



December 23, 2010

MAURA ROBINSON
VICE PRESIDENT, PRICING

JOSEPH D. MOELLER
MANAGER, REGULATORY REPORTING AND COST ANALYSIS

SUBJECT: Audit Report – Workshare Discounts Exceeding Avoided Costs
(Report Number MS-AR-11-001)

This report presents the results of our audit of Workshare Discounts Exceeding Avoided Costs (Project Number 10RG015MS000). Our objective was to determine whether U.S. Postal Service workshare discounts exceeding avoided costs were properly justified. This self-initiated audit addresses strategic risk. See [Appendix A](#) for additional information about this audit.

The Postal Service provides mailers with workshare discounts in the form of reduced postage rates for presorting, pre-barcoding, handling or transporting mail. The Postal Service credits workshare discounts with stimulating mail volume growth, enabling it to streamline its workforce and infrastructure, reducing mailing costs, and improving service. The Postal Service workshared over 80 percent of its mail volume in fiscal year (FY) 2008, resulting in an avoidance of \$14.8 billion in costs and providing \$15 billion in discounts to mailers.¹

The Postal Accountability and Enhancement Act of 2006² (the Postal Act) requires that workshare discounts not exceed the costs the Postal Service avoids as a result of workshare activity unless:

- The discount is associated with a new postal service, a change to an existing postal service or a new workshare initiative related to an existing postal service; and necessary to induce mailer behavior that furthers the economically efficient operation of the Postal Service. The Postal Service must phase out the amount of the discount exceeding avoided costs over a limited period of time.
- Reducing or eliminating the discount would impede the efficient operation of the Postal Service.

¹ OIG report: *Economic Analysis of the Postal Service's Workshare Discounts*, October 14, 2009.

² Public Law 109-435, December 20, 2006.

- The amount of the discount above costs avoided is necessary to mitigate rate shock and will be phased out over time.
- The discount is provided in connection with sub-classes of mail consisting exclusively of educational, cultural, scientific or informational value.

Postal Regulatory Commission (PRC) Annual Compliance Determinations reported 30 workshare discounts exceeding avoided costs for FY 2009³ and 35 for FY 2008.

Conclusion

Justifications for 19 workshare discounts that exceed avoided costs by approximately \$104 million were not supported by detailed documentation. Additionally, although the educational, cultural, scientific or informational exception justifies discounts that exceed avoided costs, the Postal Service did not support the reasonableness of these discounts. The Postal Service does not have a documented process outlining how it reaches pricing decisions and does not always have sufficient documentation to support the amount of workshare discounts provided to mailers. According to Postal Service management, reliable quantitative data supporting justifications are also not always available or necessary.

According to management, they do not document the price decision-making process, but make decisions after extensive discussions with parties both inside and outside the Postal Service.

In addition, Postal Service cost avoidance models may not accurately reflect avoided costs for workshared mail. This occurs because the Postal Service relies on cost models and incurred costs to estimate avoided costs and has not conducted a comprehensive study to determine the accuracy of its cost avoidance estimates and to recommend improvements to the models. Some stakeholders say that cost avoidance estimates do not capture all worksharing related cost savings, leaving workshare discounts too low; and others state that the discounts are too high because mailers workshare the mail with the lowest processing cost, raising the Postal Service's average mailpiece processing costs used to calculate avoided costs. This increases the Postal Service's avoided cost calculations and, in turn, workshare discounts.

Justification for Workshare Discounts Exceeding Avoided Costs

The Postal Service did not properly support justifications for 19 of 30 discounts that exceeded avoided costs in FY 2009 and 23 of 35 discounts that exceeded avoided

³ Thirteen of the 30 discounts in the February 10, 2009, Notice Market-Dominant Price Adjustment exceeded avoided costs. Of the remaining 17 discounts, 13 were either set at or below avoided costs and four were not estimated at the time of the price adjustment. On March 16, 2009, the PRC authorized the discounts, but stated that PRC findings are provisional and subject to subsequent review.

costs in FY 2008. [Appendix B](#) contains a detailed list of the discounts that exceeded avoided costs for FYs 2009 and 2008. See Table 1:

Table 1: Reasons Cited for Workshare Discounts Exceeding Avoided Costs

	FY 2009		FY 2008	
	Total Cited	Not Properly Justified	Total Cited	Not Properly Justified
Impede Efficient Operation	21	18	7	7
Necessary to Mitigate Rate Shock	1	1	5	5
Educational, Cultural, Scientific or Informational Value	8	0	10	0
No Justification Provided	0	0	10	10
Not a Workshare Discount	0	0	3	1
Total discounts exceeding avoided costs	30	19	35	23

For 18 of the 21 FY 2009 discounts that exceeded avoided costs justified under the “impede efficient operations” exception, the Postal Service did not identify specific operations that would be impeded, or quantify the potential impact of setting workshare discounts equal to or less than avoided costs. For the three remaining discounts justified under the “impede efficient operations” exception, we found that documentation supported only one discount that exceeded avoided costs⁴. For the other two discounts, the Postal Service asserted that the rules governing worksharing did not apply to cost and rate differences between single piece letters and First-Class™ Mixed Automated Area Distribution Center (AADC) Letters. The Postal Service also asserted that Standard Saturation⁵ mail should not be subject to the workshare discount provisions of the Postal Act.

The PRC established a docket⁶ to review those issues. Subsequently, the PRC issued Order 536,⁷ which invalidated the existing benchmark for First-Class Mixed AADC letters and temporarily allowed the Postal Service to continue this discount until an appropriate benchmark is identified. The order also determined that Standard Saturation mail occupies a unique market and is not subject to the workshare discount provisions of the Postal Act.

⁴ Standard Mail 5-Digit Machinable Parcels.

⁵ Saturation mail must meet the density requirement of at least 90% or more of the active residential addresses or 75% or more of the total number of active possible delivery addresses on each carrier route receiving this mail.

⁶ Docket No. RM2009-3, Notice of Proposed Rulemaking on Application of Workshare Discount Rate Design Principles.

⁷ Order No. 536: Order Adopting Analytical Principles Regarding Workshare Discount Methodology, September 14, 2010.

Further, the Postal Service cited the rate shock exception without providing any quantitative analysis to support the effect on mailers of lowering workshare discounts to avoided cost. In addition, the Postal Service had no plan, schedule or timetable for phasing out discounts that exceeded avoided costs justified under the rate shock provision.

The Postal Service also did not document the methodology used in determining the reasonableness of the amount of eight discounts that exceeded avoided costs justified under the educational, cultural, scientific or informational exception. For example, the passthroughs⁸ of educational, cultural, scientific or informational discounts ranged from 105.4 percent to 1,000 percent in FY 2009. The Postal Service does not provide any data, studies, analyses or projections to evaluate whether the amount of the discounts are reasonable or necessary. We discussed the matter with management who pointed out that PRC regulations do not require the Postal Service to report its methodology for setting the size of these workshare discounts.

Unsupported discounts exceeding avoided costs occur because the Postal Service has not documented the process it uses to reach its pricing decisions and does not maintain sufficient documentation to support these discounts. Although the Postal Service described the reasons for the discounts that exceeded avoided costs in the Annual Compliance Report (ACR) and other information provided under the ACR docket, the Postal Service does not support its position with quantitative data. Management stated that they use a qualitative approach in setting rates. The Postal Service makes pricing decisions after extensive discussions with stakeholders from within and outside the Postal Service, but does not believe that quantitative data to support the amount of the discounts was always reliable, available or necessary.

The maximum rate adjustment the Postal Service is authorized to make in any year is limited to the rate of inflation. This price cap, which applies to each class of mail, is based on the change in the Consumer Price Index for All Urban Consumers (CPI-U) over the most recent available 12-month period. The Postal Service is allowed to bank any unused rate adjustment authority for up to 5 years and use it for future rate increases as long as the unused authority does not exceed the CPI-U by 2 percent. The Postal Service does not have sufficient unused cap authority as of the last price adjustment to fully reduce the 19 unsupported workshare discounts totaling \$104 million. The Postal Service can however adjust prices without impacting the price cap. For example, the pricing schedules submitted by the PRC's Public Representative⁹ demonstrated that the Postal Service can fully reduce the \$37 million of First-Class Mail® (FCM) workshare discounts exceeding avoided costs and stay within the CPI price cap.

⁸ A passthrough is a workshare discount expressed as a percentage of the avoided cost.

⁹ PRC Docket RM2009-3, Filing identification 63255, May 26, 2009.

On July 6, 2010, the Postal Service requested an exigent rate increase.¹⁰ The Postal Service proposed to reduce 13 of the 30 FY 2009 discounts exceeding avoided costs to levels at or below the avoided costs. However, the PRC denied this request on September 30, 2010, and the Postal Service is appealing the decision.

Until the Postal Service adequately supports justifications for discounts exceeding avoided costs, there is an increased risk that some mailers benefit from discounts at the expense of other mailers. In addition, discounts exceeding avoided costs may result in higher mail processing costs and inefficient mailer processing decisions.

We recommend the vice president, Pricing:

1. Prepare and maintain data, analyses or other documentation to properly support the amount of discounts that exceed avoided costs when claiming exceptions specified in the Postal Accountability and Enhancement Act of 2006. Alternatively, limit proposed discounts to 100 percent of avoided costs at the next market dominant price adjustment.
2. Document the methodology and decision making process used to determine the reasonableness of discount amounts that exceed avoided costs justified under the Postal Accountability and Enhancement Act of 2006 educational, cultural, scientific or informational exception.

Management's Comments

Management agreed with recommendation 1 and disagreed with recommendation 2. Management stated they intend to comply with the PRC's rules and decisions that provide direction and guidance on the justifications for workshare discounts that exceed avoided costs. They further stated that the Postal Service provided justifications for the discounts that did exceed avoided cost and that the PRC had determined those discounts were consistent with the statute. Concerning recommendation 2, management stated that under the provisions of the Postal Accountability and Enhancement Act of 2006, the Postal Service is not required to provide justification for workshare discounts that exceed avoided costs for mail consisting exclusively of mail matter of educational, cultural, scientific, or informational value. See [Appendix C](#) for management's comments.

Evaluation of Management's Comments

The OIG considers management's comment responsive to recommendation 1. We held a meeting with management on December 7, 2010, to obtain further clarification regarding management's response to recommendation 1, and determined management

¹⁰ A rate increase above the rate of inflation. The Postal Act only allows exigent rate increases for market dominant products under extraordinary or exceptional circumstances. The PRC must determine that extraordinary or exceptional circumstances exist before an exigent rate increase can go into effect.

does plan to maintain data, analyses, or other documentation to properly support the amount of discounts that exceed avoided costs. FY 2009 was the second year the Postal Service submitted price adjustments under the Postal Act of 2006. We encourage the Postal Service to improve the process continuously so that the availability of data, analysis, and other documentation will become less dependent on PRC requests for support.

We consider management's response to recommendation 2 to be non-responsive. Management has chosen not to document the methodology and decision making process used to determine the reasonableness of discount amounts that exceed avoided costs because the Postal Act does not require them to do so. Our recommendation acknowledges that the law allows workshare discounts to exceed avoided costs for mail matter consisting exclusively of educational, cultural, scientific, or informational value. However, we believe that documenting the Postal Service methodology and decision-making process for setting those discounts is important for transparency and is a prudent business practice. As stated in the report, Postal Service passthroughs ranged from 105.4 to 1,000 percent in FY 2009, some mailers may benefit from discounts at the expense of other mailers, and the discounts may result in higher mail processing costs and inefficient mailer processing decisions. While it is important for policy makers and stakeholders to know the rationale behind the amount of these discounts, which exceed avoided costs by \$5 million, we do not plan to pursue recommendation 2 through the formal audit resolution process.

The OIG considers recommendation 1 significant and, therefore, requires concurrence before closure. Consequently, the OIG requests written confirmation when corrective actions are completed. This recommendation should not be closed in the follow-up tracking system until the OIG provides written confirmation that the recommendations can be closed.

Cost Avoidance Models

Postal Service cost avoidance estimates may not accurately reflect avoided costs for workshare mail. The Postal Service estimates unit mail processing costs by rate category using mail flow models which are based on the actual costs incurred, not avoided, for processing mail. The modeled mail processing costs are adjusted to ensure consistency with aggregate costs from the Cost and Revenue Analysis (CRA) report.¹¹

Over the years, the PRC has held public hearings with input from the Postal Service and other interested parties in order to develop and refine methodologies for determining various worksharing costs. However, stakeholders do not agree whether current methodologies accurately measure the actual avoided costs of worksharing mail. For example, stakeholders do not agree on:

¹¹ The Postal Service annually prepares the CRA report as part of its price setting process. The CRA model the agency uses to prepare the report uses cost information from the agency's accounting system and cost allocation ratios derived from various operational and statistical information sources.

- What costs should be included or excluded as worksharing costs.
- The benchmarks used to measure cost avoidance.
- Whether cost avoidance models are accurate at a time of declining volume.

The Postal Service uses the cost of non-workshare Bulk Metered First-Class Mail as a baseline to determine the difference in costs between non-workshare and workshare First-Class Mail, as required by the PRC. Non-workshare mail tends to be much more heterogeneous than workshare mail, exhibiting a wide variation of mailpiece characteristics and, as a result, has significantly higher processing costs than workshare mail. Since, the average cost of First-Class Mail is higher than the cost of a mailpiece that is likely to be converted to workshare, the Postal Service uses the cost of Bulk Metered Mail (BMM) as the piece most likely to be converted to calculate workshare discounts. However, there is considerable controversy over the appropriateness of using the BMM benchmark in estimating cost avoidance. The PRC concluded in Order Number 536 that the BMM benchmark is no longer valid and opened a docket to establish a new benchmark. See [Appendix A](#) for additional information. Furthermore, the drop in mail volume raises the question of whether the cost avoidance models are accurate in a period of volume decline. The Postal Service faces constraints in responding to reduced volume, such as no-layoff provisions in labor contracts, which could result in excess capacity. Excess capacity can result in increased total unit costs and workshare discounts that exceed the true cost the Postal Service is able to avoid.

Although it is difficult to estimate avoided costs, accuracy of cost avoidance estimates is critical as the Postal Service grants billions of dollars in workshare discounts annually. In addition, improperly setting discounts conflicts with the efficient component pricing theory.¹² When discounts are set too high, mailers and mail service providers are given an incentive to perform mail processing functions that the Postal Service could perform more efficiently. PRC Order Number 537 initiated Docket No. RM2010-13 to re-examine how the Postal Service models avoided costs. Because this docket will re-examine workshare cost modeling in detail, we are not making a recommendation concerning the models.

¹² Under the efficient component pricing theory the Postal Service sets workshare discounts equal to avoided costs. The Postal Service collects the same unit contribution to institutional costs regardless of whether the mailer or the Postal Service performs the work. In addition, proponents of efficient component pricing believe that it results in productive efficiency with the lowest cost provider (Postal Service or mailer) doing the work and this is beneficial to the economy.

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

E-Signed by Darrell E. Benjamin, Jr. 
VERIFY authenticity with ApproveIt

Darrell E. Benjamin, Jr.
Deputy Assistant Inspector General
for Revenue and Systems

Attachments

cc: Paul Vogel
Joseph Corbett
Stephen M. Kearney
Corporate Audit and Response Management

APPENDIX A: ADDITIONAL INFORMATION

BACKGROUND

The Postal Service began offering workshare discounts in 1976. These discounts are provided in the form of reduced postage rates to mailers for presorting, pre-barcoding, handling or transporting mail.

PRC Docket on BMM as Benchmark and Mail Density

In March 2009 the PRC established Docket No. RM2009-3 to examine methodologies underlying methods for calculating workshare discounts. The Postal Service proposed workshare discounts for First-Class Mail and Standard Mail that were not based on established workshare cost avoidance methodologies. For First-Class Mail, the Postal Service did not use the existing BMM benchmark to calculate avoided costs and for Standard Mail, the Postal Service did not use the existing methodology based on costs avoided between Basic and High Density and High Density and Saturation mail. In September 2010, the PRC issued an order¹³ invalidating the BMM as a benchmark, allowed the Postal Service to maintain current First-Class bulk mail rates until the matter is resolved in a separate PRC docket, and concluded that Saturation Mail is not in a worksharing relationship with other groups of Standard Mail. In a concurrent order¹⁴ the PRC established Docket No. RM2010-13 to examine new benchmarks for workshared mail and other issues related to the design of workshare discounts.

OBJECTIVE, SCOPE, AND METHODOLOGY

Our objective was to determine whether Postal Service workshare discounts exceeding avoided costs were properly justified.

To accomplish our objective we reviewed laws, regulations, policies, procedures, previous audits, and expert studies related to workshare discounts. We interviewed Postal Service and PRC officials and employee union officials. We reviewed the Postal Service's *Annual Compliance Reports* for FYs 2007, 2008, and 2009; and PRC *Annual Compliance Determination* reports and related dockets to evaluate the reasonableness of Postal Service justifications for discounts exceeding avoided costs. We reviewed comments to PRC Docket No. RM2009-3 concerning methodologies underlying the calculations of workshare discounts.

We conducted this performance audit from March through December 2010 in accordance with generally accepted government auditing standards and included such tests of internal controls as we considered necessary under the circumstances. Those

¹³ Order 536, Order Adopting Analytical Principles Regarding Workshare Discount Methodology, September 14, 2010.

¹⁴ Order 537, Notice of Proposed Rulemaking Concerning the Technical Methods to be Applied in Designing Workshare Discounts, September 14, 2010.

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 officials on October 22, 2010, and included their comments where appropriate.

We assessed the reliability of Postal Service cost and pricing data by evaluating their cost models and determined the data were sufficiently reliable for the purposes of this report.

PRIOR AUDIT COVERAGE

Report Title	Report Number	Final Report Date	Report Results
<i>A Primer on Postal Worksharing</i>	GAO-03-927	7/31/2003	The U.S. Government Accountability Office (GAO) was asked to provide information on the key activities and the rationale for worksharing and the legal basis for worksharing rates. The report helps Congress and others better understand worksharing. The report discussed the Postal Service's and the Postal Rate Commission's rationale for worksharing but did not assess the benefits they claimed for worksharing.
<i>Bound Printed Matter Workshare Discounts</i>	CRR-AR-08-005	5/9/2008	Some of the supporting documentation that management used to develop the Bound Printed Matter (BPM) discounts was old, which could have affected the reliability of the BPM workshare discount rates. The report made two recommendations which management agreed with.
<i>Improving Rate Making Data Quality through Postal Service Actions and Postal Reform Legislation</i>	GAO-05-820	7/28/2005	The GAO was asked to (1) describe key Postal Service actions that were responsive to a 1999 study to improve the quality of ratemaking data and (2) discuss possible implications of postal reform legislation for ratemaking data quality. The GAO did not assess the extent to which the Postal Service's actions affected data quality. The Postal Service took several key actions in response to the study's findings. The Postal Service reported that these actions increased the accuracy and precision of ratemaking data. The Postal Service disagreed with findings on the ratemaking structure, stating the current process has worked "remarkably well" and that the proposed legislation is unlikely to lead to "breakthrough improvements" in the quality of its ratemaking data systems without a significant increase in costs.

Report Title	Report Number	Final Report Date	Report Results
<i>Management of Special Studies</i>	CRR-AR-10-002	3/19/2010	Controls over special studies are generally adequate to ensure that special studies are updated with recurring data inputs; however, improvements are needed over controls to ensure the studies are updated with non-recurring financial and operational data. We recommended developing a plan for timely updating the Postmaster Variability Study, identifying non-recurring data inputs that should be updated in each cost model, and updating the non-recurring data inputs or identifying cost-effective alternative methods to obtain the necessary cost allocation information and updating the cost models.
<i>U.S. Postal Service: Progress Made Toward Implementing GAO's Recommendations to Strengthen Network Realignment Planning and Accountability and Improve Communication</i>	GAO-08-1134R	9/25/2008	As worksharing has increased, larger volumes of mail have bypassed most of the Postal Service's processing activities, creating excess network capacity.
<i>First-Class and Standard Mail Workshare Discounts</i>	MS-AR-10-003	7/20/2010	Workshare discounts for First-Class and Standard mail presort letters are generally based on current cost inputs; however, some of the inputs have not been updated since FY 2005 and may not be representative of current operating conditions. Postal Service cost models do not account for slim-jim letters that the Postal Service processes as flats. We recommended determining the feasibility of updating the 14 First-Class and Standard Mail cost inputs that were updated before FY 2008 and identifying needed changes to the letter cost models due to the volume of slim-jims and the percentage processed as flats.

Report Title	Report Number	Final Report Date	Report Results
<i>Assessment of Worksharing</i>	RARC-WP-10-005	7/12/2010	Worksharing dominates business mailings and is an integral part of the U.S. postal system. The Postal Service should evaluate the possibility of (1) balancing the value of workshared rates against the complexity of worksharing (2) strategically using pricing to help manage capacity and operations, and (3) enhancing earnings by settings discounts below avoided costs.

**APPENDIX B: FYs 2008 AND 2009 WORKSHARE
DISCOUNTS EXCEEDING AVOIDED COSTS**

FY 2008 Discounts Exceeding Avoided Costs

Class	Product	Discount	Exception Cited	Passthrough	Properly Justified?
FCM Bulk Letters Cards	Automated Mixed AADC Letters	Barcoding/Presorting	Not a workshare discount as defined in the Postal Act	112.2%	Note 1
FCM Bulk Letters Cards	Automation 3-Digit Letters	Barcoding/Presorting	None provided	166.0%	No
FCM Bulk Letters Cards	Automation 3-Digit Cards	Barcoding/Presorting	None provided	187.4%	No
FCM Flats	Automation ADC Flats	Barcoding/Presorting	None provided	157.5%	No
FCM Flats	Automation 3-Digit Flats	Barcoding/Presorting	None provided	150.0%	No
Periodicals, Outside County	Machinable Nonautomation ADC Flats	Presorting	Educational, cultural, scientific, or informational	180.1%	Note 2
Periodicals, Outside County	Machinable Nonautomation 3D/Sectional Center Facility (SCF) Flats	Presorting	Educational, cultural, scientific, or informational	136.7%	Note 2
Periodicals, Outside County	Machinable Automation ADC Flats	Presorting	Educational, cultural, scientific, or informational	214.5%	Note 2
Periodicals, Outside County	Machinable Automation 3D/SCF Flats	Presorting	Educational, cultural, scientific, or informational	123.9%	Note 2
Periodicals, Outside County	Nonmachinable Automation ADC Flats	Presorting	Educational, cultural, scientific, or informational	106.2%	Note 2
Periodicals, Outside County	ADC Automation Letter	Barcoding	Educational, cultural, scientific, or informational	223.4%	Note 2
Periodicals, Outside County	3-Digit Automation Letter	Barcoding	Educational, cultural, scientific, or informational	649.4%	Note 2

Class	Product	Discount	Exception Cited	Passthrough	Properly Justified?
Periodicals, Outside County	5-Digit Automation Letter	Barcoding	Educational, cultural, scientific, or informational	366.9%	Note 2
Standard Mail Letters	Automated Mixed AADC Letters	Barcoding	Impede efficiency	-31.9% ¹⁷	No
Standard Mail Letters	Automation 3-Digit Letters	Presorting	None provided	130.4%	No
Standard Mail Letters	Nonautomation ADC Nonmachinable Letters	Presorting	None provided	115.8%	No
Standard Mail High Density and Saturation Flats and Letters	Saturation Letters	Presorting	Not a workshare discount as defined in the Postal Act	-145.0% ¹⁷	Note 3
Standard Mail Flats	Automation ADC Flats	Presorting	None provided	524.2%	No
Standard Mail Flats	Automation Mixed ADC Flats	Barcoding	Impede efficiency	227.8%	No
Standard Mail Flats	Nonautomation ADC Flats	Presorting	None provided	142.7%	No
Standard Mail Parcels & Not-Flat Machinables (NFM's)	BMC Machinable Parcels	Presorting	Impede efficiency	106.1%	No
Standard Mail Parcels & NFM's	5-Digit Machinable Parcels	Presorting	Impede efficiency	106.5%	No
Standard Mail Parcels & NFM's	Destination Delivery Unit (DDU) Parcels, NFM's	Dropship	Impede efficiency	105.9%	No
Standard Mail Carrier Route	DDU Parcels	Dropship	Impede efficiency	105.9%	No
Standard Mail High Density and Saturation Flats and Parcels	DDU Parcels	Dropship	Impede efficiency	105.9%	No
Standard Mail High Density and Saturation Flats and Parcels	High Density Parcel	Presorting	Not a workshare discount as defined in the Postal Act	-7.0% ¹⁷	No

Class	Product	Discount	Exception Cited	Passthrough	Properly Justified?
Media Mail	5-Digit	Presorting	Educational, cultural, scientific, or informational	264.3%	Note 2
Library Mail	5-Digit	Presorting	Educational, cultural, scientific, or informational	253.3%	Note 2
Bound Printed Matter Flats	Carrier Route Flats	Presorting	None provided	109.0%	No
Bound Printed Matter Flats	Basic, Carrier Route Destination Bulk Mail Center (DBMC) Flats	Dropship	Rate shock	140.0%	No
Bound Printed Matter Flats	Basic, Carrier Route Destination Sectional Center Facility (DSCF) Flats	Dropship	Rate shock	107.0%	No
Bound Printed Matter Parcels	Carrier Route Parcels/Irregular Parcels and Pieces (IPPs)	Presorting	None provided	109.0%	No
Bound Printed Matter Parcels	Basic, Carrier Route DBMC Parcels/IPPs	Dropship	Rate shock	142.0%	No
Bound Printed Matter Parcels	Basic, Carrier Route DSCF Parcels/IPPs	Dropship	Rate shock	105.1%	No
Bound Printed Matter Parcels	Basic, Carrier Route DDU Parcels/IPPs	Dropship	Rate shock	103.1%	No

FY 2009 Discounts Exceeding Avoided Costs

Class	Product	Discount	Exception Cited	Passthrough	Justification Supported?
FCM Bulk Letters, Cards	Automation Mixed AADC Letters	Barcoding/ Presorting	Impede efficiency	126.1%	Note 1
FCM Bulk Letters, Cards	Automation AADC Letters	Barcoding/ Presorting	Impede efficiency	110.0%	No
FCM Bulk Letters, Cards	Automation 3-Digit Cards	Barcoding/ Presorting	Impede efficiency	200.0%	No
FCM Bulk Letters, Cards	Automation 5-Digit Cards	Barcoding/ Presorting	Impede efficiency	108.3%	No
FCM Flats	Automation ADC Flats	Barcoding/ Presorting	Rate shock	271.1%	No
Periodicals, Outside County	Nonmachinable Nonautomation 3D/SCF Flats	Presorting	Educational, cultural, scientific, or informational	164.4%	Note 2
Periodicals, Outside County	Nonmachinable Automation 3D/SCF Flats	Presorting	Educational, cultural, scientific, or informational	162.2%	Note 2
Periodicals, Outside County	ADC Automation Letter	Presorting	Educational, cultural, scientific, or informational	235.3%	Note 2
Periodicals, Outside County	3-Digit Automation Letter	Presorting	Educational, cultural, scientific, or informational	1000.0%	Note 2
Periodicals, Outside County	5-Digit Automation Letter	Presorting	Educational, cultural, scientific, or informational	300.0%	Note 2
Standard Mail Letters	Nonautomation 3-Digit Nonmachinable Letters	Presorting	Impede efficiency	169.2%	No
Standard Mail Letters	Nonautomation 5-Digit Nonmachinable Letters	Presorting	Impede efficiency	101.7%	No

Class	Product	Discount	Exception Cited	Passthrough	Justification Supported?
Standard Mail Flats	Auto ADC Flats	Presorting	impede efficiency	Per Postal Service ACR: The avoided cost rounds to zero, so a passthrough cannot be calculated.	No
Standard Mail Flats	Automation 3-Digit Flats	Presorting	Impede efficiency	107.9%	No
Standard Mail Flats	Nonautomation 5-Digit Flats	Presorting	Impede efficiency	114.1%	No
Standard Mail Flats	Automation Mixed ADC Flats	Barcoding	Impede efficiency	200.0%	No
Standard Mail Parcels and NFMs	BMC Machinable Parcels	Presorting	Impede efficiency	183.5%	No
Standard Mail Parcels and NFMs	5-Digit Machinable Parcels	Presorting	Impede efficiency	106.3%	Yes
Standard Mail Parcels and NFMs	Mixed BMC Machinable Barcoded Parcels	Barcoding	Impede efficiency	184.0%	No
Standard Mail Parcels and NFMs	Mixed ADC Irregular Barcoded Parcels	Barcoding	Impede efficiency	184.0%	No
Standard Mail Parcels and NFMs	Mixed ADC Barcoded NFMs	Barcoding	Impede efficiency	184.0%	No
Media Mail	Basic	Presorting	Educational, cultural, scientific, or informational	105.4%	Note 2
Standard Mail Letters	Saturation Letters	Presorting	Impede efficiency	-550.0% ¹⁵	Note 3
Standard Mail Parcels	High Density Parcels	Presorting	impede efficiency	-5.0% ¹⁷	No
Media Mail	5-Digit	Presorting	Educational, cultural, scientific, or informational	154.2%	Note 2
Library Mail	5-Digit	Presorting	Educational, cultural, scientific, or informational	145.8%	Note 2

¹⁵ Mail processing and unit delivery costs are anomalous and the PRC has directed the Postal Service to review and improve its costing analysis for these products.

Class	Product	Discount	Exception Cited	Passthrough	Justification Supported?
Bound Printed Matter Flats	Basic, Carrier Route DBMC Flats	Dropship	Impede efficiency	101.4%	No
Bound Printed Matter Flats	Basic, Carrier Route DBMC Parcels/IPPs	Dropship	Impede efficiency	100.5%	No
Bound Printed Matter Flats	Basic, Carrier Route DDU Flats	Dropship	Impede efficiency	104.5%	No
Bound Printed Matter Parcels	Basic, Carrier Route DDU Parcels/IPPs	Dropship	Impede efficiency	104.5%	No

Notes

- Note 1 - On September 14, 2010, PRC Order No. 537 established Docket No. RM2010-13 to revise the benchmark for Automation Mixed AADC Letters. Adjustment of First-Class Bulk Mail rates is not required while PRC Docket No. RM2010-13 is pending.
- Note 2 - The Postal Act allows educational, cultural, scientific or informational mail product workshare discounts to exceed avoided costs; however, the Postal Service does not provide any data, studies, analyses or projections to evaluate whether the size of these discounts are reasonable or necessary.
- Note 3 - PRC Order No. 536 concluded that Standard Saturation Mail occupies a unique market niche within Standard Mail, therefore, is not in a worksharing relationship with other groups of Standard Mail.

APPENDIX C: MANAGEMENT'S COMMENTS



November 22, 2010

Lucine Willis
Director, Audit Operations
1735 North Lynn Street
Arlington, VA 22209-2020

SUBJECT: Draft Audit Report – Workshare Discounts Exceeding Avoided Costs
(Report Number MS-AR-11-DRAFT)

Thank you for the opportunity to review and comment on the subject draft audit report. This provides management's response to the subject audit report.

The Postal Service agrees with the audit team's first recommendation; however, it does not agree with the team's second recommendation. Our response to the recommendations is provided below.

The audit team recommended the Vice President, Pricing, to:

Recommendation [1]:

Prepare and maintain data, analyses or other documentation to properly support the amount of discounts that exceed avoided costs when claiming exceptions specified in the Postal Accountability and Enhancement Act of 2006. Alternatively, limit proposed discounts to 100 percent of avoided costs at the next market dominant price adjustment.

Response

Management agrees with this recommendation. We intend to comply with the Postal Regulatory Commission's Rules and decisions which provide direction and guidance on the content for the required justifications to demonstrate compliance with 39 USC 3622(e) in those instances where discounts exceed avoided costs. This is consistent with our ongoing approach to both price changes and the Annual Compliance Report.

For each price change, the Postal Service has provided the justifications required by the Commission's rules in the instances where worksharing discounts were greater than avoided costs. In virtually every case, the Postal Regulatory Commission determined that these discounts were consistent with the statute.¹

The Postal Service acknowledges that the Annual Compliance Determination process provides useful information that should be evaluated for incorporation in future price changes. This OIG report focuses on the FY2009 Annual Compliance Determination which serves, in part, as an after-the-fact review of the worksharing discounts implemented in May 2009 in comparison to the avoided costs calculated for that fiscal year. The justifications provided in the Annual Compliance Determination process explain why discounts should not be adjusted by the Commission due to a determination of noncompliance using its statutory authority under 39 USC 3622. The Commission has never determined that the Postal Service was not in compliance with the relevant statutory criteria in any Annual Compliance Determination.

Consistent with Management's intention to use the Commission's Annual Compliance Determination analyses to inform pricing decisions, in its exigent price change request filed on July 6, 2010, the Postal Service proposed prices that reduced many of the discounts discussed in Appendix B to no more than avoided costs or provided the appropriate justifications. The Postal Regulatory Commission, however, denied the exigent price change request in its entirety.

Recommendation [2]:

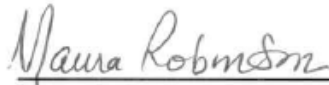
Document the methodology and decision making process used to determine the reasonableness of discount amounts that exceed avoided costs justified under the Postal Accountability and Enhancement Act of 2006 educational, cultural, scientific or informational exception.

Response

Management disagrees with this recommendation. Under the provisions of 39 USC 3622(e)(C), the limitation that discounts do not exceed avoided costs does not apply to "subclasses of mail consisting exclusively of mail matter of educational, cultural, scientific, or informational value." Consequently, no further regulatory justification discussing the "amounts that exceed avoided costs" is required.

¹ Only in one minor circumstance has the Commission found that a discount was not justified and subsequently revised. See Docket No. R2008-1, Order No. 66 ("Review of Postal Service Notice of Market Dominant Price Adjustment") at p. 57 regarding the prices associated with the planned discount for Standard Mail mixed AADC letters.

The report contains no FOIA exempt information.


Maura Robinson
Vice President, Pricing


Joseph D. Moeller
Manager, Regulatory Reporting
and Cost Analysis

cc: Stephen M. Kearney
Joseph Corbett
Scott J. Davis
Lucine Willis
Jamie Gallagher