

January 31, 2000

A. KEITH STRANGE  
VICE PRESIDENT, PURCHASING AND MATERIALS

SYLVESTER BLACK  
VICE PRESIDENT, NETWORK OPERATIONS MANAGEMENT

SUBJECT: Transmittal of Audit Report - Commercial Air Carrier Performance:  
Effectiveness of Pay for Performance (Report Number TR-AR-00-004)

This is the second of three reports resulting from our audit of commercial air carrier performance (Project Number 99PA023TR002) conducted at the request of the chief operating officer. This report addresses the effectiveness of the pay for performance clause of the Air Systems contract in improving air carrier performance.

The audit revealed pay for performance has not been effective in improving air carrier performance and performance data underlying incentive payments is unreliable. We recommended discontinuing of incentive payments and eliminating the current pay for performance clause in future renewals of the Air Systems contract. Management agreed with the report findings and recommendations. They indicated they are commencing discussions with the commercial air carriers to discontinue incentive payments from the current pay-for-performance system and the use of the current the current pay-for-performance system in future contracts. Management's comments and our evaluation of these comments are included in the report.

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

Richard F. Chambers  
Assistant Inspector General  
for Performance

Attachment

cc: Clarence E. Lewis, Jr.  
John E. Potter  
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## EXECUTIVE SUMMARY

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### Introduction

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

This report presents our assessment of the effectiveness of the pay for performance clause of the Air Systems contract in improving air carrier performance.

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### Results in Brief

The pay for performance clause of the Air Systems contract, which was introduced in September 1998, has not been effective in improving air carrier performance. Although the intent of pay for performance was to increase air carrier scores to 85 percent or better, national scores have only increased from 56 to 60 percent since September 1998. As a result, the Postal Service spent only \$7.8 million of \$67 million allocated for incentive payments under the Air Systems contract.

The six air carriers interviewed believed the pay for performance incentives offered were not adequate to justify the additional investment required to achieve contract performance targets. They also attributed limited service improvements to unreliable performance scores. Further, our February 2000 report<sup>2</sup> confirmed that performance scores are not reliable because carrier delivery times were not always accurately captured through the Postal Service's scanning operations. Air carrier scores were also not representative of overall air carrier performance because only priority mail was tested.

Because pay for performance has not produced the service improvements originally envisioned, payment amounts are not sufficient to be an incentive for carriers, and supporting scores are unreliable continued use of the current pay for performance is not appropriate.

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<sup>1</sup> The first report addressed the reliability of the Postal Service's performance measurement system used to evaluate air carrier performance and the third report addressed ground handling services performed by postal employees.

<sup>2</sup> Commercial Air Carrier Performance: Performance Measurement System, TR-AR-00-003, (January 31, 2000).

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**Summary of  
Recommendations**

Due to the questionable benefits of pay for performance and the lack of accurate performance data upon which to base payments, we recommend the vice president, Purchasing and Materials, in coordination with the vice president, Network Operations Management immediately discontinue incentive payments and eliminate the current pay for performance clause in future renewals of the Air Systems contract.

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**Summary of  
Management's  
Comments**

Management agreed with our findings and recommendations and stated they are commencing discussions with commercial air carriers to discontinue incentive payments from the current pay-for-performance system and the use of the current the current pay-for-performance system in future contracts. Management's comments are included in their entirety in the appendix of this report.

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**Overall Evaluation of  
Management's  
Comments**

Management's comments are responsive to our findings and recommendations, and planned actions address the issues identified in this report.

## INTRODUCTION

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### Background

In FY 1999 the Postal Service spent over \$670 million under its Air Systems contract with air carriers to move more than 2.1 billion pounds of Priority Mail and First-Class Mail. Although the Air Systems contract established a 98 percent on-time delivery target, national air carrier performance averaged 60 percent in FY 1999. Because air carrier performance directly impacts on-time delivery, air carrier delays can hinder the Postal Service's ability to achieve service commitments for these classes of mail.

To improve air carrier performance, in 1998 the Postal Service added a pay for performance clause to the Air Systems contract. Under this clause, air carriers are eligible to receive incremental pay for higher levels of service as determined by their national quarterly performance scores. Incremental payments range between 1 and 10 percent for performance scores of 64 percent or better, as shown below:

<b>Quarterly Performance Score (Percent)</b>	<b>Incremental Pay (Percent)</b>
64 to 67.9	1.0
68 to 69.9	1.5
70 to 73.9	2.0
74 to 75.9	4.0
76 to 79.9	5.5
80 to 84.9	7.5
85 or better	10.0

The Air Systems contract expires in September 2000, and the Postal Service is currently negotiating with commercial air carriers to renew this contract.

The quality of service provided by air carriers is evaluated by the Postal Service's performance measurement system. This system tracks mail from the time it is dispatched at origin until it is delivered to the Postal Service at the destination airport mail center/facility. Mail delivery times are scanned at arrival and compared to expected delivery times to generate performance scores.

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**Objective, Scope, and  
Methodology**

The objective of our audit was to assess the effectiveness of the pay for performance clause of the Air Systems contract in improving air carrier performance. To determine whether pay for performance has been effective, we analyzed changes in air carrier performance scores since September 1998, reviewed related incentive payments, and interviewed the contracting officer for the Air Systems contract. We also reviewed the Air Systems contract and interviewed representatives of six commercial air carriers<sup>3</sup> to obtain their views on pay for performance, performance measurement, and the level of service provided the Postal Service.

In our prior report on the Postal Service's performance measurement system for air carriers,<sup>4</sup> we concluded data supporting performance measurement was inaccurate. However, although inaccurate, we included this data in our report because it is the basis for incentive payments.

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

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<sup>3</sup> We interviewed representatives from American, Continental, Northwest, Transworld, USAir, and United Airlines.

<sup>4</sup> Commercial Air Carrier Performance: Performance Measurement System, TR-AR-00-003, (January 31, 1999).

## AUDIT RESULTS

### Effectiveness of Pay for Performance

The pay for performance clause of the Air Systems contract has not been effective in improving air carrier performance. Although the intent of pay for performance was to increase air carrier scores to 85 percent or better, national scores have only increased from 56 to 60 percent since September 1998. Further, none of the top three carriers, who collectively carried 41 percent of the mail, had scores high enough to qualify for incentive payments. As a result, during FY 1999 the Postal Service spent only \$7.8 million of \$67 million allocated for incentive payments under the Air Systems contract. Of the \$7.8 million, nearly 50 percent went to two carriers that handled 11 percent of the mail.

Listed below is a summary of average performance measurement scores and incentive payments for the 10 carriers with the greatest mail volumes in FY 1999:

Carrier	Percent of Volume Carried FY 99	FY99 National Performance Measurement Score	Average Percent Change from FY 98	Total Incentive Payments (in 000's)
United	16	51	+3	\$ 0
Delta	15	46	+2	0
American	10	55	-3	0
Northwest	8	62	-8	252.7
US Air	6	66	0	354.2
Continental	6	73	+23	1,416.2
TWA	5	67	+9	544.6
Emery	5	70	-5	711.7
Southwest	5	81	+2	2,403.7
America West	2	64	+6	138.7

The six air carriers interviewed support a performance based incentive system, but believed the pay for performance incentives offered under the Air Systems contract were insufficient to improve their performance. They indicated the additional investment required to reach the contract performance target far outweighed the potential compensation they would receive under pay for performance.

Air carriers also attributed limited service improvements to unreliable performance scores. They believed the

performance scores generated by the Postal Service's measurement system were not an accurate reflection of their true performance. Our December 28, 1999, report confirmed performance scores are not sufficiently reliable to support pay for performance incentive payments. Performance scores were unreliable because carrier delivery times were not always accurately captured through the Postal Service's scanning operations. Scan rates for testing on-time delivery were also inaccurate due to a reliance on historical versus actual mail volumes and the inclusion of air contract tagged mail. Further, we reported that because the performance measurement system tests only priority mail, which comprises less than 34 percent of the mail commercially flown, scores are not representative of overall air carrier performance.

As a result, the Postal Service paid \$7.8 million in incentive payments with no assurances that the basis for these payments was accurate. Further, these payments have not produced the level of service improvements originally envisioned under contract. Because air carriers believed pay for performance under the Air Systems contract provides them little incentive to improve performance and supporting scores are unreliable, the continued use of the current pay for performance system is not appropriate.

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**Recommendations**

Due to the questionable benefits of pay for performance and the lack of accurate performance data upon which to base payments, we recommend the vice president, Purchasing and Materials, in coordination with the vice president, Network Operations Management:

1. Immediately discontinue pay for performance incentive payments.

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**Management's  
Comments**

Management agreed and are commencing discussions with air carriers to explore discontinuance of incentive payments under the current pay for performance system.



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2. Eliminate the current pay for performance clause in the upcoming renewal of the Air Systems contract.

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Management agreed and indicated they are commencing discussions with commercial air carriers to discontinue incentive payments from the current pay-for-performance system and the use of the current the current pay-for-performance system in future contracts.

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**Evaluation of  
Management's  
Comments**

We view management's comments as responsive to our recommendations, and believe planned actions should address the issues identified in this report.

## APPENDIX. MANAGEMENT'S COMMENTS

NATIONAL MAIL TRANSPORTATION PURCHASING



January 31, 2000

RICHARD F. CHAMBERS

THRU: KEITH STRANGE

SUBJECT: Transmittal of Draft Audit Reports – Commercial Air Carrier Performance:  
Performance Measurement System (Report Number TR-AR-00-Draft) and  
Commercial Air Carrier Performance: Pay for Performance (Report Number  
TR-AR-00-Draft)

We are in agreement with your findings and recommendations related to the Performance Measurement System and Pay for Performance audit reports.

Based on your audit report on the Performance Measurement System, a series of issues we have been working, and the continued poor performance of the commercial air carriers, we have reconsidered the continued use of the Performance Measurement System. We will suspend the use of the present Performance Measurement System effective February 26, 2000. Based on our analysis of air transportation, we see commercial air carriers as key stakeholders in the movement of mail. Therefore, we will work with our internal customers and suppliers to explore other options to improve on-time performance and strengthen other aspects of our business.

In response to the second report on Pay for Performance, we are commencing discussions with commercial air carriers to discontinue incentive payments from the current pay-for-performance system. Although we may consider performance incentives in future contracts they will not rely on the current Pay for Performance system.

Please give my appreciation to your audit staff! We expect their findings will help us improve our efforts to meet the expectations of our customers.



J. Dwight Young, Manager  
National Mail Transportation Purchasing

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