

BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, D.C. 20268-0001

POSTAL RATE AND FEE CHANGES

Docket No. R2006-1

RESPONSES OF THE UNITED STATES POSTAL SERVICE
TO INTERROGATORIES OF NEWSPAPER ASSOCIATION OF AMERICA
(NAA/USPS-5-6)

The United States Postal Service hereby files its responses to the above listed interrogatories, filed on June 29, 2006.

Each interrogatory is stated verbatim and is followed by the response.

Respectfully submitted,

UNITED STATES POSTAL SERVICE

By its attorneys:

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July 13, 2006

**RESPONSE OF THE UNITED STATES POSTAL SERVICE
TO INTERROGATORY OF NEWSPAPER ASSOCIATION OF AMERICA**

NAA/USPS-5: Please provide a copy of OIG report AC-AR-03006 (dated September 29, 2003).

RESPONSE:

See attached.

September 29, 2003

PATRICK R. DONAHOE
CHIEF OPERATING OFFICER AND EXECUTIVE VICE PRESIDENT

SUBJECT: Audit Report – Enhanced Carrier Route Standard Mail Worksharing
Discounts (Report Number AC-AR-03-006)

This report presents the results of our audit on Enhanced Carrier Route Standard Mail Worksharing Discounts (Project Number 02YG018AC000). This audit was initiated as a result of a congressional inquiry at the San Antonio Processing and Distribution Center.

Our audit disclosed that Enhanced Carrier Route Standard Mail covered all of its volume variable costs in fiscal year 2001. According to the Postal Service's Cost and Revenue Analysis Report, Enhanced Carrier Route Standard Mail cost coverage was over 200 percent, one of the largest for all mail categories. Our review indicated the operational benefits of Enhanced Carrier Route letters has been reduced as the volume of letters processed to delivery point sequence has increased. Postal Service officials stated Enhanced Carrier Route Standard Mail improved Postal Service operations by providing flexibility in mail processing and delivery and increased reliability. However, we found that mailers' worksharing efforts to sequence Enhanced Carrier Route letters was not necessary when the Postal Service subsequently processed these letters in delivery point sequence. We also found that the Postal Service's delivery point sequencing of Enhanced Carrier Route letter mail with destination delivery unit discounts resulted in transportation and handling inefficiencies for the Postal Service.

Our report acknowledged the complexity of these issues involving Enhanced Carrier Route Standard Mail. We determined it was best to defer action on some of these issues until the Postal Service's plans to automate flat sorting to delivery point sequence are finalized. We made one recommendation that management develop a rate case proposal to eliminate destination entry discounts for letters destinating at delivery units that receive delivery point sequenced mail processed on delivery barcode sorters. Management agreed that it was advantageous to have mail entered at the location in which it will be processed, but disagreed with our recommendation. Management was not convinced of the magnitude of the problem and believed that a change in one rate category may yield changes in other rate categories that may be counter-productive due to the complexity of Enhanced Carrier Route rate design. Management indicated they were reviewing these issues and planned to develop a balanced rate proposal to address these issues appropriately. Management

subsequently provided additional documentation that stated they expect to complete their review in advance of the next Omnibus Rate Case. Therefore, we consider management's planned actions responsive to the intent of our recommendation. Management's comments and our evaluation of these comments are included in the report.

The Office of Inspector General (OIG) considers recommendation 1 significant and, therefore, requires OIG concurrence before closure. Consequently, the OIG requests written confirmation when corrective actions are completed. This recommendation should not be closed in the follow-up tracking system until the OIG provides written confirmation that the recommendation can be closed.

We appreciate the cooperation and courtesies provided by your staff during our audit. If you have any questions or need additional information, please contact Robert J. Batta, director, Accepting and Processing, at (703) 248-2269 or me at (703) 248-2300.

Mary W. Demory
Deputy Assistant Inspector General
for Core Operations

Attachment

cc: Anita J. Bizzotto
John A. Rapp
Susan M. Duchek

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EXECUTIVE SUMMARY

Introduction

This report presents the results of our review of Enhanced Carrier Route Standard Mail worksharing discounts. This audit was initiated as a result of a congressional inquiry at the San Antonio Processing and Distribution Center. The objectives of the audit were to determine whether Enhanced Carrier Route Standard Mail rates cover all volume variable costs; letter-shaped Enhanced Carrier Route Standard Mail improve mail-processing operations; and letter-shaped Enhanced Carrier Route Standard Mail, which was discounted for being transported to Postal Service facilities for delivery, was being shipped from these delivery units to mail processing facilities for additional processing. We also examined the methodology for determining workshare discounts.

Results in Brief

Our audit disclosed that Enhanced Carrier Route Standard Mail covered all volume variable costs in fiscal year 2001. According to the Postal Service's Cost and Revenue Analysis Report, Enhanced Carrier Route Standard Mail cost coverage was over 200 percent, one of the largest for all mail categories.

Our review indicated the operational benefits of Enhanced Carrier Route letters has been reduced as the volume of letters processed in delivery point sequence¹ has increased. We found that mailers' worksharing efforts to sequence Enhanced Carrier Route letters was not necessary when the Postal Service subsequently processed these letters in delivery point sequence. In Rate Docket Number R2001-1, Postal Service officials stated that automation-compatible² mail processed in delivery point sequence on delivery barcode sorters needs only to be sorted to the five-digit ZIP Code, so carrier route sortation provides no added value in these situations.

In addition, Enhanced Carrier Route letter mail that was discounted for direct shipment to delivery units was then sometimes transported to mail processing facilities by the Postal Service to be processed in delivery point sequence. This mail was then shipped back to the delivery unit resulting in additional transportation and handling inefficiencies. We

¹ Delivery point sequencing is a process that uses a delivery point barcode on letter mail that enables automation sorting equipment to process this mail to the delivery point level prior to presentation to the carrier.

² Mail that can be scanned and processed by automated mail-processing equipment, such as a barcode sorter, Postal Service Publication 32.

believe this practice is questionable when you consider the destination entry discount was designed to save the Postal Service these transportation and handling costs.

**Summary of
Recommendations**

We recommend management develop a rate case proposal to eliminate destination entry discounts for letters destinating at delivery units that receive delivery point sequenced letter mail processed on delivery barcode sorters.

**Summary of
Management's
Comments**

Management agreed that it was advantageous to have mail entered at the location in which it will be processed, but disagreed with our recommendation. Management was not convinced of the magnitude of the problem and believed that a change in one rate category may yield changes in other rate categories that may be counter-productive due to the complexity of Enhanced Carrier Route rate design. Management indicated they were reviewing these issues and planned to develop a balanced rate proposal to address these issues appropriately. Management's comments, in their entirety, are included in Appendix B of this report.

**Overall Evaluation of
Management's
Comments**

Our report acknowledged the complexity of these issues involving Enhanced Carrier Route Standard Mail. Management stated these issues existed since the mid-1990's and that they were in the process of reviewing them; however, they did not provide any detailed information on when their review would be completed. Management subsequently provided additional documentation that stated they expect to complete their review in advance of the next Omnibus Rate Case. Management's actions taken or planned are responsive to the recommendation and should correct the issues identified in the report.

INTRODUCTION

Background

Worksharing allows mailers to select the activities they wish to perform for the Postal Service in return for postage rate discounts. These activities include sorting the mail by ZIP Code or carrier route, applying a barcode representing the ZIP Code information for the delivery address on a mailpiece, and transporting a mailing to a Postal Service facility near the delivery address.

Enhanced Carrier Route Standard Mail is a subclass of Standard Mail consisting of mailpieces weighing less than 16 ounces and prepared for the carrier in walk sequence of the route. The Enhanced Carrier Route subclass was created in July 1996 from the third-class mail bulk rate regular subclass. This subclass was created to recognize the distinct cost and market characteristics of this mail.

Enhanced Carrier Route Standard Mail consists primarily of geographically targeted advertisements, which include letter-size³ and flat-size⁴ mail. The shape of these mailpieces impact how this mail is processed. Most Enhanced Carrier Route letter mail that is automation-compatible is merged with other letters being placed in delivery point sequence. The Postal Service does not currently sequence flats in delivery order, but initiatives are planned to automate flat-sorting to delivery sequence.

During fiscal year (FY) 2001,⁵ the Postal Service reported that it received \$4.98 billion from Enhanced Carrier Route Standard Mail.⁶ Letters accounted for approximately \$1.29 billion and flats accounted for approximately \$3.69 billion of Enhanced Carrier Route Standard Mail revenues.

³ Letter-size mail is a mail-processing category of mailpieces that do not exceed any of the dimensions for letter-size mail (11.5 inches long, 6.125 inches high, .25 inches thick).

⁴ Flat-size mail is a mail-processing category of mailpieces that exceed one of the dimensions for letter-size mail, but does not exceed 15 inches long, 12 inches high, .75 inches thick.

⁵ The Office of Inspector General (OIG) planned to use the most recent data available during the review. While some FY 2002 data was available, the finalized billing determinants were not available. As a result, the OIG used FY 2001 data throughout the report for consistency.

⁶ Enhanced Carrier Route Standard Mail includes Standard Mail Nonprofit Enhanced Carrier Route and Standard Mail Regular Enhanced Carrier Route, Cost and Revenue Analysis, FY 2001.

Discounts for Enhanced Carrier Route Standard Mail are extremely complex. The Postal Service offers presort rates by density tier, automation rates, drop ship rates,⁷ and letter/flat rate differentials to mailers who share the workload. Enhanced Carrier Route Standard Mail requires a high level of sortation as the mailer arranges the mail in carrier route sequence. In addition, the Postal Service must maintain reasonable rate relationships between mail categories in this subclass, and mail categories in other subclasses.

Enhanced Carrier Route Standard Mail rates are among the lowest that the Postal Service offers. Table 1 compares some current rates for workshared Standard Mail.⁸

Table 1. Worksharing Discounts for Standard Mail (Cents)

Categories of Standard Mail			
Rate in Cents			
Amount of Discount			
Discount Percentage			
Regular Standard Mail			
Basic letter	26.8	-	Benchmark for letters
Five-digit letter	19.0	7.8	29.1
Five-digit letter entered at the destination sectional center facility	16.4	10.4	38.8
Basic flat	34.4	-	Benchmark for flats
Enhanced Carrier Route			
Basic letter	19.4	7.4	27.6
Saturation letter	15.2	11.6	43.3
Saturation letter entered at the destination delivery unit	12.0	14.8	55.2
Basic flat	19.4	15.0	43.6
Saturation flat	16.0	18.4	53.5
Saturation flat entered at the destination delivery unit	12.8	21.6	62.8

Source: USPS 123 Ratefold, effective June 30, 2002.

⁷ Drop shipment rates reflect savings that occur when a mailing is transported by a mailer or private carrier from the point of production to a Postal Service facility located closer to the destination, thereby bypassing handling operations.

⁸ This comparison is not meant to imply that there is a direct relationship between the Enhanced Carrier Route rates and regular Standard Mail rates.

**Objectives, Scope,
and Methodology**

The objectives of the audit were:

- To determine whether Enhanced Carrier Route Standard Mail rates cover all volume variable costs.
- To determine whether letter-shaped Enhanced Carrier Route Standard Mail improve mail-processing operations.
- To determine whether letter-shaped Enhanced Carrier Route Standard Mail, which was discounted for being transported to Postal Service facilities for delivery, was being shipped from these delivery units to mail processing facilities for additional processing.
- To examine the methodology for determining workshare discounts.

To accomplish our objectives, we reviewed Postal Service and Postal Rate Commission documentation used to support rate cases. Our review focused on letter-shaped Enhanced Carrier Route Standard Mail. We also reviewed policies and procedures used to process Enhanced Carrier Route Standard Mail. We interviewed officials at Postal Service Headquarters, at the Postal Rate Commission, and at selected Postal Service delivery units.

To assess whether Postal Service handling of letter drop shipments receiving Enhanced Carrier Route workshare discounts was consistent with the discount offered, we conducted a telephone survey where we sampled 237 delivery units⁹ from the audit universe consisting of 14,201 revenue generating units in cost ascertainment groups A through G.¹⁰ This telephone survey was conducted between November 20, 2002, and January 30, 2003.

The General Accounting Office also initiated a review that included an examination of the methodology used for determining workshare discounts. Therefore, to avoid

⁹ From the sample of 237 delivery units, we determined that 59 delivery units were not within the audit scope. Therefore, from the 178 within the scope, we projected an audit subpopulation of 10,666 delivery units, with a 95 percent confidence interval of 9,889 to 11,443.

¹⁰ Cost ascertainment groups A through G include post offices generating the most revenue.

duplication, we did not examine the methodology for determining workshare discounts for Enhanced Carrier Route Standard Mail.

This audit was conducted from July 2002 through September 2003, in accordance with generally accepted government auditing standards and included such tests of internal controls as were considered necessary under the circumstances. We discussed our conclusions and observations with appropriate management officials and included their comments, where appropriate.

Prior Audit Coverage

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

AUDIT RESULTS

**Enhanced Carrier
Route Standard Mail
Covers Volume
Variable Costs**

Enhanced Carrier Route Standard Mail covered all of its volume variable costs in FY 2001. According to the Postal Service's Cost and Revenue Analysis Report, Enhanced Carrier Route Standard Mail cost coverage is over 200 percent, one of the largest for all mail categories. Cost coverage shows the ratio of revenue over volume variable costs. Table 2 shows revenue and cost coverage for various categories of mail for FY 2001.

Table 2. Summary of Revenue and Percent of Cost Coverage

Categories of Mail (in millions)	Revenue	Percent of Cost Coverage
First-Class Presort Letters	13,224.1	278.00%
Enhanced Carrier Route Standard Mail	4,980.5	233.17%
First-Class Single Piece Letters	21,451.4	173.48%
Priority Mail	4,916.1	151.25%
Regular Standard Mail	10,636.0	135.43%
International Mail	1,769.3	132.17%
Parcel Post	1,128.4	104.76%

Source: Cost and Revenue Analysis for FY 2001.

The Postal Reorganization Act of 1970 specifies that each class of mail or type of mail service should bear the direct and indirect costs attributable to it. However, Postal Service revenue and cost accounting systems generally do not provide revenue and cost information at the rate category level. Therefore, various statistical systems and special studies are needed to develop estimates of volumes, revenues, and costs for categories of mail. These estimates are used to prepare rate cases and budgets, conduct cost studies, and measure mail flow and service performance. The OIG report, Audit of Statistical Test for

Fiscal Year 2001 - Cost and Revenue Analysis (Report Number FF-AR-02-206, dated March 27, 2002), found that, generally, statistical tests to collect cost, revenue, and volume data were performed in accordance with policies and procedures established by the Postal Service.

**Reduced Operational
Benefits from
Enhanced Carrier
Route Letters**

Our review indicated that the operational benefits of Enhanced Carrier Route letters has been reduced as the volume of letters processed in delivery point sequence has increased. We found that mailers' worksharing efforts to sequence Enhanced Carrier Route letters were not necessary when the Postal Service subsequently processed these letters in delivery point sequence.

This condition exists because of the current Postal Service policy, which requires automation-compatible letter mail to be processed in delivery point sequence, service standards permitting. However, in Rate Docket Number R2001-1, Postal Service officials stated, automation-compatible mail that was processed in delivery point sequence on delivery barcode sorters only needs to be sorted to the five-digit ZIP Code; therefore, carrier route sortation provides no added value in these situations.

Postal Service criteria for processing Enhanced Carrier Route letter mail to delivery point sequence is included in an August 9, 2000, memorandum issued by the vice presidents, Delivery, and Operations Planning and Processing. These instructions require automation-compatible Enhanced Carrier Route letter mail to be processed in delivery point sequence, service standards permitting.

Postal Service officials stated that Enhanced Carrier Route Standard Mail improved Postal Service operations by providing flexibility in mail processing and delivery, and increased reliability. We agree that Enhanced Carrier Route letter mail is beneficial at delivery units that do not receive delivery point sequenced mail; however, most letter mail is sorted in delivery point sequence.

Future advances in automated mail processing are likely to further reduce the operational benefits from Enhanced Carrier Route Standard Mail. The Postal Service is developing a strategy to automate flat-sorting to delivery point sequence. These efforts are modeled after the Corporate Automation Plan for letters. In addition, Postal Service officials stated that their long-term vision for delivery operations was to include mixed letters and flats in one bundle for each delivery point. In our opinion, these

initiatives will further reduce the operational benefits of Enhanced Carrier Route Standard Mail.

In the 1995 Mail Classification Docket, the Postal Service expressed concern that establishing an Enhanced Carrier Route letter rate would be counterproductive to the Postal Service's letter mail automation program. However, the Postal Rate Commission recommended that both letter and flat carrier route categories were necessary to promote more cost-based rates. The Board of Governors approved the Postal Rate Commission's recommendation in March 1996.

Due to the complexity of these issues and the potential for rate anomalies, we believe it is best to defer action on this finding until the Postal Service's plans to automate flat sorting to delivery point sequence are finalized. This will give the Postal Service time to complete its analysis and develop proposals to address this complicated issue.

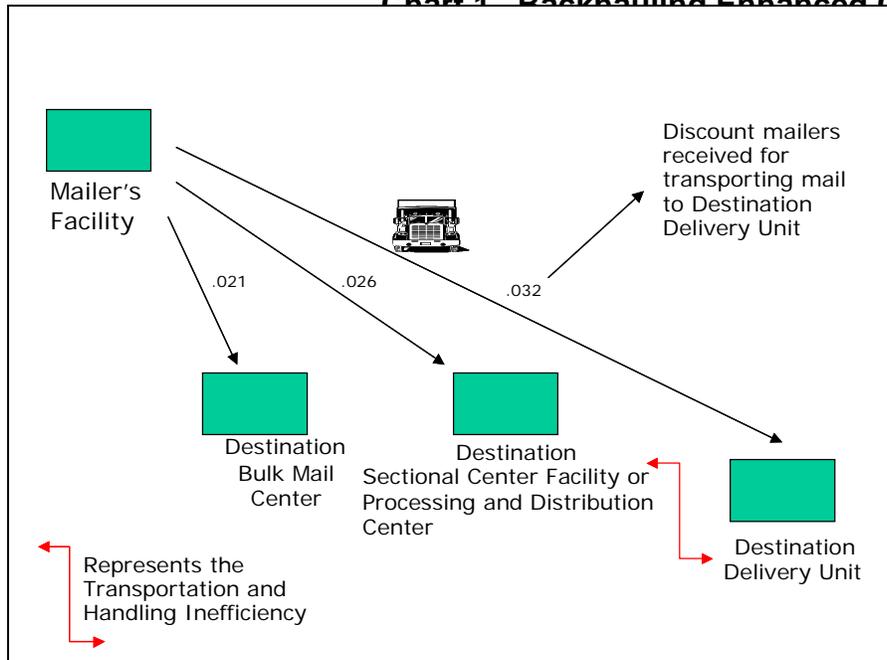
**Transportation and
Handling
Inefficiencies**

Enhanced Carrier Route letter mail discounted for direct shipment to delivery units was then sometimes transported to mail processing facilities by the Postal Service to be processed with other letters into delivery point sequence. The Postal Service subsequently shipped this mail back to the delivery units. Our projections show that this condition existed in approximately 2,337 of the approximately 3,296 delivery units in our audit universe that received both delivery point sequenced mail and drop shipments.¹¹

This condition exists because current Postal Service policy requires Enhanced Carrier Route letter mail to be processed in delivery point sequence, service standards permitting. The Postal Service offered the mailer a destination delivery unit discount to transport the mail closer to its final destination; however, the Postal Service transported most of this mail to processing facilities to be sorted in delivery point sequence. Then this mail was shipped back to the delivery unit resulting in additional costs to the Postal Service. Chart 1 shows the backhauling of this mail along with the resulting transportation and handling inefficiency. We believe this practice is questionable when you consider the destination entry discount was designed to save the Postal Service transportation and handling costs.

¹¹ Both projected values indicated in the text are point estimates at the 95 percent confidence level. We project that 2,537 to 4,054 delivery units receive both delivery point sequenced mail and letter drop shipments. We also project that 1,671 to 3,003 of the delivery units that receive delivery point sequenced mail and letter drop shipments, then transport the Enhanced Carrier Route letters to processing facilities.

Chart 1. Backhauling Enhanced Carrier Route Mail for Processing



Postal Service policy states that automation-compatible Enhanced Carrier Route letter mail received at delivery units should be sent to the applicable processing and distribution center to be processed in delivery point sequence when service standards permit. During FY 2001, mailers transported approximately 1.56 billion Enhanced Carrier Route letter mailpieces directly to delivery units. However, Postal Service officials were unable to determine the volume or the cost of transporting Enhanced Carrier Route letter mail from delivery units to processing facilities.

Recommendation

We recommend the chief operating officer and executive vice president:

1. Develop a rate case proposal to eliminate destination entry discounts for letters destinating at delivery units that receive delivery point sequenced mail that was processed on delivery barcode sorters.

**Management's
Comments**

Management agreed that it was advantageous to have mail entered at the location in which it will be processed, but disagreed with our recommendation. Management was not convinced of the magnitude of the problem and believed that a change in one rate category may yield changes in other rate categories that may be counter-productive due to the complexity of Enhanced Carrier Route rate design. Management indicated they were reviewing these issues and planned to develop a balanced rate proposal to address these issues appropriately

**Evaluation of
Management's
Comments**

Our report acknowledged the complexity of these issues involving Enhanced Carrier Route Standard Mail. Management stated these issues existed since the mid-1990's and that they were in the process of reviewing them; however, they did not provide any detailed information on when their review would be completed. Management subsequently provided additional documentation that stated they expect to complete their review in advance of the next Omnibus Rate Case. Management's actions taken or planned should correct the issues identified in the report.

**Other Matters of
Concern**

Internal controls over the acceptance of Enhanced Carrier Route Standard Mail need improvement. At the time of our review, Postal Service employees were not verifying whether Enhanced Carrier Route Standard Mail was in the correct sequence at the time of acceptance. While some Postal Service facilities have Mailing Evaluation, Readability, and Lookup Instruments to aid them in the verification process for discounted mail, the Enhanced Carrier Route sequence verification was not operational. In addition, current OIG audits of Mailing Evaluation, Readability, and Lookup Instruments have identified problems with underutilization, system operations, and operator training that impact the quantity and quality of verifications.

Postal Service Form 3749, Mail Irregularity Report, designed to improve the quality of business mailings was not an effective tool. This form is used to report serious quality issues, such as unreadable barcodes, broken bundles, mislabeled trays, and carrier route mail out of sequence. Postal Service officials acknowledge that Postal Service Form 3749 has not worked well and are developing an electronic mail irregularity reporting process using Postal ONE.

APPENDIX A. OIG'S RESPONSE TO MANAGEMENT'S COMMENTS

We appreciate management's response to our draft report. Management disagreed with the OIG recommendation and stated that the report content and its conclusions were misleading. The following presents management's comments and OIG's evaluation of management's comment. We reference management's comments to the appropriate sections in Appendix B:

1. The Postal Service indicated that OIG report concludes that Postal Service efforts to delivery point sequence letters "eliminate the value" of mailer pre-sequencing of Enhanced Carrier Route letters. (See Appendix B, page 1, paragraph 1.)

OIG Response: The OIG report on page 7 indicated that the operational benefits of Enhanced Carrier Route letters has been reduced as the volume of letters processed to delivery point sequence has increased. The report does not mention, "eliminate the value." The OIG report, page 7, states that Enhanced Carrier Route letters provide flexibility in mail processing and delivery, and increased reliability. In addition, we state that Enhanced Carrier Route letters are beneficial at delivery units that do not receive delivery point sequenced mail.

2. The Enhanced Carrier Route is a subclass and not a worksharing discount. (For the full management comment – see Appendix B, page 1, paragraph 5.)

OIG Response: The OIG report states that Enhanced Carrier Route Standard Mail is a subclass of standard mail on page 1, paragraph 2. The Postal Service does acknowledge that there are worksharing discounts within the Enhanced Carrier Route subclass.

3. Enhanced Carrier Route costs are tally-based and reflect current mail processing and transportation activities. The overall costs for Enhanced Carrier Route mail, therefore, include the cost of both processing and transportation efficiencies and inefficiencies; these costs are reflected in the prices. (For the full management comment – see Appendix B, page 1, paragraph 5, and Attachment, page 1, paragraph 2.)

OIG Response: The intent of our finding and recommendation was to identify and attempt to address an inefficiency that has existed since the mid-1990s. Even though this inefficiency may be reflected in prices, efforts should be initiated to address this issue.

4. Postal Service operational instructions have been mischaracterized. Our major concern when the instruction was issued was capturing the Enhanced Carrier Route mail as it passed through the plants and, where feasible, routing it through

automated processing if service standards permit. (For the full management comment – see Appendix B, page 1, paragraph 5.)

OIG Response: The focus of this OIG finding concerned Enhanced Carrier Route letters with destination entry discounts. We agree that the operational instructions had other impacts, but our focus was limited to the issue described.

5. Management is not convinced of the magnitude of the alleged problem. The OIG report fails to estimate both the volume of Destination Delivery Unit-entered Enhanced Carrier Route letters that are backhauled or the average frequency of backhauling per Destination Delivery Unit. (For the full management comment – see Appendix A, page 1, paragraph 5, and Attachment, page 2, paragraph 7.)

OIG Response: The OIG report states on page 10 that Postal Service officials were unable to determine the volume or cost of transporting Enhanced Carrier Route letters from delivery units to processing facilities.

6. Postal rates are price signals to mailers. It must be recognized that, due to the complexity of Enhanced Carrier Route rate design, a change in one rate category may yield price signals in other rate categories that may be counter-productive. (For the full management comment – see Appendix A, page 1, paragraph 5.)

OIG Response: The OIG report describes the complexity of Enhanced Carrier Route Standard Mail issues on page 2 of the report. The report states that discounts for Enhanced Carrier Route Standard Mail are extremely complex and the Postal Service must maintain reasonable rate relationships not only between mail categories in this subclass, but also with mail categories in other subclasses. In addition, on page 8 we state that due to the complexity of these issues and the potential for rate anomalies, the Postal Service should be given time to complete its analysis and develop proposals to address this complicated issue.

7. The comparisons between Enhanced Carrier Route rates and presorted Standard Mail rates contained in Table 1 are misleading.

OIG Response: The introduction to table 1 states that the table compares some rates for workshared Standard Mail. Footnote 8 further clarifies that this comparison is not meant to imply a direct relationship between Enhanced Carrier Route Standard Mail rates and regular Standard Mail rates.

APPENDIX B. MANAGEMENT'S COMMENTS

PATRICK R. DONAHOE
CHIEF OPERATING OFFICER
AND EXECUTIVE VICE PRESIDENT



August 8, 2003

MARY W. DEMORY
DEPUTY ASSISTANT INSPECTOR GENERAL FOR CORE OPERATIONS

SUBJECT: Management Response to Draft Audit Report – Enhanced Carrier Route
Worksharing Discounts (Report Number AC-AR-03-DRAFT)

Thank you for the opportunity to respond to the above-captioned draft audit report. In that report, the Office of Inspector General (OIG) concludes that Postal Service efforts to delivery point sequence (DPS) letters eliminate the value of mailer pre-sequencing of Enhanced Carrier Route (ECR) letters. In particular, the OIG focuses on ECR letter mail entered at the destination delivery unit (DDU), which is subsequently backhauled to a plant for “DPS-ing,” resulting in additional transportation and handling inefficiencies.

The issues raised in the draft audit report concerning delivery point sequencing and backhauling of some ECR letter mail are not new. Both the Postal Service and the ECR mailers have been aware of this situation for some time. Rate changes, such as those advocated in the audit recommendations, result from a statutory scheme in which Postal Service proposals are subject to the recommendations and guidance of the independent Postal Rate Commission. Under the Postal Reorganization Act, decisions of the Governors and the Commission are subject to review and modification in the courts or otherwise only in accordance with the procedures outlined in the Act.

In fact, the issues raised in the audit were discussed as far back as the mid-1990s, when policies to support the DPS program were discussed in the Classification Reform case, Docket No. MC95-1. As evidenced in that docket, and in every rate case since then, the Postal Service continuously reviews the impact of operational enhancements on its rate and classification structure.

Because the Postal Service was aware of the issues raised in the draft audit report, it had been in the process of reviewing them prior to initiation of the audit. Our ongoing review has convinced us that there are some assumptions included in the draft report that are either incorrect or not based on sufficient evidence. Unfortunately, these assumptions might lead one to conclude that the issues and answers are simple. Our ongoing review has convinced us that this is not the case and that much of the report content and its conclusions are misleading.

The Postal Service disagrees with the OIG recommendation that a unilateral elimination of the DDU discount for letters is warranted immediately, for reasons that are listed here and detailed in the attachment to this letter.

- ECR is a subclass, not a worksharing discount.
- ECR costs are tally-based and reflect current mail processing and transportation activities.
- Postal Service operational instructions have been mischaracterized. Our major concern when the instruction was issued was capturing the ECR mail as it passed through the plants and, where feasible, routing it through automated processing if service standards permitted.
- The OIG report fails to estimate both the volume of DDU-entered ECR letters that are backhauled and the average frequency of backhauling per DDU.
- Postal rates are price signals to mailers. It must be recognized that, due to the complexity of ECR rate design, a change in one rate category may yield price signals in other rate categories that may be counter-productive.

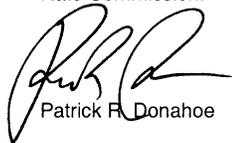
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Finally, our goal is to improve processing and transportation efficiencies, while at the same time sending the correct price signals to mailers in order to promote these efficiencies. As indicated above, our review of ECR letters is ongoing. We do not quarrel with the notion that it is advantageous to have mail entered at the location in which it will be processed. That was and will continue to be an important consideration as the next rate filing is developed, and as we continue our review of the particular issues raised here.

However, it must be recognized that there are a myriad of issues involved in rate design, and a balanced rate proposal would need to be developed that addresses all of them.

If we determine that there should be changes to the rate and classification structure, we follow the proper procedures in making those changes. Any changes are vetted internally, after careful review and analysis, ultimately coming before the Executive Committee for approval. If the Executive Committee determines that a change should be proposed, it must be approved by the Board of Governors, which has the sole responsibility, by law, to authorize a filing with the Postal Rate Commission.



Patrick F. Donahoe

Attachment

Management Response to Draft Audit Report – Enhanced
Carrier Route Worksharing Discounts
(Report Number AC-AR-03-DRAFT)

ECR is a Subclass

As a distinct subclass, ECR demonstrates both cost and market differences from the Regular Standard Mail subclass and its prices are set independently. The ECR subclass has one of the highest overall cost coverages of all subclasses. ECR is a subclass, not a worksharing discount. The prices for ECR should not be viewed as worksharing incentives for otherwise minimally-presorted Standard Mail. Therefore, comparisons such as those contained in Table 1 on page 2 of the report are misleading. While it is true that there are worksharing discounts within the ECR subclass, the Table on page 2 implies that the ECR rates as a whole are discounts and it could lead the reader to incorrectly assume that the “inefficiencies” discussed subsequently are somehow related to the rather large figures in the table.

ECR Costs are Tally-Based

As a distinct subclass, the overall costs for ECR mail are based on tallies from Postal Service processing and transportation data systems, rather than on mail flow models of operations avoided by worksharing activities. The overall costs for ECR mail, therefore, include the cost of both processing and transportation efficiencies or inefficiencies; these costs are reflected in the prices. Thus, it is not possible to automatically conclude, as OIG has seemingly done, that sorting ECR mail in delivery point sequence (DPS) necessarily results in processing or transportation inefficiencies in need of immediate correction.

Operational Instructions Have Been Mischaracterized

The draft report and its conclusions about “backhauling,” rely upon a Postal Service memorandum dated August 9, 2000, which OIG characterizes on page 7 as requiring “automation-compatible Enhanced Carrier Route letter mail to be processed in delivery point sequence, service standards permitting.” (A copy of this memorandum is included with this response.) This characterization is correct, as far as it goes, but it does not present the full picture. The memorandum deals with all carrier route letters, not just the fraction entered at the DDU. The primary thrust of the memorandum is reflected in the middle paragraph which instructs that procedures should be put in place **at the processing and distribution plant to capture** automation compatible carrier route presort letters for DPSing. This implies that the greater concern was capturing the ECR mail as it passed through the plants, and routing it to automated processing, if possible and if service standards permitted.

Volume data supports this interpretation because, at the time of the memo (FY2000), 89 percent of ECR letters were entered at upstream facilities, not the DDU. Much of the 11 percent that was entered at the DDU, and therefore subject to possible “backhauling” as described by the OIG, would not be viable candidate mail for backhauling for a number of reasons, including (1) non-automation-compatibility, (2) the DDU was a CSBCS (Carrier Sequence Barcode Sorter) site and therefore the letters were candidates for DPSing at the DDU, or (3) the particular zone was a non-DPS site, meaning the letters were sequenced manually.

In any event, as the Postal Service pointed out during the course of the audit, the preparation requirements for ECR that require sequencing and automation compatibility provide increased flexibility and reliability in both mail processing and delivery. Once the mail is received by the Postal Service, it behooves local management to use that flexibility and handle the mail as

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efficiently as possible, given the situation at hand. Presumably, any time "backhauling" occurs, it is better than the alternative of manually merging the letters at the DDU and, as discussed above, the costs of such activities are captured.

The Extent of "Backhauling" of DDU-Entered Mail is not Estimated

The draft report relies upon a telephone survey conducted by the OIG during the course of the audit. The OIG contacted approximately 200 DDUs to attempt to derive a statistical projection of DDUs that were backhauling ECR letters to a plant for DPSing. Based on this survey, the OIG projected that this happened at "approximately 2,337 of the approximately 3,296" DDUs in its audit universe.

Upon request, the Postal Service was furnished a document describing the methodology followed by the OIG for its survey, but the Postal Service was not furnished the actual questions asked in the survey. The OIG apparently believes that furnishing the survey questions would be tantamount to revealing information at the audit workpaper level and thus not permitted under its auditing procedures. Without the questions, it is not possible to conclude that backhauling is a major problem. Was the DDU asked if it had ever sent ECR letter mail back to a plant for DPSing or was it asked if it did so routinely? Also, even if it did so routinely, what are the affected volumes? As the Postal Service continues its review of this issue, perhaps the OIG would reconsider its decision to furnish the questions to the Postal Service. The information could be helpful in determining the extent of backhauling.

Simple Rate Alternatives Yield New Problems

Even if the magnitude and nature of the backhauling were known, the Postal Service is still faced with the reality that there are no easy, straightforward solutions. Simply eliminating the DDU discount for ECR letters, while an ECR DDU discount for flats remained in place, could result in narrowing, or reversing, the rate relationship between letters and flats, and encourage conversion from low-cost letters to higher-cost flats. The net result may well be counterproductive.

Another potential solution, simply rewarding SCF-entered letters with the DDU discount, would result in significant revenue losses, since the current SCF-entered mail would qualify, as well as those letters that would have been entered at the DDU. There are almost 2.5 times as many SCF-entered letters as DDU-entered letters. If the SCF mailers were to start receiving a discount for work they were already doing, the Postal Service would be forgoing revenue while not reaping any operational cost savings.

Summary of our position on the OIG Recommendation:

OIG Recommendation: We recommend the chief operating officer and executive vice president:

1. Develop a rate case proposal to eliminate destination entry unit discounts for letters destinating at delivery units that receive delivery point sequenced mail that was processed on a delivery barcode sorter.

Management Response: We disagree. As indicated above, we have been aware of the issues raised in this audit report and had commenced considering and reviewing them prior to initiation of the audit. That review is ongoing. As we also have indicated above, we are not convinced of the magnitude of the alleged problem, and the report does not detail it. Operational efficiency is a key factor among the many issues that will need to be considered in formulating any equitable and comprehensive rate proposal.

**RESPONSE OF THE UNITED STATES POSTAL SERVICE
TO INTERROGATORY OF NEWSPAPER ASSOCIATION OF AMERICA**

NAA/USPS-6: Does the Postal Service have a policy addressing the circumstances in which a mailer may obtain custom supplies (such as envelopes bearing the mailer's return address and/or a permit imprint) from the Postal Service, the expense being born by either the Postal Service alone or shared with the mailer? If so,

- a. Please describe that policy
- b. Please identify for how many mailers this is done, and for which subclasses of mail.

RESPONSE:

Customized packaging is provided for Priority Mail and Express Mail if the criteria listed below are satisfied. The costs of customized packaging, like those of standard packaging, are included in the costs of Express Mail and Priority Mail.

- Standard packaging does not meet the needs of the customer. (The customization is usually in terms of size, but may also be for closures type or production substrate. Customized packaging only rarely includes imprinting the customer's return address. Printing the customer's logo is more common.)
- The annual revenue from the customer for Priority Mail and Express Mail will exceed \$500,000.
- The customer is able to accept in each shipment a minimum quantity necessary to ensure adequate production scale for the purposes of per unit cost efficiency.
- The customer has the capacity to accommodate and unload a tractor-trailer. (The Postal Service also provides direct delivery of standard packaging to all customers; customers ordering in larger quantities may receive a shipment via a common carrier when it is more cost efficient to the Postal Service.)
- The customer expects to have expedited volume requirements allowing depletion of the supplies within six months. The customer must maintain consistent usage patterns. (The Postal Service monitors usage of the requested packaging to ensure that it is

**RESPONSE OF THE UNITED STATES POSTAL SERVICE
TO INTERROGATORY OF NEWSPAPER ASSOCIATION OF AMERICA**

being used, and for its intended purpose, as well as to avoid over-stocking the customer with potentially unwanted packaging.)

CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing document upon all participants of record in this proceeding in accordance with section 12 of the Rules of Practice.

Nan K. McKenzie

475 L'Enfant Plaza West, S.W.
Washington, D.C. 20260-1137
July 13, 2006