OFFICE OF INSPECTOR GENERAL
UNITED STATES POSTAL SERVICE

Workshare Discounts for Automated Mail Processing

Audit Report

Report Number
CP-AR-15-002

June 8, 2015

OFFICE OF INSPECTOR GENERAL
UNITED STATES POSTAL SERVICE

Highlights

Some workshare discounts for automated mail processing no longer benefit the Postal Service's processing network. Recent changes to the network offer an opportunity to re-evaluate discounted rates and potentially add new workshare discounts.

Background

The U.S. Postal Service uses workshare discounts to increase its operational efficiencies. It offers these discounts to mailers for mail preparation and distribution activities it would otherwise have to perform. The Postal Regulatory Commission approves the discounts. The Postal Accountability and Enhancement Act of 2006 states that workshare discounts should not exceed the costs the Postal Service avoids when mailers perform these preparation and distribution activities. For the Postal Service to realize the full benefits of workshare discounts, worksharing must align with its mail processing operations.

Our objective was to review workshare discounts related to automated mail processing to identify those that may no longer be valuable to the Postal Service. We also reviewed opportunities for new workshare discounts to encourage network efficiency.

What The OIG Found

Some workshare discounts for automated mail processing no longer benefit the Postal Service's processing network. Recent changes to the network offer an opportunity to re-evaluate discounted rates and potentially add new workshare discounts. Specifically, we identified workshare discounts for sorting mail into carrier route delivery point sequencing that duplicate Postal Service functions. As a result, we estimate a revenue difference of $438 million annually for mail volume that was processed in the same manner but received different rates. We also identified obsolete or unnecessary discounts and product prices that could be eliminated. Specifically, unnecessary workshare discounts exist in the current Flats Sequencing System pricing schedule. This may add complexity to the pricing structure that could deter mailers from establishing or expanding relationships with the Postal Service.

There may be opportunities for new workshare discounts that reflect current network operations. For example, mailers suggested the Postal Service could consider discounts to encourage increased participation in the Seamless Acceptance program. This program automates bulk mail acceptance and verification using data provided by mailers and gathered during mail processing. Increased participation may reduce costs associated with mail verification by business mail entry unit personnel. The Postal Service could lose opportunities to grow revenue, partner with mailers, and gain operational efficiencies if it does not update workshare discounts periodically to reflect current network operations.

What The OIG Recommended

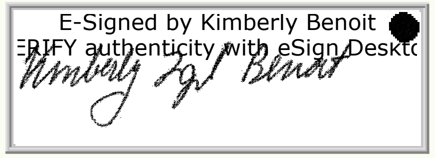
We recommended management work with the Postal Regulatory Commission to periodically review existing workshare discounts for opportunities to eliminate obsolete discounts. We also recommended management periodically evaluate potential workshare discounts and add those where opportunities for greater efficiency exist.

Transmittal Letter

OFFICE OF INSPECTOR GENERAL
UNITED STATES POSTAL SERVICE

June 8, 2015

MEMORANDUM FOR: CYNTHIA SANCHEZ-HERNANDEZ
VICE PRESIDENT, PRICING



FROM: Kimberly F. Benoit
Deputy Assistant Inspector General
for Technology, Investment and Cost

SUBJECT: Audit Report – Workshare Discounts for Automated Mail Processing (Report Number CP-AR-15-002)

This report presents the results of our audit of Workshare Discounts for Automated Mail Processing (Project Number 14RG018DP000).

We appreciate the cooperation and courtesies provided by your staff. If you have any questions or need additional information, please contact Sherry Fullwood, acting director, Cost and Pricing, or me at 703-248-2100.

Attachment

cc: Corporate Audit and Response Management

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Findings

We identified workshare discounts for sorting mail into carrier route delivery point sequencing that duplicate functions the Postal Service currently performs. We estimated a revenue difference of $438 million annually for mail volume processed in the same manner but received different rates. Additionally, we identified obsolete or unnecessary discounts and associated product prices the Postal Service could eliminate.

Introduction

This report presents the results of our self-initiated audit of Workshare Discounts for Automated Mail Processing (Project Number 14RG018DP000). Our objective was to review U.S. Postal Service workshare discounts[1] related to automated mail processing to identify those that may no longer be valuable in the current Postal Service processing network. We also reviewed opportunities for new workshare discounts to encourage network efficiency. See Appendix A for additional information about this audit.

The Postal Service offers workshare discounts to mailers who sort mail or do other work the Postal Service would otherwise do. Workshared mail accounts for about 85 percent of the market-dominant mail volume the Postal Service processes. To ensure the success of its automation program, the Postal Service introduced discounts that encourage mailers to prepare mail compatible with automated processing equipment.

The Postal Service must comply with the Postal Accountability and Enhancement Act of 2006 (PAEA)[2] when setting prices and workshare discounts. The PAEA states that workshare discounts should not exceed the costs the Postal Service avoids when mailers perform preparation or other mail tasks it would otherwise perform. The PRC oversees price changes — including establishing new discounts, reviews Postal Service filings and public comments — and determines whether products and prices meet applicable statutes.

Some Worksharing Opportunities Duplicate Functions Otherwise Performed by the Postal Service

1 A workshare discount is a postage discount the Postal Service provides to mailers to presort, pre-barcode, handle, or transport their mail. In general, the discount does not exceed the cost the Postal Service avoids as a result of the workshare activity.

2 PAEA Section 3622 (e)(2) states that, with certain exceptions, the Postal Regulatory Commission (PRC) shall ensure that workshare discounts do not exceed the cost that the Postal Service avoids as a result of workshare activity.

Conclusion

The Postal Service offers workshare discounts for automated mail processing that no longer benefit its processing network. Additionally, recent changes to the Postal Service network offer an opportunity to re-evaluate discounted rates and potentially add new workshare discounts. Specifically, we identified workshare discounts for sorting mail into carrier route DPS[3] that duplicate functions the Postal Service currently performs. We estimate a revenue difference of $438 million annually for mail volume that was processed in the same manner but received different rates. Additionally, we identified obsolete or unnecessary discounts and associated product prices the Postal Service could eliminate. Specifically, unnecessary workshare discounted prices exist in the current Flats Sequencing System (FSS)[4] pricing schedule. This may add unnecessary complexity to the pricing structure that could deter mailers from establishing or expanding relationships with the Postal Service. Further, opportunities may exist for the Postal Service to implement new workshare discounts that reflect current network operations. The Postal Service may lose opportunities to grow revenue, partner with mailers, and achieve operational efficiencies if it does not update workshare discounts periodically to reflect current network operations.

Carrier Route Workshare Discounts

Customers who sort mail into carrier route DPS for workshare discounts duplicate functions the Postal Service currently performs. The Postal Service sorts almost all letters[5] and about 20 percent of flats in its DPS operations. Consequently, it forgoes revenue when it gives mailers carrier route discounts for mail it sorts in its DPS operations.

There may be Opportunities for New Workshare Discounts that Reflect Current Network Operations

1. **Seamless Acceptance**
2. **Just-In-Time DPS Entry**
3. **First-Class Mail® (FCM) Drop Shipping**

SHOW ALL RESET

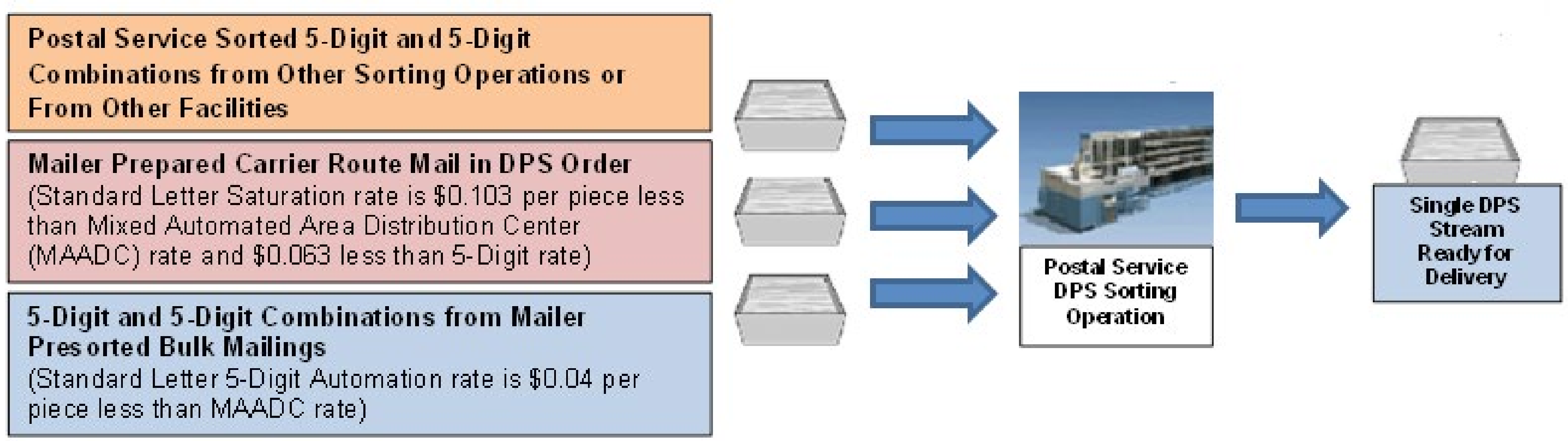
CLICK ON THE NUMBERS ABOVE

3 The process of using automation to sort mail into delivery order for carriers. This eliminates the need for carriers to manually sort the mail prior to delivery.
4 A flats sorting machine that automates the process of sorting flat-shaped mail into delivery order. The FSS processes flats from flats mailstreams, along with a significant amount of carrier presorted mail.
5 The Postal Service estimates that 93 percent of all letters are DPS-sorted.

DPS operations in a plant sort mail in delivery order for carriers. The Postal Service gains efficiencies by performing this function via automation in its plants because the alternative is for carriers to manually sort the mail before beginning their routes. Carriers could take mailer-sorted DPS mail directly to the street for delivery in addition to the plant-sorted mail; however, there are limits on the number of bundles a carrier can carry.[6] Having multiple bundles from multiple mailers and a plant-sorted DPS bundle defeats any efficiencies gained from having all mail in one DPS bundle for the carrier; therefore, the Postal Service sorts mailer-presented DPS mail along with all other mail in the plant's DPS operation to produce a single DPS bundle for each carrier.

As part of the DPS process, the Postal Service first sorts mail to 5-digit ZIP Codes before sending it to a DPS operation where it is sorted in delivery order for the carrier. Mailers get a discount for sorting their mailings in 5-digit ZIP Code order[7] because it saves sorting time and efficiently becomes part of the overall process (see Figure 1).

Figure 1. DPS Mail Flow



Further, we identified 48 obsolete workshare discounts for automating Standard regular and nonprofit carrier route letters. There is no operational need for these discounts given current network operations. Mailers pre-barcode automation carrier route letters. Preparing and processing these letters is the same as for pre-barcoded 5-Digit sorted letters in DPS operations. Since the Postal Service only sorts mail to the 5-Digit ZIP Code sequence prior to DPS induction, there is no added value from pre-barcoded carrier route mail in DPS operations. We estimate a revenue difference of $438 million annually from processing carrier route priced mail in DPS operations.[8]

Revenue is forgone when the Postal Service provides a carrier route discount to mailers for work that the Postal Service performs. The Postal Service has forgone about $438 million[9] of revenue annually from processing carrier route priced mail in DPS operations.

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6 Contractual limitations prevent city carriers from taking more than three working bundles on their route. If a city carrier has more than three bundles, one or more must be commingled with other DPS mail.
7 The discount for Carrier Route sorted mail is greater than the discount for 5-Digit ZIP Code sorted mail because the mail does not need DPS processing.
8 There are 48 nonmachinable rates that mirror the 48 obsolete Automation Carrier Route rates. There may still be an operational need for the nonmachinable rates because the physical design of some letters prevents their automation.
9 For fiscal year (FY) 2013, we calculated unrecoverable revenue loss of $423,024,180, and for FY 2014 we calculated $452,949,422. This represents the difference between the carrier route price paid by the mailer and the Automation 5-Digit or presorted price. We averaged the 2 years to provide an annualized amount.

Unnecessary Flats Sequencing System-Related Workshare Discounts

There are unnecessary workshare discount prices in the current FSS pricing schedule. In January 2014, the Postal Service published 156 new FSS prices when it implemented new sorting requirements for presorted flats going to ZIP Codes designated for FSS processing. We found that only 21 of the 156 prices were unique and offered an incentive to enter flats at FSS facilities. The Postal Service wanted to reduce the impact of the new FSS sorting requirements; therefore, it established FSS prices that mirrored prices mailers could have claimed under the non-FSS sorting requirements. Accordingly, the Postal Service established 135 FSS prices identical to existing prices.[10] During the audit, management stated that they plan to establish revised FSS prices and recently proposed changes to the FSS pricing structure to the PRC.

Continuing to offer obsolete and unnecessary discounts adds complexity to the pricing structure that could deter mailers from establishing or expanding their relationship with the Postal Service.

New Workshare Discount Opportunities

The Postal Service may have opportunities to implement new workshare discounts that reflect current network operations. The Postal Service began a "self-examination" in 1990 to determine whether its mail classification structure was appropriate, given its changing needs and capabilities and the needs of its mailers. In 1996, the Postal Service established new mail classes and subclasses and overhauled workshare discounts and related presort requirements in collaboration with mailers. For example, it established the Enhanced Carrier Route subclass for high-density non-barcoded flats and the Automation subclass to encourage more mailers to apply barcodes.

As the Postal Service closes and consolidates mail processing facilities in response to changes in mail volume and mail mix, it will further streamline the processing network. The remaining facilities will do the final processing for more delivery units and may distribute mail to delivery units from hub sites. The Postal Service should change the existing presort levels[11] for workshare discounts to align with the new structure. It could also use this opportunity to reflect on the role worksharing plays in its operations and potentially overhaul workshare discounts. The Postal Service could lose revenue, partnering opportunities, and operational efficiencies if it does not review the workshare discount program periodically to ensure it reflects current network operations. Since the PRC oversees rate changes and workshare discounts, periodic assessments would also help the Postal Service develop the basis for proposed changes to the rate structure.

Use Prices to Encourage Machinable Flats

The Postal Service could use worksharing opportunities to encourage mailers to produce more machinable flats. It previously used workshare discounts to encourage certain types of mail design. There are currently separate automation and non-automation carrier route rates for Standard letters, but not for flats. Mailers would be encouraged to produce machinable flats if rates for nonmachinable flats were higher than those for machinable flats. For instance, presorted Standard Nonmachinable[12] letters can cost more than twice as much to mail as presorted Machinable[13] letters. Rather than offer deeper discounts to encourage machinable flats, the Postal Service could work with the PRC to establish a set of higher-priced non-machinable carrier route rates.

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10 Forty-three of these rates were greyed out on September 2014 postage statements and not available for use by mailers.
11 A Sectional Center Facility (SCF) serves as the processing and distribution center (P&DC) for post offices in one or more 3-digit ZIP Code areas. Area distribution centers and automated area distribution center (AADC) are P&DCs that can service multiple SCFs and may also serve as SCFs. Mail sorted to the SCF presort level is more finely sorted than mail sorted to the AADC level. As smaller SCFs are eliminated, the resulting processing network will likely resemble the AADC structure.
12 Mail might be nonmachinable if it is irregularly shaped or not uniformly thick, has prohibited closures (such as staples or clasps), or is made with paper stock that does not meet minimum requirements.
13 The nonmachinable Mixed Area Distribution Center rate is \$0.664, while the machinable MAADC rate is \$0.309.

This could discourage mailers from producing non-machinable flats, thereby increasing the volume of flats available for automated DPS processing on the FSS.

Other Discount Opportunities

The U.S. Postal Service Office of Inspector General (OIG) hosted a forum and held other meetings where representatives from mailer groups discussed potential new workshare opportunities. Some of the ideas discussed did not specifically meet the definition of workshare discounts and were better classified as incentives or promotions. Others may be worksharing opportunities. We believe all of the ideas could add value if properly implemented.

Although we did not make a recommendation regarding specific suggestions, we are reporting the following ideas for the Postal Service's consideration and further discussion with mailers as workshare discounts as a whole are evaluated.

- **Seamless Acceptance** – Forum participants suggested participation in the Seamless Acceptance program would increase if the Postal Service offered additional discounts for Seamless Acceptance mailings. The Postal Service is remodeling the process for accepting and verifying business mailings. Electronic documentation used in conjunction with Intelligent Mail barcode (IMb) data provides an opportunity to automate verification and acceptance processes; however, mailers already get discounts for using the Full-Service IMb and Seamless Acceptance cannot work without their involvement. Increased mailer participation in this program may reduce costs associated with mail verification by business mail entry unit personnel.

- **Just-In-Time DPS Entry** – Mailers stated they could share first-pass data with the Postal Service, sort mail according to local sort plans, and enter it just in time for DPS processing. They gather data for all the mail they process during the first pass on their automated equipment. Mailers could push data to Postal Service plants after the first pass for combined mailings processed that day. Postal Service plants could use this data to update their DPS inventory and adjust sort plans and transportation based on updated volumes. They would sort mail to match locally provided schemes and enter the mail just in time for DPS processing cycles. Mailers claim this may reduce mail staging requirements and make more mail available for overnight delivery.

- **FCM Drop shipping** – Some mailers believe drop shipping FCM is a worksharing opportunity. The Postal Service's network optimization initiative reduced the number of mail processing facilities and increased transportation costs. The Postal Service revised and eased some service standards as a result. To mitigate some of the effects of network optimization, the Postal Service may consider additional drop shipping opportunities for FCM; however, programs in place allow some entry point flexibility for FCM. For example, metered mail drop ship authorizations permit mailers to enter First-Class metered mail at locations other than where they are licensed, as long as service standards are not negatively affected. Further, working under special postage payment systems, some presorters with multiple locations developed their own processing networks to increase the density of sort and maximize workshare discounts. Mailers claim drop shipping discounts for FCM may improve the timeliness of mail delivery and offset some transportation costs.

Recommendations

We recommend management periodically review existing workshare discounts to identify opportunities to eliminate discounts that no longer reflect the processing environment; evaluate potential workshare discounts to align with changing mail processing requirements; and add new discounts where opportunities for greater efficiency exist.

We recommend the vice president, Pricing, work with the Postal Regulatory Commission to:

1. Periodically review existing workshare discounts to identify opportunities to eliminate discounts that no longer reflect the processing environment, such as:
   - Carrier route workshare discounts that do not complement or encourage efficiencies; and
   - Unnecessary or obsolete automation carrier route letter prices and Flats Sequencing System prices.
2. Periodically evaluate potential workshare discounts to align with changing mail processing requirements and add new discounts where opportunities for greater efficiency exist, including evaluating a set of non-machinable, carrier route prices for flats to encourage mailers to produce machinable flats.

Management's Comments

Management partially agreed with our findings and recommendations and their proposed corrective actions are responsive to the issues discussed in this report.

Management agrees that, as technology and operations change, they should periodically review workshare discounts and possibly eliminate those that become unnecessary or obsolete. This could include some High-Density and Saturation Carrier Route Letters and Flats price categories. Management also agrees that when technology and operations change, they should periodically consider establishing new workshare discounts to promote efficiency in the postal sector. Management stated they would initiate a workshare discount review with Postal Service Operations. The target date for completing the review is the end of FY 2016, Quarter 2.

Management disagreed with $343.6 million of the $452.9 million of reported monetary impact for FY 2014 and, by extension, disagreed with $658.7 million of the $876 million of reported monetary impact over 2 years due to additional information they identified post-audit. Specifically:

- Management disagreed with the way we calculated revenue impact, asserting that Basic Carrier Route, High-Density, and Saturation price categories are not “workshare discounts” with respect to 5-Digit Standard mail. Further, management stated that the PRC does not consider Standard Mail Carrier Route to be in a workshare relationship with Regular Automation. As a result, management asserts that the OIG's calculation is overstated.
- Management asserted that their Standard Mail Carrier Route price levels are meant to reflect demand and the market, not a worksharing relationship. Further, management asserts that the PRC does not consider Standard Mail Carrier Route to be in a workshare relationship with Regular Automation.
- Management disagreed with our estimated volume loss of 37 percent and has estimated a 100 percent volume loss and expressed how significant increases in prices might impact Saturation mailer business models and ultimately decrease revenue.

Management did not agree that the OIG's calculations are revenue impact (or loss) because the PAEA price cap limits the total amount of revenue that can be collected. Any additional revenue claimed under the OIG's scheme would have to be given up elsewhere so as not to exceed the cap.

See Appendix B for management's comments, in their entirety.

Evaluation of Management's Comments

The OIG considers management's comments responsive to the findings and recommendations and corrective actions should resolve the issues identified in the report.

Regarding management's comments on the monetary impact:

- Management believes that Standard Mail Basic Carrier Route, High-Density, and Saturation are not workshare discounts with respect to 5-Digit mail, therefore should not be included in revenue impact calculations. The OIG's review of workshare discounts considered how carrier route mail was actually processed with Regular Automation. The report finding states that the Postal Service treats presorted carrier route mail the same way it treats 5-digit automation mail in DPS operations. Most prices for presorted carrier route mail are less than the 5-Digit Automation price. By treating these mail types the same in DPS operations, Carrier Route is essentially getting a discount from the 5-Digit rate and potentially causing other customers to pay higher rates.

  Further, when the Postal Service made FSS sorting requirements mandatory in January 2014, they required Basic Carrier Route pieces to be sorted to 5-Digit FSS schemes. This essentially linked Carrier Route and 5-Digit mail. Finally, Basic Carrier Route rates are the benchmark for determining the High-Density workshare discount; therefore, by extension, High-Density mail is also linked to 5-Digit mail.

  The report concluded that when the Postal Service treats presorted Carrier Route mail the same as it treats 5-Digit mail in DPS operations, it has effectively converted presorted Carrier Route mail to 5-Digit mail. Therefore, the OIG used the 5-Digit Automation rate for the revenue impact calculations.

- To simplify our discussion, we use the terminology "workshare discount" to mean a reduced postage rate allowed because a mailer has complied with specific mail preparation requirements, such as prebarcoding or presorting. This is sometimes in contrast to the technical language of the regulatory environment. After the audit, management asserted that Carrier Route prices are not true workshare discounts but prices that reflect demand and the market. First, High-Density and Saturation Carrier Route mail fits the Postal Service's workshare definition. Delivery sequencing of mail is work the Postal Service would otherwise have to perform with automated equipment or manually prior to delivery. Also, when Saturation or High-Density mailings are not properly sequenced, mailers are subject to paying additional postage, like any other type of mail receiving a workshare discount. Second, the Worksharing Discount Tables attached to the Postal Service's FY 2014 *Annual Compliance Report* include sections related to Carrier Route workshare discounts. Finally, the FY 2014 ACR[14] specifically refers to Carrier Route rates as discounts when it states that "No workshare discount associated with Standard Mail High-Density Saturation Letters, Flats, or Parcels exceeds 100 percent of avoided costs." We noted that Postal Service stakeholders consider Carrier Route mail to be workshare discount mail and some link it to 5-Digit mail:

14 Postal Service, FY 2014 *Annual Compliance Report*, Section iv, High Density and Saturation Letters, Flats, and Parcels, page 28, December 29, 2014.

- A Postal Service Sales staff training manual[15] discussing worksharing states that the deepest discounts are for mailings that reach the finest sortation level, Enhanced Carrier Route. These mailings must be prepared in the order in which the carrier delivers their route. There are three levels of discount based upon the number of pieces per route in the mailing. The prices are: Basic, High-Density, and Saturation.

- A Postal Service Operations Support document[16] discussing FSS implementation states that the Postal Service will reassess the economic and operational value of carrier route presorting in the Delivery Point Packaging and FSS environments. For DPP, the Postal Service would not require presorting below the 5-digit or scheme-based levels. For FSS, the Postal Service would substitute an 11-digit barcoded automation rate in lieu of a carrier route discount where possible."

- The January 2014 Bundle Verification Adjustment Worksheet[17] indicates that Saturation, High-Density, High-Density Plus, and Basic Carrier Route Standard Mail flats bundles are charged additional postage to equal the 5-Digit Nonautomation Flats rates when they are not properly prepared.

- Management stated that the OIG wrongly estimated a 37 percent volume loss and that not offering Carrier Route prices would result in a 100 percent volume loss; however, this assertion is unsupported speculation. The OIG based volume calculations on the Postal Service's own elasticity figures and the Postal Service did not provide alternative elasticity figures. Additionally, the OIG recognizes the Postal Service's pricing complexities; therefore our recommendations specifically stated that it should work with the PRC to evaluate changes to current workshare discounts to ensure that any price changes are in line with existing law.

- Management does not agree that the OIG's calculations are revenue impact (or loss) because they assert that the PAEA price cap limits the total amount of revenue the Postal Service can collect and requires any additional revenue to be given up elsewhere to avoid exceeding the cap. First, the PAEA price cap regulates price increases but does not cap the amount of revenue that can be collected. Second, the OIG is claiming revenue loss because we identified potential revenue the Postal Service could collect based on its mail processing capabilities, which have been in place since 1993 for letters and 2009 for flats.

The OIG understands the various pricing and business mail complexities the Postal Service faces and the recommendations take this into account. We did not review any information identified by management post-audit. Our recommendation does not state that the Postal Service should eliminate or increase current Carrier Route rates, but should periodically review and identify opportunities to eliminate discounts that no longer reflect the operational environment. As workshare discounts are evaluated, management must take into consideration growth goals for different classes of mail and the impact on the existing customer base.

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15 VLR: Sales – *Intro to the Post Office, Participant Guide*, Course Program 00010251, Workshare, Presort Discounts, pages 3-24, January 2014.
16 *Mid-Term FY 2005 Through FY 2006, Implementing Flats Sequencing, Marketing Support for DPP and FSS,* July 3, 2005.
17 Bundle_Verify_Adj_Worksheet_Jan_2014, June 20, 2014.

Appendices

Appendix A: Additional Information

Background

The Postal Service offers several types of postage discounts, including promotional discounts, incentives, and workshare discounts. This report addresses workshare discounts (we will review promotional discounts separately). The Postal Service offers these discounts to mailers for presorting, pre-barcoding, or transporting mail, with the intent of increasing mail volume and eliminating costs through efficient operations and reduced staffing and workload. Automated mail processing began in 1982 and the Postal Service devised automation discounts to encourage mailers to prepare mail compatible with automated processing equipment.

Commercial mailers can presort mail for the Postal Service in return for workshare discounts. When a commercial mailer presorts its mail, the Postal Service avoids some of the costs for machine processing and the labor it takes to sort, or more finely sort, mail before transporting to the carriers for delivery. Almost all carrier route letters are processed in the automated DPS operation. DPS processing sorts mail into the exact order that carriers deliver it. The Postal Service began sorting barcoded letters in DPS order in 1993 and began establishing rates to encourage mailers to produce barcoded letters as part of the 1996 classification reform.

In January 2014, the Postal Service made FSS mail preparation a requirement for flats. The FSS sorts flat-sized mail in delivery sequence order. Mailers prepared bundles and containers according to FSS schemes for ZIP Codes selected for DPS processing. The Postal Service estimates that about 25 percent of its delivery zones are FSS zones. Even though the Postal Service revised its flats mail preparation and processing procedures, it did not adjust prices accordingly and allowed mailers to continue claiming rates for which their mail no longer qualified.

An analysis of January 2014 First-Class, Standard, and Periodicals postage statements[18] found 777 price categories and discounts, 648 of which were for letters and flats postage.[19] There have been controversies over the size of workshare discounts, how they are calculated, and how broadly they are applied. The Postal Service's December 2014 *Annual Compliance Report* indicates there are 40 letters and flats discounts that exceed costs avoided. Also, unions have raised concerns about transferring work from the Postal Service to external parties that results in job loss.

The regulatory environment surrounding pricing and workshare discounts is complicated. This report discusses, at a high level, how the Postal Service actually handles some mail in an automated mail processing environment in contrast to the prices actually paid.

18 Postage statements can be submitted electronically or in hard copy form. Postage statement data the mailer provides to the Postal Service describes the mail being entered. Data reported includes mail class, processing category, volume, weight, and postage calculations based on the number of pieces claimed at each price.
19 The analysis did not include Priority Mail, which is classified as a competitive product.

Objective

Our objective was to review workshare discounts related to automated mail processing to identify those that may no longer be valuable in the current Postal Service processing network. We also reviewed opportunities for new workshare discounts. Our report focuses on market-dominant letter and flat workshare discounts from FYs 2013 through 2014 and potential new discounts. To accomplish our objective we:

- Reviewed the pricing structure of mail as it relates to current automated mail processing techniques and network realignment to determine whether certain workshare discounts no longer provide value.
- Reviewed postage statement data from FYs 2013 to 2014 to identify closed SCFs that are still accepting mail and providing discounts.
- Reviewed FYs 2013 and 2014 billing determinants and cost avoidance models to determine which workshare discounts mailers are using.
- Evaluated the operational decision to rework DPS carrier route mail to determine the financial and operational impact on the Postal Service.
- Reviewed Postal Service pricing tables to evaluate the number and types of discounts currently available and assess the impact of continuing to offer workshare discounts that are no longer valuable to the Postal Service.
- Conducted discussions with Postal Service managers to understand their position concerning discounts that may no longer provide value to the Postal Service.
- Conducted site visits, as needed, to observe the processing of letter and flat-shaped mail and determine whether the Postal Service is doing work already done by discounted mailers.
- Reviewed prior reports to determine whether new workshare opportunities were previously reported.
- Met with mailing group representatives to determine whether there are new workshare opportunities.
- Met with Postal Service managers to discuss the operational viability of potential new workshare discounts.
- Reviewed PRC dockets and current legislation regarding workshare discounts.

We conducted this performance audit from April 2014 through June 2015, 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 for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. We discussed our observations and conclusions with management on March 19, 2015, and included their comments where appropriate.

We did not assess the reliability of any computer-generated data for the purposes of this report.

Prior Audit Coverage

Report Title	Report Number	Final Report Date	Monetary Impact
Flat-Shaped Mail Costs	MS-AR-13-003	1/4/2013	$259,154,687 over 2 years

Report Results: Our report determined that management's decision to manually process potentially machinable mail and the lack of flats mail processing equipment at certain processing facilities have limited the Postal Service's efforts to reduce costs associated with manually processing flats. Despite investments in flat mail processing equipment, about 30 percent of flat mail continues to be manually processed. We recommended that management ensure there are established goals that lower the percentage of manually processed flat mail, evaluate opportunities for reducing the number of non-automated plants and other mail processing facilities during facility optimization initiatives, develop a processing strategy to move single-piece FCM flats from manual to automated operations in facilities that have flat automation equipment, and establish procedures for placing and processing forwarding labels that comply with computerized forwarding system requirements. Management agreed with our recommendations but not our monetary impact.

Appendix B: Management's Comments

CYNTHIA SANCHEZ-HERNANDEZ
VICE PRESIDENT, PRICING

UNITED STATES POSTAL SERVICE

4/23/2015

LORI LAU DILLARD
DIRECTOR, AUDIT OPERATIONS

SUBJECT: Workshare Discounts for Automated Mail Processing
(Report Number DP-AR-15-DRAFT)

Management commends the USPS Office of Inspector General (OIG) for a thorough investigation of certain pricing practices with respect to automated mail processing. Management generally agrees that the periodic review of existing workshare discounts to eliminate those that are no longer needed is necessary. Management also agrees that when technology and operations change, periodic consideration should be given to establishing new workshare discounts to promote efficiency in the postal sector.

Management partially agrees with OIG's recommendation number one. Management disagrees with the manner in which the revenue impact has been calculated, given that we have identified additional information needed to accurately calculate the revenue impact (post audit). Basic Carrier Route, High Density and Saturation are not "workshare discounts" with respect to 5-Digit.[1] While in the context of 39 U.S. Code §3622(e) this is true for Periodicals, it is not true for Standard Mail. Historically the Postal Regulatory Commission and the Postal Service have deemed the advertising markets for High Density and Saturation on the one hand and Regular Automation on the other hand to be separate and distinct.[2] This allows the Postal Service to price Standard Mail Carrier Route (Basic Carrier Route, High Density, and Saturation) and Regular Automation without cost-based (and supply-side) workshare reference to one another. Instead, these price levels are meant to reflect demand, and the market.

That the Postal Regulatory Commission does not consider Standard Mail Carrier Route (Basic Carrier Route, High Density, Saturation) to be in a §3622(e) workshare relationship with Regular Automation (e.g., 5-Digit) can be seen in their Fiscal Year 2014 Annual Compliance Report issued on March 27, 2015. Tables II-4 (page 18) and II-5 (page 21) show no such links for Standard Mail. By contrast, Table II-3 (page 15) does show such a link for Periodicals.

This clarification has significant implications for the calculated revenue impact. Standard Mail accounts for fully $343.6 million (76 percent) of the $452.9 million impact in FY 2014.

Consider the Saturation option for Standard Mail Letters (almost 3 billion pieces). Over 90 percent is entered at the DSCF. A Commercial user of the DSCF category currently pays 15.3 cents.

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[1] This is because Carrier Route (Basic Carrier Route, High Density, Saturation) are not in a §3622(e) workshare relationship with Regular Automation (e.g., 5-Digit).
[2] In fact, the Postal Regulatory Commission went further to say the same thing for High Density versus Saturation in Docket No. RM2009-3, Order No. 536, at pages 59 - 61.

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If the mailer were to pay the 5-Digit Automation rate or 21.7 cents, this would represent a 42 percent increase from the current level.[3] Such an increase could very well destroy the user's saturation business model, causing it to exit the mail market altogether, and losing the Postal Service hundreds of millions of dollars. Indeed, Saturation mailers face different kinds of competition from 5-Digit mailers, for example from newspaper inserts, "alternate delivery" (e.g., door-hanger) services, and Standard Mail Flats. It is precisely this kind of consideration — a separate and distinct advertising market — which properly allows the Postal Service to price Saturation without being hamstrung by cost-based workshare reference to 5-Digit Automation. The model asserts that the Postal Service is "forgoing" or "losing" 21.7 - 15.3 cents = 6.4 cents of revenue on such Letters when they are presorted to carrier walk sequence yet still Delivery-Point-Sequenced. Depending on the exigencies of the market, any attempt to increase price might cause revenue to decrease, not increase.

Management also does not believe that it is meaningful to estimate a volume impact for this example of +42% x -0.89 = -37 percent.[4] Minus 100 percent is more likely to be the case.

Finally, OIG's revenue calculation should not be deemed a "revenue impact" (or "loss") because the PAEA price cap delimits the total amount of revenue that can be collected. Any additional revenue claimed under OIG's scheme would have to be given up elsewhere so as not to pierce through the cap. What is more, effective price increases upwards of 40 percent for Standard Mail Letters (DSCF), 100 percent for Standard Mail Flats (DSCF), and 110 percent for Periodicals, are likely to break the business models of many mailers. This will lead to *ex post facto* volume losses for which no offsetting revenue allowance can be made, because the price cap methodology relies on a retrospective (backward-looking) Laspeyres Index. This means potential revenue losses rather than gains as the Report posits.

Recommendation 1:

Periodically review existing workshare discounts to identify opportunities to eliminate discounts that no longer reflect the processing environment, such as:

- Carrier route workshare discounts that do not complement or encourage efficiencies; and
- Unnecessary or obsolete automation carrier route letter prices and Flats Sequencing System prices.

Management Response:

The Postal Service agrees that as technology and operations change, workshare discounts should periodically be reviewed, and possibly "eliminated" if they become "unnecessary or obsolete." This could include some current Carrier Route (Basic Carrier Route, High Density, and Saturation) Letters and Flats price categories. As described above, workshare discounts that do not complement or encourage efficiencies need to be evaluated in a broader context that includes product, competition, and price cap implications in the decision making process.

Target Implementation Date:

[3] This exceeds the 32 percent in OIG's model because OIG assumes Origin entry when over 90 percent of Saturation Letters volume is DSCF.
[4] The -0.89 is the own-price elasticity for "Commercial ECR." This elasticity is imputed from historical volume responses to price changes — typically single-digit — and in no way is necessarily applicable to a 42 percent effective price increase.

Management will initiate a workshare discount review with USPS Operations. We plan to complete that review by the end of FY 2016 Quarter 2.

Responsible Management Official:

Steve Monteith, Manager Pricing

Recommendation 2:

Periodically evaluate potential workshare discounts to align with changing mail processing requirements and add new discounts where opportunities for greater efficiency exist, including evaluating a set of non-machinable, carrier route prices for flats to encourage mailers to produce machinable flats.

Management Response:

Management concurs with recommendation number two, that when technology and operations change, periodic consideration should be given to establishing new workshare discounts to promote efficiency in the postal sector. Indeed, for this reason, the Postal Service proposed new workshare prices for FSS Scheme and Non-Scheme Pallets and for Basic Carrier Route Flats 5-Digit Pallets in Docket No. R2015-4 (see Response to Order Remand 2, "AttachmentB-Remand2.xlsx").

Target Implementation Date:

Management will initiate a workshare discount review with USPS Operations. We plan to complete that review by the end of FY 2016 Quarter 2.

Responsible Management Official:

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