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Report to the Chairman, Committee on Post Office and Civil Service, House of Representatives

March 1994

POSTAL SERVICE

Issues Related to Settling a Disputed Contract for Air Transportation

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General Government Division

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March 24, 1994

The Honorable William L. Clay
Chairman, Committee on Post
Office and Civil Service
House of Representatives

Dear Mr. Chairman:

This report responds to your request for information about the U.S. Postal Service's court-approved settlement in April 1993 of a disputed contract for air transportation on the Service's Express Mail network. You were interested in what work and payments were agreed to by the parties to the settlement and whether it was proper contracting procedure and in the Service's best interest to settle instead of resoliciting the procurement.

You have also requested a review that we will be conducting of the adequacy of Postal Service procurement policies, particularly as they related to this disputed contract and four other major Postal Service procurements. As a part of that review, we will consider whether use of the Federal Acquisition Regulation in lieu of the Postal Service Procurement Manual would have avoided the difficulties that occurred in those procurements.

Background

In April 1992, the Service solicited contract proposals for air cargo service for its existing Eagle Network. The network, which operates from a central hub in Indianapolis, transports Express Mail and, on a space available basis, Priority Mail, the Service's expedited mail classes. At the time of the solicitation, air service was being provided by Emery Worldwide Airlines for about $120 million annually under a contract that began in 1989 and was scheduled to expire in January 1993. The Service wanted to award a 10-year contract in order to allow offerors to spread their capital investment over a longer period that would reduce the cost of the service. The solicitation called for overnight round-trip service 6 days a week from 31 cities to Indianapolis over 19 routes. Twenty-one Boeing 727 aircraft were mandated in the solicitation to be dedicated to the network each day—one for each route plus two standby spares.

The Service received four responsive offers and on September 16, 1992, awarded a contract to the lowest offeror, Postal Air Incorporated. Postal

Air's low offer of $85 million[1] annually was reduced to $80 million in postselection negotiations. Emery had the second lowest offer, $91.8 million.

On September 29, 1992, Emery and another offeror, Express One Incorporated, brought suit challenging the award to Postal Air. The U.S. District Court for the District of Columbia subsequently set aside the award to Postal Air because of a conflict of interest on the part of an individual who helped evaluate the contract proposals. The court ordered that the contract be resolicited and that Emery, Postal Air, and Express One be allowed to submit new proposals. Under the termination provisions of the Postal Air contract that was set aside, the Service was liable to Postal Air for start-up costs that the firm may have incurred.

Subsequently, with the approval of the Attorney General, the Service agreed with the other parties to the suit to settle the procurement without a resolicitation. The settlement, approved by the court on April 15, 1993, called for the contract to be awarded to Emery for $88 million annually, excluding pass-through costs, and specified that Express One would be a principal subcontractor to Emery. The Service and Emery agreed to pay Postal Air $10 million and $8.5 million, respectively, and Postal Air agreed to waive any claims it might have related to the contract award.

You posed the following questions:

(1)What work was performed by Postal Air that it will receive $10 million from the Postal Service and $8.5 million from Emery?

(2)Was the settlement in the best interest of the Postal Service, the postal ratepayer, and the American public in light of the cost and changing circumstances in the air freight industry?

(3)Was it proper contracting procedure for the Service to award the contract without resoliciting when the contract evaluation process was found flawed by the court?

[1]The total cost of the 1989 contract and amounts cited for the new contract are not comparable because of a difference in how certain cost elements are treated. The 1989 contract was variously priced at a cost per trip or cost per day over its life, and $120 million is the Service's estimate of its equivalent annual cost when the 1993 contract was solicited. The proposal for the 1992 contract called for a base annual price plus estimated pass-through costs for fuel, deicing, and landing and ramp fees, which the contractor is allowed to pass on to the Service. Only the proposed base prices were subject to evaluation, and these amounts are cited in this report. Pass-through costs were estimated to be $27.8 million under the Postal Air contract, which was set aside, and $26.8 million in the Emery contract, which replaced it.

(4)What are the specifics of the agreements among the parties?

Results in Brief

The agreements by Postal Air with the Postal Service and Emery did not require any work from Postal Air. Rather, the payments to Postal Air were negotiated to obtain a settlement and represented full settlement of any amounts that might be due to Postal Air under the termination provisions of the contract. These amounts included bid preparation costs, attorneys' fees and other start-up costs. Chief among these costs was $33.1 million related to Postal Air's commitment to purchase 23 Boeing 727 aircraft. Emery agreed to buy most of these aircraft and obtained from the aircraft suppliers releases of any claims against Postal Air. In return, Postal Air agreed to release the other parties to the litigation from any claims against them.

The Service's rationale for settling the contract was based on financial analysis and qualitative considerations. The Service determined, with the assistance of a consulting firm, that settling would be less costly and quicker than resoliciting. Because start-up after settlement took longer than expected, some of the financial benefits from settling were overstated. However, we do not believe that the differences are significant enough to warrant a change in the Service's overall conclusion. Also, we did not find any significant change in the air freight industry between the time of the original award and the settlement that would have made resolicitation preferable.

There is no doubt that this procurement was seriously flawed as a result of the decision by the Service to ignore the advice of its own legal counsel and to award the contract notwithstanding a clear conflict of interest that was not corrected. However, after the federal district court overturned the award and ordered the Service to resolicit the procurement, the decision of the Service to resolve the litigation through a court-approved settlement with the parties to the litigation was not unreasonable in our view. By entering into the settlement, the Service was able to satisfy its own needs and the legitimate interests of the parties to the dispute and the court. Had the Service not reached a settlement with the parties, it would have been required under the terms of the initial court order as well as its own procurement regulations to resolicit the procurement. Given the potential business risks from prolonging the procurement through a resolicitation, in particular the likelihood of further litigation and possible interruption of air service from changing contractors, we believe that the settlement was a reasonable course of action.

Appendix I includes additional information about the basis for the settlement and details of the various agreements among the parties to the litigation.

Scope and Methodology

We reviewed documents pertinent to the settlement, including the 1989, 1992, and 1994 air cargo contracts; offerors' technical and cost proposals for the new contract; Service documentation related to the evaluation of those proposals; agreements entered into by the parties to the settlement; the report of the management consultant who advised the Service about the settlement; and the Postal Service Procurement Manual. We reviewed trade literature and interviewed representatives of the Air Freight and Air Transport associations and the Boeing Aircraft Company about the general state of the air cargo industry at the time of the settlement. We also interviewed Service officials who were involved in the settlement. We did our work at Service headquarters in Washington, D.C., between June and December 1993 in accordance with generally accepted government auditing standards.

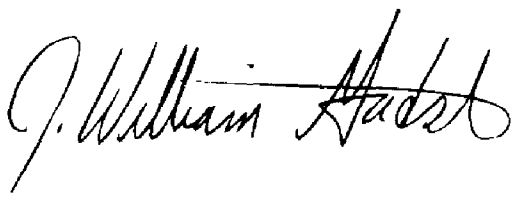
Agency Comments

The Postal Service's Chief Counsel for Purchasing and the Manager of Transportation Policies and Procedures reviewed a draft of this report. They agreed with its contents and suggested minor changes, which we incorporated where appropriate.

We are sending copies of this report to the Senate Committee on Governmental Affairs, the Postmaster General, the Postal Service Board of Governors, and other interested parties. Copies will also be made available to others on request.

The major contributors to the report are listed in appendix II. Please call me on (202) 512-8387 if you have any questions.

Sincerely yours,



J. William Gadsby
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Operations Issues

Contents

Letter		1
Appendix I Additional Information on the Settlement		8
	Was the Settlement in the Best Interest of the Postal Service, the Postal Ratepayer, and the American Public in Light of the Cost and Changing Circumstances in the Air Freight Industry?	8
	Was It Was Proper Contracting Procedure for the Postal Service to Award the Contract Without Resoliciting When the Contract Evaluation Process Was Found Flawed by the Court?	12
	What Are the Specifics of the Agreements Among the Parties?	13
Appendix II Major Contributors to This Report		15
Table	Table I.1: Estimated Resolicitation Costs	9

Additional Information on the Settlement

Was the Settlement in the Best Interest of the Postal Service, the Postal Ratepayer, and the American Public in Light of the Cost and Changing Circumstances in the Air Freight Industry?

An important factor bearing on the decision to settle or resolicit the procurement was the fact that Postal Air was entitled to recoup from the Postal Service its start-up expenses on the contract that was set aside. To help address this matter, the Postal Service engaged a management consulting firm that (1) evaluated the ability of the Service to mitigate the $38 million in claims that Postal Air said it would make under the termination provisions of the contract and (2) on the basis of that evaluation, analyzed the financial desirability of settling the procurement versus resoliciting it.

Most of the $38 million in potential termination costs reported by Postal Air related to the firm's commitment to purchase 23 Boeing 727 aircraft. Purchase agreements were entered into with two vendors on October 20 and October 22, 1992, according to copies provided to the Service by Postal Air.

The Service's consultant concluded that these planes would be difficult to dispose of if it were necessary for the Service to take possession of them under the termination provisions of the contract. Boeing 727 passenger planes, as these were configured, were in substantial excess supply in the marketplace. Demand and aircraft value were already depressed by weak world economies and were not expected to improve. Moreover, these planes had a higher operating cost than newer, more modern aircraft and were subject to increasingly stringent noise and emissions regulations that necessitated expensive retrofitting. The planes were believed to be more useful to the air express industry in a cargo configuration because cargo planes ordinarily operate fewer hours per day than passenger planes, and their higher hourly operating cost was therefore less of a factor. However, the consultant pointed out that although several hundred of these planes were in use in the growing air express industry, the major firms were adding to their fleets larger or different aircraft than the 727.

The consultant concluded that there were unlikely to be more than a few purchases of such aircraft in the near future and that buyers would likely seek substantially discounted prices. The consultant suggested that if a settlement of the disputed contract could not be reached, bidders to a new contract could be required or induced to use the planes as part of their proposals.

The consultant then estimated that a resolicitation would be financially more attractive to the Service if the new contract price were less than $82.6 million annually. This amount was derived by comparing the cost of

the proposed settlement, which was known, with the estimated cost of a resolicitation. The annual cost of settlement over 10 years was $89 million—$88 million for the new Emery contract plus one-tenth of the $10 million[2] settlement payment to Postal Air. Resolicitation costs, exclusive of the cost of a new contract, were estimated to be $64 million. This estimate is broken down in table I.1.

Table I.1: Estimated Resolicitation Costs

Dollars in millions

Nature of cost	Amount
Postal Air termination liability	$38
Claims by other offerors for proposal preparation	4
Additional commercial airlift	18
Interim airlift network	1
Litigation on hub terminal contract	1
Contract resolicitation process	2
Total estimate	**$64**

Source: U.S. Postal Service.

Postal Air Termination Costs and Claims by Offerors for Proposal Preparation

As discussed previously, Postal Air reported that its termination costs under the set-aside contract would be $38 million. Of this amount, $33.1 million related to aircraft that Postal Air had agreed to purchase. The consultant did not include in the cost comparison any estimate for the value of the planes but did note in its report that perhaps 25 percent could be recovered by selling the planes for parts or scrap. Had the consultant factored in a recovery value of 25 percent for the aircraft, the estimated termination costs would have been about $30 million instead of $38 million.

The consultant assumed that the other offerors to the solicitation would also attempt to recover their proposal preparation costs from the Service. These were estimated to amount to about $4 million.

Commercial Airlift and Interim Network Costs

The new contract was to provide for more airlift capacity than the existing contract, and the Service intends to use the extra capacity to divert mail from commercial airlines. An estimated $18 million in commercial airlift costs would be avoided if the Service could settle and begin operations under the new contract in August 1993, as compared to delaying another

[2]This was not the present value of the $10 million.

year to complete another solicitation. Similarly, the $1 million for interim network airlift costs was judged to be the minimum additional cost that the Service would incur for an emergency network during the 1 year needed to resolicit. Extending the existing contract with Emery was considered to be more expensive and unlikely in the event there was no settlement.

We noted that, as events turned out, operations under the new Emery contract were also delayed beyond August 1993. Negotiation between Emery and the aircraft vendors to settle the previous Postal Air agreements took longer than expected, and this would have delayed start-up until late October or November 1993. The Postal Service decided that an October or November start-up would put performance at risk for the Christmas mailing period and moved the effective date to January 1994.

For the cost comparison, the delay of at least 4 months under settlement, from August 1993 until January 1994, meant that resolicitation would have required an 8-month delay instead of 1 year. The $18 million estimate for commercial airlift and the $1 million for interim network airlift costs can be reduced accordingly, to about $12 million.

Litigation on Hub Terminal Contract and Resolicitation Cost

Emery had also filed a suit against the Postal Service over a separate procurement to operate the terminal hub. Withdrawal of that suit was part of the settlement. The consultant assumed that resolicitation for air transportation would result in additional litigation over the hub operation, costing the Service $1 million. The consultant also estimated that resolicitation for air transportation would cost the Service $2 million for legal and consulting fees, time spent by postal personnel, and other costs.

Proration of the estimated $64 million resolicitation cost over the 10-year life of the contract by the consultant resulted in an estimated resolicitation cost of $6.4 million per year. Subtracting this amount from the annual cost of the settlement option, which, as noted above, was $89 million, suggested that a resolicited contract of less than $82.6 million[3] would be more beneficial than settling. The consultant cited several reasons why it was unlikely that a technically acceptable offer could be obtained for that amount.

[3]This breakeven price was based on 1993 dollars. Taking into account the present value of cash payments that would not be made until later years, the consultant calculated that the breakeven price would be slightly less, at $81.7 million.

The consultant believed that because of the publicity of this litigation, the industry was aware of the bids that had been submitted. Therefore, offerors would probably make new proposals in the middle or upper part of the range bounded by the Postal Air contract amount of $80 million and Emery's offer of $91.8 million.

Only one of the four final offers, Postal Air's, was below the $88 million settlement price. Before the court suspended the contract, Postal Air was having difficulty obtaining aircraft that conformed to the proposal by the scheduled start-up date. The consultant believed that Postal Air's negotiated price of $80 million could have adversely affected the company's ability to secure financing for aircraft and other equipment. There was little reason to believe that a responsible offeror would enter into a contract at a price that would jeopardize its ability to operate the network reliably and profitably.

The consultant reviewed the cost proposals of the original offerors and concluded that there was not much fat in them, given the magnitude of fixed costs and relatively modest percentages proposed for profit and general and administrative expenses. Finally, the consultant noted that the $88 million settlement price was $1 million less than the benchmark cost estimated as reasonable and justifiable prior to submission of proposals.

As discussed previously, certain of the estimated resolicitation costs could arguably have been expected to be less than the amounts used in the cost comparison. These include $30 million instead of $38 million for Postal Air termination costs and $12 million instead of $18 million for commercial airlift costs. The total difference, $14 million, when considered over the life of the new 10-year contract, amounts to $1.4 million a year. This, in turn, would increase the breakeven value of the resolicitation from $82.6 million to $84 million. We agree with the consultant and the Service that this difference was not large enough to alter the conclusion from the financial analysis. We did not, however, verify the consultant's estimates.

The Service also pointed out some nonmonetary factors that it believed were important reasons for settling:

- Under settlement, the network would continue to be flown without interruption by a contractor of proven reliability. However, resolicitation could require an interim contract and the possibility of changing contractors three times (Emery, an interim contractor, and a new contractor) in about a year, which would put performance at risk.

- Settlement would avoid further litigation, which was believed inevitable if there were another solicitation for air service.

With regard to changing costs and circumstances in the air freight industry, a review of the trade literature and discussions with representatives of the Air Freight and Air Transport associations and the Boeing Aircraft Market Research Group revealed no indication of an apparent change in the air freight market or availability of aircraft between the time of the original award in September 1992 and settlement in April 1993 that would have made a resolicitation preferable to settlement.

Was It Was Proper Contracting Procedure for the Postal Service to Award the Contract Without Resoliciting When the Contract Evaluation Process Was Found Flawed by the Court?

To answer this question, we looked at whether the Service followed proper procedures in resolving a conflict-of-interest situation that existed when the offers were evaluated; we also looked at how the Service and the court settled the matter.

In this procurement, contracting procedures were violated when the Service failed to correct a conflict-of-interest situation that occurred when the offers were being evaluated. Specifically, an aircraft maintenance expert employed by a consulting firm that was helping the Service evaluate the awards received an invitation to a job interview by an owner of Postal Air, which later won the contract. The individual disclosed this to the contracting officer for this procurement. However, contrary to advice from the Service's legal department, the contracting officer did not require that the employee be removed from his position or refuse the job interview. The court overturned the award based on the conflict of interest and the inability of the Service to provide a rational explanation of its failure to eliminate the conflict. The court also ordered the Postal Service to request the parties in the litigation (Emery, Express One, and Postal Air) to submit new proposals for evaluation.

Subsequent to the court's order to the Service to request and evaluate new proposals, the parties to the litigation negotiated a settlement. The Service analyzed the settlement, as described previously, and concluded that it offered a savings in time and money and less chance of interrupting service than a resolicitation. Because of the high dollar value of the contract, the settlement was reviewed and approved by the Attorney General before it was submitted to the court, which amended its previous order to approve the settlement.

There is no doubt that this procurement was seriously flawed as a result of the decision by the Service to ignore the advice of its own legal counsel and to award the contract notwithstanding a clear conflict of interest that was not corrected. However, after the federal district court overturned the award and ordered the Service to resolicit the procurement, the decision of the Service to resolve the litigation through a court-approved settlement with the parties to the litigation was not unreasonable in our view. By entering into the settlement, the Service was able to satisfy its own needs and the legitimate interests of the parties to the dispute and the court. Had the Service not reached a settlement with the parties, it would have been required under the terms of the initial court order as well as its own procurement regulations to resolicit the procurement.

What Are the Specifics of the Agreements Among the Parties?

The April 15, 1993, court order, which defined the overall settlement, made effective several other agreements among the parties to the litigation. The major points in these agreements are discussed next.

Postal Service and Postal Air

On April 7, 1993, an amendment was issued to the Postal Air contract, terminating it for the Service's convenience. The amendment called for the Service to make a one-time payment of $10 million to Postal Air for full and final settlement of the contract. Postal Air released the Service from all claims relating to the litigation.

Postal Service and Emery

On April 12, 1993, the Service accepted (contingent on the court's approval) Emery's proposal of $88 million per year, $3.8 million less than its earlier $91.8 million offer to the solicitation. The main items contributing to the difference were about $5 million less in the contract for aircraft costs and about $1.6 million more for aircraft maintenance.

The contract became effective on January 10, 1994, 1 year later than contemplated in the initial procurement, and about 9 months after the settlement. As discussed previously, part of the delay was due to negotiations between Emery and the aircraft suppliers plus a decision by the Postal Service not to begin operations during the Christmas mailing period. The contract provided for the same number of aircraft and service as the initial proposal.

Emery and Express One

On March 15, 1993, Express One International entered into a subcontract with Emery to provide air transportation service over four of the routes and operate seven aircraft under Emery's contract with the Postal Service.

Emery and Postal Air

On March 23, 1993, Emery and Postal Air signed an agreement that settled the litigation issues between them. Emery agreed to pay Postal Air $2 million initially and $162,500 each quarter over a 10-year period beginning in October 1993. Emery also agreed to deliver releases by American Airlines and Caldwell Aircraft Trading Company of claims that those vendors had against Postal Air arising from Postal Air's earlier agreements to buy 23 aircraft from them. Postal Air had agreed in October 1992 to buy 7 planes from American for $14.25 million and 16 from Caldwell for $17.6 million. These agreements were made before the court set aside the award and were never fulfilled. Emery also agreed to obtain a refund of Postal Air's $700,000 deposit from American.

Postal Air agreed to release all claims it made against American, Caldwell, Emery, Express One, and Ryan Airlines, another Emery subcontractor.

Emery and American Airlines

On March 24, 1993, Emery and American Airlines signed a letter of intent for Emery to purchase from American seven Boeing 727 planes for $10.2 million. Six of the seven were the same planes that Postal Air had agreed to buy in October 1992. A purchase agreement was made on April 1, 1993, between Emery and American for the planes at the amount in the letter of intent. American agreed to refund Postal Air's deposit of $700,000, without interest, and to release Postal Air from that agreement and all other claims.

Emery and Caldwell Aircraft Trading Company

On March 26, 1993, Emery and Caldwell entered into an agreement whereby Emery would purchase from Caldwell 8 of the 16 Boeing 727 aircraft that Postal Air agreed to buy in October 1992. Emery agreed to pay $8.8 million for the planes plus $2.5 million for maintenance, storage, insurance, attorneys' fees, and administrative costs that Caldwell incurred because Postal Air failed to take delivery of the aircraft. The agreement also included $500,000 to hold the aircraft until April 26, 1993, the estimated date of the court settlement, and options to extend the agreement until May 14, 1993, for $250,000 plus additional 15-day extensions at $250,000 each.

Major Contributors to This Report

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