July 1, 2009

SUSAN M. BROWNELL
VICE PRESIDENT, SUPPLY MANAGEMENT

SUBJECT: Audit Report – Flats Sequencing System Contractual Remedies
(Report Number CA-AR-09-006)

This report presents the results of our audit of the Flats Sequencing System (FSS) contractual remedies (Project Number 09YG015CA000). Our objective was to evaluate the adequacy of the contractual actions planned for the disposition of the preproduction machine payment withhold and to address the production machine first article testing (FAT) deficiencies. Additionally, we evaluated contract payments made to date in relation to the contractual requirements of the preproduction and production contracts. The audit was self-initiated to address financial risks in the FSS program. See Appendix A for additional information about this audit.

Conclusion:

Management of the FSS contract process resulted in increased financial risk to the U.S. Postal Service. Specifically, the Postal Service paid the $500,000 preproduction machine withhold[1] to Northrop Grumman (Northrop), the contractor, although the machine did not meet the original statement of work (SOW) requirements. Additionally, although the production machine failed to achieve nearly all of the performance requirements during FAT, the Postal Service continues to provide financing to Northrop by making milestone payments. Per the terms of the contract, title to the material purchased by Northrop using these funds does not transfer to the Postal Service until the Postal Service accepts the FSS first article and production machines. Furthermore, the Postal Service subjectively increased the amount of financial liability by $61.7 million in the event of termination for convenience. As of March 31, 2009, the Postal Service paid Northrop $53.3 million for the preproduction contract[2] and $266.7 million for the production contract. They spent another $241 million on other FSS related contracts,[3] bringing the total expenditures on the FSS program to approximately $561 million.

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[1] The Postal Service withheld $500,000 as consideration when Northrop failed to achieve the 16,500 contractual throughput rate during field acceptance testing. Throughput represents the number of flat mailpieces the FSS machine processes and sorts per hour.
[2] This includes [redacted] for the FSS prototype machine and [redacted] for the FSS preproduction machine.
[3] This includes [redacted] for facility related contracts.

Disposition of the $500,000 Preproduction Machine Withhold

The Postal Service paid the $500,000 preproduction machine withhold amount although the machine did not meet the original SOW requirement for throughput. Postal Service management agreed to modify the contract to revise the SOW requirement from 16,500 pieces per hour to a subjective "reasonable effort" determination. They also agreed to pay the withhold amount so Northrop would provide a refurbished integrated tray converter (ITC) for the preproduction machine. Postal Service management said these actions would improve the performance of the preproduction and production machines. However, per the inspection and acceptance – supplies clause of the contract, Northrop was responsible for the ITC operating properly. Consequently, the Postal Service did not receive consideration when Northrop failed to meet a key performance requirement (throughput) of the preproduction contract. Overall, it paid Northrop $53.3 million for the prototype and preproduction machines including approximately $2 million related to the field acceptance test. We will report the monetary impact of $500,000 paid to Northrop as unrecoverable questioned costs[4] in our *Semiannual Report to Congress*. See Appendix B for our detailed analysis of this topic.

We recommend the Vice President, Supply Management, instruct the FSS production machine Contracting Officer (CO) that for the remainder of the FSS program, the CO should:

1. Refrain from revising contract requirements unless adequate justification and appropriate consideration is obtained.

2. Protect the Postal Service's interests by exercising the rights incorporated into the inspection and acceptance – supplies clause.

Risks Associated with the Production Machine Contract

Payments made to date for the FSS program do not appear to be commensurate with the level of performance achieved. As of March 31, 2009, the Postal Service paid Northrop $266.7 million for the FSS production contract. However, the production machine failed to achieve nearly all of the performance requirements during the initial FAT and the Postal Service has not accepted a production system. The Postal Service continues to provide financing to Northrop by making milestone payments and does not have title to the material purchased by Northrop with these funds. Furthermore, the Postal Service subjectively increased the amount of financial liability by $61.7 million in the event of a termination for convenience. This occurred because the Postal Service, as a result of negotiations, agreed to the following contract provisions in lieu of standard contract clauses.

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[4] Unrecoverable questioned costs are costs that are unnecessary, unreasonable, or an alleged violation of law or regulation.

Specifically,

- In lieu of standard advance or progress payment clauses, the Postal Service agreed to a milestone payment schedule that provides Northrop with contract financing and does not transfer title to any material until the Postal Service formally accepts delivery of a final product.

- The Postal Service added a special clause that provides for a non-standard allocation of risk in the event of a termination for convenience before first article approval or conditional approval.

Consequently, because of the contractor's failure to achieve timely first article approval, the contract's production and delivery schedule and performance of the FSS program as a whole, is at risk. Moreover, the Postal Service made payments of at least $216.6 million to Northrop under the milestone payment schedule.

Had the Postal Service obtained proper authorization and structured these payments as advance payments, it would be entitled to interest valued at $7.7 million from Northrop. Had the Postal Service used the standard progress payment clause, it would have acquired title to at least $158.4 million in material that Northrop purchased with Postal Service funds. Also, the Postal Service assumed financial liability in the event of a termination for convenience of approximately $121.9 million. We will report the non-monetary impact of $216,601,258 in milestone payments as disbursements at risk[5] and the monetary impact of $7,733,522 in uncollected interest as unrecoverable revenue loss[6] in our *Semiannual Report to Congress.* See Appendix B for our detailed analysis of these topics.

We recommend the Vice President, Supply Management direct Automation Category Management Center Contracting Officers to:

3. Ensure that any contract utilizing milestone payments include the standard clauses for advance or progress payments, as appropriate, to limit risk and protect the Postal Service's interest.

Management's Comments

Management agreed with recommendations 1 and 2, and partially agreed with the intent of recommendation 3. However, management disagreed with the findings and monetary impacts. Management stated the actions taken by the CO were appropriate business decisions, made in collaboration with internal stakeholders, executed in the best interest of the Postal Service, and fully documented in accordance with contracting policies. See Appendix E for management's comments, in their entirety.

[5] Disbursements made where proper Postal Service internal controls and processes were not followed.
[6] Revenue that should have been recognized for goods delivered or services rendered but were not recognized because of the passage of time or other circumstances.

Evaluation of Management's Comments

The U.S. Postal Service Office of Inspector General (OIG) considers management's comments responsive to the recommendations, as management's corrective actions should resolve the issues identified in the report.

Concerning the disposition of the $500,000 preproduction machine withhold, Northrop was responsible for producing a machine that met the requirements of the contract. By releasing the withhold in exchange for a refurbished ITC, the Postal Service paid for something that was Northrop's responsibility and failed to hold Northrop to the requirements of the contract. Both the Postal Service and Northrop were aware of the risk involved in running the preproduction and production contracts concurrently. That risk does not diminish Northrop's responsibility to meet the terms of the preproduction contract nor the Postal Service's responsibility to seek damages when the terms of that contract were not met. Therefore, we continue to consider the $500,000 payment to be unrecoverable questioned costs. In addition, we will monitor the implementation of recommendations 1 and 2 as they pertain to the FSS contract for the duration of the contract.

Concerning the risks associated with the production machine contract, the contract provisions agreed to by the Postal Service increased its financial risk. The Postal Service made milestone payments based on a calendar schedule rather than objective measures. While management comments note that the Postal Service is prepared to stop milestone payments if adequate progress is not achieved, milestone payments have continued to flow to the contractor even though progress is severely off schedule. The Postal Service would have been better protected had they utilized either of the standard interim payment provisions in the FSS contract.[7] Depending on which standard interim payment method is used, the Postal Service either would have retained rights to property acquired by Northrop or obtained financing revenue. Under the FSS contract, the title to material purchased by Northrop does not transfer to the Postal Service until the Postal Service accepts the FSS machines. Management's response stated that, in the event of a termination for convenience, the Postal Service would obtain control over production components and materials. That would be true if the standard progress payment clause had been included. However, the production contract lacks that clause and is silent regarding transfer of title in the event of a termination.

In addition, we would expect that the value of production components and materials to the Postal Service would be significantly decreased in the event of a termination, as there would be no production machines to benefit from excess components or materials. Therefore, the Postal Service made $216.6 million in milestone payments without receiving title to materials and even though an FSS machine has not yet been fully accepted. As such, we continue to consider the $216.6 million in milestone

[7] The Federal Acquisition Regulation termination for convenience clause referenced on page 5 of management's comments was also not included in the contract.

payments to be disbursements at risk. Absent the standard interim payment clauses, the milestone payments constitute advance-financing payments. The *Supplying Principles and Practices* do not allow the Postal Service to reimburse a supplier for contract financing costs. Accordingly, the Postal Service should have ensured it received the interest it is entitled to from Northrop. Therefore, we continue to consider the $7.7 million in uncollected interest to be unrecoverable revenue loss. We agree with the Postal Service's plan to assess the need for an appropriate standard clause for milestone payments. It is important that future contracts utilizing milestone payments properly protect the Postal Service.

The OIG considers recommendation 3 significant, and therefore requires OIG concurrence before closure. Consequently, the OIG requests written confirmation when corrective action is completed. The recommendation should not be closed in the Postal Service's follow-up tracking system until the OIG provides written confirmation that the recommendation can be closed.

We appreciate the cooperation and courtesies provided by your staff. If you have any questions or need additional information, please contact Judith Leonhardt, Director, Supply Management, or me at (703) 248-2100.

E-Signed by Miguel Castillo
VERIFY authenticity with ApproveIt

Miguel Castillo

Miguel A. Castillo
Acting Deputy Assistance Inspector General
for Support Operations

Attachments

cc: Joseph Corbett
David E. Williams
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Don Crone
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APPENDIX A: ADDITIONAL INFORMATION

BACKGROUND

One daily activity of Postal Service letter carriers is to manually sort flat mail[8] into delivery sequence order. The Postal Service uses high-speed automated equipment to perform this function for letter mail, but carriers currently handle the flat mailpieces manually. To improve this process, the Postal Service is developing the FSS.

[redacted]

[redacted]. As a result, the primary benefit of the FSS will be eliminating carriers' manual casing of flat mail. Once deployment is complete,[9] the Postal Service projects an annual operating savings of $599.5 million. [redacted]

On January 16, 2009, the Postal Service CO notified Northrop that the FSS production machine failed FAT, because it did not meet key performance requirements of the contract. The CO advised Northrop that its requests for a conditional approval and to proceed with the deployment of FSS machines were denied. Additionally, the CO noted that the first article system failure raised significant implications to the Postal Service's planned FSS savings. Specifically, the CO advised Northrop that the Postal Service adjusted field operating budgets and the loss of operational savings substantially harms the Postal Service. Consequently, the CO requested Northrop to proceed with urgency and make the necessary fixes to avoid losses to Postal Service savings. Additionally, to minimize the delay and to provide Northrop an opportunity to train its installation crews and refine its installation plan, the CO authorized Northrop to install hardware at certain locations at its own risk.

[8] Examples of flat mail include magazines, large envelopes, newspapers, and catalogs.
[9] Deployment of all 100 machines (Phase 1) is scheduled to be completed in 2010.

The CO also accepted Northrop's request for a two-part first article retest with the first retest scheduled to be completed in May 2009 and the second retest scheduled for August 2009. The CO stipulated that the supplier would be responsible for all expenses associated with the retests.

OBJECTIVE, SCOPE, AND METHODOLOGY

Our objective was to evaluate the adequacy of the contractual actions planned for the disposition of the preproduction machine payment withhold and to address the production machine FAT deficiencies. Additionally, we evaluated contract payments made to date in relation to the contractual requirements of the preproduction and production contracts.

To accomplish our objectives, we reviewed the FSS preproduction and production contract and files including the contract modifications, FAT results, and the milestone payment schedule. We obtained the contract payment invoices for the preproduction and production contracts. We also obtained contract file correspondence. We monitored the disposition of the previously withheld amount of $500,000. We reviewed Postal Service's policy for contract financing and advance and progress payments. We analyzed contract language to determine whether the Postal Service retained the rights to the advance purchase of material in the event of a termination. We also interviewed key contracting personnel, including the CO, Contract Specialist, and Program Manager.

We conducted this performance audit from January 2009 through July 2009 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 on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. We discussed our observations and conclusions with management on May 1, 2009, and included their comments where appropriate. We relied on data obtained from the Postal Service's Enterprise Data Warehouse, Contract Authoring Management System, Financial Data Mart, and Application System Reporting. We did not test the validity of controls over the systems. However, we obtained source documentation that validated the data we obtained from them.

PRIOR AUDIT COVERAGE

Report Title	Report Number	Final Report Date	Monetary Impact	Report Results
Flats Sequencing System: Program Status	DA-AR-09-001	December 23, 2008	None	The audit determined that program management was attentive to system performance and schedule risks. However, declines in mail volume introduce a substantial new deployment risk to the program that requires management to develop a mitigation plan.
Management of Contract Changes – Flats Sequencing System	CA-MA-09-002	December 1, 2008	None	The report did not identify any unnecessary or inappropriate increased costs to the Postal Service because of changes to the FSS contracts. However, the Postal Service did not fully document the basis of a payment withhold when a contract requirement was not met. As a result, it was not apparent whether the withhold amount was appropriate and reasonable.
Flats Sequencing System: Production First Article Testing Readiness and Quality	DA-AR-08-006	June 4, 2008	None	The audit determined the Postal Service needed to focus greater attention on workload, FAT schedule, and critical deliverables.
Flat Sequencing System Risk Management	DA-AR-07-003	July 31, 2007	None	The audit determined that Postal Service Engineering needed to focus greater attention on risk management standards to ensure that the significant risks associated with deployment of the FSS were adequately identified and managed.
Flats Sequencing System Production Revised Proposal Submitted by Northrop Grumman Corporation, Electronic Systems Company	CA-CAR-07-005	December 29, 2006	$91,710,395	This audit disclosed questioned costs of $91,710,395. Questioned costs primarily represented direct material and labor.

Report Title	Report Number	Final Report Date	Monetary Impact	Report Results
Flats Sequencing System Production Proposal Submitted by Northrop Grumman Corporation, Electronic Systems Company	CA-CAR-07-003	December 4, 2006	$175,670,235	This audit disclosed questioned costs of $175,670,235. Questioned costs primarily represented direct material and labor.

APPENDIX B: DETAILED ANALYSIS

Disposition of the $500,000 Preproduction Machine Withhold

The original SOW required the supplier to achieve a throughput rate of 16,500 mailpieces per hour. However, modification 18 to the preproduction contract eliminated the target performance requirement. Specifically, modification 18:

- Changed the 16,500 throughput requirement to a subjective "reasonable effort" determination.
- Released the $500,000 withhold in exchange for a refurbished ITC.
- Required Northrop to perform a throughput demonstration using the refurbished ITC showing it used a “reasonable effort” to achieve the 16,500 throughput rate.

Postal Service management said they opted for the ITC refurbishment and were willing to accept a "reasonable effort" determination instead of what was in the SOW for two primary reasons. First, the Dulles Processing and Distribution Center (P&DC) would be provided with a more reliable preproduction machine, and second, the production FAT system would be provided with live mail test time with ITC improvements.

The throughput demonstration results indicated that the ITC showed performance improvements in two areas - average/run hour and downtime/event. However, the throughput rate actually decreased when compared with the throughput rate achieved during field acceptance testing. The throughput rate achieved during field acceptance testing was 13,545 pieces per hour versus 10,708 at the demonstration. In addition, it is not clear that Northrop used a “reasonable effort” in achieving the 16,500 throughput requirement because the throughput rate achieved at the demonstration was only 65 percent (10,708/16,500) of the target requirement. Furthermore, although the Postal Service said it benefited from the ITC refurbishment, it was not the Postal Service’s responsibility to pay for the refurbishment. Under the terms of the contract, the supplier should have assumed responsibility for correcting the ITC at no cost to the Postal Service. Specifically, according to clause 2-1 *"Inspection and Acceptance - Supplies"* in the preproduction contract, the Postal Service may reject defective supplies or services and:

- Require replacement or correction of the defects without cost to the Postal Service.
- Acquire replacement products at the supplier's expense.
- Accept the supplies or services at a reduced price.

Risks Associated with the Production Machine Contract

The Postal Service's Test Evaluation and Quality group conducted the FSS production FAT at the Dulles P&DC. The test lasted for 23 days beginning on November 23, 2008, and ending on December 20, 2008. The results indicated the production machine failed to achieve 13 of 17 performance requirements. See Appendix C for the detailed results of FAT.

Despite the FAT failure, the Postal Service continued to make scheduled payments to Northrop. The CO said that these payments were considered milestone payments and they were being made to provide financing to Northrop in advance of delivery of the FSS machines. The Postal Service's *Supplying Principles and Practices* state that usually the Postal Service pays for supplies and services after delivery or performance. However, for some purchases, sources may be unavailable or competition too limited without the availability of advance or progress payments. The *Supplying Principles and Practices* include protective clauses for advance and progress payments. Also, Management Instruction FM-610-2003-1, *Advance Payments,* requires the supplier to pay interest on the daily balance of the unliquidated advance payment. In addition, the Management Instruction states the Vice President, Controller, Finance, must approve advance payments for more than $1 million and the Manager of Accounting and the Supply Management Portfolio Manager must approve advance payments of $50,000 to $1 million.

During contract negotiations, the Postal Service agreed to a milestone payment schedule that required the Postal Service to finance the contract by making payments to Northrop before delivery of supplies or the rendering of services. The contract does not include protective clauses associated with the milestone payment schedule. Originally, the Postal Service wanted to structure the contract for progress payments, which is typical for these types of contracts. Progress payments would have allowed the Postal Service to make payments that were commensurate with the level of performance achieved. However, per the contract's negotiation memorandum, Northrop was unwilling to accept progress payments because that went against its corporate structure and would affect the way it 'booked' sales. The Postal Service did not obtain approvals or collect interest for the milestone payments made to Northrop. See Appendix D for the details of the milestone payments made by the Postal Service as of March 31, 2009.

Many of the milestone payments were for material purchased by Northrop for the production of the FSS machines. However, although the Postal Service has paid Northrop for the material, it does not have title to the material. According to clause 4-1 *"General Terms and Conditions"* Section (n), title to items furnished under this contract will pass to the Postal Service upon acceptance, regardless of when or where the Postal Service takes physical possession. The Postal Service has not accepted the first article machine or any production machines. Therefore, title for the material has not transferred to the Postal Service. If the Postal Service had structured the contract for progress payments, the Postal Service would have had certain protections built into the contract. For example, the standard progress payment clause would have vested title to material to the Postal Service at the time Northrop acquired or used it.

As of March 31, 2009, the Postal Service paid Northrop at least $158.4 million in advance for material acquisition. The payments are detailed below.

- Three payments totaling $60.2 million for "Production Long Lead Turn On."

- Four payments totaling $90.3 million for "Production Lead Time Material Build Up."

- Three payments totaling $7.9 million for "System Deploys – Start."

Also, during contract negotiations the Postal Service agreed to include special clause 3-57, *"Long Lead and Production Material Ordering/Costs",* to the contract. This clause supersedes certain sections of standard clause 2-5, *"First Article Approval – Postal Service Testing,"* of the contract. Under Sections (g) and (h) of standard clause 2-5, acquisition of materials or components for the balance of the contract quantity or commencement of production is at the supplier's sole risk before first article approval. However, special clause 3-57 reallocated risk from Northrop to the Postal Service for certain material purchased before first article approval.

The Postal Service's rationale for abandoning its standard risk allocation provisions in standard clause 2-5 Sections (g) and (h) and for replacing them with special provisions is explained in special clause 3-57. Special clause 3-57 states that to assure the Postal Service of the delivery schedule provided for within the contract at the pricing shown within the schedule, Northrop must provide for subcontract commitments concerning material acquisition purchases before the period provided within clause 2-5. However, this rationale makes less sense when Northrop's failure to achieve timely first article approval delays the contract's production and delivery schedule and as a result, potentially impacts Postal Service's savings.

Special clause 3-57 identifies the amount of financial liability for material the Postal Service will assume in the event of a termination for convenience. According to the clause, there are two primary trigger points that pass financial liability in the event of a termination for convenience on to the Postal Service:

- Section 2(a) states that the Postal Service will assume termination liability for the acquisition of the long lead production material after the Postal Service approves or conditionally approves the preproduction field acceptance test.

  The Postal Service conditionally approved the preproduction machine on May 5, 2008, and as a result, assumed full termination liability associated with the "Production Long Lead Turn On" payments. This amounts to approximately $60.2 million (three milestone payments were made).

- Section 2(b) states that the Postal Service will assume termination liability for the acquisition of the balance of the production material (non-long lead materials) after approval or condition approval of the production first article in-plant test.

  As of March 31, 2009, the Postal Service had not approved or conditionally approved the production first article in-plant test and as a result, has not yet assumed termination liability for the “Production Lead Time Material Build Up” and “System Deploys - Start” payments. As of March 31, 2009, the Postal Service made four milestone payments, totaling $90.3 million for “Production Lead Time Material Build Up,” and three milestone payments, totaling $7.9 million for “System Deploys – Start.”

In addition, Section 2(d) of clause 357 allows the Postal Service to subjectively assume additional termination liability. Specifically, Section 2(d) allows Northrop an opportunity to present other existing information supporting design stability and critical performance of the system to convince the Postal Service to assume termination liability on other than the first article in-plant test results. In a letter dated June 19, 2008, Northrop requested the Postal Service assume an additional $61.7 million in termination liability per Section 2(d) of clause 3-57. The Postal Service agreed to assume the additional termination liability based on the information Northrop presented. Therefore, as of March 31, 2009, the Postal Service assumed financial liability in the event of a termination for convenience for material of approximately $121.9 million.[10]

[10] The Postal Service is currently negotiating with Northrop to increase the termination liability by $201.8 million, which would bring the total to approximately $323.7 million.

APPENDIX C: DETAILED RESULTS OF FAT

Performance Criteria	Contract Requirement	First Article Test Results	Contract Requirement Achieved (Yes or No)
Throughput Rate 2-Pass	Minimum of 16,500 Pieces Per Hour	10,601 Pieces Per Hour	No
Throughput Rate 2-Pass over 45,000 Pieces	Minimum of 16,500 Pieces Per Hour	12,499 Pieces Per Hour	No
Accuracy Rate	Minimum of 98.70 %	98.60%	No
Accept Rate	Minimum of 94.60 %	89.96%	No
Operational Availability Rate	Minimum of 95.00 %	-16.34%	No
Mail Damage Category 2 Rate	Not to Exceed 1 Piece Per 1,200 Flats Processed (0.083 %)	1.62%	No
Mail Damage Category 3 Rate	Not to Exceed 1 Piece Per 2,500 Flats Processed	6.35 Pieces	No
Flyout Rate	Not to Exceed 10 Flyouts Per 10,000 Flats Processed	66.43 Flyouts	No
Throughput Rate Non-2-Pass	Minimum of 37,000 Pieces Per Hour	29,657 Pieces Per Hour	No
Flats Identification Coding System Label Placement Accuracy Rate	Minimum of 99.00 %	90.92%	No
Carrier Automated Street Tray Rack Sort Accuracy Retention Rate	Minimum of 99.00 %	This test was not conducted because it was known before FAT that there were issues with the FSS meeting this requirement.	No
Carbon Insert Damage Rate	Not to Exceed 1 Per 1,000 Pieces	This test was not conducted.	No

Performance Criteria	Contract Requirement	First Article Test Results	Contract Requirement Achieved (Yes or No)
Static Discharge	Shall not damage or incur degradation of performance because of a static discharge set to a level of 11kv into any external surface area of the equipment.	This test was not conducted.	No
Tray Labeler Jam Rate	Not to Exceed 1 Jam Per 300 Tray Labels Applied	0.00 Jams	Yes
Remote Encoding Center (REC) Image Volume Rate	Not to Exceed 10 % of Images Sent to the REC	6.30%	Yes
Optical Character Reader Performance Rate	Minimum of 90.00 %	94.60%	Yes
Flats Identification Coding System Data Accuracy Rate	Minimum of 99.00 %	99.99%	Yes

APPENDIX D: SCHEDULE OF MILESTONE PAYMENTS AS OF MARCH 31, 2009

Payment Description	Invoice Number	Amount	Days Paid Early[11]	Uncollected Interest[12]
Major Subcontractor Turn-on (Nonrecurring Engineering(NRE) /Long Lead 1st 5 systems)	90158263	$5,787,365	740	$508,356
Major Subcontractor Turn-on(NRE/Long Lead 1st 5 systems)	90159610	5,787,365	721	493,300
Major Subcontractor Turn-on(NRE/Long Lead 1st 5 systems)	90161256	5,787,365	710	484,602
Technical Review Meeting (TRM) 1	90157189	2,178,897	756	196,176
TRM 2	90159612	2,178,897	728	187,810
TRM 3	90161846	2,178,897	693	177,397
TRM 4	90165427	2,178,897	655	166,145
TRM 5	90166945	2,178,897	630	158,774
TRM 6	90169974	2,178,897	592	147,617
TRM 7	90171579	2,178,897	567	140,308
TRM 8	90174854	2,178,897	536	131,806
TRM 9	90175951	2,178,897	529	129,890
TRM 10	90180040	2,178,897	469	113,531
TRM 11	90182709	2,178,897	445	107,021
TRM 12	90185109	2,178,897	416	99,179
TRM 13	90187089	2,178,897	389	91,903
TRM 14	90189600	2,178,897	355	82,774

[11] We used June 8, 2009, (30 days after the expected completion of the first FAT retest) as the estimated payment date for goods delivered.
[12] Uncollected interest was calculated as follows: {(Interest Rate(Number of Days Paid Early/365)*Payment Amount-Payment Amount)}.

Payment Description	Invoice Number	Amount	Days Paid Early[11]	Uncollected Interest[12]
TRM 15	90139140	2,178,897	318	72,883
TRM 16	90194905	2,178,897	298	67,554
TRM 17	90197521	2,178,897	269	59,850
TRM 18	90200488	2,178,897	222	47,422
Deployment Technical Review Meeting (DTRM) 1	90202410	323,150	214	6,720
DTRM 2	90205197	323,150	182	5,591
DTRM 3	90208157	323,150	152	4,663
DTRM 4	90210339	323,150	119	3,645
DTRM 5	90212964	323,150	88	2,691
Production Long Lead Turn On #1	90186515	12,500,000	404	550,409
Production Long Lead Turn On #2	90188201	27,500,000	369	1,092,087
Production Long Lead Turn On #3	90193695	20,194,685	318	675,498
Production Lead Time Material Build Up #1	90202081	20,000,000	220	430,443
Production Lead Time Material Build Up #1	90204246	10,097,342	194	185,603
Production Lead Time Material Build Up #2	90204757	30,097,343	189	540,938
Production Lead Time Material Build Up #3	90207111	30,097,343	159	454,430
System Deploys - Start #1	90203531	2,638,852	200	50,416
System Deploys - Start #2	90207110	2,638,852	161	40,348
System Deploys - Start #3	90211677	2,638,852	103	25,742
Totals:		**$216,601,258**		**$7,733,522**

APPENDIX E: MANAGEMENT'S COMMENTS

SUSAN M. BROWNELL
VICE PRESIDENT, SUPPLY MANAGEMENT

UNITED STATES POSTAL SERVICE

June 12, 2009

LUCINE M. WILLIS

SUBJECT: Draft Audit Report – Flats Sequencing System (FSS) Contractual Remedies (Report Number CA-AR-09-DRAFT)

Thank you for the opportunity to review and comment on the subject audit report. Supply Management's response to your findings and recommendations are contained within this memorandum.

Postal Service Conclusion: The Postal Service disagrees with the conclusions of the OIG's draft report and believes that the findings and recommendations are not completely reflective of the actual events reviewed. The report also excludes important considerations upon which the Contracting Officer evaluated and acted upon in administering the FSS program contracts which are not reflected in the draft report or recommendations. Accordingly, we disagree with the findings and assessed monetary risk related to FSS contract administration and preproduction negotiation results. We believe that in each case noted by the OIG, the actions taken by the Contracting Officer were appropriate business decisions. They were made in collaboration with internal stakeholders, executed in the best interest of the Postal Service, and fully documented in accordance with our contracting policies.

Specific response to each recommendation is as follows:

Recommendation: We recommend that the Vice President, Supply Management instruct the FSS production machine Contracting Officer that for the remainder of the FSS program, the Contracting Officer should:

1. Refrain from revising contract requirements unless adequate justification and appropriate consideration is obtained.

2. Protect the Postal Service's interest by exercising the rights incorporated into the inspection and acceptance – supplies clause.

Management Response: Recommendations 1 and 2 are existing performance expectations and appropriate practices of all Contracting Officers across Supply Management in administering contracts for the Postal Service. The FSS Contracting Officer was fully cognizant of these obligations, and fully documented his actions in correctly applying these practices under the FSS preproduction and production programs. Accordingly, we agree with these recommendations and will ensure that such are continued to be observed by the FSS Contracting Officer under program administration. In the context of your findings however, we believe the rationale for our decisions and actions as documented below support our position for disagreement with the OIG's findings that the Postal Service incurred $500,000 in unrecoverable costs.

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In the section titled *Disposition of the $500,000 Preproduction Machine Withhold*, the OIG states that: *"The Postal Service paid the $500,000 preproduction machine withhold amount although the machine did not meet the original Statement of Work (SOW) requirement for throughput."* That, *"per the inspection and acceptance – supplies clause of the contract, the supplier was responsible for the integrated tray converter (ITC) operating properly."* And, *"the Postal Service did not receive consideration when the supplier failed to meet a key performance requirement (throughput) of the preproduction contract."*

Within the FSS preproduction contract, the Contracting Officer provided for a withholding of payment in the amount of $500,000 to protect the Postal Service's interest against the supplier not completing development activities related to the ITC machine component. The ITC is a unique component not previously fielded in any automated solution for any of the world's posts. It transfers mail pieces from one container to another and re-orients the mail pieces within differing trays required for automated mail sequencing.

The Contracting Officer is provided the authority and has the responsibility to be able to change the contract to achieve best value for the Postal Service. After reviewing the status of both the preproduction and the production programs, it became apparent that the delays occurring in the preproduction program were starting to impact the production program, because the supplier had certain key personnel supporting both programs. Additionally, it was realized that the existing preproduction design could not achieve the needed results without extensive rework to the system. The Contracting Officer came to the conclusion that forcing the supplier to continue to incur time and money to bring the preproduction system into full compliance with the SOW would ultimately be at the expense of the FSS production program. The expected return on investment as identified in the production DAR far outweighs the $500,000 withheld on the preproduction machine. Importantly as discussed below, the supplier communicated and program officials confirmed to the Contracting Officer that the improvements offered by the supplier and desired by the Postal Service's Engineering Flat Mail Technology (FMT) organization for the preproduction ITC would reflect or exceed the value of the $500,000 withheld. Finally, the draft report also omits that continuing work on the preproduction ITC would also require the supplier to expend resources on extensive software modifications that could not be used on the production system and that the preproduction system was to be disassembled and removed from our Dulles P&DC facility. Therefore, after discussion and consideration with program officials, it was determined to be in the best interest of the Postal Service for the Contracting Officer to negotiate a trade for additional work to be performed on the ITC by the supplier. In exchange, payment of the $500,000 previously withheld by the Contracting Officer for the supplier's failure to meet the throughput requirement for the preproduction system was authorized.

The Postal Service FMT program office as noted did see other opportunities for getting value out of the preproduction system to ensure the likelihood that the production system would be successful. Throughput and availability were two of the critical key performance parameters that needed additional work, as indicated from the field acceptance test results. These parameters drive a large portion of the production DAR's expected savings. The supplier had previously submitted a "Throughput Improvement Roadmap" that presented their plans to make adequate progress towards a fully compliant production machine. Based upon the timing and availability of some of these improvements, the program office decided that the preproduction machine would not be upgraded with all the possible enhancements. By getting the supplier to agree to perform the highest value based modifications enabled us time to assess the improvements and confirm that the proposed ITC improvements would help the production system achieve a higher throughput. Additionally, it would provide greater stability to the preproduction machine during our busy mailing season. .

These additional valued improvements to the preproduction ITC were proposed by the supplier at a price of $519,778. Since the proposed price was close to the $500,000 withheld, a settlement was reached. These improvements were designed to prevent jams and, therefore, enhance machine throughput and availability. By themselves, these modifications would not improve the throughput of the machine to the SOW requirement of 16,500 and that was understood by both parties. Therefore, we accepted a best efforts approach. After the modifications were accomplished, a demonstration was performed, and the throughput did not show signs of improvement primarily because other parts of the system were not functioning well and masked the ITC improvements. However, we were able to determine that the number of jams and the downtime for the operators to clear jams went down significantly, which indicated the improvements were valid and helped boost our confidence that the improvements would benefit the production machine. Listed below are the results of that demonstration:

ITC Data from System Acceptance Test

Summary	Jam Time	Maint Time	Total
Average / Run Hr	0:06:46	0:14:59	0:21:46
Downtime per Event	0:01:40	0:01:52	0:01:48

ITC Data from ITC Refurbishment Demonstration

Summary	Jam Time	Maint Time	Total
Average / Run Hr	0:05:48	0:08:02	0:13:50
Downtime per Event	0:00:49	0:01:46	0:01:11

Another factor not taken into account within the OIG's draft report was any consideration of the risk to the Postal Service if the existing preproduction ITC's could not survive the operational processing needs for the heavy fall mailing season in 2008. With that in mind, the Contracting Officer and program officials had to act quickly to prevent a potential failure of the ITCs which would have prevented the Dulles P&DC from processing mail on the preproduction FSS. Carrier route adjustments had already been made to accommodate the processing of mail on the FSS.

Based on the above factors and demonstrated rationale, the value of the ITC refurbishment is well in excess of the $500,000 payment made, and we disagree that this value is unrecoverable questioned cost.

Recommendation 3: We recommend the Vice President, Supply Management direct Automation Category Management Center Contracting Officers to:

3. Ensure that any contract utilizing milestone payments include the standard clauses for advance or progress payments, as appropriate, to limit risk and protect the Postal Service's interest.

Management Response: We believe our rationale for our decisions and actions as documented below supports our position for disagreement with the OIG's findings in this section. Furthermore, we disagree with the OIG conclusion that the Postal Service incurred $7,733,522 of unrecoverable revenue loss or non-monetary impact of $216,601,258 for disbursements at risk. However, we do partially agree with the intent of Recommendation 3 and will assess the need for an appropriate standard clause for milestone payments. Assessment completion is targeted for November 2009.

In the section titled *"Risks Associated with the Production Machine Contract,"* the OIG commented on several payment issues regarding the production FSS program and are summarized below:

1. *Postal Service payments to date are not commensurate with the level of supplier performance received.*

2. *The Postal Service is providing financing to the supplier by making milestone payments, which has resulted in either the unrecoverable revenue loss of uncollected interest*

payments amounting to $7,733,522 if the advanced payment clause had been used, or the Postal Service would have received title to $158.4 million in material if the Progress Payments clause had been used.

3. *By using milestone payments instead of advanced payments or progress payments, the Postal Service did not follow internal controls, and put the Postal Service at greater risk than necessary, resulting in payments of at least $216.6 million.*

The Postal Service addresses each of these items below and provides our rationale for what we believe to be actions within the policy guidelines of the Supplying Principles and Practices:

1. The Postal Service has been monitoring the FSS progress to ensure adequate progress is being made against the milestone payments that have been made to date. The value received is a subjective matter. We have been prepared to stop milestone payments in the event the supplier does not continue to make progress, just as we would progress payments. While there have not been any production units fully accepted to date, the Postal Service has been receiving the benefit of the systems running live mail and already has started to receive a return on our investment. There are currently three systems running live mail, and several more within a few weeks of operational readiness. The supplier has provided management presentations which reflect they have been financing significant financial expense well beyond total Postal payments to date which was not anticipated at time of contract award. This has resulted in a significant negative cash flow to the supplier. Based upon the system performance measured during the recent completion of the First Article Test, the Postal Service has provided conditional approval of the system, which in turn as the conditions are met, will allow the supplier to proceed with more machine installations.

2. The Postal Service uses the Supplying Principles and Practices as a guideline to how we administer contracts. Our policy identifies progress payments and advanced payments as two possible methods of contract financing. We do not see this policy as restrictive and only allowing these two methods of contract payments. The Contracting Officer chose to use certain milestone payments linked to production materials and performance as the financing method for this contract. This method of supplier financing has been a well established past practice. The OIG identified $7,733,522 as an unrecoverable revenue loss, due to the Postal Service's failure to collect interest if advanced payments would have been utilized on this contract. Advanced payments are not typically used in this type of major contract. The Postal Service did not consider this type of funding because it is typically used as a payment type for goods or services for which the supplier has not yet incurred costs, such as for facility rentals, magazine subscriptions, booth space at conventions, tuition, and software maintenance, but are typically paid "up front". The OIG view of $7.7 million of unrecoverable revenue loss is misguided because if milestone payments had not been negotiated, progress payments would have been the most logical method of supplier financing, not advanced payments. No interest would have been required if progress payments was used. In fact, the original solicitation for the production requirement included the clause for progress payments. However, the supplier and Contracting Officer ultimately determined to incorporate milestone payments within the contract.

   Certain milestone payments provided for in this contract were an alternative to progress payments, and were carefully planned and negotiated so that the milestones were tied to performance or timeframes, and the supplier would have already incurred the costs, rather than being paid in advance of performance. We anticipated financing to closely follow a similar cash outlay as progress payments would have consumed. During contract negotiations the supplier provided cash flow projections that we relied upon in negotiating milestone payments.

As concerns title to material, the OIG report identified there would be a financial advantage in that the Postal Service would have received title to approximately $158.4 million of material in the event of a termination for convenience or termination for default. Under the FSS contract terms and termination for convenience clauses, our exposure for material liability is limiting and controlled until after successful completion of two tests, the preproduction field acceptance test and the production in plant test. Accordingly, by the terms of the contract, our material liability is limited. Under advanced payments or progress payments, the liability could have been much higher, as the supplier would have been able to invoice a percentage of cost incurred or in advance would have been paid not linked to performance.

3. Since our negotiated milestone payments were based upon the supplier's anticipated cash outflow, the milestone payments that were identified by the OIG totaling $216,601,258 would have been paid out if we had used either advanced payments or progress payments. In fact, we added the clause, *Long Lead and Production Material Ordering/Costs*, specifically to limit our risk and liability in the event of a termination for convenience. We do not agree that the money we paid for the purchase of components and materials for FSS are lost funds. In the event of a termination for convenience the Postal Service would get control of those components and materials. The Postal Service could then direct the supplier to sell the components for our benefit. As a practical matter, the Postal Service ends up in the same position as though we had title to the material and components not used in machines delivered. By way of benchmarking, within the Federal Acquisition Regulation (FAR), the termination for convenience clause makes this clear ("The termination clauses provide that the contractor is responsible for preservation of the termination inventory and must tender the inventory to the Government" Nash and Cibinic, Administration of Contracts at 1118). In the Postal Service we follow this principle in the calculation of settlement damages.

   In addition, we do not agree that the $216.6 million in payments made represent disbursements at risk for which proper Postal Service internal controls and processes were not followed and we do not agree that we lost the $7.7 million in interest that an advance payment clause would grant. If we contracted with an advance payment clause that required the supplier to pay us interest on advance payments, then the supplier would have insisted upon a price for the FSS that was $7.7 million higher. There is no free financing.

We do not believe that this report contains any proprietary or business information and may be disclosed pursuant to the Freedom of Information Act. If you have any questions about this response, please contact Susan Witt at (202) 268-4833.

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