problem occurred because the contractor did not implement a shipment tracking system that identified when the shipment was off-loaded at Seattle and whether it arrived in Anchorage. As a result, USPS transported network Priority Mail that should have been transported by network subcontractors. Network personnel had already identified the problem and, during the course of our audit, took corrective action to recover [redacted] in transportation costs for mail abandoned by subcontractors from November 1997 through August 1998.

[redacted]

[redacted]

39 USC 410(c)(2)

[redacted]

Recommendations	The Vice President, Network Operations Management, should: 1. Perform an analysis of the cost of end-to-end service for Priority Mail processed through the network compared to that processed by USPS without a network on a periodic basis. Use the results of this analysis as a management tool to evaluate the Priority Mail Network.
Management's Comments	Management agrees with the specific recommendation. Management intends to use the suggested analysis as another management tool to evaluate the Priority Mail Processing Center Network performance against a non-network scenario. However, any future analysis of potential network options will only include network costs.
	2. [redacted]
Management's Comments	[redacted]
	3[redacted]
Management's Comments	[redacted]

39 USC 410(c)(2)
b(3)

[redacted]

	4. Assess the feasibility and potential savings of including the Priority Mail Network diesel fuel suppliers in the USPS Fuel Management Program.
Management's Comments	Management agrees with the recommendation. Management notes that the pilot phase of the program is underway, and they anticipate the results will not be available until December 1999. The opportunities will be better understood once that program is fully implemented.
Evaluation of Management's Comments	Management's comments meet the intent of the recommendations.

SYLVESTER BLACK
VICE PRESIDENT, NETWORK OPERATIONS MANAGEMENT

UNITED STATES
POSTAL SERVICE

September 17, 1999

RICHARD F. CHAMBERS

SUBJECT: Response to Draft Audit Report DA-AR-99-Draft

Please find attached an updated response to the subject audit report. I appreciate the opportunity to work with you to develop a mutually satisfactory report. In the future, I hope our respective staffs will continue to work together in the interest of better serving our public's trust. We will send redacted copy of the audit report and our response to your office next week, as soon as we receive a final draft of the audit report.

Should you require additional information, please contact Mike Cronin, manager, Priority Mail Network, at (202) 268-8766.

Sylvester Black

Attachment

cc: Mr. Henderson
Mr. Lewis
Mr. Porras
Mr. Potter

475 L'ENFANT PLAZA SW
WASHINGTON DC 20260-7100
202-268-7206
FAX: 202-268-3331

2

Recommendation 1: Perform an analysis of the cost of end-to-end service for Priority Mail processed through the network compared to that processed by USPS without a network on a periodic basis. Use the results of the analysis as a management tool to evaluate the Priority Mail Network (PMN).

Management Response

39 USC 410(c)(2) b(3)

We agree with the recommendation. Improved service was the principal reason management agreed to the [redacted] of the PMPC concept. The OIG's finding that processing costs through the network solution cost [redacted] more than if the mail was processed in-house without a network is consistent with the decision analysis report approved by the Board.

We concur with the recommendation to use the suggested analysis as another management tool to evaluate the PMPC network performance against a non-network scenario. However, any future analysis of potential network options will only include network costs.

[redacted]

[redacted]

[redacted]

[redacted]

3

39 USC 410(c)(2)
b(3)

[redacted]

Recommendation 4: Assess the feasibility and potential savings of including the Priority Mail Network diesel fuel suppliers in the USPS Fuel Management Program.

Management Response

We agree with the recommendation that there may be opportunities in the future to achieve savings under the Diesel Fuel Management Program, which began in March 1999. The pilot phase of the program is underway, and we anticipate the results won't

4

be available until December 1999. The opportunities will be better understood once that program is fully implemented. Savings would probably be [redacted] projected in the report based on the fact that the network contractor has on-site fuel agreements. Contractor involvement in the Fuel Management Program may, in fact, require the contractor to drive his vehicles to an off-site fuel station. [redacted] This cost needs to be considered as an offset to any potential savings.

39 USC 410(c)(2)
b(3)

[redacted]

• [redacted]

Major Contributors to the Report

b6

[redacted]

[redacted]

Inspection Service

[redacted]