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SUBJECT: Audit Report – Postal Service’s Negotiated Service Agreement With
Capital One (Report Number ST-AR-05-001)

This report presents the results of our self-initiated audit of the Postal Service’s Negotiated Service Agreement (NSA) with Capital One Services, Inc. (Capital One) (Project Number 04BN003MS000). Our objectives were to determine the extent to which the NSA with Capital One achieved the intended results of increasing mail volume, revenue, and cost savings; and to determine whether the Postal Service could rely on the Postal Service systems used to obtain accurate and timely data on mail volume and revenue.

The Postal Service could not rely on the Permit System to account for all of Capital One’s mail volume because a third-party mailer could not provide mail volume data specific to Capital One. The Office of Inspector General (OIG) withdrew its second finding regarding use of an independent party to validate mail volume data, and the associated recommendation, because of information provided by management. The Postal Service did not establish a dedicated team for the NSA process to ensure adequate involvement by each Postal Service department required to ensure a successful NSA.

We made three recommendations to the Postal Service. In recommendation 1, we recommended the Postal Service include a clause in all future NSAs to require customers to stipulate that all third-party mailers provide the Postal Service with customer specific mail volume data. The OIG withdrew its second recommendation. In recommendation 3, we recommended the Postal Service finalize the draft Handbook for Negotiated Service Agreements.

Management disagreed in part with recommendation 1. Specifically, management agreed they would look for ways to explicitly describe obligations of third parties in providing mail volume; however, they felt the Postal Service does not need third-party mailers to provide data that are not relevant to an NSA. As previously stated, the OIG withdrew recommendation 2. For recommendation 3, management agreed to finalize the draft Handbook for Negotiated Service Agreements by December 2004. Management's comments and our evaluation of these comments are included in the report.

We appreciate the cooperation and courtesies provided by your staff during the review. If you have any questions or need additional information, please contact Michael L. Thompson, Director, Strategy, Performance and Marketing, or me at (703) 248-2300.

/s/ John M. Seeba

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TABLE OF CONTENTS

Executive Summary	i
Part I	
Introduction	1
Background	1
Objectives, Scope, and Methodology	4
Prior Audit Coverage	5
Part II	
Audit Results	7
Permit System Does Not Contain Total Data on Mail Volume	7
Terms of the NSA With Capital One	7
The Manual Mail Volume Process	7
Recommendation	9
Management's Comments	9
Evaluation of Management's Comments	9
Management Controls Need Improvement	10
Process for NSA	11
Dedicated NSA Team	11
NSA Policies and Procedures	11
Recommendation	12
Management's Comments	12
Evaluation of Management's Comments	12
Appendix A. Abbreviations and Acronyms	13
Appendix B. Equation Elements	14
Appendix C. Prior Audit Reports	16
Appendix D. Management's Comments	17

EXECUTIVE SUMMARY

Introduction

The Office of Inspector (OIG) completed a self-initiated audit of the Postal Service's negotiated service agreement (NSA) with Capital One Services, Inc. (Capital One). Our objectives were to determine the extent to which the NSA with Capital One achieved the intended results of increasing mail volume, revenue, and cost savings;¹ and to determine whether the Postal Service could rely on the Postal Service systems used to obtain accurate and timely data on mail volume and revenue.

Results in Brief

The Postal Service could not rely on the Permit System to account for all of Capital One's mail volume because a third-party mailer did not provide mail volume data specific to Capital One. According to the Postal Rate Commission (PRC) Opinion and Recommended Decision and terms of the Capital One agreement, the Postal Service will use the Permit System to capture mail volume and revenue data. As a result, the Postal Service had to manually calculate a portion of Capital One's mail volume, which may not accurately account for mail volume data needed to determine whether Capital One is entitled to a refund.

In addition, Postal Service officials did not establish a dedicated team throughout the NSA process to ensure adequate involvement by each Postal Service department needed to develop the NSA. This condition occurred because the Postal Service did not have formal policies and procedures that defined the roles, responsibilities, and established timelines to process an NSA. As a result, Postal Service departments may encounter internal delays and experience a breakdown in communication throughout the process.

Summary of Recommendations

We made three recommendations to the Postal Service. In recommendation 1, we recommended the Postal Service include a clause in all future NSAs to require customers to stipulate that all third-party mailers provide the Postal Service with customer specific mail volume data. The OIG withdrew recommendation 2 because of information provided by management. In

¹ Because the NSA with Capital One had not completed its first year, we were unable to determine the extent to which the intended results were achieved.

recommendation 3, we recommended the Postal Service finalize the draft Handbook for Negotiated Service Agreements.

**Summary of
Management's
Comments**

Management disagreed in part with recommendation 1. Specifically, management agreed they would look for ways to explicitly describe obligations of third parties in providing mail volume; however, they felt the Postal Service does not need third-party mailers to provide data that are not relevant to an NSA. As previously stated, the OIG withdrew recommendation 2. For recommendation 3, management agreed to finalize the draft Handbook for Negotiated Service Agreements by December 2004. Management's comments, in their entirety, are included in Appendix D of this report.

**Overall Evaluation of
Management's
Comments**

Management's comments are responsive to recommendations 1 and 3. Management's planned actions should correct the issues identified in this report. We do not plan to pursue the formal audit resolution process for management's disagreement in part to recommendation 1. Recommendation 2 was withdrawn.

INTRODUCTION

Background

A negotiated service agreement (NSA) is a contractual agreement between the Postal Service and customers that gives pricing incentives in exchange for a shift in customer behavior that benefits the Postal Service. For example, a shift in behavior may be a substantial increase in annual First-Class Mail (FCM) or Standard Mail volume. The Postal Rate Commission (PRC) reviews and recommends the proposed NSA, and the Postal Service Governors have final approval authority.²

Effective September 1, 2003, the Postal Service implemented its first NSA with Capital One, which is a three-year experiment. The pricing incentive under the NSA allows Capital One to receive discounts of 3 to 6 cents per piece for annual FCM volumes exceeding 1.225 billion pieces for the next three years.³ Table 1 below shows the rate schedule outlining the declining volume block ranges⁴ and incremental discounts.

Table 1. Rate Schedule for the NSA with Capital One.

FCM Volume Block Range	Incremental Discounts
1,225,000,000 - 1,275,000,000	3.0 cents
1,275,000,001 - 1,325,000,000	3.5 cents
1,325,000,001 - 1,375,000,000	4.0 cents
1,375,000,001 - 1,450,000,000	4.5 cents
1,450,000,001 - 1,525,000,000	5.0 cents
1,525,000,001 - 1,600,000,000	5.5 cents
1,600,000,001 and above	6.0 cents

Source: PRC Opinion and Recommended Decision.

In exchange for the discounts, Capital One converted its systems to use the Address Change Service (ACS) and forgo the physical return of undeliverable as addressed (UAA) mailpieces. ACS is an electronic notification system

² According to the PRC, the following is required for filing an NSA proposal. The NSA proposal is required to be reviewed in a public proceeding; the agreed-upon rate and service change will work to the mutual benefit of mailers, users, and the Postal Service system as a whole; and the negotiated rate-and-service package should be made available on the same terms to other potential users willing to meet the same conditions of service.

³ The PRC Opinion and Recommended Decision "Experimental Rate and Service Changes to Implement Negotiated Service Agreement with Capital One," Docket Number MC2002-2, May 15, 2003, capped the maximum cumulative discount available to Capital One over the duration of the agreement at \$40.637 million.

⁴ Declining volume block rates are a series of declining rates applied to a corresponding sequence of blocks of mailings of predetermined sizes over a fixed period such as a year.

that will notify mailers of new addresses and the reason for the undeliverable mailpiece. As a result, the Postal Service will not have to sort millions of UAA mailpieces and return them to Capital One. The NSA with Capital One is also the first time a separate rate discount has been offered to a single mailer who agrees to reduce Postal Service costs.

On February 18, 2004, the PRC published its final ruling⁵ for filing NSAs. The final ruling included rules for requesting the following types of NSAs.

- A "baseline NSA" is a pilot or test case that is not based on an NSA currently in effect.
- A "functional equivalent NSA" is an NSA that has been previously recommended by the PRC and is currently in effect.
- A renewal of an NSA previously recommended by the PRC with existing participants.
- A modification of an NSA previously recommended by the PRC.

On July 21, 2004, the Postal Service filed two new NSA proposals with the PRC, one for Bank One Corporation and the other for Discover Financial Services, Inc. The Postal Service expects approval for the NSAs within the next few months because the new proposals were filed as functional equivalents to the NSA with Capital One.

NSA Process

The NSA with Capital One took approximately 23 months and consisted of the inception, negotiation, proposal, review and decision, approval, and implementation phases:

- Inception Phase. The primary participants were Capital One and the Postal Service's Pricing Strategy and Pricing teams, and Operations. During this phase, the idea for an NSA proposal was generated and defined. The inception phase began in October 2001 and continued through January 2002.

⁵ PRC, 39 Code of Federal Regulations, Part 3001, Negotiated Services Agreements, was published in the Federal Register, Volume 69, Number 32, February 18, 2004.

- Negotiation Phase. The primary participants were Capital One and the Postal Service's Pricing Strategy, Finance, the Law Department and the Vice President, Pricing and Classification. During this phase, the proposed NSA was further refined by the Postal Service and Capital One. The negotiation phase began in January 2002 and continued through July 2002. The Postal Service's Law Department drafted the Capital One agreement.
- Proposal Phase. The primary participants were Capital One and the Postal Service's Pricing Strategy, Finance, and the Law Departments. During this phase, the Postal Service approved the proposed NSA with Capital One. The proposal phase began in July 2002 and continued through August 2002.
- Review and Decision Phase. The primary participants were the PRC, Postal Service's Pricing Strategy, Capital One, and several interveners.⁶ During this phase, the PRC reviewed the proposed NSA. The Postal Service and Capital One provided testimony and participated in hearings before the PRC. The review and decision phase began in September 2002 and the PRC filed its opinion and recommended decision on May 15, 2003.
- Approval Phase. The primary participants were the Postal Service Governors and the Postal Service Law Department. During this phase, the PRC sent its opinion and recommended decision to the Governors for consideration and approval. The Governors had 30 to 60 days to approve the PRC's opinion and recommended decision. The approval phase began in May 2003, and the Governors approved the NSA with Capital One on June 3, 2003.
- Implementation Phase. The primary participants were Capital One and the Postal Service's Pricing Strategy and Operations departments. During this phase, the

⁶ Intervenors are interested parties, including Postal Service competitors, who participate in the PRC public hearings to make their views known on the proposed rate changes.

Postal Service implemented the approved NSA with Capital One in July 2003. The NSA with Capital One became effective September 1, 2003.

Throughout the process, Capital One paid its own costs in participating with the Postal Service in the negotiation and litigation of the agreement before the PRC, which included separate counsel, research and documentation, and witness expenses.

Postal Service Value of the NSA with Capital One

The Postal Service valued the first seven months⁷ of the NSA with Capital One at \$9.8 million. To determine the estimated value of the NSA with Capital One, the Postal Service added the contribution of the new FCM volume and the cost savings resulting from ACS,⁸ minus the discount leakage. Table 2 below shows the equation the Postal Service used to value the NSA and Appendix B provides a breakdown of the equation elements.

Table 2. Equation Used by Postal Service to Value the NSA.

Equation Elements	September 1 2003 to March 31, 2004
Total New Mail Contribution	\$ 4,338,250
Total Discount Leakage	(1,094,165)
Total ACS Savings	6,591,741
Total Value of NSA:	\$ 9,835,826

Source: Postal Service Pricing Strategy team.

Objectives, Scope, and Methodology

Our overall objective was to determine the extent to which the NSA with Capital One achieved the intended results of increasing mail volume, revenue, and cost savings. We also determined whether the Postal Service could rely on the Postal Service systems used to obtain accurate and timely data on mail volume and revenue.

To address the first objective, we interviewed Postal Service officials to identify the process used to value the NSA with Capital One. Because the NSA with Capital One had not

⁷ The first seven months of the NSA with Capital One covers quarter one, September 1, 2003, through December 31, 2003, and quarter two, January 1, 2004, through March 31, 2004.

⁸ The Capital One agreement, states the Postal Service will waive ACS fees if Capital One mails more than 750 million pieces of FCM within any year of the agreement. If Capital One does not mail more than 750 million pieces, Capital One will pay the Postal Service the greater of either (1) all applicable ACS fees for the first year; or (2) \$1,000,000.

completed its first year, we were unable to determine the extent to which the intended results were achieved.

We also interviewed Postal Service officials, Capital One officials, and a third-party mailer to identify the data systems and processes used to track mail volume, revenue, and cost savings. We discussed the Permit System⁹ with the Office of Inspector General (OIG) Information Systems team. We also discussed the implementation of *PostalOne!*¹⁰ with Postal Service officials.

In addition, we interviewed Postal Service officials, Capital One officials, and the PRC to outline the process involved in developing, approving, and implementing the NSA with Capital One. The Postal Service, Capital One, and the PRC commented this was the first NSA and asked the OIG to take into consideration that the process is still under development. We also reviewed the Capital One agreement¹¹ and the PRC Opinion and Recommended Decision. We reviewed applicable guidance, regulations, instructions, and other supporting documentation.

This audit was conducted from March 2004 through December 2004, in accordance with generally accepted government auditing standards and included such tests of internal controls, as were considered necessary under the circumstances. We reviewed established management controls over the NSA with Capital One as they related to the audit objectives. Specifically, we reviewed policies and procedures over the NSA with Capital One to ensure management's program objectives were met. We also discussed our observations and conclusions with appropriate management officials and included their comments, where appropriate.

Prior Audit Coverage

Although we did not find audit reports related specifically to NSAs, we reviewed two Government Accountability Office (GAO)¹² reports issued in 1996 and 1999 regarding the

⁹ The Permit System processes postage statements and maintains advanced deposit trust funds for FCM, Standard A Mail, Standard B Mail, and business reply mail permits. About 75 percent of United States mail is processed through the Permit System.

¹⁰ *PostalOne!* will replace the Permit System and allow bulk mail entry units to enter postage statements, deposits, and other financial transactions. Mailers will also use *PostalOne!* to enter postage statements and other information.

¹¹ The Capital One agreement was signed on September 9, 2002, by the Postal Service's Senior Vice President, Chief Marketing Officer and the Senior Vice President, Capital One Services, Inc.

¹² GAO was formerly the General Accounting Office. The name was changed effective July 7, 2004.

Postal Service's business mail acceptance practices. We also reviewed audit reports issued by the OIG related to the Postal Service's rate case development process, the Address Change Service, *PostalOne!*, and fiscal year (FY) 2002 Financial Installation Audits of business mail entry units. For highlights of these reviews, see Appendix C.

AUDIT RESULTS

Permit System Does Not Contain Total Data on Mail Volume	The Postal Service could not rely on the Permit System ¹³ to account for all of Capital One's mail volume and revenue because a third-party mailer ¹⁴ did not provide mail volume data specific to Capital One. According to the <u>PRC Opinion and Recommended Decision</u> and terms of the Capital One agreement, the Postal Service will use the Permit System to capture mail volume and revenue data. As a result, the Postal Service had to manually calculate a portion of Capital One's mail volume, which may not accurately account for mail volume data needed to determine whether Capital One is entitled to a refund.
Terms of the NSA With Capital One	The <u>PRC Opinion and Recommended Decision</u> regarding the NSA with Capital One states that volume and revenue data will be captured by the Postal Service's Permit System. According to the Capital One agreement, the data in the Postal Service's permit accounts are used to determine whether thresholds have been met. Furthermore, if Capital One FCM volume exceeds the threshold for a quarter, Capital One will be eligible to receive a discount on subsequent FCM volume, sent through the designated permit accounts.
The Manual Mail Volume Process	The Postal Service uses permit numbers to track Capital One's mail volume and revenue data in the Permit System. Capital One and its third-party mailers are required to complete a postage statement for each mailing. The postage statement must include the permit number, mail volume, and revenue data. However, one of the third-party mailers could not provide the Postal Service with a postage statement that contains mail volume and revenue data specific to Capital One. According to the third-party mailer and Postal Service officials, the third-party mailer's processing operation could not provide customer-specific mail volume data. As a result, the third-party mailer

¹³ The Postal Service Permit System User Guide, (updated through version CAN 71-001110, November 8, 2000). The guide states, "When a mailing house is acting for a client, specifically when a separate customer originated and prepared the mail, a client's permit number maybe used "by" an agent who performs the mailing. The Permit System charges the mailing to the account in the agent permit number field; however, both the agent and the client need permit numbers."

¹⁴ Third party mailers are also referred to as agents or mailing houses that perform mail printing and preparation processing services. These third party mailers mail on behalf of other entities and their services are considered by the Postal Service to be by-for relationships.

provides the Postal Service with one postage statement that contains commingled mail volume and revenue information.

The Postal Service uses an intensive manual process to calculate the Capital One monthly mail volume data. The process involves the following steps.

1. Obtain Capital One mail volume data entered into the Permit System, using permit numbers.
2. Obtain Capital One mail volume data entered into the Permit System but processed by third-party mailer that could provide a separate postage statement.
3. Obtain Capital One mail volume data for the third-party mailer that could not provide a separate postage statement. This information is obtained by manually capturing the mail volume data from the job requests or invoices received from the mailer.
4. Perform a monthly reconciliation of the mail volume data with Capital One to identify differences in mail volume data caused by timing issues with data entry¹⁵ and manual calculation of mail volume data received from third-party mailers that could not provide a separate postage statement.

Because the Postal Service cannot rely solely on the Permit System to obtain all mail volume data for Capital One, we discussed our concerns with Postal Service officials. During our discussions, we received conflicting information on the proposed capabilities of *PostalOne!* According to one group of Postal Service officials, *PostalOne!* will replace the Permit System and alleviate the problem with commingled mail. However, Postal Service officials involved in implementing *PostalOne!* stated the new system will not resolve the problem because the third party mailer provides one postage statement with commingled mail.

¹⁵ According to Postal Service officials, there have been instances of delayed entry of postage statement information into the Permit System. This can occur when the mail entry unit clerk does not enter the mailer's postage statement data into the Permit System in a timely manner and can result in differences in mail volume at the beginning and/or end of each month.

Recommendation	We recommend the Vice President, Pricing and Classification: 1. Include a clause in future negotiated services agreements to require customers to stipulate that third-party mailers will provide the Postal Service with customer specific mail volume data.
Management's Comments	Management disagreed in part with the recommendation. Management agreed that future contracts could be written to make the obligations of third parties more explicit; however, they believe the Postal Service does not need to require third-party mailers to provide data that are not relevant to an NSA. Management stated they could and would look for ways to explicitly describe the obligations of third parties that are consistent with future NSA terms subject to customer-specific constraints.
Evaluation of Management's Comments	Management's comments are responsive to recommendation 1. Although management disagreed in part with the recommendation, they plan to look for ways to explicitly describe obligations of third parties in future NSAs. This action is considered responsive and we do not plan to pursue the formal audit resolution process for management's disagreement in part to the recommendation.

Management Controls Need Improvement	This finding was withdrawn because of information provided to the OIG by management.
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Recommendation	2. This recommendation was withdrawn.
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Process for NSA	Postal Service officials did not establish a dedicated team throughout the NSA process to ensure adequate involvement by each Postal Service department needed to develop the NSA. This condition occurred because the Postal Service did not have formal policies and procedures that defined the roles and responsibilities for Postal Service departments, or established timelines to process an NSA. As a result, Postal Service departments may encounter internal delays and experience a breakdown in communication throughout the process.
Dedicated NSA Team	Postal Service officials did not initially establish a dedicated NSA team between Postal Service departments, such as Marketing, Finance, Law Department, and Operations. The Pricing Strategy team participated in all phases of the process and was the primary Postal Service department involved in developing the NSA with Capital One. According to a Pricing Strategy official, there was no established process to develop the NSA with Capital One because this was the first of its kind. However, once the proposal for the NSA was finalized, it was considered a rate case and the Postal Service already had an established process for filing a rate case. During a normal rate case, the Law Department is responsible for filing the case with the PRC and the Finance Department has to certify the case before it is proposed.
NSA Policies and Procedures	Without formal policies and procedures, the Postal Service did not have defined departmental roles and responsibilities, or establish timelines for completing each phase of the NSA process. To assist in this effort, during negotiations with Capital One, a Pricing Strategy official requested volunteers from Postal Service departments to develop a process to administer NSAs. As a result, the team developed a draft <u>Handbook for Negotiated Service Agreements</u> , dated February 2004. This draft handbook defines departmental roles and responsibilities, and established timelines for each phase of an NSA process. However, as of December 2004, the Postal Service had not finalized the handbook.

Recommendation	We recommend the Vice President, Pricing and Classification:
	3. Finalize the draft <u>Handbook for Negotiated Service Agreements</u> .
Management's Comments	Management agreed to finalize the draft <u>Handbook for Negotiated Service Agreements</u> . Management stated they recognize the need for a formal process for NSA development and implementation. Management also stated they are currently finalizing the <u>Handbook for Negotiated Service Agreements</u> and expect completion by December 2004.
Evaluation of Management's Comments	Management's comments are responsive to the recommendation. Management's actions planned should correct the issues identified in the finding.

APPENDIX A. ABBREVIATIONS AND ACRONYMS

FY	Fiscal Year
FCM	First-Class Mail
OIG	Office of Inspector General
NSA	Negotiated Service Agreement
PRC	Postal Rate Commission
ACS	Address Change Service
Capital One	Capital One Services, Inc.
UAA	Undeliverable as Addressed

APPENDIX B. EQUATION ELEMENTS

Value of the NSA with Capital One. As stated in the background section of the audit report, the Postal Service valued the first seven months of the NSA with Capital One at \$9.8 million. To determine the estimated value, the Postal Service added the contribution of the new FCM volume and the cost savings resulting from ACS, minus the discount leakage. The tables below show the breakdown of each equation element.

New Mail Contribution. The pricing incentive under the NSA allows Capital One to receive a discount of 3 to 6 cents per piece for annual FCM volumes exceeding 1.225 billion pieces for the next three years. Capital One has two types of discounts, the workshare discounts outlined in the rate schedule and the volume discounts in the NSA. An average of revenue per mailpiece was estimated to be 29.10 cents. The Postal Service estimated the average cost per piece to be 12.66 cents, resulting in a contribution per piece of 16.54 cents. Table 3 below shows the contribution of the new FCM:

Table 3. Contribution of New First-Class Mail.

Increased Mail Volume	35,885,675
Capital One Contribution Per Mailpiece	x .1654
Total New Contribution	\$ 5,935,491
Discount on the Mail Volume	(1,597,241)
Total Contribution of New FCM	\$ 4,338,250

Source: Postal Service Pricing Strategy team.

Discount Leakage. The Postal Service must also recognize “discount leakage” which is any mail volume that Capital One would have mailed even in the absence of the NSA. The discount leakage would occur if the Postal Service gave a discount on this mail volume. This mail volume would be deducted to obtain the new mail contribution. Table 4 shows the discount leakage.

Table 4. Discount Leakage.

	Mailpieces in Millions
Mail Volume Above Threshold	72.44
Discount Leakage Mail Volume	(36.47)
Incremental Increase in Mail Volume	35.97
Discount Leakage 36.47 million X .030 cents discount = \$1,094,164	

Source: Postal Service Pricing Strategy team.

ACS Savings. Capital One has agreed to convert its systems to accept ACS electronic notification in place of physical returns of UAA mail for FCM solicitations. This reduces the costly physical return of mailpieces, saving the Postal Service

money. For each Capital One solicitation piece found to be UAA, the Postal Service will save the difference between the cost of physical returns and the cost of electronic ACS notifications. Table 5 below shows the calculation for ACS savings.

Table 5. Savings from Capital One Using Address Change Service.

	Costs in Cents
Estimate Cost for Each Manual Return of UAA Mail	53.47
Estimate Cost for Each Electronic Return of UAA Mail	(33.21)
Estimated Cost Savings	20.26
32,540,719 ACS transactions X 20.3 cents per piece = \$6,592,749	

Source: Postal Service Pricing Strategy team

The Postal Service has estimated an increase in net revenue of \$11.1 million in the test year due to the cost savings associated with Capital One converting to ACS.

APPENDIX C. PRIOR AUDIT REPORTS

AGENCY	TITLE OF REPORT DATE ISSUED	REPORT HIGHLIGHTS
GAO	<u>U.S. Postal Service, Changes Made to Improve Acceptance Controls for Business Mail</u> , (Report Number GAO/GGD-00-31, November 9, 1999)	This report was a follow-up to the 1996 report and determined the status of recommendations. The report stated that the Postal Service made changes to controls over the acceptance of business mail, which should help prevent against losses. However, the Postal Service lacked information on how well its controls were working and could not ensure that it was collecting all the revenue due from its business mail operations.
GAO	<u>U.S. Postal Service, Stronger Mail Acceptance Controls Could Help Prevent Revenue Losses</u> , (Report Number GAO/GGD-09-126, June 25, 1996)	This report discussed weaknesses in the Postal Service's acceptance system for business bulk mail, including the inadequacy of bulk mail acceptance controls, staffing, and training. The report also stated the system could not identify how much revenue the Postal Service was losing. GAO recommended the Postal Service periodically report operations of the bulk mail acceptance system and initiatives, as well as the progress and effectiveness of related improvements. GAO also recommended the Postal Service develop methodologies to determine system wide losses caused by accepting improperly prepared mailings.
Postal Service - OIG	<u>Rate Case Development Process</u> (Product Number FT-OT-04-001, January 29, 2004)	This was an informational report documenting the internal process of an omnibus rate case. The report outlined the three primary Postal Service organizations involved in the process, Finance, Marketing, and the Law Department; and the four major rate case development phases, which are costing, volume forecasting, roll forward and revenue requirement, and pricing and rate design. The report concluded the rate case process takes approximately 18 months from development to approval, and consists of three parts; a rate case proposal, commission proceedings, and rate implementation.
Postal Service - OIG	<u>Address Change Service</u> (Report Number TD-AR-03-004, March 12, 2003)	This report stated the Postal Service could save \$14 million over the next two years by eliminating unnecessary manual handling of ACS mail. Although 80 percent of mail volume was properly processed, we estimated that 20 percent was mishandled, resulting in unnecessary processing costs of over \$20 million.
Postal Service - OIG	<u>FY 2003 Financial Installation Audit – Business Mail Entry Units</u> (Report Number FF-AR-04-256, March 28, 2003)	This report presents the results of our financial installation audit of statistically selected business mail entry units for fiscal year 2003. This audit was conducted in support of the audit of the Postal Service's financial statements. We recommended management reinforce procedures for mail acceptance and verification, reviews of Periodicals publications, mailers' qualifications for nonprofit rates, operations at convenience deposit points, trust account balances, Permit System overrides and access, bypass mailings, and agreements for special postage payment systems. Management agreed with our findings and recommendations and the actions taken or planned should correct the issues identified in the report.
Postal Service - OIG	<u>PostalOne! Phase Two</u> (Product Number DA-AR-03-001, October 24, 2002)	This report discussed <i>PostalOne!</i> Phase Two Business Customer Support System and Transportation Management. The objectives of the audit were to evaluate management's corrective actions from the <u>PostalOne! Phase One</u> audit; validate the business case; evaluate costs, benefits, and risks; and review internal controls. We recognized opportunities for the Postal Service to align systems to corporate goals, objectives, and policies; to mitigate risks; and to measure and evaluate performance and customer satisfaction.

APPENDIX D. MANAGEMENT'S COMMENTS



September 24, 2004

KIM STROUD
DIRECTOR OF AUDIT OPERATIONS
OFFICE OF THE INSPECTOR GENERAL

SUBJECT: Response to Draft Audit Report–Postal Service's Negotiated Service Agreement
With Capital One (Report Number-MS-AR-04-DRAFT)

We have reviewed the Draft Audit Report and offer the following responses addressing the findings and recommendations.

The intent of the audit of the Negotiated Service Agreement (NSA) was to determine whether the NSA with Capital One achieved the intended results of increasing mail volume, revenue, and cost savings. As noted in the report's introduction, the Office of the Inspector General (OIG) could not determine if the Capital One NSA was providing the stated benefits because there was not yet a full year of data available.

The report is correct in pointing out that a full year of data is unavailable, and therefore, does not attempt to determine whether the intended results had been achieved. A minimum of one year's worth of empirical data is necessary to measure volume changes. However, for the cost savings portion of the NSA, a full year's data are not required. As of March 31, 2004, the \$6.6 million of cost savings that resulted from the elimination of physical returns in lieu of electronic returns are actual cost savings. In addition, the NSA improved the Address Change Service (ACS) process resulting in benefits not only for Capital One but for all ACS participants.

The report then presents findings related to the adequacy of U.S. Postal Service data systems and controls, and recommends formalizing internal processes for the further development of NSAs. Management agrees that sound systems and processes are necessary for the successful development of NSAs and appreciates the OIG's recommendations in this area. While each recommendation will be discussed at greater length below, it is worth pointing out that the Capital One NSA was the first attempt by the Postal Service to develop customer-specific prices. As a result, there were no existing models to follow, and postal management adapted available processes and resources by necessity. Before the activation of the Capital One agreement, the Postal Service had already begun to develop a formalized process for NSA development, which resulted in the NSA handbook referred to in the report.

- 2 -

Permit System Does Not Contain Total Data on Mail Volume

Recommendation:

We recommend the Vice President, Pricing and Classification:

1. Include a clause in future negotiated service agreements to require customers to stipulate that third-party mailers will provide the Postal Service with customer specific mail volume data.

Response:

Management disagrees in part.

The Capital One NSA contract requires that all mail to be counted toward volume thresholds must be entered under specified permits, whether those permits are held by Capital One or a third party. Future contracts could be written to make the obligations of third parties more explicit; however, the Postal Service need not require third-party mailers to provide data that are not relevant to an NSA.

The report concluded that the "permit system does not contain total data on mail volume." The apparent concern is that this requires manual calculation to account for all of Capital One's mail.

In fact, all of the data used to calculate Capital One's volumes are taken from the Permit/Postal One! systems. The report accurately points out that some of Capital One's mail is entered under mailing permits held by third-party vendors, which is typical of virtually all large mailers who often commingle their mail with the mail of other companies to take advantage of presort discounts. In a classification-based pricing system it is not necessary to precisely measure the volume of a specific customer. The terms of the Capital One contract, however, require that the Postal Service be able to account for all of Capital One's volume.

Currently, the Capital One NSA contains the following clause on page 6, Section J, Volume Accounting, number 1: *"Capital One will provide the Postal Service with the numbers of the permit accounts that will determine Capital One's eligibility for discounts. The accounts may be used only upon the Postal Service acknowledgement. Only First-Class Mail letter mail in these accounts will be counted toward the thresholds. Separate qualifying permit accounts will be used for customer mail and for solicitation mail. The data in the Postal Service's permit accounts [will be] used to determine whether the thresholds have been met."*

Capital One has provided specific permits, per the NSA, for tracking their First-Class mail volume. In some cases, third-party vendors present mailing statements containing commingled volumes. In these instances, documentation prepared by vendor software is reviewed by USPS acceptance staff and forwarded to Pricing Strategy so that the volume can be included in the reconciliation process. This is the only manual activity that is performed during the monthly reconciliation process, and it is necessary because customer-specific pricing requires greater precision in measuring customer volumes.

The Postal Service can and will look for ways to more explicitly describe the obligations of third parties that are consistent with future NSA terms subject to customer-specific constraints.

- 3 -

Management Controls Need Improvement

Recommendation:

We recommend the Vice President, Pricing and Classification:

2. Request an independent validation of all negotiated service agreements mail volume data from a Postal Service Department outside of the Pricing Strategy team prior to issuing refunds.

Response:

We agree that third-party validation is important. However, as described in relevant Government Accounting Office (GAO) documentation,¹ appropriate steps have been taken. As the GAO standards cited in page 10 of the report make clear, the term "internal control" refers to a range of activities designed to ensure appropriate control over Postal Service funds.

Several Postal Service departments outside of Pricing Strategy have been involved in validating mail volumes prior to the issuance of Capital One's first quarter refund. Internal processes were formalized and agreed upon by a cross-functional team on February 10, 2004. In attendance were members from Finance Accounting Services, Finance Statistical Programs, Finance National Accounting, San Mateo Accounting Services, New York Rates and Classification Service Center (RCSC) and Business Mailers Support. Finance Accounting Services agreed to develop a Standard Operating Procedure (SOP) for NSA quarterly payments or refunds. The SOP was developed and circulated for review by all cross-functional team members. It was agreed that the Pricing Strategy group would prepare the quarterly volumes report and the Finance Internal Controls group would audit the process for developing the quarterly volume report. As stated in the NSA, any disputes on volume reconciliation raised by Capital One would be appealed to a third party, the New York RCSC. It is also worth noting that the findings relate solely to the quarterly refund and do not acknowledge that there will be a year-end reconciliation. This year-end reconciliation will again be conducted with inter-departmental participation.

Additionally, mail volumes are validated at the point of acceptance. Local Business Mail Entry Units (BMEU) personnel enter the data into the Permit/PostalOne! System. All other cross-functional groups have 'read only' access to the system to view the data. Specifically for the Capital One NSA, the data are loaded into the Goldmine system for the Pricing Strategy group to prepare monthly reconciliation volumes. The Finance Internal Control group audits the process from data entry at local BMEU, to permit volume reconciliation and final refund payment issuance. Further, the report downplays the significance of providing data to the Postal Rate Commission (PRC). However, any data provided to the PRC reflect the best available information and are audited; the provider is subject to severe penalties for perjury. These cross-functional activities and processes are in compliance with the cited GAO special publication.

As the Capital One NSA was the first ever, substantial involvement by the Pricing Strategy group was required in all aspects of the process. As NSAs become more routine, the degree of involvement by Pricing Strategy will further diminish, making for an ever greater separation of responsibilities.

¹ See GAO Special Publication, Standard for Internal Control in the Federal Government, AIMD-00-21.3.1, November 1, 1999.

- 4 -

Process for NSA

Recommendation:

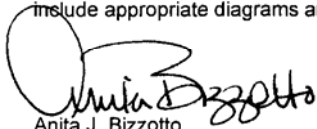
We recommend the Vice President, Pricing and Classification:

3. Finalize the draft Handbook for Negotiated Service Agreements.

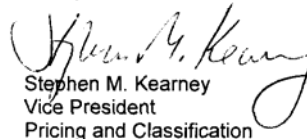
Response:

We agree with this recommendation.

The Pricing Strategy team has recognized the need for a formal process for NSA development and implementation. The Manager, Pricing Strategy, and his staff, are currently finalizing the Handbook for Negotiated Service Agreements, and expect completion by December 2004. This handbook will include appropriate diagrams and flowcharts to illustrate the various NSA processes.



Anita J. Bizzotto
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Vice President
Pricing and Classification

cc: Deputy Assistant Inspector General
for Financial Management