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USPS-ST-44

BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON DC 20268-0001

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POSTAL RATE COMMISSION
OFFICE OF THE SECRETARY

POSTAL RATE AND FEE CHANGES, 2000

Docket No. R2000-1

SUPPLEMENTAL TESTIMONY OF
RICHARD PATELUNAS
ON BEHALF OF
UNITED STATES POSTAL SERVICE
IN RESPONSE
TO ORDER
NO. 1294

July 7, 2000

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Supplemental Testimony
of
Richard Patelunas

AUTOBIOGRAPHICAL SKETCH

1 My name is Richard Patelunas. I am a Financial Analyst with the U. S.
2 Postal Service and I began as a career employee in 1977. Before coming to
3 Headquarters in 1986, I held the craft positions of city carrier, LSM Operator,
4 distribution clerk and window clerk. Prior to that, I had several temporary
5 appointments between 1974 and 1977.

6 I presented testimony before the Postal Rate Commission in Docket Nos.
7 R90-1, MC93-1, R94-1, MC95-1, MC96-3 and R97-1. I have a B.A. in
8 Economics from the State University of New York at Binghamton (1978) and an
9 M.B.A. from Syracuse University (1986).

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I. PURPOSE OF TESTIMONY

My testimony presents the changes to the Postal Service's Docket No. R2000-1 revenue requirement and test year costs that result from utilizing FY 99 actual audited accounting data and costs by class of mail as the base year. These changes are in response to Order No. 1294, issued by the Postal Rate Commission on May 26, 2000, that instructed the Postal Service to incorporate actual FY 99 costs into its test year forecasts. In its Request, the Postal Service used FY 98 accounting and class of mail costs for the base year. Additionally, the cost change factors used in the rollforward model to estimate FY 2000 and test year costs have been updated in accordance with Presiding Officer's Ruling No. R2000-1/71, also issued on May 26, 2000. My testimony outlines the results of this update and is supported by several Exhibits and an electronic version of the rollforward model which will be filed in USPS-LR-I-406. Each of the changes and their impact on the revenue requirement, test year costs, and revenues are discussed below.

There are no workpapers associated with my testimony. The library references supporting my testimony will be filed by July 21, 2000.

II. FY 99 ACTUAL ACCOUNTING COSTS AND OTHER ACTUAL FY 99 DATA

In the update, the base year was changed from FY 98 to FY 99, and all base year data used for rollforward factor development and in the rollforward model was changed to reflect FY 99 actual results. In addition to costs by cost segment and component, which are reflected in the FY 99 Reallocated Trial Balance and the FY 99 Cost and Revenue Analysis Report, all other base year data were updated to reflect FY 99 actual results. These include data from the National Payroll Hour Summary Report,

the On Rolls and Paid Employee Report, and data provided by the Office of Personnel Management related to annuitant costs. The FY 99 estimated costs by segment and component reflected in the Request were very close to the actual costs by cost segment and component; in total the amount of variance was only 8 million dollars.

III. UPDATES IN ADDITION TO THE FY 99 CRA

A. COST LEVEL CHANGE

The non-personnel cost level change factors were updated to reflect the most recent inflation forecasts available. Both actual and forecasted inflation rates have increased since the Request. The key DRI indexes used for this update are reflected in Exhibit USPS-ST-44AB which compares the update to the forecasted DRI indexes reflected in the Request. The forecast for almost all key indexes is now higher for FY 2000 and the test year. The gas and oil index, in particular, is dramatically higher. These changes drove FY 2000 and test year non-personnel costs higher than the amounts originally reflected in the Request.

Personnel cost level change factors were also updated. Particularly relevant to personnel cost levels is the Employment Cost Index (ECI) which is now estimated to increase by .76% more in the test year than estimated in the Request. Postal Service wages represent the Postal Service's largest expense, and the ECI is a key index because it is used as a benchmark for estimating changes in test year wage rates for bargaining unit employees whose labor contracts do not extend into the test year. The Cost of Living Allowances (COLA) paid to bargaining unit employees under their labor contracts were updated to reflect the latest CPI-W forecast. The COLA effective on September 11, 2000, estimated in the Request to be \$291 for most bargaining unit

employees is now estimated to be twice that amount, or \$582. The test year forecast for health benefit premiums was not revised since the latest forecast is still close to the one used for the Request. However, the calculation for estimating health benefit unit cost changes for bargaining employees was adjusted to reflect the fact that rural carriers will receive the benefit of a two percent cost shift to the Postal Service one year later than other bargaining employees. The test year labor contract assumption for those bargaining units that do not have contracts has also been re-evaluated and has been changed to reflect a total change in wage rates equal to the estimated change in the Employment Cost Index. After subtracting the impact of FY 2000 carryover costs, the effective change in wages related to the new contract is 2.8 to 3.0 percent, or 1.7 to 1.8 percent less than the Employment Cost Index. This assumption is consistent with the FY 2001 Operating Budget. A comparison of updated unit labor costs to those used in the original filing is reflected in Exhibit-USPS-ST-44H. The impact of the agreement with the National Rural Carriers Association to extend their labor contract to November, 2000 has also been reflected in this update. These changes are the same ones reflected in the Postal Service's response to POIR No. 7, filed on April 17, 2000. Other changes include the method used to calculate the impact of step increases for clerks. An agreement to "average out" the large step increases previously characterized by extended steps has resulted in the temporary creation of a new salary schedule with uniform step increases and waiting periods. The detailed calculations supporting these changes will be reflected in the Uncst_est workbook in USPS-LR-I-421. Updated salary and benefit cost level changes are summarized in Exhibit USPS ST44J.

1 B. MAIL VOLUME CHANGE

2 The same mail volume forecast used in the original filing was used for this
3 update. As a result, the mail volume effect was little changed from the Request and
4 related mainly to changes to base year costs. As noted on page 2 of 6 of Exhibit
5 USPS-ST-44L, the FY 2000 mail volume effect for Periodicals has been recalculated
6 using the volumes shown in the FY 99 Cost and Revenue Analysis Report as the base.
7 Also see the response of witness Kashani to OCA/USPS-T14-5.

8
9 C. NON-VOLUME WORKLOAD

10 The same non-volume workload factors used in the Request were used for this
11 update. As a result the non-volume workload cost changes were little changed from
12 the Request and relate mainly to changes to base year costs.

13
14 D. ADDITIONAL WORKDAY EFFECT

15 The same additional workday effect factors used in the Request were used for
16 this update. As a result the additional workday changes were little changed from the
17 Request and relate mainly to changes to base year costs.

1
2 E. COST REDUCTIONS

3 Test year cost reductions were updated to reflect the impact of breakthrough
4 productivity and additional Periodicals initiatives savings identified since the Request
5 was filed. A comparison of the original cost reduction program changes to the updated
6 changes are reflected in Exhibits ST 44Z and AA. It should be noted that some cost
7 reductions related to breakthrough productivity were reflected as other programs due to
8 the limitations of the cost factor models and the limited amount of time to change them.
9

10 F. OTHER PROGRAMS

11 As explained on page 15 of USPS-T-9, other programs can be divided into two
12 major categories. The first category relates to changes in costs associated with
13 management-initiated actions other than cost reductions that change the status quo.
14 This category consists mainly of Headquarters Administered Programs and Corporate-
15 wide Activities. The accounting base for Headquarters Administered Programs and
16 Corporate-wide Activities was updated to reflect FY 99 actual expenses. However,
17 other than a few changes and additions, the amount of year to year change in this
18 category of other programs was adjusted to produce the same level of test year costs
19 reflected in the Request. Three programs were revised for the test year resulting in a
20 net decrease of \$12 million. Advertising costs were decreased from \$270 million to
21 \$160 million, Expedited Supplies costs were increased from \$57 million to \$110 million,
22 and Priority Mail Processing Contract costs were increased from \$522 million to \$567
23 million. Additionally, Priority Mail Processing Contract costs were increased by \$123
24 million from \$472 million to \$595 million. Two new programs, E-Commerce and Co-

1 Branded Advertising/Expanded Retail Product sales, were added to the test year. An
2 additional \$146 million was added to the test year to cover the cost of E-Commerce
3 programs, and \$50 million was added for the cost related to Co-branded advertising
4 and Expanded Retail Product sales. The revenue effects of these two programs are
5 discussed in a separate section below.

6 The second major category reflected under other programs includes expenses not
7 directly linked to operations such as depreciation, interest, and corporate-wide
8 personnel costs, such as annuitant costs and worker's compensation. Depreciation
9 was updated only to reflect the impact of the FY 99 base. Corporate-wide personnel
10 costs were updated to reflect the impact of the FY 99 base as well as the impact of
11 inflation drivers such as the CPI for annuitant colas, and wage costs for CSRS

12 Unfunded Liability and Repricing of Annual Leave. Interest expense would be
13 somewhat higher for FY 2000 and the test year due to the fact that the net income
14 (loss) reflected in this update are less favorable than those reflected in the Request.

15 Due to time constraints, however, interest expense calculations have not been changed
16 from the amounts reflected in the Request. FY 2000 workers' compensation costs were
17 increased to \$848.676 million to reflect the increased number of claims and rising
18 medical costs appearing in recent trends. These increases were partially offset by a
19 change in the life tables used to calculate the liability related to long term cases.

20 Updated test year costs were reflected at the same level as updated FY 2000 estimate,
21 consistent with the proposed FY 2001 Operating Budget, despite the fact that current
22 trends and our estimation methodology indicate a much higher level of expense. These
23 calculations and additional documentation are reflected in USPS-LR-I-422. Plans are
24 being formulated to reduce the modeled level of workers' compensation costs back to

the amount budgeted for FY 2001. A summary of the major change to other programs changes from the Request is reflected in Exhibit ST 44AA.

G. WORKYEAR MIX ADJUSTMENT

The workyear mix adjustment was updated to reflect the impact of FY 99 actual personnel costs and the FY 99 actual workyear mix. The overtime assumption was updated to reflect the overtime planned in the FY 2000 operating budget and the fact that overtime is currently over plan. The Transitional Employee (TE) workyear assumption was updated to reflect the actual number of TE's through Accounting Period 9, PFY 2000. The career employee retirement assumption was updated to reflect FY 99 actual retirements. As a result of large cost reductions and minimal workload increases in the test year after rates, workyear reductions are required that are in excess of the number that will result from estimated retirements for career clerks and mail handlers. Since TE workyears are derived separately, and overtime is currently running over plan, the additional workyear reductions required to balance to the total estimated after rates test year clerk and mail handler workyears were assumed to be taken from casuals.

H. FINAL ADJUSTMENTS

Changes to final adjustments are explained in USPS-LR's-I-419 and 421.

I. PROVISION FOR CONTINGENCIES

The 2.5% contingency was used in the update.

J. PRIOR YEARS LOSS RECOVERY

The method used to calculate the Prior Years' Loss Recovery was not changed from the Request. As reflected in the following table the amount of recovery required is \$311.709 million. This is higher than the \$268.257 million reflected in the Request due to the estimated net loss of \$325.463 million in FY 2000 instead of the \$65.603 million net income estimated in the Request.

Computation of Prior Years' Loss Recovery
(\$000)

Deficit from Operations since commencement on July 1, 1971 through September 30, 1998	3,843,327
Less: Actual net income in FY 1999	363,411
Plus: Estimated net loss in FY 2000	325,463
Less: Funds from Public Law No. 94-421	1,000,000
Total Recovery Required	2,805,379
Annual Increment (1/9)	311,709

K. REVENUE

Mail and Services Revenue for FY 2000, and the Test Year Before and After Rates have been updated for the changes made to Exhibits USPS-32A, B and C (revised 4/21/00). Other income has also been revised for the Test Year Before and After rates to include additional revenue reflected in the proposed FY 2001 Operating Budget related to new Retail Product sales of \$100 million, co-branded advertising revenue of \$100 million, and E-commerce revenue of \$104 million.

L. NET INCOME (LOSS)/TEST YEAR REVENUE DEFICIENCY

As reflected on Exhibit ST44A, the changes discussed above result in an FY 2000 net loss of \$325.5 million, a test year before rates deficiency of \$3.799 billion, and a test

1 year after rates deficiency of \$275.3 million. This compares to a FY 2000 net income of
2 \$65.6 million, a test year before rates deficiency of \$3.688 billion, and a test year after
3 rates deficiency of \$21.8 million, reflected in the Request.

4 5 IV. ROLLFORWARD MODEL UPDATES

6 The rollforward methodology is the same as in the Request, although certain
7 changes were required to perform the update. The changes can be summarized as
8 follows:

- 9 1) additional cost reductions and other programs were incorporated,
- 10 2) the FY 1999 base volumes for Periodicals were changed to agree with the Cost and
11 Revenue Analysis Report,
- 12 3) errors discovered since the Request were corrected, and
- 13 4) incorporate the PESSA cost impact of the transition of Special Delivery Messengers
14 from Cost Segment 9 to Cost Segment 3 were incorporated.

15
16 Item 1) was accomplished by either incorporating the additional amounts with
17 cost reductions and other programs that existed in the Request or incorporating
18 additional amounts and associated distribution keys where necessary. The
19 development of all cost reductions and other programs will be contained in USPS-LR-I-
20 421 and the factors used in the updated rollforward are shown in Exhibit USPS-ST44L.
21 The main frame computer input data files and the processing documentation reports
22 used in the update are contained in USPS-LRs-411 and 412.

23 Item 2) can be seen in the calculation of the revised FY 2000 mail volume effect
24 used in the update is shown on page 2 of Exhibit USPS-ST44L. The calculation merely

1 substitutes the Periodicals volumes as reported in the FY 99 Cost and Revenue
2 Analysis Report for the FY 1999 volumes used in the Request. Also see the response
3 of witness Kashani to OCA/USPS-T14-5. This is the only adjustment related to mail
4 volumes because the forecast used in the Request is otherwise used in the update.

5 Item 3) relates to questions that arose during discovery on the Postal Service.
6 The questions pointed out confusion about the rollforward model processes and errors
7 that went unnoticed in the Request. One area of confusion was the migration of
8 volumes of Standard A Single Piece to First-Class Single Piece and Priority Mail. The
9 Standard A Single Piece Migration is still necessary in the update because one quarter
10 of Standard A Single Piece mail is reflected in the FY 99 Cost and Revenue Analysis
11 report. The migration reflected in the Request caused questions, and subsequently
12 errata were filed to the testimony of witness Kashani, USPS-T-14 (see witness
13 Kashani's responses to Presiding Officer's Information Requests Nos. 10 and 12). To
14 avoid a recurrence of the confusion, I expanded witness Kashani's approach to
15 mechanically move 95% of Standard A Single Piece mail to First Class Single Piece
16 and the remaining 5% of Standard A Single Piece to Priority Mail using the first
17 rollforward adjustment – the cost level adjustment, although the migration is actually
18 unrelated to any cost level change. The amounts migrated are shown in Exhibit USPS-
19 ST44Y. I removed the mail volume effect because in the Request it masked the
20 migration because it removed the residual amounts from Standard A Single Piece
21 without migrating all of the costs to First-Class Single Piece and Priority Mail. Upon
22 examination of the results, I found that there were no Standard A Single Piece costs in
23 any of the files following this procedure, so I am confident that the migration was
24 complete.

1 There were a number of other errors in the rollforward filed with the Request.
2 See the responses of witness Kashani to OCA/USPS-T14-2, OCA/USPS-T14-3 and
3 MPA/USPS-T14-2. These are corrected in the update as described in the Kashani
4 responses or will be detailed in USPS-LRs-411 and 412.

5 Item 4) was also an area of confusion in the Request because the first
6 rollforward year (FY 99) was the year in which the transition of Special Delivery
7 Messengers for Cost Segment 9 to Cost Segment 3 would occur. The adjustment for
8 this transition is not necessary in the update because the FY 99 Reallocated Trial
9 Balance and the FY 99 Cost and Revenue Analysis report include the transition. Model
10 changes were required though to reflect the inclusion of the FY 1999 CRA PESSA cost
11 methodology into each of the rollforward years. The CRA PESSA cost methodology is
12 the same as used in Base Year 1998 in the Request except for the transition of Special
13 Delivery Messengers from Cost Segment 9 to Cost Segment 3. The model adjustments
14 for the PESSA cost methodology will be found in USPS-LRs-411 and 412.

EXHIBITS

STATEMENTS OF REVENUE AND EXPENSE FY 1999 - TEST YEAR AFTER RATES	USPS-ST-44A
ROLLFORWARD SOURCE OF CHANGE SUMMARIES FY 1999 THROUGH THE TEST YEAR AFTER	USPS-ST-44B
MAIL AND SPECIAL SERVICES REVENUE, FY 1999 THROUGH TEST YEAR AFTER RATES	USPS-ST-44C
REVENUE REQUIREMENT, SUMMARY ANALYSIS OF INCOME AND EXPENSES	USPS-ST-44D
SUMMARY OF NET INCOME (LOSS) & EQUITY	USPS-ST-44E
SUMMARY OF CHANGES IN ACCRUED COSTS BY SOURCE	USPS-ST-44F
NET INCOME (LOSS) GAP FROM EQUITY RESTORATION TARGET	USPS-ST-44G
COMPARISON OF UNIT LABOR COSTS FOR MAJOR EMPLOYEE GROUPS	USPS-ST-44H
SUMMARY OF CHANGES IN WORKYEARS BY SOURCE	USPS-ST-44I
ANALYSIS OF CHANGES IN PERSONNEL COSTS	USPS-ST-44J
ADJUSTMENT OF ROLLFORWARD COST FOR WORKYEAR MIX AND FINAL ADJUSTMENTS	USPS-ST-44K
ROLLFORWARD FACTORS	USPS-ST-44L
COST SEGMENTS AND COMPONENTS, FY 1999 AFTER MIGRATION OF STANDARD A SINGLE PIECE	USPS-ST-44M
FINAL ADJUSTMENTS, FY 1999 AFTER MIGRATION OF STANDARD A SINGLE PIECE	USPS-ST-44N
COST AND REVENUE ANALYSIS, FY 1999 AFTER MIGRATION OF STANDARD A SINGLE PIECE	USPS-ST-44O

EXHIBITS

COST SEGMENTS AND COMPONENTS, FY 2000	USPS-ST-44P
FINAL ADJUSTMENTS, FY 2000	USPS-ST-44Q
COST AND REVENUE ANALYSIS, FY 2000	USPS-ST-44R
COST SEGMENTS AND COMPONENTS, TY 2001BR	USPS-ST-44S
FINAL ADJUSTMENTS, TY 2001 BR	USPS-ST-44T
COST AND REVENUE ANALYSIS, TY 2001 BR	USPS-ST-44U
COST SEGMENTS AND COMPONENTS, TY 2001 AR	USPS-ST-44V
FINAL ADJUSTMENTS, TY 2001 AR	USPS-ST-44W
COST AND REVENUE ANALYSIS, TY 2001 AR	USPS-ST-44X
STANDARD A SINGLE PIECE MIGRATION	USPS-ST-44Y
COMPARISON OF ORIGINAL TO UPDATED COST REDUCTIONS	USPS-ST-44Z
COMPARISON OF ORIGINAL TO UPDATED OTHER PROGRAMS	USPS-ST-44AA
COMPARISON OF KEY INFLATION INDICES	USPS-ST-44AB