August 16, 2005

STEPHEN M. KEARNEY
VICE PRESIDENT, PRICING AND CLASSIFICATION

SUBJECT: Audit Report – International Customized Mail Agreements (Report Number MS-AR-05-001)

This report presents the results of our self-initiated, nationwide audit of the International Customized Mail (ICM) program (Project Number 04BN001MS000). The overall objective of our audit was to determine whether ICM agreements were profitable.

Although Postal Service management reported the ICM program, as a whole, had a positive contribution, opportunities exist to improve the program. Managers of the ICM program did not conduct annual reviews of individual ICM agreements to determine whether they met or exceeded their cost coverage and contribution level goals in all mail categories, or monitor individual agreements to ensure that mailers met the agreement commitments. As a result, the Postal Service did not collect payments due from guarantee clauses. These funds totaled $905,438 in additional revenue and we will report them as such in our Semiannual Report to Congress. Management revised the ICM program procedures to correct the deficiencies we identified during the audit. However, we believe management should take additional steps to improve the ICM program.

We recommended management establish the following recently implemented program changes as written policy: require annual reviews of each ICM agreement to determine cost coverage percentages and contribution levels, and require review of each ICM agreement on its anniversary date to determine whether mailers met their agreed-upon commitment levels. We also recommended management enforce the renegotiation of the postage rates and the guarantee clauses, and establish policies and procedures to ensure that annual reviews of ICM agreements are fully documented.

Management agreed with our recommendations and has initiatives planned and completed addressing the issues in this report. Management did not agree with our potential monetary benefits. Management's comments and our evaluation 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 Robert Mitchell, Director, Marketing, or me at (703) 248-2300.

/s/ John M. Seeba

John M. Seeba
Deputy Assistant Inspector General
for Financial Operations

Attachments

cc: Anita J. Bizzotto
James P. Wade
Michael K. Plunkett
John F. Alepa
Steven R. Phelps

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EXECUTIVE SUMMARY

Introduction

This report presents the results of our self-initiated, nationwide audit of the International Customized Mail (ICM) program. Our objective was to determine whether ICM agreements were profitable.

Results in Brief

In fiscal year 2003, Postal Service management reported that the ICM program had an overall positive contribution of approximately $6 million. Although the overall contribution level was positive, four international mail categories had a negative contribution of approximately $12 million. Therefore, we believe opportunities exist to improve the program.

Managers of the ICM program did not conduct annual reviews of single- and multi-year individual ICM agreements to determine whether they met or exceeded their cost coverage and contribution level goals in all mail categories. By not conducting annual reviews, management was unable to identify whether individual ICM agreements, over their terms, provided a positive or a negative contribution.

Program management did not consistently monitor individual agreements in accordance with post-agreement management procedures to ensure the mailers met the agreement commitments. We identified over $905,000 in additional revenue Postal Service management could have collected—through enforcement of guarantee clauses—from mailers who did not meet their commitments. The Office of Inspector General plans to report the additional revenue in our Semiannual Report to Congress.

During our audit, management took actions to correct identified deficiencies. Specifically, management began performing annual reviews to determine cost coverage percentages for each ICM agreement, and began requiring a review of each ICM agreement on its anniversary date to determine whether mailers met their commitment levels. In addition, management eliminated ICM agreements exceeding two years.

Summary of Recommendations

We recommended management establish the following recently implemented program changes as written policy: require annual reviews of each ICM agreement to determine cost coverage percentages and contribution levels, and require review of each ICM agreement on its anniversary date to determine whether mailers met their agreed-upon commitment levels. We also recommended management enforce ICM agreement articles allowing for renegotiation of the postage rates and guarantees, and establish policies and procedures to ensure that annual reviews of ICM agreements are fully documented.

Summary of Management's Comments

Management agreed with our recommendations and issued written policies and procedures for the ICM process in June 2005. In addition, management plans to implement the following corrective actions:

- Restrict all new ICM agreements to one-year terms.
- Review each ICM agreement on its anniversary date to determine whether mailers met their commitments.
- Enforce the guarantee clauses in ICM agreements.

In addition, management requested we eliminate all references to ICM agreement funds from this report. Management also disagreed with our potential monetary benefits. Management's comments, in their entirety, are included in Appendix C of this report.

Overall Evaluation of Management's Comments

Management's comments were responsive to our recommendations and actions planned and taken address the issues identified in the report.

INTRODUCTION

Background

International Customized Mail (ICM) agreements are contracts between the Postal Service and a mailer for a period of one or more years. These agreements provide negotiated discounts within certain categories of outbound[1] international mail. The mailer agrees to meet a prescribed annual minimum revenue or volume requirement in return for a reduced international mail rate. According to the International Mail Manual, mailers must be capable, on an annual basis, of one of the following to qualify for negotiated discounts:

- Tendering at least one million pounds of international letter-post[2] mail (excluding Global Priority Mail) or paying at least $2 million in international letter-post postage.
- Tendering at least 600 pieces of international non-letter-post mail[3] (including Global Priority Mail) or paying at least $12,000 in international non-letter-post postage.

The ICM agreement process consisted of:

- Mailer Qualification – identification of mailers who meet ICM qualifications and submission of a completed ICM application.
- Proposal Development and Approval – preparation of an ICM proposal of rates and services[4] offered by the Postal Service, joint review, [5] and final approval of the proposal to be offered to the mailer.
- Agreement Development – drafting a formal agreement for signature, based on the mailer's acceptance of the proposed terms.

[1]Outbound mail is mail departing the United States for other countries.
[2] International letter-post mail consists of letters, letter packages, publications, cards, etc.
[3]International non-letter-post mail consists of Air Parcel Post and Global Express Mail. For purposes of mailer qualification, Global Priority Mail is included in this category, although it could be considered letter-post as well.
[4]Discounts through ICM agreements can range from 2.5 to 25 percent based upon potential volume or postage commitments. Fiscal year (FY) 2003 ICM agreement discounts ranged from 12 to 15 percent.
[5]Joint review consisted of circulating ICM proposals through Marketing's Sales, International Product Development, and International Pricing, as well as Postal Service Headquarters' Legal department.

- Post-Agreement Management – monitoring mailers' compliance with agreement terms and conditions and taking corrective measures as warranted.

The Postal Service's ICM program is the responsibility of the Pricing Strategy group under Marketing's vice president for Pricing and Classification. The program was established in 1992 to identify new customers to generate contribution through customer unique pricing. The ICM program was subsequently modified to allow package mailers to also qualify for discounted pricing.

Objective, Scope, and Methodology

The objective of our audit was to determine whether ICM agreements were profitable.[6] To accomplish our objective, we reviewed the status of 53 of 195 ICM agreements[7] with an open commitment period during FY 2003 that the Postal Service tracked in the Goldmine database system.[8] We also reviewed volume and revenue data for 49[9] of these agreements and performed a detailed historical cost coverage review of one agreement. In addition, we interviewed Postal Service Headquarters personnel in Marketing, Finance, and Information Technology, as well as field personnel in Sales. We also interviewed officials from the Postal Rate Commission (PRC). We reviewed and analyzed International Cost and Revenue Analysis (ICRA) reports; Agreement Detail Reports; the Postal Service's Purchasing Manual; and two reports issued by the PRC – Report to the Congress FY 2002 [and FY 2003] International Mail Volumes, Costs and Revenues, issued June 27, 2003, and June 30, 2004, respectively.

We conducted this audit from March 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 reviewed management controls over the ICM program related to the audit objective. Specifically,

[6]For the purposes of this report, the Office of Inspector General (OIG) defines profitability as an ICM agreement with cost coverage greater than or equal to 100 percent or contribution greater than or equal to zero.
[7]We excluded all 136 Global Package Discount agreements because the Postal Service did not individually track them by mailer and because program management eliminated these agreements from the ICM program. We also excluded six agreements that were for inbound international mail.
[8]The Goldmine database is a data warehouse used by Marketing to track ICM agreements.
[9]Four of the fifty-three agreements had not completed their commitment period at the time of sample selection and review.

we reviewed policies and procedures governing the ICM program to ensure that management met their program objectives. We discussed our observations and conclusions with management officials and included their comments where appropriate. We did not assess the reliability of the Goldmine database as part of our audit; therefore, given this limitation, we base no conclusions or recommendations solely on the data contained in the database.

Prior Audit Coverage

We did not identify any prior OIG audits related to the objective of this audit, although we did identify two reports issued by the PRC: Report To The Congress: The FY 2002 [and FY 2003] International Mail Volumes, Costs and Revenues, issued June 27, 2003, and June 30, 2004, respectively.

In the FY 2002 report, the PRC reported that ICM agreements were collectively responsible for more than $31.6 million in negative contributions. In response to a congressional inquiry, the Postal Service reviewed its original submission to the PRC and identified the erroneous reporting of inbound mail. The Postal Service submitted revised data, reducing the negative contributions from $31.6 million to $10 million. The Postal Service's positive contributions totaled $24 million. Overall, the contribution for ICM agreements in FY 2002 was approximately $14 million.[10]

In the FY 2003 report, the PRC reported ICM agreements had an overall positive contribution of approximately $6 million despite over $12 million in negative contribution in four mail categories.[11] The PRC also reported ICM agreements should not be cross-subsidized by domestic mailers and other (outbound) international mailers. The PRC recommended that the Postal Service continue to reassess each ICM agreement annually and include sufficient rate escalation clauses in contracts with terms longer than one year.

During our audit, ICM program management told the OIG they have taken steps to ensure the PRC is provided with

[10]The PRC and the Postal Service both used data derived from the FY 2002 International Cost and Revenue Analysis Report – PRC version.
[11]Negative mail categories in FY 2003 included economy letter packages, air letter and letter packages, air parcel post, and global direct outbound.

data showing the true financial status of ICM agreements while preserving the integrity of proprietary cost information. Specifically, program management told the OIG they had revised product categories to better fit standard product names and were in the process of developing more specific costing information directly related to ICM agreements.

AUDIT RESULTS

Although Postal Service management reported the ICM program, as a whole, had a positive contribution for FY 2003, opportunities existed to improve the program and increase cost coverage and contribution levels. Specifically, program managers did not adequately oversee the ICM agreements by conducting annual reviews of individual agreements after they were implemented to determine whether program cost coverage goals and commitments were met. As a result, over $905,000 in additional revenue could have been collected from mailers who did not meet their commitments.

During our audit, management took actions to correct deficiencies we identified. Specifically, management began performing annual reviews to determine cost coverage percentages for each ICM agreement, and changed ICM program procedures to include a review of each ICM agreement on its anniversary date, to determine whether mailers met their commitment levels. In addition, management eliminated the use of ICM agreements exceeding two years.

We believe these changes will allow the Postal Service to more quickly identify those ICM agreements not meeting program cost coverage goals and revenue and volume commitments. This will allow management to make timely business decisions concerning the impact of individual ICM agreements on the overall contribution level of the ICM program.

Annual Reviews Not Conducted

Managers of the ICM program did not conduct annual reviews of individual ICM agreements to determine whether they met or exceeded their cost coverage or contribution level goals in all mail categories. Management stated this occurred because they:

- Could not decide which of two ICRA reports to use to measure costs because of timing differences between the reports.[12]

[12] There are two versions of the ICRA report: a PRC version released each March and a Postal Service version released each June.

- Focused on customer retention.

- Used total revenue as the metric to measure success.

However, post-agreement management procedures required program management to monitor ICM agreements for compliance with agreed-upon terms and conditions in order to make changes when warranted.[13] By not conducting annual reviews, management did not identify whether individual ICM agreements provided a positive or a negative contribution.

We identified 53 active, outbound, non-Global Package Discount ICM agreements in FY 2003, 20 of which were 1-year agreements and 33 of which had 2 to 5-year terms. Program managers prepared cost coverage and contribution estimates during the proposal phase of the ICM agreement process, but did not review the 33 multi-year agreements after the first year to determine whether customers maintained contribution goals, even though data was available to calculate contribution and cost coverage percentages.

Positive Contribution Not Provided in All Mail Categories

Overall, the ICM program had a positive contribution of approximately $6 million in FY 2003. However, four of seven international mail categories accounted for over $12 million in negative contributions for mail tendered under ICM agreements. See Appendix A for details.

Program managers identified deficiencies in the average unit cost calculation and informed us that one of the four categories'[14] average unit cost was not correct because it did not take into account the different weight characteristics among package types. Management further explained that the ICM agreement-specific unit cost was less than the average unit cost because the ICM agreement-specific unit cost did not include costs associated with retail operations.

[13]Postal Service personnel told the OIG that the monitoring procedures, though unwritten, were requirements under the ICM process' Post-Agreement Management phase.
[14]The mail category to which Postal Service management referred was economy–letter packages.

Although program managers identified deficiencies in the methodology used to calculate ICM agreement costs, they said the current calculation method was the only method available. Further, although ICM agreement-specific unit costs were less than the average unit costs, the four categories of international mail totaling $12 million in negative contribution indicated that not all individual ICM agreements covered their costs.

Targeted Cost Coverage Not Always Met

During our audit, we selected one active ICM agreement with a $10 million revenue commitment for a review of historical cost coverage for the period of January 1, 2001, through December 31, 2004, to determine whether the agreement met cost coverage goals. This ICM agreement involved two international mail categories: International Priority Airmail and International Surface Air Lift Mail.

As shown in the chart below, the cost coverage percentage for International Priority Airmail declined 30 percent from FYs 2001 to 2004. Its targeted cost coverage was 120 percent.[15] Program managers attributed the decline in the cost coverage of this agreement to the combination of static postage rates and cost increases in the category of International Priority Airmail.

Selected ICM Agreement – Cost Coverage Percentage Analysis[16]

	FY 2001	FY 2002	FY 2003	FY 2004[17]
International Priority Airmail	133%	111%	108%	103%
International Surface Air Lift Mail	123%	122%	123%	118%

Had management conducted annual reviews of this ICM agreement, they could have identified the lost cost coverage percentage and modified the ICM agreement.[18]

During our review of seven other ICM agreements, we identified five agreements containing a clause designed to

[15]The International Business Unit originally established an internal directive that no ICM agreement shall have an overall cost coverage below 120 percent without a compelling business case. However, the Pricing Strategy group later changed the internal directive to reflect an overall cost coverage of 110 percent to 114 percent due to rising costs and static postage rates for certain mail classes, which made the earlier goal impractical.
[16]Source: Postal Service International Pricing.
[17]Based on Goldmine data for January and February 2004, the most current data available at the time of our review.
[18]ICM agreements contain a clause designed to allow the Postal Service to modify negotiated ICM rates if costs for qualifying mail increase over 5 percent.

allow the Postal Service to raise postage rates if costs for qualifying mail increased over 5 percent. However, program managers did not exercise this clause and took no action when the qualifying mail costs increased over 5 percent. See Appendix B for additional details.

Revenue and Volume Commitments Not Always Met

Management developed ICM agreements to grow revenue and provide a positive contribution for the Postal Service. Of 49[19] active FY 2003 ICM agreements reviewed, 12 achieved revenue or volume increases above the commitment figures. However, 37 of the 49 (76 percent) did not meet their agreed-upon revenue or volume commitments. Had program managers consistently monitored individual agreements for compliance with ICM agreement clauses, program managers could have made timely business decisions resulting in over $905,000 in additional revenue during commitment periods falling within FY 2003.

Program managers stated their focus was on generating revenue rather than conducting regularly scheduled annual reviews of individual agreements to determine whether customers were on target to meet the revenue or volume terms of their agreements.

Of the 12 ICM agreements that achieved revenue or volume increases:

- Seven revenue only agreements for $89.4 million exceeded their commitments by $22.2 million, for a total of $111.6 million.

- Five volume only agreements exceeded their commitments by 22 million pieces mailed.

Of the 37 ICM agreements that did not meet agreed-upon commitments:

- Seven revenue only agreements did not meet their commitments by $17.8 million out of a total of $73 million.

- Eighteen volume only agreements did not meet their commitments by a total of 14 million pieces mailed.

[19]Four of the fifty-three agreements had not completed their commitment period at the time of sample selection and review. Therefore, we could not determine whether these agreements met their agreed-upon FY 2003 revenue or volume commitments.

- Twelve agreements[20] did not meet their revenue and/or volume commitments.

Five of the seven ICM agreements that did not meet revenue commitments contained guarantee clauses, enabling the Postal Service to collect an additional $905,438 as revenue in unearned discounts from mailers who did not meet the terms of their agreements. However, program managers did not exercise this clause and took no action when the mailers did not meet their commitments. See Appendix B for additional details.

Management's Changes to the ICM Program

During our audit, management took actions to correct identified deficiencies. Beginning in July 2004, management began performing annual cost reviews. Although program managers recorded a business case decision for each open ICM agreement, they did not always document the bases for each business case decision reached. Management also implemented ICM program procedures requiring a review of each ICM agreement on its anniversary date to determine whether mailers met their agreed-upon commitment levels. Lastly, management eliminated the use of ICM agreements with terms exceeding two years.

Although management had taken actions to identify whether individual ICM agreements would provide positive contribution to the Postal Service on an annual basis, we believe management should incorporate these recent changes into official policy.

Recommendations

We recommend the vice president, Pricing and Classification:

1. Incorporate into policy the recently implemented program changes to:

    - Perform an annual review of each ICM agreement to determine cost coverage percentages and contribution levels.

[20]Terms of 11 of these agreements contained an annual minimum revenue or volume requirement for which the mailer agreed to meet either one term or the other during the commitment period, while the terms for one agreement required the mailer to meet an annual minimum revenue and volume commitment.

- Review each ICM agreement on its anniversary date to determine whether mailers met their agreed-upon commitment levels.

2. Direct program managers to enforce the ICM agreement Articles allowing for renegotiation of the postage rates in ICM agreements in order to adjust postage rates affected by at least a 5 percent increase in qualifying mail costs, unless a written business case is made not to take action.

3. Direct program managers to enforce guarantee clauses to assess and collect payments from mailers not in compliance with ICM agreement terms in order to recover lost discounts, unless a written business case is made not to take action.

4. Establish policies and procedures to ensure that annual reviews of ICM agreements are documented to establish the business case for actions taken or not taken concerning cost coverage and contribution levels.

Management's Comments

Postal Service management agreed with all four of our recommendations and issued written policies and procedures for the ICM process in June 2005. In addition, management has restricted all new ICM agreements to one-year terms, which necessitates the annual review of rates and cost coverage, as well as adjustments for the effects of cost increases. Further, management stated it reviews each ICM agreement before its anniversary date to determine if the mailer has met the agreed-upon commitment and takes appropriate action to enforce the guarantee clauses. Finally, management requested we eliminate all references to ICM agreement from this report.

However, Postal Service management offered alternative explanations for mailers who did not meet revenue commitments in response to our draft audit report.

In response to our finding that they did not conduct annual reviews of ICM agreements, management stated they review ICM proposals and agreements annually as part of the normal vetting process. Specifically, management stated they review the customized rates for Postal Service products annually rather than review individual ICM agreements. Management added they were constantly aware of the contribution levels of the customized rates in comparison to the individual products.

In response to our finding that not all mail categories provided a positive contribution, Postal Service management stated that it appeared the negative contribution the PRC reported was due to inappropriate allocation of costs to Postal Service products with customized rates. Management further explained that the negative contribution was not a function of the customized rates themselves and that the Postal Service had corrected the cost method for data sent to the PRC, eliminating this error.

In response to our finding they did not always meet targeted cost coverage, Postal Service management never intended the cost coverage information in the executive summary – which accompanied each ICM proposal and agreement – as a target. Management also stated it took corrective action when the cost coverage declined.

In response to our finding they did not always meet revenue and volume commitments, Postal Service management stated its review process identified and enabled collection of the required penalties. Specifically, management did not agree with our monetary impact, stating that the Postal Service had either collected all postage due or determined that the commitment had been met in all categories of mail.

Management stated its position on each of the five agreements (outlined in Appendix B) where OIG claimed mailer guarantee funds were due the Postal Service, as follows:

- One agreement's volume did not include revenue from Global Bulk Economy and Global Direct-Canada Admail, which brought the total above the commitment level for the period.

- One agreement had no mail that qualified under the penalty clause.

- Three agreements were terminated prior to the expiration date, with two mailers having met their "annualized" commitments and one mailer having paid an agreed-upon amount of the penalty due based on reconciled volumes and recognized market conditions.

Evaluation of Management's Comments

Management's comments are responsive to the recommendations and actions planned and taken address the issues identified in the finding. However, the OIG disagrees with Postal Service management's practices for identifying and collecting lost discounts.

Specifically, the OIG disagrees with management's assessment that one agreement's revenue did not contain all mail types. Management stated this agreement, as reported, did not include revenue from Global Bulk Economy and Global Direct-Canada Admail. The OIG obtained supporting documentation from Postal Service management, which did contain these mail types.

We take exception to allowing mailers to terminate their agreements prior to their expiration dates and prorating their previously agreed-upon commitment levels by "annualizing" the mailer's annual obligation.

Mailers who agree to a higher commitment level and terminate their agreements receive deeper discounts than those mailers who commit to and meet a lower level, even though both mailers may have mailed an equal amount in revenue or volume.

APPENDIX A
FY 2003 REVENUE, ATTRIBUTABLE COSTS, AND CONTRIBUTIONS OF MAIL TENDERED USING ICM AGREEMENTS

	Revenue $(000)	Attributable Costs $(000)	Contribution $(000)	Cost Coverage Percentage
Economy				
Letter Packages	$1,765	$8,157	$(6,392)	21.6%
International Surface Air Lift	65,519	55,702	9,817	117.6%
Air				
Letters and Letter Packages	2,245	4,812	(2,567)	46.7%
International Priority Airmail	65,788	57,820	7,968	113.8%
Express	5,466	5,251	215	104.1%
Air Parcel Post	3,603	6,732	(3,129)	53.5%
Initiatives				
Global Direct Outbound	1,064	1,065	(1)	99.9%
Total	$145,450	$139,539	$5,911	104.2%

Source: PRC's Report to the Congress FY 2002 [and FY 2003] International Mail Volumes, Costs and Revenues, issued June 27, 2003, and June 30, 2004, respectively, with data provided by the Postal Service.

APPENDIX B
REVENUE COMMITMENTS NOT MET

ICM Agreement	Revenue Commitment ($)[21]	Revenue Collected ($)[22]	Revenue Not Collected ($)[23]	Percent Revenue Not Collected (%)	Cancellation Clause[24]	Cost Renegotiation Clause[25]	Cost Increase >5%[26]	Mailer Guarantee Unearned Discount[27]	Mailer Guarantee $ Due Postal Service[28]
1	$10,000,000	$5,428,155	$4,571,845	45.72%	No	Yes	Yes	Yes	$336,257
2	1,000,000	35,464	964,536	96.45	No	Yes	No	No	0
3	1,000,000	37,233	962,767	96.28	No	Yes	Yes	Yes	[29] 0
4	950,000	543,977	406,023	42.74	No	No	Yes	No	0
5	10,000,000	7,787,068	2,212,932	22.13	Yes	Yes	Yes	Yes	[30] 299,979
6	10,000,000	8,488,419	1,511,581	15.12	Yes	Yes	Yes	Yes	199,728
7	25,000,000	23,343,257	1,656,743	6.63	Yes	Yes	Yes	Yes	69,474
TOTALS	**$57,950,000**	**$45,663,573**	**$12,286,427**	**21.20%**					**$905,438**

[21]Revenue commitment is the dollar amount of postage the mailer agreed to pay each calendar year during the term of the agreement.
[22]Revenue collected is the dollar amount of postage the mailer paid during the commitment period falling within FY 2003.
[23]Revenue not collected represents the difference between the revenue commitment and the revenue collected during the commitment period falling within FY 2003.
[24]A cancellation clause allows the Postal Service or the mailer to cancel the agreement with six months notice and with no penalty.
[25]A cost renegotiation clause allows the Postal Service to raise postage rates in an agreement if costs for qualifying mail increase over 5 percent during the term of the agreement.
[26]This column is to indicate whether costs for qualifying mail increased over 5 percent during FY 2003.
[27]A guarantee clause between the mailer and the Postal Service provides for the Postal Service to be reimbursed for any rate discount not earned by the mailer.
[28]This is the unearned discount the mailer should have paid during the commitment period falling within FY 2003.
[29]This mailer had no mailings applicable to the guarantee clause; therefore, no reimbursement is due the Postal Service.
[30]The mailer paid the Postal Service $220,285.39 on January 13, 2005. This leaves a remaining balance of approximately $79,694.

APPENDIX C. MANAGEMENT'S COMMENTS

STEPHEN M. KEARNEY
VICE PRESIDENT
PRICING AND CLASSIFICATION

UNITED STATES POSTAL SERVICE

April 11, 2005

KIM H. STROUD
DIRECTOR, AUDIT OPERATIONS
OFFICE OF INSPECTOR GENERAL

SUBJECT: Response to Draft Audit Report – International Customized Mail Agreement (Report Number MS-AR-05-DRAFT)

This office has reviewed the Draft Audit Report. We note that the Office of Inspector General (OIG) acknowledges that the United States Postal Service (USPS) had implemented the corrective actions suggested in the four recommendations prior to the audit. The essential OIG recommendation is that the USPS continue to enforce its standing policies and procedures regarding International Customized Mail (ICM). We agree with that recommendation.

USPS management requires that contribution levels, cost coverage, cost, volume, and revenues be treated confidentially. Therefore, appendices A and B should be removed from the final version of the report. I am enclosing a supplemental response to the Draft Audit Report which addresses issues raised in the appendices.

Recommendation 1:
Incorporate into policy the recently implemented program changes to:

- Perform an annual review of each ICM agreement to determine cost coverage percentages and contribution levels.
- Review each ICM agreement on its anniversary date to determine if mailers met their agreed-upon commitment levels.

Response:
We agree with this recommendation.

USPS management has restricted all new ICM agreements to a term of one year. This necessitates an annual review of rates and cost coverage based upon the updated attributable cost for each product. Each ICM is reviewed before its anniversary date to determine if the mailer has met the agreed-upon commitment. Any new agreement is written based upon the cost and published rates in effect at the time of renewal. If a customer has not met its commitment, a determination is made as to whether to enter into a new ICM agreement, and, if so, at what rate level.

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Recommendation 2:
Direct program managers to enforce the renegotiation of postage rates clause in ICM agreements in order to adjust postage rates affected by at least a five percent increase in qualifying mail costs, unless a written business case is made not to take action.

Response:
The Postal Service agrees with this recommendation.

All ICM agreements are reviewed a minimum of once each year to adjust for the effects of cost increases as recommended.

Recommendation 3:
Direct program managers to enforce guarantee clauses to assess and collect payments from mailers not in compliance with ICM agreements in order to recover lost discounts, unless a written business case is made not to take action.

Response:
The Postal Service agrees with this recommendation.

The USPS takes appropriate action to enforce the guarantee clauses. (See also supplemental response to appendices A & B.)

Recommendation 4:
Establish policies and procedures to ensure that annual reviews of ICM agreements are documented to establish the business case for actions taken or not taken concerning cost coverage and contribution levels.

Response:
The Postal Service agrees with this recommendation.

The USPS reviews all ICM agreements on their anniversary dates. In addition, all ICM agreements are reviewed at least once each year in light of foreign exchange rate fluctuations and updated attributable cost. Postal Qualified Wholesalers with ICM agreements including a guarantee clause are notified of their penalty obligations, if necessary, at the time of their annual review. All other ICM agreements are evaluated on their anniversary dates and are either not renewed, or renewed at rates appropriate to their actual postage or volume.

Stephen M. Kearney

Attachment

cc: Ms. Bizzotto
Mr. Phelps

Supplemental Response to Draft Audit Report – International Customized Mail Agreement (Report Number MS-AR-05-DRAFT)

Annual Reviews Not Conducted

Targeted Cost Coverage Not Always Met

Response:
Postal management was aware of the declining cost coverage caused by rising costs and static published rates. Postal management took the appropriate actions to address the situation on a system-wide basis.

The ICM program was established at a time when there were regular rate increases based on rising costs. Discounted ICM rates were tied to published rates that increased in value relative to the cost. In FY2003, the Postal Service decided, as a matter of public policy, to hold rates steady until FY2006. This event had a significant impact on the ICM program. Postal management realized that as the cost of international products rose, the contribution levels for ICM agreements decreased. In response, Postal management made four important policy decisions.

- First, Airmail Parcel Post would no longer have discounted rates except for weights up to four pounds to Japan where ICM rates were possible because of a special arrangement.
- Second, all ICM agreements would have a term of one year.
- Third, ICM rates for Global Express Mail would be determined based on a cost margin rather than a discount from published rates.
- Fourth, there would no longer be published discounts for International Priority Airmail and International Surface Airlift mail.

Positive Contribution Not Provided In All Mail Categories

Response:
The Postal Service is aware that reports to the Postal Rate Commission in prior years have not taken into account the unique characteristics of ICM mail and have underreported the true contribution of the ICM program. The Postal Service has corrected these errors in methodology. The corrected methodology demonstrates that ICM mail has a positive contribution in all categories of mail. (See attachment.)

Revenue and Volume Commitments Not Always Met

Response:
We do not agree with the assertion that there is $907,398 in revenue the Postal Service should have collected from mailers who did not meet their commitments. USPS management has either collected all postage due or determined that the commitment was met and no further postage is due.

The mailer identified as ICM agreement #1 in Appendix B with a commitment of $10 million terminated the agreement prior to the expiration date. The mailer met its annualized commitment up to the termination date and no additional postage is due the USPS.

The mailer identified as ICM agreement #3 in Appendix B with a commitment of $1 million had no mail volume to which the guarantee clause applied. No additional postage is due the USPS.

The mailer identified as ICM agreement #5 in Appendix B with a commitment of $10 million was notified of its penalty and has paid the Postal Service. No additional postage is due the USPS.

The mailer identified as ICM agreement #6 in Appendix B with a commitment of $10 million stopped mailing prior to the expiration date. The mailer met its annualized commitment up to the date of their last mailing. No additional postage is due the USPS.

For the mailer identified as ICM agreement #7 in Appendix B with a commitment of $25 million, the revenue reported in the audit does not include all revenue from all types of mail. When all revenue is included, the total exceeds the commitment. No additional postage is due the USPS.

For the mailers identified as ICM agreements #2 and #4 in Appendix B, no additional postage is due to the USPS.

All references to these funds should be eliminated from the final report.

The USPS would be pleased to review these ICM agreements and supporting documentation with the Office of inspector General in more detail.

FISCAL YEAR 2004

#	US Origin	Non-ICMS Rev	Non-ICMS VVC	Non-ICMS Cntr	Non-ICMS %	ICMs Rev	ICMs VVC	ICMs Cntr	ICMs %	Total Revenue	Total Contribution
	All Countries										
	Economy										
1	Letter Packages [1]	$40,430	$43,788	-$3,358	92					$40,430	-$3,358
2	Global Bulk Economy					$2,145	$2,031	$114	106	$2,145	$114
3	Periodicals	$21,851	$26,731	-$4,880	82					$21,851	-$4,880
4	ISAL [2]	$3,456	$2,250	$1,206	154	$66,615	$58,418	$8,197	114	$70,071	$9,403
5	Parcel Post	$80,771	$61,982	$18,789	130					$80,771	$18,789
	Total Economy	$146,508	$134,751	$11,757	109	$68,760	$60,449	$8,311	114	$215,268	$20,068
	Air										
6	Letters and Ltr packages	$598,009	$377,921	$220,088	158					$598,009	$220,088
7	Global Direct Lettermail Canada (GDL)					$3,423	$3,053	$370	112	$3,423	$370
8	Postcards	$22,044	$13,099	$8,945	168					$22,044	$8,945
9	IPA [3]	$6,423	$4,752	$1,670	135	$82,348	$79,292	$3,056	104	$88,771	$4,726
10	GPM	$66,165	$42,979	$23,186	154					$66,165	$23,186
11	Air Parcel Post [4), 5)]	$225,381	$197,266	$28,163	114	$4,729	$3,413	$1,269	139	$230,110	$29,432
12	Express Mail [4), 5)]	$164,615	$114,938	$49,677	143	$2,505	$2,233	$271	112	$167,120	$49,948
	Total Air	$1,082,637	$750,955	$331,729	144	$93,005	$87,991	$5,014	106	$1,175,642	$336,695
	Sub Total	$1,229,145	$885,706	$343,486	139	$161,765	$148,440	$13,325	109	$1,390,910	$356,763
	Initiatives										
13	Global Direct Admail Canada (GDA)	-	-	-	-	$1,703	$691	$1,012	246	$1,703	$1,012
	GRAND TOTAL	$1,229,145	$885,706	$343,486	139	$163,468	$149,131	$14,337	110	$1,392,613	$357,775

1) Removed Global Bulk Economy (GBE). GBE is an international economy mail product with a different cost structure.
2) Split ISAL between ICM and non-ICM revenue
3) Split IPA between ICM and non-ICM revenue
4) Split Air Parcel Post between ICM and non-ICM revenue
5) Redistributed the International Commercial Package revenue between Air Parcel Post and Express Mail in the ICM revenue category

Response to Draft Audit Report – International Customized Mail Agreement (Report Number MS-AR-05-DRAFT)

Finding:
Annual Reviews Not Conducted

Response:
In Postal fiscal year 2003, as part of the normal vetting process for ICM proposals and agreements, USPS management reviewed the contribution levels of its customized rates vis-à-vis the products in question on sixty one (61) separate documented occasions. Individual ICM agreements are not independent of Postal Service products. Individual ICM agreements allow customized rates for existing Postal Service products. If a given rate for a particular product provides for positive contribution, that rate provides a positive contribution each time it is applied. The contribution levels for USPS international products are calculated using the unit attributable cost of the relevant product. The contribution levels are not based on the particular cost characteristics of an individual ICM holder. USPS management was constantly aware of the contribution levels of the customized rates vis-à-vis the individual products.

Finding:
Positive Contribution Not Provided In All Mail Categories

Response:
From a review of Appendix A, it appears that negative contribution in a Postal Rate Commission report was the result of an inappropriate allocation of cost to Postal Service products for which customized rates were given. The reported negative contribution was not a function of the customized rates themselves. USPS management has corrected the costing methodology for data it sends to the Postal Rate Commission and has eliminated this error. USPS management believes this reporting error to be unrelated to the annual review of individual ICM agreements and to the actual contribution levels for customized rates. The OIG report states that it believes that although ICM agreement-specific unit costs were less than the average unit costs, not all individual ICM agreements covered their costs. However, the OIG report does not give a justification for that belief. The Postal Service further believes that the way the finding is stated unfairly ascribes negative contribution levels to ICMs.

Finding
Targeted Cost Coverage Not Always Met

Response:
The information in the executive summary which accompanies each ICM proposal and agreement was never intended to set a target. Using the most current information available at the time, the executive summary documents the fact that that the customized rates for individual products allow for positive cost coverage. Because the cost information in the executive summary is an average unit attributable cost, the cost coverage is the same for any piece of mail which is mailed at the same rate and is not volume variable. Because of the review procedures inherent in the ongoing production of executive summaries, USPS management was aware that unit cost was increasing during a period of static published rates. In direct response, USPS management took the following actions.

- First, all discounts for the Airmail Parcel Post product were discontinued except for weights up to four pounds to Japan where ICM rates were possible because of a special arrangement with Japan.
- Second, all ICM agreements were limited to a term of one year.
- Third, ICM rates for Global Express Mail were determined based on a specified markup over cost rather than a discount from published rates.
- Fourth, published discounts for International Priority Airmail and International Surface Airlift mail were eliminated.

Finding
Revenue and Volume Commitments Not Always Met

Response:

It is the position of USPS management that because of its review process, the required penalties were identified and collected. The majority of ICM agreements do not provide penalties for the customer in the event that the revenue and volume commitment is not met. In those cases, USPS management reviews the actual revenue and volume at the time of renewal and makes a determination as to whether or not to renew the agreement, and, if a decision is made to renew, what customized rates to offer. Unfortunately, not all postal customers were able to fulfill their commitments for one reason or another. These reasons are not always under the control of the customer or of the USPS. Other ICM agreements do provide for penalties. The OIG report identifies five agreements containing guarantee clauses under which the USPS should have initiated action. The OIG finds that USPS management took no action when these mailers did not meet their commitment. USPS management requires that contribution levels, cost coverage, cost, volume, and revenues be treated confidentially. Therefore I am providing a supplemental response which addresses this issue.

USPS management shall provide the OIG with a written set of policies and procedures for the ICM process by July 1, 2005.

Supplemental Response to Draft Audit Report – International Customized Mail
(Report Number MS-AR-05-DRAFT)

Revenue and Volume Commitments Not Always Met

Response:

The mailer identified as ICM agreement #1 in Appendix B with a commitment of $10 million terminated the agreement prior to the expiration date. The mailer met its annualized commitment up to the termination date and no additional postage is due the USPS. The manager previously responsible for this agreement can verify that proper notification was made and the target compliance period was achieved at the time of notification, therefore no additional postage was due.

The mailer identified as ICM agreement #5 in Appendix B with a commitment of $10 million was notified of a penalty due for the compliance period extending over calendar years 2002 and 2003. The mailer ended the contract in September 2003. The Postal Service and the mailer agreed upon the amount of the penalty based upon reconciled volumes and recognized market conditions. The mailer paid the Postal Service $220,285.39 on January 13, 2005. No additional postage is due the USPS.

The mailer identified as ICM agreement #6 in Appendix B with a commitment of $10 million stopped mailing under the contract in April 2003 with a total of $4,601,127 in postage paid for the 2003 compliance period. The target for the compliance period was $3,333,333. The mailer met its annualized commitment up to the date of their last mailing and exceeded its annualized commitment by 38%. No additional postage is due the USPS.

For the mailer identified as ICM agreement #7 in Appendix B with a commitment of $25 million, the revenue referenced in the audit report did not include revenue from Global Bulk Economy (GBE) and revenue from Global Direct – Canada Admail. When these are included, the total exceeds the commitment. No additional postage is due the USPS.

All references to these funds should be eliminated from the final report.

The USPS would be pleased to review these ICM agreements and supporting documentation with the Office of inspector General in more detail.