



November 8, 2007

MICHAEL K. PLUNKETT
ACTING VICE PRESIDENT, PRICING AND CLASSIFICATION

SUSAN M. PLONKEY
VICE PRESIDENT, CUSTOMER SERVICE

WALTER F. O'TORMEY
VICE PRESIDENT, ENGINEERING

SUBJECT: Audit Report – Review of Postal Service First-Class Permit Reply Mail
(Report Number MS-AR-08-001)

This report presents the results of our self-initiated audit of the U.S. Postal Service First-Class Permit Reply Mail (PRM) (Project Number 06YG041MS000). We initiated this audit based on concerns raised regarding potential preferential treatment given to a large digital versatile disc (DVD) mailer. Our objective was to determine whether PRM mailers' mailpieces are processed in accordance with their approved classification and pricing.

The Postal Service generally processes PRM mailpieces in accordance with their approved classification and pricing, as outlined in the *Domestic Mail Manual* (DMM). However, employees manually process approximately 70 percent of the approved First-Class two-way DVD return mailpieces from one DVD rental company because these mailpieces sustain damage, jam equipment and cause missorts during automated processing. Nonmachinable mailpieces are subject to a surcharge. However, the DMM does not currently address the characteristics of the mailer's two-way DVD return mailpiece that make it nonmachinable.

Because these mailpieces are not machinable, the Postal Service pays significant additional labor costs to manually process them. We estimate the additional labor costs to process these mailpieces were \$41.9 million during the past 2 years, and will be \$61.5 million over the next 2 years. We will report this monetary impact of \$103.4 million in our *Semiannual Report to Congress* as \$41.9 million in unrecoverable costs and \$61.5 million in funds put to better use.

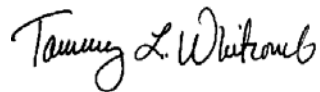
We recommended management revise the DMM's Nonmachinable Criteria for First-Class letter-size mail to identify additional nonmachinable characteristics and physical

standards for these mailpieces. We also recommended management notify affected mailers that Postal Service Engineering must test the mailers' two-way DVD return mailpieces against the revised Nonmachinable Criteria to ensure the affected mailpieces are machinable, or be subject to the \$0.17 nonmachinable surcharge. Should a mailer not make its mailpiece machinable, we recommended management ensure Business Mail Entry Unit employees begin collecting the \$0.17 per piece nonmachinable surcharge.

Management was not responsive to the findings and recommendations because, although they indicated agreement with the recommendations, they did not provide actions to address the recommendations nor did management provide action completion dates. Management has no initiatives in progress, completed, or planned to address the issues in this report. Management's comments and our evaluation of these comments are included in the report.

The OIG considers recommendations 1, 2, and 3 significant, and therefore requires concurrence before closure. Consequently, the OIG requests written confirmation when corrective actions are completed. These recommendations should not be closed in the follow-up tracking system until the OIG provides written confirmation the recommendations can be closed.

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, Sales and Service, or me at (703) 248-2100.



Tammy L. Whitcomb
Deputy Assistant Inspector General
for Revenue and Systems

Attachments

cc: Anita J. Bizzotto
Pritha N. Mehra
Jessica D. Lowrance
George R. Laws
Katherine S. Banks

INTRODUCTION

Background

The U.S. Postal Service delivers optical disks, digital versatile discs (DVDs), compact discs (CDs), and minidisks for on-line rental service companies such as Netflix, Inc.[®], Blockbuster Online[®], GameFly[®], and Simply Audiobooks[®], through the use of prepaid envelopes using the Business Reply Mail (BRM) and Permit Reply Mail (PRM) formats. Subscribers receive the DVDs or CDs through the mail, generally with 1-day delivery.

These companies use the Postal Service for timely delivery of rented DVDs and CDs. For example, one DVD rental company operates more than 100 shipping centers throughout the U.S. and, on average, ships 1.6 million DVDs each day. Another DVD rental company ships DVDs via the Postal Service from 38 distribution centers in the U.S. Other companies have also entered the marketplace with similar product offerings, bringing increased revenue to the Postal Service.

Outbound PRM two-way DVD mailpieces processed with other First-Class Mail[®] at the Houston, Texas, Processing and Distribution Center (P&DC), November 2, 2006.

Redacted

PRM is a mailer service which enables a permit imprint holder to receive First-Class Mail[®] and Priority Mail[®] back from customers by prepaying postage for reply pieces at the time of mailing. Mailers must distribute PRM pieces as part

of a discount First-Class Mail mailing and not through any other means.¹

On August 3, 2006, the Postal Service launched PRM to replace BRM because DVD mailpieces were not well-suited for the BRM classification. Mailers who use PRM are those who have close to 100 percent returns, such as DVD rental companies.

Most PRM mailers currently use a two-way DVD mailpiece for shipping to and from the customer, where the envelope used to ship the DVD to the customer is converted and used to return the DVD to the rental company (referred to as the two-way DVD return mailpiece). One DVD rental company mailer places the DVD in the front of the envelope on its way to the customer, creating a hard leading edge on the mailpiece. On the return trip back to the rental company, the DVD ends up on the trailing edge when the envelope is converted by the customer. This is because the customer tears off the perforated cover of the envelope to expose the return address. The return address information is printed upside down relative to the original cover, meaning that the envelope must be rotated 180 degrees to be processed upright. After this rotation, the DVD is positioned on the trailing edge of the envelope, creating a leading flap that is referred to as a “floppy leading edge.”

Regarding pricing, PRM DVD mailers present their mailings at a business mail entry unit, and most pay First-Class presort automation letter rates for outbound mailpieces. Postage for the return envelopes is prepaid at full First-Class Mail rates and is collected when the outbound pieces are mailed. Mailpieces that fail one or more of the nonmachinable criteria in the Domestic Mail Manual (DMM) are assessed a nonmachinable surcharge of \$0.17 per piece.²

The Postal Service has two ways of granting PRM authorizations. Mailers wishing to obtain individual mail entry site authorizations must apply for PRM through the Manager, Business Mail Entry (MBME) at the district office where the permit imprint account is held, and mailpieces must be approved by the local Mailpiece Design Analyst. Mailers seeking a national authorization must submit a

¹ DMM, Section 507.9.1.1 (updated May 14, 2007).

² DMM, Section 133.1.9 (updated May 14, 2007).

request to the Pricing and Classification Service Center (PCSC).

Locally, if a mailpiece's design cannot be authorized according to the DMM, the MBME informs the mailer in writing that the PCSC will make a determination. The letter sent by the MBME to the mailer should request that the mailer provide additional sample mailpieces to the MBME, along with a letter asking that these mailpieces be tested by Postal Service Engineering (Engineering) for automation letter-size rates. The MBME forwards the mailer's letter and sample mailpieces to the PCSC for a determination. The PCSC then follows its normal authorization procedures (outlined below).

The PCSC receives letter requests directly from mailers seeking a national authorization or from MBMEs seeking clarification for a local authorization. These requests include sample mailpieces to be tested. The PCSC reviews the mailpieces and determines whether to deny authorization or forward the sample mailpieces to Marketing's Mailing Standards group, to Engineering, or to both for further review. Engineering notifies Mailing Standards and the PCSC of test results in writing, and the PCSC or Mailing Standards issues a ruling to the mailer. Marketing announces national authorizations in the *Pricing & Classification Weekly Communication* and any other media that reach the internal postal audience.

To better understand how DVDs are processed, the Postal Service contracted with an outside consultant to study the mail characteristics and processing methods used by postal facilities that process DVD envelopes. This study, titled *United States Postal Service (USPS) Mail Characteristics Study of DVD-by-Mail*, includes cost and volume estimates that reflect the Postal Service's current processing methods. Results of this study are discussed later in this report.

Objective, Scope, and Methodology

See Appendix A.

Prior Audit Coverage

We did not identify any prior audits or reviews related to the objective of this audit.

AUDIT RESULTS

Many Two-Way DVD Return Mailpieces Processed Manually, But Surcharge Not Assessed

The Postal Service generally processes PRM mailpieces in accordance with their approved DMM classification and pricing. However, approximately 70 percent³ of one DVD rental company's approved First-Class two-way return mailpieces⁴ are manually processed. The Postal Service manually processes such a significant number of these mailpieces because of the nonmachinability of the envelope design. This design uses a floppy leading edge, which often sustains damage, causes jams in equipment, and missorts during automated processing.

The Postal Service has specific criteria in the DMM to determine whether letter mail is nonmachinable.⁵ Currently, the envelope design with the floppy leading edge meets these criteria, as none of the negative characteristics listed in the DMM specifically apply to this type of mailpiece.

Additionally, in 2002, Postal Service Marketing's Preparation and Standards⁶ group (Marketing) notified this DVD rental company that their two-way DVD return mailpiece was machinable, although Engineering had determined 2 weeks earlier that the same mailpiece was not automation-compatible. As a result, the mailer was not required to pay either the current \$0.17 or older (prior to May 14, 2007) \$0.13 nonmachinable surcharge.⁷

Manually processing these mailpieces is costly to the Postal Service. We estimated that the costs to the Postal Service for this manual effort for the past 2 years were \$41.9 million. If the Postal Service were to revise the DMM's nonmachinable criteria⁸ to identify additional characteristics and physical standards for First-Class letter mailpieces with the same design and general characteristics as the current mailer, the Postal Service could reduce processing costs

³ The OIG performed a statistical sample of 24 Postal Service sites that handle the DVD rental company's return mailpieces. Based on projections of the sample results, we estimate 70 percent of this company's two-way DVD returned mailpieces were processed manually.

⁴ A return mailpiece is one that a customer is returning to the mailer.

⁵ DMM 101, *Physical Standards*, Section 1.2, *Nonmachinable Criteria*.

⁶ Marketing's Preparation and Standards group has been renamed Mailing Standards and reports to the Vice President, Pricing and Classification.

⁷ On May 14, 2007, the Postal Service announced a rate change. DMM 133, *Rates and Eligibility*, Section 1.9, *Nonmachinable Surcharge*, now requires a \$0.17 surcharge for any nonmachinable mailpiece. Prior to May 14, 2007, the surcharge was \$0.13 per piece (DMM 133.1.6, Footnote 3).

⁸ DMM 101, *Physical Standards*, Section 1.2, *Nonmachinable Criteria*.

and would have funds put to better use of \$61.5 million over the next 2 years. (See Appendix B for details.)

Manual Processing
Observed

In 2005, the Postal Service contracted with an outside consultant to study the mail characteristics and processing methods used by Postal Service facilities that process two-way DVD mailpieces. The outside consultant concluded that the Postal Service manually processed 77 percent of one of the large on-line DVD rental companies' two-way DVD return mailpieces.

Through observation and contact with 24 P&DCs, the U.S. Postal Service Office of Inspector General (OIG) estimates that 70 percent of this DVD rental company's two-way DVD return mailpieces are manually processed, a figure slightly lower than the outside consultant's 77 percent. Both the outside consultant and the OIG observed that the two-way return mailpieces are diverted at various points throughout the mailstream and processed manually rather than being processed by automation, as required by two-way DVD classification and pricing.

At the P&DCs where the OIG observed two-way DVD mail processing, we found operations personnel manually taking two-way DVD return mailpieces from the initial rough cull,⁹ from the Advanced Facer-Canceller System machine; and at other points during processing operations for later facing¹⁰ and placing them in trays at the end of the shift. Western Area management issued a standard operating procedure (SOP) directing delivery and operations employees to isolate all two-way DVD return mailpieces from the mailstream before they enter the plant for processing. At the Denver P&DC, we found that even with an SOP to isolate all two-way DVD return mailpieces before they arrive at the plant, operations personnel still removed PRM mailers to be faced and placed in trays at the end of the shift. At the Queens, NY P&DC, we found a sign instructing operations personnel to pull out one DVD rental

⁹ Culling refers to removing, by hand, nonletter mail (such as small parcels, rolls, and odd-shaped material) from letter mail, and nonmachinable mailpieces from automation rate pieces.

¹⁰ Facing refers to arranging mail in a uniform orientation with the delivery address facing forward and the postage stamp, meter stamp, or permit imprint positioned in the upper right corner.

company's return mailpieces from collection mail. The OIG did not observe any other PRM mailer's two-way DVD return mailpieces being manually processed as much as this specific mailer's pieces were manually processed.

At the P&DCs where the OIG observed Postal Service processing of two-way DVD mailers, operations personnel told the OIG that the return mailpieces were manually pulled to avoid damaging the mailpiece, jamming the mail processing equipment, and missorting during processing.

After being removed from the mailstream, PRM mailpieces at the Denver P&DC await facing and placing in trays, November 8, 2006.

Redacted

The outside consultant's study also noted:

"Often employees cull the easily identifiable bright colored envelopes from the automated mail stream. Some supervisors in mail processing facilities believe these pieces will not run correctly on automation machinery based on their experiences working with this equipment, or feel that the risk of damage, mis-sorts, or rejects justifies their removal from the automated processing stream. It was not unusual to see containers of separated return DVDs at points throughout the mail processing flow."

Improper Notification
Letter Provided

On June 11, 2002, Engineering issued a letter to the DVD rental company regarding the test results of their two-way DVD mailpiece. Engineering concluded that the return portion of the two-way envelope used by this mailer was not

automation compatible because “the pieces did not stack correctly” and “many pieces. . . had the flimsy end fold over and covered the address information.” The letter did not address machinability.

In response to Engineering’s letter, on June 17, 2002, the mailer sent an e-mail questioning Engineering’s determination. On June 24, 2002, Marketing responded to the mailer with a letter stating that although their two-way DVD return mailpieces were “not completely automation-compatible, [they] were machinable.” The letter also stated, “return pieces tested would not be subject to the nonmachinable surcharge effective June 30, 2002, for mailpieces that must be handled manually.”

Marketing’s June 24, 2002, letter negated Engineering’s determination that the mailpieces were not automation-compatible by stating that this DVD mailer’s return mailpieces, “although not completely automation-compatible, were machinable.” By adding the phrase “although not completely,” Marketing not only changed Engineering’s earlier determination that this DVD mailer’s return mailpieces sent in for testing “were not automation compatible,” but also made a determination on machinability without performing flexibility testing on the mailpiece. The DMM¹¹ states that Engineering, not Marketing, is responsible for advising mailers of its findings (by letter) regarding the results of flexibility testing.

The OIG asked Engineering representatives for all copies of the 2002 testing results, but were told that none existed. Engineering officials told the OIG they did not know of any separate testing that Marketing conducted on the subject mailpieces in order to arrive at their conclusion. We questioned both Marketing and Engineering officials about whether the return mailpieces were machinable. Marketing asserts – and Engineering denies – that Engineering advised Marketing that the return mailpieces were machinable.

In addition, in December 2005, Postal Service Engineering conducted testing on a two-way DVD mailpiece submitted by another DVD rental company that was similar to the one

¹¹ DMM 201, Section 3.11.2 states in part: “A mailer wanting to have mailpieces tested for flexibility must submit at least 50 sample pieces and a written request to USPS Engineering. . . .The request must describe mailpiece contents. . . and Engineering advises the mailer by letter of its findings.”

used by the aforementioned DVD rental company. Engineering determined that the return portion of this other company's DVD mailer was nonmachinable. In a December 28, 2005, letter to the company, Engineering noted the similarities between the two companies' DVD mailpieces, stating:

"It should be noted that Engineering tested a similar mailpiece in 2002 and in a letter dated June 11 of that year, informed [a DVD rental company] that the mailpiece was not automation compatible. The samples submitted by [the other company] have not been modified in any way that would significantly improve machinability. . . . In a sense, this mailpiece design is being tested everyday throughout the Postal system with very poor results. Engineering's ongoing experience with the poor machinability of [the DVD rental company's] mailers indicates that the [current] design will sustain damage, cause jams and be mis-sorted during processing. This will lead operations personnel to divert the mailers from the automation mail stream and handle them manually. Based on current experience, the test performed and the tabbing deficiencies noted, Engineering finds [the other company's] two-way DVD mailer is not machinable."

Engineering's determination that the other DVD rental company's mailpiece is nonmachinable is inconsistent with Marketing's determination that the DVD rental company's identical mailpiece is machinable. The Postal Service should give consistent treatment to two mailpieces with the same characteristics. Inconsistent treatment of mailpieces with the same characteristics may lead mailers to perceive that the Postal Service shows favoritism towards some DVD rental service companies.

DMM Nonmachinable
Criteria Needs
Revision

The DMM does not address characteristics that make the DVD rental company's two-way return mailpiece nonmachinable.

DMM, Section 101 gives criteria for identifying mailpieces that are subject to the nonmachinable surcharge. The following guidance was in effect at the time Marketing determined the mailpiece to be machinable:

- DMM, Section 101.6.4.1: Letter-size pieces that weigh 1 ounce or less and meet one or more of the nonmachinable characteristics in section 1.2 are subject to the nonmachinable surcharge (see section 133.1.9).
- DMM, Section 101.1.2: A letter-size piece is nonmachinable if it has one or more of the following characteristics, including:
 - a) An aspect ratio (length divided by height) of less than 1.3 or more than 2.5.
 - b) Is polybagged, polywrapped, or enclosed in any plastic material.
 - c) Has clasps, strings, buttons, or similar closure devices.
 - d) Contains items such as pens, pencils, or loose keys or coins that cause the thickness of the mailpiece to be uneven.
 - e) Is too rigid (does not bend easily when subjected to a transport belt tension of 40 pounds around an 11-inch diameter turn).
 - f) For pieces more than 4-1/4 inches high or 6 inches long, the thickness is less than 0.009 inch.
 - g) Has a delivery address parallel to the shorter dimension of the mailpiece.
 - h) Is a self-mailer with a folded edge perpendicular to the address if the piece is not folded and secured.
 - i) Booklet-type pieces with the bound edge (spine) along the shorter dimension of the piece or at the top.

Although the DVD rental company's two-way DVD return mailpiece adheres to the DMM machinability criteria listed above, Engineering's testing of this and similar mailpieces

has consistently shown that this type of mailpiece is not machinable. Engineering has noted that mailpieces with this design “will sustain damage, cause jams, and be missorted.” The OIG, through observations of DVD mailpiece processing conducted at 10 P&DCs, also found this specific two-way DVD mailpiece was likely to become damaged, jam equipment, and be missorted during automated processing.

Based on Engineering’s conclusions about the PRM two-way DVD mailpieces, the Postal Service should revise the DMM to identify additional nonmachinable characteristics and physical standards for First-Class letter-size mail. If affected mailers choose not to redesign their two-way DVD mailpiece the Postal Service should impose nonmachinable surcharges of \$0.17 per piece.

Recommendations

We recommend the Acting Vice President, Pricing and Classification:

1. Coordinate with the Vice President, Engineering, on a Domestic Mail Manual (DMM) revision to the Nonmachinable Criteria DMM, Section 101.1.2 in order to identify additional nonmachinable characteristics and physical standards for First-Class letter-size mail with the same design and general characteristics of the mailpiece with the floppy leading edge.
2. Notify affected mailers that their two-way Digital Video Disk return mailpieces must be tested by Postal Service Engineering against the revised Nonmachinable Criteria DMM, Section 101.1.2 to ensure that the affected mailpieces are machinable, or be subject to the \$0.17 nonmachinable surcharge.

We recommend the Vice President, Customer Service:

3. Ensure that Business Mail Entry Unit employees begin collecting the \$0.17 per piece nonmachinable surcharge for all affected mailpieces if mailers do not alter their mailpieces.

**Management’s
Comments**

In response to recommendation 1 management stated that in the last year 742 million pieces of Permit Reply Mail comprised only 0.77% of more than 96 billion pieces of First-Class Mail. Management agreed that machinability

standards need to be reexamined periodically, but cautioned that it must also consider how any DMM changes would affect all users of the mail. Additionally, management stated that the specific changes envisioned by this audit could have implications for other customers that are not yet properly understood. In addition to cost, the Postal Service is greatly concerned with the possible negative impact on affected customers if a DMM change results in a substantial price increase.

Concerning recommendation 2, management agreed to test DVD return mailpieces “against DMM standards when and if those standards are altered.” In response to recommendation 3, management stated that “customers who mail pieces that do not conform to current DMM standards should pay the nonmachinable surcharge.”

Management also had a comment regarding the following statement in Appendix A of our report: “We did not assess the reliability of the Corporate Business Customer Information System (CBCIS) as part of our audit; therefore, we do not base our conclusions or recommendations solely on information in the database.” Management believes this statement conflicts with our use of CBCIS volume data in Appendix B.

We have included management’s comments, in their entirety, in Appendix C.

**Evaluation of
Management’s
Comments**

Although management agreed with our findings, their comments were not responsive to the findings and recommendations. Management did not identify any actions it will take to address the issues raised in this report.

Management’s comments misquote our first recommendation as a suggestion that the DMM be revised to “identify additional nonmachinable characteristics and physical standards for First-Class Mail letter-size mail.” Management omitted the rest of the recommendation, “*with the same design and general characteristics of the mailpiece with the floppy leading edge,*” and offered no indication that it would act to address the floppy leading edge problem identified in this report. Our recommendation to revise the DMM would not affect all First-Class mailers. It pertains only to mailpieces with a floppy leading edge, which sustain damage, cause jams in equipment, and

missort during automated processing. As for the impact on affected customers, rejecting similar mailpieces from other mailers, while allowing one mailer to continue using this mailpiece creates the appearance of favoring a large mailer over smaller ones.

Agreeing to test DVD return mailpieces against DMM standards “when and if those standards are altered,” without having committed to altering the DMM, does not satisfy these recommendations.

Regarding recommendation 3, management stated that customers who mail pieces that do not conform to current DMM standards should pay the nonmachinable surcharge. Our recommendation pertained to “affected mailpieces,” (mailpieces affected by the DMM revisions suggested in recommendation 1). In any case, management did not specify any action that it would take to collect the surcharge, under either current or revised DMM criteria.

The OIG disagrees with management’s assertion of a conflict between information presented in Appendices A and B. Our statement in Appendix A means we did not conduct a review of data processing controls over the CBCIS. However, we tested the reasonableness of the CBCIS data. To test the reasonableness of projected return volume using CBCIS, we compared it to a separate projection using the mailer’s internal forecasted customer base for March 2007 and the mid-point of its forecasted range of its customer base for December 2007.

The results of the two forecasts were nearly identical, giving us reasonable assurance that we could use the data obtained from the CBCIS to support the monetary impact calculation.

Note also that we estimated the unit cost of manual processing at \$0.08146. Management’s response indicates that the unit cost is \$0.11291. If management is correct, our monetary impact calculation is very conservative.

**Additional Matter
Needing
Management's
Attention**

The DMM gives the Postal Service's complete mailing standards. Customers and Postal Service employees depend on the DMM for information and guidance about mailing. Further, the DMM attempts to give users all the information they need within a single section without referring users to different sections. Although one of the Postal Service's goals is to reduce the need to refer to another section, in some circumstances, a reference directs a user to a different section.

During our review of PRM guidance, we noted that clarification is needed to Section 9 of the DMM 507, which provides information on the PRM category and elements. Section 9.1.1 states that mailers must distribute PRM pieces as part of a discount First-Class mailing and not through any other means, but does not refer users to the PRM guidelines in DMM 200, *Discount Mail Letters and Cards*, and Section 230, *First-Class Mail*. Although it is the Postal Service's goal to reduce the number of instances a user is referred out of a section, we believe it is important to give users an out-of-section reference to the section on discount First-Class Mail. This reference, when added to Section 9.1.1, would give PRM mailers complete guidelines.

Suggestion

We suggest the Acting Vice President, Pricing and Classification, revise the DMM to include an out-of-section reference from the PRM section at 9.1.1 to DMM, Section 230, *First-Class Mail*.

APPENDIX A

OBJECTIVE, SCOPE AND METHODOLOGY

We initiated this audit based on concerns raised regarding potential preferential treatment given to a large DVD mailer. We determined whether PRM mailers' mailpieces are processed according to their approved classification and pricing.

To accomplish our objective, we performed a walk-through of the PRM process (tracing from permit to authorization to outbound to return of mail to automation compared to manual sorting). We also reviewed applicable regulations, manuals, instructions, and other supporting documentation relating to PRM, and its predecessor BRM, to evaluate internal controls and the reliability and validity of data.

We interviewed Postal Service personnel for background information on DVD mailing approvals and processes. We interviewed Postal Service officials at the PCSC to determine their role in the process for mailers seeking approval to use PRM, especially those who mail automation-compatible DVD and CD mailpieces. We also interviewed industry officials for information on their distribution processes.

We visited 10 Postal Service facilities to observe the mailing of DVDs to determine how they were processed, and contacted an additional 14 Postal Service facilities by telephone to confirm their processing of DVDs.

We reviewed the November 2006 study, *USPS Mail Characteristics Study of DVD-by-Mail*, developed by an outside consultant for the Postal Service, to determine why the study was requested and how the Postal Service used the results.

We conducted this performance audit from September 2006 through November 2007 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 officials on August 15, 2007, and included their comments where appropriate. We did not assess the reliability of the CBCIS as part of our audit; therefore, we do not base our conclusions or recommendations solely on information in the database.

APPENDIX B

MONETARY IMPACT CALCULATION METHODOLOGY DESCRIPTION

Redacted

APPENDIX C. MANAGEMENT'S COMMENTS



October 25, 2007

TAMMY L. WHITCOMB
DEPUTY ASSISTANT INSPECTOR GENERAL FOR REVENUE AND SYSTEMS

SUBJECT: Review of Postal Service First-Class Permit Reply Mail
(Report Number MS-AR-07-DRAFT)

This report has been reviewed by management from USPS Engineering, HQ Marketing, and Operations. After a review of the findings, management agrees with some of the recommendations, but disagrees with a number of issues.

Recommendation 1:

Coordinate with Vice President, Engineering on a *Domestic Mail Manual* [DMM] revision to the Nonmachinable Criteria (DMM Sections 101.1.2 [and 201.2.1]) in order to identify additional nonmachinable characteristics and physical standards for First-Class Mail letter-size mail.

Response:

Management agrees that machinability standards need to be reexamined periodically. However, there are several factors that must be taken into consideration with respect to the instant audit. First, the Postal Service management must consider the magnitude of this decision. In the last year there were more than 96 billion pieces of First-Class Mail. Of this number, only 742 million were Permit Reply Mail which equates to 0.77% of all First-Class Mail. Before changing any criteria in the DMM, the Postal Service must consider how proposed changes would affect all users of the mail. The specific changes envisioned by this audit could have implications for other customers that are not yet properly understood.

Second, the cost is but one factor to consider when setting prices. In addition to cost, the Postal Service is greatly concerned with the possible negative impact on affected customers if a change in mailing standards results in a substantial price increase. Under the Postal Accountability and Enhancement Act (PAEA), it is even more important to consider all aspects of a product to properly price it within the marketplace.

475 L'ENFANT PLAZA SW
WASHINGTON DC 20260-5127
202-268-7283
FAX: 202-268-5773

-2-

Recommendation 2:

Notify affected mailers that their two-way [DVD] return mailpieces must be tested by Postal Service Engineering against the revised Nonmachinable Criteria (*Domestic Mail Manual* Section 101.1.2), in order to ensure the affected mailpieces are machinable, or be subject to the \$0.17 nonmachinable surcharge.

Response:

Management agrees that two-way DVD return mailpieces should be tested against DMM standards when and if those standards are altered. Pricing and Classification will work to ensure all Permit Reply Mail (PRM) customers are treated equally with advance notification in writing concerning any proposed changes in the DMM that will affect their mailpieces.

Recommendation 3:

Ensure Business Mail Entry Unit (BMEU) employees begin collecting the \$0.17 per piece nonmachinable surcharge for all affected mailpieces should mailers not alter their current mailpiece.

Response:

Management agrees with Recommendation 3 that customers who mail pieces that do not conform to current DMM standards should pay the nonmachinable surcharge.

Additional Comments

Background:

The paragraph above the picture on page 1 describing a PRM customer and its company profile needs to be deleted or redacted from the report. It has no bearing on the report or findings of this report.

All PRM customers must apply for authorization through the district manager overseeing the BMEU where the permit imprint account is held. Permit holders must submit pre-production samples of PRM pieces for USPS approval prior to distribution.

Mailpieces are processed manually:

The Postal Service does handle PRM return pieces inconsistently throughout the entire country. This reflects variations by plant in volume and handling characteristics of diverse PRM return pieces which are produced by different PRM mailers, and in the mix of sorter models present at each plant. Plants use a mix of handling practices, including some automation designed to minimize costs consistent with service given their unique circumstances. Through an outside consultant, the Postal Service learned that all PRM designs contribute positive contribution.

Improper Notification Letter Provided:

Although the course of events is accurately portrayed in this section, it is to be noted that this use of First-Class Mail at the time was relatively new and no Standard Operating Procedures (SOP), were in place to include new customers in this service. Since this use has expanded, an SOP has been put into place.

Appendices:

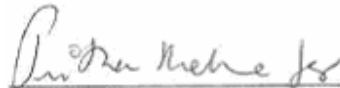
In Appendix A, it is stated, "We did not assess the reliability of the Corporate Business Customer Information System (CBCIS) as part of our audit; therefore, we base no conclusions or recommendations solely on the data contained in the database." [REDACTED]

It is also to be noted that under the new law, USPS will only submit PRC cost methodology. Therefore, the difference in labor costs per piece between automated and manual processing for the Outgoing Primary Operation is 11.291 cents.

From PRC-LR-12, FCM Letters Costs Final.xls, Sheet SPNMACH COST

Outgoing Primary:

Automation	0.790 cents
Manual	12.081 cents
Difference	11.291 cents



Susan M. Plonkey
Vice President, Customer Service



Michael K. Plunkett
AVice President, Pricing and Classification

cc: Anita J. Bizzotto
William Galligan
Walter O'Tormey
Katherine S. Banks
Sharon Daniel
George R. Laws
Jessica D. Lowrance
Marc D. McCreary
Pritha N. Mehra
Christine R. Ray