

March 27, 2000

A. KEITH STRANGE
VICE PRESIDENT, PURCHASING AND MATERIALS

SUBJECT: Transmittal of Audit Report – Commercial Air Carrier Performance:
Payment for Ground Handling Services
(Report Number TR-AR-00-006)

This is the third of three reports resulting from our audit of commercial air carrier performance conducted at the request of the chief operating officer (Project Number 99PA023TR000). The audit revealed the Postal Service was paying commercial airlines for ground handling services performed by postal employees. We provided three recommendations to correct the problems identified in this report and potentially save approximately \$28 million (over a five-year period) by adjusting the contract rate.

Management generally agreed with the report findings and recommendations, but planned to delay concurrence on the estimated cost savings until contract specifications for the upcoming 2001 Air Systems contract are reevaluated.

We appreciate the cooperation and courtesies provided by your staff during the audit. If you have questions or need additional information, please contact [REDACTED] or me at (703) 248-2300.

/SIGNED/
Robert L. Emmons
Acting Assistant Inspector General
for Performance

Attachment

cc: Clarence E. Lewis, Jr.
John E. Potter
Sylvester Black
J. Dwight Young
Anthony M. Pajunas
John R. Gunnels

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EXECUTIVE SUMMARY

Introduction

This is the third of three reports resulting from our audit of commercial air carrier performance.¹ The chief operating officer requested that we review air carrier performance because carriers have not been meeting expected on-time delivery targets established by the Postal Service's Air Systems contract. In fiscal year (FY) 1999, the national average score for on-time performance was 60 percent, as reported by the Postal Service.

This report presents our assessment of ground handling services performed by postal employees at 17 airport mail centers/facilities. A list of these locations is provided in Appendix A.

Results in Brief

The Postal Service incurred over \$5.6 million in FY 1999 for ground handling services² performed by postal employees at 17 airport mail centers/facilities that commercial air carriers were paid to provide. Although the Air Systems contract requires air carriers to unload the mail at delivery points, the Postal Service changed these procedures through local agreements at 17 locations. At 14 of these locations, agreements were verbal and at 3 sites agreements were in writing.³ Postal managers indicated revised delivery procedures were needed because air carrier service had been unreliable and poorly designed induction systems made it difficult for air carriers to unload the mail.

Although the Postal Service assumed responsibility for unloading the mail at the 17 airport mail centers/facilities, corresponding adjustments to the contract rate for these services were not made. While the original terms of the Air Systems contract allows alternate delivery procedures to be negotiated, it does not provide for rate adjustments when tender or delivery changes are made through local

¹ The first report, Commercial Air Carrier Performance: Performance Measurement System, addressed the reliability of the performance measurement system used to evaluate air carriers. The third report will address the effectiveness of the Air Systems contract in improving air carrier performance.

² Ground handling services consist of the loading and unloading of mail at origin and destination postal facilities and sorting the mail by flight.

³ The three sites that had written agreements were Philadelphia, Los Angeles, and Indianapolis. However the Philadelphia agreement did not address delivery procedures.

agreements. As a result, the Air Systems contract is in conflict with the Postal Service's Purchasing Manual, which requires fair and reasonable contract pricing.

Obligating the Postal Service to reimburse carriers for services not performed does not constitute fair and reasonable pricing. While the Air Systems contract makes no rate adjustments for changes in delivery procedures, paying for services not performed is a waste of postal funds and constitutes ineffective financial management. With the Air Systems contract coming up for renewal in September 2000, the Postal Service has an opportunity to save approximately \$28 million over the next five years by adjusting the contract rate by the cost for postal employees to perform these services.

Summary of Recommendations	In negotiating the terms of the new Air Systems contract, we recommend the vice president of Purchasing and Materials determine the contract value for delivery services, reduce the contract rate where postal employees are unloading the mail, and eliminate provisions that prohibit contract rate adjustments when service changes occur.
Summary of Management's Comments	Management generally agreed with our findings and recommendations but delayed concurrence on estimated cost savings. Specifically, they sent existing specifications, which include the value of delivery services, to the area offices for updating, and will make any necessary changes at that time. Although management did not totally agree with the estimated cost savings, they agreed to give special attention to the cost of delivery services performed by postal employees in the upcoming 2001 Air Systems contract, and determine cost savings at that time. Management also planned to reevaluate, and if necessary, eliminate any provision that prohibits contract adjustments in the 2001 Air Systems contract.
Overall Evaluation of Management's Comments	Management's comments were generally responsive to our findings and recommendations, and planned actions should correct the issues identified in this report. While management did not fully agree with our estimated savings resulting from reducing the contract rate for services performed by postal employees, they plan to give special attention to this area in setting the rate for the 2001 Air Systems contract.

INTRODUCTION

Background

Under the Air Systems contract the Postal Service pays commercial air carriers approximately \$.31 a pound to transport Priority Mail and First-Class Mail. Approximately two-thirds of this rate covers ground handling costs and one-third covers line haul services between origin and destination airport mail centers/facilities. Ground handling includes loading and unloading mail at origin and destination postal facilities and sorting the mail by flight. Line haul comprises the flight itself.

The Air Systems contract requires air carriers to deliver mail to postal airport mail centers/facilities and unload it onto the Postal Service's mail transport equipment and/or induction belt system. The contract also allows the Postal Service to change delivery arrangements through local agreements. According to the Air Systems contract, the Postal Service has agreed to offload the mail at 17 of 79 airport mail centers/facilities.

The Air Systems contract expires in September 2000, and the Postal Service is currently negotiating the renewal of this contract.

Objective, Scope, and Methodology

Our overall objective was to assess whether the delivery and ground handling provisions of the Air Systems contract were in the Postal Service's best interest. To accomplish this objective, we reviewed the Air Systems contract and local agreements, interviewed headquarters contracting officials, and analyzed the Postal Service's costs to unload mail at airport mail centers/facilities. We also visited three⁴ airport mail centers/facilities that had local agreements and interviewed plant managers at these locations.

This audit was conducted from May 1999 through March 2000 in accordance with generally accepted government auditing standards and included tests of internal controls as were considered necessary under the circumstances. We discussed our findings with appropriate management officials and included their comments, where appropriate.

⁴ Sites visited included Baltimore, Chicago, and Philadelphia Airport Mail Centers/Facilities.

AUDIT RESULTS

Payment for Ground Handling Services

The Postal Service incurred over \$5.6 million in FY 1999 for ground handling services performed by postal employees at 17 airport mail centers/facilities that commercial air carriers were paid to provide. Although the Air Systems contract requires air carriers to unload the mail at delivery points, the Postal Service changed these procedures through local agreements at 17 locations. At 14 of these locations agreements were verbal and at 3 sites agreements were in writing.

The Postal Service primarily used existing staff to unload the mail at the 17 delivery points. However, one location increased staffing and another contracted out these services.⁵ Based on postal estimates, the cost to the Postal Service to unload the mail was approximately \$5.6 million in FY 1999, as shown in appendix A.

Postal managers indicated revised delivery procedures were needed because air carrier service had been unreliable, and in some cases, ineffective induction systems made it difficult for carriers to unload the mail. For example, at one location⁶ we found the induction belt system congested and unable to efficiently handle the volume of mail delivered by the air carriers.

Although the Postal Service assumed responsibility for unloading the mail at the 17 airport mail centers/facilities, corresponding adjustments to the contract rate for these services were not made. While the original terms of the Air Systems contract allows alternate delivery procedures to be negotiated, it does not provide for rate adjustments when tender or delivery changes are made through local agreements. Therefore, the terms of the Air Systems contract obligate the Postal Service to reimburse carriers the contract rate, even though postal employees perform some ground handling services. As a result, the Air Systems contract is in conflict with the Postal Service's Purchasing Manual governing contract pricing. Under the Purchasing Manual, when determining contract prices and pricing modifications, the Postal Service must ensure

⁵ Los Angeles Airport Mail Center increased staffing and the Seattle Airport Mail Center contracted these services out at an annual cost of \$1.5 million.

⁶ The Philadelphia Airport Mail Center had an inefficient induction belt system.

contract prices are fair and reasonable. Obligating the Postal Service to reimburse carriers for services not performed does not constitute fair and reasonable pricing.

According to contracting officials, the Air Systems contract was constructed to allow postal employees to unload the mail with no financial consequences to the air carriers. Because delivery inefficiencies were primarily attributable to ineffective postal induction belt systems, postal officials believed that offloading the mail would give the Postal Service better leverage, improved service, and less congestion within the facilities. However, paying for services not performed is a waste of postal funds and constitutes ineffective financial management.

The pending renewal of the Air Systems contract presents the Postal Service with an opportunity to change the provisions of the contract governing the payment of delivery services not performed by the air carriers. We believe the Postal Service can save approximately \$28 million over the next five years by reducing the Air Systems contract rate where postal employees are performing delivery services for air carriers.

Recommendation	In negotiating the terms of the new Air Systems contract, we recommend the vice president of Purchasing and Materials: 1. Enter into discussions with the air carriers to determine the contract value for delivery services under the Air Systems contract.
Management's Comments	Management agreed with the findings and recommendation and asked area offices update existing specifications, to include delivery service requirements. They plan to make necessary updates in preparing for renewal of the 2001 Air Systems contract.
Recommendation	2. Reduce the contract rate by the cost of delivery services at those airport mail centers/facilities where postal employees are unloading the mail.
Management's Comments	Management disagreed, stating that although there may be savings, rates should not be reduced for the current contract. Such a rate reduction would open up the entire population of over 300 air stop points around the country to

examination. Management indicated that, in several instances, airlines are doing more than what is called for in the contract. However, they plan to give special attention to this area in setting the rate for the 2001 Air Systems contract, and determine potential savings at that time.

Recommendation	3. Eliminate provisions that prohibit contract rate adjustments when service changes occur in the new Air Systems contract.
Management's Comments	Management generally agreed with the recommendation. They stated the contract adequately allows for rate changes; however, they will reevaluate, and if necessary eliminate provisions in negotiating the 2001 Air Systems contract.
Evaluation of Management's Comments	Management's comments were generally responsive to our findings and recommendations. Management's planned actions should correct the issues identified in this report. Management did not fully agree with the estimated savings resulting from a reduced contract rate for services performed by postal employees. However, they planned to give special attention to this area when setting the rate for the 2001 Air Systems contract and to determine actual cost savings at that time. Further, although they believe the current contract allows rate changes, management agreed to reevaluate, and if necessary, eliminate provisions prohibiting rate adjustments in the 2001 Air Systems contract.

**APPENDIX A.
 POSTAL SERVICE'S GROUND HANDLING
 COSTS AT 17 AIRPORT MAIL CENTER/FACILITIES**

Airport Mail Center/Facility	Local Agreement	Total FY 1999 Cost*
Albany, NY	Verbal	\$ 152,250
Baltimore, MD	Verbal	210,000
Sacramento, CA	Verbal	105,000
Buffalo, NY	Verbal	210,000
Chicago, IL **	Verbal	680,800
Dallas, TX ***	Verbal	521,858
Detroit, MI	Verbal	78,750
Grand Rapids, MI	Verbal	35,000
Greenville, SC	Verbal	94,500
Indianapolis, IN	Written	70,000
Los Angeles, CA	Written	315,000
Philadelphia, PA	Written	805,000
Portland, ME	Verbal	70,000
San Diego, CA	Verbal	105,000
San Francisco, CA	Verbal	525,000
Seattle, WA ****	Verbal	1,585,965
Syracuse, NY	Verbal	<u>70,000</u>
Total Annual Cost		\$ 5,634,123
Projected savings over the next 5 years: 5 years x \$5.6 million		\$28 million

*Cost based on approximate employee annual salary of \$35,000 excluding benefits.

**Total taken from Decision Analysis Report for the Chicago Airport Mail Center.

***Total taken from Decision Analysis Report dated August 16, 1999.

****Cost taken from contract for Seattle Airport Mail Center.

APPENDIX B. MANAGEMENT'S COMMENTS

NATIONAL MAIL TRANSPORTATION PURCHASING



February 29, 2000

RICHARD F. CHAMBERS

THRU: KEITH STRANGE

SUBJECT: Transmittal of Draft Audit Report - Commercial Air Carrier Performance
Payment for Ground Handling Services
(Report Number TR-AR-00-DRAFT)

This is in response to the recommendations contained in the subject report, dated January 31, 2000. The report recommends a series of modifications to the contracts with commercial air carriers to reduce the uniform rate to eliminate payment for ground handling services where the Postal Service performs what might seem to be work that should or is normally performed by the contractor at some airports.

Background:

Dating back to the early eighties, the rates for transporting mail in the domestic market were established by the Civil Aeronautics Board (CAB). The CAB was sunset in the mid-eighties, and the Postal Service went to the competitive marketplace to purchase transportation services from the commercial air carriers. This approach led to significant service failures and cost overruns in those markets where one or two carriers were dominant. Internally, postal operations routed mail based on the price per pound, without a clear picture of the operational impacts that would occur when "low priced planes" bulked out. The experiences of the early eighties led to the development of the current uniform negotiated rate environment.

Review of ASYS 94-01 and ASYS 96-01 Rate Development Methodology

ASYS 94 and 96 rates were developed "from scratch" using a bottom-up methodology. The Postal Service retained the services of PriceWaterhouseCoopers (PwC) (then Price Waterhouse) to conduct a survey to determine comparable commercial freight rates and split these overall rates into line-haul and terminal components using econometric analysis. These base freight rates were then adjusted to account for cost differences between mail and freight and to reflect the mail's priority boarding status over freight. The various ground handling and other operational variances were also considered during the negotiations process.

Review of ASYS 97-01 and ASYS 98-01 Rate Adjustment Methodology

For the ASYS 97 and 98 contracts, the Postal Service successfully applied a new approach to developing the contract. This approach adjusted the existing rate for recent market and mail characteristics changes, rather than conducting a new rate survey and calculating the new rates from scratch. As the current contract was set in place, the various operational differences were considered during the negotiating process.

Although the recommendations discussed in items 1 through 3 will be items of negotiation in future contracts, the weighted net effect these type of operating changes remains to be seen. The recommendations will be evaluated during the contract negotiations for ASYS-200.

475 L'ENFANT PLAZA SW
WASHINGTON DC 20260-4210
202-388-4277
FAX: 202-288-4313

The uniform rate, dating back to its inception in 1894, is not the highest nor lowest possible rate that the carriers could be paid using the above analysis and negotiating process. It represents an agreement between the Postal Service and a group of suppliers to perform work (transportation and ground handling) at an agreed upon fixed rate. The rate represents the price the Postal Service pays for the movement of mail by the commercial carriers "all things considered." As previously mentioned, the various ground handling differences were discussed with postal field representatives and finally with the carrier representatives. After much discussion and some modifications to the rate, it was agreed that the carriers would provide their services "all things considered" at a uniform rate. A key part of the agreement is that local postal managers would have the flexibility to form local agreements to meet local operating requirements. The negotiated uniform rate was implemented in the best interest of the Postal Service with the flexibility of local agreements clearly intended. As we move forward into a more flexible operating and purchasing environment where we adjust the contract rate for local operating differences, it will likely increase bottom line cost to the Postal Service.

ASYS Contract Pricing Conflicts With Purchasing Manual (PM) Pricing:

Although the PM is designed to promote uniformity, it does support a number of the unique requirements of transportation purchasing. Section 4.5.1.b indicates that in those cases where there is a conflict between that section and other parts of the manual, 4.5.1.b governs. Section 4.5.5.d1.(d) of the PM was specifically inserted to support uniform rate contracts such as the ASYS contracts. Given the intent and structure of the PM, we cannot agree that there is a conflict.

Specific Recommendations:

1. Enter into discussions with the air carriers to determine the contract value for delivery services under the Air Systems contract.

Response: We agree with the recommendation, and submit that the solution to the recommendation is currently underway as has been our standard practice in former ASYS contracts. Logistics has sent the existing specifications to the Area asking for updated requirements, which include the specific delivery service requirements. Updates will be made where necessary in preparation for the revised Air System Contract to be effective FY 2001.

2. Reduce the contract rate by the cost of delivery services at those airport mail centers/facilities where postal employees are unloading the mail.

Response: We do not agree. Although there may be savings, we do not agree that rates should be reduced based on this particular study. Specifically to do so would open up the entire population of over 300 air stop points around the country to examination. Based upon our experience, the airlines, in several instances, are doing more than what is called for in the contract. Additionally, a uniform system rate yields an overall cost advantage to the Postal Service. We will give special attention to this item in arriving at the rate for the upcoming ASYS 2001 contract. An evaluation of any potential savings will be determined as we move forward with the ASYS 2001 contract.

3. Eliminate provisions that prohibit contract rate adjustments when service changes occur in the new Air Systems contract.

Response: We believe that the contract adequately allows for rate changes due to changed conditions throughout the term, but we will re-evaluate and eliminate the provisions, if necessary, in the upcoming months leading up to ASYS 2001.

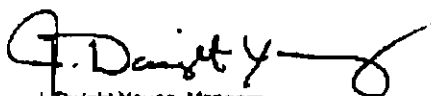
Note: The recommendations are directed at the 2001 ASYS contract, not the existing contract. As long as we employ a uniform rate contract, we think that an overall cost advantage accrues to the Postal Service; however, one of the constraints that must be taken into

consideration is that not every operational variant can be addressed on a case by case basis.

Summary:

The recommendations outlined in the subject report will be pursued as we move into a competitive purchasing environment. Based on our experiences in contracting with large suppliers for air transportation and ground handling services, we will improve overall performance, but it will likely be at an average line-haul cost greater than \$32 per pound mile.

Thank you for your feedback, and we look forward to working with you and the members of your team in the future.



J. Dwight Young, Manager
National Mail Transportation Purchasing

**Major Contributors to
the Report**

