

RECEIVED

DMA-T-1

BEFORE THE **POSTAL RATE COMMISSION**
WASHINGTON DC 20268-5001

May 22 3 48 PM '00

POSTAL RATE COMMISSION
OFFICE OF THE SECRETARY

POSTAL RATE AND FEE CHANGES, 2000

Docket No. R2000-1

DIRECT TESTIMONY
OF

LAWRENCE G. BUC

ON BEHALF OF

DIRECT MARKETING ASSOCIATION, INC.
ADVO, INC.
ALLIANCE OF NONPROFIT MAILERS
AMAZON.COM, INC.
AMERICAN BUSINESS MEDIA
ASSOCIATION FOR POSTAL COMMERCE
ASSOCIATION OF PRIORITY MAIL USERS, INC.
DOW JONES & COMPANY, INC.
FLORIDA GIFT FRUIT SHIPPERS ASSOCIATION
GREETING CARD ASSOCIATION
MAGAZINE PUBLISHERS OF AMERICA
MAIL ORDER ASSOCIATION OF AMERICA
MAJOR MAILERS ASSOCIATION
PARCEL SHIPPERS ASSOCIATION
TIME WARNER INC.

Communications Concerning This
Testimony Should Be Addressed To:

Dana T. Ackerly II
Covington & Burling
1201 Pennsylvania Avenue, N.W
Washington, D.C. 20004-2401
202-662-5296

TABLE OF CONTENTS

<u>AUTOBIOGRAPHICAL SKETCH</u>	ii
<u>I. PURPOSE AND SCOPE OF TESTIMONY</u>	1
<u>II. CONTINGENCY</u>	2
<u>A. The Commission has clearly explained how a reasonable contingency should be determined</u>	3
<u>B. Witness Tayman provides little support for his contingency proposal in this case</u>	9
<u>C. The Postal Service's contingency request is not reasonable; a contingency of one percent is reasonable</u>	11
<u>III. COST REDUCTION AND OTHER PROGRAMS</u>	17
<u>A. Correcting a flaw in the rollforward model</u>	17
<u>B. Correcting an error in the AFSM 100 cost reduction estimate</u>	19
<u>IV. CONCLUSION</u>	23

1 **AUTOBIOGRAPHICAL SKETCH**

2 My name is Lawrence G. Buc. I am the President of Project Performance
3 Corporation (PPC), a consulting firm headquartered in McLean, Virginia. PPC
4 provides management, information technology, and environmental consulting
5 services to private and public sector clients. At the firm, I co-direct a practice that
6 focuses on economic and cost analysis, usually in a postal or environmental
7 context. I am also responsible for the overall finances of the firm.

8 I attended Brown University and graduated in 1968 with an AB with honors
9 in mathematics and economics. In 1978, I received an MA degree in economics
10 from the George Washington University of America. While there, I was a
11 member of Omicron Delta Upsilon, the national honorary economics society. I
12 am a member of the American Economic Association.

13 I have participated in United States Postal Service (Postal Service) rate
14 and classification cases for over 25 years; I joined the Revenue and Cost
15 Analysis Division of the Postal Service in March of 1975 and have analyzed
16 postal issues ever since. I have worked not only for the Postal Service, but also
17 for the United States Postal Rate Commission (the Commission) and private
18 clients with interests in postal topics. I have been involved in seven previous rate
19 cases: R74-1, R76-1, R77-1, R84-1, R87-1, R90-1, and R97-1.

20 This is the seventh case in which I have submitted testimony to the
21 Commission. In R84-1, R90-1, and R97-1, I appeared as a witness for
22 intervenors before the Commission; in MC76-1, I appeared as a witness for the
23 Postal Service; in MC77-2, I appeared as a witness for the Office of the
24 Consumer Advocate, and in C99-4, I appeared as a witness for the complainant.

1 **I. PURPOSE AND SCOPE OF TESTIMONY**

2 In this testimony, I analyze the revenue requirement of the Postal Service.
3 In particular, I analyze the proposed contingency and cost reduction and other
4 programs presented by witness Tayman in USPS T-9. I show that the Postal
5 Service has overstated its revenue requirement by at least \$1.30 billion, by
6 overstating the contingency by \$1.01 billion and understating cost reduction and
7 other programs by \$293 million. Table 1, below, shows the adjustments I make
8 to the Postal Service's proposed revenue requirement.

9 **TABLE 1**
10 **TEST YEAR AFTER RATES**
11 **REVENUE REQUIREMENT ADJUSTMENTS**
12

	USPS (\$Thousands)	DMA (\$Thousands)	ADJUSTMENT (\$Thousands)
Contingency ¹	\$1,679,766	\$ 668,978	\$ (1,010,788)
Rollforward Flaw ²			(92,943)
AFSM 100 ³	169,379	369,312	(199,933)
Total Adjustment			\$ (1,303,665)

13 ¹Attachment A, pg 1.

14 ²Attachment B, pg 1.

15 ³Attachment C, pg 1.

16 The Postal Service has requested a contingency of \$1.68 billion in the
17 Test Year, which is two and one half percent of the total costs (including final
18 adjustments). Section II of my testimony shows that this request is neither
19 reasoned nor reasonable and that the logic described by the Commission in
20 previous rate cases for determining a reasonable contingency would result in a
21 contingency of one percent of total costs, which is \$669 million (after adjusting
22 for two other overstatements to the revenue requirement, discussed next.)

1 Thus, the Postal Service has overstated its contingency requirement by \$1.01
2 billion.

3 In addition to the unreasonable request for contingency, there are also two
4 errors in cost reduction and other programs that lead witness Tayman to
5 overstate the revenue requirement by an additional \$293 million. In Section III, I
6 describe and then correct these errors. The first is a flaw in the rollforward
7 program for supervisors of clerks and mailhandlers and carriers, which the
8 Commission corrected in the last case, but which the Postal Service has
9 apparently not yet adopted. The second is an error in cost reduction programs
10 for the Advanced Flat Sorting Machine 100 (AFSM 100).

11 **II. CONTINGENCY**

12 Under the Postal Reorganization Act, the revenue requirement includes “a
13 reasonable provision for contingencies”. 39 U.S.C. §3621. As the Commission
14 wrote in its R76-1 Opinion and Recommended Decision, the purpose of the
15 contingency is to cover “expenses which could be neither foreseen nor
16 prevented through the exercise of honest, efficient, and economical
17 management...” Op. R76-1 at 52. In this case, the Postal Service requests a
18 contingency of 2.5 percent of its costs, or \$1.68 billion.

19 Although the Commission has accepted all but one of the Postal Service’s
20 previous contingency requests, the Commission has also said that the
21 requirement for a reasonable provision for contingency “requires that the amount
22 be reasoned.” Op. R97-1 at 21.

23 In the following section of this testimony, I will first review the
24 Commission’s body of writing pertaining to the contingency. I will next
25 summarize the Postal Service’s support for its request in this case. I will then
26 show that witness Tayman provides little support for a contingency of 2.5 percent
27 and that this request is neither reasoned nor reasonable given the Commission’s
28 past decisions. By contrast, a contingency of one percent is both.

1 **A. The Commission has clearly explained how a reasonable contingency**
2 **should be determined**

3 On many occasions, the Commission has reiterated the principles that
4 govern the size of a “reasonable” contingency. In preparing this testimony, I
5 reviewed the section of the Opinion and Recommended Decision pertaining to
6 the contingency in the eight omnibus cases from R76-1 to R97-1. In these eight
7 decisions, the Commission has clearly articulated (1) what a “reasonable”
8 contingency should cover and what it conversely should not cover and (2) how
9 the size of a “reasonable” contingency should be determined. To provide context
10 for my analysis of the contingency request in this case, I first review the
11 Commission’s statements of these principles.

12 Writing in R76-1, the Commission stated: “[t]he general standard should
13 be that expenses which could be neither foreseen nor prevented through the
14 exercise of honest, efficient, and economical management are properly provided
15 against by the creation of a contingency provision.” Op. R76-1 at 52. Then, in
16 R77-1, the Commission described why a contingency was necessary: “[t]he
17 contingency allowance is a recognized provision designed to offset the effects of
18 misestimates in the test year relating to revenue and costs.” Op. R77-1 at 29.
19 Writing in R80-1, the Commission expanded on its view of why misestimates
20 were likely to occur:

21 ...the discipline of detailed line item forecasting makes it
22 probable that the ratemaking projections will differ from
23 actual results. Generally, the causes of these differences,
24 or variances, between estimated and actual results will
25 occur as a result of errors in assumptions underlying
26 projections contained in the rate filing estimates arising
27 from unforeseen events and/or errors in forecasting
28 techniques. Op. R80-1 at 20.

29 By R84-1, the Commission had synthesized its view:

30 [a]s our opinions in prior omnibus rate proceedings have
31 emphasized, the purpose of the contingency provision set
32 forth in 39 U.S.C. section 3621 is two-fold. First, it provides
33 insurance against the possibility of misestimates of test

1 year accrued revenues and expenses. As we have stated
2 in the past, such variances are inherent in the forecasting
3 process. Second, the provision is intended to protect
4 against unforeseeable events, not capable of being
5 prevented through honest, efficient and economical
6 management, and which might have a significant adverse
7 impact on the financial position of the Service or its
8 operations. Op. R84-1 at 13.

9 The Commission has also made it clear that the contingency should not
10 cover all unforeseen costs. It clearly expressed this position in R 76-1:

11 [t]hus we do not contemplate that every unforeseen cost
12 increase is appropriate for contingency treatment. If, in the
13 exercise of sound and efficient management, a necessary
14 cost increase should reasonably have been foreseen, it
15 should be reflected in the specific cost justification offered
16 for increased rates, not in the provision for contingencies.
17 Op. R76-1 at 52.

18 Equally, the contingency does not cover revenue shortfalls that could have
19 been foreseen. Writing about the Postal Service's plan to delay implementation
20 of rates until part way through the Test Year in R94-1, the Commission wrote,
21 "first, as a conceptual matter, this anticipated development cannot properly be
22 included among the "unforeseen adversities" for which the contingency provision
23 is intended to provide..." Op. R94-1 at II-14.

24 The Commission has been equally clear about both the process and the
25 analysis for determining the permissible size of the contingency. First of all, a
26 reasonable contingency cannot be arbitrary; nor can it be determined by a rigid
27 formula. In R97-1, the Commission wrote, "Arguments attempting to justify an
28 arbitrary amount will not be accorded much weight." Op. R97-1 at 21. In R76-1
29 it stated: "[w]e may add that the use of any formula or set percentage--except as
30 a starting point for inquiry--does not seem to us an appropriate method for
31 determining the contingency allowance." Op. R97-1 at 59. Rather, a reasonable
32 contingency should be based on a variance analysis and a consideration of both
33 the financial condition of the Postal Service and general economic conditions.

1 Although the Commission did not use the words “variance analysis” in
2 their R76-1 Opinion and Recommended Opinion, it discussed the general
3 concept:

4 [t]he contingency provision could in this way be accounted
5 for by a suitable post-audit procedure showing how far the
6 actual costs have departed from estimates. The treatment
7 of the contingency provision just suggested would assist
8 the Postal Service in determining any areas in which its
9 estimates of future costs are particularly liable to
10 inaccuracy. Op. R76-1 at 53-54.

11 And even in this early Opinion, the Commission recognized that general
12 economic conditions should affect the size of the contingency: “...we believe it is
13 appropriate to look to national economic conditions first for general guidance as
14 to the usefulness of such predictions.” Op. R76-1 at 56. It also recognized that
15 the financial condition of the Postal Service was relevant in setting the
16 contingency: “[w]e must also take into account, in this connection, the ability of
17 the Postal Service to absorb the consequences of erroneous predictions of costs
18 and revenues.” Op. R76-1 at 57.

19 The Commission reiterated these views in the R77-1 case. Its third Notice
20 of Inquiry formally solicited views on the use of variance analysis in establishing
21 the contingency and noted,

22 The purely judgmental means employed by Postal Service
23 witness Klutz for estimating a contingency were
24 technically deficient and that more ‘analytic methods’ are
25 needed to measure the Postal Service’s needs for a
26 contingency. We have reviewed the comments of the
27 parties to the Third Notice of Inquiry and conclude that
28 historical variance analysis supplemented by other
29 pertinent factors is a proper and feasible procedure to
30 employ in establishing a reasonable contingency provision.
31 Op. R77-1 at 31.

32 Later, in its Opinion, the Commission expanded on this statement:

33 ...it is our view that over the long run the relative
34 magnitude of unforeseen events (variances between
35 estimates and actual results caused by uncontrollable
36 external events) will prospectively tend to display a certain

1 degree of predictability, albeit not precise, with historical
2 results [footnote omitted]. Specifically, we believe that
3 historical variance analysis will allow the Commission to
4 project on a reliable basis the magnitude of adverse events
5 befalling the Postal Service in any particular test year and
6 thus provide a basis for the Commission to make
7 allowances for these uncertainties in the revenue
8 requirement. Thus, we find appropriate the utilization of
9 variance analysis as a starting point in evaluating the
10 Postal Service's contingency request. Op. R77-1 at 31-
11 32.

12 As in the R76-1 Opinion, the Commission expressed the importance of the
13 financial condition of the Postal Service: "[a]lso we must be mindful of the degree
14 to which the Postal Service is able to absorb unforeseen expenses or
15 unfavorable revenue variances." Op. R76-1 at 39. And, again as in R76-1, it
16 expressed the importance of the economy: "...uncertainties relating to the
17 economy generally, in our judgment, remain substantial and thus support the
18 reasonableness of a four percent contingency." Op. R77-1 at 40.

19 By R80-1, the Commission had refined its presentation on the proper way
20 to set a contingency while remaining true to its previous Opinions. It wrote,

21 Albeit a sound analytical tool which we continue to
22 endorse, it was never our intent ...to rely on variance
23 analysis to the exclusion of other factors which have a
24 bearing on our judgmental determination of an appropriate
25 contingency allowance. The role of variance analysis is
26 that it serves as a tool which provides a precise figure to
27 which we apply other factors pertinent to the determination
28 of an adequate contingency provision. Factors such as
29 the financial condition of the Postal Service [footnote
30 omitted], the state of the economy [footnote omitted], the
31 causes for the variances [footnote omitted], and such other
32 relevant factors which may arise must be considered in
33 arriving at a contingency provision. Op. R80-1 at 21-22.

34 The Opinion in R84-1 issued following the opinion of the U.S. Court of
35 Appeals for the Second Circuit in the Newsweek case. In this Opinion, the
36 Commission stated that it had not only the authority but also the responsibility to
37 modify the revenue requirement requested by the Postal Service as long as the
38 Commission complied with certain criteria:

1 [a]ccordingly, we have concluded that the Commission has
2 both the authority and the responsibility to make
3 adjustments in the Postal Service's proposed revenue
4 requirement, so long as our adjustments are not arbitrary,
5 our reasoning is fully articulated and based upon
6 substantial evidence in the record, and where our
7 adjustments have neither the intent nor the effect of
8 causing more frequent rate filings nor constitute an
9 intrusion into policymaking domain of the Board in
10 accordance with the holding in Newsweek [footnote
11 omitted]. Op. R84-1 at 25.

12 In this decision, the Commission again articulated its position on how to
13 set the contingency:

14 [f]urthermore, the Commission has emphasized that
15 variance analysis should not be the exclusive determinant
16 of a contingency provision. PRC Op. R80-1 at 21. Other
17 items which should be considered in arriving at an
18 appropriate contingency include the Postal Service's
19 financial condition, the state of the economy, and other
20 factors deemed appropriate by the Commission. Id. At 21-
21 22. Op. R84-1 at 27.

22 In R87-1, the Commission repeated that it had the authority to review the
23 contingency request:

24 [i]t is understandable that the Postal Service would
25 emphasize the subjective element of the determination of
26 the contingency reserve above all others, since it tends to
27 relegate that determination to the province of
28 management. It is also understandable that the parties
29 with an interest in adjusting the proposed contingency
30 should emphasize the objective element of that
31 determination, since it tends to subject that determination
32 to outside criticism and analysis. In prior dockets, we have
33 concluded that the subjective element of the contingency
34 determination entitles management's determination to a
35 good measure of deference, but that it does not render that
36 judgment unreviewable. As we noted in Docket No. R84-1,
37 judgment implies opinion or assessment, and is not
38 necessarily equated to management discretion. Because
39 the statutory requirement that a contingency be supported
40 by substantial evidence remains in effect, management still
41 must provide such evidence, and the Commission must
42 still review it. Op. R87-1 at 35-36.

1 The Commission also addressed the issue of how the contingency should
2 be set:

3 [t]he Postal Service argues that unforeseeable risks,
4 because they are unknown, by their very nature cannot be
5 articulated or analyzed, but must remain in an intuitive
6 realm. But in our view, if such risks are to be the
7 predominant basis of the Postal Service's contingency
8 determination, management's perception of those risks
9 must be articulated to a reasonable degree in order to
10 satisfy the substantial evidence requirement. Without
11 laying down any particular guidelines for articulating such
12 risks, we would offer as possible guidelines an
13 identification of at least the set of events from which the
14 intuitively sensed risks might be drawn, the role of past
15 experience in influencing the sensed magnitude and
16 likelihood of the unforeseen risk, and some indication of
17 the importance of unforeseeable risks relative to
18 recognized-but-unquantifiable risks, and the assumed level
19 of error in forecasting quantifiable factors that went into its
20 contingency determination. Op. R87-1 at 36.

21 In its Opinion, the Commission also discussed the issue of addressing
22 both forecasting errors and unknown risks:

23 ...the Commission views the contingency determination as
24 a blending of subjective judgment concerning unknown
25 risk, and objective judgment concerning forecast errors
26 and their sources. The former can and should be
27 articulated, even if primarily intuitive, while the latter can
28 and should be subjected to statistical analysis. The
29 Commission has never advocated that statistical analysis
30 be the exclusive determinant of the proper contingency
31 amount, nor that it should be accepted uncritically, in terms
32 of its precision, or its ability to account for external factors.
33 See PRC Op. R84-1 at para. 1051; PRC Op. R77-1 at 30-
34 31. We maintain our view, however, forecasting errors
35 have sources, and that much can be learned by
36 systematically evaluating the behavior of those sources
37 over time. We also adhere to our view expressed in
38 Docket No. R77-1 that the relative magnitude of
39 unforeseen events, including external events, over the long
40 run will tend to display a degree of predictability, based
41 upon historical results. PRC Op. R77-1 at 31. Op. R87-1
42 at 37.

43 Finally, the Commission said, "we view variance analysis, both adjusted
44 and unadjusted, as reliable enough to indicate a range within which a reasonable

1 contingency should fall, but not sufficiently reliable to determine the specific
2 contingency amount.” Op. R87-1 at 40.

3 Then, in R94-1, reflecting its position on the use of variance analysis to set
4 a contingency, the Commission approved the Postal Service’s request for a two
5 percent contingency even though the analysis presented by the Postal Service
6 showed variances ranging from 3.9 to 5.0 percent. The Commission wrote:

7 [t]he mathematical incompatibility of a 2 percent
8 contingency provision with the variance analysis... does not
9 necessarily invalidate management’s informed choice of
10 that figure. While variance analysis provides statistical
11 results on which the Commission has frequently relied in
12 appraising the Postal Service’s proposed contingency
13 allowance, its guidance is neither definitive nor without
14 potential flaws. Op. R94-1 at II-13.

15 **B. Witness Tayman provides little support for his contingency proposal in**
16 **this case other than subjective judgment**

17
18 Witness Tayman’s support for the proposed \$1.68 billion contingency
19 appears in three pages of his testimony, between pages 43 and 46, as well as
20 his responses to interrogatories. Because of the size of the contingency and the
21 paucity of support, DMA sought to obtain additional supporting information.
22 DMA/USPS-T9-36 asked witness Tayman to provide “any analysis, decision
23 memos, options analysis, briefings, etc, relating to the contingency for this rate
24 case.” The Postal Service, however, objected to this interrogatory and a similar
25 one from the OCA. Subsequently, witness Tayman testified on oral cross-
26 examination that his written testimony contains all the factors he considered in
27 deciding on the proper size of the contingency, “I think pages 43 through 45 of
28 the testimony pretty much delineate all the factors we considered in coming up
29 with our decision.” Tayman, Tr. 2/505. Thus, the entire support for the
30 contingency lies in the three pages of testimony.

31 Of these three pages of testimony, only about two pages explain his
32 position, because over a page is devoted to his discussion of the variance

1 analyses. Although witness Tayman presents a variance analysis, “in deference
2 to the Commission’s desire to evaluate forecast errors and their sources,” USPS-
3 T-9 at 44, he places little stock in it. In discussing the use of variance analysis,
4 he says, “I am convinced that variance analysis cannot be relied upon in a
5 vacuum as the basis for determining an appropriate contingency level.” USPS-T-
6 9 at 45.

7 Instead of relying on variance analysis, witness Tayman apparently is
8 comfortable relying mainly on management discretion, “Regardless of what
9 history shows, management must be allowed to assume its responsibility to
10 determine the amount of contingency most appropriate for achieving its goals.”
11 USPS-T-9 at 45. He also relies heavily on subjective judgment. When asked to
12 “identify and explain each new or increased concern, risk, issue or other criteria
13 management considered when deciding that the contingency should be
14 increased in this docket from the level requested in Docket No. R97-1” he
15 responded, “The determination was largely subjective” Tayman, Tr. 2/385.

16 Witness Tayman attempts to provide support for the request by discussing
17 recent challenges: “[r]ecent financial performance has not been as favorable as
18 in the mid 1990’s.” USPS-T-9 at 43. He further states:

19 [s]pecifically, in Fiscal Year 1999, the Postal Service fell
20 significantly short of its revenue plan, with revenue more
21 than \$600 million below plan. To achieve our net income
22 plan for the year required significant cost cutting. This was
23 in addition to funding greater than expected costs
24 associated with the year 2000 computer transition and
25 higher than planned labor costs. USPS-T-9 at 43.

26 Perhaps in deference to the Commission’s Decision in R87-1
27 (“management’s perception of ...risks must be articulated to a reasonable degree
28 in order to satisfy the substantial evidence requirement.” Op. R87-1 at 36),
29 witness Tayman also recites a litany of other factors, which could affect future
30 costs or revenues:

31 1. “[v]olume growth is below historical norms.” USPS-T-9 at 43.

- 1 2. "...projections of Fiscal Year 2000 require workyears to be held
2 at the Fiscal Year 1999 level while mail volume and the delivery
3 network continue to grow." USPS-T-9 at 43-44.
- 4 3. "[h]ealth benefit cost increases have now returned to near
5 double digit rates. Also, the labor contracts which have become
6 effective since the last rate filing are significantly more costly
7 than the previous contracts." USPS-T-9 at 44.
- 8 4. "...the internet appears to be making inroads into the Postal
9 Service's transaction and correspondence mail volume and may
10 be diverting advertising and marketing revenues from the Postal
11 Service as well." USPS-T-9 at 44.
- 12 5. "[o]ur more traditional competitors appear to be more
13 aggressively pursuing legislative limitations on the Postal
14 Service's ability to operate in a business-like manner." USPS-T-
15 9 at 44.
- 16 6. "...foreign postal administrations have been expanding their
17 operations into the United States." USPS-T-9 at 44.
- 18 7. "[f]inally, the earliest the rates can be implemented is in January
19 of the Test Year." USPS-T-9 at 44.

20 **C. The Postal Service's contingency request is not reasonable; a**
21 **contingency of one percent is reasonable**

22 In this section, I first address specific elements of witness Tayman's
23 justification of a 2.5 percent contingency and show that most of the challenges
24 and risks he relies upon are not germane to determining a reasonable
25 contingency, according to the proper approach articulated so often by the
26 Commission. Accordingly, these challenges and risks do not support witness
27 Tayman's request. Then, I use the framework developed by the Commission
28 over the last 25 years and show that a one percent contingency is more
29 reasoned and reasonable.

1 ***Five of witness Tayman's seven factors do not support his contingency***
2 ***proposal***

3 In analyzing specific elements of witness Tayman's proposal, I started with
4 the Commission's view on what the contingency should cover: "[t]he general
5 standard should be that expenses which could be neither foreseen nor prevented
6 through the exercise of honest, efficient, and economical management are
7 properly provided against by the creation of a contingency provision" Op. R76-1
8 at 52.

9 Under this standard, Witness Tayman's lamentations pertaining to
10 financial challenges in Fiscal Year 1999 are irrelevant in setting the proper
11 contingency for the Test Year. A contingency is to provide for "unforeseen and
12 unforeseeable events", not those that have already transpired. Further,
13 regardless of the challenges it faced in FY 1999, the Postal Service still made net
14 income of \$363 million. Consequently, it further improved its equity position so
15 that equity improved for the fifth year in a row, to negative \$447 million, from a
16 low of almost negative \$6 billion at the end of 1994. Thus, the positive net
17 income in FY 1999 should actually reduce the need for a contingency.

18 Similarly, application of the Commission's standard to witness Tayman's
19 listing of future challenges shows that the majority of them are not relevant to the
20 contingency. Witness Tayman confirmed that the Postal Service took account of
21 the first three challenges in the rollforward model. Tayman, Tr. 2/280. Thus,
22 since they are foreseen and already accounted for in cost and revenue estimates
23 of the Test Year, they cannot be considered in the contingency. Also, to the
24 extent that the internet is diverting volumes, witness Tolley describes at great
25 length all electronic diversion of first-class and Standard A mail in his testimony.
26 USPS-T-6 at 43-52, 63-64, 120-123, 125, and 140-143. According to witness
27 Tayman, "diversion is implied by the trend variables in the equation used to
28 develop the volume forecast." Responses of United States Postal Service
29 Witness Tayman to Questions Posed During Oral Cross-Examination, response
30 to question posed by Chairman Gleiman, Tr. 2/570.

1 Similarly, the fact that rates will not go into effect until part way through
2 the Test Year is foreseeable, and the Commission has previously stated that the
3 revenue loss from an implementation of rates part way through a test year is not
4 properly part of the contingency. Op. R94-1 at II-14. In fact, witness Tayman,
5 under questioning from Chairman Gleiman, stated that his contingency includes
6 about \$425 million to mitigate the fact that rates will be implemented in the
7 second quarter of the test year. Tayman, Tr. 2/561-563.

8 Thus, of the seven factors that witness Tayman presents as justifying his
9 contingency, the first four are foreseen and foreseeable, have already been
10 accounted for in the cost and revenue forecasts, and therefore, according to the
11 Commission, do not support a contingency request. And the seventh reason
12 witness Tayman presents (the fact that rates go into effect part way through the
13 test year) is actually a reason for reducing his proposed contingency.

14 ***Witness Tayman gives no weight to a variance analysis***

15 Although witness Tayman is quite dismissive of the variance analysis, the
16 Commission clearly believes that it is the necessary starting point for analysis of
17 the contingency request, as I have described above. In this case, Tayman
18 calculated four different variances which produce results ranging from -2.2
19 percent to 2.3 percent.

20 Table 2, below, shows the Postal Service's proposed contingency in this
21 case and the two previous cases, the amount the Commission accepted for the
22 last two cases, and the range of results produced by the variance analysis in this
23 case and the last two cases. As the table shows, in the last two cases, the
24 variance analyses by itself indicated the need for a much higher contingency
25 than in this case.

26 Further, it is important to note that in this case, unlike either of the last two
27 cases, witness Tayman has proposed a contingency higher than any of the
28 variances produced by the variance analyses. In R97-1, he proposed a
29 contingency within the range covered by the variance analysis and in R94-1 the

1 Postal Service proposed a variance smaller than the range produced by the
2 variance analysis.

3

4

TABLE 2

5

PROPOSED AND ACCEPTED CONTINGENCIES

6

AND VARIANCE RESULTS

	USPS PROPOSED CONTINGENCY (%)	PRC APPROVED CONTINGENCY (%)	VARIANCE ANALYSIS RANGE (%)
R2000-1	2.5 ¹		-2.2 – 2.3 ²
R97-1	1.0 ³	1.0 ⁴	-.2 – 3.5 ⁵
R94-1	2.0 ⁶	2.0 ⁷	3.9 – 5.0 ⁸

7

¹ Direct Testimony of Witness Tayman, R2000-1 USPS-T-9, pg 44.

8

² Direct Testimony of Witness Tayman, R2000-1 USPS-T-9, pg 45.

9

³ Direct Testimony of Witness Tayman, R97-1 USPS-T-9, pg 38.

10

⁴ PRC, Opinion and Recommended Decision R97-1, pg 21.

11

⁵ Direct Testimony of Witness Tayman, R97-1 USPS-T-9, pg 38.

12

⁶ Direct Testimony of Witness Ward, R94-1 USPS-T-8, pg 42.

13

⁷ PRC, Opinion and Recommended Decision R94-1, pg II-16.

14

⁸ Direct Testimony of Witness Ward, R94-1 USPS-T-8, pg 44.

15

Neither the Postal Service's financial condition nor general economic

16

conditions support witness Tayman's contingency request

17

While the Commission considers the variance analysis as the starting

18

point in setting the contingency, it has indicated consistently that the Postal

19

Service's financial condition is also germane, as are general conditions in the

20

economy at large.

21

The Postal Service is in far better financial condition in this case than it

22

was in the last two cases. Table 3, below, shows for this case and the previous

23

two cases the equity position of the Postal Service at the end of the fiscal year

24

immediately before the year in which it filed a rate request, together with the

1 amount of the contingency request and, for the last two cases, the amount the
2 Commission approved.

3 Measured from the fiscal year ended immediately before filing, the Postal
4 Service's equity has improved by \$2.2 billion since the last case and \$4.6 billion
5 since the case before that. Thus, as the Commission has articulated, the Postal
6 Service is better able to withstand adverse unforeseen events than it was in the
7 last two cases when the Commission approved contingency requests of one and
8 two percent.

9 **TABLE 3**
10 **EQUITY IN YEAR PRECEEDING RATE FILING**

	USPS PROPOSED CONTINGENCY (%)	PRC CONTINGENCY (%)	EQUITY AT END OF YEAR BEFORE FILING (\$Thousands)
R2000-1	2.5 ¹		\$ (445,992) ²
R97-1	1.0 ³	1.0 ⁴	(2,623,500) ⁵
R94-1	2.0 ⁶	2.0 ⁷	(5,047,700) ⁸

11 ¹Direct Testimony of Witness Tayman, R2000-1 USPS-T-9, pg 44.

12 ²Direct Testimony of Witness Tayman, R2000-1 USPS-T-9, Exhibit 9L for FY 1999.

13 ³Direct Testimony of Witness Tayman, R97-1 USPS-T-9, pg 38.

14 ⁴PRC, Opinion and Recommended Decision R97-1, pg 21.

15 ⁵Direct Testimony of Witness Tayman, R2000-1 USPS-T-9, Exhibit 9L for FY 1996.

16 ⁶Direct Testimony of Witness Ward, R94-1 USPS-T-8, pg 42.

17 ⁷PRC, Opinion and Recommended Decision R94-1, pg 11-16.

18 ⁸Direct Testimony of Witness Tayman, R2000-1 USPS-T-9, Exhibit 9L for FY 1993.

19 Not only has equity improved, but the Postal Service is actually ahead of
20 its cumulative target for equity restoration, as displayed in witness Tayman's
21 Exhibit USPS 9N.

22 The Commission has indicated that general financial conditions in the
23 economy are important in setting the contingency and projected inflation rates
24 are often taken as a measure of these conditions. If projected inflation is high,
25 there is a greater need for a contingency since the future is less certain. Table 4,
26 below, shows three selected estimated inflation rates presented by the Postal

1 Service in this case and the two previous cases: the consumer price index (CPI-
 2 W), the Employment Cost Index (ECI), and the Producer Price Index (WPI).

3 The CPI-W is an important measure of inflation because changes in it
 4 trigger changes in craft cost of living adjustments; the ECI may be important if
 5 projections of increases lead to higher wage demands from crafts whose
 6 contracts are expiring. The WPI is also important as a measure of inflation for
 7 inputs other than labor.

8 As the table shows, projected inflation in the test year does not indicate
 9 the need for a higher contingency in this case than in the previous two. The CPI-
 10 W estimate for the Test Year is lower in this case than it was in the previous two
 11 cases although the ECI estimate is higher. While projected inflation in wholesale
 12 prices is higher in this case than in the previous one, it is far lower than in R94-1.

13 **TABLE 4**
 14 **PROJECTED TEST YEAR INFLATION**

	USPS PROPOSED CONTINGENCY (%)	PRC CONTINGENCY (%)	TEST YEAR CPI-W (%)	TEST YEAR ECI (%)	TEST YEAR WPI (%)
R2000-1	2.5 ¹		2.0 ²	3.9 ³	.5 ⁴
R97-1	1.0 ⁵	1.0 ⁶	2.6 ⁷	3.3 ⁸	.2 ⁹
R94-1	2.0 ¹⁰	2.0 ¹¹	3.2 ¹²	3.2 ¹³	2.6 ¹⁴

15 ¹Direct Testimony of Witness Tayman, R2000-1 USPS-T-9, pg 44.

16 ²Direct Testimony of Witness Tayman, R2000-1 USPS-T-9, pg 21.

17 ³Ibid.

18 ⁴Workpaper of Witness Tayman, R2000-1 LR-I-127, Workbook Dri_00, Worksheet ANNUAL,
 19 Wholesale Price Index.

20 ⁵Direct Testimony of Witness Tayman, R97-1 USPS-T-9, pg 38.

21 ⁶PRC, Opinion and Recommended Decision R97-1, pg 21.

22 ⁷Direct Testimony of Witness Tayman, R97-1 USPS-T-9, pg 19.

23 ⁸Workpaper of Witness Tayman, R97-1 H-12, Workbook Dri_2_97, Worksheet ANNUAL,
 24 Employment Compensation Index - Wages and Salaries - Private Industry

25 ⁹Workpaper of Witness Tayman, R97-1 H-12, Workbook Dri_2_97, Worksheet ANNUAL,
 26 Wholesale Price Index.

27 ¹⁰Direct Testimony of Witness Ward, R94-1 USPS-T-8, pg 42.

28 ¹¹PRC, Opinion and Recommended Decision R94-1, pg II-16.

29 ¹²Direct Testimony of Witness Ward, R94-1 USPS-T-8, pg 24.

30 ¹³Ibid.

31 ¹⁴Ibid.

1 Given the results of the variance analysis, the financial condition of the
2 Postal Service, the state of the economy, and the Commission's decisions over
3 the last 25 years, it is clear that a reasoned and reasonable contingency in this
4 case should not be larger than in either of the previous two cases. In comparing
5 R94-1 to R2000-1, the variance analysis and the financial condition of the Postal
6 Service both indicate the need for a much smaller contingency in R2000-1 and
7 the general state of the economy, as measured through inflation indices, could
8 support a lower contingency in R2000-1. And in comparing R97-1 to R2000-1,
9 the variance analysis and the financial condition of the Postal Service also both
10 indicate the need for a smaller contingency in R2000-1 and the general state of
11 the economy, as measured through the inflation indices, could support the same
12 contingency in R2000-1. Since the contingency was two percent in R94-1 and
13 one percent in R97-1, I conclude that a reasoned and reasonable contingency is
14 one percent in R2000-1.

15 **III. COST REDUCTION AND OTHER PROGRAMS**

16 In this section of my testimony, I discuss two errors in cost reduction and
17 other programs. First, although corrected by the Commission in the R97-1
18 Opinion, the Postal Service again has a flaw in the rollforward model. Second,
19 as can be shown by using estimates from Postal Service witnesses, witness
20 Tayman has underestimated savings from the AFSM 100 program. I discuss
21 each of these errors below.

22 **A. Correcting a flaw in the rollforward model**

23 In R97-1, I pointed out that cost reductions for clerks and mailhandlers and
24 carriers should be, but were not, accompanied by reductions in costs for their
25 supervisors. I also pointed out that the rollforward model keeps the ratio of
26 supervisors to those supervised constant, so that increases in craft costs are
27 accompanied by increases in supervisors' costs.

28 The Commission corrected this flaw:

1 Buc's contention that supervisor's work hours and costs
2 should go down when their managed employees' work
3 hours and costs go down is both consistent with the
4 technique the Postal Service has used in this case to
5 project test year supervisor costs and essentially
6 un rebutted. Consequently, the Commission has
7 concluded that it will make the adjustment suggested by
8 witness Buc. Op. R97-1 at 62.

9 In this case, the Postal Service again presents cost reductions for clerks and
10 mailhandlers and for carriers that are not accompanied by corresponding cost
11 reductions for their supervisors. The Postal Service did so even though it
12 realized that changes in craft labor induce changes in supervisor labor:

13 [t]he workhours, and therefore the costs, for first line
14 supervisors are largely a function of the workhour-related
15 costs of the supervised activities and supervisory span of
16 control (number of employees per supervisor). Mail
17 processing supervisors have a span of control that is
18 essentially constant in a given work organization structure.
19 It is recognized that a change in employees workhours,
20 caused by a change in mail volume, may not be
21 accompanied immediately by a corresponding change in
22 first line supervisory workhours. However, for any
23 substantial or prolonged change in the level of
24 nonsupervisory employee effort for a given work activity,
25 there will be an accompanying change in first line
26 supervisory requirements. Summary Description of USPS
27 Development of Costs by Segments and Components,
28 Fiscal Year 1998; USPS LR-I-1 at 2-2.

29 The Postal Service also provides support for this view for supervision of
30 delivery and collection, "As in the case of mail processing supervision, these
31 costs are largely a function of the workhour-related costs of each of the
32 supervised activities." Summary Description of USPS Development of Costs by
33 Segments and Components, Fiscal Year 1998; USPS LR-I-1 at 2-4.

34 Correcting this flaw again would result in savings of \$93 million in 2001 as
35 displayed in Table 5, below. Attachment B shows the derivation of my estimates.

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24

TABLE 5
CORRECTING THE FLAW IN THE ROLLFORWARD MODEL¹

Supervision of:	USPS (\$Thousands)	DMA (\$Thousands)	Difference (\$Thousands)
Mail Processing	\$989,776	\$920,374	(\$69,402)
City Carriers (In-Office)	291,243	259,143	(32,100)
City Carriers (Street)	622,338	630,898	8,560
Total	\$1,903,357	\$1,810,414	(\$92,943)

¹ Attachment B, pg 1.

B. Correcting an error in the AFSM 100 cost reduction estimate

There has been enormous confusion surrounding the cost reduction program for the AFSM 100. In fact, even witness Tayman concedes that the presentation has been confusing. Tayman, Tr.2/532. Presumably to help clarify the issues, witness Tayman filed errata to his original testimony and library references pertaining to the AFSM 100. In response, intervenors served interrogatories asking questions about the new numbers and the underlying calculations, and witness Tayman reinterpreted his presentations yet again. Fortunately, there is no reason to rely on witness Tayman's estimates of the cost reductions in this program; it is possible to estimate them directly using numbers in the testimony and library references of other Postal Service witnesses.

In his testimony, witness Tayman originally described three cost savings programs related to increased automation of flat-shaped mail through deployment of the new, high-speed flat sorting machines, the AFSM 100. Table 6, below, shows the workhour and cost savings originally projected in the Test Year for each of these.

1
2
3

TABLE 6
USPS ORIGINAL AFSM 100 COST SAVINGS ESTIMATES

Program	Number of Machines	Workhour Savings per Machine	Total Workhour Savings	Cost Savings ⁴ (\$ dollars)
AFSM ¹	1086	2,500	2,715,000	\$76,070,000
Accelerate AFSM Buy ²	44	29,727.3	1,308,000	36,648,000
AFSM to Upper Bound ³	44	43,181.8	1,900,000	53,235,000

4
5
6
7
8
9
10

¹USPS-LR-I-126 at 6.

²USPS-LR-I-126 at 6.

³USPS-LR-I-126 at 18.

⁴Docket No. R2000-1, USPS-LR-I-126, PRG_ANAL-revised.xls, 'Data'. Cost savings obtained by multiplying \$27.99 (hourly wage rate) by work total work hour savings. Hourly wage rate calculated from dividing Clerk/Mailhandler Avg. Personnel Cost (50,125) by Workhours Per Workyear (1,791).

11
12
13
14
15
16
17
18

The first row in the table describes the initial AFSM 100 program; i.e., the procurement and installation of the first set of machines. As witness Kingsley described, "The first deployment of ... AFSM 100s will be primarily used to add additional capacity to our flat mail processing network. They will handle *incoming* secondary (not outgoing secondary) flats that are currently sorted manually to carrier route at our plants and associated offices." Kingsley, Tr. 5/1782. The second and third programs buy additional machines "to replace existing FSM 881s." Tayman, Tr. 2/164.

19
20
21
22
23
24

It is obvious that the data were incorrect in the first of the three cost savings programs. They showed deployment of 1086 AFSM 100 machines when the Postal Service planned to buy only about 175 machines in its initial purchase. They also showed a workhour savings figure per machine that is much lower than the savings per machine used in the other two cost reduction programs for the same machine.

1 Witness Tayman filed errata on February 18, revising his testimony and
 2 changing the number of machines from 1086 to 173. He also provided a revised
 3 workhour savings per machine that kept intact the original total workhour savings
 4 for the cost savings program. Table 7, below, compares the original estimates
 5 for number of machines, workhour savings per machine, and total workhour
 6 savings in the Test Year for the first deployment of the AFSM 100 with the
 7 revised estimate.

8 **TABLE 7**
 9 **COMPARISON OF USPS ORIGINAL AND REVISED**
 10 **AFSM 100 FIRST DEPLOYMENT COST SAVINGS ESTIMATE**

Program	Number of Machines	Workhour Savings per Machine	Total Workhour Savings	Cost savings (\$ Thousands)
Original estimate ¹	1086	2500	2,715,000	\$76,070
Revised estimate ²	173	15,693.6	2,715,000	76,070

11 ¹USPS-LR-I-126 at 6.

12 ²USPS-LR-I-126, 2/18/00 Revised version

13 ³Docket No. R2000-1, USPS-LR-I-126, PRG_ANAL-revised.xls, 'Data'. Cost savings obtained by
 14 multiplying \$27.99 (hourly wage rate) by work total work hour savings. Hourly wage rate
 15 calculated from dividing Clerk/Mailhandler Avg. Personnel Cost (50,125) by Workhours Per
 16 Workyear (1,791).

17 Witness Tayman's revision is no more defensible than his original
 18 estimates: his revised cost savings per machine are very low compared to the
 19 other two programs, even though they do have the apparent "virtue" of
 20 preserving his original total workhours savings.

21 In response to interrogatories from MPA and DMA and in a revised
 22 response to an ANM interrogatory, witness Tayman tried to clarify the issue;
 23 there are only two buys of machines and the program "accelerate AFSM to upper
 24 bound" means that productivity on the first buy will be enhanced above the
 25 original estimate. Tayman, Tr.2/319-322, 314, 164-166. Regardless of all
 26 explanations, the ultimate source of the estimates remains with Postal Service
 27 "Program managers" and not with witness Tayman. Tayman, Tr. 2/ 490, 492,

1 540, 542, and 543. Further, in spite of all attempts at explanations, witness
2 Tayman did not provide any underlying calculations showing the derivation of the
3 cost reductions.

4 Because witness Tayman's explanations are so unsatisfying, I estimated
5 savings for the AFSM 100 based on other available information, including the
6 number of AFSM 100 sorts in the Test Year, sorting productivity on the AFSM
7 100, and savings per AFSM 100 sort, which is provided in the testimony and
8 Library References of Postal Service witnesses. I also used a conservative
9 estimate of savings. First, consistent with witness Tayman's and witness
10 Yacobucci's (USPS-T-25) cost estimating methods, I used an average wage rate
11 to determine cost savings. This completely ignores the additional savings that
12 will result from paying AFSM 100 clerks at a lower wage rate than the manual
13 clerks and keyers that the AFSM 100s will partially replace. Kingsley, Tr. 5/1803-
14 1804, 1840-1842, 1941. Second, I assumed that one half of the sorts the AFSM
15 100 will replace are low-cost sorts when the Postal Service will at least partially
16 use these machines to replace higher-cost sorts in the Test Year. Third, I
17 included savings only from the original set of machines and did not include any
18 savings from the portion of the additional 363 machines the Postal Service will
19 install during the test year. O'Tormey, Tr. 21/8349-8351.

20 For the Test Year, it was possible to develop cost reduction estimates
21 directly from information on the record rather than relying on estimates from
22 "Program Mangers". Attachment C provides the derivation of my estimates.

23 Table 8, below, provides witness Tayman's estimates and my estimates.
24 As the table shows, witness Tayman has understated AFSM 100 cost reductions
25 by at least \$199.6 million in the Test Year.

26

27

28

29

1
2
3
4
5
6
7
8
9
10
11
12

TABLE 8
COMPARISON OF USPS AND DMA
AFSM 100 TYAR COST SAVINGS ESTIMATE¹

	USPS (\$Thousands)	DMA (\$Thousands)	Difference (\$Thousands)
Clerk and MH Savings	\$ 169,379	\$ 369,312	\$ (199,933)

¹ Attachment C, pg 1.

IV. CONCLUSION

As I have demonstrated, the Postal Service ignores the Commission's principles for setting a reasonable contingency and consequently overstates their contingency request by \$1.01 billion dollars. Correcting the flaw in the rollforward program per the Commission's Opinion in R97-1 reduces the revenue request by an additional \$93 million dollars. And calculating cost savings for the AFSM 100 using the Postal Service's own data increases these cost savings by \$200 million. Thus, the revenue requirement should be reduced by \$1.30 billion.

Test Year Revenue Requirement with Contingency Adjustment (all dollar figures in thousands)

USPS			Cost Adjustments		DMA			Total Accrued Cost (w/ Contingency)	Total Contingency Adjustment	Total Revenue Req. Adjustment
Total Accrued Cost	Contingency	Accrued Cost (w/ Contingency)	Rollforward Flaw	AFSM 100	Total Accrued Cost	% Contingency	Contingency			
[1]	[2]	[3]=[1]+[2]	[4]	[5]	[6]=[1]+[4]+[5]	[7]	[8]=[6]*[7]	[9]=[6]+[8]	[10]=[8]-[2]	[11]=[9]-[3]
\$67,190,634	\$1,679,766	\$68,870,400	(\$92,943)	(\$199,933)	\$66,897,758	1.0%	\$668,978	\$67,566,735	(\$1,010,788)	(\$1,303,665)

Sources:

- [1],[2] Direct Testimony of Witness Tayman, R2000-1 USPS-T-9, pg. 22, Table 15.
- [4] Attachment B, pg 1.
- [5] Attachment C, pg 1.
- [7] Contingency rate proposed by DMA.

Summary

Attachment B

Calculation of DMA/Buc Adjustment (in thousands of dollars)

Supervisor Type	FY 1999 Cost			FY 2000 Cost			Test Year After Rates		
	Initial	Adjusted	Adjustment	Initial	Adjusted	Adjustment	Initial	DMA Adjust.	Adjusted
	[1]	[2]	[3]=[2]-[1]	[4]	[5]	[6]=[5]-[4]	[7]	[8]	[9]=[8]-[7]
Mail Processing /1	\$930,540	\$915,804	(\$14,736)	\$958,256	\$930,058	(\$28,198)	\$989,776	\$920,374	(\$69,402)
City Carriers (In-Office) /2	\$277,121	\$267,810	(\$9,311)	\$281,473	\$258,093	(\$23,380)	\$291,243	\$259,143	(\$32,100)
City Carriers (Street) /3	\$595,310	\$594,180	(\$1,130)	\$599,718	\$608,603	\$8,885	\$622,338	\$630,898	\$8,560
Total:	\$1,802,971	\$1,777,793	(\$25,178)	\$1,839,447	\$1,796,755	(\$42,692)	\$1,903,357	\$1,810,414	(\$92,943)

Sources:

[4] Workpaper of Witness Kashani, R2000-1, USPS-T-14, WP-E, pg. 3, 4, 6, 7.

[7] Workpaper of Witness Kashani, R2000-1, USPS-T-14, WP-I, pg. 3, 4, 6, 7.

[1],[2],[5],[8] Attachment B, pg. 2-3.

/1 Segment/Component Code 0004

/2 Segment/Component Code 0013

/3 Segment/Component Code 0020 - Segment/Component Code 0013

AFSM 100 Savings Comparison

Attachment C

AFSM 100 Cost Savings Comparison (all numbers in thousands)

	DMA	USPS	Difference
	[1]	[2]	[3]=[1]-[2]
Total Savings	\$ 369,312	\$ 169,379	\$ 199,933

Sources:

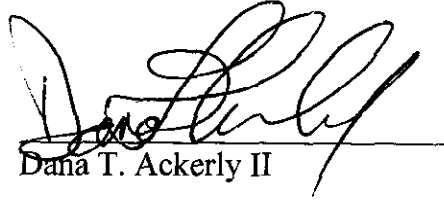
[1] Attachment C, pg 2.

[2] Attachment C, pg 3.

CERTIFICATE OF SERVICE

I hereby certify that I have this date served the foregoing document in accordance with the Commission's Rules of Practice.

May 22, 2000


Dana T. Ackerly II