



# OFFICE OF INSPECTOR GENERAL

## UNITED STATES POSTAL SERVICE

### Strategies for Underwater Market Dominant Products

### Audit Report

Report Number  
CP-AR-16-005

May 25, 2016





# OFFICE OF INSPECTOR GENERAL

## UNITED STATES POSTAL SERVICE

## Highlights

***The Postal Service does not have strategies in place to manage “underwater products” as a whole.***

### Background

The Postal Accountability and Enhancement Act (PAEA) of 2006 requires “each class of mail or type of mail service bear the direct and indirect postal costs attributable to each class or type of mail service through reliably identified causal relationships...” To meet cost coverage, revenue generated from the product must be equal to or exceed 100 percent of the expected attributable cost incurred. The Postal Service considers products that fail to cover 100 percent of their attributable costs to be “underwater.”

Each year the Postal Regulatory Commission (PRC) reviews the cost coverage of each product, as reported in the U.S Postal Service’s *Annual Compliance Report*, and presents the results of its analysis in its *Annual Compliance Determination* report. When the PRC identifies noncompliance, it can instruct the Postal Service to take such action it deems appropriate to achieve compliance or remedy the effects of the noncompliance.

The PRC stated that “the problem of individual market dominant product revenues failing to cover either attributable or overhead costs was so pervasive in fiscal year (FY) 2009 that it has become a systemic problem” and required the Postal Service to “develop and present a plan explaining how the Postal Service expected to increase cost coverage.”

The objective of this audit was to evaluate whether the Postal Service has strategies in place for managing underwater products and whether those strategies were effective to meet desired goals.

### What the OIG Found

The Postal Service does not have strategies in place to manage “underwater products” as a whole. While strategies exist to optimize efficiency and decrease costs, the strategies developed to specifically address attributable cost coverage lack a formal framework to accurately assess their effectiveness and achieve 100 percent cost coverage as required by the PAEA.

The net cost coverage shortfall related to five market dominant products was \$1.2 billion for FY 2015 – their 7th consecutive year of net shortfalls.

### What the OIG Recommended

We recommended management develop and implement a formal strategic framework for underwater products as a whole to assess effectiveness of meeting goals.


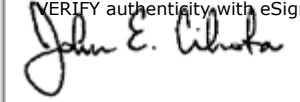
# Transmittal Letter



OFFICE OF INSPECTOR GENERAL  
UNITED STATES POSTAL SERVICE

May 25, 2016

**MEMORANDUM FOR:** SHARON D. OWENS  
VICE PRESIDENT, PRICING AND COSTING

E-Signed by John Cihota  
VERIFY authenticity with eSign Desktop   


**FROM:** John E. Cihota  
Deputy Assistant Inspector General  
for Finance, Pricing and Investments

**SUBJECT:** Audit Report – Strategies for Underwater Market Dominant  
Products (Report Number CP-AR-16-005)

This report presents the results of our self-initiated audit of the U.S. Postal Service's Strategies for Underwater Market Dominant Products (Project Number 16TG002CP000).

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

Attachment

cc: Corporate and Audit Response Management

# Table of Contents

Cover	
Highlights.....	1
Background.....	1
What the OIG Found.....	1
What the OIG Recommended.....	1
Transmittal Letter.....	2
Findings.....	4
Introduction.....	4
Summary.....	5
Postal Service Strategic Overview.....	6
Recommendations.....	9
Management's Comments.....	9
Evaluation of Management's Comments.....	10
Appendices.....	11
Appendix A: Additional Information.....	12
Background.....	12
Objective, Scope, and Methodology.....	13
Prior Audit Coverage.....	14
Appendix B: Management's Comments.....	15
Contact Information.....	17



# Findings

***While the Postal Service does have strategies with the goal of optimizing efficiency and decreasing costs, the strategies in place related to underwater products lack a formal framework.***

## Introduction

This report presents the results of our self-initiated audit of the U.S. Postal Service's strategies for underwater market dominant products (Project Number 16TG002CP000). Our objective was to evaluate whether the U.S. Postal Service has strategies in place for managing underwater <sup>1</sup> products and whether those strategies were effective to meet desired goals. See [Appendix A](#) for additional information about this audit.

The Postal Accountability and Enhancement Act (PAEA) <sup>2</sup> of 2006 requires “that each class of mail or type of mail service bear the direct and indirect postal costs attributable to each class or type of mail service through reliably identified causal relationships...” To meet cost coverage, revenue generated from a product must be equal to 100 percent or exceed the attributable cost incurred.<sup>3</sup> Products that fail to cover 100 percent of attributable costs are considered “underwater.”

Each year the Postal Regulatory Commission (PRC) reviews the cost coverage of each product, as reported in the Annual Compliance Report (ACR), and presents the results of this analysis in its Annual Compliance Determination (ACD) report. If the PRC finds that there is noncompliance, it can instruct the Postal Service to take appropriate action to achieve compliance or remedy the effects of any noncompliance. In extreme circumstances, the PRC can also require the Postal Service to take appropriate action at the product level. An extreme circumstance is when one or more of the following exist:

- A significant and growing cost coverage shortfall.
- Duration of the shortfall over a significant period.
- Evidence that the cost coverage shortfall is likely to increase further.
- A significant adverse impact on users of other mail products that requires subsidizing the non-complying product.
- A failure of the Postal Service to address the shortfall through rate increases, cost decreases, or a combination thereof, despite the ability to do so.
- A failure of the Postal Service to provide an adequate explanation for not taking necessary remedial steps designed to ameliorate the cost coverage shortfall.

The PRC stated that “the problem of individual market dominant product revenue failing to cover either attributable or overhead costs was so pervasive in FY 2009, that it has become a systemic problem” and required the Postal Service to “develop and present a plan explaining how the Postal Service expected to increase cost coverage.”

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<sup>1</sup> A product or group of products with cost coverage below 100 percent is commonly referred to as underwater.

<sup>2</sup> Effective January 3, 2006, Title 39 U.S.C. §3622(c) (2).

<sup>3</sup> Attributable costs are the sum of volume variable plus product specific costs.

In fiscal year (FY) 2009, of the market dominant products and services that failed to cover their attributable costs, five products accounted for \$1.5 billion of the shortfall, specifically:

- \$629 million from Outside County Periodicals.
- \$616 million from Standard Mail Flats.
- \$205 million from Standard Mail Parcels.
- \$74 million from Media and Library Mail.
- \$13 million from In County Periodicals.<sup>4</sup>

In FY 2015, the same five products failed to cover their attributable costs, and the management of their respective strategies are the scope of this audit.

## Summary

The Postal Service does not have strategies in place to manage “underwater products” as a whole. While the Postal Service does have strategies with the goal of optimizing efficiency and decreasing costs, the strategies in place related to underwater products lack a formal framework to:

- Assess effectiveness in meeting strategic goals.
- Measure performance to demonstrate impact on cost coverage.
- Facilitate cross-functional dialogue and collaboration.
- Promote ownership and accountability.

The net cost coverage shortfall related to five market dominant products was \$1.2 billion for FY 2015 – their 7<sup>th</sup> consecutive year of net shortfalls. Out of the five market dominant mail classes,<sup>5</sup> Periodicals was the only mail class that did not cover its attributable costs in FY 2015. In addition, there were three mail products<sup>6</sup> that did not cover their attributable costs, which were Standard Mail Flats, Standard Mail Parcels, and Media and Library Mail. Figure 1 illustrates the cost coverage of the five products for the period of FY 2009 to FY 2015.

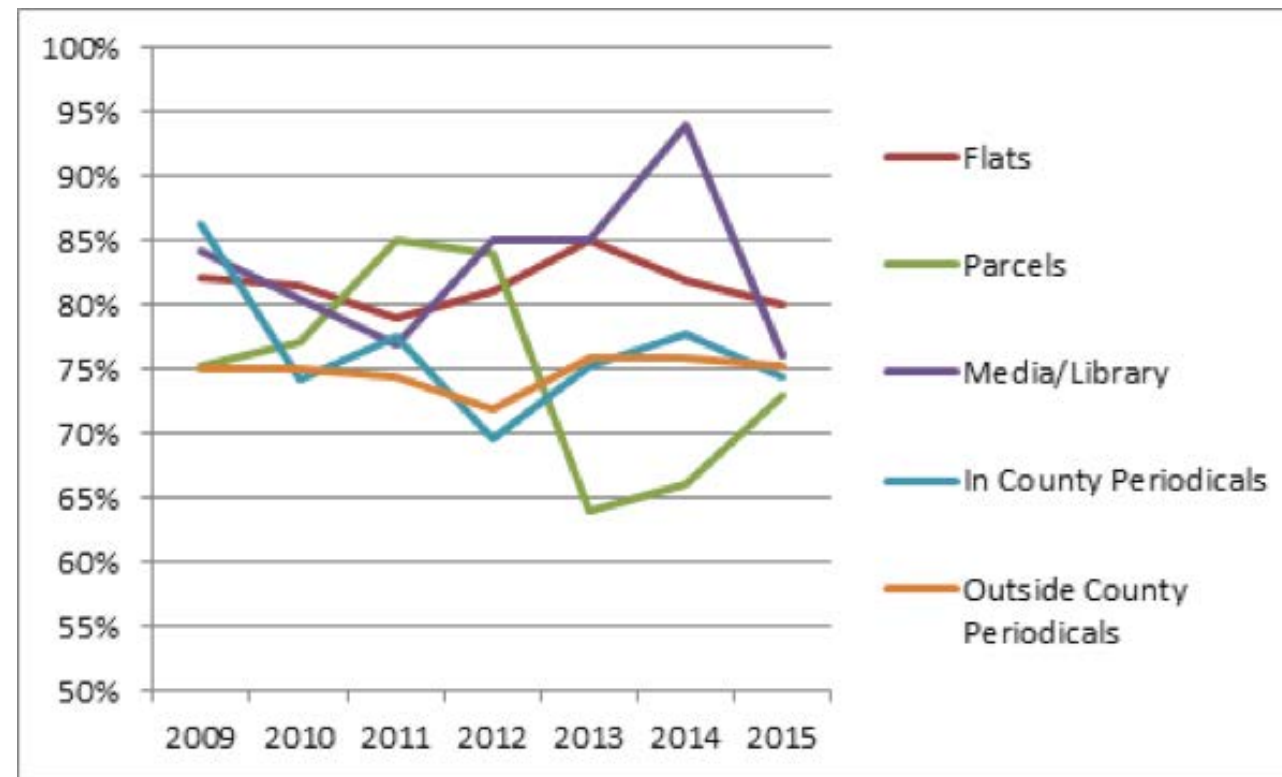
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<sup>4</sup> See [Table 1](#) for FY 2015 cost coverage shortfall amounts.

<sup>5</sup> The five market dominant mail classes are First-Class Mail, Standard Mail, Periodicals, Package Services, and Special Services.

<sup>6</sup> Mail products are sub-components of mail classes.

**Figure 1. Product Cost Coverage FY 2009 - FY 2015**



Source: Postal Service Public Cost and Revenue Analysis report.

## Postal Service Strategic Overview

The Postal Service does not have strategies in place to manage “underwater products” as a whole. The strategies the Postal Service developed to specifically address attributable cost coverage lack a formal framework to accurately assess effectiveness and achieve the 100 percent cost coverage required by the PAEA. Postal Service strategies strive to optimize operational efficiency and decrease costs.

The Postal Service’s various departments (such as Costing and Pricing, Network Operations) develop strategies designed to align with the organization’s overall goals and objectives. As the Postal Service strives to reduce costs and generate revenue, the strategic goals should be bold and aggressive, have measurable outcomes, and be critical to the short- and long-term success of the Postal Service.

A framework is a structure intended to support or guide the implementation or building of something that expands the structure into something useful.

An effective strategic framework would:

- Be formally documented to promote consistency in application.
- Identify process owners and/or stakeholders to promote ownership and accountability.

- Have measurable performance metrics to assess effectiveness and impact.
- Have milestones or target dates to assess efficiency.
- Be centrally accessible to promote cross-functional dialogue and collaboration.

In addition to internal development of strategies, the Postal Service has collaborated in the development of strategies specific to mail classes or mail products not covering their attributable costs as part of the ACD process or other legislative mandate. For example, strategies identified in the 2011 *Periodicals Mail Study* were the result of a joint effort between the Postal Service and the PRC, which was mandated by the PAEA.<sup>7</sup>

As communicated in the 2014 ACD, the Postal Service acknowledged implementing 22 of 28<sup>8</sup> operational strategies related to cost coverage for Periodicals and Flats. As Periodicals and Flats are a highly visible class/product for the Postal Service, there have been several strategies implemented to address efficiency, including, but not limited to:

- Focusing on the quality of data for attributing costs and opportunities for operational efficiencies, including pricing incentives.
- Reducing manual processing through automation.
- Implementing a schedule of above-consumer price index (CPI) price increases.
- Realigning and reclassifying products.
- Reducing air transportation costs by merging service standards.

In January 2014, the Postal Service implemented an exigent price<sup>9</sup> increase, which expired April 2016, and will have an immediate impact on cost coverage.

In FY 2015, the PRC required the Postal Service develop and present plans outlining its approach to addressing cost coverage of the five underwater products. Despite the Postal Service's efforts to implement operational strategies, cost coverage percentages have remained fairly consistent and the five underwater products had a revenue shortfall of about \$1.2 billion, as illustrated in [Table 1](#).

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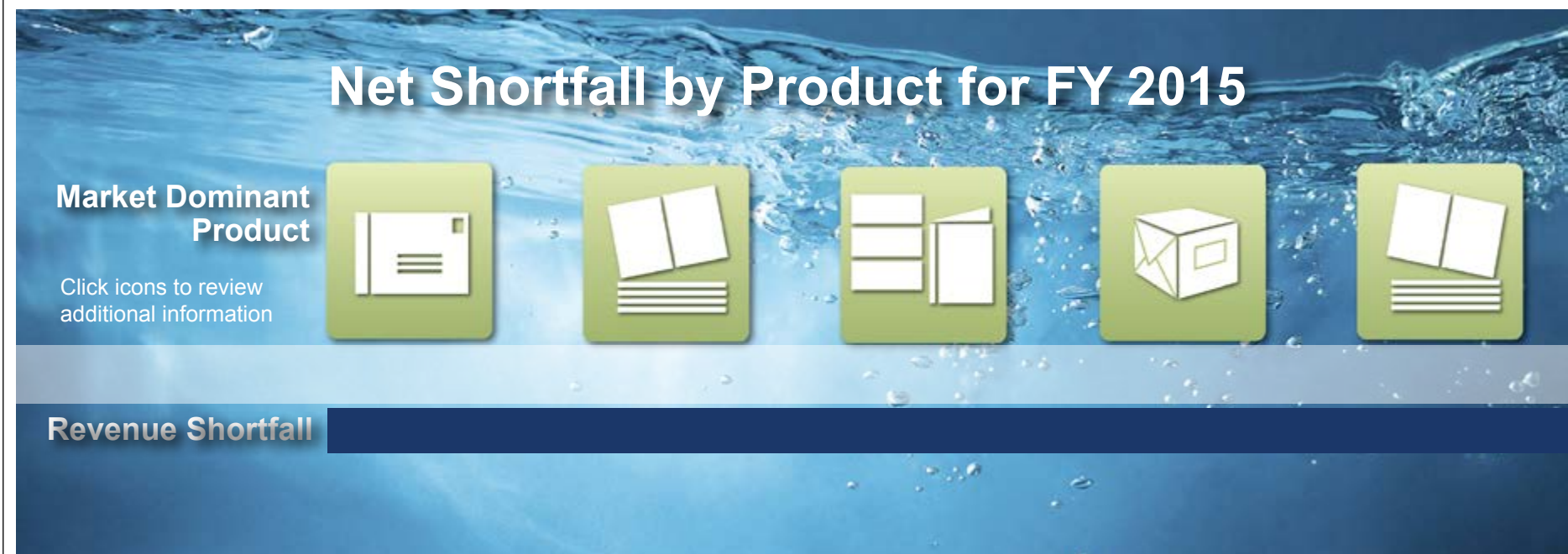
<sup>7</sup> PAEA, Section 708.

<sup>8</sup> The remaining six strategies were not implemented due to cost considerations, not being ready for deployment, and overall feasibility issues.

<sup>9</sup> A price-setting provision under the PAEA that allows the Postal Service, under extraordinary or exceptional circumstances and in an expedited manner, to adjust the prices of market dominant products beyond the limitation of the price cap that uses the CPI.



**Table 1. Net Shortfall by Product for FY 2015**



Source: Postal Service Public Cost and Revenue Analysis report.

The 2015 ACD report was issued in March 2016. As with the 2015 ACR, PRC again addressed underwater products and related Postal Service strategies. In addition, with the loss of additional revenue with the exigent price increase ending, we expect the shortfall trend for these products to continue.

Due to current factors (the exigent price increase ending, price increases subject to regulatory cap requirements, and the historical performance of Periodicals and other underwater products), a formal strategic framework would allow for increased oversight and accountability of strategic approaches.

The Postal Service is unable to quantify cost savings gained from operational strategies, as there is not a formal framework to accurately measure the specific cost impact of each initiative. The cost coverage strategies currently in place lack measurable performance metrics to quantify effectiveness, designated strategy owners to promote accountability, and a central repository for transparency and coordination.

# Recommendations

***We recommend management develop a formal strategic framework for underwater products as a whole to assess effectiveness in meeting strategic goals, measure performance to demonstrate impact on cost coverage, facilitate cross-functional dialogue and collaboration, and promote ownership and accountability.***

We recommend the vice president, Pricing and Costing:

1. Develop a formal strategic framework for underwater products as a whole to assess effectiveness in meeting strategic goals, measure performance to demonstrate impact on cost coverage, facilitate cross-functional dialogue and collaboration, and promote ownership and accountability.

## Management's Comments

In subsequent correspondence, management specifically disagreed with our recommendation to develop a formal strategic framework for underwater products as a whole. Management did agree, in principle, that revenues should exceed attributable costs at a product level. While management agrees with the need for a cross-functional strategy, they disagree with the need for a formal strategic framework beyond what is required by the PRC. Management stated that raising prices of underwater products to achieve attributable cost coverage is either not possible under the current regulatory constraints (for example, price cap), or the most fiscally responsible approach to improve net income. Management noted that they consider it more desirable and financially responsible to design prices to improve contribution in total instead of improving contribution for specific products simply because they do not currently cover their attributable costs. They added that since many products not covering costs are also experiencing declining volumes, in some cases, they may determine it is more prudent to use limited cap space to increase prices on products that have growing or stable volume.

Management also stated that the strategy to improve net income is not product specific. Rather, they develop and implement strategies across the entire organization that will have the greatest impact on controlling costs and increasing net income.

Further, management identified a number of venues where cross-functional collaboration occurs as it relates to improvement of cost coverage, including Delivering Results, Innovation, Value, and Efficiency (DRIVE), mailing community, and functional area meetings.

Management disagreed with the \$1.2 billion as monetary impact, as they stated the actions to recover this amount are beyond their control due to the limits of the price cap. Management states that if all available cap space was used on underwater products, it would not come close to bringing the products to 100 percent cost coverage, or recovering the \$1.2 billion.

Management also indicated that they are currently working on a response to the PRC related to the FY 2015 ACD comments issued in March 2016. In the ACD, the PRC required the Postal Service to provide follow-up reports on improving efficiency for the underwater Periodicals class and Standard Mail Flats. See [Appendix B](#) for management's comments in their entirety.

## Evaluation of Management's Comments

The OIG considers management's comments unresponsive to the recommendation in the report. Management disagreed with our recommendation to develop a formal strategic framework for underwater products as a whole. We understand that the Postal Service operates in a regulatory environment (the price cap) and has had declining mail volume for the underwater products. However, the business decision to strategically focus on operations across the organization that has the greatest impact on net income rather than product specific strategies has not been successful in addressing underwater products or meeting the PAEA mandate for attributable cost coverage.

Management agrees there is a need for cross-functional strategies and indicated cross-functional internal coordination, via DRIVE and other internal meetings; however, this does not constitute a formal framework that specifically addresses the recommendation. Key components of a formal framework are not included. These components include having measurable performance metrics to demonstrate impact and the ability to promote ownership and accountability. The formal framework would provide a streamlined process that could help drive transparency and the decision-making process related to strategies.

The \$1.2 billion monetary impact identified is the net short fall of the underwater products achieving 100 percent attributable cost coverage. We acknowledge that the Postal Service operates in a price cap environment; however, the Postal Service currently cannot accurately assess or quantify the effectiveness of any strategies in place to address underwater products. Further, the Postal Service has made decisions to allow these products to remain underwater by determining it more desirable and financially responsible to design prices to improve contribution in total instead of improving contribution for specific products simply because they do not currently cover their attributable costs (as noted in their response).

Finally, as discussed in the report, the Postal Service did not comply with PAEA specifically that each market dominant mail class must cover its attributable costs and individual market dominant products need to cover costs when extreme circumstances exist. For any product considered an extreme circumstance, the PRC can instruct the Postal Service to remedy the effects of noncompliance to meet PAEA requirements. Consequently, we continue to believe it is appropriate to recognize the \$1.2 billion as monetary impact.

As the Postal Service is required to provide the PRC a formal response to strategies related to underwater Periodicals and Standard Mail Flats, we do not plan to pursue recommendation 1 through the formal audit resolution process. We consider recommendation 1 closed with the issuance of this report.

# Appendices

*Click on the appendix title  
to the right to navigate  
to the section content.*

Appendix A: Additional Information ..... 12

    Background ..... 12

    Objective, Scope, and Methodology ..... 13

    Prior Audit Coverage ..... 14

Appendix B: Management’s Comments..... 15

Background

The PAEA states that all Postal Service mail classes should cover their attributable costs. Cost coverage is the ratio of revenue to attributable cost for each Postal Service product. To meet cost coverage, revenue generated from the product or service must be equal to or exceed the expected attributable cost incurred. The Postal Service considers products that fail to cover 100 percent of their attributable cost to be underwater.

Per the PAEA, rate increases for market dominant products are capped by the CPI, which applies to the class of mail and not the individual product. As price increases are limited to the class of mail, there may be an offset within the class with some products incurring an above-CPI increase and others incurring a below-CPI increase. A strategy for some underwater products was to implement rate increases above the CPI; however, those increases have not brought the products to cost coverage.

In FY 2015, there were seven products and services that did not cover their attributable costs, as illustrated in Table 2. Our analysis focused on the five products that have trended underwater since FY 2009.

Table 2. Underwater Products and Services for FY 2015

Market Dominant Products and Services	Revenue	Attributable Costs	Cost Coverage
In County Periodicals	\$66,014,812	\$88,626,924	74%
Outside County Periodicals	1,515,353,664	2,012,450,279	75%
Standard Mail Flats	2,106,185,410	2,627,914,611	80%
Standard Mail Parcels	65,093,448	89,402,483	73%
Media/Library Mail	273,736,146	359,082,639	76%
Inbound International <sup>10</sup>	250,676,825	348,601,250	72%
Stamp Fulfillment Services <sup>11</sup>	3,910,286	6,621,451	59%

Source: Postal Service Public Cost and Revenue Analysis report.

In FY 2015, the Postal Service processed 5.8 billion Periodicals mail pieces, generating \$1.6 billion in revenue. The Periodicals class consists of magazines, newspapers, and other publications with a primary function of transmitting information to an established list of subscribers or requesters. The Periodicals class consists of two products: In County Periodicals, which include publications that are mailed and delivered in the same county; and Outside County Periodicals, which are mailed in one county and delivered in another.

Historically, the Periodicals class has not covered its attributable costs. The Periodicals class are recognized for their educational, cultural, scientific, and informational (ECSI) value. As such, from 1972 to 1993, Periodicals received congressional appropriations to help reach 100 percent cost coverage. After the appropriations ceased, it has been a challenge for the Periodicals class to cover its costs and it has not done so since 1997. In FY 2015, the cost coverage was 75.6 percent for the Periodicals mail class, resulting in a revenue shortfall of \$519 million.

<sup>10</sup> Inbound Letter Post prices are set by the Universal Postal Union and, therefore, are not a part of our review.

<sup>11</sup> Stamp Fulfillment Services meets the objectives of reducing costs and increasing efficiency according to Title 39 and, therefore, was not part of our review.



Standard Mail Flats is mail that meets specific dimension requirements but is not required to be sent using First-Class Mail. Standard Mail is typically used for advertisements, flyers, and catalogs. In FY 2015, cost coverage was 80.2 percent for Standard Mail Flats, resulting in a revenue shortfall of \$521 million.

Standard Mail Parcels are packages or mail that does not meet the mail processing category of letter- or flat-size mail. These parcels are usually enclosed in a mailing container such as a carton. Mail pieces are considered eligible parcels if they are not required to be mailed at First-Class Mail prices or are not authorized for Periodicals prices. In FY 2015, cost coverage was 72.8 percent for Standard Mail Parcels, resulting in a revenue shortfall of \$24 million.

Media Mail is a Package Services product that consists of books, sheet music, printed educational material, film, sound recordings, and computer pre-recorded media such as CD-ROMs. Library Mail is also a Package Services product and consists of items sent to, from, or between academic institutions, public libraries, museums, and other authorized organizations. In FY 2015, the cost coverage was 76.2 percent for Media and Library Mail, resulting in a revenue shortfall of \$85 million.

## Objective, Scope, and Methodology

Our objective was to evaluate whether the Postal Service has strategies in place for managing underwater products and whether those strategies were effective to meet desired goals, including:

- Existence of underwater product strategies.
- Compliance with required regulations, policies, and/or procedures.
- Risk imposed on the Postal Service for products not meeting cost coverage.
- Resources used efficiently and economically to ensure objectives are achieved.

To accomplish our objective we:

- Identified and reviewed strategies for bringing underwater products into compliance with the Title 39 requirement to cover 100 percent of attributable costs.
- Obtained opinions on Postal Service strategies from the PRC through interviews and review of the FY 2014 ACD report.
- Met with stakeholders to understand various perspectives and impacts of underwater products.
- Trended volume, revenue, and cost coverage for underwater products from FY 2009 to FY 2015.
- Evaluated the impact of underwater products by determining the difference between revenue and attributable costs.

The scope for this project included underwater products for FYs 2014 and 2015 and related strategies.

We conducted this performance audit from November 2015 through May 2016, 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 April 8, 2016, and included their comments where appropriate.

We did not assess the reliability of any computer-generated data for the purposes of this report. The data utilized for analysis were public reports issued by the Postal Service and the PRC.

### Prior Audit Coverage

Report Title	Report Number	Final Report Date	Monetary Impact (in millions)
<i>Impact of Postal Accountability and Enhancement Act Price Caps</i>	<a href="#">CRR-AR-10-005</a>	9/27/2010	\$2,000

**Report Results:** The Postal Act of 2006 expedited the rate-making process and introduced price predictability; however, it impacts the Postal Service's ability to appropriately cover costs within certain mail classes and provide sufficient profit margins to cover overhead costs. We recommended, among other items, that management develop a detailed transparent plan, with established milestones, for each individual product to move towards coverage of their costs and a contribution to overhead costs. Management did not agree with the recommendation, citing that a detailed plan would prevent the Board of Governors from fulfilling their statutory duty to balance all relevant considerations in establishing prices. Management stated that the recommendation elevates the cost coverage requirement above all other factors and objectives in a way PAEA did not contemplate.

## Appendix B: Management's Comments

SHARON OWENS  
VICE PRESIDENT, PRICING AND COSTING



May 10, 2016

LORI LAU DILLARD  
DIRECTOR, AUDIT OPERATIONS

SUBJECT: Draft Audit Report – Strategies for Underwater Market  
Dominant Products (Report Number CP-AR-16-DRAFT)

***Develop a formal strategic framework for underwater products as a whole to assess effectiveness in meeting strategic goals, measure performance to demonstrate impact on cost coverage, facilitate cross-functional dialogue and collaboration, and promote ownership and accountability.***

While products must usually be priced to cover attributable costs and make a contribution to institutional costs, raising the prices of underwater products to achieve such a goal is either not possible under the current regulatory constraints, or not the most fiscally responsible approach to improve net income. Organizationally, the Postal Service is working to improve net income while improving service performance. However, our strategy for improving net income is not product specific; we develop and implement strategies across the entire organization that will have the greatest impact on controlling costs and increasing net income. As part of this strategy, Operations continues to take steps designed to make operational processes more efficient. These include the use of lean six sigma projects and tools, increased use of automation, and identifying more efficient mail preparation rules and other initiatives.

With regard to pricing, the Postal Service's ability to raise market dominant prices is constrained by the CPI price cap, which limits the ability to increase prices sufficiently to ensure revenue exceeds attributable costs for every product. If the Postal Service were to use all of its cap authority in an attempt to address only underwater products, this would undermine our ability to address other issues that arise in rate relationships. Constraints in the form of statutorily-mandated discounts off of commercial prices for non-profit mail and longstanding preferences for educational, cultural, scientific and information content further impede our ability to cover attributable costs. For Inbound Letter Post, the rates we charge foreign posts are established by the Universal Postal Union (UPU) and outside of our direct control; nonetheless, the Commission unfortunately treats these rates as subject to the price cap. We consider it more desirable and financially responsible to design prices to improve contribution in total instead of improving contribution for specific products simply because they do not currently cover their attributable costs. Since many of the products that are not covering costs are also experiencing declining volumes, in some cases, we may determine that it is more prudent to use our limited cap space to increase prices on products that have growing or stable year over year volume, to maximize the volume to which price increases apply.

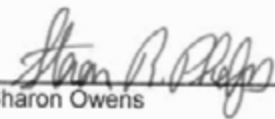
Costing data is collected throughout the year and product specific cost coverages are reported annually as part of our Annual Compliance Report to the Postal Regulatory Commission (PRC). The PRC evaluates our progress towards improving underwater product cost coverages and provides their assessment in the Annual Compliance Determination (ACD) which is issued in March each year. In this year's ACD, moreover, the PRC requested follow-up reports on improving efficiency for the underwater Periodicals class and Standard Mail Flats product. The Postal Service is currently working on its responses.

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Moreover, there are a number of venues where cross-functional collaboration occurs as it relates to improvement of cost coverage. At DRIVE, strategies to reduce costs are a regular part of the meetings. Also as part of DRIVE, goals are established and progress is measured for those responsible for operational improvements and growing profitable revenue. On a regular basis, Marketing and Sales and Finance coordinate on pricing strategy and how best to increase net income. Pricing and Costing team members also collaborate with team members from Enterprise Analytics, Business Mail Entry and Payment Technology, Retail Operations and Network Operations to share data and coordinate effective price designs. There have also been ongoing meetings with the mailing community on ways to gain operational efficiencies and incentivize mailing behavior that increases cost coverage.

This audit also reports a monetary impact of \$1.2 billion dollars. The \$1.2 billion is calculated as the difference between the revenues and attributable costs for those market dominant products not covering costs. As part of the Postal Accountability and Enhancement Act, Congress included a CPI cap which restricts the Postal Service's ability to increase prices on market dominate products. Even if the Postal Service were to use all available cap space on underwater products, it would not come close in bringing these products to 100 percent cost coverage, or recovering \$1.2 billion. This is especially so when an entire class is underwater, as is the case for Periodicals. For other classes, using the price cap on underwater products simply costs the Postal Service revenue from the other products in the class. Moreover, as stated above, it may not be in the Postal Service's best interest to use significant cap space to increase prices on underwater products, as they tend to be declining in volume and it would not serve to maximize the contribution to the Postal Service. Therefore, we find that the inclusion of \$1.2 billion as questioned costs to be highly inappropriate as the actions to recover this amount are beyond our control.

In summary, the Postal Service agrees that, in principle, revenues should exceed attributable costs at a product level; we are currently working cross-functionally and with the PRC to address underwater products within our regulatory constraints.

for   
Sharon Owens

cc: Manager, Corporate Audit and Response Management



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