



December 1, 2008

SUSAN M. BROWNELL
VICE PRESIDENT, SUPPLY MANAGEMENT

SUBJECT: Management Advisory – Management of Contract Changes – Flats Sequencing System (Report Number CA-MA-09-002)

This report presents the results of our review of the management of contract changes for the Flats Sequencing System (FSS)¹ (Project Number 08YG003CA002). Our objective was to determine whether the U.S. Postal Service incurred unnecessary or inappropriate increased costs because of changes to the FSS contracts. The review was self-initiated as part of a series of reviews on the Postal Service's management of contract changes and addresses operational risks in the Postal Service's contracting process. See [Appendix A](#) for additional information about this review.

Conclusion

We did not identify any unnecessary or inappropriate increased costs to the Postal Service because of changes to the FSS contracts. Modifications to the pre-production contract were primarily for funding increases to further R&D efforts. Modifications to the production contract were primarily for revisions to the statement of work and enhancements the Postal Service required on FSS equipment. However, we did identify one area of concern — we could not determine whether the monetary amount the Postal Service withheld from the contractor was appropriate when contract requirements were not met.

Valuation of Withheld Payment

The Postal Service withheld \$500,000 when a key requirement of the pre-production contract was not met. However, we were unable to determine whether this was an appropriate amount to withhold because Postal Service officials did not fully document the basis for determining whether it was reasonable. According to Postal Service officials, they based the amount withheld on extensive discussions between supply

¹ There were two contracts awarded to Northrop Grumman in support of the FSS initiative. The first contract (Contract Number 3AAERD-04-B-0506), referred to as the pre-production contract, was awarded in October 2003 for research and development (R&D) of the FSS. The second contract (Contract Number 3AAFLT-07-B-0004), referred to as the production contract, was awarded in February 2007 to develop, purchase, and deploy 100 FSS machines. The FSS is intended to enhance flat mail processing by sorting flat mail in the precise order that mail carriers walk their routes, eliminating the need for the carriers to manually sort the mail.

management and engineering and it was ultimately based on their professional opinion. However, management did not document the objective measures that provided a basis for the \$500,000. Consequently, the Postal Service is at an increased risk of not receiving equitable consideration for contractor nonperformance.

The key requirement not met was the pre-production machine failed to achieve the throughput² requirement of 16,500 flat mail pieces per hour during field acceptance testing. The throughput requirement is a significant requirement of the contract because if it is not achieved, that will negatively impact the expected savings identified in the production Decision Analysis Report (DAR). During field acceptance testing, the pre-production machine processed 13,545 flat mail pieces per hour. During subsequent demonstration testing, performance improved to 15,704 flat mail pieces per hour (approximately 5 percent less than the throughput requirement). However, the Postal Service withheld only a small fraction of the contract value³ (less than 1 percent).

We recommend the Vice President, Supply Management:

1. Require contracting officers to fully document the rationale and basis for determining whether withheld payment amounts are reasonable. This should be accomplished using objective measures to the extent practicable.

Management's Comments

Management agreed with the finding and recommendation and has prepared a memorandum to the file describing the rationale and basis for withholding payments. A copy of the letter will be provided to the U.S. Postal Service Office of Inspector General (OIG) for review. Supply Management will cascade the final audit report to contracting officers and emphasize the need for documenting contract files with decision rationale and the basis for determining payment adjustments. See [Appendix B](#) for management's comments, in their entirety.

Evaluation of Management Comments

The OIG considers management's comments responsive to the recommendation. Management's corrective actions should correct the issue identified in the report.

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

² Throughput represents the number of flat mail pieces the FSS machine processes and sorts per hour.

³ The pre-production contract is valued at approximately \$53.7 million.

We appreciate the cooperation and courtesies provided by your staff. If you have any questions or need additional information, please contact Judy Leonhardt, Director, Supply Management, 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 Support Operations

cc: H. Glen Walker
Robert D. D'Orso
Susan A. Witt
Katherine S. Banks

APPENDIX A: ADDITIONAL INFORMATION

BACKGROUND

A core daily activity of Postal Service letter carriers is to manually sort mail into delivery sequence order. The Postal Service uses high-speed automated equipment to perform this function for letter mail, but carriers currently handle the approximately 53 billion annual flat mail pieces⁴ manually.

[REDACTED]

[REDACTED]. As a result, the primary benefit of the FSS will be eliminating carriers' casing of manual flat mail. Once deployment is complete,⁶ the Postal Service is projecting annual operating savings of \$599.5 million.

[REDACTED]

OBJECTIVE, SCOPE, AND METHODOLOGY

Our objective was to determine whether the Postal Service incurred unnecessary or inappropriate increased costs because of changes to the FSS contracts. Specifically, we reviewed contract modifications to determine the reasons for the changes and determined if the changes were necessitated due to poor contract planning or inappropriate concessions to the contractor.

To accomplish our objective we obtained and reviewed the FSS pre-production and production contract files including the basic contracts and modifications. We determined the purpose for each contract modification and whether the modifications materially changed the scope of the basic contracts. We analyzed modifications to determine whether they were properly approved, documented, and executed. We also interviewed key contracting personnel, including the contracting officer.

⁴ Examples of flat mail include magazines, large envelopes, newspapers, and catalogs.

⁵ [REDACTED]

⁶ Deployment of all 100 machines (Phase 1) is scheduled to be completed in 2010.

In addition, we reviewed:

- The letter sent to Northrop Grumman granting conditional approval of the FSS pre-production machine.
- Two DARs related to the FSS.
- The Postal Service’s quarterly investment report to determine whether schedule slippages were fully disclosed.

We conducted this review from July through November 2008 in accordance with the President’s Council on Integrity and Efficiency, *Quality Standards for Inspections*. We discussed our observations and conclusions with management on October 30, 2008, and included their comments where appropriate. We did not rely on computer generated data to support our finding.

PRIOR AUDIT COVERAGE

Report Title	Report Number	Final Report Date	Monetary Impact	Report Results
<i>Flats Sequencing System: Production First Article Testing Readiness and Quality</i>	DA-AR-08-006	June 4, 2008	None	To enhance FSS program success, the Postal Service needed to focus greater attention on several areas to better prepare for production first article testing and improve production quality.

<i>Flat Sequencing System Risk Management</i>	DA-AR-07-003	July 31, 2007	None	Engineering needed to focus more attention on risk management standards to ensure the significant risks associated with deployment of the FSS are adequately identified and managed.
<i>Flats Sequencing System Production Revised Proposal Submitted by Northrop Grumman Corporation, Electronic Systems Company</i>	CA-CAR-07-005	December 29, 2006	\$91,710,395 in questioned costs	This audit disclosed questioned costs of \$91,710,395. Questioned costs primarily represented direct material and labor.
<i>Flats Sequencing System Production Proposal Submitted by Northrop Grumman Corporation, Electronic Systems Company</i>	CA-CAR-07-003	December 4, 2006	\$175,670,235 in questioned costs	This audit disclosed questioned costs of \$175,670,235. Questioned costs primarily represented direct material and labor.

APPENDIX B: MANAGEMENT'S COMMENTS

SUSAN M. BROWNELL
VICE PRESIDENT, SUPPLY MANAGEMENT



November 21, 2008

LUCINE M. WILLIS

SUBJECT: Draft Audit Report – Management of Contract Changes –Flats Sequencing System
(Report Number CA-MA-09-DRAFT)

Thank you for the opportunity to review and comment on the subject audit report. Management agrees with the finding and recommendation. The following addresses our complete response.

Recommendation 1: Require contracting officers to fully document the rationale and basis for determining whether withheld payment amounts are reasonable. This should be accomplished using objective measures to the extent practicable.

Management Response: Management agrees with the finding and recommendation and has prepared a memorandum to the file describing the rationale and basis for withholding payment. A copy of this document will be provided by November 26 for OIG review to ensure compliance with this recommendation and close out. Also, within 30 days from issuance of the final audit, Supply Management will cascade the report to contracting officers and emphasize the need for documenting contract files with decision rationale and the basis for determining payment adjustments.

We do believe that this report contains proprietary or business information that should not be disclosed pursuant to the Freedom of Information Act. A separate response addressing those exemptions will be provided by November 26. If you have any questions about this response, please contact Susan Witt at (202) 268-4833.

A handwritten signature in cursive script that reads "Susan M. Brownell".

cc: H. Glen Walker
Robert D. D'Orso
Katherine S. Banks

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