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SUBJECT: Audit Report – Postal Service’s Innovation Process for Competitive
and Market-Dominant Products (Report Number MS-AR-11-004)

This report presents the results of our self-initiated audit of the U.S. Postal Service’s innovation process (Project Number 09RG014MS000). Our objective was to assess the Postal Service’s innovation process for competitive and market-dominant products. This is the first project of two that we plan to perform on innovation at the Postal Service. We plan to follow this project with a detailed analysis of the innovation management processes used by several major companies.¹ This audit addresses strategic risk to the Postal Service. See [Appendix A](#) for additional information about this audit.

To overcome its current financial challenges,² the Postal Service must recognize innovation not as the byproduct of an effort to improve operational efficiency only, but as a distinct strategic goal and activity. It must embrace a culture of innovation that begins with the most senior levels of management, understand the process that turns ideas into innovation, and commit to an organizational structure that allows innovation teams to work free from the constraints of day-to-day operations.

¹ Specifically, we plan to review innovation management in major U.S. corporations to determine how they integrate innovation strategies into their business strategy, create and capture new ideas from internal and external sources, determine which innovations to pursue, evaluate the progress of each innovation initiative, and manage the relationship between the innovation activity and ongoing work.

² The Postal Service is facing significant financial challenges as mail volumes decline because of the economic downturn and electronic diversion. Volume declined 12.8 percent in fiscal year (FY) 2009 and 3.5 percent in FY 2010. The Postal Service lost \$3.8 billion and \$8.5 billion in FYs 2009 and 2010, respectively.

Conclusion

The Postal Service faces regulatory and market constraints to innovation that private companies do not. For example, it must prove to the Postal Regulatory Commission (PRC) that new products and services will not violate statutory restrictions, will cover their attributable costs,³ and will not create an unfair competitive advantage.⁴ The Postal Service may not offer loss leaders, defined as goods or services advertised and sold at or below cost,⁵ whereas private sector businesses are free to use this business strategy. Despite these external barriers, the Postal Service has introduced some innovations including Priority Mail® Flat Rate Boxes, Intelligent Mail barcode (IMb), Critical Mail, Simplified Addressing, and the Flats Sequencing System (FSS).

However, management should increase its efforts to support a culture of innovation that would support advancements within current statutory authority. This includes a comprehensive innovation strategy and a more disciplined process for the development and implementation of market-based initiatives. One approach worth considering is the creation of an organizational structure that allows dedicated innovation teams to work free from the constraints of also managing day-to-day operations in support of existing products and services. Liberated from the constant burden of meeting stringent deadlines and production goals, these innovators would be free to spend additional time developing product line extensions, additional special services,⁶ and experimental products.

Regulatory Constraints

The Postal Reorganization Act of 1970 (PRA) created a business model for the Postal Service that relied on moderate volume growth and periodic rate increases to finance universal service. As long as mail volume was increasing, there was no urgent need to innovate. While this business model was sufficient to finance operations throughout most of the 20th Century, it did not anticipate the impact of electronic diversion and a prolonged economic downturn.

³ The Postal Accountability and Enhancement Act of 2006 (Postal Act) defines attributable costs as the “direct and indirect postal costs attributable to such product through reliably identified causal relationships.” 39 U.S.C. §3631(b). The statute requires the PRC to “promulgate regulations to...ensure that each competitive product covers its costs attributable,” 39 U.S.C. §3633(a)(2).

⁴ 39 U.S.C. §404(a)(1) states the Postal Service may not “establish any rule or regulation (including any standard) the effect of which is to preclude competition or establish the terms of competition unless the Postal Service demonstrates that the regulation does not create an unfair competitive advantage for itself or any entity funded (in whole or in part) by the Postal Service.”

⁵ The purpose of a loss leader is to bring in (lead) customers to the retail store on the assumption that, once inside the store, the customers will be stimulated to buy full priced items as well. 39 U.S.C. §3662(c) states that in cases of justified service or rate complaints, the PRC may order unlawful rates to be adjusted to lawful levels, ordering the cancellation of market tests, *ordering the Postal Service to discontinue providing loss-making products*, [emphasis added] or requiring the Postal Service to make up for revenue shortfalls in competitive products).

⁶ Special services are mail services for a fee in addition to required postage that include Registered Mail™, Certified Mail™, Insured Mail, Collect on Delivery, recorded delivery, special delivery, special handling, parcel airlift, business reply mail, and return receipt for merchandise.

While foreign posts have turned to alternate businesses—including banking, investment, and insurance—to address their economic challenges, the Postal Act prohibits the Postal Service from offering non-postal products and services, except for a limited number that were offered before January 1, 2006. In addition, the Postal Service faces challenges to innovation that private sector businesses are not subject to. For example, the Postal Service must prove to the PRC that new products and services will not violate statutory restrictions and will not create an unfair competitive advantage. The Postal Service may not offer loss leaders, whereas private sector businesses are free to use this business strategy. The Postal Service is also required to attribute costs in such a way that new products bear the full cost of research and development, advertising and promotion, and implementation.⁷ In the private sector, many of these costs are considered overhead. Further, each product the Postal Service offers must bear transaction costs as an individual unit, even though items sold at retail facilities are often add-ons to other transactions with lower incremental costs.

Under legislation proposed in September 2010,⁸ the prohibition against offering non-postal products and services would be revised, allowing non-postal offerings that are in the public interest and making use of the existing postal network, thereby giving the Postal Service additional flexibility. The Postal Service would also be permitted to offer services to state and local governments. For example, post offices might provide voter registration and driver's license renewal.

While we recognize the Postal Service is legislatively constrained from entering the financial industry, in order to meet the needs of consumers and business partners in the 21st Century, the Postal Service must pursue product, process, and technology innovations the statute does not prohibit while it works toward legislative changes. These innovations could include line extensions, additional special services, and experimental products. Without innovations that leverage technological advances and changing consumer needs, the Postal Service risks insolvency. See [Appendix B](#) for our detailed analysis of this topic.

Postal Service Innovation Efforts

Although the Postal Service does not have a formal innovation process or a comprehensive innovation strategy, it has introduced innovations such as Priority Mail Flat Rate Boxes, IMb, Critical Mail, Simplified Addressing, and the FSS. One of the Postal Service's most significant innovations was the introduction of worksharing in 1976, a large-scale outsourcing of postal operations to the private sector, resulting in lower total postage costs and increased mail volume. Approximately 80 percent of mail volume is currently workshared. The Postal Service has also introduced complex

⁷ The PRC "shall...promulgate...regulations to ensure that each competitive product covers its costs attributable and ensure that all competitive products collectively cover what the Commission determines to be an appropriate share of the institutional costs of the Postal Service." 39 U.S.C. §3633(a)(2)-(3).

⁸ Senator Tom Carper introduced The Postal Operations Sustainment and Transformation (POST) Act of 2010 on September 23, 2010.

information systems such as the Address Information System (AIS)⁹ and Delivery Operations Information System (DOIS),¹⁰ which are essential for managing its large-scale operations. Postal Service automation innovations also required adjustments to its network operations,¹¹ delivery services, and human resource management. See [Appendix B](#) for our detailed analysis of this topic.

Comprehensive Innovation Strategy Needed

The Postal Service does not have a comprehensive innovation strategy that partners with stakeholders to grow new revenue streams and provides feedback from concept design to market implementation and success. Rather, the Postal Service's innovation strategies have focused primarily on enhancing existing products and addressing operational needs. Postal Service officials have focused mainly on day-to-day operations rather than on new product development and do not utilize product development specialists, product owners, and distinct innovation teams that are free from operational responsibilities to energize and engineer the innovation of new revenue streams and products. Product implementation can experience delays or failure without designated product owners, free from the conflicting demands of daily operations, to track progress. See [Appendix B](#) for our detailed analysis of this topic.

Need for a Consolidated Approach to Product Development

Although the Postal Service has a process for approving investments in some new products, it does not have a consolidated approach to product development. Rather, each functional unit follows its own procedures. Those procedures depend on the type of product being developed and the resources required to implement the product. Further, while the Postal Service provides instructions for submitting ideas, concepts, products, processes, or technology in a publication,¹² these instructions address improvements in Postal Service operations, not entrepreneurial marketing efforts intended to increase market share. Further, the type of submissions these instructions cover is limited, and the instructions provide little guidance beyond an address to which to send the proposal. See [Appendix B](#) for our detailed analysis of this topic.

Need for Independent Innovation Teams

The Postal Service could benefit from independent innovation teams. Innovation experts contend that to innovate successfully, companies must distinguish the innovation team from operations. According to a recent Capgemini survey of 28 postal operators from around the world, "among those operators who consider themselves innovative...most have defined, separate budgets, teams, and decision-making processes in place."

⁹ AIS products are raw database files made available to customers to enhance address standardization and/or obtain detailed address information.

¹⁰ DOIS is a system developed to improve the management of delivery unit operations. Delivery unit supervisors use DOIS to effectively manage the daily activities of city carriers.

¹¹ Network Operations is responsible for the national network of mail processing and distribution centers, and the domestic transportation network that moves the U.S. Mail.

¹² Publication 131, *The Postal Service Unsolicited Proposal Program*, published January 2003.

Innovation experts Vijay Govindarajan and Chris Trimble also emphasize the importance of distinguishing the innovation team from operations, stating, “Every innovation initiative needs a special kind of team and plan.” They stated, “One of the most common reasons that established companies struggle to execute innovation initiatives is that they fail to appreciate just how differently they must treat them. The group working on an innovation initiative cannot just be a home to a more creative culture....The innovation team must be distinct from [operations].”

The Postal Service lags behind leading innovative companies such as Procter & Gamble (P&G), Nokia, and 3M in this regard. Unlike the Postal Service, these companies have implemented strategic processes or business units specifically designed to foster innovation, unencumbered by the demands of day-to-day operations. For example, P&G created the position of vice president for innovation and knowledge and transformed its traditional in-house research and development process into an open-source innovation strategy. Nokia has a research center dedicated to open innovation through collaboration with world-leading institutions, and 3M uses teams of four to six individuals from both technical and marketing functions to explore areas where existing company knowledge is slim, because those areas represent prime areas for generating new products and concepts.

In each case, what matters is not the exact organizational structure, but that those tasked with innovation are free to focus on innovation. Innovative companies use a top-down innovation strategy with dedicated staff to coordinate and focus their efforts. Their innovation teams thus have the opportunity to develop creative solutions to ever-changing consumer demands, because they do not carry the additional burden of meeting operational goals. Instead, they can focus on solving consumer problems and meeting customer needs with innovative products. To understand how a company can meet its customers' needs, innovation teams cannot be isolated from operations, but they must not be impeded by operational duties either. See [Appendix B](#) for our detailed analysis of this topic.

Need to Effectively Manage Ideas from External Stakeholders

The Postal Service has a system to track ideas for improvements that are generated by Postal Service employees. The eIDEAS program is a web-based application that allows Postal Service employees to submit ideas online or at kiosks located in processing plants. The Postal Service encourages employees to contribute constructive ideas to improve customer satisfaction, generate revenue, increase productivity, and improve competitiveness.¹³ However, management of that system has been troubled. A U.S. Postal Service Office of Inspector General (OIG) report published in August 2010¹⁴ found that the eIDEAS program was not timely, and management's resulting actions were not transparent.

¹³ Local supervisors usually complete level 1 evaluations. District or area managers usually complete level 2 evaluations. National - level personnel or functional vice presidents usually complete level 3 evaluations.

¹⁴ *eIDEAS Timeliness and Transparency*, Report Number DA-MA-10-003, dated August 3, 2010.

Although it has a system for employee ideas, the Postal Service has not developed a formal tracking system to capture innovation ideas presented by the public and members of the mailing community. Such a tracking system would allow the Postal Service to systemically evaluate the ideas presented, including trends or common overarching themes regarding ideas for innovation.

Tracking of innovative ideas is even more important as the Postal Service begins engaging stakeholders in a more focused way on the process of innovation. The Postal Service has held three innovation symposiums in the past year to seriously engage with stakeholders on innovation. At the August 11, 2010, Mailers' Technical Advisory Committee Innovation Symposium, one of the presenters¹⁵ proposed creating a culture of innovation. In Portland, OR, on September 15, 2010, the postmaster general stressed that long-term sustainability for the Postal Service will be achieved through fundamental change. He asked Postal Customer Councils (PCC) and the mailing industry for their best ideas on new products and services and encouraged them to become a part of the Postal Service's "era of innovation." At the William F. Bolger Academy in Potomac, MD, on October 13, 2010, approximately 200 stakeholders representing Congress, regulators, customers and the Postal Service heard presentations from experts on the future of the mail and shared their thoughts on innovation.

Some entrepreneurs seeking to partner with the Postal Service by introducing innovative products or services offered their views regarding obstacles they encountered. During interviews with the OIG, they described a Postal Service culture resistant to change and unresponsive to customers' needs. We interviewed individuals who attempted to introduce or develop innovations at the Postal Service to obtain feedback regarding their experiences. One individual developing innovative software for the Postal Service noted that management delayed the project so much that it eventually failed. However, several years later, the Postal Service implemented a similar application. Another individual experienced significant delays in obtaining approval for a mailing product that met his customers' needs and satisfied Postal Service regulations. These entrepreneurs cited further obstacles to innovation, including:

- Guidelines regarding whom to approach with new ideas or improvements to existing products and services are not transparent and easily identifiable.
- The Postal Service dictates conditions to customers rather than listening to customers' suggestions.
- The Postal Service discourages innovation by requiring innovators to present ideas without providing assurance that either the idea will be safeguarded or the innovator compensated.

¹⁵ Chuck Chamberlain and Ty Taylor, *Improving Innovation at USPS*.

- The Postal Service resists adopting innovations suggested by customers if those innovations do not fit seamlessly into current operations. Instead, it requires customers to modify their innovations to meet all current standards.
- A process has not been established for approving new products and services or improvements to existing ones.
- Feedback regarding approval of products and services is not presented timely.
- Innovators within the Postal Service tend to get pushed out.
- There is an “us versus them” attitude.
- The Postal Service does not reward risk takers.
- The Postal Service, in certain situations, prohibits vendors from meeting with engineers to determine why products fail tests.

While the Postal Service is making an effort to engage a culture of innovation, the lack of a comprehensive innovation strategy including systemic tracking and management of innovative ideas has the effect of both limiting strategic vision and creating an organization that responds slowly to a rapidly changing business and technological environment. To overcome the challenges it faces, the Postal Service must reach beyond its current vision and embrace a culture of innovation that begins with the most senior levels of management, understand the process that turns ideas into innovation, and commit to an organizational structure that allows innovation teams to work free from the constraints of day-to-day operations. Without such a comprehensive innovation strategy, the Postal Service jeopardizes its long-term viability through loss of business to electronic diversion and industry competitors. See [Appendix B](#) for our detailed analysis of this topic.

We recommend the vice president, Government Relations and Public Policy:

1. Continue to work toward legislative changes that will allow the Postal Service more flexibility to introduce new products and services.

We recommend the president and chief marketing/sales officer and the chief financial officer and executive vice president:

2. Consider a comprehensive innovation strategy, based on the best practices of companies considered leaders in the field that includes innovation teams that are both independent of operations and actively collaborate with outside organizations, or other generally accepted forms of innovation teams. The strategy should also contain a system to support tracking and management of innovative ideas that are generated.

Management's Comments

Management agreed with our findings and recommendation 1. Management stated that the Postal Service's Government Relations group widely shared the requested legislative language with members of Congress in March and April 2010 and continues to advocate for this change. Management further stated that they support recent legislation introduced by Senator Carper on September 23, 2010, and May 17, 2011,¹⁶ which includes language increasing the Postal Service's ability to offer new products and services.

Management did not agree with recommendation 2 and stated that they currently have procedures in place to collaborate with customers and outside organizations. Further, they do not believe additional investment in separate innovation teams is warranted at this time due to legal and competitive constraints. In the Postal Service's recent organizational redesign, all innovative ideas are managed and tracked by the chief information officer, who is independent of the chief operating officer. See [Appendix E](#) for management's comments, in their entirety.

Evaluation of Management's Comments

The OIG considers management's comments responsive to recommendation 1, and corrective actions should resolve the issues identified in the report. Based on management's actions, we consider this recommendation closed.

We consider management's response to recommendation 2 non-responsive, as we continue to believe that the Postal Service would benefit from implementing a comprehensive innovation strategy using innovation teams that are independent of operations and actively collaborative with outside organizations. We view the disagreement on recommendation 2 as unresolved, but at this time, we do not plan to pursue it through the formal audit resolution process.

¹⁶ S. 1010, *Postal Operations Sustainment and Transformation Act of 2011*.

We appreciate the cooperation and courtesies provided by your staff. If you have any questions or need additional information, please contact Janet M. Sorensen, director, Sales and Service, or me at 703-248-2100.

E-Signed by Darrell E. Benjamin, Jr. 
VERIFY authenticity with e-Sign

Darrell E. Benjamin, Jr.
Deputy Assistant Inspector General
for Revenue and Systems

Attachments

cc: Corporate Audit and Response Management

APPENDIX A: ADDITIONAL INFORMATION

BACKGROUND

Innovation experts Vijay Govindarajan and Chris Trimble believe innovation is important enough to claim, “through innovation, business organizations can change the world.” Though the Postal Service’s mission is not to change the world, the Postal Service is a critical part of the world’s economy and communications network and must become a proficient innovator if it is to survive the economic challenges it faces. In an Aberdeen Group survey,¹⁷ manufacturers who improved product innovation processes reported an increase in revenue and a decrease in costs. The Boston Consulting Group’s sixth annual global survey and report on innovation¹⁸ found that innovative companies generate vastly superior total returns for shareholders. If innovation is crucial to a company’s ability to increase revenue and decrease costs, to provide superior return on investment—perhaps even to survive—the Postal Service must understand what innovation is and how to successfully implement it.

Dirk Palder, vice president of the Global Postal Leadership Team at Capgemini, states that innovation is the implementation of a new product, service, or process. It indicates a new way of doing something, he notes, and may refer to incremental and emergent or radical and revolutionary changes in thinking, products, processes, or organizations. Palder differentiates between invention—the first occurrence of an idea for a new product or process, and innovation—the first attempt to carry the idea out into practice. Stephen Shapiro, author of *Stephen Shapiro’s Little Book of Big Innovation Ideas*, also distinguishes between ideas and innovation. He stated that to move from merely generating ideas—which many companies do very well—to innovation, you need a process to systematically gather, filter, and implement ideas. The process should:

- Define opportunities.
- Find solutions.
- Strengthen, select, and plan.
- Implement.

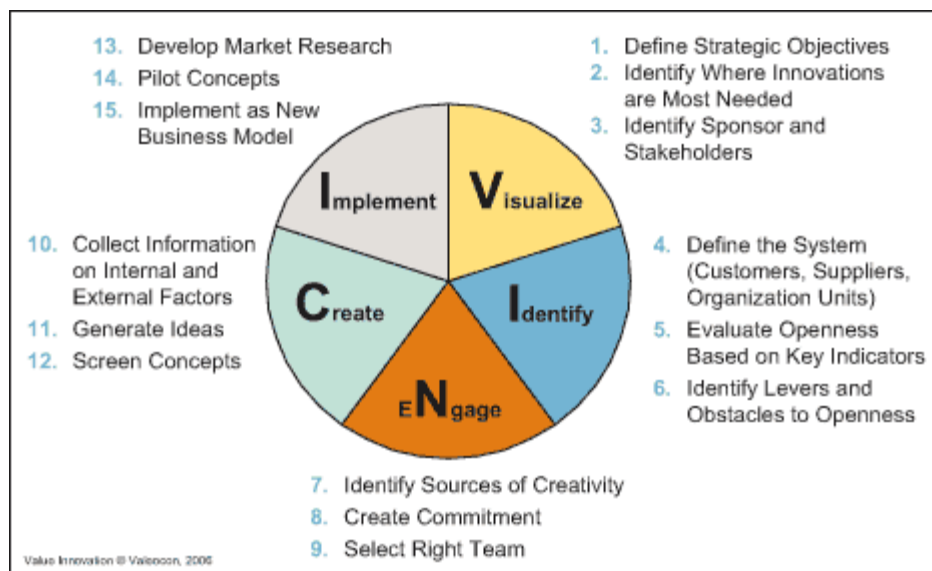
Steve Crom, an innovation leader at Valeocon Management Consulting outlined the process as:

- Visualize.
- Identify.
- Engage.
- Create.
- Implement.

¹⁷ *The Product Innovation Agenda Benchmark Report: Product Innovation, Product Development, and Engineering Improvement for Profitable Growth*, September 2005.

¹⁸ *Innovation 2009: Making Hard Decisions in the Downturn*, April 2009.

Each step is further broken down, as illustrated in the following diagram:



Regardless of how one defines the steps, experts suggest two necessary conditions for any innovation initiative to succeed: 1) Every level of management, from the top down, must support the initiative, and 2) the innovation team must be distinct and independent from operations. Additionally, this strategy would address the various phases of innovation, including idea intake, tracking, triage, assignment to responsible entities and monitoring of success.

OBJECTIVE, SCOPE, AND METHODOLOGY

Our objective was to assess the Postal Service's innovation process for competitive and market-dominant products. To accomplish our objective, we:

- Reviewed the PRA, Postal Act, and policies related to Postal Service market-dominant and competitive products.
- Interviewed Postal Service Headquarters officials to obtain an understanding of their innovation process, market-dominant and competitive products, and Postal Service initiatives.
- Reviewed available project documents, projections and approvals to determine the process of implementing market-dominant and competitive product initiatives.
- Reviewed the Postal Service's lists of product filings to the PRC.
- Reviewed literature describing the innovation process in the current business environment.

- Interviewed Postal Service business partners who have sought to introduce innovative products or services.

We conducted this performance audit from March 2009 through June 2011 in accordance with generally accepted government auditing standards and included such tests of internal controls as we considered necessary under the circumstances. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. We discussed our observations and conclusions with management on April 6, 2011, and included their comments where appropriate.

PRIOR AUDIT COVERAGE

| Report Title | Report Number | Final Report Date | Report Results |
|--|---------------|-------------------|---|
| <i>eIDEAS Timeliness and Transparency</i> | DA-MA-10-003 | 8/3/2010 | We found the eIDEAS program was not timely, and management's resulting actions were not transparent. Specifically, while the eIDEAS program guide stipulates evaluators assess ideas within 7 days of submission, we found that evaluators took more than 2 years to process some ideas. We recommended that management re-evaluate Postal Service's level of commitment to the eIDEAS program and implement modifications as appropriate. We also recommended that management take action to improve the timeliness of the evaluation process and the transparency of resulting management actions. Management agreed with our recommendations. |
| <i>U.S. POSTAL SERVICE: Legislation Needed to Address Key Challenges</i> | GAO-11-244T | 12/2/2010 | The Postal Service's financial condition continued to decline in FY 2010 and its financial outlook is poor for FY 2011 and the foreseeable future. The Postal Service incurred a record \$8.5 billion loss, increased its outstanding debt to the U.S. Department of Treasury by \$1.8 billion to a total of \$12 billion, and ended FY 2010 with a \$1.2 billion cash balance. The Postal Service has reported close to \$13 billion in cost savings in the past 5 fiscal years. However, as FCM, its most profitable core product, continues to decline, the Postal Service must modernize and restructure to become more efficient, control costs, keep rates affordable, and meet changing customer needs. The proposed POST Act provides a starting point for addressing key issues facing the Postal Service and facilitating changes that will take time to implement and produce results. Three key areas addressed by the bill include compensation and benefits, rightsizing Postal Service networks and workforce, and whether to allow the Postal Service to expand its non-postal activities. Allowing the Postal Service to expand into non-postal activities raises issues of how to mitigate risks associated with new lines of business, assure fair competition with the private sector, and how to finance such efforts. Congress and the Postal Service urgently need to take action to restore the Postal Service's financial viability. |

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|--|---------------|-----------|--|
| <i>USPS Financial Challenges Continue, with Relatively Limited Results from Recent Revenue- Generation Efforts</i> | GAO-10-191-T1 | 11/5/2009 | <p>The testimony focused on the Postal Service's financial condition and outlook; described that the Postal Act provided the Postal Service with greater flexibility to generate revenues; outlined the results that the Postal Service achieved using this flexibility since 2006; and discussed options for the Postal Service to generate increased revenues in the future. Except for annual rate increases, the Postal Service revenue-generation actions since the Postal Act was enacted have generally achieved limited results compared to its deficits. The GAO stated the Postal Service has opportunities to continue pursuing the flexibilities provided by the Postal Act to help generate additional revenue from postal products and services, while also making significant reductions in its workforce and network costs. Restructuring will require the Postal Service to align its costs with revenues, generate sufficient earnings to finance capital investment, and manage its debt.</p> |
|--|---------------|-----------|--|

APPENDIX B: DETAILED ANALYSIS

Regulatory Constraints

The PRA transformed the Post Office Department into an independent establishment in order to improve the overall management and efficiency of the Post Office. The business model created by the PRA relied on moderate volume growth and periodic rate increases at or below the rate of inflation to finance universal service and the expanding delivery network. The Postal Service was a monopoly, and mail volume increased as the economy grew. The core products and services were set by legislation, and public policy set stringent restrictions on the exercise of postal monopoly power. While this business model was sufficient to finance operations throughout most of the 20th Century, it did not anticipate the impact of electronic diversion and economic downturn.

Foreign posts experiencing many similar financial challenges have turned to alternate businesses—including banking, investment, and insurance—to address their economic challenges. (See [Appendix D](#) for a detailed analysis of foreign postal innovations.) However, the Postal Act prohibits the Postal Service from offering products similar to foreign posts, except for a limited number of products that were offered before January 1, 2006. Specifically, it states,

Nothing in this section shall be considered to permit or require that the Postal Service provide any nonpostal service, except that the Postal Service may provide nonpostal services which were offered as of January 1, 2006.¹⁹

It also states,

...not later than 2 years after the date of enactment of the [Postal Act], the Postal Regulatory Commission shall review each nonpostal service offered by the Postal Service on the date of enactment of that Act and determine whether that nonpostal service shall continue, taking into account the public need for the service; and the ability of the private sector to meet the public need for the service.²⁰

¹⁹ 39 U.S.C. § 102(2). The Postal Act defines a non-postal service as “any service that is not a postal service defined in 39 U.S.C. § 102(5).” In turn, 39 U.S.C. 101(5) defines a postal service as “the delivery of letters, printed matter, or mailable packages, including acceptance, collection, sorting, transportation, or other function ancillary thereto.” Non-postal services are therefore very broadly defined and preclude offerings commonly found at many other retail establishments.

²⁰ 39 U.S.C. § 102(3).

While the Postal Act gave the Postal Service some additional operational and market flexibility,²¹ under the Postal Act, the Postal Service maintains its monopoly of market dominant products²² but may not introduce new non-postal products.²³

In addition, the Postal Service faces significant challenges to innovation that private sector businesses are not subject to. For example, the Postal Service bears the burden of proof with the PRC that new products and services will not violate statutory restrictions, will cover their attributable costs, and will not create an unfair competitive advantage.

Specifically, the PRC may limit the amount of revenue the Postal Service generates from any particular geographic market to prevent the Postal Service from having an unfair competitive advantage. The Postal Service is further limited to performing experimental tests on products and services that are significantly different from their current offerings.²⁴ In addition, the Postal Service may not offer loss leaders, whereas private sector businesses are free to use this business strategy.

The Postal Service is also required to attribute costs in such a way that every new product bear the full cost of research and development, advertising and promotion, and implementation. In the private sector, many of these costs are considered overhead. Also, each product the Postal Service offers must bear transaction costs as an individual unit, even though items sold at retail facilities are often add-ons to other transactions with lower incremental costs.

While these statutory and market constraints make it difficult for the Postal Service to bring innovative products and services to the market, the Postal Service has opportunities to further innovate postal products, processes, and technology that are not explicitly prohibited by legislation. These innovations would assist in meeting the needs of consumers and ensuring the continued viability of the Postal Service.

Under legislation proposed in September 2010,²⁵ the prohibition against offering non-postal products and services would be revised, allowing non-postal offerings that are in the public interest and making use of the existing postal network, thereby giving the Postal Service additional flexibility. The Postal Service would also be permitted to offer services to state and local governments. For example, Post Offices might provide voter registration and driver's license renewal. While increased innovation efforts are possible, current legislation makes it challenging for the Postal Service to replace

²¹ For example, 39 U.S.C. § 3622(b) gives the Postal Service pricing flexibility for its market dominant products and allows retained earnings.

²² 39 U.S.C. § 3621(a) defines market dominant products as First-Class Mail ® (FCM) letters and sealed parcels, FCM cards, periodicals, standard mail, single-piece parcel post, media mail, bound printed matter, library mail, special services, and single-piece international mail.

²³ 39 U.S.C. § 102(2).

²⁴ The Postal Act states that experimental products must be "significantly different from all products offered by the Postal Service within the 2-year period preceding the start of the test." § 203(b)(1).

²⁵ Senator Tom Carper introduced The Postal Operations Sustainment and Transformation (POST) Act of 2010 on September 23, 2010.

revenue losses resulting from lower mail volume with new revenue streams generated by innovative products.

Postal Service Innovation Efforts

Although the Postal Service does not have a formal innovation process or a comprehensive innovation strategy, it has introduced innovations such as Priority Mail Flat Rate Boxes, IMb, and the FSS. According to usps.com, mailers can ship anything that fits into a flat rate box anywhere in the U.S. for one rate. Mailers do not need to weigh or calculate anything, and packages reach their destination in 2 to 3 days. An IMb placed on a mailpiece is capable of uniquely identifying the sender, mailpiece, or mail aggregate; providing a destination ZIP Code for sortation and routing; and encoding special service indicators or Address Change Service™ requests. The FSS sorts flat-sized mail into walk sequence for each letter carrier, which has resulted in significant operational efficiencies and cost savings for the Postal Service.

One of the Postal Service's most significant innovations was the introduction of worksharing in 1976, a large-scale outsourcing of postal operations to the private sector, resulting in lower total postage costs and increased mail volume. Approximately 80 percent of current mail volume is workshared. The Postal Service has also introduced complex information systems essential for managing its large-scale operations (for example, the AIS²⁶ and DOIS²⁷). Enhancements to the Postal Service's automation program also required adjustments to its network operations,²⁸ delivery services, and human resource management.

Comprehensive Innovation Strategy Needed

The Postal Service does not have a comprehensive innovation strategy that partners with stakeholders to grow new revenue streams and provides feedback from concept design to market implementation and success. Rather, the Postal Service's innovation strategies have focused primarily on enhancing existing products and addressing operational needs. Postal Service officials have focused mainly on day-to-day operations rather than on new product development and do not utilize product development specialists, product owners, and distinct innovation teams that are free from operational responsibilities to energize and engineer the innovation of new revenue streams and products. Product implementation can experience delays or failure without designated product owners, free from the conflicting demands of daily operations, to track progress.

Need for a Consolidated Approach to Product Development

Although the Postal Service has a process for approving investments in some new products, it does not have a consolidated approach to product development. Rather, each functional unit follows its own procedures. Those procedures depend on the type

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of product being developed and the resources required to implement the product. Further, while the Postal Service provides instructions for submitting ideas, concepts, products, processes, or technology in a publication,²⁹ these instructions address improvements in Postal Service operations and not entrepreneurial marketing efforts intended to increase market share. Further, the type of submissions these instructions cover is limited, and the instructions provide little guidance beyond an address to which to send the proposal. The absence of a consolidated approach has the effect of both limiting strategic vision and creating an organization that responds slowly to a rapidly changing business and technological environment.

Need for Independent Innovation Teams

Innovation experts contend that to innovate successfully, companies must separate the innovation team from operations. According to the Capgemini study, “among those operators who consider themselves innovative...most have defined, separate budgets, teams, and decision-making processes in place.” The study points out, “to take innovations from their infancy to something that will well serve both the operators and their customers requires a shift in corporate culture.”

Dirk Palder, vice president of the Global Postal Leadership Team at Capgemini, in a survey of 28 postal operators from around the world, states that postal innovations need to be managed more tightly and with an end-to-end perspective if they are to be successful.³⁰ Innovations are not a matter of delegation, but rather of organization, from thought to finish and should be delivered by a single unified team. Postal operators around the world need to plan the innovation process carefully through clear end-to-end innovation management, starting at the board level, to encourage an entrepreneurial culture that allows innovation to grow and flourish and promotes company-wide enthusiasm for change.

Innovation experts Vijay Govindarajan and Chris Trimble also emphasized the importance of distinguishing the innovation team from operations, stating that “every innovation initiative needs a special kind of team and plan.” They stated,

one of the most common reasons that established companies struggle to execute innovation initiatives is that they fail to appreciate just how differently they must treat them. The group working on an innovation initiative cannot just be a home to a more creative culture....The innovation team must be distinct from [operations].

The Postal Service lags behind leading innovators like P&G, Nokia, and 3M. For example, P&G created the position of vice president for innovation and knowledge and transformed its traditional in-house research and development process into an open-

²⁹ Publication 131, *The Postal Service Unsolicited Proposal Program*, published January 2003.

³⁰ *Innovation Management in the Postal Industry – the Key for Business Transformation*, Capgemini, September 8, 2010.

source innovation strategy called “Connect + Develop.”³¹ Launched in 2001, Connect + Develop’s goal was to deliver 50 percent of the company’s innovation through external collaboration. P&G exceeded that goal, resulting in innovations such as Swiffer Dusters®, Tide Total Care™, Mr. Clean® Magic Eraser, and the Oral B® Pulsonic® Toothbrush. Connect + Develop has established more than 1,000 active agreements with innovation partners, and in October 2010 P&G announced its intention to triple the impact of the program.

Nokia has a research center that engages in open innovation through research collaborations with world-leading institutions. Its Open Innovation network reflects its ambition to foster innovation, tackle key technical challenges, and unlock global business opportunities in collaboration with the world’s leading experts.

William McKnight, former chairman of the board, created a corporate culture at 3M that encourages employee initiative and innovation. 3M uses teams of four to six individuals from both technical and marketing functions to explore areas where existing company knowledge is slim, because those areas represent prime locations for generating new products and concepts.³² 3M’s most successful product innovations, such as Scotch® tape and Post-it® Notes, solved problems and met customer needs. These products changed the competitive playing field by introducing new ideas to the marketplace.³³ William Coyne, former senior vice president of research and development, summarized the 3M view of innovation: “At 3M, we live by our wits. Innovation may be an important element of other corporate strategies; but for us, innovation is our strategy.”³⁴

In each case, what matters is not the exact organizational structure but that those tasked with innovation are free to focus on innovation. Innovative companies use a top-down innovation strategy with dedicated staff to coordinate and focus their efforts. Their innovation teams thus have the opportunity to develop creative solutions to ever-changing consumer demands, because they do not carry the additional burden of meeting operational goals. Instead, they can focus on solving consumer problems and meeting customer needs with innovative products. To understand how a company can meet its customers’ needs, innovation teams cannot be isolated from operations, but they must not be impeded by operational duties either.

Need to Effectively Manage Ideas from External Stakeholders

The Postal Service has a system to track ideas for improvements that are generated by Postal Service employees. The eIDEAS program is a web-based application that allows Postal Service employees to submit ideas online or at kiosks located in processing plants. The Postal Service encourages employees to contribute constructive ideas to improve customer satisfaction, generate revenue, increase productivity, and improve

³¹ P&G’s website states Connect + Develop is its “version of open innovation: the practice of accessing externally developed intellectual property in [its] own business and allowing [its] internally developed assets and know-how to be used by others.”

³² Shor, R. *Managed Innovation: 3M’s latest model for new products*, January 16, 2006.

³³ *A Century of Innovation: The 3M Story*, pp. 22, 102. 3M Company, 2002.

³⁴ *Ibid.*, p. 32.

competitiveness.³⁵ However, management of that system has been troubled. An OIG report published in August 2010³⁶ found that the eIDEAS program was not timely and management's resulting actions were not transparent.

Although it has a system for employee ideas, the Postal Service has not developed a formal tracking system to capture innovation ideas presented by the public and members of the mailing community. Such a tracking system would allow the Postal Service to systemically evaluate the ideas presented, including trends or common overarching themes regarding ideas for innovation.

Tracking of innovative ideas is even more important as the Postal Service begins engaging stakeholders in a more focused way on the process of innovation. The Postal Service has held three innovation symposiums in the past year to seriously engage with stakeholders on innovation. At the August 11, 2010, Mailers' Technical Advisory Committee Innovation Symposium, one of the presenters³⁷ proposed creating a culture of innovation. In Portland, OR, on September 15, 2010, the postmaster general stressed that long-term sustainability for the Postal Service will be achieved through fundamental change. He asked PCC and the mailing industry for their best ideas on new products and services and encouraged them to become a part of the Postal Service's "era of innovation." At the William F. Bolger Academy in Potomac, MD, on October 13, 2010, approximately 200 stakeholders representing Congress, regulators, customers and the Postal Service heard presentations from experts on the future of the mail and shared their thoughts on innovation.

Some entrepreneurs seeking to partner with the Postal Service by introducing innovative products or services offered their views regarding obstacles they encountered. During interviews with the OIG, they described a Postal Service culture resistant to change and unresponsive to customers' needs. We interviewed individuals who attempted to introduce or develop innovations at the Postal Service to obtain feedback regarding their experiences. One individual developing innovative software for the Postal Service noted that management delayed the project so much that it eventually failed. However, several years later, the Postal Service implemented a similar application. Another individual experienced significant delays in obtaining approval for a mailing product that met his customers' needs and satisfied Postal Service regulations.

While the Postal Service is making an effort to engage a culture of innovation, the lack of a comprehensive innovation strategy including systemic tracking and management of innovative ideas has the effect of both limiting strategic vision and creating an organization that responds slowly to a rapidly changing business and technological environment. To overcome the challenges it faces, the Postal Service must reach beyond its current vision and embrace a culture of innovation that begins with the most

³⁵ Local supervisors usually complete level 1 evaluations. District or area managers usually complete level 2 evaluations. National - level personnel or functional vice presidents usually complete level 3 evaluations.

³⁶ *eIDEAS Timeliness and Transparency* (Report Number DA-MA-10-003, dated August 3, 2010).

³⁷ Chuck Chamberlain and Ty Taylor, *Improving Innovation at USPS*.

senior levels of management, understand the process that turns ideas into innovation, and commit to an organizational structure that allows innovation teams to work free from the constraints of day-to-day operations. Without such a comprehensive innovation strategy, the Postal Service jeopardizes its long-term viability through loss of business to electronic diversion and industry competitors.

APPENDIX C: NEW INITIATIVES INVESTMENT PROCESS

Handbook F-66D, *Investment Policies and Procedures — Business Initiatives, Alliances, Real Estate Development, and Major Operating Expense Investments*, provides guidance for investment in some new products and services, enhancements to existing products and services, and new initiatives intended to generate revenue. New initiatives have the potential to significantly impact revenue and have high public visibility. Therefore, the Postal Service has a fiduciary responsibility to subject new initiatives to rigorous financial analysis, testing, and measurement, to determine whether they will make a positive financial contribution to the organization. However, only a small percentage of products and services are subject to the Handbook F-66D process.

The current product development, enhancement, and initiative investment approval process requires Postal Service officials to:

- Generate ideas for new products, enhancement or modification to core business.
- Prepare a business proposition statement.
- Develop a business plan.
- Perform operation test.
- Perform market test.
- Implement project.
- Track performance.

Idea Generation

Generate idea for enhancement or modification to core business by:

- Listening to customers.³⁸
- Conducting market research.
- Obtaining sales feedback.
- Reviewing suggestions from management.
- Obtaining a competitive response.
- A representative of the senior vice president adds the idea to the project tracking database with the following information:
 - Name of project (deliverable).
 - Date proposal was submitted.
 - Brief description of idea.
 - Key milestones and who is responsible for action (when, who, status of action).

³⁸ This step takes place within the context of the internal approval process for investment spending; it does not require active solicitation of innovative ideas from customers.

Business Proposition Statement

The project manager prepares business proposition statement, which outlines:

- Concept overview and rationale, business description, market situation, investment costs, and expected outcomes.
- Business definition, identifiable customers, services or product, distribution approach, value added, Postal Service positioning in market, and strategic fit.
- Issues to be addressed, target customers, product, market potential, competitive environment, Postal Service competency, technology, use of Postal Service facilities, capital investment, testing, and regulatory issues.
- Approval of business proposition statement by sponsoring vice president and senior vice president, which is then forwarded to Postal Service Finance.

Preliminary Business Plan

A cross-functional team updates the business proposition statement to form a preliminary business plan. At a minimum, the cross-functional team includes members from the Postal Service offices of General Counsel, Finance, and Supply Management. The preliminary business plan includes:

- Business concept.
- Market analysis.
- Product design specifications and business impact.
- Service delivery and operations.
- Operations and market test specifications.
- Drafts of agreements and contracts.
- Quality standards and measures.
- Financial analysis.
- Project schedule and process review milestones through roll-out plan.
- Responsibilities of sponsoring vice president.
- Resolution of any issues from a cross-functional team. Submission of documents to the Executive Committee of preliminary business plan and proposed operations test.

Operations Test

Conduct an operations test in a geographic area representative of the operational environment expected during roll-out. Limit the test to one market with limited customers. The test should validate the fundamental assumptions laid out by the cross-functional team. The project manager evaluates the results of the operations test with the cross-functional team:

- Summarize operations test results.

- Determine if success criteria are met.
- Develop market test plan incorporating experience from operations test.
- The project manager presents the recommendations to the sponsoring vice president. If the success criteria are not met, recommend no go or change in initiative.
- The sponsoring vice president briefs the Executive Committee on recommendations for market test.
- Upon recommendation by the Executive Committee, the sponsoring vice president provides the preliminary business plan to the Strategic Planning Committee of the Board of Governors (BOG).

Market Test

Test according to market test plan in several major, diverse markets. Determine the locations of the market tests based on sites that are representative of planned future expansion. The project manager evaluates the test results with the cross-functional team.

- Summarize market test results.
- Determine if success criteria are met.

Final Business Plan

The project manager, with input from cross-functional team, revises the business plan incorporating experience from the market test. The project manager presents recommendations to sponsoring vice president, making changes as necessary. If success criteria are not met, recommend no go or change in initiative. The sponsoring vice president briefs the senior vice president.

- The senior vice president briefs the Executive Committee on the business plan and makes recommendations for roll-out. The Executive Committee determines if the project needs approval by the BOG. If BOG approval is required, the business plan stage of process is followed.
- Upon recommendation by the Executive Committee, the sponsoring vice president provides the final business plan to the BOG Strategic Planning Committee.
- Roll out implementation to field units.
- Schedule roll-out implementation.

- Plan training.
- Plan communications.
- Execute plans.
- The project manager, in conjunction with Postal Service Finance, tracks results against plan and assesses continued strategic fit.

Project Implementation Review

- The senior vice president briefs the Executive Committee on the success of the roll out.

APPENDIX D: EXAMPLES OF FOREIGN POSTAL ADMINISTRATION INNOVATION EFFORTS

The Capgemini study stated, "There is a general tendency among all postal operators to diversify by investments outside their core business (mail, parcel)," especially into the logistics and financial services areas. Among European operators, Poste Italiane, Swiss Post, Deutsche Post DHL (Germany), and Austrian Post in particular have increased their share of the non-core business.

Poste Italiane

According to Poste Italiane's website, investments in innovation have allowed the company to guarantee its customers cutting-edge services and have made it an important factor in Italy's growth and modernization. Poste Italiane's financial statements have shown increasing profits for 8 years running, a memorable milestone after 50 years of red ink.

Post Italiane introduced the Postepay prepaid card at the end of 2003. More than 5.6 million individuals in Italy have used the prepaid Postepay card, which allows customers to make purchases and withdraw cash from ATMs and can be reloaded. Poste Italiane charges a onetime fee of €5 (\$6.44) for opening the account. Adding credit to the card or withdrawing money costs €1 (\$1.29) at an Italian Post.

Post Italiane's Postepay Gift card can be used to pay for purchases in Italy and abroad wherever MasterCard® is accepted. The card is issued at the time of purchase and can be loaded with flexible denominations of up to €500 (\$646). Postepay Gift is designed for electronic use only – that is, online over the Internet and at electronic point-of-sale locations. This enables people to shop easily and conveniently, with all of the safety, security, and control features that electronic payment cards provide.

Poste Italiane received the "Postal Technology International Award" 2009, presented to the year's top Service Provider for outstanding performance in terms of research and development and process innovation.

Swiss Post

Swiss Post provides A-Post Plus service exclusively for business customers. A-Post Plus combines next-day mail delivery service with an electronic tracking function. A-Post Plus provides the option of on-screen tracking and monitoring of the delivery process, including acceptance, delivery, and forwarding. Dispatch by A-Post Plus is more cost-effective than registered mail and is the right mailing solution if receipt does not have to be legally proven but the item contains important, valuable, irreplaceable or time-critical documents such as contracts, degree certificates, official documents or tickets.

Deutsche Post DHL

The Packstation is a free locker box service of DHL available since 2002 to customers in Germany. It is an optional alternative to home deliveries. Customers can indicate via Internet when and where they wish to receive parcels, depending on their personal preferences and availability. Customers register to become users of the locker box service and then receive access details such as a personal identification code or card. Customers ordering items from retailers provide the locker box as the shipping address. Once the delivery is made, the consignee receives a message via email.

Austrian Post

Austrian Post operates a banking network called PSK BANK. PSK BANK has an office staffed by trained financial advisors at every postal branch and offers services including:

- Free bank accounts.
- High-yield insurance products such as retirement planning products.
- Eastern European stocks.

APPENDIX E: MANAGEMENT'S COMMENTS



May 27, 2011

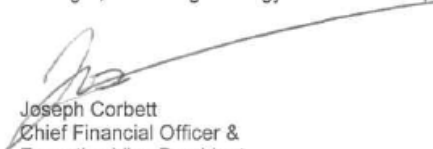
Lucine M. Willis
Director, Audit Operations
1735 North Lynn Street
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SUBJECT: Transmittal of Draft Audit Report – Postal Service's Innovation Process for
Competitive and Market-Dominant Products (Report Number MS-AR-11-DRAFT)

Thank you for the opportunity to review and comment on the subject draft audit report. We are in agreement with recommendation 1 and have some concerns relating to recommendation 2 of the report.

The subject report and this response are not believed to contain information deemed exempt from disclosure under the Freedom of Information Act.

If you have any questions or comments regarding this response, please contact Ray Van Iterson, Manager, Marketing Strategy and Innovation, at (202) 268-8155.


Joseph Corbett
Chief Financial Officer &
Executive Vice President


Paul Vogel
President & Chief
Marketing/Sales Officer


Marie Therese Dominguez
Vice President, Government
Relations & Public Policy

Attachment

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Transmittal of Draft Audit Report – Postal Service's Innovation Process for Competitive and
Market-Dominant Products (Report Number MS-AR-11-DRAFT)

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We recommend the vice president, Government Relations and Public Policy:

1. Continue to work toward legislative changes that will allow the Postal Service more flexibility to introduce new products and services.

Management Response/Action Plan: Management concurs with this recommendation. In fact, the Postal Service has already undertaken this action. On March 2, 2010, the Postal Service unveiled its *Action Plan for the Future*. One of the legislative items contained in that Plan was the need for greater statutory flexibility to offer new products and services. Government Relations widely shared the requested legislative language with Members of Congress in March and April of 2010 and continues to advocate for this change. On September 23, 2010, and May 17, 2011, Senator Tom Carper introduced S. 1010, the Postal Operations Sustainment and Transformation Act of 2011", which includes language increasing the Postal Service's ability to offer new products and services. The Postal Service strongly supports S. 1010 and the language related to new products and services.

Target Implementation Date: Ongoing

Responsible Official: Marie Therese Dominguez, Vice President, Government Relations and Public Policy

We recommend the president and chief marketing/sales officer and the chief financial officer and executive vice president consider a comprehensive innovation strategy, based on the best practices of companies considered leaders in the field, that:

2. Includes innovation teams that are both independent of operations and actively collaborate with outside organizations, or other generally accepted forms of innovation teams. The strategy should also contain a system to support tracking and management of innovative ideas that are generated.

Management Response/Action Plan: We already have procedures in place to actively collaborate with customers and outside organizations, where appropriate, in the development of innovative product and service offerings. As such, management does not believe that investments in additional innovation teams are appropriate at this time given the legal constraints around the types of products and services we can bring to market, and the competitive constraints that any business must be cognizant of when developing new products. Additionally, within our Engineering group, we conduct research and development. In our recent redesign effort, the Engineering group and research and development activities were transferred to the Chief Information Officer who is independent of the Chief Operating Officer. Management also does not believe it is necessary to create a separate system to track and manage innovative ideas. All strategic and marketing initiatives, most of which were initially an innovative idea, will be managed and tracked.