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UNITED STATES OF AMERICA
Before The
POSTAL RATE COMMISSION
WASHINGTON, D.C. 20268-0001

Postal Rate and Fee Changes, 2000) Docket No. R2000-1

COMMENTS
OF
THE OFFICE OF THE CONSUMER ADVOCATE
ON
REQUEST FOR RECONSIDERATION

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COMMENTS OF THE OFFICE OF THE CONSUMER ADVOCATE ON REQUEST FOR RECONSIDERATION

The Office of the Consumer Advocate ("OCA"), pursuant to Order No. 1301,[1] hereby submits its comments on the Request of the United States Postal Service for reconsideration of certain aspects of the "Opinion and Recommended Decision" issued in this Docket on November 13, 2000.[2]

EXECUTIVE SUMMARY

Nothing in the Governors' Decision or the Postal Service Memorandum demonstrates any error on the Commission's part in evaluating and acting upon the evidence of record in Docket No. R2000-1. While clearly the Postal Service would like the Commission to rubber-stamp its rate and revenue requests, that is not the function

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1 "Notice of Request for Reconsideration and Order Establishing Procedures," issued December 11, 2000.

2 On December 5, 2000, the Postal Service filed a "Notice of the United States Postal Service of Decision of the Governors." That Notice was accompanied by the December 4, 2000, "Decision of the Governors of the United States Postal Service on the Recommended Decision of the Postal Rate Commission on Postal Rate and Fee Changes, Docket No. R2000-1." In addition, on December 20, 2000, the Postal Service filed a "Memorandum of the United States Postal Service on Reconsideration and Request for Expedition." These documents will be referred to as the "Governors' Decision" and the "Memorandum," respectively.

of the Commission. The Commission has reached fully defensible decisions on the recommended rates, and no basis has been presented upon which the Commission should change any of its recommended rates in this proceeding.

The reconsideration must be confined to the evidence of record. Reliance upon any extra-record material would undermine the validity of the reconsideration decision. When the record is reviewed, the Commission must conclude that it acted within its authority and properly recommended that the contingency request be reduced to a reasonable 1.5 percent level, and that the field reserve be considered part of the contingency.

The Commission certainly did not substitute its judgment for that of the Governors, as the Postal Service alleges. The Commission exercised its statutory responsibility to recommend a reasonable contingency supported by record evidence. The fact is that the record evidence of the OCA and other parties on the contingency was far more credible and convincing than the scant justifications offered by the Postal Service.

The Commission did not err in its treatment of the field reserve. Nothing in the evidence provides credible support for the Postal Service's contention that this money is committed to expenditures in the test year. The Commission correctly concluded that it is a classic example of funds held for uncertainties. Nor did the Commission err in considering the relationship of the contingency request to the overall rate increase. The Commission correctly concluded that the Postal Service's contingency request in this case was unprecedented in relation to the growth in operating costs.

A significant factor in favor of reaffirming the Commission's decision to recommend a reduced level of contingency is the wholesale acceptance by the Commission of the Postal Service's base and test year updates. These updates, which included both higher index factors and the use of ECI rather than the historical ECI-1 calculation for wage increases, added approximately $617.5 million, on a net basis, to the Postal Service's filed revenue request.[3] The use of more recent cost figures has increased the operating costs upon which the recommended rates are based and has reduced the level of the Postal Service's risk, both valid reasons to recommend a 1.5 percent contingency fund. Moreover, the Governors' request to apply the originally filed 2.5 percent contingency request to the higher cost figures resulting from the update process must be rejected.

Turning to the other issues raised on reconsideration, the Commission should distribute single-piece First-Class additional ounces based upon the "as-filed" methodology as suggested by the Postal Service. This change does not, however, rise to a level that requires adjusting any First-Class rates. Looking to the future, the problem of forecasting additional ounces should be resolved by producing a linear trend from a reasonable past period of data to forecast additional ounces in the test year. This period should be sufficiently long to avoid short-term distortions.

With respect to the non-profit rates, the Commission should maintain its recommended rates. The legislation became law quite late in the rate-setting process, and the Commission commendably used a methodology intended to achieve the most

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[3] *See* PRC Op. R2000-1, App. K, p. 2.

accurate application of the new 60 percent rule. The result meets the statutory standard of satisfying the test "as nearly as practicable" in the context of this case. Nonetheless, consideration should be given to the methodology suggested by the Postal Service. That should be done, however, in the next rate case, when all interested parties can address the issue fully.

ARGUMENT

I. THE COMMISSION'S RECONSIDERATION MUST BE CONFINED TO THE EVIDENCE CONTAINED IN THE R2000-1 RECORD

Order No. 1301, noticing the Governors' December 5, 2000, request for reconsideration and a further recommended decision, establishes the proper framework for review: "The Commission will review the evidentiary record and the applicable legal standards applicable to each of [the] issues [raised]." Order No. 1301 At 3. It is plain from this statement that the Commission will (and should) confine its review to evidence presented during the course of the Docket No. R2000-1 proceeding, pursuant to 39 U.S.C. § 3624(a) and sections of the Administrative Procedure Act, *i.e.*, 5 U.S.C. §§ 556 and 557, that are referenced by § 3624(a).

Section 3624(a) provides that "the Commission shall not recommend a decision until the opportunity for a hearing on the record under Sections 556 and 557 of Title 5 has been accorded to the Postal Service, users of the mails, and an officer of the Commission . . . ." Therefore, the OCA and other R2000-1 participants have standing to insist that any decision made by the Commission, even upon reconsideration, conform to the requirements of the Administrative Procedure Act.

Under part (d) of 5 U.S.C. § 556, a party (including the OCA)

> is entitled to present his case or defense by oral or documentary evidence, to submit rebuttal evidence, and to conduct such cross-examination as may be required for a full and true disclosure of the facts.

The Commission's duty, under part (e) of the same section, is to issue a decision based exclusively on the record established under part (d).

A Commission decision that strays beyond the APA-conforming record is liable to be found in breach of 39 U.S.C. § 3624(a) by the courts and remanded for proper consideration. This occurred following an appeal of the Commission's decision in Docket No. R90-1 to implement a new discount for a Public's Automation Rate (PAR) that the court said lacked sufficient evidentiary support in the R90-1 record. In *Mail Order Ass'n of America v. U.S.P.S.*, 2 F.3d 408 (D. C. Cir. 1993) (hereinafter "*MOAA*"), the Court of Appeals held that the Commission, like other adjudicatory entities subject to the APA, must base its findings exclusively upon record evidence:

> The evidence must be found "within the record of closed-record proceedings to which it exclusively applies. The importance of that requirement should not be underestimated."[4]

In the first omnibus rate case to follow issuance of the *MOAA* decision, the Commission acknowledged the explicit imposition of this duty upon it by the *MOAA* court.[5]

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[4] 2 F.3d at 420 (citation omitted).

[5] PRC Op. and Further Recommended Decision, Docket No. R94-1, issued June 7, 1995, at pages 22, 29, 31, and 35. Nearly two decades earlier, in Docket No. R80-1, the Commission took account of "the most recent available financial reports of the Postal Service," *i.e.*, information that became available after the R80-1 record had been closed. PRC Op. Upon Reconsideration, issued June 4, 1981, at 9. This exercise, however, was for the limited purpose of determining whether the record should be re-opened to consider additional evidence. There was no suggestion that the Commission would use such post-record information without affording all parties the opportunity to exercise all of their rights under the APA, namely the right to cross-examine the bases and soundness of such evidence and the opportunity to offer (continued on next page)

A careful review of the Governors' Decision in Docket No. R2000-1 reveals that the Governors have not relied on extra-record information in reaching their decision, nor have they asked that the Commission do so:

> In light of our serious concerns about the Postal Service's financial condition, *as reflected on the record* and in our comments above, we urge the Commission to provide further recommended adjustments . . . .[6]

Similarly, the Postal Service's Memorandum specifically asks that no further proceedings be conducted and that the decision on reconsideration be made on the basis of the existing record.[7] Consonant with the position taken by the Governors and the Postal Service, the Commission should limit its review to the R2000-1 record.

II. THE COMMISSION SHOULD REAFFIRM ITS DECISION REGARDING THE CONTINGENCY AND THE FIELD RESERVE

Review of the Docket No. R2000-1 record leads to the indisputable conclusion that there is an ample evidentiary basis for reducing the contingency and, furthermore, that no new legal issues have been raised either by the Governors in their Decision nor by the Postal Service in its supporting Memorandum. Rather, the Governors and the Postal Service merely repeat arguments that were raised during the proceeding, weighed by the Commission during its deliberations, and rejected by the Commission as unconvincing.

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counter-evidence. The OCA notes that neither the Governors nor the Postal Service has asked that the R2000-1 record be re-opened.

[6] Governors' Decision at 12 (emphasis added).

[7] Memorandum at 4. Despite this statement, however, the Postal Service's Memorandum contains several extra-record assertions about developments since the close of the Docket No. R2000-1 record. While these must be ignored, the OCA also addresses the implications of these statements in Section III, *infra*.

A. The Commission Has the Authority To Recommend a Reasonable Contingency Different from that Requested by the Postal Service

The Governors assert that "the Commission's responsibility is limited to an assessment of whether the Board's judgment is reasonable." Governors' Decision at 10. The Commission sharply disagrees that its authority is so narrowly circumscribed. Citing its opinion issued in the first omnibus rate proceeding, the Commission hews to the view that:

> its statutory responsibilities require that the Service's aggregate cost and revenue estimates be subjected to the same scrutiny as its rate proposals. . . . [I]ts independent review of the revenue requirement is necessary to implement the legislative intent to introduce a system of checks and balances into the ratemaking process.[8]

To be sure, the Commission acknowledges "the primacy of the Governors' authority to assure that rates and fees generate sufficient revenues to enable the Postal Service to perform its public mission." *Id.*, ¶ 2144. This primacy is effected by filing rate increase requests under 39 U.S.C. § 3622, and is confirmed by the power to modify a further recommended decision of the Commission under Section 3625(d). It should not be forgotten, however, that the Governors may modify the revenue requirement recommended by the Commission only "*in accord with the record* and the policies of [chapter 36]." (Emphasis added.)

The Commission's view of its role vis-a-vis the Governors' conforms to the Supreme Court's declaration that ratemaking responsibility is divided between the two

[8] PRC Op. R2000-1, ¶ 2146.

agencies, with the Governors having the final responsibility of ensuring that revenues and costs are in equilibrium.[9]

The Commission exercises its authority during the "intermediate process" (*i.e.*, Section 3624 proceedings) to evaluate the strength of the evidence submitted by the Postal Service and other participants and to make independent, substantive determinations based on the record. That is what has occurred in this case. The disparity between the Commission's and the Governors' views of the Commission's authority is succinctly summarized in the Commission's opinion: "the Commission must respectfully agree to continue disagreeing in this area." *Id.*, ¶ 2149.

B. The Commission Has Not Substituted Its Judgment for that of Postal Service Management

The Governors' Decision and the Postal Service Memorandum both incorrectly characterize the Commission's recommendation of a 1.5 percent contingency as substitution of the Commission's judgment for that of the Postal Service. This is an inaccurate and self-serving argument that fails to acknowledge the care with which the Commission reviewed and relied on the extensive and probative evidence of the OCA and other parties. The simple fact is that this evidence was more probative and credible than that of the Postal Service.[10]

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[9] *Id.*, ¶ 2149, *citing Nat'l Ass'n of Greeting Card Publishers v. U.S.P.S.*, 462 U.S. 810, 821 (1983) (NAGCP IV).

[10] It is imperative to keep in mind that the Postal Service bears the burden of proof to support all facets of its rate increase request, including the contingency. When conflicting evidence is presented, it is the Commission's task to evaluate and weigh that testimony to determine which evidence is more credible and reliable. On the issue of the amount of the contingency, there is no doubt that the OCA's and the intervenors' evidence was the more substantial and credible.

Postal Service witnesses were frank in their descriptions of the approach they followed in determining the size of the contingency. Witness Tayman, the Postal Service witness charged with supporting the request for a 2.5 percent contingency, stated that the Postal Service's decision to increase the contingency from its then-current level of one percent "was largely subjective."[11] When asked to explain his assertion that the Postal Service is subject to greater risks now than in the previous two omnibus rate cases, witness Tayman said only that "[t]he statement is subjective and intuitive."[12]

In short, all that the Postal Service provided for the Commission's consideration was a scant two pages by witness Tayman of vague concerns about possible adverse circumstances in the test year. No quantitative information was provided, and the Postal Service was unbending in its refusal to provide any analysis (if such existed) that led to the management decision to increase the requested contingency from one to 2.5 percent.[13] The Governors choose to ignore the Commission's explicit declaration that, unlike prior cases where there was an "absence of participants' initiatives to explore the subject [of the contingency] on the record," in R2000-1 "participants have made

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[11] Tayman's response to interrogatory OCA/USPS-T9-43(c) (Tr. 2/385).

[12] Tayman's response to interrogatory DMA/USPS-T9-47 (Tr. 2/304).

[13] In fact, the Postal Service adamantly refused to respond to OCA interrogatories seeking Postal Service documentation and studies providing foundational support for the 2.5 percent contingency request. Rather than make any information available (if indeed there was any such information), the Postal Service repeatedly objected. The result was a stipulation by the Postal Service that it would not use any such material on rebuttal. As far as the OCA can discern, the Postal Service abided by the stipulation—the Postal Service's rebuttal witness, Richard Strasser, was unable to point to any record evidence that quantitative analyses were ever performed or relied upon. Tr. 46A/20281-82.

voluminous presentations on the contingency provision, challenging the Service's proposal on a variety of grounds." PRC Op. R2000-1, ¶¶ 2150-51.

Among the participant testimony that was cited and relied upon in the Commission's opinion, are several pieces of testimony containing well documented, carefully explained analyses. OCA witnesses Rosenberg and Burns, as well as intervenor witnesses Buc and Haldi, all provided incisive, penetrating assessments of the level of contingency needed by the Postal Service in the test year. Witness Rosenberg, for example, presented an analysis demonstrating that high contingency levels were generally recommended only in times of high inflation and serious economic instability. Those conditions did not prevail during the pendency of the R2000-1 proceeding, nor is there convincing record evidence that such conditions will prevail during the test period.

Another important point made by witness Rosenberg is that several financial tools are available to achieve the desired result of balancing revenues with costs. Tr. 22/9819 (OCA-T-3 at 15). Among them is the provision for recovery of prior years' losses. There is probably agreement among the participants (the Postal Service included) that one of the chief cost uncertainties for the test year is the size of the wage agreements that will be forged between postal management and several of the bargaining units. That uncertainty looms just as large today as it did during the time that evidence was adduced in the R2000-1 proceeding. If it were to happen that the ECI formula incorporated by the Commission into the cost estimates generates insufficient revenues, then the best tool for dealing with this eventuality is the prior year

loss tool, not the contingency provision, which may cause postal customers needlessly large opportunity losses.[14]

The Postal Service relies upon the rebuttal testimony of witness Zarnowitz for a *post hoc* justification of the requested 2.5 percent contingency. Memorandum at 19. The Zarnowitz testimony, however, was too general and had too mixed a character to be of help to the Postal Service.[15] One concession made by witness Zarnowitz that was never refuted by other postal evidence is that the U.S. economy is growing and is still experiencing a relatively strong expansion compared to the decades of the 1960's and 1980's. Tr. 41/18279, 18286.

Unlike the Postal Service, the Commission cited and described the record evidence it relied upon, setting forth its findings in a logical, orderly manner so that a reader could easily discern the reasoning path. The Commission's 40–page discourse on the contingency is a demonstration of the adjudicative process in its best sense: the evidence was painstakingly reviewed and weighed; the principles to be applied were articulated; those principles were applied to the record facts; and the conclusions reached were clearly stated.

C. The Commission Has Properly Treated the Field Reserve As Part of the Contingency

The Governors view the Field Reserve as "an amount retained at headquarters for allocation during the year to those operations that are unable to achieve" the

[14] Tr. 22/9828 and 9824, respectively.

[15] *See* discussion in the Initial Brief of the Office of the Consumer Advocate, filed September 13, 2000, at 47-53.

Breakthrough Productivity reduction targets established by postal management. Governors' Decision at 5. The Governors add that:

> it is predictable that some expenses will occur beyond the levels to which regional budgets have been reduced [and] furthermore . . . to the extent any of the field reserve funds are not needed to fund field operations, they will be spent on approved investments and programs [] for which they had previously been budgeted. *Id.*

This argument is no more persuasive after repetition than it was when made by the Postal Service in its Reply Brief at II-36. Citing the testimony of witness Strasser, the Postal Service argued then, as it does now, that "if the field reserve does not end up being needed for field operations, the reserved funds will be spent on infrastructure improvements, other capital projects, and to increase a reduced advertising budget."

In its opinion, the Commission explicitly took into account witness Strasser's testimony that the $200 million Field Reserve is an offset to cost savings that "recognizes the difficulty in achieving the aggressive cost reductions in FY 2001, the first year of the Breakthrough Productivity Initiative."[16] Without equivocation, the Commission held that this hedge against uncertainty is simply a specific type of contingency. The character of the $200 million Field Reserve is only different from other contingency reserves in that it is specified as a dollar figure instead of a percentage figure and is associated with a specific cost reduction effort, *i.e.*, $1 billion of Breakthrough Productivity savings.

The Commission's failure to be swayed by the Postal Service's contention that the Field Reserve is money that will definitely be spent is understandable in light of the

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[16] PRC Op. R2000-1, ¶ 2164, *citing* Tr. 46D/21595, n.2.

implausibility of the claim. In its recently filed Memorandum, the Postal Service quotes extensively from the testimony of witness Strasser, who explained that in order to achieve worthy Breakthrough Productivity goals,

> field units are going to have to reduce work hours . . . twice as much as they have achieved in the reductions this year. In other words, it is going to be somewhere in the range of 1.5 percent to a 2 percent reduction in work hours compared to the work hours in this fiscal year.

The Postmaster General has made numerous public statements concerning the Postal Service's resolve to cut costs substantially over a four-year period.[17] The uncertain or *contingent* nature of the Field Reserve is that field offices may be able to restrain expenditures during the test year or they may not. That cannot be known with certainty at the present time. However, the projected flattening of volumes for upcoming periods justifies greater optimism that workhour reductions should be possible.[18]

Postal management's bluster that the $200 million will assuredly be spent during the test year on capital projects, infrastructure improvements, and advertising is not credible. Witness Strasser claimed that $200 million of investments for mail transport equipment, information platform infrastructure, and advertising will be held in reserve until postal management is convinced that

> breakthrough productivity works. If it works and we get indications during the beginning of the year that it is being achieved, we will spend the $200 million on those specific investments . . . .

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[17] In the R2000-1 proceeding, this resolution came to be known as Breakthrough Productivity. *See* Tr. 38/17197 and Tr. 46D/21595.

[18] *See* Tr. 46A/20280. Upon questioning, witness Strasser conceded that in postal management's development of its test year budget, slowing volume growth could result in possible reductions in attributable costs.

This scenario is honeycombed with gaps in logic. Importantly, the Breakthrough Productivity program is being *launched* in the test year. How can the determination be made at the *beginning* of the test year that "breakthrough productivity works"? The simple truth is that it cannot. Of necessity, many months—likely the entire year— must elapse before the success of the program can be assessed. It follows that the Field Reserve cannot be immediately applied to investment programs and advertising. Possibly in FY 2002 the monies could be redirected in the way Strasser suggests, but not in FY 2001. The Commission rightly decided that for the period of the test year it would be correct to view the Field Reserve as a contingent amount that might not be spent.

D. The Commission Did Not Err in Considering the Unprecedentedly High Proportion of the Contingency in Relation to the Proposed Rate Increase

One of the many factors considered by the Commission is that the $1.68 billion contingency request constituted an unprecedented 60 percent of the total requested revenue increase. This, the Governors argue, "would suggest that equipoise in before-rates test year revenues and operating costs would justify no contingency at all." Governors' Decision at 11.

While the argument is less than clear, it appears that the Governors claim an absolute right to file (and be granted) a request for increased postal rates solely for the purpose of generating test year contingency funds. This novel view of the statutory sections in question is not supportable.

Of course, this suggestion has never been tested because the Postal Service has never requested a rate increase exclusively to generate contingency funds. If it

were to do so, the OCA is of the view that such a rate increase would not be "reasonable" under Section 3621 nor under Section 403. One important key to reaching this conclusion is found in Section 3622. Since the amount for contingencies is, by its very nature speculative and uncertain, the Commission would be unable to exercise the Section 3622(b) *requirement* that each class of mail bear the direct and indirect postal costs attributable to it. Establishing causation by particular class of mail would be impossible because the Commission would not even know whether such exigencies would ever arise during the test year. Equally important, it would be impossible to determine with even the smallest degree of assurance that particular classes of mail would cause such costs to come about. The nature of subsection (b)(3) and the importance placed upon it by Congress strongly indicate that rate increases are to be imposed upon the public only when absolutely necessary and upon particular classes of mail only when the Commission is satisfied that they have been caused, at least in part, by those particular classes.

This is essentially the reasoning articulated by the Commission in limiting the contingency:

> the Service's proposed allowance represents a majority of the total requested revenue increase, an unprecedented proportion of revenue burden to distribute to the classes of service *without attribution on the basis of cause.*[19]

An additional concern is articulated by the Commission in limiting the proportion of the contingency to the proposed rate increase:

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[19] PRC Op. R2000-1, ¶ 2166 (emphasis added).

> large forecast error is more likely when projecting large changes (for example in a period of rapid inflation) than when projecting small changes (for example during stable economic times). The Postal Service projects small, gradual increases in operating expenses . . . .[20]

It thus follows that a fairly low risk of incorrectly projecting operating costs is associated with the Postal Service's expectation that a relatively low increase in costs is expected in the test year.

In short, the Commission has sound reasons for limiting the size of the contingency in relation to the overall size of the increase in operating costs in the test year.

E. Use of Updated Costs Does Reduce Test Year Risk

The Governors and the Postal Service continue to insist that "use[] [of] updated costs does not reduce . . . risk." Memorandum at 20. This view was flatly contradicted by the Postal Service's own expert witness Zarnowitz, who testified that shortening the time for estimating costs reduces the uncertainty of the estimates. Tr. 41/18234. Witness Strasser also conceded that updating ECI costs gave a more "realistic" picture of labor costs in the test year, that updating COLA payment information made that element of the cost update more certain and that, in general, more recent forecasts are more "accurate." Tr. 46A/20275-77 and 20361.

The Governors' position is simply untenable. The tautology implicitly adhered to by the Commission in its decision—that use of updated costs reduces the uncertainty of

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[20] *Id.* at ¶ 2167.

cost estimates, in turn making possible a reduction in the contingency—cannot reasonably be ignored.

The Postal Service also persists in discounting variance analyses that it provides at the Commission's request. The Governors argue that the Commission's rejection of the requested 2.5 percent contingency, which falls *outside* all of the test year variance projections of –2.2 percent to 2.3 percent, gives the Postal Service only "even odds on achieving a surplus or a deficit." Governors' Decision at 9. This claim is unfounded since it is evident from the cited range of variances, *i.e.*, -2.2 to 2.3 percent, that a *zero* contingency would give the Postal Service approximately even odds of achieving a surplus or deficit. The recommended contingency of 1.5 percent produces a high probability that the Postal Service will break even in the test year and a good chance that it will end the test year with a surplus.

III. IF THE COMMISSION TAKES INTO ACCOUNT EXTRA-RECORD ASSERTIONS BY THE POSTAL SERVICE, THEN OFFSETTING FACTS MUST ALSO BE TAKEN INTO ACCOUNT

As noted in argument Section I, *supra*, the OCA is firmly of the view that the Commission must make its reconsideration decision solely with reference to the evidence of record in this proceeding. The OCA notes, however, that the Postal Service makes several extra-record assertions in the course of its Memorandum, particularly about the outcome of FY 2000. Because the OCA is uncertain how the Commission may treat these assertions by the Postal Service, the OCA wishes at least to furnish the Commission a more balanced picture about FY 2000. The following

discussion, however, should in no way be viewed as an endorsement by the OCA that the Commission base its decision upon reconsideration on extra-record information.

The Postal Service argues that actual FY 2000 revenue is $236 million less than the amount estimated in the Request and used in the Recommended Decision. Memorandum at 7, n.7. However, the Postal Service neglects to mention that the expenses for FY 2000 that were estimated by witness Patelunas in Exh. ST-44A, and which were adopted wholesale by the Commission in rolling forward expenses to the test year, are overstated by nearly $400 million. The following shows how this conclusion was reached.

- In its Memorandum, the Postal Service states that actual FY 2000 revenue is $236 million less than the amount estimated in the initial Request, *i.e.*, $64.8174 billion. Therefore, actual FY 2000 revenues must have been $64.5814 billion.
- In a Postal Service press release dated December 5, 2000, coinciding with the issuance of the Governors Decision, Ernst & Young reported a net loss for FY 2000 of $199 million.
- For a $199 million net loss to be correct, total FY 2000 expenses must have been $64.7804 billion, *i.e.*, $199 million more than actual FY 2000 revenues of $64.5814 billion.
- Witness Patelunas, in the supplemental testimony that the Commission adopted as the basis for its roll-forward calculation, estimated FY 2000 expenses to be $65.1715 billion. This figure is $391,100,000 higher than FY 2000 expenses actually incurred. Effectively, this gives the Postal Service a cushion of approximately $410,000,000 to cover test year costs.[21]

The effect of basing test year costs on an FY 2000 figure $410 million higher than the actual figure is to award the Postal Service a revenue increase even higher

[21] Since inflationary factors are used to roll forward FY 2000 costs to FY 2001, the $391 million overstatement is actually somewhat higher in the test year. To illustrate, witness Patelunas estimated that FY 2000 costs, when rolled forward, would increase by roughly 4.89 percent ($68,357.5 billion - 65,171.5/65,171.5, from Exh. USPS ST-44A). The $391 million overstatement rolled forward is approximately $410 million ($391 million x 104.89 percent). For this reason, the OCA shall refer to the cost overstatement in the test year as approximately $410 million.

than that originally requested by the Service. Table 2-2 of the Commission's opinion (¶ 2168), discussed by the Postal Service in its Memorandum, indicates that the Commission allowed an increase in revenue $280 million less than that requested by the Postal Service. In fact, the Commission has designed rates that allow revenue increases $130 million higher than the amount the Postal Service would have requested at the commencement of the case had it known its actual FY 2000 expenses. Thus the Postal Service has available to it in the test year $1.012 billion in contingency funds (at 1.5 percent) plus the unexpected $410 million windfall, *i.e.*, $1.422 billion, to act as a buffer against costs higher than projected or revenues less than projected.

Another important point to consider is that the FY 2000 net loss projected by witness Patelunas—$325.5 million[22]—proved to be substantially higher than the actual loss of $199 million officially reported in December 2000. This means that the Commission's recommendation on the amount for the recovery of prior years' losses also was overstated. Since RPYL is amortized over a nine year period, the amount of the overstatement was $14 million,[23] which effectively increases the buffer in the recommended rates to $1.436 billion.

IV. THE ACTION URGED BY THE GOVERNORS—TO APPLY A 2.5 PERCENT CONTINGENCY TO UPDATED COSTS—IS UNREASONABLE

The Governors' demand that the proposed 2.5 percent level of contingency be applied to the updated costs furnished in response to Order No. 1294 must be rejected.

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22 USPS-ST-44A.

23 $325.5 million - $199 million ÷ 9 = $14 million.

The Commission's full acceptance of all of the updated economic factors (almost all of which were higher than equivalent factors incorporated into the initial presentation), including the Postal Service's controversial use of ECI rather than ECI minus one percent, dramatically reduces the risk that revenues will be insufficient to cover costs in the test year.[24] Applying the same contingency level (2.5 percent) to the higher level of the updated costs is manifestly unreasonable.

The contingency of $1 billion that the Commission recommended in lieu of the $1.7 billion contingency proposed by the Postal Service reflects the fact that the Commission had accepted witness Patelunas' cost updates, which raised witness Tayman's cost estimate of $67.191 billion (TYAR) to $67.642 billion (TYAR). In its Opinion, the Commission underscores that "recognition of updated test year costs . . . reduces forecasting error." PRC Op. R2000-1, ¶ 2159. As a consequence of accepting the cost update furnished by witness Patelunas, the contingency provision could be significantly reduced since the possibility of misestimation of test year accrued costs has been substantially reduced. *Id.*

The best illustration of the unfairness of the Governors' demand is seen in the factors that shape the final labor cost estimates. When the Postal Service first filed its

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[24] The Postal Service contends that the Commission erred in incorporating all of the revenues from co-branded advertising, retail sales, and e-commerce programs, claiming that such programs "are high-risk initiatives much less certain to produce the targeted revenue . . . ." Memorandum at 6-7. This is certainly a new argument. The Postal Service was invited to make any and all changes it believed were appropriate in furnishing the update. Order No. 1294, issued May 26, 2000 ("The Postal Service may incorporate with this information such other updates as it believes will more accurately forecast test year results"). If the Postal Service doubted these revenues, it could have qualified them or at least had witness Patelunas address them in supplemental testimony when he first introduced these revenue figures. USPS-ST-44 at 8. Having failed to do so at the time the record was being developed, the Postal Service cannot now complain about the Commission's justifiable reliance on the data presented. The Commission must reject the Postal Service's current contention as an untested, extra-record assertion.

request on January 12, 2000, witness Tayman testified that he employed "[r]easonable and conservative assumptions" to estimate bargaining unit salary increases in the test year. USPS-T-9 at 19. This included using the November 1999 Employment Cost Index for Wages and Salaries (ECI) and a further assumption that the salary increase would be limited to ECI *minus one*. Tr. 35/16672; USPS-T-9 at 19. Tayman believed that the 2.5 percent contingency he proposed was adequate to protect against "significant new pressures on salary and benefit cost levels," in other words, any possibility that bargaining unit salaries would be higher than his November 1999 ECI-1 estimate. USPS-T9 at 44.

When given the opportunity to update test year cost estimates, however, witness Patelunas employed a substantially higher ECI figure (4.63 percent instead of the initial figure of 3.87 percent). Exh. USPS-ST-44AB. This increased the test year labor cost estimate by $185.6 million. Tr. 46A/20267. Abandonment of the ECI-1 constraint increased the labor cost estimate by an additional $245 million. *Id.* One of the explicit purposes of the initial contingency request of $1.7 billion was to protect against these two eventualities. In fairness to the public, the Commission's incorporation of these ECI cost increases into the accrued cost estimates should allow a commensurate reduction in the contingency allowance—on the order of $430 million. This, together with the reduction of risk inherent in the use of more recent cost estimates, easily justifies the Commission's recommended reduction in the contingency.

V. TEST YEAR COSTS FOR SINGLE-PIECE FIRST-CLASS MAIL SHOULD BE INCREASED TO REFLECT THE DISTRIBUTION OF ADDITIONAL OUNCES BASED UPON THE "AS-FILED" METHODOLOGY

The Postal Service maintains that the Commission's final adjustment cost model should be revised to recognize the distribution of single-piece additional ounces based upon a consistent application of the "as-filed" methodology. Memorandum at 26-28. According to the Postal Service, incorporating the distribution of additional ounces entailed by the "as-filed" methodology would result in a single-piece final adjustment of $80.053 million, as compared to the Commission's final adjustment of $59.387 million.

The OCA concurs in the reasoning and analysis of the Postal Service. The Commission's conclusions as to the appropriateness of the "as-filed" methodology for forecasting the number of additional ounces in this proceeding, by comparison to the revised or "historical" methodology, are fully supported by the record. However, the Commission's final adjustment model evidently does not contain the distribution of additional ounces as determined by the "as-filed" methodology developed by the Postal Service. Rather, the Commission appears to have distributed additional ounces based upon the "historical" methodology. The Commission's use of the distribution produced by the "historical" methodology in the final adjustment model should be changed to the distribution of additional ounces based upon the "as-filed" methodology. The resulting $20.7 million in additional costs would reduce infinitesimally the First-Class Letter Mail cost coverage, and should have no effect on single-piece First-Class rates.

Despite the Commission's justifiable reliance on the "as-filed" methodology in this proceeding, it should be noted that both the "as-filed" methodology and the "historical" methodology are problematic. Under both methodologies, the ratio of

additional ounces to pieces for single-piece, workshare, and total letters from a given base year is used to forecast the number of additional ounces in the test year. The ratio for each, or the number of additional ounces per piece, is simply a "snapshot" from the base year applied to the test year. The only difference between the methodologies is, in the case of the "as-filed" methodology, the ratio of workshare and total letters is assumed to be constant, producing an increase in the number of single-piece additional ounces. In the case of the "historical" methodology, the ratio of single-piece and workshare pieces is assumed to be constant, producing an increase in the number of total additional ounces.

Similarly, the forecast number of additional ounces of both methodologies is "back tested" to historical data. In this proceeding, with respect to the "as-filed" methodology, the number of single-piece additional ounces forecasted in the test year was compared to the historical trend for the period 1990 through 1999. A linear regression through the historical data projected forward to the test year revealed that the number of single-piece additional ounces forecast by the "as-filed" methodology tracked very closely with the projected trend line. Tr. 46B/20593. This finding supported the Commission's "conclusion that the initial forecasting method provides a better reflection of the long-term trend." PRC Op. R2000-1, ¶ 5118. However, the fact that the number of single-piece additional ounces forecast by the "as-filed" methodology nearly matches the long-term trend appears almost accidental—a function of the base year selected. That the number of single-piece additional ounces in the test year forecast by the "as-filed" methodology is significantly affected by the selection of the base year is evidenced by comparison to the forecast using the hybrid base year (*e.g.*,

FY99 Q3 - FY00 Q2). By selecting the hybrid base year, "the Commission forecasts fewer additional ounces in the test year than the Postal Service's initial filing, but more than its revised forecast." *Id.*, ¶ 5119.

With respect to the "historical" methodology, the forecast number of single-piece additional ounces caused by the constant ratio between the base year and test year was compared with a very limited recent period (seven quarters) of historical data. That data revealed very little change in the number of additional ounces, and thus compared favorably with the number of single-piece additional ounces forecast by the "historical" methodology for the test year.

Since both the "as-filed" and the "historical" methodology produce results dependent largely upon the selection of the base year, with validation by reference to some period of historical data, it would seem that a more rigorous methodology based upon greater use of historical data should be adopted. Such a methodology would use a linear regression of some number of prior years projected forward from the base year to the test year to forecast the number of single-piece additional ounces. Doing so would eliminate forecasts based upon the base year alone. Using a longer time period, over which the irregular increase in the number of additional ounces from year-to-year would smooth out, would give more weight to the earlier data used in the regression, and be consistent with the Commission's view. *Id.*, ¶ 5117. However, a shorter time period would give more weight to the latter years used in the development of the regression projected forward to the test year, and respond to concerns of the Postal Service. The OCA recommends that this approach be explored in the next rate case to improve the forecast of additional ounces.

VI. THE COMMISSION SHOULD NOT ADJUST STANDARD MAIL NONPROFIT RATES

The Governors ask the Commission to "reconsider" rates for the nonprofit subclasses of Standard Mail. Governors' Decision at 14. The Governors allege that the Commission had failed to follow a new statutory command when it used test year after rates ("TYAR") billing determinants to demonstrate that its recommended nonprofit rates produced an average revenue per piece ("ARP") that was 60 percent of the ARP generated by its recommended commercial rates. The Postal Service repeats the Governors' request for reconsideration. Memorandum at 22. The Postal Service's interpretation of new legislation, while plausible, is not the only possible interpretation. Accordingly, the Commission should leave resolution of this dispute to the next rate case.

The statute referred to by the Governors and the Postal Service was known as S. 2686 during the course of proceedings in Docket No. R2000-1.[25] The Commission refers to it as such in its opinion. PRC Op. R2000-1, ¶ 5556. The statute creates a new Section 3626(a)(6) of Title 39. Subsection 3626(a)(6)(A) requires that the ARP for nonprofit Standard Mail subclasses be 60 percent of the ARP for corresponding regular-rate subclasses. Subsection 3626(a)(6)(B) reads, in relevant part:

> [T]he estimated average revenue per piece of each *regular-rate* subclass shall be calculated on the basis of expected volumes and mix of mail for such subclass at current rates in the test year [*i.e.*, test year before rates billing determinants]. (Emphasis added.)

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[25] Enacted as Pub. L. No. 106-384, ___ Stat. ___ (2000).

The Postal Service interprets this subsection to require use of test year before rates ("TYBR") billing determinants for *both* nonprofit and commercial subclasses. If the Commission is required to use TYBR billing determinants at all, then the Postal Service's interpretation makes sense. However, the precise wording of the statute requires the use of TYBR billing determinants only for commercial subclasses. Since the literal wording of the statute is imprecise, the Commission's use of TYAR billing determinants is reasonable, and its recommended rates certainly meet the "as nearly as practicable" test in subsection 3626(a)(6)(A).

A. The Commission Has Accurately Set Nonprofit Average Revenue Per Piece at 60 Percent of Commercial Average Revenue Per Piece

The Commission should hesitate to read into a statute an instruction to ignore reality. The Postal Service has provided a description of the statutory requirement for setting nonprofit Standard Mail rates. Memorandum at 32-33. At first glance, it would appear that the new statute does require the use of test year *before* rates billing determinants, as suggested by the Postal Service. However, the use of TYBR billing determinants means that the actual ARP of nonprofit Standard Mail will certainly *not* be 60 percent of commercial Standard Mail.

The Postal Service has demonstrated, and the OCA has confirmed, that multiplying TYBR billing determinants by new rates to calculate the ratio of nonprofit ARP to commercial ARP produces a result different from that obtained by using TYAR billing determinants. This is hardly surprising. The real question is whether it makes sense.

The Postal Service suggests that its approach makes life easier for rate designers. Memorandum at 33. This is no doubt the case. However, given the late passage of the legislation and the lack of any opportunity for the parties to address its implementation on this record, the Commission should be leery of adjusting the rates as suggested by the Postal Service. The fact that the Commission was able to use consistent billing determinants and rates in its workpapers suggests that using the methodology urged by the Postal Service does not produce a significant benefit in setting Docket No. R2000-1 nonprofit rates.

B. The Revenue That Would Be Obtained from Bringing the Rates for Nonprofit Standard Mail into Conformance with the Postal Service's Reading of S. 2686 Is Minuscule

The OCA estimates that the nonprofit Standard Mail rates recommended by the Commission produce $26.574 million less than the amount needed to comply with the Postal Service's interpretation of S. 2686.[26] Raising this amount of money from nonprofit Standard Mail would require an average 1.5 percent rate increase. The Postal Service has not proposed a new nonprofit rate schedule. It has not even shown that it is possible to adjust nonprofit rates in such a way that anomalies are avoided and the ratios of nonprofit to commercial ARPs are closer to 0.6. Unless the Postal Service can do so, the nonprofit rates recommended by the Commission would appear to satisfy the "as nearly as practicable" test of S. 2686.

[26] The OCA obtained this estimate by replacing current rates with recommended rates on pages 6 and 7 of workpapers 1 and 2 of library reference PRC-LR-15.

Moreover, the Commission should give consideration to the burden a small change in the nonprofit Standard Mail rates would place on all nonprofit mailers. The increase in the rate would be only about 1.5 percent, but each nonprofit mailer would incur the expense of again reprogramming meters, scales, and software as well as retraining mail personnel. The practical solution to the problem is to retain the recommended rates and to address the implementation methodology in the next rate case.

VII. THE POSTAL SERVICE HAS NOT IDENTIFIED RATES TO BE INCREASED

In Order No. 1301, the Commission directed the Postal Service to "present its views on the appropriate portions of total revenues that each subclass and service should contribute" and invited the Postal Service to "suggest specific rates that would achieve these subclass and service specific revenue goals." Order No. 1301 at 3. The Postal Service has failed to do so.

Instead of responding, the Postal Service said that it is "not in a position to undertake a comprehensive translation . . . into specific rates" but that Postal Service evidence "provide[s] guidelines for establishing markups." Memorandum at 23. Although the Postal Service abdicated any responsibility for revising rates upwards, it did then single out Money Orders, First-Class Cards, and First-Class additional ounces for adverse comments. *Id.* at 24-25.

None of these comments provides a sufficient basis for changing the rates already recommended. It seems ironic that the Postal Service would first complain about the slight rate reduction for Money Orders. The 5-cent reduction will lower Postal

Service revenues by less than $12 million. The reduction is appropriate, however, given the Commission's finding that this service is of particular importance to "military personnel, isolated rural residents, or people lacking access to credit cards and checking accounts." PRC Op. R2000-1, ¶ 6152.

The Postal Service complains a Money Order rate reduction is inconsistent with the 17.93 percent increase in unit attributable costs noted in Appendix J to the Commission's Decision. Memorandum at 24. But the Postal Service overlooks the very substantial other revenues resulting from its Money Order service, which also increased by 9.7 percent.[27] When the Commission considered the total revenues related to Money Order service, it was able to recommend a modest 5-cent reduction in the fee while still maintaining a very substantial 153 percent overall cost coverage, quite close to the system average cost coverage. PRC Op. R2000-1, ¶ 6153.

The Postal Service also comments negatively on First-Class cards and First-Class additional ounces, although the Postal Service again stops short of suggesting that these are the rates that should be raised in response to its request for reconsideration. Memorandum at 24-26. No comments are made on the recommended rates for other classes of mail.

It would be shortsighted, however, to expect First-Class mail to make significant additional revenue contributions. As matters stand, First-Class letters and cards together have a cost coverage of 177.1 percent, far in excess of the system average of

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[27] *Compare* Docket No. R97-1, Appendix G, p. 24 *with* Docket No. R2000-1, Appendix G, p. 25 (Money Order float interest, outstanding Money Orders taken into revenue, and Money Order international commissions).

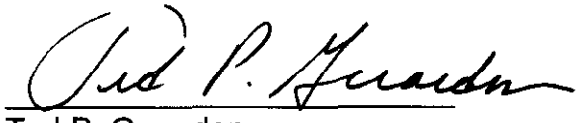
158.7 percent. Under the Commission's recommended rates, together they contribute $16,016,035,000 to the Postal Service's $25,453,171,000 of institutional costs—some 63 percent. PRC Op. R2000-1, Appendix G, p. 1. The already high and growing institutional cost contribution of First-Class mailers was well-documented in the record and was noted by the Commission.[28] There is no basis to increase this burden yet further.[29]

CONCLUSION

For all of the foregoing reasons, the OCA urges the Commission to deny the Governors' request for reconsideration of the recommended rates in this proceeding.

Respectfully submitted,

OFFICE OF THE CONSUMER ADVOCATE



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[28] PRC Op. R2000-1, ¶ 5059-5064. *See also* Tr. 22/10104-121.

[29] The Postal Service also comments obliquely on the additional ounce rate, evidently suggesting that the Commission shifted revenue burdens from First-Class to other categories of mail. Memorandum at 25. But a comparison of the recommended rates in this case and Docket No. R97-1 shows that the unit contribution of other large categories of mail to institutional costs has not changed much, and in many cases has been reduced—in the case of Periodicals, to an almost infinitesimal level.

CERTIFICATE OF SERVICE

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

Stephanie S. Wallace

Washington, D.C. 20268-0001
January 12, 2001