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SUBJECT: Management Advisory – Cost Reduction
Programs (Report Number MS-MA-06-001)

This report presents the results of our review of the U.S. Postal Service's cost reduction programs (Project Number 06BG002MS000). We determined whether Postal Service efficiencies and cost savings are appropriately factored into the ratemaking process and how Postal Service managers are required to achieve planned efficiencies. Senator Charles E. Grassley, Chairman, Senate Finance Committee, requested this review.

Postal Service cost reduction programs were appropriately factored into rate case R2005-1 and were comparable to cost reduction programs in Postal Service budgets. The budget process requires managers to achieve planned efficiencies and cost savings. As part of the budget process, workhour reductions from cost reduction programs are factored into the Postal Service budgets. Cost reduction programs were reviewed during rate case R2005-1 and they were comparable to cost reduction programs in prior rate cases.

Management reviewed a draft copy of this report. We incorporated their suggested changes into this final report.

Background

When the Postal Service needs to change domestic postal rates and fees, it submits a request to the Postal Rate Commission (Commission). The Commission, an independent agency separate from the Postal Service, reviews the request in public proceedings and makes recommendations to the Postal Service Board of Governors. A Postal Service request to change numerous postal rates and mail classifications is known as an omnibus rate case.

The Commission's rules of practice describe the supporting data and information the Postal Service must file with rate and classification requests. In general, the Postal Service is required to report its latest operating results and to provide its best estimate of future revenues and costs.

The Postal Reorganization Act of 1970 established the basic principles on which the Postal Service sets rates. The primary requirement is that the Postal Service attains a financial "break even." For a rate case, the break even requirement is applied for a single prospective year — known as the test year — a fiscal year beginning not more than 24 months subsequent to the filing date of the rate case. To estimate its test year revenue needs, the Postal Service identifies a recently concluded fiscal year as a base period, adjusts the historical results through an intermediate period, and rolls the results forward to arrive at an estimate of the test year revenue requirement. For omnibus rate case Docket No. R2005-1 (R2005-1), the base year was fiscal year (FY) 2004, the intermediate period was FY 2005, and the test year was FY 2006.

During rate case proceedings, the Postal Service presents actual and projected efficiencies and cost reduction programs that it estimates will result in significant future cost savings. The cost reduction programs reduce total costs in the intermediate and test year. In rate case R2005-1, the Postal Service presented 42 cost reduction programs with an estimated cost savings of \$1.3 billion in FY 2005 and \$1.3 billion in FY 2006. Most of the cost reduction programs involved savings from automation and other equipment. See Attachment A for a description of the cost reduction programs. Attachment B lists savings for each cost reduction program.

Two Postal Service offices have a role in developing, validating, and presenting the cost reduction estimates. The Capital and Program Evaluation group reviews Decision Analysis Reports¹ containing cost reduction programs and the controller validates them as part of the Postal Service investment review and approval process. Additionally, when preparing an omnibus rate case, the Corporate Financial Planning group collects the cost reduction program data and presents the data during ratemaking proceedings.

Objectives, Scope, and Methodology

Our objectives were to determine whether Postal Service efficiencies and cost savings were appropriately factored into the ratemaking process and how Postal Service managers are required to achieve planned efficiencies.

We examined FYs 2005 and 2006 Postal Service cost reduction programs presented in rate case R2005-1. To determine whether Postal Service efficiencies and cost savings were appropriately factored into the ratemaking process, we compared cost reduction programs in rate case R2005-1 to cost reduction programs in the FY 2005 and 2006 Postal Service budgets. We also compared cost reductions in rate case R2005-1 to cost reductions identified in prior rate cases.

To determine how managers are required to achieve planned efficiencies, we compared cost reduction program workhour reductions in rate case R2005-1 with workhour reductions in the FY 2005 and 2006 Postal Service budgets.

We conducted this review from November 2005 through March 2006 in accordance with the President’s Council on Integrity and Efficiency, *Quality Standards for Inspections*. We discussed our observations and conclusions with management officials and included their comments where appropriate.

¹ A Postal Service document prepared by the requiring organization which justifies why a major investment should be approved. Generally, all major capital investments exceeding \$5 million require a Decision Analysis Report.

Prior Audit Coverage We did not identify any prior audits or reviews related to the objectives of this review.

Savings Were Appropriately Factored into Rate Case R2005-1 Postal Service cost reduction programs were appropriately factored into the ratemaking process:

- Cost reduction programs presented in rate case R2005-1 were comparable to cost reduction programs in Postal Service budgets.
- The Commission reviewed and updated cost reduction programs in rate case R2005-1.
- Cost reduction programs in rate case R2005-1 were comparable to cost reduction programs in prior rate cases.

Rate Case Programs in Budget Table 1 lists ten cost reduction programs in rate case R2005-1 that were not itemized in the FY 2005 or 2006 Postal Service budgets. There were three reasons why management did not itemize these programs in the budgets:

1. Five programs were combined with other cost reduction initiatives in the budget; therefore, the workhour reduction goals were incorporated into those programs.
2. There are timing differences between filing the rate case and developing the budget. Rate case R2005-1 was filed in April 2005, while the FY 2006 budget was developed in June 2005. Between April and June 2005, three programs had schedule changes that eliminated the estimated FY 2006 workhour reductions that had been filed with rate case R2005-1. The omission of these workhour reductions did not have a material impact on the budgets.²
3. Two programs were one-time events that reduced/eliminated costs in FY 2005.

² Workhour reductions for the three programs totaled 578,000 workhours, while the FY 2006 budget was about 1.4 billion workhours.

Table 1. Cost Reduction Programs Not in Budget

<p><u>Combined With Other Cost Reduction Programs in Budget</u></p> <ul style="list-style-type: none"> ○ Receipt and Dispatch Unloaders ○ Three-Digit Scheme for Flats ○ Skin Sacks Reduction Program ○ Periodicals Cost Reduction Initiative ○ Breakthrough Productivity Initiative (Inventory Red) <p><u>Timing Differences Between Rate Case and Budgets</u></p> <ul style="list-style-type: none"> ○ Automated Package Processing System – Phase 2 ○ Singulation, Scan, Induction Unit Video Code ○ Human Capital Enterprise/Human Resources Shared Services <p><u>One-Time Events That Eliminate/Reduce Costs</u></p> <ul style="list-style-type: none"> ○ AMTRAK Termination ○ Emergency Preparedness Plan

Cost Reduction Programs Were Reviewed During Rate Case R2005-1

The Commission reviewed and updated the cost reduction programs in rate case R2005-1 and made two adjustments to them. First, the Commission made a total \$2.9 million in adjustments to the \$1.3 billion FY 2005 estimate and the \$1.3 billion FY 2006 estimate. The adjustments were the result of updating cost-of-living-allowance and contract estimates with actual data. The second adjustment to cost reduction programs was a correction of savings associated with the “Skin Sack” Cost Reduction Savings. The workhour savings for the program were not fully developed when the rate case was filed in April 2005 and the savings were not fully incorporated at that time. The Commission incorporated the latest savings estimates, resulting in a \$1.2 million adjustment to the cost reduction programs.

Cost Reduction Programs Were Comparable to Prior Rate Cases

Cost reduction programs in rate case R2005-1 were comparable to cost reduction programs in prior rate cases.³ In rate case R2005-1, total estimated FY 2005 cost reduction programs of \$1.3 billion were 1.8 percent of the total estimated FY 2005 costs of \$72.6 billion. Table 2 shows that cost reduction programs averaged about 1 percent of total test year costs in prior rate cases.

³ We compared test year cost reduction programs. In rate case R2005-1, the test year was FY 2006.

Table 2. Cost Reduction Programs in Prior Rate Cases

Rate Case*	Cost Reductions (millions)	Test Year Total Costs (millions)	Cost Reductions as a Percentage of Total Costs
R71-1	\$160.0	\$12,091.6	1.32
R77-1	272.3	15,634.0	1.74
R80-1	312.0	21,858.1	1.43
R84-1	115.5	28,068.6	0.41
R87-1	363.0	37,346.5	0.97
R90-1	251.9	46,205.8	0.55
R94-1	645.4	52,597.1	1.23
R97-1	931.0	60,546.5	1.54
R2000-1	653.9	67,824.9	0.96
R2001-1	496.7	72,013.5	0.69
Average:			1.01
R2005-1	\$1,332.9	\$72,636.2	1.84

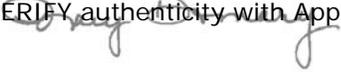
* Cost reduction programs were not identified in rate cases R74-1, R76-1, and R83-1.

Achieving Planned Efficiencies

The Postal Service budget process requires managers to achieve planned efficiencies and cost savings. Management factors workhour reductions from the cost reduction programs into field operational budgets as part of the Postal Service budget process. Management also incorporates estimated workhour savings from the cost reduction programs into the budgets and adjusts the estimate during the budget year. Typically, they adjust budgets to account for cost reduction program operational changes and scheduling changes.

Cost reduction program workhour savings presented in rate case R2005-1 were comparable to workhour reductions factored into the FYs 2005 and 2006 budgets. Differences between the rate case and budget data were traced to timing differences and updated assumptions.

We appreciate the cooperation and courtesies provided by your staff during the review. If you have any questions or need additional information, please contact Robert Mitchell, director, Marketing, or me at (703) 248-2300.

E-Signed by Mary Demory 
VERIFY authenticity with Approve!


Mary W. Demory
Deputy Assistant Inspector General
for Headquarters Operations

Attachments

cc: Steven R. Phelps

APPENDIX A. DESCRIPTION OF COST REDUCTION PROGRAMS

Breakthrough Productivity Initiatives. Various initiatives and actions by the field and headquarters to achieve savings in addition to specific operational programs. The savings are achieved through implementation of standardized field operations procedures and information systems resulting in increased efficiencies in operational functions, reductions in administrative functional areas, and more efficient transportation utilization.

Emergency Preparedness Plan. Irradiation equipment that did not meet Postal Service needs was transferred to other agencies in the base year (FY 2004). This charge for disposition of property and other machine related expenses (depreciation, operating, labor) were removed from FY 2005 costs.

Postal Automated Redirection System – Phase I. Improves the way that the Postal Service processes Undeliverable-as-Addressed (UAA) mail.

Amtrak Termination. The Postal Service and Amtrak terminated their business relationship at the end of FY 2004. As a result, Amtrak-related expenses after the base year will be zero.

Automated Postal Center. An interactive self-service kiosk that offers postal products and services comparable to those offered at the counter.

Flat Recognition Improvement Program. Enhances the address recognition technology used in flat mail automation equipment.

Letter Recognition Enhancement Program. Enhances the handwritten and machine-print address recognition technology used in letter mail automation equipment.

Automated Package Processing Systems. Purchases of machines designed to replace the older, labor-intensive small parcel and bundle sorters in larger offices.

Flats Identification Code Sort. Enhances the automation features of the automatic flat sorting machines by adding the capability to place a label and print an identification tag on all non-barcoded flat mail that is processed on the machine.

Breakthrough Productivity Initiative-Inventory Reduction Program. The second initiative focuses on reducing the replenishment costs of maintenance spare parts and supplies in field maintenance stock rooms.

Point-of-Service One – Stage 3. Continues deployment of a Point-of-Sale System that is replacing the Integrated Retail Terminals.

Labor Scheduler – Phase 1. Improves the current labor scheduling process which is a time-consuming, largely manual process.

Delivery Bar Code Sorter (DBCS) Stacker Modules. Provides DBCS stacker modules and supporting sweep-side tray carts for existing machines at postal facilities.

Facility Single-Source Provided Program. Improves the efficiency of the facilities management organization.

Decision Analysis Report Impact From New Facilities. Facility modernization program. As new facilities are activated, the costs and benefits that justified the capital investment are incorporated in the operating budget.

Optical Character Reader Enhancements for Letter Automation. Purchases new DBCS machines and installs modifications to existing DBCS, advanced facer canceller system, and remote computer reader equipment.

Skin Sack Reduction Program. Modifies mailing standards to no longer allow the preparation of certain sacks within Periodicals that contain fewer than the established minimum of 24 pieces. Operational savings will be achieved through a significant reduction in sacks which will result in a reduction in the labor associated with processing these sacks.

Field Material Handling Systems. This program is a consolidation of site specific capital requests for material handling equipment.

Low Cost Tray Sorters. Deployed to support material handling operations in postal plants.

Automatic Flat Sorting Machine Feeder Enhancements. Upgrades the feeders on operational and training machines.

Three-Digit Scheme for Flats. Changes the preparation of flat-shaped mail by allowing three-digit bundles to contain multiple three-digit ZIP Codes that align with sort plans.

Automatic Flats Tray Lidders. Deployed automatic flats tray lidders for use in dispatch operations nationwide.

Remote Encoding Center Consolidation – Phase 4. As the technology for computerized resolution of addresses improves, the percentage of mail requiring manual keying at the remote encoding centers is reduced.

Mail Processing Infrastructure – Phase 2. Upgrades the existing mail processing data networks at postal facilities.

Flat Remote Encoding System. Standardizes and improves the efficiency of the video encoding operations being performed at remote encoding centers.

Integrated Dispatch and Receipt Program. Combines the acquisition of machines for dispatching and receiving operations with integrated tray transport systems.

Advanced Facer Cancellor System Improvements. Improves the performance of letter mail cancellation equipment by providing double feed detection and cancellation upgrades for all 1,086 advanced facer canceller system machines.

Surface Visibility – Surface Air Support System Phase III. Deploys scanners and related infrastructure to track mail handling units, containers, and trailers through the surface transportation system.

Intelligent Mail Data Acquisition System Mobile Data Collection Device Replacements. Replaces existing data collection devices used by postal carriers and clerks with intelligent mail devices.

Automatic Tray Handling System for Automatic Flat Sorting Machines. Adds an automatic tray handling system to operational and training machines.

Wide Field of View Camera. Replaced aging wide area bar code reader systems used on all barcode sorting equipment with 11,266 wide field of view camera systems.

Singulation, Scan, Induction Unit. Equipment deployment to postal facilities, deployment was completed in August 2003 and final residual savings were captured in FY 2005.

Mail Evaluation, Readability, and Lookup INstrument – Phase 2. Automates the verification of Bulk Business Mail to ensure that mailing preparation requirements are met.

Postal Automated Redirection System – Phase II. Covers the implementation for handling UAA mail in the remaining postal facilities. Expected to begin in late FY 2006.

Automatic Induction Systems for Automatic Flat Sorting Machines. Automates the preparation and feeding of flat mail on automated flat sorting machines.

Automatic Tray Handling System for Automatic Flat Sorting Machines – Phase 2. Adds an automatic tray handling system on additional automatic flat sorting machines. Deployment is expected to begin at the completion of Phase I deployment in May 2006.

Receipt and Dispatch Unloaders. Automates the unloading of trays from mail transport equipment, thus improving the efficiency of platform operations.

Automated Package Processing Systems – Phase 2. Purchases and deploys machines at the conclusion of the Phase 1 deployment.

Singulate, Scan, Induction Unit Video Codes. Automates parcel processing by adding video coding capability to the singulation, scan, induction units.

Airline Receiving Concourse and Trayline System. Provides for the design, fabrication, and installation of a totally reconfigured airline receiving concourse including a mail tray takeaway transport conveyor (trayline) at the New York International Service Center.

Periodicals Cost Reduction Initiative. A management objective over the next 12 to 18 months to aggressively reduce the processing and transportation costs associated with the handling of Periodicals mail.

Human Capital Enterprise/Human Resources Shared Services. Replaces outdated human resources technology with a state-of-the-art, vendor-supported, fully integrated system.

APPENDIX B. COST REDUCTION PROGRAM IMPACTS

Cost Reduction Programs (proposed)	2005 (millions)	2006 (millions)
Breakthrough Productivity Initiatives	\$738.2	\$619.4
Emergency Preparedness Plan	97.5	0.0
Postal Automated Redirection System – Phase I	86.1	15.5
AMTRAK Termination	46.4	0.1
Automated Postal Center	45.3	44.4
Flats Recognition Improvement Program	36.3	20.5
Letter Recognition Enhancement Program	30.4	39.4
Automated Package Processing System	29.8	107.1
Flat Identification Code Sort	20.7	36.6
Breakthrough Productivity Initiative (Inventory Reduction)	20.0	0.0
Point-of-Service One – Stage 3	19.3	0.0
Labor Scheduler Phase 1	17.9	7.2
Delivery Bar Code Sorter Stacker Modules	16.6	1.3
Facility Single Source Provider Program	9.0	5.8
Decision Analysis Review Impact from New Facilities	8.2	18.7
Optical Character Reader Enhancements for Letter Automation	7.9	24.4
Skin Sack Reduction	7.1	15.2
Field Material Handling System	6.0	6.1
Low Cost Tray Sorters	5.1	0.0
Automated Flat Sorter Machine Enhancements	4.9	0.0
Three-Digit Scheme for Flats	4.1	6.3
Automatic Flats Tray Ladders	3.9	0.1
Remote Encoding Center Consolidation – Phase 4	3.7	4.5
Mail Processing Infrastructure – Phase 2	3.5	2.6
Flat Remote Encoding System	2.6	8.5
Integrated Dispatch and Receipt Systems	2.1	30.3
Advanced Facer Cancellor System Improvements	1.0	5.3
Surface Visibility – Surface Air Support System Phase III	0.9	45.3
Intelligent Mail Data Acquisition System-Mobile Data Collection Device	0.8	5.4
Automatic Tray Handling System for the Automated Flat Sorter Machine	0.5	29.5
Wide Field of View Camera	0.4	0.0
Singulate, Scan, Induction Unit	0.1	0.0
Mail Evaluation, Readability, and Lookup INstrument – Phase 2	0.1	0.0
Postal Automated Redirection System-Phase II	0.0	18.8
Automatic Induction System for the Automated Flat Sorter Machine	0.0	20.6
Automatic Tray Handling for the Automated Flat Sorter Machine – Phase 2	0.0	.2
Receipt and Dispatch Unloaders	0.0	6.8
Automated Package Processing System – Phase 2	0.0	17.6
Singulate, Scan, Induction Unit Video Code	0.0	4.1
Airline Receiving Concourse and Trayline System	0.0	4.7
Periodicals Cost Reduction Initiative	0.0	150.0
Human Capital Enterprise/Human Resources Shared Services	<u>0.0</u>	<u>10.8</u>
Totals: (May not sum due to rounding)	\$1,276.3	\$1,332.9