March 31, 2003

DONNA M. PEAK
VICE PRESIDENT, FINANCE, CONTROLLER

RUDOLPH K. UMSCHEID
VICE PRESIDENT, FACILITIES

SUBJECT: Management Advisory – Impact of Freezing Capital Construction Projects (Report Number CA-MA-03-007)

This report presents the results of our self-initiated review of the impact of freezing capital construction projects (Project Number 02XR001CA000). The objective of our review was to determine the effect of the capital freeze on the Postal Service's ability to maintain, preserve, and expand buildings as needed in an economical and effective manner.

Results in Brief

The Postal Service has generally managed the restraints imposed by the capital freeze by implementing several major initiatives to maintain, preserve, and expand facilities in the short-term.[1] However, we are concerned that long-term continuation of the capital freeze will contribute to deteriorating Postal Service facilities, difficulty in providing needed space for high growth areas, incurring rising construction costs and delays in upgrading facilities for handicapped accessibility.

We recommended Postal Service management continue to resolve the specific issues identified in this report and as funding becomes available reprioritize projects regarding life/safety, emergencies, and legal requirements. Management agreed with the recommendation and has taken or planned corrective actions that are responsive to our recommendation.

[1] Constraints on facilities-related spending involved both capital and expense funding. This management advisory primarily addresses capital funding.

Management's comments, in their entirety, are included in the appendix of this report.

Background

Capital projects are necessary to construct new facilities and maintain over 37,000 existing facilities. Because of deteriorating financial conditions during the past several years, the Postal Service reduced capital commitments for facilities projects from $1.8 billion in fiscal year (FY) 1998 to $244 million in FY 2002. On February 8, 2001, funding for capital construction projects was suspended indefinitely. However, funding for capital construction projects allowed for exceptions for emergency and safety issues. In addition, when approved by headquarters on a case-by-case basis, funding has been granted for buildouts on leases and capital improvements.

Objective, Scope, and Methodology

The objective of our review was to determine the effect of the capital freeze on the Postal Service's ability to maintain, preserve, and expand buildings as needed in an economical and effective manner. We conducted a review at three districts in the Western Area (Colorado/Wyoming, Arizona, and Mid-America).[2] We selected the Western Area because it had the highest number of planned construction projects before the capital freeze and contained several high-growth states.

To accomplish our objective, we quantified financial impacts of repairing versus replacing, canceling, and delaying projects from cash flow information in Decision Analysis Reports related to the capital freeze. We also reviewed nonfinancial impacts including overcrowding, safety, and handicapped accessibility. We interviewed Postal Service management at headquarters, the Western Area, and the three districts. We conducted on-site observations of facilities where projects were delayed because of the capital freeze, and reviewed applicable Postal Service policies and procedures.[3]

This review was conducted from January 2002 through March 2003 in accordance with the President's Council on

[2] Effective July 2002, Arizona became part of the Pacific Area.
[3] Postal Service Handbook F-66, General Investment Policies and Procedures, April 1999, Postal Service Handbook F-66A, Investment Policies and Procedures Major Facilities, March 1999, Postal Service Handbook F-66c, Field Investment Policies and Procedures, March 1999, and all policy memorandums related to the capital freeze.

Integrity and Efficiency, Quality Standards for Inspections. We discussed our conclusions and observations with appropriate management officials and included their comments, where appropriate.

Prior Audit Coverage

The General Accounting Office (GAO) acknowledged long-term concerns in its February 2002 report, U.S. Postal Service: Deteriorating Financial Outlook Increases Need for Transformation (Report Number GAO-02-355). The GAO concluded that limitations on capital investments might have some detrimental effects, such as deterioration of existing physical infrastructure, operational impediments resulting from delays in repairing deteriorating facilities and expansions to cover new delivery points, and higher costs of future projects. The GAO recommended the Postal Service Board of Governors and the postmaster general develop and implement strategies to include: (1) actions that the Postal Service can take within its current authority, (2) specific congressional actions that would enable the Postal Service to take a number of incremental steps to address its growing financial and operational challenges, and (3) a process to address a range of comprehensive legislative reforms that will be needed to address key unresolved transformation issues.

Capital Freeze Initiatives Implemented but Long-Term Concerns Remain

The Postal Service has generally managed the restraints imposed by the capital freeze by implementing several major initiatives to maintain, preserve, and expand facilities in the short-term. However, we are concerned that long-term continuation of the capital freeze will contribute to deteriorating Postal Service facilities; difficulty in providing needed space for high growth areas; incurring rising construction costs; and delays in upgrading facilities for handicapped accessibility.

Capital Freeze Initiatives

The Postal Service has implemented several major initiatives to help maintain, preserve, and expand facilities since the inception of the capital freeze:

- Postal Service management implemented a nationwide process to allow exceptions for projects that meet criteria for life/safety, emergencies, and legal requirements. From the beginning of the capital freeze on February 8, 2001, and continuing through June 14, 2002, the Postal Service committed

$293 million in capital funds for construction projects that met the requirements for these exceptions. The Office of Inspector General (OIG) reviewed 297 exception projects and found proper advance approval and compliance with all but 6 exception requests.

- Facilities personnel at headquarters closely monitored the expenditures of capital construction funds by requesting that area officials determine their highest priority construction projects. Area officials nationwide determined the highest priority projects based on the following categories:

    - Replacement facilities that had been leased but not renovated for Postal Service use.
    - Expansion space that had been leased but not renovated for Postal Service use.
    - Sites that had been leased for modular buildings, but the modular building had not been installed.
    - Existing buildings that had been purchased but not renovated for Postal Service use.

  As a result, management advised the Board of Governors of the need to proceed with 42 projects valued at $28.4 million that were needed for buildouts of purchased or leased space. In addition, area officials identified and received funding for 314 building improvement projects valued at $56 million. These projects included roof replacements, new heating and air conditioning systems, and lead paint removal.

- District level management in the Western Area used modular trailers and consolidated or moved routes to alleviate overcrowding.

For example, a modular trailer was installed at the Queen Creek, Arizona, post office to provide more working space.

In addition, on February 19, 2002, 40 routes were moved out of the Aurora Gateway, Colorado, post office to alleviate overcrowding.

Long Term Concerns

Although Postal Service management has generally been able to maintain, preserve, and expand some facilities during the capital freeze, we found long-term concerns with overcrowding, safety, repairing versus replacing projects, canceling projects, delaying projects, incurring rising construction costs, and upgrading facilities for handicapped accessibility. Specifically:

We observed seven overcrowded facilities,[4] including:

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[4] Colorado Springs, Colorado; Larkspur, Colorado; Windsor, Colorado; Scottsdale, Arizona; Tucson, Arizona; Louisburg, Kansas; and Cameron, Missouri.

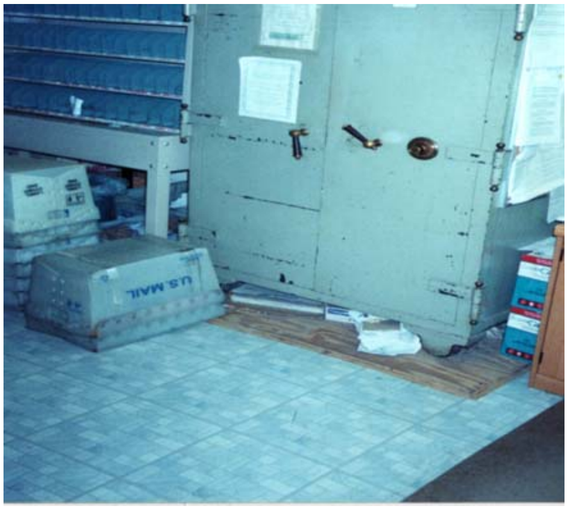
A crowded post office in Scottsdale, Arizona (pictured below) where packages were sorted and temporarily stored in the parking lot exposing them to potentially unfavorable weather conditions.

A crowded facility in Larkspur, Colorado, (pictured below) where employees unloaded morning mail in an unenclosed area, exposing them to extreme weather conditions during the winter.

We observed seven facilities with safety concerns in the Western Area.[5] For example, as pictured below, we observed:

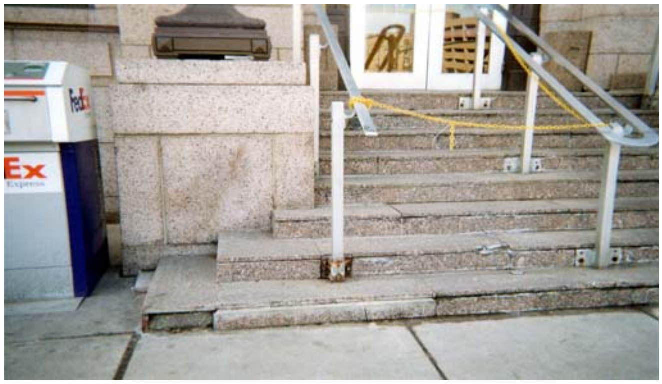
A leaning floor in Wappepello, Missouri.

A floor being supported by a wooden plank to handle the weight of a safe in Qulin, Missouri.



[5] Bellvue, Colorado; Colorado Springs, Colorado; Rio Salado, Arizona; Phoenix, Arizona; Wappepello, Missouri; Qulin, Missouri; and Kansas City, Missouri.

Shifting slabs on outside stairs in Colorado Springs, Colorado.



Leaning handicapped rail in Bellvue, Colorado.

For two of the safety issues we identified, Postal Service management completed corrective actions. For the other five issues, actions were in process.

The longer the capital freeze continues, the greater the risk that overcrowding and safety issues increase and become more severe. Postal Service forecasts show that Western Area delivery points should increase by 340,000 in FY 2003 because of high growth in the area. Also, according to the Census Bureau, the Western Area contained the five fastest growing states from 1990 to 2000:[6]

[6] Effective July 2002, both Arizona and Nevada became part of the Pacific Area.

  - Nevada, 66 percent growth.
  - Arizona, 40 percent growth.
  - Colorado, 31 percent growth.
  - Utah, 30 percent growth.
  - Idaho, 29 percent growth

- One district reduced costs by completing repair projects or canceling projects instead of completing the full scope of the project. During the capital freeze, six replacement projects valued at $1.1 million were converted to repair projects valued at $63,152. For example, roofs that needed replacement were patched and heating, air conditioning, and ventilation systems needing replacement were repaired. In addition, heating, air conditioning, and ventilation replacement projects were canceled in Branson, Missouri, and Pueblo, Colorado. Partial repairs may soon become insufficient and the Postal Service may need to fund more expensive replacement projects. In addition, when the capital freeze was implemented certain facilities service offices and districts canceled capital construction projects in the planning or design phase. For example, the Denver Facilities Service Office canceled over $560,000 in planning and design costs because of the capital freeze. When these projects are restarted, the plans and designs could be out of date, and additional expenditures might be required.

- We found that the Postal Service has not incurred additional costs by delaying construction of new facilities during the capital freeze. We analyzed the 10-year cash flow data in 56 approved Decision Analysis Reports for construction projects that were not started because of the capital freeze. We based our calculations on construction being completed in FY 2003 at a time when borrowing rates were decreasing. We are concerned that if construction projects delayed because of the capital freeze are not completed during FY 2003, borrowing rates will rise. Rising borrowing rates combined with the escalation of construction costs may cause the Postal Service to incur higher costs when these projects are restarted.

- Several districts delayed completion of handicapped accessibility projects. For example, the Mid-America District planned to upgrade three government-owned facilities for handicapped accessibility; however, these projects were not started because of the capital freeze. Customers with special needs at these locations could be inconvenienced.

Recommendation

We recommend the vice president, Facilities, and the vice president, Finance, controller**:**

1. Continue to resolve the specific issues identified in this report and as funding becomes available reprioritize projects regarding life/safety, emergencies, and legal requirements.

Management's Comments

Management agreed with the recommendation stating that on an ongoing basis they continue to emphasize the need to maintain assets and address life and safety issues, emergencies, and legal requirements. They have also expanded the criteria for facilities-related spending to include asset maintenance, areas of high growth, and significant space deficiencies. Finally, they have taken actions to ensure that available funds are directed towards the highest priority projects nationwide, and will continue to adjust spending criteria as necessary to maintain the Postal Service infrastructure

Management did not address actions taken to resolve the specific issues identified in this report. However, we are actively pursuing resolution of these items with Postal Service management.

Management also provided clarifications to statements made in this report regarding capital and expense funding, Board of Governors approvals, and realignment of Postal Service areas.

Evaluation of Management's Comments

Management's comments are responsive to our recommendation, and actions taken or planned should correct the issues identified in the report. We acknowledge the clarifications management provided and have revised statements as necessary.

We appreciate the cooperation and courtesies provided by your staff during the review. If you have any questions or need additional information, please contact Lorie Siewert, director, Contracts and Facilities, at (651) 855-5856 or me at (703) 248-2300.

John M. Seeba
Assistant Inspector General
for Audit

Attachment

cc: Richard J. Strasser, Jr.
Sylvester Black
Susan M. Duchek

APPENDIX. MANAGEMENT'S COMMENTS

UNITED STATES
POSTAL SERVICE

March 24, 2003

JOHN M. SEEBA

SUBJECT: Draft Management Advisory—Impact of Freezing Capital Construction Projects (Report Number CA-MA-03-DRAFT)

The following are our comments on the subject report.

Overall, we feel the audit reflected significant efforts made by management to control spending, while ensuring that our infrastructure is maintained. In principle, we agree that long-term constraints in capital spending could have an impact on facilities programs nationwide. However, the constraints have been in place since February 2001—clearly not a long-term situation. Moreover, we have expanded the criteria as the constraints have continued to ensure that critical infrastructure needs are addressed.

As noted in the audit, headquarters Finance and Facilities established an exception process to appropriately prioritize facilities spending. The exception criteria originally included emergencies, safety issues, legal issues, and modifications to existing contracts. Subsequently, this was expanded to include asset maintenance. As the constraints continued, expense funding for repairs of facilities was released to the field, so that they could pursue projects meeting the expanded criteria without further review by headquarters. Finally, the criteria were expanded once again in fiscal year 2003 to include funding for high growth areas and to relieve significant space deficiencies. Thus, it has been an evolving process designed to minimize negative impacts.

The audit notes that projects were canceled or reduced in scope as a result of the funding constraints. It also notes that some plans and designs might have to be updated when funding is available. This is what would be expected in the Postal Service and the private sector when constraints on spending are necessary. When repairs or replacements must be postponed, the possibility exists that the repair or replacement will cost more in the future. However, if funding is not available to make the full repair or replacement, the project will have to be modified or postponed until funding is available. Consequently, plans and designs must be updated. In addition, there will be occasions where new operating strategies and/or increased productivities will result in the need for less space in the future, and this will have a positive impact on costs.

In regards to handicapped accessibility projects, we continue to emphasize the need to complete such projects in accordance with our established policies.

Three clarifications are necessary in the audit. First, the constraints on facilities-related spending involved capital <u>and</u> expense funding. The audit appears to address only capital funding. Second, the Board of Governors did not approve funding for the 42 projects involving the buildout of projects that had been leased or purchased previously. Management advised the Board of the need to proceed with these projects. Finally, the audit should note that both Arizona and Nevada are now part of the Pacific Area; therefore, the Western Area no longer contains the five fastest growing states.

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The following is our response to the recommendation in the audit.

Recommendation: We recommend the vice president, Facilities, and the vice president, Finance, Controller continue to resolve the specific issues identified in this report. As funding becomes available, reprioritize projects regarding life/safety, emergencies, and legal requirements.

Management Response: We agree with the recommendation. On an ongoing basis, we continue to emphasize the need to maintain our assets and address life/safety, emergencies, and legal requirements and have expanded the criteria for facilities-related spending to include areas of high growth and significant space deficiencies. Recently, we completed our review of new or expanded space projects submitted for fiscal year 2003 funding. We have issued the approved list of projects to the field. Action will begin on these projects in the next several weeks. In addition, we developed and issued a new process for prioritization of customer service projects for future years. These additional actions will ensure that the funds available are directed to the highest priority projects nationwide. We will continue to adjust the criteria as necessary to maintain our infrastructure.

We are available to discuss this Management Advisory before finalization.

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Vice President, Finance, Controller

Rudolph K. Umscheid
Vice President, Facilities

cc: Mr. Donahoe
Mr. Rapp
Mr. Strasser
Ms. Duchek