January 26, 2007

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SUBJECT: Audit Report – Automated Package Processing System Status and Administration (Report Number DA-AR-07-001)

This report presents the results of our audit of the Automated Package Processing Systems (APPS) (Project Number 05XG019DA000). The audit was self-initiated as part of our continuing review of the APPS program.

At the start of our audit, APPS machines, conditionally accepted by the U.S. Postal Service, did not fully meet program objectives due to performance challenges. However, recent Postal Service test results indicate that a retrofit improved system performance. In addition, the Postal Service established payment withholds for technical performance shortfalls, sought appropriate recoveries for contractor schedule slippages, and specified conditions for full acceptance. However, Postal Service officials could improve certain contracting activities to better support program requirements according to Postal Service policies and procedures. These issues resulted in non-monetary benefits of $12 million for assets at risk and monetary benefits of $1,980,150 for unrecoverable questioned costs. These amounts will be reported in our *Semiannual Report to Congress.*

We recommended that management encourage the removal of targeted operations as performance warrants, reassess the investment impact of unanticipated costs, and ensure that future major equipment contracts adequately detail maintenance specifications. In addition, we made four more recommendations to improve contracting activities. Management generally agreed with our recommendations. However, management disagreed with our categorization of a separate $12 million contract and payment as an advance payment. They also disagreed with the categorization of $1.98 million in unrecoverable questioned costs stemming from interest lost on the advance payment. Management's comments and our evaluation of those comments are included in the report.

Actions taken relating to recommendations 1, 3, 5, 6, and 7 were sufficient to close them. However, the U.S. Postal Service Office of Inspector General (OIG) considers recommendation 2 significant and remains open. Therefore, recommendation 2 requires OIG concurrence before closure and we request written confirmation when the planned corrective action is completed. This recommendation should not be closed in the follow-up tracking system until the OIG provides written confirmation the recommendation can be closed. In addition, management agreed to recommendation 4, but their comments were not responsive to the issues identified in the finding. We do not plan to pursue recommendation 4 through the formal audit resolution process.

We appreciate the cooperation and courtesies provided by your staff during the audit. If you have any questions or need additional information, please contact Miguel Castillo, Director, Engineering; Judy Leonhardt, Director, Supply Management and Facilities; or me at (703) 248-2100.

E-Signed by Colleen McAnte
ERIFY authenticity with Approve

Colleen A. McAntee
Deputy Assistant Inspector General
for Core Operations

Attachments

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# EXECUTIVE SUMMARY

**Introduction**

The U.S. Postal Service Office of Inspector General assessed whether the Automated Package Processing System (APPS) met program objectives for replacing Small Parcel and Bundle Sorter (SPBS) machines and statement of work objectives for minimizing maintenance requirements. In addition, we determined whether the Postal Service sought appropriate recoveries for contractor nonperformance. Finally, we determined whether contract activities supported program requirements and whether they were performed according to Postal Service policies and procedures.

**Results in Brief**

At the start of our audit, APPS machines that were conditionally accepted by the Postal Service were breaking mail bundles and incurring excessive maintenance. Hence, management retained SPBS machines they had planned to replace to process mail that did not sort on APPS machines. We estimate the Postal Service incurred over $30 million in unexpected costs for SPBS operations and excessive maintenance on these conditionally accepted APPS machines.

Recently, the Postal Service reported that field tests for fully accepted APPS machines indicate that a retrofit improved the sustained performance and availability, providing a reliable platform on which to process mail. However, our analysis indicated that excessive maintenance workhours remained a concern.

The Postal Service established payment withholds for technical performance shortfalls, sought appropriate recoveries for contractor schedule slippages, and specified the conditions for full acceptance. Also, APPS program managers properly paid contractor invoices and properly reduced invoices to liquidate contractor progress payments and to withhold amounts for contractor nonperformance. However, Postal Service officials could improve certain contracting activities to better support program requirements according to Postal Service policies and procedures. Specifically, the Postal Service awarded two contracts to the APPS supplier, resulting in an apparent unapproved $12 million advance payment and a loss to the Postal Service of approximately $2 million in interest on advanced monies. These issues resulted in non-monetary benefits of $12 million for assets at risk and monetary benefits of $1,980,150 for unrecoverable questioned costs. These amounts will be reported in our *Semiannual Report to Congress.*

Additionally, the contracting officer did not formally notify the contractor of the conditional acceptance following first article test or timely modify the contract to reflect subsequent agreements to revised testing and acceptance procedures. Finally, the contracting officer's representative did not review and maintain receiving reports or other supporting documentation for nine of 39 contractor invoices[1] before certifying them for payment.

**Summary of Recommendations**

We recommended the Vice President, Engineering, in coordination with the Vice President, Supply Management, encourage the removal of SPBS operations as planned, reassess the investment impact of unanticipated costs, and ensure that future major equipment contracts adequately detail maintenance specifications. In addition, we made four more recommendations to improve contracting activities.

**Summary of Management's Comments**

Management agreed with our recommendations to remove the remaining SPBS as APPS performance warrants and to ensure future U.S. Postal Service major equipment contracts adequately detail maintenance specifications prior to contract award. Management partially agreed with our recommendation to reassess the investment impact of operating APPS with unanticipated additional SPBS and maintenance hours, stating such an assessment would be part of an After Cost Study undertaken by Headquarters Finance.

Management also agreed with our recommendations to document the APPS contract file to explain how the contracting officer communicated conditional acceptance to the contractor and to timely modify the contract to incorporate any future revisions to testing and acceptance. Additionally, management agreed to our recommendation to review and maintain copies of invoice supporting documentation as evidence that contractors actually

[1] The nine invoices totaled approximately $59.7 million, while the 39 invoices totaled approximately $228 million.

incurred costs claimed for progress payments and provided supplies and services before certifying invoices for payments.

Finally, management agreed with our recommendation to obtain appropriate approvals prior to executing contracts resulting in alternative payment agreements or advance payment and require contractors to pay interest, as appropriate. However, management disagreed with our categorization of the separate $12 million contract and payment as an advance payment, stating the contract was part of the negotiations and resulted in a price reduction that was in the Postal Service's best interest. They also disagreed with the categorization of $1.98 million in unrecoverable questioned costs stemming from interest lost on the advance payment. Management's comments, in their entirety, are included in Appendix B of this report.

**Overall Evaluation of Management's Comments**

Management's actions taken or planned are responsive to recommendations 1, 3, 5, 6, and 7 and should correct the issues identified in the findings. Although management agreed to recommendation 2 and their planned action is responsive, no timeframes were specified for completion. Thus, we continue to consider the recommendation open and significant. In addition, management agreed to recommendation 4, however, their comments were not responsive to the issues identified in the finding. Although we agree the separate contract was part of the negotiations and resulted in an overall reduced price, we believe the Postal Service's agreement is most analogous to an advance payment since the arrangement allowed the contractor to receive monies before delivering any supplies. Consequently, we continue to believe our recommendation and claimed benefits are appropriate. However, we do not plan to pursue recommendation 4 through the formal audit resolution process.

# INTRODUCTION

## Background

The U.S. Postal Service is deploying Automated Package Processing Systems (APPS) to replace the Small Parcel and Bundle Sorters (SPBS). APPS machines are expected to improve processing efficiency and increase the capacity of bundle and parcel sorting through automation, thus reducing costs. The Postal Service currently uses SPBS to process bundles of flats or letters, parcel-sized Priority Mail®, and Parcel Post®. The Postal Service's plan is to replace one or two SPBS for every APPS machine installed at selected plants.

The APPS contract requires the contractor to deliver APPS machines that meet statement of work (SOW) requirements according to a deployment schedule. The APPS program received first article test (FAT) conditional acceptance in May 2004. In July 2004, the Postal Service began deploying and conditionally accepting APPS machines, but had performance and reliability challenges. In May 2006, the Postal Service had conditionally accepted the first 50 deployed APPS units with the understanding that the vendor would bring the machines into compliance with the SOW.

To address issues with APPS performance and reliability, the vendor has installed a retrofit kit. Fleet Acceptance Testing (FLAT) was designed to ensure the installed retrofit kits corrected previously identified APPS performance shortfalls on the first 50 deployed APPS machines.

The contracting officer is responsible for ensuring timely contract performance according to contract specifications and ensuring the supplier is promptly compensated in the proper amount. The contracting officer may appoint, in writing, one or more representatives (COR) to perform any administrative function that does not involve a change in the scope of work, specifications, or cost or duration of contract performance.

## Objectives, Scope, and Methodology

The U.S. Postal Service Office of Inspector General (OIG) assessed whether the APPS program met objectives for replacing SPBS machines and SOW objectives for minimizing maintenance requirements. In addition, we determined whether the Postal Service sought appropriate recoveries for contractor nonperformance. Finally, we determined whether contract activities supported program requirements and were performed according to Postal Service policies and procedures.

Our review focused primarily on conditionally accepted, non-retrofitted APPS machines. The Postal Service had not deployed retrofitted unconditionally accepted machines at the start of our audit. To assess whether the APPS program met objectives for replacing SPBS machines and achieving system maintenance requirements, we:

- Determined whether sites with deployed APPS units replaced SPBS operations as documented in the SOW and detailed in the Decision Analysis Report (DAR) field budget and, if not, calculated the additional SPBS workhours.

- Measured APPS maintenance hours against SOW expectations as stated in Section F.

- Interviewed and obtained site-specific information from Postal Service program managers and field officials.

We relied on computer-processed data maintained in Postal Service operational systems, including the End of Run Reports, Maintenance Activity Reports, eDeploy, and Management Operating Data System Reports. We conducted a preliminary assessment of data reliability and concluded the data used was sufficiently reliable to answer the audit objectives.

We reviewed the contract file (including modifications, correspondence, and negotiation memoranda) to determine whether the Postal Service sought appropriate recoveries for contractor nonperformance and whether contract activities supported program requirements and were performed according to Postal Service policies and procedures. Additionally, we reviewed contractor invoices and supporting documentation from the contract award date of September 20, 2002, through April 5, 2006. To perform our analysis, we relied on computer-generated data in the Accounts Payable Accounting and Reporting System (APARS) and the Accounts Payable System. For the period reviewed, we compared invoice numbers, dates, and amounts with payment data in APARS and the Accounts Payable System. We believe the data were sufficiently reliable to form our conclusions and recommendations.

We conducted this audit from October 2005 through January 2007 in accordance with generally accepted government auditing standards and included such tests of internal controls as we considered necessary under the circumstances. We discussed our observations and conclusions with management officials and included their comments where appropriate.

## Prior Audit Coverage

The OIG issued a report titled *Audit of Firm Fixed Price Proposal Submitted by Lockheed Martin Distribution Technologies, Under Solicitation Number 102590-01-A-0040, Contract Pricing Case Number PC-02-029* (Report Number CA-CAR-02-054, dated September 13, 2002). The report stated the contractor submitted adequate cost or pricing data and prepared the proposal in accordance with applicable provisions of the Postal Service's *Purchasing Manual*. The contractor's proposed price was approximately $357 million. Finally, the report concluded the contractor proposal was acceptable as a basis for negotiation of a fair and reasonable price.

Also, the OIG issued a report titled *Automated Package Processing System First Article Test* (Report Number DA-AR-04-001, dated August 20, 2004). The report identified problems with throughput performance during the testing phase and issues related to facility modification costs. Management agreed with our findings and recommendations to capture all relevant costs and provided detailed specifications to the sites affected.

Additionally, the OIG issued a report titled *Automated Package Processing System Deployment* (Report Number DA-AR-06-004, dated March 21, 2006). The report identified significant performance challenges at APPS deployment sites and retest plans that provided inadequate protection to the Postal Service. Management disagreed with our findings, but agreed with the recommendation to test sustained performance in accordance with the SOW before acceptance.

# AUDIT RESULTS

**Automated Package Processing System Program and Statement of Work Objectives**

At the start of our audit, conditionally accepted APPS machines did not fully meet program objectives. Specifically, management retained SPBS machines they had planned to replace to process mail that did not sort on APPS machines. In addition, APPS maintenance workhours exceeded SOW objectives. As a result, we estimate the Postal Service has incurred over $30 million in unexpected costs for SPBS operations and excessive APPS maintenance on these conditionally accepted machines. (See Table 1.)

**Table 1. SPBS Operations Costs and APPS Maintenance**

| Costs | Amount |
|---|---|
| Unexpected SPBS Operational Costs (Conditional acceptance through planned retrofit date) | $27,870,233 |
| Excess APPS Maintenance Costs (Installation date to December 31, 2005) | 2,397,329 |
| **Total Costs** | **$30,267,562** |

Replacing Small Parcel and Bundle Sorter

As of December 2005, we determined that 15 of the first 31 APPS deployment sites continued to maintain their SPBS operations.[2] We estimated these sites will incur SPBS labor and maintenance costs of approximately $27.9 million from conditional acceptance through the retrofit[3] date. At the time of our audit, the 15 sites had already incurred almost $22 million[4] in SPBS labor and maintenance costs. The Postal Service incurred additional SPBS labor and maintenance costs up to the retrofit installation date. We estimate this additional cost at $5.9 million.

According to program objectives stated in the SOW, the APPS units were supposed to replace the existing SPBS machines by handling all the packages and bundles processed on the current SPBS machines. This would allow the Postal Service to eliminate the corresponding SPBS labor and maintenance costs. However, Postal Service field officials stated that mail was diverted to SPBS

[2] We obtained APPS deployment information from eDeploy.
[3] The vendor is installing a retrofit to address the system's performance and reliability issues.
[4] We calculated SPBS workhour costs by multiplying excess SPBS regular and overtime workhours incurred from the conditional acceptance date through December 31, 2005, by the Postal Service's March 2004 published rate for a Postal Service level 05 (PS-05) mail processing clerk.

operations because the APPS machines could not always process it. Specifically, sites that retained SPBS machines used them to process mail bundles broken apart at the APPS induction conveyor system waterfall or to process mail the APPS machines rejected.

**Illustration 1. We observed Standard A mail bundles breaking apart on the APPS induction conveyor system waterfall.**

In addition, excessive debris jams and system downtime furthered the need for sites to maintain SPBS operations.

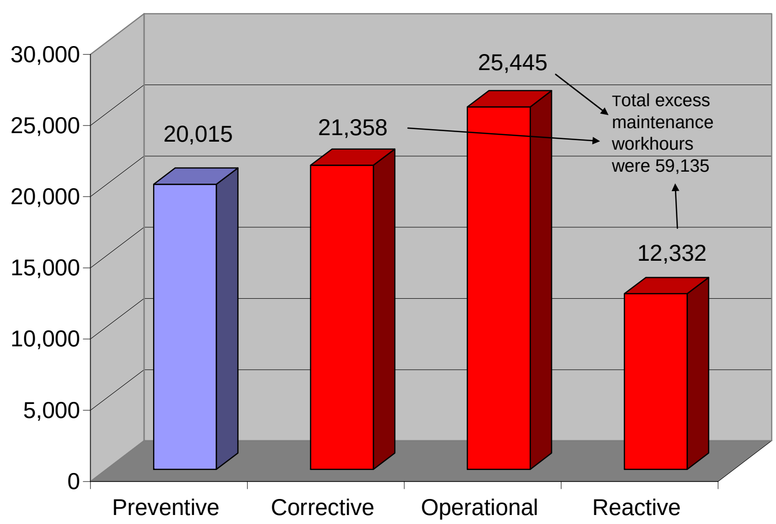
Replacing SPBS operations with APPS machines was the basis of the labor savings used to calculate the return on investment in the DAR.[5] However, because of APPS performance concerns, the Postal Service operated both APPS and SPBS machines. As a result, the Postal Service will not fully realize the expected reduction in SPBS operational costs.

[5] We obtained the APPS replacement plan for SPBS operations from the DAR field budget.

**Minimizing Maintenance Costs**

Maintenance workhours for conditionally accepted APPS machines exceeded SOW objectives. According to Section F of the SOW, the equipment design minimizes maintenance costs and personnel requirements and allows for 12 workhours of daily preventive maintenance.[6] Excluding these 12 workhours of daily preventive maintenance per machine, the Postal Service incurred 59,135 additional maintenance workhours[7] at the first 31 deployment sites. These excess maintenance hours consisted of corrective, operational, and reactive maintenance[8] and cost the Postal Service approximately $2.4 million.[9] While one of the SOW objectives was to minimize maintenance personnel costs, it did not specify acceptable levels of corrective, operational, and reactive maintenance. As a result, the contractor delivered, and the Postal Service has been accepting, systems with three times the amount of allowable maintenance.

**Illustration 2. APPS Maintenance Workhours**
**(from installation date through December 31, 2005)**




[6] Per SOW Section F.9.1, the APPS are allowed a 4-hour window using a maximum of three maintenance personnel to conduct preventive maintenance.
[7] We collected maintenance workhours from the installation date to December 31, 2005.
[8] Corrective maintenance is repairing or replacing a failed or defective part and returning the equipment to operating condition. Operational maintenance is generally monitoring equipment performance. Reactive maintenance is maintenance of equipment when an unforeseen failure occurs.
[9] We calculated APPS maintenance costs by multiplying the excess maintenance hours of 59,135 by the average salary rate for Postal Service maintenance personnel.

**Recent Developments**

Recent test results from the Postal Service indicate that a retrofit improved the sustained performance and availability, providing a reliable platform on which to process mail. However, a workhour review of the first eight fully accepted[10] machines indicated excessive maintenance is still a concern. Specifically, on average, corrective, operational, and reactive maintenance workhours continued to significantly exceed[11] the allowed preventive maintenance workhours. This could partially be attributed to the Postal Service's decision to authorize one operational maintenance workhour per APPS run-hour per system primarily for visual checks and observation activities.[12]

**Recoveries for Nonperformance**

To protect its interests, the Postal Service established payment withholds for technical performance shortfalls, sought appropriate recoveries for contractor schedule slippages, and specified the conditions for full acceptance.

[redacted]

In February 2006, the Postal Service negotiated an [redacted], primarily in the form of Postal Service use of enhanced recognition software. Additionally, the Postal Service and contractor agreed to a mutual release of claims arising from the facts or circumstances up to the date of the execution of the contract modification. However, the Postal Service did not release the supplier from performance requirements for deployed and conditionally accepted equipment. The Postal Service's rationale for this consideration appeared reasonable in light of actual damages suffered and its goal of not jeopardizing future contract performance.

In July 2006, management specified the conditions for full acceptance of machines through a contract modification

[10] The Field Acceptance Test Plan criteria were used to accept Postal Service fielded systems.
[11] Combined corrective, operational, and reactive maintenance accounted for approximately 84 percent of total maintenance at these sites.
[12] Per Maintenance Bulletin Maintenance Management Order (MMO) -115-05, a run-hour is defined as the number of hours the APPS is processing mail. Visual checks and observation activities are described in MMO-073-04, dated October 8, 2004.
[redacted].

(modification 18) to include the replacement of certain problematic equipment parts contributing to excessive maintenance. While the modification detailed retrofit fixes, reinspection, and release of previously withheld payments, it did not limit Postal Service remedies under the existing warranty provision.

**Recommendations**

We recommend the Vice President, Engineering:

1. Remove the remaining Small Parcel and Bundle Sorters as Automated Package Processing Systems performance warrants.

2. Reassess the investment impact of operating Automated Package Processing Systems with unanticipated additional Small Parcel and Bundle Sorter and maintenance hours.

We recommend the Vice President, Engineering, in coordination with the Vice President, Supply Management:

3. Ensure future U.S. Postal Service major equipment contracts adequately detail maintenance specifications prior to contract award.

**Management's Comments**

Management agreed with recommendation 1 and indicated they would remove all remaining SPBS machines by March 2007. Management partially agreed with recommendation 2. They indicated that the actual impacts from the APPS Phase 1 Program would be part of the After Cost Study undertaken by Headquarters Finance. They also indicated that any savings produced from relocated SPBS machines would offset any additional SPBS maintenance hours incurred. Management agreed with recommendation 3 and stated they will include performance-based requirements concerning machine availability and maintenance metrics within the Statement of Work for mail processing platforms.

**Evaluation of Management's Comments**

Management's comments are responsive to recommendations 1 and 3. Actions taken should correct the findings identified in the report. Although management agreed to recommendation 2 and their planned action is responsive, no timeframes were specified for completion. Thus, we continue to consider the recommendation open and significant.

| | |
|---|---|
| **Automated Package Processing System Contracting Activities** | APPS program managers properly paid contractor invoices and properly reduced invoices to liquidate contractor progress payments and to withhold amounts for contractor nonperformance. However, Postal Service officials could improve certain contracting activities to better support program requirements according to Postal Service policies and procedures. Specifically, the Postal Service awarded two contracts to the APPS supplier, resulting in an apparent unapproved advance payment and the Postal Service's loss of interest on advanced monies. Additionally, the contracting officer did not formally notify the contractor of conditional acceptance following FAT or timely modify the contract to reflect subsequent agreements to revised testing and acceptance procedures. Finally, the COR did not review and maintain receiving reports or other supporting documentation for nine of 39 contractor invoices[14] before certifying them for payment. |
| Advance Payment to the Contractor | At the time the Postal Service awarded the APPS production and deployment contract, it also awarded a second contract to the same contractor, resulting in an apparent unapproved $12 million advance payment. Specifically, on September 20, 2002, the Postal Service awarded a $308.8 million contract for the design, manufacture, test and acceptance, delivery, installation, and support of the production level APPS. On the same day, the Postal Service awarded a $12 million contract to the same contractor for APPS core recognition technology software, Version 1.0, and nonrecurring engineering. Three days later, the contractor delivered the software on a CD-ROM and the Postal Service paid the contractor $12 million on October 16, 2002. Supply Management personnel stated this alternative payment agreement was made to facilitate a reduction in the final contract price. This arrangement allowed the contractor to receive monies before delivering any supplies. Program management personnel stated they did not test or use the CD-ROM or know its whereabouts.<br><br>The Postal Service's *Purchasing Manual*, Issue 2, paragraph 1.6.7, Advance Payments and Progress Payments, states the Postal Service usually pays for supplies and services after delivery or performance. |

[14] The nine invoices totaled approximately $59.7 million, while the 39 invoices totaled approximately $228 million.

Management Instruction FM-610-96-1, *Advance Payments*, dated March 20, 1996, required the Vice Presidents, Purchasing and Materials, and Controller, Finance, to approve advance payments of more than $50,000 and the supplier to pay interest on the daily balance of unliquidated advance payments.[15]

The contractor's initial proposal price of approximately $357 million was audited and found to be reasonable. Per the negotiation memorandum, the Postal Service agreed to the additional $12 million contract to encourage the contractor to lower its overall APPS proposal price from $336.8 million to $320.8 million during final negotiations. This approach to contract negotiation and financing is most analogous to an advance payment. However, the contracting officer did not request the Vice President, Controller, Finance, to approve advance monies, as required by Postal Service policy. Additionally, the contractor was not required to pay interest on the daily balance of the unliquidated advance payment.

By advancing the contractor $12 million and not fulfilling all the control requirements for an advance payment, the Postal Service accepted additional financial risks and incurred approximately $2 million in lost interest on advanced monies. This represents non-monetary benefits of $12 million for assets at risk and monetary benefits of approximately $2 million of unrecoverable questioned costs. These amounts will be reported as such in our *Semiannual Report to Congress.* (See Appendix A.)

[15] Management Instruction FM-610-96-1, *Advance Payments*, dated March 20, 1996, was superseded after the date of the contract award by Management Instruction FM-610-2003-1, *Advance Payments*, dated November 28, 2003. The requirement to obtain approval remains the same; however, the threshold was raised to $1 million.

| | |
|---|---|
| **Recommendation** | We recommend the Vice President, Supply Management, in coordination with the Vice President, Engineering:<br><br>4. Ensure management obtains appropriate approvals prior to contract execution when negotiations result in alternative payment agreements or advance payments and require contractors to pay interest, as appropriate. |
| **Management's Comments** | Management agreed with the recommendation and stated they communicated it to applicable personnel. However, management disagreed with our categorization of the $12 million payment as an advance payment, stating the separate contract was part of the overall negotiations and in the Postal Service's best interest. |
| **Evaluation of Management's Comments** | While management's comments are responsive to the recommendation, they are not responsive to the issues raised in the finding. We agree the separate contract was part of the negotiations and resulted in an overall reduced price. However, we believe the Postal Service's agreement is most analogous to an advance payment since the arrangement allowed the contractor to receive monies before delivering any supplies. Specifically, program management stated they did not test or use the Version 1.0 CD-ROM or know its whereabouts. Consequently, we continue to believe our recommendation and claimed benefits are appropriate. However, we do not plan to pursue this recommendation through the formal audit resolution process. |
| Documenting Decisions and Agreements | The contracting officer did not formally notify the contractor of conditional acceptance following FAT or timely modify the $308.8 million APPS production contract to reflect subsequent agreements to revised testing and acceptance procedures. Correspondence in the contract file showed the Postal Service communicated conditional acceptance;[16] however, the contracting officer could not show the communication included the contracting officer's signature. Additionally, the Postal Service used modified test and acceptance procedures (FLAT) at four sites to determine whether retrofit improvements enabled conditionally |

[16] The Postal Service transmitted a copy of the conditional acceptance letter via email on May 21, 2004.

accepted APPS machines to achieve system performance requirements.

The contractor participated in the modified test procedures; however, those procedures were not incorporated into the contract. The *Purchasing Manual*, paragraph 1.4.2.a, makes contracting officers responsible for ensuring the performance of all actions necessary for efficient and effective purchasing, ensuring compliance with the terms of contracts, and protecting the interests of the Postal Service in all contractual relationships.

Supply Management personnel stated the absence of the contracting officer's signature on the conditional acceptance letter was an oversight. They also said FLAT procedures were not new contractual obligations, but were designed to facilitate retesting of conditionally accepted APPS machines. Therefore, contracting personnel believed they did not need to incorporate FLAT retest procedures, implemented in August 2005, into the contract. However, in July 2006, the Postal Service modified the contract to document FLAT and post-FLAT results and incorporate revised testing and acceptance procedures for conditionally accepted APPS machines.[17]

Documenting the contracting officer's signature on the conditional acceptance letter and timely incorporating revised testing and acceptance procedures into the contract reduce the Postal Service's risk of contractor claims for costs associated with revised testing procedures.

## Recommendations

We recommend the Vice President, Supply Management:

5. Direct the contracting officer to document the contract file to explain how conditional acceptance was communicated to the contractor.

6. Direct the contracting officer to timely modify the Automated Package Processing System contract to incorporate any future revisions to testing and acceptance procedures.

[17] Modification 18 was signed and effective on July 21, 2006. Among other things, it included a post-FLAT retrofit plan.

| | |
|---|---|
| **Management's Comments** | Management agreed with the recommendations and stated they added supporting documentation to the contract file to explain how the contracting officer communicated conditional acceptance to the contractor and will incorporate future testing and acceptance revisions into the contract timely. |
| **Evaluation of Management's Comments** | Management's comments are responsive to the recommendations and actions taken should correct the findings identified in the report. |

Controls Over Automated Package Processing System Contract Payments

The COR received 39 contractor invoices,[18] but did not review and maintain supporting documentation for progress payments or receiving reports for nine[19] of them before certifying them for payment. Specifically, the COR did not review and maintain supporting documents to validate the contractor incurred the claimed costs for six of 26 progress payment invoices.[20] Additionally, the COR did not review and maintain associated receiving documents to verify delivery and Postal Service acceptance for three of 13 invoices[21] submitted for supplies and services.

The COR designation letter, dated December 20, 2002, requires the COR, upon receipt, to verify invoices and promptly certify them for payment.

The COR stated that when verifying invoices, she did not always review and maintain supporting documentation for progress payments and did not review and maintain receiving reports due to an oversight.

Reviewing and maintaining supporting documentation for invoices helps the Postal Service ensure that contractors actually incurred the costs they claim for progress payments and provided supplies and services prior to payment. As part of the audit, we validated that progress payments did not exceed the contractor's eligible costs and that the Postal Service received supplies and services paid for under the

[18] The 39 invoices totaled approximately $228 million.
[19] The nine invoices totaled approximately $59.7 million.
[20] The 26 total progress payment invoices totaled approximately $209 million, while the six questioned progress payment invoices totaled approximately $58.8 million.
[21] The 13 total acceptance invoices totaled approximately $19 million, while the three questioned acceptance invoices totaled approximately $924,000.

invoices.

**Recommendation**

We recommend the Vice President, Supply Management, direct the contracting officer to instruct the contracting officer's representative to:

7. Review and maintain copies of invoice supporting documentation as evidence that contractors actually incurred costs they claimed for progress payments and provided supplies and services before management certifies invoices for payment.

**Management's Comments**

Management agreed with the recommendation and stated they communicated the recommendation to applicable personnel.

**Evaluation of Management's Comments**

Management's comments are responsive to the recommendation and actions taken should correct the finding identified in the report.

# APPENDIX A. ASSETS AT RISK AND UNRECOVERABLE QUESTIONED COSTS

## Non-Monetary Benefits

1. By advancing the contractor $12 million on October 16, 2002, without proper approvals, the Postal Service accepted additional financial risks.

**Total Assets at Risk = $12,000,000**

## Monetary Benefits

2. To calculate the estimated cost of the $12 million advance payment to the contractor on October 16, 2002, repayment of the $12 million principal amount is modeled to have occurred in the same proportions and timing as actual invoices paid relative to the total $308.8 million APPS contract between July 23, 2004, and March 23, 2006. For any period, the cost is the principal balance multiplied by the fraction of the Postal Service's published cost of borrowing annual rate that corresponds with the number of days in the period. For example, for 100 days and a 5 percent annual rate, cost = principal x ((1.05^(100/365)) - 1). The Postal Service's published cost of borrowing annual rate was updated on November 4, 2005, from 5 percent to 5.25 percent. Therefore, the principal amount between the September 21, 2005, invoice and the December 15, 2005, invoice was subject to 44 days at 5 percent and 41 days at 5.25 percent.

| Payment Date | Invoice Paid Amount | Cumulative Payments | Fraction of $308,800,000 Paid | Portion of $12 million Advance Outstanding | # of Days | Cost at 5 Percent Annual Rate | Cost at 5.25 Percent Annual Rate | Total Cost |
|---|---|---|---|---|---|---|---|---|
| 10/16/02 | | | | $12,000,000 | 646 | $1,082,279 | | $1,082,279 |
| 7/23/04 | $1,200,000.00 | $1,200,000.00 | 0.00388601 | 11,953,368 | 31 | 49,635 | | 49,635 |
| 8/23/04 | 9,903,028.36 | 11,103,028.36 | 0.035955403 | 11,568,535 | 32 | 49,590 | | 49,590 |
| 9/24/04 | 11,796,339.00 | 22,899,367.36 | 0.074155982 | 11,110,128 | 188 | 282,738 | | 282,738 |
| 3/31/05 | 1,603,236.00 | 24,502,603.36 | 0.079347809 | 11,047,826 | 91 | 135,208 | | 135,208 |
| 6/30/05 | 29,005,071.00 | 53,507,674.36 | 0.173276148 | 9,920,686 | 60 | 79,887 | | 79,887 |
| 8/29/05 | 586,551.00 | 54,094,225.36 | 0.1751756 | 9,897,893 | 21 | 27,823 | | 27,823 |
| 9/19/05 | 2,458,530.00 | 56,552,755.36 | 0.183137161 | 9,802,354 | 2 | 2,621 | | 2,621 |
| 9/21/05 | 33,947,917.00 | 90,500,672.36 | 0.293072126 | 8,483,134 | 85 | 50,041 | $48,899 | 98,940 |
| 12/15/05 | 15,855,780.00 | 106,356,452.36 | 0.344418563 | 7,866,977 | 69 | | 76,466 | 76,466 |
| 2/22/06 | 27,685,405.00 | 134,041,857.36 | 0.434073372 | 6,791,120 | 29 | | 27,665 | 27,665 |
| 3/23/06 | 35,180,706.00 | 169,222,563.36 | 0.548000529 | 5,423,994 | | | | |
| | | | | | | | | **$1,912,852**[22] |

[22] As of March 23, 2006, an estimated $5,423,994 of the original $12,000,000 advance payment remained outstanding.

3. For the future period from the last invoice date (March 23, 2006) to the planned final delivery date (September 15, 2006), in the absence of specific information, a conservative assumption was that the remaining estimated principal balance of $5,423,994 should be retired proportionally each day — $30,818 per day for 175 days and $30,844 on the 176th and final day. Cost was calculated on the remaining principal balance each day. That computation resulted in an additional $67,298 in estimated interest costs. Therefore, total estimated cost is $1,912,852 + $67,298 = $1,980,150.

**Total Unrecoverable Questioned Costs = $1,980,150**

## NOTES

**ASSETS AT RISK** – Dollar value of assets deemed to be at risk of loss due to inadequate internal controls.

**QUESTIONED COSTS** – A cost that is unnecessary, unreasonable, unsupported, or an alleged violation of law, regulation, or contract.

**UNRECOVERABLE COSTS** – A cost that should not have been incurred and is not recoverable.

# APPENDIX B. MANAGEMENT'S COMMENTS

UNITED STATES
POSTAL SERVICE

December 21, 2006

COLLEEN A. MCANTEE

SUBJECT: Draft Audit Report – Automated Package Processing System Status and Administration (Report Number DA-AR-07-DRAFT)

We appreciate your staff's communication concerning their efforts associated with review of the Automated Package Processing System (APPS) program objectives and equipment deployment. APPS represents a state-of-the-art equipment program that has allowed the Postal Service to automate package processing by providing greater capacity through automatic package induction, singulation and address recognition. While management challenges are expected, APPS required more corrective action from the supplier for machine acceptance than with other major automation equipment deployments. The corrective actions are being addressed and significant performance improvements have been made since this audit started in October 2005.

The attachment provides our agreement or partial agreement to the report's seven recommendations. We also detail actions taken by our respective organizations to satisfy each of the report's recommendations. In addition, we will cascade summary results of this report through Supply Management's Review for Excellence Program (SM REP) to managers in Supply Management and in Engineering's Technology Acquisition Management for review and self-assessment.

However, we cannot agree with the Office of Inspector General's (OIG) interpretation that management made an unapproved advance payment resulting in nonmonetary benefits of $12 million (assets at risk) and monetary benefits of $1,980,150 (unrecoverable questioned costs). While we do not disagree that this payment could be viewed as an alternate method of financing, the Postal Service tendered it to reimburse the supplier for services rendered. Further, this payment was based on a $16 million negotiated price reduction in the supplier's proposal, providing an overall monetary benefit to the Postal Service. This proposal was submitted by the supplier and audited by the OIG as outlined in this report. For these reasons, the above dollar amounts should not be considered monetary impact or reported in your Semiannual Report to Congress.

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We do not believe that this report contains any proprietary or business information and may be disclosed pursuant to the Freedom of Information Act (FOIA). You may contact Marie Martinez, of Supply Management, if you have any questions regarding actions taken to satisfy the report's recommendations. She can be reached at (202) 268-4117.

Walter O'Tormey
Walter O'Tormey
Vice President
Engineering

Susan M. Brownell
Susan M. Brownell
Vice President
Supply Management

Attachment

cc: Mr. Walker (all w/attachment)
Mr. Galligan
Mr. Sanchez
Mr. Guilfoil
Ms. Martinez
Mr. Phelps

**ATTACHMENT**
Engineering and Supply Management Response
OIG Report DA-AR-07-DRAFT
Page 1 of 2

**RESPONSES TO OIG REPORT RECOMMENDATIONS**

*We recommend the Vice President, Engineering:*

*1. Remove the remaining Small Parcel and Bundle Sorters as Automated Package Processing Systems performance warrants.*

**Management Response:** Management agrees with this recommendation.
SPBS retention was due to poor package preparation and address hygiene by the mailers. To correct the problem, the Postal Service worked aggressively with mailers in 2005 to improve readability and bundle integrity problems through a combination of information sharing (Bundle Blitz initiative) and deficiency reporting (eMIR). In April 2006, mailing requirements were changed that positively affected the need for SPBS.

Nevertheless, prior to APPS, there were 143 Small Parcel and Bundle Sorter (SPBS) at 62 APPS sites. We already removed 106 SPBS which exceeds the DAR plan. In addition, Postal Operations is planning to remove additional SPBS machines by March 2007. No further response from the Engineering organization is anticipated in response to this recommendation.

*2. Reassess the investment impact of operating Automated Package Processing Systems with unanticipated additional Small Parcel and Bundle Sorter and maintenance hours.*

**Management Response:** Management partially agrees with this recommendation. The proposed assessment of the actual impacts from the APPS Phase 1 Program and these SPBSs would be part of the After Cost Study undertaken by Headquarters Finance and not necessarily at this time. In addition, the situation described in this report is incomplete. The APPS Phase 1 Program does not credit any savings produced from relocated SPBS machines even though the gaining sites experience savings. The benefits of these unclaimed savings would outweigh any unanticipated/additional SPBS maintenance hours that have been incurred. No further action by the Engineering organization is required in response to this recommendation.

*We recommend the Vice President, Engineering, in coordination with the Vice President, Supply Management:*

*3. Ensure future U.S. Postal Service major equipment contracts adequately detail maintenance specifications prior to contract award.*

**Management Response:** Management agrees with this recommendation and will continue to include performance based requirements concerning machine availability and maintenance metrics within the Statement of Work for mail processing platforms. A copy of this draft report and recommendation were shared with applicable Engineering and Supply Management contracting staff. No further action by our respective organizations is anticipated in response to this recommendation.

*We recommend the Vice President, Supply Management, in coordination with the Vice President, Engineering:*

**ATTACHMENT**
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*4. Ensure management obtains appropriate approvals prior to contract execution when negotiations result in alternative payment agreements or advance payments and require contractors to pay interest, as appropriate.*

**Management Response:** Management agrees with this recommendation. However, the situation described in this report was not an advance payment. The separate contract was part of the overall negotiations and resulted in a net savings of approximately $4 million and, as such, was in the Postal Service's best interest. Regardless, obtaining appropriate approvals for advance payments is in accordance with our established purchasing practices. A copy of this draft report and recommendation were shared with applicable Supply Management and Engineering contracting staff. No further action by our respective organizations is anticipated in response to this recommendation.

*We recommend the Vice President, Supply Management:*

*5. Direct the contracting officer to document the contract file to explain how conditional acceptance was communicated to the contractor.*

**Management Response:** Management agrees with this recommendation. Conditional acceptance was communicated in a letter to the supplier via contracting officer email transmission on May 21, 2006. Supporting documentation was added to the contract file by the contracting officer. No further action is necessary in response to this recommendation.

*6. Direct the contracting officer to timely modify the Automated Package Processing System contract to incorporate any future revisions to testing and acceptance procedures.*

**Management Response:** Management agrees with this recommendation. Revisions to testing and acceptance procedures were made via contract modification on July 21, 2006, in Modification 018 to the APPS contract. Future revisions will be incorporated into the contract in a timely manner. A copy of this draft report and the recommendation were shared with the contracting officer. No further action is necessary in response to this recommendation.

*We recommend the Vice President, Supply Management, direct the contracting officer to instruct the contracting officer's representative to:*

*7. Review and maintain copies of invoice supporting documentation as evidence that contractors actually incurred costs they claimed for progress payments and provided supplies and services before management certifies invoices for payment.*

**Management Response:** Management agrees with this recommendation. However, the situation described in this report is misleading. The invoices certified were authorized by a contract modification that restarted progress payments after a long suspension. The incurred costs were reviewed and verified prior to issuing the contract modification. Prior to certifying the invoices for payment, the Contracting Officer's Representative (COR) thoroughly reviewed them for compliance with contract terms. Regardless, reviewing all invoices for proper documentation, validity, and accuracy prior to certification and submission to San Mateo for payment is in accordance with our established purchasing practices. A copy of this draft report and recommendation were shared with the contracting officer and contracting officer's representative. No further action is necessary in response to this recommendation.