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Before the

UNITED STATES POSTAL RATE COMMISSION

In the Matter of: POSTAL RATE AND FEE CHANGE

Docket No. R2000-1

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BEFORE THE

POSTAL RATE COMMISSION

- -X

In the Matter of: :

POSTAL RATE AND FEE CHANGE : Docket No. R2000-1

- -X

Third Floor Hearing Room

Postal Rate Commission

1333 H Street, N.W.

Washington, D.C 20268

Volume XLVI-A

Thursday, August 31, 2000

The above-entitled matter came on for hearing, pursuant to notice, at 8:32 a.m.

BEFORE:

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HON. W.H. "TREY" LeBLANC, COMMISSIONER

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C O N T E N T S

EXHIBITS

PROCEEDINGS

[8:32 a.m.]

CHAIRMAN GLEIMAN: Good morning. Today we begin our final session of hearings in Docket R2000-1.

I have a procedural matter before we begin today. In Ruling Number 131, I set out how materials provided at the end of the case could be designated for incorporation into the evidentiary record.

A large number of designations have been received, and I have directed the Commission staff to prepare a packet for incorporation during today's hearings.

The packet will be in the hearing room later this morning, I hope. We have one of our staff actually here all night long, putting the package together.

After our lunch break, the materials will be admitted into evidence. Our lunch breaks don't necessarily come at what some people consider to be the normal lunch hour.

As stated in Ruling 131, transcript corrections and additional designations should be filed by September the 6th. Last evening, I requested Postal Service Witness Degen to provide additional supporting materials related to his testimony.

I asked that those materials be submitted by September the 6th. It is my intention to add those materials to the evidentiary record.

Does any participant have a matter that they would like to raise at this point?

[No response.]

CHAIRMAN GLEIMAN: If not, I would like to mention one matter that was made of record yesterday. Yesterday, I issued a ruling, Ruling 138, denying an OCA motion to compel disclosure of certain materials by the Postal Service.

If I may for just a moment, I think it would be worthwhile reading that very short ruling, because I think it is relevant to what goes on and may go on in the hearing room today.

On August the 22nd, 2000, the Office of the Consumer Advocate filed a motion to compel a response to Interrogatory OCA/USPS-ST-44-51. A flurry of pleadings has followed.

The Postal Service filed an answer; OCA filed a response to the answer, and the Postal Service filed a rejoinder to that response. I accepted all those pleadings, and I denied the motion to compel.

The OCA interrogatory requested the production of a document that Postal Service counsel has assured us does not exist. The OCA and many in the mailing industry, including members of the Commission and its staff, might have surmised that the Postal Service operated under an annual budget that was carefully developed and was then reviewed and eventually approved by the Board of Governors before the beginning of each fiscal year.

We have been told that Fiscal 2001 will have begun and been ongoing for approximately a month before the Governors will see what passes for a formal budget at the Postal Service.

And we have been told that what the Governors will approve is, and I quote, "a net income goal and a set of planning parameters that support that net income goal. The Board is not supplied with and does not vote on detailed operating plans. Detailed operating plans have typically not been completed at the time the Board votes on the budget."

This quote appears in two Postal Service pleadings on this topic. Since detailed operating plans have not typically been completed at the time the Board votes on at budget, which is after the fiscal year has already begun, it is clear that such plans cannot be provided now in response to the OCA's discovery request.

OCA and other parties may argue the significance of these facts to the Commission as they relate to the weight the Commission should give to statements of Witness Patelunas and other witnesses, that testimony is consistent with the fiscal operating 2001 budget.

Eight witnesses are scheduled to present testimony today. The witnesses are Strasser, Dowling, Bernheimer, O'Hara, Greene, Bozzo, Neels and Smith. Witness Neels will be presenting two separate pieces of testimony.

Mr. Reiter?

MR. REITER: Our next witness is Richard Strasser.

Whereupon,

RICHARD J. STRASSER, JR.

a witness, having been called for examination, and, having been first duly sworn, was examined and testified as follows:

DIRECT EXAMINATION

BY MR. REITER:

Q Mr. Strasser, you have a document entitled Rebuttal Testimony of Richard J. Strasser, Jr., on Behalf of the United States Postal Service, designated USPS-RT-1.

Was that testimony prepared by you or under your direction?

A Yes, it was.

Q And if you were to testify orally here today, would your testimony be the same?

A Yes, it would.

MR. REITER: Mr. Chairman, with that, I ask that the testimony be entered into the record of this proceeding.

CHAIRMAN GLEIMAN: Is there an objection?

[No response.]

CHAIRMAN GLEIMAN: Hearing none, counsel, if you would please provide two copies of Mr. Strasser's testimony to the Court Reporter, I will direct that the material be received into evidence and transcribed into the record.

[Written Rebuttal Testimony of Richard J. Strasser, Jr., USPS-RT-1, was received into evidence and transcribed into the record.]

USPS-RT-1

BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON DC 20268-0001

POSTAL RATE AND FEE CHANGES, 2000	Docket No. R2000-1

REBUTTAL TESTIMONY OF
RICHARD J. STRASSER, JR.
ON BEHALF OF
THE UNITED STATES POSTAL SERVICE

CONTENTS

Direct Testimony

of

Richard J. Strasser Jr.

AUTOBIOGRAPHICAL SKETCH

My name is Richard J. Strasser, Jr. I am Acting Chief Financial Officer and Executive Vice President of the United States Postal Service. I was appointed to this position on May 3, 2000, after serving as District Manager, Northern Virginia, since 1992.

While serving as District Manager, I led a team that continually improved service in Northern Virginia, while satisfying growing customer demands fueled by rapid commercial development and residential growth. Prior to this field assignment, I served as Chief Marketing Officer and Chief Planning Officer. My postal career began as a management intern in 1969. Before becoming an officer, I held progressively responsible management positions, including the first product manager for Express Mail.

I graduated from Seton Hall University with a BA in political science and accounting. I also received a Master's degree in Public Administration through the Key Executive program at American University. I attended executive programs at the University of Virginia's Darden School and at Duke University's Fuqua School of Management. I have lectured extensively on the topic of government-sponsored enterprises.

I. PURPOSE AND SCOPE OF TESTIMONY

My testimony responds to and rebuts intervenors who propose reducing the Postal Service's revenue requirement for the Test Year. In the following, I demonstrate that neither their testimony nor post-filing events form a legitimate basis for the proposed reductions. In particular, several intervenor witnesses urge the Postal Rate Commission to override management's discretion and reduce the Postal Service's contingency from 2.5 percent to 1.0 percent. I will reaffirm that, contrary to these intervenors' testimonies, in the circumstances of the Docket No. R2000-1 rate case, the 2.5 percent provision for contingencies is not only reasonable, it is responsible and conservative.

In connection with my discussion of the proposed revenue requirement reductions, I will also briefly review the major implications of the updates to the Postal Service's test year estimates that resulted from Commission Order No. 1294 and related rulings and requests for information. These updated estimates are contained in witness Patelunas's supplemental testimony, numerous library references, and in Postal Service responses to various inquiries from intervenors, the Presiding Officer, and the Commission. The Postal Service does not believe that it would be appropriate to supplant the financial foundation for its filing with a reformulated base year and completely revised test year estimates. Accordingly, it has not proposed amending its Request for new revenues as a result of the updates. I must emphasize, however, that any attempt to update the Postal Service's revenue needs in the test year should at a minimum take account of the assumptions and adjustments presented in Mr. Patelunas's testimony.

Four other Postal Service witnesses present rebuttal or supplemental testimony related to the revenue requirement. Witness Zarnowitz (USPS-RT-2) explains that the business cycle is not dead and outlines the substantial uncertainty and inflationary pressures we face in today's economic environment. Witness Thress (USPS-ST-46) shows that interim period volume projections have tracked well with actual results. This renders it unlikely that we will be "bailed out" by higher than projected volumes and revenues in the test year. Witness Dowling, in response to ANM witness Haldi, explains how the Postal Service has responsibly pursued opportunities to develop and implement technology to reduce flat processing costs. My testimony also responds to witness Haldi and shows why Haldi's productivity adjustment should not be made. Finally, witness Patelunas's rebuttal testimony addresses DMA et. al. witness Buc's efforts to increase the Postal Service's already substantial cost savings program estimates. My testimony responds to witness Buc's testimony on issues relating to the contingency.

II. THE POSTAL SERVICE'S PROPOSED CONTINGENCY PROVISION FALLS WELL WITHIN A WELL-ESTABLISHED RANGE OF REASONABLENESS

Several intervenors have argued that the Postal Service does not need a 2.5 percent contingency, because it has operated successfully over the last two rate cycles with lower contingency provisions. In so arguing, however, they have not recognized the increased risk that now characterizes the time period through the test year. They have also argued that the Postal Service has not adequately supported its contingency provision, and has not followed the approach for justifying the contingency established by the Commission in its prior Opinions. For example, Witness Buc makes the extreme claim that the Postal Service has never in the history of postal ratemaking developed a reasoned contingency provision. Tr. 22/9563.

On the contrary, the Postal Service has rationally reckoned its contingencies from rate case to rate case, pursuant to a judgmental assessment of the need for a cushion against unknown developments in the test year. This assessment appropriately takes account of a variety of factors, including the Postal Service's expected financial condition, historical experience, the potential for unknown future adversities, and the Postal Service's financial, operational, and ratemaking policies.

By contrast, intervenors have argued that the contingency must be justified largely empirically, with statistics and hard data, such as a historical variance or probability analyses. As the Postal Service has long maintained, however, while historical and forecasted quantitative data can clearly aid the decision-making process, the ultimate decision to include a provision for contingencies is logically and necessarily judgmental, and represents a major policy choice by the Board of Governors as to the level of risk the Postal Service is willing to assume in the test year with regard to unknown developments. In this regard, it seems ironic that each intervenor witness who insists that judgment should not be the basis for determining the contingency has in fact used the very approach he has argued against. Each of them has considered historical data, examined forecasts and trends related to the future, and then judgmentally determined that a lower contingency is warranted based on the facts they have considered. This is the same process the Postal Service followed.

Selection of an appropriate provision for contingencies has always been an integral part of a responsibly-developed revenue requirement. Congress expected that the Postal Service would include a contingency amount in estimating its future revenue needs. Section 3621 of the Postal Reorganization Act (39 U.S.C. § 3621) provides that :

> Postal rates and fees shall provide sufficient revenue so that total estimated income and appropriations to the Postal Service will equal as nearly as practicable total estimated costs of the Postal Service. For the purposes of this section, "total estimated costs" shall include (without limitation)...a reasonable provision for contingencies.

The Kappel Commission, furthermore, suggested 3.0 to 5.0 percent as a reasonable range. Over the course of 30 years of postal ratemaking, the Postal

Rate Commission has recommended all but one of the Postal Service's contingency requests, which have ranged between 1.0 and 5.0 percent.[1]

The intervenors emphasize that in Docket Nos. R94-1 and R97-1, the Postal Service included relatively low provisions for contingencies (2.0 and 1.0 percent, respectively), compared to the historical pattern of from 3.0 to 5.0 percent. As explained by Witness Tayman, however, the situations justifying the Postal Service's judgment in those cases, were unique. The Postal Service's financial performance has since become more marginal, and new uncertainties are emerging. Consequently, the Postal Service has restored the contingency to a more normal, but still modest level of 2.5 percent. In fact, the predicate for returning the level of the contingency provision in this case closer to the historical norm was laid by Witness Tayman in Docket No. R97-1, when he testified concerning the 1.0 percent contingency provision in that case. He stated,

> This conclusion does not represent a permanent change in management's judgment concerning the level of coverage generally necessary to protect against unforeseen events and forecasting errors. In different circumstances in the future, it may well be necessary to return to the higher levels of contingency historically deemed prudent to provide the protection intended by the provision for contingencies.

USPS-T-9, p. 38, Docket No. R97-1.

Intervenors attacking the contingency, exemplified by OCA witness Rosenberg, refuse to acknowledge that current circumstances are different. See Tr. 22/9852 and Tr. 22/9875-78. Fiscal Year 2000, however, which is an interim year in this rate filing, has been one of the most challenging years for Postal

[1] Docket No. R80-1 was the lone instance where the Commission recommended reducing the contingency provision. An appellate court overruled, as an "unlawful intrusion into the policy-making domain of the Board," the Commission's recommendation that the Postal Service's 3.0 percent contingency provision in that docket be reduced to 1.8 percent.

Service managers in recent memory. Fiscal Year 2001 (the Test Year) promises to be even more challenging.

In this regard, there is absolutely no reason to reduce the proposed contingency in response to OCA Witness Burns' unfounded concern that the contingency constructs a "moral hazard for lax and inefficient management" (See Tr. 22/9775), or Witness Rosenberg's fear that the contingency provision provides a cushion that results "in a tendency toward slackness." See. Tr. 22/9826. As a field District Manager, I take must emphatically take exception to these suggestions. Postal managers and craft employees are concerned about our customers and the future of our business and *do not* behave in this manner. Extraordinary efforts have been made by dedicated managers and employees working to achieve the $100 million net income goal set forth for FY 2000. There have been continuing field and headquarters operating budget cuts throughout this year.

Despite these efforts, it has appeared less and less likely as this year progresses that we will actually achieve a positive net income. Through Accounting Period 11, we are $436 million behind our $100 million FY 2000 net income plan. This level of financial performance is dramatically different from the circumstances that prevailed in Docket No. R97-1, where we earned a substantial positive net income in the interim year, and had been consistently performing well ahead of plan.

Without exhaustively listing all differences in the financial and operating environment since the last rate case, I believe it is clear that inflation has already accelerated beyond what was embedded in our current rate case filing. During Docket No. R97-1, inflation had moderated relative to what was embedded in that filing. And, the fact that overall inflationary pressures specific to the Postal Service are quite different comparing Docket Nos. R97-1 and R2000-1 is suggested by the relative magnitudes of the rate increases – 2.9 percent in Docket No. R97-1, versus a proposed 6.5 percent in the current rate case. This difference in rate increase percentages is not due to changes in the contingency alone. Further, there is greater uncertainty pertaining to test year labor expenses in this case than pertained in Docket No. R97-1, due to the fact that the labor contracts for all major craft unions except city carriers will expire during the test year of this rate case. These are all differences that factor into an increased contingency.

III. DMA WITNESS BUC'S ONE-PERCENT CONTINGENCY PROPOSAL SHOULD BE REJECTED

DMA Witness Buc makes several arguments disputing the reasonableness of the Postal Service's 2.5 percent contingency provision. He concludes that no more than a 1.0 percent contingency is justified. I disagree with his arguments, as I explain below.

A. The Postal Service Has Followed an Appropriate Framework for Determining the Contingency Provision

Witness Buc stated his opinion that the Postal Service has not followed the appropriate "framework" for determining the contingency established by the Commission in its prior Opinions. Tr. 22/9563. He and other intervenor witnesses suggest that the Commission has determined that quantitative measures centering on analysis of variances in estimates of costs and revenues, versus actual operating results, should guide the selection of a contingency provision. Tr. 22/9534, 9542 (Buc); 9714 (Burns).

I have been advised that, although in early decisions the Commission expressed a hope that a quantitative approach, such as the historical variance analysis, would prove workable, this view evolved over time. I have been advised that, in more recent cases, the Commission expressed the views that evaluation of the contingency should combine subjective judgment and objective judgment, and it disclaimed necessary reliance on quantitative methods.[2] I

[2] See the Commission's Opinions and Recommended Decisions in Docket Nos. R87-1 and R94-1.

agree that this is an appropriate way to approach the Postal Service's policy choice of a contingency provision.

In its most recent Opinion in an omnibus rate case (Docket No. R97-1), the Commission made no reference at all to the usefulness of variance analysis. It did not rely on any approaches more quantitative or objective than those used by the Postal Service for determining the amount of the contingency. It is worth recalling that, in Docket No. R97-1, the weighted average variances calculated from the four previous test years would have implied the need for 3.5 percent contingency, when applied to estimated test year costs, rather than the 1.0 percent contingency provision that the Postal Service used in determining its revenue requirement, and that the Commission recommended.[3] I find it interesting that no party proposed relying on variance analysis to determine the contingency provision in Docket No. R97-1.

The Postal Service has consistently provided a reasoned articulation of risk in its rate case requests, and this case is no exception. While we have consistently said that "variance analysis cannot be relied upon in a vacuum as the basis for determining an appropriate contingency level" (see USPS-T-9, p.45), Postal Service management does examine historical trends and performs objective and quantitative analyses. These aid judgment in selecting the contingency. This was explained by the Postal Service in its response to OCA Question on the Contingency No. 2 (May 17, 2000), where we stated:

> [T]he framework for assessing the reasonableness of the contingency amount is embodied in a basic approach to identifying sources of risk in estimating future needs. Some of these uncertainties are more identifiable than others. To the extent they can be identified, an attempt is usually made to evaluate the potential effects on future needs by some order of magnitude (e.g., calculate the value of various percentage changes in revenue, health benefits or wages). These potential effects are combined with a more subjective assessment of the potential for totally

[3] See Docket No. R97-1, Direct Testimony of William P. Tayman, Exhibit 9J, page 4).

unknown adversities in the current environment. This evaluation necessarily also involves consideration of historical circumstances, as well as knowledge of and forecasts for the economy in general, operational challenges, market trends, and certain institutional factors, such as the relative unpredictability of the collective bargaining process. The overall sense of risk that emerges from this evaluation is balanced subjectively against the other elements of the Postal Service's proposals and policy choices, such as the impact of rate increases on customers and the Board's policy regarding equity restoration.

B. Lower Prior Years' Losses Do Not Support a Lower Contingency

Witness Buc supports his proposal for a lower contingency based also on recent improvements in equity. He points out in his testimony (Table 3) that equity improved to a negative $446 million by the end of FY 1999. Tr.22/9545. He also suggests that the current equity position could be improved, if the Postal Service were to manage its real estate holdings more "rationally." Tr. 22/9566.

First, there is no logical connection between the status of equity restoration, which is based mathematically on known, past financial results, and the Postal Service's vulnerability to unknown future adversities or shortfalls. It does not follow that improving the equity position should lead to increasingly lower contingency provisions. If that were the case, Congress would not have deemed it necessary to mandate that a reasonable contingency provision be included in estimating revenue needs, in light of the fact that, when Congress created the Postal Service in 1971, it had positive equity of $1.7 billion.

The Postal Service remains strongly committed to eliminating its negative equity position, as the Board of Governors affirmed in Resolution No. 95-9. It would make no sense to risk that goal as justification for a potentially inadequate contingency provision. Over time, inadequate contingencies will only contribute to operating losses and to higher negative equity. Future rate-payers would have to shoulder the consequences of our failure to provide adequately for contingencies now.

Witness Buc contends that the appraised value of postal real estate is higher than its book value, suggesting that negative equity is overstated. Tr. 22/9566. He states that the Postal Service's financial position could be improved by carrying real estate at its book value. Tr. 22/9600. In other words, he advises us, in effect, not to worry about future deficits resulting from unforeseen events, because the Postal Service is in better financial shape than the books of account would suggest. He also suggests that disposing of real estate, as an additional source of revenue, could hypothetically contribute to equity restoration. Tr. 22/9566,9600.

I do not believe that the Commission's recommendation should impose that financial policy choice on the Postal Service. In any event, the credibility of Witness Buc's contention that the Postal Service's financial condition is or could be better, if real estate were managed differently, is suspect. He appears to have limited expertise in real estate management, accounting theory, or the Postal Service operations network. Tr. 22/9599-9602. His general argument is speculative and does not bear specifically on the Postal Service's estimated revenue needs in the test year. Furthermore, it ignores the legal and practical realities of postal operations. The Postal Service has universal service obligations and owns real estate for the purpose of supporting and operating a nationwide service network to satisfy those obligations. The Postal Service cannot dispose of its real estate at will in order to realize its market value.

C. The State of the Economy, As Well as a Return to Normal Growth in Postal Volume, Support the Reasonableness of the 2.5 Percent Contingency

Witness Buc testified that the state of the economy supports a lower contingency. He provided no support for this conclusion beyond the three inflation indices in Table 4 in his testimony. See Tr. 22/9570. He attempted to bolster his argument by citing the unemployment rate as further evidence of a strong economy. However, he does not explain how unemployment relates to the Postal Service's estimated test year revenues and expenses.

The fact is that low unemployment indicates a tight labor market, as witness Buc confirmed when asked. Tr. 22/9592. Low unemployment has contributed to the increased wage expectations reflected in the ECI, which has put additional pressure on Postal Service labor costs.

Inflation trends can be an important consideration in determining the size of an appropriate contingency. In the case of the Postal Service, the most relevant index is the ECI, since it serves as the benchmark for estimating test year wage changes for most of the Postal Service's bargaining employees. Wages are the Postal Service's most significant expense. Increases in the ECI forecast portend potentially higher postal service wage rates. Witness Buc confirmed the importance of the ECI as an indicator of test year wage changes, as well as the fact that the ECI forecast is higher in this case than it was in either of the last two rate cases. Tr. 22/9568-69.

The updated DRI indices provided in Exhibit USPS-ST-44AB indicate that inflation has increased beyond what was predicted when the Postal Service developed its Request. This volatility supports the need for a larger contingency, not a lower one. The opposite was experienced during the last rate case, when a 1.0 percent contingency was adopted. During Docket No. R97-1, inflation dropped below what had been assumed at the time the Request was filed. Such a difference in circumstances between the two rate cases validates the concerns which led to the 2.5 contingency provision.

Even if the economy were to be stable throughout the test year, a strong economy does not necessarily translate into a lower contingency provision. Volume and revenue growth rates continue to be low and fall short of plan, despite the current strong economy. In discussing the justification for a 2.5 percent contingency provision, Witness Tayman described the "increasingly competitive environment in which the Postal Service operates." He stated:

> In particular, the Internet appears to be making inroads into the Postal Service's transaction and correspondence mail volume and may be diverting advertising and marketing revenues from the Postal Service as well. Our more traditional competitors appear to be more aggressively pursuing legislative limitations on the Postal Service's ability to operate in a business-like manner. In addition, foreign postal administrations have been expanding their operations into the United States."

USPS-T-9, at 44.

I agree with witness Tayman's characterization. I am concerned about the adverse financial impact of weak volume growth, even if the economic climate remains strong.

In my opinion, Postal Service witness Zarnowitz (USPS-RT-2) provides a better informed and more balanced view than the intervenors of the risks inherent in the economy. The uncertainty for the future embodied in the current situation reinforces the need for a reasonable contingency of 2.5 percent.

IV. OCA WITNESS BURNS USES A MISGUIDED ANALOGY TO OPPOSE THE PROPOSED CONTINGENCY PROVISION

OCA Witness Burns (OCA-T-2) criticizes the Postal Service's 2.5 percent contingency provision, arguing that the Postal Service failed to articulate "a reasonable basis for its subjective judgment." Tr. 22/9715. He maintains that a contingency provision

> cannot be adjudged to be reasonable without some justification stemming from an assessment and systematic analysis of the risks that the contingency reserve is expected to protect the Postal Service against. Relying solely on management discretion to pick the contingency reserve will not guarantee its reasonableness.

Tr. 22/9709. He concludes that witness Tayman's justification of the 2.5 percent provision "must be judged as primarily being a subjective articulation of management's perception of unforeseeable and uncontrollable risk." Tr. 22/9715.

I do not agree with witness Burns's suggestion that the Postal Service relied "solely on discretion" to determine its contingency provision. To the extent possible, an "assessment and systematic analysis of the risks that the contingency reserve is expected to protect the Postal Service against" was in fact done. This process was described in the Postal Service's response to OCA Question 2 on the contingency, which I quoted above.

Witness Burns criticizes the Postal Service's approach by contrasting it with the method employed by the insurance industry to determine insurance reserves. Tr. 22/9709. In my opinion, this analogy is faulty. The insurance industry and the Postal Service are very different. Witness Burns declares, but makes no effort to explain and justify why the nature and function of the insurance reserve is similar to the contingency in the Postal Service's revenue requirement. At a level of from 13 to 18 percent, in effect (see Tr. 22/ 9726-27), typical insurance industry reserves exceed by more than five times the proposed 2.5 percent contingency provision. As witness Burns confirms, furthermore, insurance companies differ fundamentally from the Postal Service, because they are allowed to earn profits and most have positive equity. In other words, the role and size of insurance reserves as a financial cushion, and the abilities of the insurance companies to absorb future adversities differ fundamentally from the functions the contingency performs in the Postal Service's revenue requirement. Tr. 22/9723. In fact, it was no doubt largely because the Postal Service, with its break-even mandate, does not have the profit margins or provisions for return on investment enjoyed by other firms that Congress believed it important to provide for contingencies in outlining the revenue requirement in 39 U.S.C. § 3621.

Adhering to his inapt analogy, Witness Burns emphasizes that "the Postal Service has failed to perform the type of probability analysis and quantitative assessment that the insurance industry performs." Tr. 22/9728. Again, his analogy is inappropriate and incomplete, and it fails to account for essential differences. In particular, the purpose of insurance reserves is significantly different from the function of the contingency. In order to guarantee that there will be enough money to pay on their customers claims, insurance companies seek to predict whether the random occurrence of accidents or natural disasters will differ from a historical pattern. Witness Burns testifies that probability analysis is used in the insurance industry "to predict the likely number, severity, and location" of catastrophes." Tr. 22/9744. He further testifies that "items for which a history exists," such as natural catastrophes," lend themselves to probability and variance analysis more readily than items for which no history exists." Tr. 22/9746. By contrast, the contingency in postal ratemaking is designed to protect against the totally unknown and "known unknowns," such as volume erosion due to the Internet or future legislation. There is no history for the totally unknown and there is usually insufficient history for "known unknowns" on which to base a probability analysis. A totally unknown adverse event that depended on complicated political relationships, such as the unplanned legislative transfer of Post Office Department annuitant costs to the Postal Service (which occurred under the Omnibus Budget and Reconciliation Act (OBRA) of 1990) simply could not have been predicted by a probability analysis.

The contingency provision is designed to maintain stability in achieving the break-even mandate, in light of the largely unpredictable consequences of an interplay among a complicated array of economic, social, and political forces, as well as accidents and natural disasters. Most fundamentally, Witness Burns does not explain whether and how the estimation of insurance industry reserves, beyond merely assessing probabilities of predictable occurrences, treats critical drivers of uncertainty relating to the Postal Service contingency provision, such as the future state of the economy, inflation, labor contract negotiations, legislative change, arbitration awards, and volume growth. In my opinion, predicting the consequences of unknown change among these complex and interrelated factors and conditions is much more complicated than predicting the probability of changes in accident rates, for example. Furthermore, apart from merely predicting the level of future expenses, the contingency has an important policy dimension, in that it represents the level of risk that postal management is prepared to accept in directing the Postal Service's operations and finances.

When asked if he had used any of the forecasting methods he advocates to calculate the OCA's proposed 1.0 percent contingency, Witness Burns confirmed that he had not. Tr. 22/9748. In my opinion, no such analyses were performed, because the type of probability analysis used by the insurance industry would be inappropriate and ineffective in the financial management of the Postal Service.

V. OCA WITNESS ROSENBERG'S ANALYSIS DOES NOT SUPPORT OVERRIDING THE 2.5 PERCENT CONTINGENCY PROVISION

OCA witness Rosenberg says a contingency provision of 2.5 percent of total estimated costs is neither necessary nor in the public interest at this time. Tr. 22/9807. He testifies that historical and forecasted inflation and economic growth data, along with the history of success under previously-recommended contingency provisions, support a 1.0 percent contingency. See Tr. 22/9812-18. OCA Witness Burns supports Witness Rosenberg's analysis. Tr. 22/9725.

As I have already discussed with regard to witness Buc, the Commission has not established firm, objective guidelines that would conform to witnesses Rosenberg's and Burns's formalistic prescriptions for justifying the contingency. Further, witness Rosenberg's selection of a 1.0 percent contingency is itself, to a large extent, subjective and judgmental. As explained below, an alternative analysis that groups the data relied upon by witness Rosenberg more rationally supports the Postal Service's 2.5 percent contingency, rather than witness Rosenberg's 1.0 percent recommendation.

Witness Rosenberg contends that the current economy is "operating in a climate of relatively low inflation." Tr. 22/9812. His Table 5 compares historical consumer price inflation to historical rate case contingency amounts recommended by the PRC. He concludes that the time path of inflation has both trended lower and become less erratic in recent years. Both lower inflation and less erratic inflation are factors that support a smaller contingency provision.

Tr. 22/9819.

Witness Rosenberg's analysis is flawed. First, he relies totally on historical inflation data to correlate inflation and the contingency. But, the data most relevant to the test year are forecasted, not historical data. In the analysis below, I include forecasted FY 2000 and FY 2001 data that are omitted from Witness Rosenberg's Table 5. This results in a more meaningful analysis. Second, witness Rosenberg's analysis focuses on CPI instead of ECI. The CPI measures inflation in consumer goods and services, but these differ from the goods and services predominantly used by the Postal Service. The largest Postal Service expense consists of wages, which are not measured by the CPI. COLAs paid to postal employees are based on changes in the CPI, but CPI is only one of several wage increase components that are benchmarked in total against the ECI. New COLAs effective in the test year are projected only for city carriers, and amount to a small portion of the estimated increase in postal wages. Third, Witness Rosenberg's grouping of inflation and contingency data into five-year intervals is arbitrary and masks the true relationships between inflation and contingency amounts.

My Table 1, "History of Key Inflation Indices and Contingencies" shows a different picture.

Table 1
History Of Key Inflation Indices
And Contingencies

Rate Case	Fiscal Year	Contingency	CPI-W	ECI
R87-1	1986		2.16	3.85
	1987		2.68	3.01
	1988		4.06	3.47
Test Year	1989		4.76	4.13
	Average	**3.5**	**3.42**	**3.62**
R90-1	1990		4.83	4.28
	1991		4.91	3.88
Test Year	1992		2.84	3.26
	Average	**3.5**	**4.19**	**3.81**
R94-1	1993		2.93	2.73
	1994		2.49	2.99
Test Year	1995		2.86	2.87
	Average	**2.0**	**2.76**	**2.86**
R97-1	1996		2.77	3.16
	1997		2.59	3.36
Test Year	1998		1.41	3.99
	Average	**1.0**	**2.26**	**3.50**
R2000-1	1999		1.90	3.56
	2000		3.29	4.03
Test Year	2001		2.50	4.53
	Average	**2.5**	**2.56**	**4.04**

Source: USPS-RT-1A

Instead of following Witness Rosenberg's arbitrary convention of grouping data by five-year increments, this Table, and the related Exhibit (USPS-RT-1A, attached), group the data by rate case test year, and by the years feeding into each test year. Also, all Docket No. R2000-1 data are included, not merely data through the end of 1999. By including all the R2000-1 data, this analysis shows that inflation rates are actually increasing, rather than decreasing. For example, the average CPI-W estimate for Docket No. R2000-1 spikes up relative to the Docket No. R97-1 rate case. Further, the FY 2000 CPI-W inflation rate spikes to the highest level in almost a decade. As for the more important ECI index, the Docket No. R2000-1 average inflation rate is the greatest of each of the five rate cases listed, and the test year inflation rate is the greatest over the entire 15 years included in Table 1.

As shown in Exhibit USPS-RT-1A, every one of the eleven key indices shows a larger increase in the Docket No. R2000-1 test year than the increases that occurred in the Docket No. R97-1 test year. Seven of the eleven indices show a larger test year increase than the increases that occurred in the Docket No. R94-1 test year, when the proposed contingency was 2.0 percent. Following Witness Rosenberg's reasoning, it appears that these inflationary trends actually support, rather than refute, the 2.5 percent contingency. In fact, these data taken alone could support an even higher contingency, because the rate of increase in ECI is now higher than it was the last two times a 3.5 percent contingency was selected.

Another specific indication of inflation's adverse impact on the Postal Service relates the recent surge in fuel prices reflected in Exhibit USPS-RT-1A. Principal competitors of the Postal Service, FedEx and UPS, imposed fuel surcharges to recover the costs associated with this cost increase shortly after the rise in fuel prices. The Postal Service has no such mechanism in its rate setting processes to rapidly impose a surcharge. Postal rate changes are subject to a 10 month statutory process that requires considerable additional time for planning and preparation. The contingency helps the Postal Service protect itself against adversities that cannot be countered due to this lengthy regulatory lag period.

Witness Rosenberg also asserts that the Postal Service's recent string of positive net incomes supports a low contingency. Tr. 22/9815. The need for a reasonable provision for contingencies, however, is not limited to periods experiencing financial losses. As discussed above, I am concerned about the declining trend in our net incomes that has developed, in spite of recent financial successes and favorable economic conditions. Net income has declined in every year since FY 1995, and the Postal Service is $436 million behind its FY 2000 net income plan through accounting period 11.

Consistent with this most recent performance, in the Postal Service's response to Order No. 1294, we estimated a FY 2000 net loss of $325 million. Our estimate for the test year was also updated, and it now shows an after-rates deficiency of $475 million. See Exhibit USPS-ST-44A and Revised Response to POIR 14. In this regard, it is important to note that the updated test year deficiency would have been much larger without the benefit of offsetting cost decreases due to breakthrough productivity initiatives, and increases in miscellaneous revenue due to revenue generation initiatives. In other words, in light of this updated information, increased costs are very likely to be incurred. In addition, the offsetting cost reductions and the generation of additional miscellaneous revenue, which are critical to achieving test year financial goals, clearly involve a heightened degree of risk. Given this higher level of uncertainty, it would not be reasonable for the contingency provision to be any lower than 2.5 percent.

Witness Rosenberg concludes that the contingency should be reduced because

> other things being equal, relatively favorable and stable economic conditions at present and forecasts of reasonable stability over the near-term future can be expected to strengthen the ability of the Postal Service to forecast revenues and expenses on a going forward basis, so the Postal Service's estimates would be expected to be more reliable now than in more uncertain times.

Tr. 22/9811.

But, as witness Rosenberg also testified, "other things are rarely equal." Tr. 22/9852. I noted above, with regard to witness Buc, that a favorable economy has not translated into strong volume and revenue growth for the Postal Service. In fact, one element of current economic strength — strong employment — has actually had an adverse impact on the Postal Service, because it has put pressure on postal wages. The current strong economy has also resulted in a recent round of interest rate increases by the Federal Reserve. The Fed is concerned that the economy is overheating, and this could lead to an even larger jump in inflation than we have already seen. Higher interest rates have increased the Postal Service's cost of borrowing, and further interest rate hikes remain possible. These developments have increased the possibility of an economic slowdown, which could cause additional harm to the Postal Service's already weak volume and revenue growth.

Witness Rosenberg also advises that the Postal Service should not use the contingency provision to restore equity. See Tr.22/9830-32. I think his concern is misplaced as a policy matter, since our equity is currently negative, and we remain almost $3 billion short of restoring prior years' losses. USPS-ST-44, p. 8. More directly to his point, however, it does appear quite possible that a very appreciable portion of the contingency will not be available to the Postal Service in FY 2001. It is, for example, well known that the Postal Service does not plan to implement rates until January of 2001. This means that more than a quarter of the test year, including the high volume and revenue Fall and Holiday mailing seasons, will have passed before the Postal Service receives the benefit of new rates. Based on this timing alone, much of the test-year contingency provision will be consumed in FY 2001. Much of the remainder of the contingency is likely to be eliminated by the $651.5 cost increase now estimated for the test year.[4] If other financial risks materialize, such as failure to achieve all of the bold breakthrough productivity cost savings projections, continued slowing of volume growth, and a shortfall in our new revenue generation initiatives, or adverse legislation,[5] it is possible that none of the 2.5 percent contingency provision would actually be unconsumed.

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[4] In witness Tayman's testimony (USPS-9A), total accrued costs are $67,190.6 million. Witness Patelunas's estimate in USPS-ST-44A is $67,642.1 million. In his revised response to POIR 14, witness Patelunas identified $200 million additional expense item that was inadvertently omitted from his rollforward.

[5] Both the Senate (S.1232) and the House (H.R. 416) have passed legislation to fix retirement errors for those employees erroneously placed in the wrong retirement system. It is estimated that approximately 20,000 federal employees

Finally, Witness Rosenberg presents a list of what he refers to as "safety nets" that he claims reduce the need for a contingency. See Tr. 22/ 9828-33. These include borrowing authority, a mechanism to recover prior years' losses, the use of pro forma revenue and expense estimates in rate cases, management's ability to control expenses, and the ability to request new rates. All of these factors are considered when the Postal Service determines its contingency. None of them is intended to protect against incurring a loss in the test year as a result of unknown adverse events or estimating errors. I therefore disagree strongly that the existence of any of these factors supports a lower contingency.

Consider for example, management's ability to control expenses. Through AP 11 of Fiscal Year 2000, workhours are 0.7 percent less than the same period in the prior year, while the number of new delivery points (approximately 1.7 million) would require approximately 6000 new carriers (letter and rural) and the equivalent space in delivery facilities, which would cost upwards of $500 million. This is strong performance, yet we remain below our net income plan. There are limits to how much control can be exerted. The FY 2001 preliminary plan is even more challenging, as it calls for a 1.7 percent decrease in workhours, also with further volume and delivery point growth. Nevertheless, management is obligated to maintain and improve the quality of service.

VI. WITNESS HALDI'S $94 MILLION PRODUCTIVITY ADJUSTMENT SHOULD BE REJECTED

Witness Haldi, on behalf of ANM, proposes a $94 million productivity related adjustment to periodicals costs. Tr. 22/9653. He urges this amount be

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were placed in the wrong retirement plan. The Congressional Budget Office estimates the cost to be in the range of $121 million for the entire federal government. There will be a cost to the Postal Service to correct these errors, but when and how much has not yet been determined, nor estimated.

disallowed from the revenue requirement. Tr. 22/9654. In order to calculate this adjustment, witness Haldi relies on a series of wage-adjusted unit flat costs from 1989 through 1998. He takes 1993 as his base period. Tr. 22/9655. This is the year with the lowest unit cost. He does not review the projected unit costs through the test year. He takes the difference between the 1993 and 1998 unit costs and multiplies those by the 1998 volumes to derive the $94 million adjustment. Tr. 22/9656. He claims that inadequate capital investment in flats processing equipment has driven up the unit costs for flats and cites Total Factor Productivity trends. See Tr. 22/9619.

Witness Haldi's adjustment should be rejected. His support for the productivity adjustment is based on faulty premises concerning the appropriate level of capital investment in the Postal Service and the skewed selection of a base period. Total Factor Productivity relates to Postal Service productivity as a whole and does not isolate productivity performance for any particular shape or type of mail. Also, by stopping his analysis in FY 1998, witness Haldi fails to calculate or acknowledge the degree to which the new and expanded cost savings programs built into the Postal Service test year estimates will moderate the growth in periodical costs.

Witness Haldi says that the Postal Service's rate of net investment is far lower than that achieved by efficient firms in competitive industries. He cites the fact that Quad/Graphics has spent 20 percent of its revenue on investment in automation over the past 25 years. Tr. 22/9628. However, he also acknowledges that Quad/Graphics is in the printing business. Tr. 22/9677. I do not believe it reasonable to expect a service firm, such as the Postal Service, to invest a similar proportion of its revenues in automation as would a printer, like Quad/Graphics. Quad/Graphics is a highly valued customer, but it is in a distinctly different line of business.

Witness Haldi criticizes the Postal Service's depreciation expense average of 2.4 percent of revenues for being "far below the national average for nonfinancial corporate businesses of about 11 percent." Tr. 22/9625. The

Postal Service, however, is not an "average" nonfinancial business. If such comparisons are to be made at all, United Parcel Service (UPS) likely would provide a sounder basis for comparison than would a national average. Witness Haldi testified that UPS's reported depreciation expense averaged 4.5 percent of the revenues for the period 1997 through 1999, compared to 2.8 percent for the Postal Service over the same time period. Tr. 22/9675. He also testified that about 25 percent of UPS's assets are aircraft. *Id.* As the Postal Service's business practice is to contract for air transportation or to use commercial air transportation rather than to purchase aircraft, and the Postal Service does not capitalize leases for any aircraft, none of the Postal Service's depreciation expense relates to aircraft. Making allowance for this different Postal Service business practice would reduce UPS's estimated depreciation expense by 25 percent to 3.4 percent of total revenues, which is very close to the Postal Service's 2.8 percent. If further allowances were made for depreciation expense forgone by the Postal Service's policy to contract for inter-city surface transportation, the Postal Service and UPS depreciation percentages would further converge.

Witness Haldi's calculation of his proposed $94 million disallowance is predicated on a 1993 base year. See Tr. 22/9655-56. This inappropriate base period distorts the trend of periodical cost growth. Unit labor costs were unusually low in 1993. As witness Haldi acknowledged on cross-examination, there were reductions in craft employees in 1993 and these reductions "didn't last very long.". Tr. 22/9700. These reductions resulted from the Postal Service's restructuring that took effect in early Fiscal Year 1993. Service suffered dramatically in 1993, because too many craft employees accepted separation incentives. The majority of the 47,000 employees who retired were craft employees (34,000 bargaining unit employees). Most of these needed to be subsequently replaced in order to process and deliver the mail. Service suffered. This level of service which prevailed in Dr. Haldi's base period proved to be unacceptable to our customers, particularly including Periodicals mailers. It is not a representative base period for calculating productivity.

Dr. Haldi's proposal is further skewed by his failure to account for cost savings programs that inure to the benefit of Periodicals between the base year and the test year of this rate case. The only specific cost reduction program he would allow to offset the proposed revenue requirement disallowance is for the AFSM 100s. See Tr. 22/9689. His refusal to incorporate the impact of numerous other cost savings programs reveals an unbalanced approach that should be rejected.

I do not believe it prudent to disallow expenses, simply because there has been an increase in unit costs for a particular service. In particular cases, unit cost increases may reflect investments in improving the quality of service or changes in the makeup of the mailstream that are not easily quantifiable. There are many, sometimes highly complex reasons for changes in unit costs.

Finally, witness Dowling's rebuttal testimony demonstrates that the Postal Service has pursued flats automation opportunities in a responsible way. Although the Postal Service is striving to improve the efficiency of flats processing, the underlying circumstances do not demonstrate that the Postal Service is inefficient. Flats automation presents a much greater challenge than letter automation. That is inherent in the much wider variation in the physical characteristics of flat mail. I believe that we are beginning to make progress in this area, and am hopeful that we will be able turn the corner on flats automation over the next decade, much like we were able to turn the corner on letter automation in the 1990's.

VII. WITNESS PATELUNAS'S SUPPLEMENTAL TESTIMONY REFLECTS THE NEED FOR THE POSTAL SERVICE'S REVENUE REQUIREMENT.

In response to Commission Order No. 1294 and subsequent inquiries, the Postal Service filed numerous materials reflecting the FY 1999 Cost and Revenue Analysis (CRA) Report, and other data and projections that are more recent than information that was available when the Postal Service's Request and testimony in this docket were filed. These additional materials included the Supplemental Testimony of Mr. Patelunas, as well as numerous exhibits, library references, and responses to written questions. Most of this updated and revised information has a significant bearing on the Postal Service's proposals, and particularly on issues that have been raised pertaining to the Postal Service's requirement.

In the following, I provide an overview of the salient elements of the updated financial projections prepared by the Postal Service pursuant to the Commission's directive. I am not fully conversant with all of the implications of the complex array of interrelated issues raised by the updates. I will, however, attempt to place this information in the appropriate context, at least with respect to the Postal Service's revenue goals and the issues raised in this rebuttal testimony.

Whenever the Postal Service prepares a case to support general rate increases, it must make numerous compromises sacrificing its ability to update for more recent information that becomes available just prior to filing and during the lengthy ten-month litigation cycle. This situation results, not only from the nature of the rate setting process, but, from the Postal Service's perspective, in part from limitations on the personnel and resources required to put a case together. These inflexibilities, moreover, are also caused by the interplay of a variety of other factors, such as the timing of complex financial reports and special studies, and the need to conform to Commission rules requiring extensive documentation and explanation of the Postal Service's proposals. As a result of these complexities, preparation of a Postal Service Request takes many months, and commonly, at the time of filing and during litigation, more recent information comes out that, if incorporated, would have the effect of casting some of the Postal Service's proposals in a different light. Typically, the Postal Service tries to approach these situations responsibly by not presenting the Commission and litigants with a moving target to consider in evaluating the Postal Service's needs and proposals.

I am told that in recent years there has been an increasing tendency for the Commission to try to incorporate the most current information available before the rate case is concluded, particularly when major financial and operational reports become available. The Commission's ability to accommodate these updates has usually been, and should be, subject to the need to give all of the parties a fair opportunity to explore and comment on the new information. This tendency seems to be particularly strong in circumstances like those prevailing in the last rate case (Docket No. R97-1), in which the Postal Service was faring financially better than had been expected when the case was filed. I am told that, over the years, the inclination to take account of new information has been much weaker or nonexistent when current information merely reinforced the original request or made clear that even more revenue might be needed to cover increasing costs.

It is my understanding that the Postal Service originally prepared the current case to file in the fall of 1999. When it was actually filed in January of 2000, the assumptions and base data were still viable to constitute a realistic foundation for the Postal Service's proposals, although some of the economic estimates had been overtaken somewhat by more recent information and projections. In fact, to the extent possible, the Postal Service had already incorporated some FY 1999 financial data in the original filing. As we all know, furthermore, approximately a little more than three months after filing, the Postal Service's FY 1999 CRA Report became available and was submitted to the Commission.

The Postal Service's response to this situation was and is to continue to maintain the basic revenue goals incorporated in the original filing. This decision is driven in large part by the aforementioned disinclination to present a moving target and to needlessly complicate the litigation. Candidly, however, it is also motivated by the realities involved in presenting a comprehensive and completely accurate foundation for Postal Service proposals, fully explained and documented in accordance with the Commission's rules and other requirements. In other words, as the Postal Service has repeatedly emphasized, there has not been enough time in this proceeding to replicate all the necessary elements of a Postal Service rate request. We have made a good faith effort to comply with the Commission's directives and parties' requests up to this point, but only time and events will tell to what extent the Commission can rely on the updated information. Particular problems have been presented adjusting for and reconciling the dictates of the ratemaking process, which requires a relatively static record, and the budget and planning processes, which are dynamic and continually evolving. In this regard, we have presented an accurate and fair assessment of future needs for ratemaking purposes, while trying not to abandon the goal-setting and management dimensions of the planning process, which is essential to improvement and efficiency. Inevitably the appearance of inconsistencies might have been created in presenting the updated information. Wherever possible, however, we have tried to reconcile the revisions in favor of improvements in our revenue and expense outlook that are fair to both the mailers and other intervenors, as well as the Postal Service.

Witness Patelunas's Supplemental Testimony, USPS-ST-44, includes the impact of updated test year costs, as requested by Order No. 1294. It also includes several new revenue initiatives. The inputs and revisions used in running his new rollforward were intended to reflect material changes that had occurred since the filing, as well as significant changes in management plans and objectives, and changes required to permit the most realistic and accurate estimates for the test year. I believe that these revisions are essential considerations if the Commission attempts to incorporate the updates in its recommendations.

The updates in USPS-ST-44 reflect the major cost and revenue drivers of test year estimates that could be incorporated, given the time and resources available. They include the following.

1. Updated Base Year Data. In conformance with Order No. 1294, base year accounting, Cost and Revenue Analysis and related labor data were updated to reflect final FY 1999 results.
2. Updated Cost Level Data. Key inflation level indices were updated. Because actual and forecasted inflation had grown since the Postal Service filed the case, these updates increased test year costs. Also, the test year ECI minus 1 assumption was changed to an assumption that reflects management's expectation of what will be a more realistic outcome. As noted at USPS-ST-44, p. 3, after subtracting "carryover costs, the effective change is wages related to the new contract is ... 1.7 to 1.8 percent less than the Employment Cost Index."
3. Test Year Cost Reductions. Test year cost reductions were updated to reflect the impact of breakthrough productivity initiatives and Periodicals initiatives. The breakthrough productivity initiatives represent management's attempt to offset adverse inflationary impacts. These initiatives represent a significant challenge and are at greater risk of achievement than the cost savings programs included in the Postal Service's Request.[6]

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[6] In discussions pertaining to these adjustments, there has been some confusion regarding the character and impact of the approximately $200 million "field reserve." There has been some suggestion that this expense is merely an element of the contingency provision. This conclusion is wrong. In estimating the cost savings associated with breakthrough productivity initiatives, witness Patelunas intended to net out the impact of a $200 million field reserve. The field reserve is an actual budget expense item that the Postal Service projects it will spend during the test year. It is as real as any other expense in the Postal Service's budget. It has not yet been assigned to a particular expense account, pending evaluation in the field of the particular needs of each location as the year progresses. Its status is similar to a series of other reserved line items in the Postal Service's budget process. For example, budgeted field expenses for projected COLAs and increased health benefit expenses are held in a headquarters reserve account at the beginning of the year. They are not allocated to field operating units until well into the budget year, when the actual CPIs (in the case of COLAs) and the actual health benefit increases are known. The reserve is then distributed to the field as needed as the year progresses. In the same way, the breakthrough productivity field reserve will be distributed as

4. Other Programs. Various other program costs were increased or decreased to reflect more current data or to accord with the Postal Service's most recent plans, as explained at USPS-ST-44, pp. 5-7. Even though current data and trends would support significantly higher workers' compensation expense[7], this update held test year workers' compensation expenses at the FY 2000 level. This is another area of significant financial uncertainty and risk.
5. Workyear Mix Adjustment. Current workyear trends were reflected.
6. Revenue Projections. The impact of three new revenue initiatives was added to the test year – Retail Product Sales of $100 million, co-branded advertising revenue of $100 million, and E-Business revenue of $104 million. Because these initiatives call for significantly stretching our sales and marketing accomplishments beyond our historical base, the $304 million of projected revenue is at greater risk than the basic revenue projections reflected in the econometric forecast filed with the case.

I am aware that, during witness Patelunas' cross examination and in other communications subsequent to witness Patelunas' appearance, issues have been raised concerning the Postal Service's updated labor cost increase assumptions. I want to respond to those issues here.

It will be recalled that Postal Rate Commission Order (PRC) No. 1294 required the Postal Service to update the test year forecasts to incorporate FY 1999 CRA results and "to incorporate with this information such other updates as

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needed as the year progresses, once it is known where and for what the funds are needed. Breakthrough productivity is most certainly not a new contingency provision beyond what was included in the Postal Service's request. To the contrary, it represents a new level of increased risk for the Postal Service, further supporting the need for the Postal Service's 2.5 percent contingency provision.

[7] To date, we have been unable to ascertain the reason for this development. There has been a very significant increase in the number of cases approved by the Department of Labor, without a parallel increase in accident rates. We are seeking a conference to explore whether this results from a one-time acceleration in the speed of processing of cases, or a trend that will significantly

it believes will more accurately reflect test year results." Consistent with this requirement, in calculating changes in wage rates for those bargaining units whose contracts expire in the test year, the Postal Service utilized a calculation assuming an ECI as opposed to ECI minus 1 wage increase. We made this change in order to present the most realistic and accurate labor cost assumptions for the test year. It is, in my opinion, extremely conservative, since we have also included record-setting productivity.

The updated labor cost estimate presented in response to PRC Order No. 1294 does not abandon our historical collective bargaining position. The Postal Service's negotiating position has been, and continues to be, that negotiated wage increases should not exceed, on a contract year basis, ECI minus 1. The net result of this update, after incorporating a higher ECI index and the carryover of cost increases from existing contracts into the test year, is a "new money" wage increase of ECI minus 1.7 to 1.8, fully consistent with the Postal Service's historical bargaining goals.

As stated above, this rebuttal testimony and the rollforward previously filed by witness Patelunas are not intended to supplant the Postal Service's Request. The Postal Service's Request is an integrated and balanced proposal that complies with legal requirements and considers all relevant factors. As explained, furthermore, time and resources have not permitted a comprehensive update of the Postal Service's filing. In this regard, Witness Patelunas included in the updated rollforward all material changes that could practically be included without totally rebuilding the rate case from the bottom up. Those rollforward results indicate that our revenue needs have increased since we filed this case, and they further support the need for the 2.5 percent contingency provision. Because witness Patelunas strove to include all material changes, if the Commission were to attempt to update test year projections, care should be taken to include all the updates included in witness Patleunas's rollforward. To

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increase accrued expenses in FY 2001.

not do so would unbalance the record and would jeopardize the Postal Service's financial performance.

Even though the Postal Service is not changing its original revenue request, I am particularly concerned about the overall level of revenues and the integrity of the Postal Service's proposed contingency provision. Witness Patelunas's supplemental testimony, as corrected by his revised response to POIR 14, indicates a test year after rates deficiency of $475 million. That projection occurs as a result of making a number of very aggressive assumptions regarding cost levels, cost savings, and revenue. When these are considered as a package, along with the changed circumstances from the last rate case, the potential volatility of the economy, the Postal Service's current financial performance, and the evolving competitive environment, the Postal Service's revenue requirement is clearly justified. In particular, proposal of a contingency provision representing 2.5 percent of overall expenses reflects an important policy choice that cannot be circumvented by merely recommending the dollar amount of the contingency in the Postal Service's original revenue request within the context of a revised revenue requirement. In my opinion, failure to adopt the 2.5 percent contingency on the terms proposed would constitute an unacceptable rejection of the proposal.

VIII. SUMMARY AND CONCLUSIONS

The Postal Service's contingency provision falls within a well-established range of reasonableness. Circumstances have changed since that last rate case and support the need for the Postal Service's 2.5 percent contingency provision. It should be accepted.

In particular, the baseless claim that the Postal Service's selection of a contingency provision was arbitrary, and incapable of being assessed as reasonable, should be laid to rest. I agree with witness Tayman's clear justification for a 2.5 percent contingency amount. In addition, in the discussions above, I have identified numerous factors that support the proposed contingency provision, both objectively, and as exercise of the Board of Governors' policy judgment as to the level of risk against unknown adversities that the Postal Service should take in these circumstances. Of the pertinent factors, I have discussed the rising trend in inflation, the uncertainty of the labor contract situation, adverse financial trends, the effect of January implementation, the aggressive nature of the Postal Service's assumptions regarding future expenses and cost reduction initiatives, uncertain trends in revenue generation, and the possibility of adverse legislation, among others.

DMA witness Buc's proposal to reduce the contingency provision should be rejected. Contrary to witness Buc's testimony, the Postal Service follows an appropriate framework for establishing the contingency. Further, the contingency provision should not be reduced by virtue of revaluing real estate assets or requiring the Postal Service to dispose of those assets at market value. Prior years' loss recovery does not obviate the need for the Postal Service's reasonable contingency, nor does the state of the economy.

Similarly, the OCA's proposed contingency provision should be rejected. OCA witness Burns uses a seriously flawed insurance analogy to support the OCA proposal. OCA witness Rosenberg's support for the OCA proposal relies on flawed assumptions about economic trends and mistaken assumptions concerning the state of the economy.

ANM witness Haldi's proposed productivity adjustment should be denied. He has not shown that the Postal Service is operating inefficiently.

Finally, the Postal Service would prefer to stand on the revenue requirement in its original request, rather than rely on a financial foundation that is less than comprehensive and might not meet standards of fairness in this litigation. Nevertheless, we must point out that new data and information that has become available since the Request was filed reinforces the need for the level of increase revenues requested.

USPS-RT-1A

History of Key Inflation Indexes and Contingencies
R87-1 to R00-1

	Contingency	Fiscal Yr	CPI -W	ECI 1/ Wages and Salaries	ECI 1/ Benefits	Air Freight	Interstate Trucking	Rents	Paper and Paper Product	Supplies & Materials	Gas & Oil	Natural Gas	Electricity
R87-1		1986	2.16	3.85	3.49	n/a	n/a	6.17	-1.34	-2.59	-13.79	-4.46	2.14
		1987	2.68	3.01	3.17	n/a	n/a	4.47	5.64	0.11	-9.24	-5.12	-1.04
		1988	4.06	3.47	5.33	n/a	n/a	3.81	8.55	5.41	5.84	-2.05	1.16
Test Year		1989	4.76	4.13	6	n/a	n/a	3.79	7.41	5.22	6.98	3.05	2.85
	3.5	**Average**	**3.42**	**3.62**	**4.50**			**4.56**	**5.07**	**2.04**	**-2.55**	**-2.15**	1.28
R90-1		1990	4.83	4.28	6.69	-0.72	n/a	4.21	1.51	1.72	7.41	0.4	2.54
		1991	4.91	3.88	6.27	3.11	n/a	3.85	-1.7	1.89	11.66	1.06	3.14
Test Year		1992	2.84	3.26	5.88	0.96	n/a	2.65	-1.39	-0.77	-5.7	0.97	2.52
	3.5	**Average**	**4.19**	**3.81**	**6.28**	**1.12**		**3.57**	**-0.53**	**0.95**	**4.46**	**0.81**	2.73
R94-1		1993	2.93	2.73	5.47	5.32	n/a	2.39	-0.68	1.36	0.56	6.07	2.04
		1994	2.49	2.99	4.44	-1.22	1.99	2.35	0.9	1.27	-1.46	3.8	0.46
Test Year		1995	2.86	2.87	2.96	1.34	2.39	2.48	21.81	5.47	3.74	-4.57	1.51
	2.0	**Average**	**2.76**	**2.86**	**4.29**	**1.81**	**2.19**	**2.41**	7.34	**2.70**	**0.95**	**1.77**	1.34
R97-1		1996	2.77	3.16	1.84	-2.61	1.95	2.56	-1.75	1.41	2.54	0.57	2.27
		1997	2.59	3.36	1.98	-0.64	3.07	2.84	-6.89	0.19	3.18	7.79	0.77
Test Year		1998	1.41	3.99	2.4	-2.96	2.71	3.15	2.73	-1.46	-10.23	0.59	-2.84
	1.0	**Average**	**2.26**	**3.50**	**2.07**	**-2.07**	**2.58**	**2.85**	**-1.97**	**0.05**	**-1.50**	**2.98**	0.07
R 2000-1		1999	1.9	3.56	2.48	1.75	3.54	3.25	-1.68	-1.35	-0.76	-1.64	-1.96
		2000	3.29	4.03	4.87	0.9	3.8	3.29	8.42	4.42	30.69	5.87	2.69
Test Year		2001	2.5	4.53	4.89	0.37	3.09	3.53	4.24	0.87	6.13	2.8	2.25
	2.5	**Average**	**2.56**	**4.04**	**4.08**	**1.01**	**3.48**	**3.36**	**3.66**	**1.31**	**12.02**	**2.34**	0.99

1/ Private Industry

Source: DRI USSIM/CONTROL0500
DRI CISSIM/TREND36YR0200
Actual CPI and PPI through March 2000
Actual ECI through 2000:Q1

CHAIRMAN GLEIMAN: Three parties have requested oral cross examination of this witness, the Direct Marketing Association; the Office of the Consumer Advocate; and ValPak Systems, Inc., Carol Wright Promotions, Inc.

Is there any other party who wishes to cross examine this witness?

[No response.]

CHAIRMAN GLEIMAN: If not, Mr. Ackerly, you may begin when you're ready.

CROSS EXAMINATION

BY MR. ACKERLY:

Q Good morning, Mr. Strasser.

A Good morning.

Q My name is Todd Ackerly, representing the Direct Marketing Association, and with respect to issues relating to the revenue requirement, also acting on behalf of a broad coalition of Intervenors.

Would you please refer to your testimony at page 2, beginning at line 27, where you state, and I quote, "The Postal Service has rationally reckoned its contingencies from rate case to rate case, pursuant to a judgmental assessment of the need for a cushion against unknown developments in the test year." End of quotation.

You go on to state that this judgmental assessment takes into account, and I quote again, "a variety of factors, including the Postal Service's expected financial condition, historical experience, the potential for unknown future adversities, and the Postal Service's financial, operational, and ratemaking policies."

It is the policies that I would like to direct your attention to, in particular.

Were the policies that you refer to determined by the Board of Governors?

A The contingency provision that was filed in January of this year was determined when I was out in the District Office in Northern Virginia.

I was not part of that process. I have discussed Witness Tayman's testimony with him, and I have reviewed in the four months that I have been Acting Chief Financial Officer, the circumstances which we face in the coming fiscal year, and I have concluded that I believe the contingency is a very reasonable one, given the uncertainty of our outlook.

And that's probably the extent I can tell you about the formulation of the contingency, other than Witness Tayman's testimony.

Q Mr. Strasser, let me direct your attention then to page 3 of your testimony, beginning at line 8 where you state, and I quote, and you are referring, I believe, to the decision with respect to the provision for contingencies.

The quotation is this: "This decision, represents a major policy choice by the Board of Governors as to the level of risk the Postal Service is willing to assume in the test year with regard to unknown developments." End of quotation.

Do you see that?

A Yes, I do.

Q In light of what you just said, could you explain further, what you meant on page 3 when you said it represents a major policy choice by the Board of Governors?

A Each new rate filing and the formulation of filings over the course of the Postal Service's existence the determination as to the level of contingency is a choice that is recommended and the Governors have to, when they review the filing for purposes of approving its filing with the Commission, the Governors are advised of the recommendation of management as to what the appropriate contingency level is.

The contingency of course has to take into account what is going on in the business environment. It also has to take into account the risks that in terms of the unknowns and as a matter of fact it ends up having an effect on the revenue requirement and therefore the rates and so the Board, you know, considers the contingency and its impact on our ability to finance the Postal Service but also on the issues on what it means to the ratepayers and to the mailing industry.

Q So the policy choice that you refer to on page 3 was made in the context of the Board's approval of the entire rate case filing? Do I understand you correctly?

A I wasn't there but I would assume so.

Q Are you aware of a specific discussion by the Board of Governors with respect to the size of the contingency as a separate issue?

A No, I am not aware of that.

Q Was the policy that you refer to on page 3 articulated anywhere other than in the Postal Service's initial filing in this case?

A I am not aware of any other articulation.

Q If I understand your testimony correctly then, you were not present at any of the meetings at which the Board of Governors would have discussed or made the policy choice that you refer to on page 3?

A No, I was in Northern Virginia.

Q Do you have any information as to why the figure of 2.5 percent was chosen?

A Well, I think it represents a judgment that indicates, that takes into account what has recently come up on the horizon and it is fairly in line with previous contingency percentages. In fact, it is conservative in my opinion, having experienced the past development of rate case preparations and discussions in the '70s and '80s.

I am aware that historically it has been 3 to 5 percent or 3.5 to 5 percent, with the exception of 1974, and I think that what has occurred is that the Governors have seen a situation where things that have actually occurred this year, such as the fuel price increases and some of the other aspects.

Another good example is the diminution of growth in First Class mail this year, somewhat tied to the advent of the Sweepstakes discussions and the subsequent legislation that has diminished First Class volume growth from previous forecasted levels, so I think in the context of the fact that the future is uncertain, that the test year particularly and the outcome of our -- of many events that are underway, the judgment was made that 2.5 percent is a reasonable determination for the contingency.

I think it is natural based on the economic forecasts that are saying now that there is an indication the economy may be slowing down, and so I think it fits in line in the context of going back up as Witness Tayman said to a more moderate level of contingency from the very low levels in the previous two cases.

Q Mr. Strasser, perhaps you didn't understand my question. I am going to get to the issue of your opinion with respect to the level of the contingency, but what I would like to focus on is the role of the Board of Governors with respect to the determination of the level of the contingency up through the time that this case was filed.

In other words, the decision of 2.5 percent that is reflected in the rate case filing, you state on page 3, represents a major policy choice by the Board of Governors and I would like to find out as much as I can about exactly what went into that policy choice.

So if I could ask my question again, and that is are you aware of any of the factors that the Governors took into account, their mental process if you will, other than as reflected in the filing itself in the Postal Service's testimony?

A The only other aspect of the process I believe is the response to an interrogatory from the OCA as to what risk analysis was taken into account as it relates to the development of the contingency and there are several factors that are mentioned in our response to that interrogatory.

Q Do you know what those factors were, again, focusing on the choice that the Governors made in connection with the decision to file a case that contained a 2.5 percent contingency?

A The response to the interrogatory does not specifically state whether this was the particular discussion that was gone through with the Governors or whether this is the analysis that we go through as we determine what we would recommend.

Q What I would like to focus on for the moment is specifically what the Governors thought about, what their analysis was, so again I would like to ask you a very specific question. That is, to your knowledge did the Board consider any objective factors, such as a variance analysis, in making the determination as to the size of the contingency to incorporate in the rate case filing?

A I am not aware of what specifics they considered.

Q Okay. Now there came a time when the Postal Service made a filing in this case that updated some of the Postal Service's numbers -- in particular, the actual fiscal year 1999 results. Are you familiar with that filing?

A Are you referring to the response to the Order 1294?

Q Yes, I am.

A Yes.

Q Was the Board involved in any aspects of that filing in terms of the estimates that were included in it or the policy judgments that may have been reflected in it?

A First of all, I don't believe there are any policy adjustments reflected in the update.

The update was in response to the order to add the

CRA data and to update I believe, paraphrasing the language, such factors as might be determined to have significantly been needed, but the Board was advised of the update and the results of the roll-forward. Well, actually the management committee was advised of it and we discussed it with the Board later.

Q So the fact that you are here today defending the 2.5 percent contingency in light of the information that was filed pursuant to Order 1294 does not involve a decision by the Board in any way, does it?

A There was no decision, policy decision incorporated in the 1294 update, if that is what you are referring to.

Q Nor did the Board discuss whether or not a 2.5 percent contingency continued to be reasonable in light of the numbers filed pursuant to 1294 -- that's correct, isn't it?

A I am not aware of any discussion.

Q Please refer to your testimony at page 14, beginning at line 19. There you state, and I quote, "The Commission has not established firm, objective guidelines that would conform to Witnesses Rosenberg and Burns' formalistic prescription for justifying the contingency." end of quotation. Do you see that?

A Page 14, did you say?

Q Yes.

A What line?

Q Beginning at line 19.

A No, I don't.

[Pause.]

MR. ACKERLY: Mr. Chairman, I will state for the record that apparently there are two different pagination versions of Mr. Strasser's testimony. Mine is different from the witnesses. We have now determined the language that I am referring to. It appears in Section V at the beginning of the second paragraph of his testimony.

CHAIRMAN GLEIMAN: Well, I thank you, Mr. Ackerly. It makes one wonder when all the rest of us seem to be singing off the same song sheet except for the witness. Mine is at page 14, line 19, the last two words in the line is where you started quoting.

MR. ACKERLY: I think the morals of modern technology may have had something to do with this, I don't know.

CHAIRMAN GLEIMAN: Hopefully. Hopefully, that is all is.

THE WITNESS: It is probably in my laptop. Okay. I am on the same page.

BY MR. ACKERLY:

Q Do you see that language, Mr. Strasser?

A Yes.

Q You state that the Commission has not established firm objective guidelines. Are you familiar with whether the Commission has established any guidelines whatsoever with respect to the way in which a contingency should be justified?

A I know that over the course of ratemaking history, there has been discussion about approaches to the development or estimation of the contingency. I also am aware that the Commission needs to determine the reasonableness of the contingency. I am not specifically well versed in the past comments or the current thoughts of the Commission as it relates to the development of the contingency. I couldn't pretend to be an expert in that.

Q Do you have any information as to whether the Board of Governors, when it made its policy choice concerning the size of the contingency to include in the initial rate filing, took into account any guidelines from the Commission?

A I wasn't there. My experience with the Board is that they would ask the people who were presenting, including our attorneys, the questions that relate to those kinds of decisions.

Q Are you aware at any time, either before the filing of the case or any time thereafter, whether there was any mention of the relationship between the size of the contingency and the Board's policy concerning equity restoration?

A I am unaware of any.

Q Do you have any understanding as to whether the Board has a policy concerning equity restoration, and, if so, what that policy is?

A Yeah, the Board does have the policy, and it is probably one of several factors that went into their discussion and decision on the estimation of the contingency. How much it weighed vis-a-vis other factors and concerns, as I mentioned, about the effects of rates on the mailing community and on the mailing industry, I am unaware.

Q What, to the best of your understanding, is the Board's policy concerning equity restoration?

A Over time they believe that equity should be restored from its negative position.

Q Do you know what the current equity position of the Postal Service is?

A It is $3 billion -- over $3 billion in negative equity.

Q Mr. Strasser, I would like you to make a distinction between the current equity position of the Postal Service and the extent to which the Postal Service has been able to recover what we refer to as prior year losses. With that distinction in mind, could you tell me what the current equity position of the Postal Service is?

A Yes, I apologize. The current equity position from our latest financial statement is a negative $468 million.

Q So am I right that if all a sudden the Postal Service came into a windfall of $468 million, that equity would have been restored as it is understood by the Board of Governors and their policy concerning equity restoration?

A That sounds like a reasonable assumption.

Q Mr. Strasser, do you have available the financial and operating statements of the Postal Service for accounting period in the current fiscal year? It was just recently filed with the Commission.

A Yes, I do.

Q I would like to be sure that I understand correctly some of the numbers, so if I could address your attention, please, to page 1. On the righthand side where it says "Year-to-Date," under "Actual," it appears that the Postal Service has an income, year-to-date income of $226.1 million. Is my understanding correct?

A Yes, it is.

Q Looking then at the numbers in Accounting Period 12, it appears that you had an actual loss of $212.2

million. Is my understanding of that number also correct?

A Yes, it is.

Q Am I correct in understanding then that if the Postal Service were to lose $226.1 million in Accounting Period 13, that it would breakeven for the current fiscal year?

A If it were to lose $226 million for its Accounting Period 13, and the ensuing period that constitutes the government fiscal year, it would breakeven for the fiscal year.

Q I appreciate that clarification. Would you turn now, please, to page 5 of your testimony?

The paragraph begins at line 15, and on line 17 you state that through Accounting Period 11, we are $436 million behind our $100 billion FY 2000 net income plan, do you see that?

A Yes, sir.

Q Could you describe for me the relationship between the $436 million figure, where you were behind plan through Accounting Period 11, and the net income numbers that we were just discussing from Accounting Period 12?

A Certainly. Accounting Period 12 was one of the -- it was the most favorable in the four accounting periods that I have been Acting Chief Financial Officer. We had a reversal of the annual trends wherein our revenue approximated our plan for an accounting period at, as you see, 3.7 percent. Now that revenue figure includes the sale of some Los Angeles BMC property, so the revenue attributable to volume growth was really 3 percent, but it was healthy compared, for example, to Accounting Period 11 where revenue growth was only 1 percent.

And our expenses were, for the second accounting period in a row, tremendously constrained by the efforts that are underway to cut costs and hold them to a bare minimum. They only grew 2.6 percent compared to the same period last year, as opposed to annual trend of 3.7 percent.

So what we see here is that we actually, if you refer to the Accounting Period 12 data on page 1, it indicates that we had a planned budget deficit of $281 million, and we only had a deficit of $212, so we beat the plan by about $69 million.

So if you then look to the year-to-date, what it says is that our variance to budget against our plan net income is $365 million. So the $365 relates to the $436 million in that we beat the budget by $69 million, and then there might be some prior period adjustments.

But what has essentially happened is that instead of being $436 million behind the net income plan of $100 at the end of AP 11, we are now $365 million because we gained in AP 12.

Q Thank you. That was very helpful. I believe you mentioned that a sale of real estate in Los Angeles had an impact on these numbers?

A Yes.

Q Did I understand you correctly?

A Yes, sir.

Q Could you describe that impact and the extent of it?

A Yeah. The gross revenue from it was about $33 million, netted against that was $2 million in depreciation, so the net was $31 million.

Q So, of the $69 million by which you beat the plan in Accounting Period 12, slightly over $30 million can be attributed to this real estate sale, is that correct?

A The sale of real estate assets is in the plan for the year, so it -- the timing of these are unpredictable, so, yes, it does have that effect for that particular period in AP 12. But it is within our plan to have revenues in that order of magnitude.

Q Do you happen to know the amount of income that the plan includes for the entire Fiscal Year 2000 for the sale of real estate?

A I don't specifically know. There is an "other" category that we report on. Let me see if I can identify it for you.

If you turn to page 6 -- no, that is other personnel. No, that is non-personnel, okay. If you turn to page 6, it is embedded in -- the expense is embedded in the "other" category of supplies and services, or netted against the depreciation account. I believe the revenue for such items is on page 5A.

Q What number are you referring to on page 5A?

A Let me just -- it is in one of two locations. It is either in the number that is listed as "Other Income," which is the fifth line from the bottom.

MR. ACKERLY: Perhaps, Mr. Chairman, for the purposes of saving time, I could just make a request that the Postal Service supply that number, and the number I am referring to is the amount of net income from the sale of real estate that is in the Fiscal Year 2000 plan.

THE WITNESS: The amount of revenue is in the plan. The net income is not -- is specifically in the plan because it is not known which assets are being sold at the beginning of the year, and so the net income effect is not known. There is an estimate that is put in for each year, fiscal year, of the approximate revenue that we would anticipate.

MR. ACKERLY: With that clarification, Mr. Chairman, I would accept the revenue figure for real estate sales.

CHAIRMAN GLEIMAN: I want to make sure I understand what you are asking for. Now, what you want the Postal Service to supply is the figure that they have in their integrated financial plan for Year 2000, FY 2000, the line or number that shows what they anticipate netting in real estate sales?

MR. ACKERLY: That is correct, Mr. Chairman.

CHAIRMAN GLEIMAN: Could we please have that number supplied? And the sooner, the better, but certainly by next week on the 6th.

MR. REITER: We will do that.

CHAIRMAN GLEIMAN: Thank you.

BY MR. ACKERLY:

Q Mr. Strasser, do you have any information as to how the Postal Service's equity position has changed over the last six or seven years?

A It has improved over the last six or seven years quite dramatically with the net income that has been achieved.

Q Do you have some understanding as to the order of magnitude of that improvement?

A Well, the equity position would improve based on the net incomes that have been generated from 1995 through 1999. So if you totaled those, it would be an approximation of what the equity improvement has been.

Q Has the Postal Service been able to pay off any significant portion of its debt beginning, let's take 1993 as a beginning year, from 1993 to the present?

A It actually has from 1995 used the net income and the equity that has been restored to pay down debt, yes.

Q Has the Postal Service been able to make substantial capital investments during this period without borrowing?

A If your question is, have we been able to make substantial capital investments without borrowing additional funds and increasing debt, the answer is yes. There is a technicality there as to whether we borrowed before we had the net income and things like that.

Q I understand. If you take the amount of debt that has been retired, and if you add to it the amount of capital investment that the Postal Service has made, and you get the sum of those two numbers, that represents an increase in the equity position of the Postal Service, does it not?

A I don't think technically that works that way. The capital investment is partially funded from non-cash accruals, and the non-cash accruals are already on the statement of liabilities and assets.

Q Mr. Strasser, I have handed you a sheet of paper with the title USPS Debt and CapEx Analysis. CapEx refers to capital expenditures.

I direct your attention to the two numbers at the bottom of the page. The number representing term debt paid off from the end of 1993 through August 2000 is five-billion four-hundred-seventy-point-three million, and the number representing total capital expenditures, '93 through 2000, is nineteen-billion eight-hundred-eighty-six-point-one million. These numbers come from Postal Service AP13, and I believe they are audited numbers.

Do you have -- first of all, do you have any reason to believe that the numbers on this page are inaccurate in any way?

MR. REITER: Mr. Chairman, I would point out that we were not supplied these numbers ahead of time and we really did not have an opportunity to check them. There's an awful lot of numbers on this page.

MR. ACKERLY: Mr. Chairman, that's absolutely correct.

CHAIRMAN GLEIMAN: Thank you for pointing out that you didn't have it ahead of time. The question, I believe, if I heard it correctly as I was trying to read something else, was subject to check?

MR. ACKERLY: The question, Mr. Chairman, was whether or not the witness had any reason to believe that these numbers are inaccurate.

CHAIRMAN GLEIMAN: He can tell us if he has reason to believe --

MR. REITER: I think that's a different question. If Mr. Ackerly is asking him to accept them subject to check, that's one thing, but a witness can't have a reason to believe they're right or wrong without having been given an opportunity to check them.

MR. ACKERLY: My assumption, Mr. Chairman, was perhaps Mr. Strasser was generally familiar with the Postal Service's finances and might have an opinion on the subject.

CHAIRMAN GLEIMAN: Just keep going with the cross examination.

THE WITNESS: I don't -- the number I can, which is unaudited for AP12 -- I believe you said AP13, but the AP12 figure that's listed under the line 2000/A12, the number I can tell you is accurate because it's in this AP12 document is the 2551 of long-term debt.

BY MR. ACKERLY:

Q Assuming that these numbers are accurate, is it not a correct conclusion that the Postal Service's equity position has improved since 1993 by a figure that is in excess of $25 billion?

A That is not a correct conclusion.

Q Would you explain in what respect it is not correct.

A What you're getting into is the source and uses of funds as it relates to capital investment. The Postal Service basically has three sources of funds. It has borrowing authority, it has net income, and it has non-cash accruals which are liabilities that have to be accrued in a fiscal year but for which cash doesn't have to be paid out.

So if debt is not going up, then the equity position is only changed by your net income accumulated because what you're funding the rest of your capital investment with is non-cash accruals, which are increases in your liabilities for things like workers' comp, deferred retirement, and things of that nature.

So you're not improving the equity position by accumulating assets without some other liability on the ledger sheet funding those assets, so it's not a net equity increase. The only net equity increase that you can garner is from net income or from other revenues that somebody -- if Congress gave us, like they did in 1976 and '77, a billion dollars.

Q Do you know to what extent this $25 billion may contain non-cash accruals?

A I would say that just in general terms, it must be made up of the accumulated net income from '95, and if you add that up and subtract it from the capital expenditures, if this is the accurate figure for what we've actually invested in capital investments, if you subtract it from that, the net of that ought to be what's been funded from non-cash accruals because the balance sheet has to balance.

Q The net income of the Postal Service in any given year includes accruals, does it not?

A Yes. We follow generally accepted accounting principles and we're audited by our outside auditor.

Q Do you have any information as to the extent to which ratepayers, people who pay cash to send their mail through the Postal Service, have contributed to this $25.3 billion number that shows up on this sheet as the sum of total debt paid off and total capital expenditures? How much of it is cash from ratepayers or other sources and how much of it is accruals and accounting manipulations of numbers on books?

A Well, the bottom line is that ratepayers would pay the entire amount. Is that what you wanted to know?

Q Yes.

A Yes.

MR. ACKERLY: Mr. Chairman, understanding that the Postal Service has not had a chance to review these numbers, I nevertheless would like to get this sheet into the record and admitted into evidence for the convenience of all parties. It is my firm understanding that these are accurate numbers and I would certainly make my motion conditioned upon the Postal Service's verification of the numbers.

But subject to that, I would move that this sheet be transcribed into the record as a cross examination exhibit of Mr. Strasser and admitted into evidence.

MR. REITER: I won't object to it being transcribed. I don't think it's appropriate to move it into evidence at this point.

CHAIRMAN GLEIMAN: Well, there's not going to be much opportunity beyond today to move things into evidence unless we do it by designation later on. So why don't we move it into evidence as well as transcribe it and your rights to object and to request reconsideration are available and we'll entertain an objection or request for reconsideration after today's hearing if you so wish to -- the Postal Service so wishes to file one.

If you are going to request reconsideration or object, do it by Tuesday and we'll give you an answer by Wednesday.

We need to provide two copies to the court reporter and we need to mark them, so if you can mark a copy and I have a copy marked here and I'll hand this one to the reporter, DMA/USPS-RT1-XE-1.

[DMA/USPS-RT1-XE-1 was received in evidence and transcribed in the record.]

USPS Debt and CapEx Analysis

	Curr Portion Term Debt	LTD	Total Term Debt	Cap Ex
1993	1,062.0	8,686.3	9,748.3	1,678.2
1994	1,260.9	7,726.7	8,987.6	1,654.7
1995	260.9	7,018.6	7,279.5	1,803.4
1996	2,009.5	3,909.2	5,918.7	2,295.9
1997	2,647.0	3,225.0	5,872.0	3,074.9
1998	3,633.0	2,788.0	6,421.0	2,949.5
1999	3,363.0	3,554.0	6,917.0	3,624.1
2000/A12	1,727.0	2,551.0	4,278.0	2,805.4

Term Debt Paid Off From End of 1993 through August 2000	5,470.3
Total CapEx 93 - 00	19,886.1

BY MR. ACKERLY:

Q Mr. Strasser, I'd now like to get back to this matter of the policy decision that the board made and ask your opinion as to the relevance of the point that you make on page 3 of your testimony about it representing a major policy choice by the board.

We have already discussed a little bit about the role of the board in determining the 2.5 percent number, and I would like to get your views as to what the relevance for this Commission is of the fact that it is, as you put it, policy choice by the Board of Governors.

So let me ask the question this way: How much deference, in your opinion, should the Commission give to the judgment of the Board of Governors concerning the size of a reasonable contingency under Section 3621 of the Postal Reorganization Act of 1970?

A You're asking me my opinion as to how much deference the Commission should give to the Board of Governors' policy decision?

Q Yes.

A Realizing that I'm an acting officer of the United States Postal Service?

Q Yes.

A I think in the provision for a contingency, they should -- unless they can find it in some way totally unreasonable, they should give deference to the policy decision.

Q Let's say that the Board decided that they wanted a contingency of 5 percent and that although it wasn't so stated, what was actually going on in their mind was that they wanted to increase the equity position of the Postal Service at an even faster rate than it has been done over the last five or eight years.

Under those circumstances, what deference do you think the Commission ought to give to the Board's judgment?

A That's really the Commission's decision. I mean, they've got to determine the reasonableness of the proposed contingency, I believe.

Q And it's your job, Mr. Strasser, isn't it, and that of people like Mr. Tayman and your colleagues at the Postal Service, to present enough justification so that the Commission will be convinced that the contingency of the size that you request should be approved and reflected in their recommended decision; is that correct?

A I think we should explain the process we use and some of the uncertainty and reasons why we would come about it at a level of contingency. I think that -- you know, there's certainly an obligation to be open about the aspects of things as to -- and to, quite honestly, discuss these aspects.

I mean, we -- the Commission is -- these hearings have gone over the uncertainty of the future economic environment, you know, there's discussions about diversion of mail to electronics, there is situations that have occurred in the past and may occur in the future that are costly aspects that have to be funded, and the contingency is to fund things that come up that are not estimates, but they do come up.

The contingency is an insurance policy, and it's -- the advantage of it is that if it's not needed, it's not used, and it's not going to go away. When you and I pay our insurance policy, if our house doesn't burn down, the insurance company pockets it assuming that they haven't had any catastrophes. But in this case, the Postal Service contingency is used for other purposes, perhaps to prolong time between rate increases, perhaps to invest in infrastructure; but the ratepayer who pays the contingency as an insurance for the test year receives benefit from that payment. It's not like it's going away.

Q And one of the ways in which it might not go away if it's not used is to restore the equity position of the Postal Service?

A If it's not used and it becomes net income in the test year, it would restore the equity. But in restoring the equity, it would essentially be a process that it would either be held in cash or used to pay down debt, which then reduces interest, if that's the decision.

See, there's various uses you could use it for. You'd want to use it for the most return on the money. If there's an investment that can be made with it that would have a return on that investment, you would use it there. If it made sense to keep it in cash as a contingency because the cash levels of the organization needed to be at a certain level, you would leave it there. And you could so choose to pay down debt, and by paying down debt, the net equity of the Postal Service is restored.

So there's several aspects you could use it for.

Q But when you are going through the analysis of the size of a reasonable contingency, providing cash to restore the equity position of the Postal Service is not one of the relevant factors, is it? That's the function to the extent that it gets into the ratemaking process of the prior year loss recovery; am I not correct in that analysis?

A Right.

Q Thank you.

Could you now refer, please, to page 9, line 13 of your testimony. Actually, let me begin quoting beginning at line 11. Quote: "The credibility of Witness Buc's contention that the Postal Service's financial condition is or could be better if real estate were managed differently is suspect. He appears to have limited expertise in real estate management, accounting theory, or the Postal Service operations network."

Is your view of Mr. Buc's contention -- i.e., that it's suspect -- related to the fact that he has limited expertise in real estate management?

A The whole issue surrounding the accounting for real estate is what strikes one when reading this. The notion that you can appraise -- reappraise real estate and increase the book value rather than the cost as the basis for the book value of the real estate is foreign in generally accepted accounting principles.

Q But the generally accepted accounting principles that you are talking about are a convention, are they not? It's a way of reflecting the assets of the Postal Service or any other entity on a sheet of paper. That's correct, isn't it?

A It's the way that the IRS determines the private sector will reflect their assets as -- yes. I guess in bottom-line terms, your description is accurate.

Q And so if you are looking at the reality of the financial strength of an institution, be it the Postal Service or any other corporation, it would be relevant to know the extent to which the fair market value of the piece of real estate is in excess or perhaps less than the value at which that real estate is carried on the books for accounting purposes.

A If I were buying or selling the institution, yes.

Q So when we are talking about the equity of the Postal Service, isn't it reasonable to take into consideration the fair market value of the real estate assets that the Postal Service possesses?

A I don't think so.

Q Why not?

A Because it's not according to generally accepted accounting principles.

Q Mr. Strasser, I would like to read you something. Quote: The vast infrastructure of the USPS -- buildings, real estate and vehicles -- offers other potential opportunities for revenue generation. For example, some lobbies have space that might be sub-leased or excess retail window space might be provided to other organizations for a fee. Some facilities may be appropriate for selling air rights for developers." End of quotation.

Does that statement ring any bells with you? Have you heard it before?

A Yes.

Q Where did you hear it?

A I don't recall, but I have heard that before.

Q Do you think that that is a reasonable statement?

Do you concur with it?

A I know that in fact, we have had instances where we have sold air rights in New York City, and I think to some degree -- I don't necessarily believe that other than maybe some of the lobbies that were built in the '30s and '40s, I don't necessarily agree that we've got a lot of space available in the lobbies that are modern-day for other than postal use.

Q Would you accept subject to check that the language I just read came from a draft of a Postal Service strategic plan?

A Sure, subject to check.

Q Would you refer back now, Mr. Strasser, to page 9, line --

MR. REITER: Excuse me. Would Mr. Ackerly mind giving us a little more specific information so that we can check that?

MR. ACKERLY: It's on your Website.

MR. REITER: Is it a particular year, period?

MR. ACKERLY: The current one. My understanding, it's the current strategic plan on the Website.

THE WITNESS: I believe it's the current one that has been put out for comment by our constituencies out of Bob Reisner's shop.

MR. REITER: That will help us. Thank you.

BY MR. ACKERLY:

Q Would you refer now, Mr. Strasser, to page 9, line 15 of your testimony. I'm referring back to your statement concerning Mr. Buc, and in particular where you say he has limited expertise in the Postal Service operations network.

Are you familiar with Mr. Buc's career and the extent to which he has worked for the Postal Service?

A Yes, I am familiar. I don't recall having seen anything in his career that indicates he has been in the field.

Q Are you familiar with the fact that he has, in fact, presented testimony before this Commission on behalf of the Postal Service?

A Yes.

Q Are you familiar with the subject of that testimony?

A Not specifically.

Q Would you accept subject to check that it was in MC76-1, where his testimony dealt with mail flows for local and non-local first-class mail?

A Sure, that sounds like it's possible. I might add to you that mail flows since 1976 have completely changed in postal operations today. There is virtually, especially for letter mail flows, and as well as flats, there is virtually no resemblance, I would say, to what exists today in terms of postal operations.

Q Could you turn now, please, to page 6 of your testimony. Beginning at line 26, you state, and I quote, "I have been advised that in more recent cases, the Commission expressed the views that evaluation of the contingency should combine subjective judgment and objective judgment and that it disclaimed necessary reliance on quantitative measures." And you have a citation to the Commission's opinions and recommended decisions in Dockets R87-1 and R94-1.

My first question is, from whom did you get the advice to which you refer there?

A I have been discussing the -- in discussions for the preparation of my testimony, I asked a lot of questions about the history of the discussions that have gone on in rate filings on contingency and we've been involved primarily with my staff who works on the rate process as well as the marketing staff who works on the pricing and is very, very knowledgeable over the course of the years as to what has gone on in that regard, as well as counsel, internal counsel.

Q You say that the Commission has expressed certain views as to the way the contingency should be evaluated. Do you personally agree with those views -- in other words, that this analysis should combine subjective judgment and objective judgment without any necessary reliance on quantitative methods?

A I think to the extent that you have information about uncertainty or what might be uncertain and then, in fact, you have a sense of what the risks are in your financial plan, if that's what subjective judgment and objective judgment means in your perception, then yes, that's what I would agree --

Q Well, Mr. Strasser, these are your words and the views of the Commission over time are a matter of record. What I am trying to understand, since you are the person who is justifying the 2.5 percent contingency in the current situation, I'm trying to understand what your view is as to how this contingency should be evaluated, and I want to know, in your views, the analysis should combine subjective judgment and objective judgment but not rely necessarily on quantitative methods.

A You're asking me what my opinion is as to how this contingency should be reviewed?

Q Yes.

A I think it should be reviewed for whether it's reasonable.

Q And should that review incorporate both subjective and objective judgments?

A As I mentioned, objective judgments, it being those that we know where certain uncertainties or we know what certain trends are and we know that they may have some future impact on our financial situation, that's what I would determine the objective judgments. I don't view them to be quantitative methods.

Q Let me put the question another way. As I understand your testimony, you did not rely on any quantitative benchmarks such as a variance analysis; is that correct?

A I'm unaware of -- when they did the determination and the discussion, I'm unaware of any variance analysis or anything that was done.

Q And reference to a variance analysis does not form any part of your current testimony, does it?

A No.

Q There are about 14 months remaining between today -- check that -- there are 13 months remaining between today and the end of the test year; is that correct?

A Sounds reasonable.

Q When the Postal Service developed its filing, which I understand to be during the Fall of 1999, the end of the test year was in excess of 20 months into the future; is that correct?

A Yes.

Q So, the amount of time that has transpired, the period of time during which risks are being assessed and protections against risks are trying to be put in place, that period of time has significantly shortened; hasn't it?

A The timeframe has shortened, yes.

Q Do you think that that fact is relevant to the Commission's analysis as to the size of a reasonable contingency in this case?

A Absolutely not, and the reason is that I believe the risks and the uncertainties from last Fall when everyone said that this economy is different from traditional economies, and last Fall, we had no foresight for the price of oil and what it's done just to our cost of living allowances in our labor contracts.

Coming up to September, it has more than doubled. I believe that the uncertainties have dramatically increased.

And just yesterday's announcement of the Leading Indicators and the adjustment to the Leading Indicators are now down for the last three months, so I categorically state that the timeframe and the proximity of time does not reduce the risk, in my opinion.

Q Well, I'd like to sort of break the analysis into several of its parts. I understand your testimony that there are increased uncertainties that have developed since the rate case was filed.

But I would like to direct your attention simply to the period of time that we are looking at.

Is it not the fact that the shorter the period of time you need to worry about, all other things being equal, the less you need a contingency?

A No. I think that's absolutely incorrect.

Q The Postal Service has filed updated estimates for a number of the factors that affect estimated test year costs. And it made this filing pursuant to Order 1294; that's correct, isn't it?

A Yes.

Q For example, the Postal Service updated its ECI number to reflect a greater anticipated level of inflation; is that correct?

A With the update, the ECI had increased, yes, and from the time that the rate filing was developed to the update period, ECI had gone up, yes.

Q Is the fact that that estimate is more recent, should that give the Commission more confidence that the estimate of test year costs that are affected by the ECI are more likely to be reliable?

A Not necessarily, in my opinion, because we don't know where it's headed. To give you an example, in January when we began our budget process for 2001, we had an estimate of a COLA allowance for the September COLA which covers the January through June period.

And it was based on the updated estimate of the economists on where the CPI that generates the COLA increase was going to be going in the January through June period.

And if you track the updated estimates from January, February, March, even into April, the CPI starts creeping up and the forecasters say, well, it's going to moderate, fuel prices are going to come back down, and therefore it's going to moderate in the summertime and things like that.

Well, the net result of the process was that we ended up with a COLA payment that was $170 million more than was estimated in January.

So, just because estimates are updated and they're the most -- all I can say is that they are the most recent; they are not necessarily the most accurate or any more accurate.

Q Well, let's say that the updated ECI number had not been filed when the other information concerning fiscal year 1999 results were filed pursuant to Order 1294.

Under those circumstances, the Commission would have in front of it, an inflation estimate for the ECI that was current as of the beginning of the year 2000 when the rate case was filed.

Now, the Commission has an ECI estimate that is current as of July, 2000, six months more recent.

Don't you think that the Commission would be reasonable in having more confidence in the more recent estimate for the ECI? Doesn't that make sense?

A I have seen forecasts that have been very accurate and I have seen the opposite, and I honestly wouldn't know how to advise the Commission. I am not an economist in this respect.

You know, given labor markets and the discussion of tight labor markets and a whole host of other things, I am not at all sure.

Q Are you aware of any other case before this Commission in which the inflation estimate was updated during the course of the case as late as six months into the case?

A Well, I think as a matter of fact inflation was moderating in the last case before the Commission and the Postal Service filed in its -- my recollection is the Postal Service filed reduced revenue requirements because inflation had moderated during the proceeding of the case in its rebuttal testimony.

Q Let me ask you to turn now to your testimony, page 2, line 19, where you state that the Intervenors including Mr. Buc who have testified that the Postal Service doesn't need a 2.5 percent contingency, quote, "have not recognized the increased risk that now characterizes the time period through the test year."

Do you see that?

A Yes, sir.

Q I would also like to direct your attention to page 4, lines 8 and 9, where you refer to, and I quote, "new uncertainties are emerging".

That is one of your major points, isn't it, that in spite of the passage of time, in spite of the updated numbers, that there are other uncertainties that have appeared on the horizon since the rate case was initially filed. Is that a fair summary of your testimony?

A That is certainly one aspect of the need for the contingency. The other is the sheer unknowns.

Q Okay. It is these new uncertainties that I would like you to focus on, and I want to be sure that the record has as complete a list as possible of what those uncertainties are.

Could you try to explain as specifically as you can the uncertainties to which you are referring?

A Well, the first and most immediate in my mind is the behavior of volume and revenue growth since I have been in the finance function.

We have a revenue plan for the year that anticipated close to 3.5 percent, 4 percent revenue growth.

When I came in in Accounting Period 9, revenue had grown only 1.3 percent and the behavior of First Class mail was -- the growth in First Class mail was virtually flat and we attempted to diagnose what was happening and in AP-10 it went up to 2.3 percent revenue growth but it was still under -- the shortfall, this revenue shortfall continued, but a 2.3 percent in AP-10 appeared reasonable.

Well, AP-11 the growth tanked back down to a 1 percent increase and in AP-12, as you saw, as I mentioned, it was very favorable -- a 3 three percent increase.

Now to me there's, as I have said, and we have tried to get involved in analyzing this by industry and things like that, but there is a major uncertainty as to what the appropriate growth rate is to count on and First Class is certainly a very, very key component of financing the postal system.

In fact, it has -- we just in our budget-setting process for 2001 made a recommendation to the management committee to reduce the growth level of First Class from the forecasted 2 percent level for our fiscal year 2001 down to 1.2 percent, which it's growing right now, and took $430 million out of our revenue side of our budget process, which is part of what is causing the challenge to determine, along with other things, as to estimated costs, determine what has happened.

Another example of an uncertainty that I know about but I don't know the outcome of is the Worker Compensation behavior. Our Workers Compensation, if we had not modified an actuarial table with the advise and consent of our outside auditors, I might had, if we had not modified an actuarial table and used a different table that we believe is more accurate.

If we had used the table, for example, that was used in last year's estimates of future liabilities for Workers Compensation, if we used it this year just rotely, Workers Compensation costs would be about $500 million more than they are on our income statement today.

Now the actuarial table change that has been acceptable to the auditors indicates that it is a one time change. I have had a meeting just Tuesday afternoon with the Acting Director of OWCP attempting to understand what is causing these new cases and this inflation, and he is determining and going to provide us some data so that we can assess whether this is a one time occurrence or a continuing one.

If you look at the 1294 update on Workers Comp costs, it estimates a $1.1 billion expense in the test year. Our filing estimates $800 million. That is a new uncertainty.

There are -- just before the case was filed of course was the outcome of the arbitration for the letter carriers, and as you know we have begun negotiations with three others of our major unions.

The issues surrounding the competition for the Internet parcel business, parcel delivery business, we had anticipated for example our Parcel Select dropship category to have grown much more extensively than it has, being a -- but the consolidating industry has not been able to formulate as rapidly as we anticipated.

So all of these things that, you know, I can't go on and on, but in my opinion, as I have stated in my testimony, I think that the experience, the financial performance has become more marginal as evidenced by the fact that we don't think we are going to achieve our net income of $100 million plan this year, and these new uncertainties have emerged in terms of the behavior of what is happening.

By all means the economy is so robust right now that normally we have always felt that mail volume growth tracks the growth in the economy and we would expect significant growth, but when you end up with accounting periods with a 1 percent growth, with more than a year after rates have been increased and then you are rolling into doing a rate increase, it is a pretty serious concern.

Q A lot of the factors that you just talked about were taken into account when the filings pursuant to Order 1294 were made. My understanding is correct, is it not? Let's take, for example, the updated ECI number that had a significant increase on the test year estimates for labor costs. In other words, very recently, the Postal Service did the best it could and updated its estimates for the test year, estimates that relate directly to several of the points that you just mentioned, that is correct, isn't it?

A No, we did not update the forecast for mail volume. We simply applied the CRA data to the filed forecast.

Q But you did with respect to labor costs?

A We updated the ECI, we did not, as I said, we did not update the workers compensation estimate. So I don't understand how your premise can be made.

Q I didn't say that you updated every one of those factors, but I believe I am correct in understanding that at least some of them were updated in the Order 1294 filings. And I believe you just admitted that, at least with respect to the labor costs, the ECI number, that has been updated very recently?

A But the uncertainty surrounding that has not diminished. What is in embedded in the ECI estimate is two things, they are the carryover costs for labor that have been updated, the aforementioned COLA payment in September and things like that. And I want to put this flat-out, because it probably will come out today, we did not change our policy. As I mentioned, 1294 did not change policy. Our policy on labor negotiations and contracts remains moderate wage restraint, ECI minus 1.

What we did in 1294 process was we took the carryover costs for things like the COLA payment in September from the previous contract and updated the labor costs. When you take the carryover costs away from the labor cost estimate, what remains is an ECI minus 1.7 for the new contracts with the remaining three unions. So, as to whether or not ECI minus 1.7 will or can be achieved in negotiations, or in arbitration, remains an uncertainty.

Q Now, Mr. Strasser, one of the points that you didn't mention orally just now, but which is mentioned on page 11 of your testimony, and I refer you in particular to the paragraph beginning at line 15, are the, as you put it, risks inherent in the economy, do you see that?

A Yes.

Q That is the subject that was addressed by Postal Service Witness Zarnowitz, wasn't it?

A Yes.

Q Are you relying upon him to convey a notion of the risks inherent in the economy as perceived by the Postal Service, or do you have your own independent analysis of those risks?

A For what purpose, for discussing them or for what -- do I have an independent analysis?

Q Basically, -- I don't want to play games. You state that there are risks inherent in the economy.

A Yes.

Q We have already discussed that general subject at some length with Dr. Zarnowitz.

A Yes.

Q I am trying to figure out if there is anything more here in your testimony that we did not discuss in Dr. Zarnowitz's testimony. Whether there is anything more I need to find out about the Postal Service's position with respect to those risks. My understanding is that that subject was addressed by Dr. Zarnowitz and you have simply relied upon him and included that point in your testimony. Is my understanding generally correct?

A Well, I relied upon him, as well as my own observations, knowledge, readings. I just don't --

Q Are you an expert in the subject of general economic trends?

A By no means.

Q Could you turn now to page 10 of your testimony? I would like to direct your attention to the sentence that begins at line 4 where you state, "Low unemployment has contributed to the increased wage expectations reflected in the ECI, which has put additional pressure on Postal Service labor costs." Do you see that?

A Yes.

Q Are you familiar with the concept of the Phillips curve?

A No.

Q Would you accept, whether or not you are familiar with that particular curve, that there is a tradeoff between inflation in the general economy and the level of unemployment in the general economy?

A Can you describe what you mean by a tradeoff?

Q One tends to offset the other. In other words, when one is high, the other tends to be low, and vice versa.

A So what you are saying is if growth in the economy is high, employment tends to be -- unemployment tends to be low, is that what you are saying?

Q Unemployment.

A Tends to be low?

Q Yes.

A Which one is the driving cause?

Q Well, I am not an economist either, I am not sure whether there is -- an identification of the driving cause makes a difference. Here is my point. You have testified that you are worried about low unemployment which tends to go along with a strong economy. That is a factor that you identify here as putting pressure on labor costs.

On the other hand, you also seem to be worried about the fact that the economy may not be so strong, because that would reduce Postal Service volumes. And my point is, is it not correct that those two factors tend to offset one another? In other words, if one phenomenon that is adverse to Postal Service finances occurs, then the other one is not so likely to occur.

A What I am saying -- what I said in my testimony is low unemployment already has contributed to the increased wage expectations reflected in the ECI, which has put additional pressure on Postal Service labor costs, that is what I said.

Q And to the extent that that has already existed, that is reflected in the Postal Service estimates, correct?

A It's also in the uncertainty because of increased wage expectations.

MR. ACKERLY: Mr. Chairman, I have no further questions.

CHAIRMAN GLEIMAN: I think it would be worthwhile taking a short break right now. Let's take ten, so that everybody gets a chance to stretch and we'll come back at 20 after the hour.

[Recess.]

CHAIRMAN GLEIMAN: Ms. Dreifuss?

CROSS EXAMINATION

BY MS. DREIFUSS:

Q Good morning, Mr. Strasser. I'm Shelly Dreifuss for the Office of the Consumer Advocate.

A Good morning.

Q I'd like to start out by thanking the Postal Service, and, in particular, Dan Foucheaux for getting the AP-12 report to us so quickly, even ahead of the printing and distribution. He was extremely cooperative in that.

The first matter I'd like to take up with you, Mr. Strasser, concerns -- it touches on the conversation you had with Mr. Ackerly on ECI.

Did I hear you right that the Postal Service actually used ECI minus 1.7 in the update, the 1294 update?

A The 1294 update for total labor cost assumptions is at ECI. What I said was that when you take the carryover components out of the update, those are the things that have to do with prior years contracts that affect the test year.

For example, the January through June period for the COLA allowance, that COLA allowance is increased in September. And so there are carryover costs into the test year that have to be accounted for.

When you separate those carryover costs from the remainder, that leaves ECI minus 1.7 for the new contracts.

Q So your testimony is consistent with that of Witness Patelunas that the Postal Service changed from an assumption of ECI minus one in its initial filing, to ECI in the 1294 update; is that correct?

A Yes, that's correct.

MS. DREIFUSS: Mr. Chairman, I have a cross examination exhibit on this point. We have found these matters to be very complicated, but very important, and so what we have attempted to do is sort it all out in this cross examination exhibit.

I gave it to counsel for the Postal Service yesterday, and if I'm right in the way I have identified it, Mr. Chairman, I have marked it OCA/USPS-RT-1-XE-1; is that about right?

CHAIRMAN GLEIMAN: That sounds about right to me.

[Exhibit Number OCA/USPS-RT-1-XE-1 was marked for identification.]

BY MS. DREIFUSS:

Q Mr. Strasser, have you had a chance to look over that cross examination exhibit?

A Late yesterday, yes.

Q We've titled it Comparison of Employment Cost Indices, and what we've tried to do here is, we've tried to separate out the ECI versus ECI-1 assumption from the use of a later forecast, 4.63 percent versus 2.87 percent.

The 4.63 percent was the most recent ECI forecast; was it not?

A Yes.

Q And the comparable figure would have been 3.87 percent in the initial filing; is that correct?

A I believe that's true.

Q Do you have any reason to find the figures, the cost figures set out on this cross examination exhibit, incorrect?

MR. REITER: Mr. Chairman, before the witness answers -- and I don't mean to not allow him to answer, but I do want to point out, if I may, that we received this and a Library Reference of about 30 pages that underlie these figures, yesterday afternoon.

The rules do require that complicated cross examination exhibits be provided at least two days ahead of time.

Having said that, we did endeavor as best we could to go through the Library Reference which shows, as I said, in 30-some-odd pages, the calculations that underline this one deceptively simple-looking sheet.

With that caveat, I will allow the witness to tell us what he was about to discern about that, but I did want to point that out for the record.

CHAIRMAN GLEIMAN: We've seen lots of deceptively simple numbers on pieces of paper around here, but I really do appreciate your allowing the witness to answer the question.

BY MS. DREIFUSS:

Q Mr. Strasser, do you have any reason to believe these figures to be inaccurate?

A No, known reason. I don't know that they're accurate, either, though, but --

Q Right.

Is it your understanding that the OCA set out its methodology for calculating -- actually, one of the figures was previously provided in Witness Thompson's testimony; were you aware of that?

A Which one was that?

Q That was the $245 million figure, 4.63 percent of ECI versus 3.63 percent of ECI. That is moving from ECI to ECI-1.

A I wasn't aware of that, but, okay.

Q Were you aware that OCA sponsored testimony by Witness Pamela Thompson?

A I have heard her name, yes.

Q Well, please accept it, subject to check, that that figure was presented in her testimony, so the only new figure that we've asked you to review is the figure, $185.576 million that is at line number 5.

And the background for calculating that figure was presented in an OCA Library Reference, Library Reference Number 6.

Were you aware of that?

A Is this the Library Reference, I believe, that my counsel referred to?

Q Yes, it is.

A Yes.

Q Let me add that I know you've been very pressed for time and had to prepare, obviously, for your appearance here today, but let me just inform you, if you have not had time to review these figures yourself or have somebody at the Postal Service who's knowledgeable about the use of these figures review it, that the OCA analyst who prepared this was able to prepare it in about an hour and a half.

So I would expect that it wouldn't take much longer than that to review that Library Reference for accuracy.

A Right, and my understanding is the formats were the same that were used in our calculations on the part of the Postal Service.

MS. DREIFUSS: Mr. Chairman, I'm going to ask that this be received into evidence. As I said earlier, this is a very important change that the Postal Service made from its initial filing to the Order Number 1294 update.

And as you pointed out earlier, we're running out of time to get important matters like this into the record.

CHAIRMAN GLEIMAN: Mr. Reiter, I'm going to put it into the record, transcribe it and introduce it into evidence, and the same as with the cross examination exhibit earlier that you had a concern about, you can request reconsideration by Tuesday, and we'll let you know by Wednesday.

[Exhibit Number OCA/USPS-RT-1-XE-1 was received into evidence and transcribed into the record.]

OCA/USPS-RT-1-XE #1

COMPARISON OF EMPLOYMENT COST INDICES					
LINE NO.	Source	ECI	ECI-1	Total FY 01 Cost Level Increase	ID
1	USPS-LR-I-421	4.63%	N/A	$ 48,423,495,000	a
2	OCA-LR-I-5	4.63%	3.63%	$ 48,178,490,000	b
3	Cross-Exam Exhibit	3.87%	2.87%	$ 47,992,914,000	c
4	4.63% ECI vs 3.63% ECI-1		d = a-b	$ 245,005,000	d
5	3.63% ECI-1 vs 2.87% ECI-1		e = b-c	$ 185,576,000	e
6	4.63% ECI vx 2.87% ECI-1		f = a-c	$ 430,581,000	f

'/8'

DECLARATION

I, Pamela A. Thomspon, declare under penalty of perjury that OCA-LR-I-6 entitled "Comparison of Economic Cost Indices" is true and correct, to the best of my knowledge, information and belief.

Executed Aug 31, 2000

Pamela A. Thompson

Page 20269 was renumbered 20290B

The number 20269 is no longer in use.

MR. REITER: I actually think that I can make it simpler right now, if you'd entertain that.

CHAIRMAN GLEIMAN: Sure, I'm always interested in making things simpler.

MR. REITER: Inasmuch as these figures are based on the Library Reference, I believe it's OCA Library Reference 6, why don't we put that into the record as well, so that the record will reflect the basis for the calculations and those can be evaluated on the record.

CHAIRMAN GLEIMAN: I have no problems with that, except, quite frankly, I don't remember whose Library Reference 6 is, and we don't have Library Reference 6 support here to introduce. But if we can overcome that quickly, I'm prepared to put Library Reference 6 into evidence, if it isn't already in evidence.

MS. DREIFUSS: Library Reference 6 was actually a diskette, and one would need to print the pages out. I do have one copy of the printout with me.

MR. REITER: And I have a copy that I would be happy to volunteer for the record, too.

MS. DREIFUSS: Well, that satisfies me, if it's all right with you, Mr. Chairman.

CHAIRMAN GLEIMAN: Could you hold it up so that I can see how big it is?

Okay. I think the most expeditious thing, and if it makes the Postal Service a little less uncomfortable, let's get those two copies over there, mark them as -- it's the Library Reference, so we'll just introduce the Library Reference into evidence, and in this case, since it's not a Category II Library Reference, we are going to transcribe it into the record in its hard-copy form.

I just want to make sure, OCA counsel, all of the numbers come out of the Library Reference, so you don't need the cross examination exhibit in evidence?

MS. DREIFUSS: No, we would, Mr. Chairman. The cross examination exhibit gives you the results of performing the calculations in the Library Reference.

CHAIRMAN GLEIMAN: It's not altogether clear to me that if we're going to put the one-pager in, why we need to put 20 pages of material in there. So let's backtrack a little bit.

Everybody agrees that the numbers came out of the Library Reference. The Library Reference is identified. Let's just put the cross examination exhibit in, since we know that the source of the numbers on the cross examination exhibit is the Library Reference.

I mean, it seems to me that that's less pages for somebody to have to pay for later on. The only people who should be aggrieved should be the reporting company, it would seem to me.

MR. REITER: Well, Mr. Chairman, isn't it your practice for Library References of this nature, I think it's Category II, that they be put in evidence, but not transcribed?

CHAIRMAN GLEIMAN: Yes, but we also have people who stand up here and say they support the Library Reference. And I don't have that -- we don't have that situation right here today, so it is a Category II Library Reference.

It may or should have been entered into evidence, but the person who prepared it and can stand up for it today is not here. We all agree that's where the numbers came from.

Unless somebody can give me a real good reason in the next 30 seconds as to why it doesn't make sense to put less paper in rather than more, we're going to put the one page in there, transcribed, entered into evidence. The clock is running -- 30 seconds.

MR. REITER: I'm not asking that more paper be wasted; I'm simply asking that it be put into evidence and not transcribed, and perhaps the OCA would be willing to provide a declaration from Witness Thompson to that effect.

MS. DREIFUSS: We would be happy to provide that, Mr. Chairman.

CHAIRMAN GLEIMAN: If OCA can provide a

declaration, sometime later today, then that Library Reference will at that point be received into evidence, but not transcribed into the record. I'm not sure what difference that makes in the overall scheme of things, but if it makes everybody else happy, then we can get on with the cross examination.

BY MS. DREIFUSS:

Q Mr. Strasser, I would like to follow up on a couple of points that you discussed with Mr. Ackerly.

It seems to me that you indicated to him that you didn't think the Postal Service's understanding of its risk going into labor negotiations was any different following the use of April and May ECI indices than it was when it filed the case initially in January.

Did I understand you correctly?

A I think what I stated was that the same uncertainty exists. Inherent in our filing as well as in the data that is incorporated in 1294 is an assumption of new contracts which will result in ECI minus 1.7.

What we don't know at this point is the outcome of the negotiations or the arbitration as to whether that will result in that assumption.

Q What I would like to focus on for a moment is the use of an updated forecast figure.

The Postal Service used an ECI inflationary index when it filed the case in January and then updated that inflationary index in Witness Patelunas's testimony, didn't they?

A Yes.

Q Did that reduce the amount of uncertainty about the outcome of labor negotiations that will be taking place this month and early next month?

A Inherent in our filing at the time it was filed with the assumption of the ECI minus one that was used, when you took the carryover costs out, our filing assumed that the outcome of the labor negotiations arbitration would be ECI minus 2.1 using the ECI minus 1 that is incorporated into our filing.

Q Mr. Strasser, this is not at all responsive to my question.

I asked you, and I am focusing on the forecast index, and I told you that a moment ago, did the use of a more recent forecast index for ECI -- and let's set aside now any assumption about ECI versus ECI minus 1 -- did that make, did that reduce the risk that whatever the resulting contract is, contracts are that the Postal Service is now negotiating with some of its labor unions, was that risk reduced by using a more recent ECI Index?

A No. The risk was not reduced.

Q Then why did the Postal Service bother filing a whole new set of inflationary indices if it didn't have any effect on risk?

A The reason that we filed an update to the ECI is that in fact the ECI inflation had increased and in order to determine more realistic costs that we foresaw in the test year, it was appropriate to update using the new ECI.

Q Doesn't a more realistic cost suggest a more certain cost?

A No. It does not suggest anything as to the outcome of the labor negotiations or arbitration.

Q I am afraid I don't understand the difference between something that is more realistic and something that is more certain.

A The realistic cost is that there has been inflation in employee compensation and it is likely that that inflation will carry over into the year.

I mentioned the realistic costs being the fact that our COLA payment for September more than doubled, so --

Q Mr. Strasser, I am going to interrupt you because I didn't ask you about the COLA payments.

Again, I am confining myself to the use of the more recent ECI Index, so please do not discuss COLA payments.

A The COLA payments are the reason the ECI assumption was made partly.

The COLA payment went up $170 million and so in the analysis that was what changed the update to an ECI assumption from an ECI minus one. That was part of the components of it. That is why I mentioned it.

Q Did the COLA payment go up with certainty, that $170 million you just spoke about?

A Yes.

Q So that item is more certain now in the update than it was in the initial filing, isn't that true?

A Yes. That particular item is.

Q Now would you recommend that the Commission use the ECI inflationary index for May and April? I don't remember exactly which month Witness Patelunas derived that run from DRI. Would you recommend to the Commission that it use the May-April ECI Index, whatever is contained in the Patelunas testimony, or the ECI Index from November?

A I am not in a position of recommending anything at this point.

We used the updated ECI estimate for purposes of the 1294 update response.

Q Is it your personal opinion that this Commission should use the more recent inflationary index for ECI?

A For what purpose?

Q For forecasting labor costs for the test year.

A We determined that it was a more realistic estimate of labor costs for the test year when we filed 1294.

Keep in mind that the Postal Service has not changed its filing.

Q I am aware of that. So you believe, it is your personal opinion that it is better to use the May-April, the labor costs that result from applying May-April index figure than the figure used in the January filing?

A We determined in our discussions that it presented a more realistic outlook of the anticipated labor cost.

Q When Mr. Ackerly asked you about new uncertainties he was quoting a sentence from your testimony -- do you remember that discussion with him?

A Yes.

Q One of the things you mentioned is that the Postal Service was concerned that revenue growth, projected revenue growth of 3.5 to 4 percent had gone on at about a 1.3 percent level for a period of time, then declined to 1 percent in AP-11 but had a 3 percent increase in AP-12. Does that sound about right to you?

A About right, yes.

Q Okay. I hoped I made my notes accurately.

Wouldn't you agree that if the Postal Service is now projecting a reduction in volumes for the test year that it should also trim costs accordingly to reflect the fact that less volume may be received in the test year?

A For purposes of the test year, we are not changing our forecast.

Q I understand that you are not, but you said before you were concerned that one of the risks you thought the contingency ought to take account of was what management now expects to be less volume in the test year than it once believed. That is true, isn't it?

A One of the risks that we are concerned about, yes, that's true.

Q Now shouldn't an efficient management system take account of the fact that volumes are expected to be less in the test year and trim costs accordingly?

A The opportunity to trim costs based on a lower volume estimate is broken into two parts.

The first part is yes, an absolutely efficient system should reduce the attributable cost of the lost volume. However, the institutional costs and the ability to reduce those in a short timeframe is another matter.

Q So at least with respect to the volume variable costs, management should and you believe will take steps to trim those costs where they may?

A And the issue there is -- and that is exactly, you are getting to the crux of the challenge we are having in setting our 2001 budget. The issue there is what volume do you plan for because, as has occurred this year, the revenue shortfall that we are experiencing this year in a real-time basis makes it absolutely very, very difficult with mail mix changes and things to be as efficient as to get all the attributable costs out of the system in a short timeframe.

Q You said the management committee was going to reduce its revenue growth estimates in the FY 2000 -- I think this was the FY 2001 operating budget?

A Budget process. Budget process, right, that we are undergoing.

Q Wouldn't efficient managers also make commensurate changes in cost estimates to reflect that?

A You would hope that you could. The difficulty is that the -- I mentioned the $430 million figure in First Class and it is a $200 million figure in Priority Mail. The attributable cost of that particular workload that has been reduced is only $230 million, so that then leaves $400 million that would have to be sought to be cut in other places.

And that is the crux of the challenge, those are -- that is an environment where we have reduced our expenditures for supplies and services this year by 10 percent compared to last year, and there are some infrastructure investments and programs that must be funded, and that is the challenge. That is the difficulty.

Q Would you go ahead with infrastructure programs if you felt that there wasn't going to be sufficient volume to warrant them?

A The fact of the matter is that $630 million against a $67 or $68 billion operation, you need the infrastructure for the remaining huge -- because we are talking about less than 1 percent change in the volume.

Q At any rate, there are some costs, you refer to them as the attributable costs, that should be more readily cut as a result of projection of declining -- not declining, but slowing volume growth, is that correct?

A In our budget process, yes.

Q Could you turn to your testimony at page 12, lines 3 to 5, please? There you state that "An assessment and systematic analysis of the risks that the contingency reserve is expected to protect the Postal Service against was, in fact, done." Did I read that right?

A Yes.

Q Isn't it correct that although this systematic analysis was stated to be performed in response to OCA Hearing Question 2, the systematic analysis itself was never provided by the Postal Service for the record, was it?

A I don't know.

Q Let me make you aware, and we can make this subject to check, about some pleadings that were filed by the OCA and the Postal Service surrounding the provision of those analyses. The OCA has asked an Interrogatory Number OCA/USPS-T9-43B of Witness Tayman. We asked for all documents, notes and analysis performed in determining the level of the contingency for the present docket.

Were you aware that on March 27th the Postal Service objected to provision of any of that, claiming that the material was privileged?

A No, I wasn't aware of that.

Q Earlier, DMA has asked, in an Interrogatory DMA/USPS-T9-36, if the Postal Service would provide any analysis, decision, memos, options and analyses, briefings, et cetera, relating to the contingency for this rate case. Were you aware that on March 2nd, as I mentioned earlier, the Postal Service objected to providing any of this material claiming a deliberative process privilege?

A No, I was not aware of that.

Q So, the only thing we can get from your testimony on page 12 is that the analyses were performed, but you can't make the further statement that they were made a part of this record and available for other parties and the Commission to review and assess, is that correct?

A I am unaware of what could or was, or has been provided.

Q Right. So you are unaware, and you can't make the affirmative statement that those materials are part of this record, can you?

A No, I can't.

Q Could you turn to your testimony at page 16, Table 1, please? First, I want to ask you a little bit about the source of the figures in the table. Did you use the most recent CPIW and ECI figures in this table?

A I believe we used the figures that are more recent. No, I don't recall exactly which month was used. I note that that is a slightly different figure in the ECI from the one that Witness Patelunas used.

Q Right. Do you know whether that is a typographical error, or did you intentionally use that ECI figure?

A No, I mean it is not typographical. We proofed it, but I can't recall the exact month of the forecast that we used for that table.

MS. DREIFUSS: Mr. Chairman, I was wondering if the Postal Service could provide the source for the figures, to the extent that they different from anything in Witness Patelunas' testimony.

CHAIRMAN GLEIMAN: Can the Postal Service do that?

MR. REITER: I am sure we can.

CHAIRMAN GLEIMAN: Again, we would like to have it before then, but certainly by next Tuesday.

MS. DREIFUSS: Thank you.

BY MS. DREIFUSS:

Q Now, at page 15, lines 6 through 8, you state that "Witness Rosenberg's analysis is flawed. First, he relies totally on historical inflation data to correlated inflation and the contingency, but the data most relevant to the test year are forecasted, not historical data." Did I read that correctly?

A Yes.

Q I have several pages out of Witness Rosenberg's testimony, and it might make it easier for you to answer these questions if I had them to you now.

Let's go to Witness Rosenberg's Figure 1. That is from transcript 22, page 9812, and that's the first of the pages that I have handed you. Do you see his Figure 1?

A Yes, I do.

Q Do you see that the Figure 1 is labeled Historical Data From Table 4, Estimates for 2000 and 2001 From Table 3; do you see that?

A Yes.

Q Then when you go to Table 3, which is on transcript page 9814, that's the last of the three pages that I handed you, and you will see that he has a column in which he presents DRI's forecast for the U.S. economy. That's the right-most column; do you see that?

A Yes.

Q So, your statement on page 15 is not correct; is it?

[Pause.]

A It appears as if he has used 2000 and 2001 data.

Q Thank you.

A But where is Table 5 from Witness Rosenberg?

Q I could get that out, if you'd like. I assume that you correctly reported that in Table 5 he had not, but I, as I said, wanted to focus your attention on the fact that in other places, he had.

A In other places, he had, but I believe, if I'm not mistaken, in Table 5 -- he might have relied on Table 5 to come to his conclusion, more than the first three tables.

I can't recall exactly, but --

Q Do you have any reason to believe that he did rely on Table 5 more than Figure 1 or Table 3?

A Well, I think that was the reason I cited Table 5 in my testimony.

[Pause.]

Q It may be very time consuming to have you look at Table 5 and read through what may be all of his testimony to see whether he relied on Figure 1 or Table 3.

Let's see if we can agree on this limitation to your statement at page 15 of your testimony:

Would you agree that the statement is only correct with respect to Table 5?

A It's correct with respect to Table 5, is what I agree to, yes.

Q Okay, great, that's great.

A And I have his testimony in front of me, and it does state that Table 5 shows that the average rate of inflation has been generally declining; that it also includes information on the path of the contingency.

And as can be readily seen here, the time path of inflation has been trending lower and become less erratic in recent years in both lower inflation and less erratic inflation or factors that support a smaller contingency.

This is confirmed in the downward trend of the contingency provision over time. To increase the contingency provision from the current one to 2.5 percent would certainly deviate from the past trend illustrated in Table 5.

What my point is in Table 1, if you had put the historic data in, Table 5's trend would show that the historic data of inflation is going in the opposite direction from his premise.

Q But you're not able to say that he didn't rely on Figure 1 or Table 3; are you?

A No. What I'm saying is that he presented the conclusion based on Table 5's trend, which did not include the forecast. It's there, but if you see Table 5 --

CHAIRMAN GLEIMAN: If somebody else is going to be speaking, they have to turn on the mike and speak up. We can't have off-the-record conversations.

COMMISSIONER GOLDWAY: I apologize. I just couldn't resist, Mr. Chairman. The forecasts do include trending down as well.

THE WITNESS: Yes, Commissioner, but if you look at Table 1, my Table 1 in my testimony, we present the data by the rate period.

COMMISSIONER GOLDWAY: No, Rosenberg's table's forecasts for inflation.

THE WITNESS: You're absolutely right.

COMMISSIONER GOLDWAY: In addition to Table 5, his reference for future forecasts of inflation are trending down.

THE WITNESS: They trend -- the CPI trends down.

COMMISSIONER GOLDWAY: Yes.

THE WITNESS: But my other point in my testimony was the ECI, which is related to our labor costs, is going up, and that was also omitted from Rosenberg's testimony.

That's why we constructed Table 1, essentially.

COMMISSIONER GOLDWAY: Well, you have no reason to believe that he did not rely on his Figure 1 or Table 3; do you?

THE WITNESS: No. What I was concluding was that Table 5 is where he makes his major concluding statements.

COMMISSIONER GOLDWAY: He -- did you think there was any purpose to presenting Figure 1 and Table 3?

THE WITNESS: Well, I think that Figure 1 shows the annual trends. Table 5 shows the trends by rate timeframe, which is probably the more accurate way to show them.

BY MS. DREIFUSS:

Q If you look at his testimony, and actually, Commissioner Goldway's help here is very valuable to me -- if you look at the bottom of page 14, of Rosenberg's testimony, he talks about Table 5, and then he continues the discussion on the next page at the top of 15 and says, as can readily be seen here, and in Figure 1 above, the time path of inflation has both trended lower and become less erratic in recent years; did he not say that?

A He said that. But if you look at Table 5, he did not include the test year, nor the 2000 inflation in his arithmetic of annual CPI rates.

So we constructed Table 1 to essentially replicate his CPIW to show that he concludes an arithmetic average of 2.33 for the R97 timeframe, and for the R200 timeframe, the CPI is 2.56.

And more dramatic is the ECI, which is what drives labor costs, primarily. During this same period that he -- for the R97 period, it inflated at 3.5; for the R2000, the forecast is four percent.

We simply took Table 5 and added the ECI and extended into the current timeframe for this filing.

Q Well, let's get back to my original question. When you said on page 15, lines 6 through 8, he relies totally on historical inflation data to correlate inflation and the contingency, but the data most relevant to the test year are forecasted, not historical data, that statement is not correct, is it, because -- because you can see on page 15 that he relied on Table 5 and Figure 1. Do you agree with that?

A If he had constructed the rate period for this current case the way he did for the other cases in the historic record on Table 5, that conclusion would have been shown to be incorrect.

That is the purpose of my Table 1 was to show that it would be incorrect, so he referred to Figure 1, yes, but he said the data, if he had done it parallel and consistently for Table 5, that conclusion would not have been able to be stated.

Q You might not agree with his conclusion, however it is not accurate to say that he didn't rely on forecasted data, is it?

A It is only correct to say that he didn't have forecasted data in Table 5.

Q Okay. Thank you.

A And I think it should have been there.

Q Let's look at Figure 1 for a moment from the Rosenberg testimony.

This is CPI inflation from 1970 through 2001, is that correct? That is what Rosenberg says he was doing.

A Right.

Q And is his observation correct that at the time he prepared this table CPI inflation was trending downward in 2000 and 2001?

A On 2000 it looks like it went up and in 2001 it looks like it is forecasted to go down.

Q I'm sorry, right.

For 2001 it went down. In fact, if you look at the actual figures on Table 3, you will see that CPI, all urban consumers, is 2.1 for 2001 down from 2.7 in 2000 -- do you see that?

A Right, I do.

Q Now I know you have criticized him for not using Employment Cost Index information, but as it happens he does at least present it in Table 3.

If you look at the Employment Cost Index you will see that it also trended downward from 2000 to 20001, is that correct?

A According I guess to the DRI's control forecast for April 2000.

I think it's changed substantially since then.

Q The Postal Service uses DRI forecasts, doesn't it, in the Patelunas update for example?

A I believe we do, yes.

Q I have got something I would like you to look at and I think this is another cross examination exhibit, so I am going to take that out now.

The only thing I have added on this is I have written in by hand that it is from DRI so there would be no mistake about the source.

MS. DREIFUSS: Mr. Chairman, I guess I should identify this as OCA/USPS-RT-1-XE-2. Does that sound right?

CHAIRMAN GLEIMAN: I am keeping count. I think we are up to Number 2 at this point. Number 1, witness. Number 2, cross examination exhibit for OCA.

[Cross-Examination Exhibit OCA/USPS-RT-1-XE-2 was marked for identification.]

CHAIRMAN GLEIMAN: Mr. Strasser, could I ask you to pull your microphone a little bit closer?

THE WITNESS: Certainly.

TABLE 1

Summary for the U.S. Economy

	1999:4	2000:1	2000:2	2000:3	2000:4	2001:1	1998	1999	2000	2001	2002	2003	2004
Composition of Real GDP (Annual percent change)													
Gross Domestic Product	7.3	5.5	3.6	2.7	3.0	3.0	4.3	4.1	4.7	2.8	3.4	4.6	3.8
Final Sales	6.0	7.1	2.9	2.2	3.2	3.5	4.3	4.5	4.7	2.9	3.3	4.4	3.9
Gross National Product	6.4	5.8	4.1	2.8	3.2	3.2	4.1	4.0	4.8	3.0	3.4	4.6	3.8
Total Consumption	5.9	7.7	2.9	3.2	3.2	3.9	4.9	5.3	5.1	3.2	3.2	4.4	3.6
Durable Goods	13.0	24.3	-4.8	1.6	1.2	3.6	11.3	11.5	8.9	2.3	5.6	9.6	5.9
Nondurable Goods	7.6	5.8	2.7	3.6	3.2	3.5	4.0	5.4	4.7	3.1	2.7	3.5	3.1
Services	3.7	5.5	4.7	3.3	3.6	4.2	4.1	4.0	4.5	3.5	3.0	3.9	3.3
Nonres. Fixed Investment	2.9	23.8	12.0	5.3	6.3	4.4	12.7	8.3	11.3	5.0	3.9	6.4	6.9
Equipment and Software	4.0	24.7	10.6	6.5	7.3	5.7	15.8	12.0	12.6	6.0	4.8	7.5	7.6
Computers	17.9	44.8	25.4	24.3	22.8	20.9	55.8	43.1	31.5	21.9	20.9	22.8	21.9
Private Nonres. Structures	-0.5	20.6	16.8	1.5	3.1	0.2	4.1	-2.4	7.3	1.8	0.9	2.9	4.6
Buildings and Other	-1.8	23.4	14.0	1.7	7.7	2.1	5.0	-2.1	6.4	4.1	1.3	2.7	5.0
Residential Fixed Investment	1.8	5.2	-3.1	-8.4	-4.2	2.4	9.2	7.4	-0.5	-0.4	3.2	5.9	3.8
Exports	10.1	6.2	7.2	7.6	6.9	5.5	2.2	3.8	7.8	6.2	7.8	9.3	9.1
Imports	8.7	11.7	11.9	8.8	5.5	6.3	11.6	11.7	10.9	7.0	5.6	7.9	7.8
Federal Government	14.7	-15.2	4.0	-0.7	2.3	3.1	-0.9	2.8	-0.1	2.4	2.1	1.8	1.9
State and Local Governments	6.4	6.7	1.1	1.4	1.9	2.2	3.2	4.2	4.0	2.1	2.5	2.8	2.9
Billions of Dollars													
Real GDP (Chained 1996 $)	9037.2	9158.2	9239.7	9301.7	9371.3	9441.2	8495.7	8848.2	9267.7	9530.0	9850.8	10303.3	10694.4
Gross Domestic Product	9507.9	9707.0	9864.5	9988.3	10130.2	10267.5	8760.0	9256.1	9922.5	10450.1	11004.2	11724.0	12410.7
Prices and Wages (Annual percent change)													
GDP Price Index (Chain-Wt.)	2.0	3.0	2.9	2.4	2.7	2.5	1.2	1.4	2.3	2.4	1.9	1.9	2.0
CPI - All Urban Consumers	2.9	4.0	3.1	2.9	2.5	1.9	1.6	2.2	3.2	2.2	1.8	1.9	2.1
Excl. Food & Energy	2.3	2.3	2.8	3.0	2.8	2.4	2.3	2.1	2.4	2.5	2.1	2.1	2.3
Producer Price Index - Fin. Gds.	3.4	4.9	3.0	2.0	1.9	1.0	-0.9	1.8	3.5	1.4	0.8	1.0	1.1
Emp. Cost Index - Total Comp.	4.0	5.9	5.3	4.8	4.3	4.0	3.5	3.2	4.8	4.3	3.6	3.6	3.8
Output per Hour	6.9	2.4	3.1	1.8	2.6	3.2	2.8	3.0	3.5	2.8	3.7	3.8	3.0
Other Key Measures													
Industrial Production (% ch)	5.3	6.4	7.0	0.5	2.1	1.2	4.3	3.5	5.0	1.6	2.1	4.4	4.1
Nonfarm Inven. Accumulation (Billion chained 1996 $)	72.3	34.0	43.2	56.1	53.5	42.4	73.2	42.4	46.7	39.1	44.1	62.1	56.6
Consumer Confidence Index	105.3	110.1	108.8	104.2	103.5	102.7	104.6	106.8	106.7	101.8	101.1	105.4	104.9
Housing Starts (Mil. units)	1.689	1.732	1.627	1.579	1.563	1.566	1.6	1.7	1.6	1.6	1.6	1.7	1.8
Light-Vehicle Sales (Mil. units)	17.0	18.3	17.3	17.0	16.7	16.5	15.6	16.9	17.3	16.4	17.1	18.9	19.4
Unemployment Rate (%)	4.1	4.1	4.0	3.9	3.9	4.0	4.5	4.2	4.0	4.1	4.3	4.0	3.9
Payroll Employment (% ch.)	2.2	2.6	2.8	1.5	1.4	0.9	2.6	2.3	2.3	1.1	0.8	1.5	1.5
Federal Budget Surplus (Unified, CY, bil. $)	-20.6	-15.0	192.2	57.9	54.4	41.4	54.4	158.3	289.6	223.8	209.5	222.1	251.9
Foreign Trade													
Curr. Account Balance (Bil. $)	-384.9	-409.2	-407.0	-417.6	-416.2	-402.5	-217.1	-331.5	-412.5	-407.4	-400.1	-412.6	-426.7
Foreign Crude Oil ($ per barrel)	23.1	26.8	26.8	27.8	26.8	26.2	12.1	17.3	27.0	24.9	23.5	22.7	21.9
Financial Markets													
Money Supply (M2, billion $)	4630	4700	4777	4847	4912	4974	4363	4630	4912	5163	5441	5742	6065
Percent Change	6.1	5.7	5.9	6.0	6.1	5.8	8.5	6.1	6.1	5.1	5.4	5.5	5.6
Thirty-Year Mortgage Rate (%)	7.8	8.3	8.3	8.0	8.0	7.9	6.9	7.4	8.1	7.8	7.6	7.3	7.3
Ten-Year Treasury Note Yield (%)	6.1	6.5	6.2	5.9	5.9	5.9	5.3	5.6	6.1	5.8	5.6	5.4	5.4
Treasury Bill Rate (%)	5.0	5.5	5.7	6.1	6.2	6.2	4.8	4.6	5.9	6.0	5.5	5.4	5.3
Federal Funds Rate (%)	5.3	5.7	6.3	6.6	6.8	6.8	5.4	5.0	6.3	6.6	6.1	6.0	5.9
Prime Rate (%)	8.4	8.7	9.3	9.6	9.8	9.8	8.4	8.0	9.3	9.6	9.1	9.0	8.9
S&P 500 Stock Index	1373	1419	1447	1455	1539	1599	1084	1326	1465	1593	1637	1814	1919
Incomes													
Personal Income (% ch)	7973	8100	8243	8361	8474	8600	7359	7792	8295	8754	9193	9733	10295
Real Disposable Income (% ch)	6440	6463	6538	6598	6649	6723	6107	6349	6562	6800	7047	7361	7626
Saving Rate (%)	1.8	0.3	0.7	0.8	0.8	0.9	3.6	2.4	0.7	0.9	1.2	1.2	1.1
Profits After Tax (% chya)	15.0	13.3	13.0	6.2	3.4	-3.4	-2.9	8.8	8.9	-2.2	7.6	14.4	6.1

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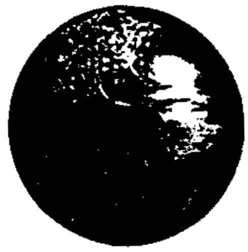

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CHAIRMAN GLEIMAN: Thank you.

BY MS. DREIFUSS:

Q I thought it would be useful since Witness Rosenberg, as you pointed out, probably only had April data at the time he prepared his testimony, to see what was happening with CPI and ECI in the most recent forecast I was able to obtain, that's July 2000.

If you look, please, at the third second down from the top, prices and wages, annual percent change -- do you see that?

A Yes, I do.

Q And the second item listed is CPI, all urban consumers, do you see that?

A Yes.

Q Now from 2000 to 2001 CPI seems to be trending downward from 3.2 to 2.2, do you see that?

A Is this the control forecast or which forecast? You know, DRI publishes several forecasts.

Q I have the book that I took this from in front of me. I don't think I could tell you immediately the source without looking through this, so I am afraid I can't answer that for you.

A See --

Q But we, if you like we could check this on a break later.

A Well, see, the issue here is when you are dealing with DRI's forecasts, they generally publish a control and an optimistic and a pessimistic, and they have probabilities that are assigned to each of these forecasts and they differ in probability for each time they issue these forecasts, so you have to have the information surrounding without -- you can't rotely assume that these numbers are the numbers that are going to be the official forecast. The probabilities change every time they issue a forecast.

CHAIRMAN GLEIMAN: Counsel, why don't we take just a couple of minutes and see if you can identify the document, because I think it is relevant to whatever cross examination you are going to have.

MS. DREIFUSS: Thank you, Mr. Chairman.

[Recess.]

CHAIRMAN GLEIMAN: Well, I think our first inning stretch is over.

THE WITNESS: First or seventh?

CHAIRMAN GLEIMAN: First.

MS. DREIFUSS: I appreciate the Chair's indulgence in allowing us to straighten this out.

BY MS. DREIFUSS:

Q Mr. Strasser, you have had a chance to look at the publication from which I took this page.

Do you now have an understanding of which forecast this is?

A Yes, I do.

Q Is it the control forecast?

A Yes, I believe it is.

Q That is the one that is neither too pessimistic nor too optimistic, is that right?

A Most of the time. Sometimes it ends up being the pessimistic.

Q So anyway, let's get back to page 13 out of that report, the one that I handed you as a cross examination exhibit, and let's again turn our attention to CPI, all urban consumers, for 2000 versus 2001.

You would agree that the trend is downward from 3.2 in 2000 to 2.2 in 2001, is that right?

A That is the end-of-year numbers, yes.

Q Okay.

A End of calendar year, not test year or our fiscal year.

Q The Postal Service, I guess, has customized runs through DRI?

A What we do, let me explain it, what we do is we take the monthly forecasts and we add them up for our fiscal year and average them so that you get a median, so that that is the appropriate average to use for estimating your costs for a given fiscal year.

Q Well, I will have to offer that this is the best we would be able to do without ordering customized runs. So let's --

A Well, for example, your 2.2 for 2001 is a reflection of what your inflation -- your costs are going to be increased for 2002, it is the end of the year rate.

Q Okay. And let's look also at Employment Cost Index, that is --

A That is likewise the same scenario, plus, in addition to that, we use the ECI for wages only, there is a separation calculation of benefits inflation, and we use it for wages in the private sector. So you have got a combination of our fiscal year, the fact that we use the month-by-month, which then, say, for the test year, as you can see, the 4.8 would be relevant in the year 2000, because as you can see in 2000 Quarter 3, it is 4.8, and in 2000 Quarter 4, it is 4.3. Then it goes down to 4 for Quarter 1. So you have got that factor and then also the factor that it is private sector wages, not Total Compensation.

Q Right. But with respect to the Employment Cost Index Total Compensation that we have in front of us as Exhibit Number 2, you would agree that ECI is trending downward from 4.8 percent in 2000 to 4.3 percent in 2001?

A I would agree that DRI is forecasting the end-of-year ECI to be 4.8 trending down to 4.3, yes, calendar year.

Q Could you turn to your testimony at page 27, footnote 6, please? You state there, it is about maybe a third of the way down, "The field reserve is an actual budget expense item that the Postal Service projects it will spend during the test year. It is as real as any other expense in the Postal Service's budget. It has not yet been assigned to a particular expense account pending evaluation in the field of the particular needs of each location as the year progresses." Do you see that?

A Yes.

Q If this amount is pending evaluation, does that suggest that these needs may not materialize as the year progresses?

A No. It is evaluation as to what they will be used on. These will definitely be spent. What we did in our budget process is that we have a list of investments that should be made, and there is too many on the list to fund and end up anywhere near where we want to end the year in terms of net income.

In addition, we have, as you know, added our breakthrough productivity to the normal array of cost reductions we have given to the Postal field, and the field units are going to have to reduce work hours, compared to this year, 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.

So there is increased, with our breakthrough productivity, there is increased uncertainty as to whether the opportunity for -- we are discussing with the field where the opportunity is for breakthrough productivity and what the specified amounts are by field location. So we have created this $200 million field reserve by holding back the investments that equate to $200 million. And specifically, what we have done is we have reduced the budget for mail transport equipment, which is a risk due to the fall mailing season next year.

We have reduced the advertising budget and held it steady and constant when we, in fact, are having new production introductions like Priority Mail Global Guaranteed.

We have held back on infrastructure, information platform infrastructures that we need for this mail, the mailing community, and we are trying to create an opportunity to give the mailers a window on the process to find out where their mail is, and there is $100 million in infrastructure expenses that need to be put towards that program.

We have held those specific expenses in reserve until we are sure that the breakthrough productivity and the allocation of the breakthrough productivity works in this process. 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 that I just mentioned. It if doesn't work, we will have to hold back on those investments for a future fiscal year and cover the shortfall in the breakthrough productivity.

Q Mr. Strasser, I had a feeling you prepared for that question.

A Yes, I was.

Q And it was a long answer. But as I understood it, it sounded like there was a chance that the $200 million might not be spent. If certain events didn't fall into place, then you might not spend that $200 million, is that right?

A No, that is not correct. What I said was, if we don't need it to cover the breakthrough productivity, and if the field achieves the reduction in the work hours that we have targeted to achieve with this very massive effort, we will spend it on the infrastructure for the information platform, the advertising for product introductions, and the mail transport equipment that we believe we need for next fall's mailing season.

Q Does this $200 million come from the $744 million breakthrough productivity figure?

A No.

Q It does not?

A No.

Q So it is your testimony that the $200 million, the $200 million field reserve was not an add-back from breakthrough productivity into expenses?

A That's correct.

MS. DREIFUSS: Mr. Chairman, I think, because I need to look for something and I don't want to take a lot of time, I'm going to come back to this in a few minutes in the hope that I will be able to find what I'm looking for. So I'll change to something else.

BY MS. DREIFUSS:

Q Could you turn to your testimony at page 13, line 25, please?

You characterize at that point -- I'm sorry, I've got the wrong page. Give me just a moment to turn to the right one.

You characterize volume growth as a critical driver of uncertainty relating to the Postal Service contingency provision; is that correct?

A One among many known and, of course, there's the unknown.

Q Now, at the bottom of page 1 and top of page 2 of your testimony, you state that interim volume projections have tracked well with results. Don't you say that?

A Uh-huh.

Q And furthermore -- I'll ask you to accept this subject to check. I looked in Witness Thress' testimony, USPS-ST-46, at page 1 and I found him saying there that the initial forecast is performing quite well compared with the most recent actuals.

Are you somewhat familiar with his position?

A Vaguely, yes.

Q At page 2 of his testimony, he states: Overall, domestic volume for the first three quarters of 2000 has been within one-half of one percent of the R2000-1 forecast, and special service volume has been within 2/3rds of one percent of the forecast.

Would you accept that subject to check?

A Sure.

Q And he goes on to say, even the forecasts by major class and subclass of mail have generally been accurate to within one to two percent.

A Yes.

Q Isn't it also -- isn't it true that if the Postal Service is pretty successful at forecasting its volumes for the test year, just as it has been for fiscal year 2000, that that tends to reduce any uncertainty about the volume forecast for FY 2000?

A Well, I need to remind you that a volume forecast or a revenue forecast that's accurate in the one to two percent range can provide $600 million to $1.2 billion in revenue swings. So while the percentages sound like it's reducing the risk, the fact in real dollars in a $68 billion base, one percent is a $680 million shift and a two percent is twice that. And we're asking for a 2.5 percent contingency.

Q Could you give me those figures again, please? I was looking at something else.

A It's just arithmetic off the top of my head. If it's a $68 billion revenue stream that you're focusing and there's a one percent error, it's $680 million. If it's two percent error, it's twice that amount. And the witness that you cited said the volume forecasts have been within one to two percent accurate.

Q As we stated earlier, if volume growth doesn't materialize at as high a level as the Postal Service anticipates for FY 2001, won't the Postal Service take steps to trim its attributable costs commensurate with any observed changes in volumes?

A Well, as I believe you have seen in a processing environment since you were on the tour with me, there is no way in real·time to measure volume shifts on a given tour or a given evening. So basically, we have to be very, very accurate about our plan.

When the volume does not materialize, the resources that have been scheduled to run an operation are basically used, and so it does make it very difficult in that kind of environment.

The other type of revenue volume challenge that you have is differentiating what types of mail mix are not materializing. For example, a piece of first-class letter mail not materializing, you still run the operation with the automation and such, and that's on aspect.

But if you have a shift towards increased drop shipments and things like that, then you've got to change your scheduling in the processing center because your delivery unit is the one picking up the workload.

So there's a lot of -- in a real-world operation, there's a lot of factors that come into play, and the system has a real challenge adjusting to a plan that's less than what it had planned.

Q I remember meeting you at Merrifield, also.

Just using Merrifield as an example, if the managers at Merrifield observe a distinct volume trend, either, you know, a shift of some sort from certain operations to other operations, or even a reduction, wouldn't they try to take immediate action based upon that observation?

A But in the real time, how do you observe a shift or a decline of one percent or two percent of mail volume? It's impractical.

Q So the Postal Service doesn't try to monitor such changes in volume?

A It definitely tries to monitor. It attempts to forecast, it attempts to understand. We compare volumes today with volumes last year, outgoing operations, two or three. They know exactly what they had last year on two or three on this day. And if there's significant shifts, they analyze it continuously to try to determine whether it's a long-term trend or just a bloop or something like that. That goes on by tour, by day, by week, by month, by accounting period.

Q And if a long-term trend is observed, then the managers would try to take steps to use their resources in a more --

A Yes. We catch up with it in the longer-term trends, yes.

Q Right. They try to use their resources in a more cost-efficient way.

A Absolutely.

Q Also on page 13 at line 25, you state that, among other things, legislative change is also a critical driver of uncertainty; is that correct?

A It has been in the past, yes.

Q And also at page 19, line 23, you state that -- or you refer to adverse legislation as a financial risk; is that correct?

A Page 19, line?

Q Yes. Actually, I guess you would really need to look at the sentence beginning with 20 and ending at line 23. If other financial risks materialize such as, and apparently one of them is adverse legislation; is that right? I've got page 19, line --

A Yes.

Q Okay.

A Yes. It refers to the footnote number 5.

Q Right. And then you go on and you give an example in footnote 5 at the bottom of page 19. You talk about -- you say that the Senate and House have passed legislation to fix retirement errors in that footnote; is that right?

A Yes, I do.

Q And you say that it affects 20,000 Federal employees at a cost of $121 million for the entire Federal Government; that's right, isn't it?

A Yes, that's I believe the correct CBO estimate.

Q And then you go on to say that there will be a

cost to the Postal Service; is that right?
A Yes.
Q Do you have a rough idea of the total number of federal employees?
A No, I don't.
Q I don't know exactly either, but do numbers in the many millions sound plausible to you?
A Many millions? Is this civilian employees?
Q Yes.
A Many millions sounds high.
Q The federal employees that you were referring to in the footnote, would that be civilian employees or civilian or military, both -- civilian or military or both?
A My guess would be that it deals only with the civilian because I think the military has a separate retirement plan.
Q You thought my estimate of several million federal employees is high? What would be your estimate?
[Pause.]
A I couldn't guess.
Q Well, let me ask you if you know this.
A A couple million?
Q Let me ask you if you know this. Do you know what proportion -- in your capacity as now chief financial officer or otherwise as you have worked for the Postal

Service over the years, do you have any idea what proportion of total federal employment the Postal Service comprises? Just a ball park number would be fine.

A Not of the top of my head. We are by far and away the largest civilian agency, but I don't know the proportion.

Q Do you think that the Postal Service comprises half of the federal civilian workforce?

A I don't know.

Q Well, let's say it is under half. Let's assume hypothetically that it's under half. Then the most exposure the Postal Service could have for this amount would be $60 million or a little less than $60 million, wouldn't it?

A Based on your proposal and your assumption. I guess. I don't know. I don't know what the components are, whether it -- their cost is based on whether the employees opt to change or whether the cost is based -- whether you can just do arithmetic and divide the 20,000 into 121. I don't know the details of that.

Q Are you aware that in a past opinion, the Commission has specifically addressed the issue of the type of legislative change that will be given weight in determining the size of the contingency, and, on the other hand, legislative change that is so speculative that it will not be given weight?

A No, I --

Q Have you come across that in your readings?

A I'm not aware of that.

Q Are you aware of pending legislation identified as H.R. 22?

A Yes, I am.

Q The Postal Service supports that legislation, does it not?

A I believe so.

Q So it could be expected that any changes resulting from that would very likely be beneficial for the Postal Service, wouldn't it?

A I don't know -- are you presuming it being passed as proposed?

Q Now I am speculating. If it were to be proposed.

A If it were to be --

Q Would the changes be beneficial for the Postal Service.

A I think there is some benefits. I think there's also some risks.

Q Could you turn to your testimony at the bottom of page 26, please? It appears to be your position there that if the Commission decides to use any of the roll-forward costs, it should use all of them; is that right?

A Yes, it is.

Q And is it also your recommendation that a 2-1/2 percent contingency be applied to that increased amount?

A I believe that's what's been past precedent.

Q Is that your recommendation to the Commission?

A What we've said is that we have remained steadfast in proposing the filing that we've filed. The Postal Service has indicated by doing so that the revenues requested in our filing is what our position is at this point.

Q Well, if the Commission were to decide to incorporate the updated information in its cost estimates, and you said just a moment ago that you would strongly urge them to use all of those updates, would you then also advise them to apply the 2.5 percent contingency to those additional amounts resulting from the update?

A I didn't say that I strongly urge them to use all of the updates. What I said is if they determined to use the updates, I urged that they use all of them.

Q And furthermore, do you recommend that they apply the 2.5 percent contingency to those additional costs?

A As I mentioned, that has been past practice. I really don't have a recommendation in that regard.

Q Could you turn to your testimony at page 18, please. I am going to look at lines 1 through 4.

You state or you express a concern there about an

FY2000 net loss of $325 million, is that right?

A That's what was the result of the update for 1294, yes.

Q Are you concerned about that loss actually materializing or do you think instead that the Postal Service is more likely to break even or sustain a smaller loss than that?

A What we have said is our best judgment at this tie is that we are not going to reach our $100 million net income plan and our losses could be as high as $300 million.

Q Is the Postal Service taking steps to curb its expenditures at the end of FY2000?

A Big time. As I mentioned, we have reduced our supplies and services and contracts by 9.5 percent compared to the same period last year. We have generated approximately 2 percent in total factor productivity, which means and translates into about a billion dollars in expenditures we would have incurred had we not had that kind of productivity improvement.

It is the most improved level of productivity since 1993 and, yes, we are and have been since Quarter 4 of the year before this year.

Q Are you familiar with a message from the controller, Acting Vice President of Finance, Controller Donna M. Peak, that was published in Postal Bulletin 22029 and the date for that is July 27th, 2000, and the message concerned fiscal year closing guidance.

Does that sound familiar to you?

A It sounds like it is a Postal Bulletin that we put out for each fiscal year.

Q Do you happen to remember Ms. Peak's exhortation to Postal employees concerning reducing -- controlling discretionary activities and making prudent choices in spending money at the end of the year?

A No, I don't specifically recall that.

Q But anyway it is consistent with what you said a moment ago, that the Postal Service is really doing some belt-tightening at the end of FY2000. Is that right?

A It has been doing it for the entire fiscal year.

[Pause.]

MS. DREIFUSS: I have another cross examination exhibit. I would like to hand it to you now.

Mr. Chairman, I think we are up to Number 3. Does that sound right to you?

CHAIRMAN GLEIMAN: I believe so.

MS. DREIFUSS: Okay.

[Cross-Examination Exhibit OCA/USPS-RT-1-XE-3 was marked for identification.]

MS. DREIFUSS: What I have on this cross

examination exhibit is a comparison of FY2000 operating plan expenses --

CHAIRMAN GLEIMAN: Ms. Dreifuss, can you wait until the document is in the hands of Postal Service counsel and the witness at least?

MS. DREIFUSS: Certainly.

[Pause.]

BY MS. DREIFUSS:

Q Mr. Strasser, I am aware that I had not provided this to you or your counsel earlier, but let me tell you what's here and let's see if you can answer some of my questions about it.

As I said before, this is a comparison of FY2000 operating plan expenses with actual FY2000 expenses and these figures are expressed in thousands.

What I have done here is I have presented by AP the expenses from the operating plan. Those were provided to OCA in response to an interrogatory and that interrogatory response is found at Transcript 21, page 9219.

What I am comparing that to is the Postal Service's actual expenditures that we now know through AP-12 due to the fact that the Postal Service filed the last report, AP-12, a couple of days ago.

So I would ask you to accept subject to check that I have correctly transferred the operating plan expenses on that line for operating plan expenses, and also please accept subject to check that I have correctly transferred the AP expenses reported in the financial and operating statements correctly onto this cross examination exhibit.

Would you accept that subject to check?

A Can you tell me again when you got the operating expense plan, the first line, and what is from -- it's from an interrogatory?

Q Well, it's at Transcript 21, page 9219.

A Okay.

Q I don't know if I have a date on that. Is that important?

A Well, no. Subject to check that's fine.

Q Okay --

CHAIRMAN GLEIMAN: It identifies the interrogatory response also in addition to the transcript page.

THE WITNESS: I see.

MS. DREIFUSS: Right, right. That's right, redirected from Witness Tayman to the Postal Service for an answer.

BY MS. DREIFUSS:

Q The Postal Service files financial and operating statements under the Commission's periodic reporting rules, doesn't it?

A Yes. I believe so.

Q Okay. So when the OCA received the operating plan expenses we had it laid out just as you see it on this exhibit. It was broken out by AP and we got the total for the year.

Below that, as I say, I have presented the financial and operating statement expenditures by AP.

We were missing just one figure, as you might imagine, and that was AP-13, because AP-13 is still in progress, isn't it?

A Yes.

Q So what I did is I thought I would constructively estimate what Postal Service actual expenditures might be for FY2000 and in place of what would be an actual AP-13 figure, I used instead the AP-13 operating plan figure.

You see in my second group of figures that I have set out the AP-13 operating plan figure as 5.226 billion dollars. Do you see that?

A Yes, I do.

Q And you can see that I have transferred that amount below on the line for actual expenditures, do you see that?

A Yes.

Q In doing so, what I came up with as a possible total set of expenditures for the Postal Service from APs 1-13 for FY2000, was $64.281 billion; do you see that?

A Yes, I do.

Q Now, I'd like to see whether my step and using the AP-13 expense figure is a reasonable one. Would you agree with me right off that it's reasonable to make that substitution?

A To assume that we're going to make our expense plan?

Q Yes.

A I guess or hope that that would be reasonable.

Q Okay.

And if that's reasonable, then it makes the total reasonable also, because that comes from actual figures, with the exception of AP-13, subject to check?

A Well, I am having a problem because I have the POS, the FOS that you say you got the data from.

And you list expenses, and I can't find -- the operating expense number is not the same.

Q Well, I was using the total expense figure.

A You were using the total expense figure. Okay, let me find that.

I thought it said operating expenses.

Q Well, operating plan expenses, with actual FY2000 expenses.

So, for example, I think you have the AP-12 report in front of you; don't you?

A But the operating plan expenses are different from total expenses. That's my concern.

Q Well, what's the difference?

A Total expenses include interest expense, interest on deferred liabilities, a host of things that are not operational.

Q So the expenses reported in the operating plan are limited to operating expenses?

A If you say those are the operating expense -- operations expenses, they are. I just don't know because I haven't looked at that interrogatory.

Q Well, the OCA asked for the operating plan expenses, and that's what the Postal Service gave to use.

Well, let me ask you about just to enlighten me, for FY2001, the Postal Service is now preparing an operating plan; isn't it?

A It's in the process, yes.

Q And the expense figure that you will provide the Board of Governors, will that be merely operating expenses or total expenses?

A That will be total expenses.

Q Well, again, let's assume, hypothetically, that the operating plan expenses that I present are the total expenses, as opposed to merely the operating expenses.

A Okay.

Q Then I should be able to make that comparison that I spoke about a moment ago, or rather, I should be able to have some confidence in my total expense figure for the year, with the substitution of an operating plan expense figure for AP-13 actual expenses; shouldn't I?

A No.

Q Why not?

A Because operating expenses are not total expenses.

Q No. What I said a moment ago is, let's assume, hypothetically, that the operating plan expenses are the total expenses, and, furthermore, let me accept -- I'll ask you to accept, subject to check, that the financial and operating expense figures that I used were the total expense figures from the financial operating statements.

A Yes, I can see that now for AP-12. I found it.

Q Okay, so if the operating plan expenses are total expenses for FY2000, just as you say you would present similar information to the Board of Governors in FY2001, then I can have some confidence in my total figure for AP-13 with the substitution of an operating plan expense figure for AP-13 for the actual figure; is that right?

A For the actual figure representing the Postal Fiscal Year?

Q For the Postal Fiscal Year, right.

A I guess that's reasonable.

Q And if I really want to be kosher about this, and try to make this comparable to the Government Fiscal Year, I should add in for FY2000, an amount representing the additional work day in FY2000; shouldn't I?

A Well, there are two additional, I believe, this year.

Q Well, I know that there are two additional days, calendar days in Government Fiscal Year 2000, but do you know if that meant two additional work days or just one?

A I don't know, sorry.

Q Well, I'm going to ask you to accept, subject to check -- in fact, if you give me a moment, I can actually show you what I'm working from.

[Pause.]

What I have in front of me, which sheds light on how much one should add in to make -- to account for the additional work day in FY2000, is something that the Postal Service filed yesterday.

It was Library Reference USPS-LR-I-489, and called the Integrated Financial Plan, FY2000.

At page 7 of that Library Reference, what I see is -- and I'll give you a copy in just a moment so you can see for yourself -- that one would add $172 million to account for the additional work day in the Government Fiscal Year.

But I will pause just for a minute to give everybody a chance to look at that.

A I have a copy, thanks.

[Pause.]

Q Mr. Strasser, you're apparently familiar with the Library Reference because you said you had brought a copy with you today?

A Yes, I have it.

Q Okay.

If you read down to the fourth paragraph, it starts with a sentence, "The 11.6 percent increase...;" do you see that?

A Yes, I do.

Q And the second sentence in that paragraph states that FY2000 Service-wide expenses include $172 million to recognize the incremental cost of an extra work day; do you see that?

A Yes.

Q Does that sound right to you, that $172 million would account for the extra work day in FY2000?

A I would assume that they made an accurate estimate.

Q So, if I wanted to make my cross examination figure, $64.281 billion comparable to the Government Fiscal Year, I should add the $172 million to it; shouldn't I?

A Plus the timeframe from September 9th to September

29th.

Q Do you have any information on any additional costs that are expected to occur because of the change in timeframe?

A Well, the Government Fiscal Year Plan includes September 9th through September 30th. What happens is, the Postal Fiscal Year, AP-1 expenses through September 30th have to be taken off the front end of the Postal year, and the expenses for September 9th to September 30th have to be added on in order to conform to the Government Fiscal Year financial report.

Q Do you know whether that shift -- first of all, do you know whether that shift will cause the Government Fiscal Year expenses, aside from the problem of an extra work day, and let's say we've added the extra work day in?

Do you know whether the shift from Postal Fiscal Year to Government Fiscal Year will cause any additional expenses to be added to the Postal Fiscal Year?

A The Postal Fiscal Year ends September 8th.

Q Yes.

A That's the Postal Fiscal Year expenditures through AP-13. The Government Fiscal Year goes through September 30th, so what are you -- I'm not sure what you're asking.

Q I presume the Postal Fiscal Year must have started earlier than the Government Fiscal Year?

A Yes.

Q So you -- it's basically just a shift from one time period to another; isn't it?

A Well, it's a shift in time period, but it's also a change in costs, because presumably all the inflation that's occurred would increase the days that the Government's Fiscal Year consists of.

They'd be higher costs. Labor costs have risen, you know, and all of that, COLA payment have risen and everything, so there are differences in the costs. They don't -- it's not just one day at the beginning of the Fiscal Year is equal to one day at the end.

Q Do you have any idea of the amount of that difference?

A No, I don't.

MS. DREIFUSS: Mr. Chairman, I would ask that the OCA Cross-Examination Exhibit Number 3 be entered into evidence. I think Mr. Strasser said that he would have some confidence in what we purported to do in that cross-examination exhibit. And I would also ask that the page out of Library Reference I-489 also be entered into evidence so as to help us achieve the purpose of showing what the government fiscal year total might look like.

MR. REITER: I think along the way there was a lot of subject to checks and other questions that were raised about the OCA's numbers. However, I have the feeling, Mr. Chairman, you are going to tell me the same thing you told me before. I could be wrong.

CHAIRMAN GLEIMAN: I don't want to disappoint you. What should I tell you? Lecture 1, let's do it in shorthand from now on. I understand that there was a lot of subject to check and a lot of questions, that all shows up in the record and, you know, the evidence in question will be given appropriate weight in that context.

The Cross-Examination Exhibit Number 3 and the page out of the Library Reference that was distributed will be transcribed in the record and entered into evidence.

[Cross-Examination Exhibit No. OCA/USPS-RT-1-XE-3 and above-referenced page from LR-I-489 were received into evidence and transcribed into the record.]

OCA/USPS-RT1-XE #3

Comparison of FY 2000 Operating Plan Expenses with Actual FY 2000 Expenses

(thousands)

AP	AP 1	AP 2	AP 3	AP 4	AP 5	AP 6	AP 7	AP 8	AP 9
Expenses-- Operating Plan (Tr. 21/9219)	4,799,807	4,885,628	4,896,929	5,124,244	4,986,468	4,958,393	5,077,083	5,033,264	5,029,886
Expenses-- (Financial & Operating Statements)	4,717,700	4,834,700	4,833,900	5,191,100	4,932,500	5,000,300	5,047,400	5,021,500	5,003,200

AP	AP 10	AP 11	AP 12	AP 13	Total for year
Expenses-- Operating Plan (Tr. 21/9219	4,851,244	4,861,054	5,008,615	5,226,386	64,739,001
Expenses-- (Financial & Operating Statements)	4,777,300	4,758,700	4,937,300	*[5,226,386]*	*[64,281,986]*

Tr. 21/9219 consists of an attachment to a Postal Service response to interrogatory OCA/USPS-T9-27, redirected from witness Tayman. It is entitled "U.S. Postal Service FY 2000 Operating Plan."

Financial and Operating Statements are filed as Periodic Reports pursuant to Commission Rule 102, 39 CFR sec. 3001.102.

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The field budget receives the largest increase at $2.3 billion. Although total salaries and benefits grew in the field by 4.6 percent, total work hours are planned to decrease one percent below FY 1999. This will be the largest decrease in hours since FY 1979 and the first decrease in work hours since FY 1992. Program savings and significant productivity improvements are driving the decreases. An increasing amount of work sharing by our business partners is also a factor in the decrease. Most field units have made a head start on the FY 2000 targets by scaling back complement and reducing work hour and overtime usage in the last two quarters of FY 1999.

Headquarters administrative costs include expense of headquarters organizations and the field service units. Headquarters administrative plans will be $2 million below FY 1999 levels. Components of the headquarters budget include a $32 million, or 81 percent, increase in the inspector general's budget submission that is pending Board approval and a $34 million decrease in all other headquarters administrative activities. Strategies to achieve this reduction include an overall seven percent reduction in non-personnel expenses and a complement reduction of 500 positions.

FY 2000 OPERATING BUDGET
($ Millions)

	FY 1999 Estimate	FY 2000 BUDGET	Change	% Chg
Field	50,035.6	52,381.7	2,346.1	4.7%
Headquarters	1,416.8	1,414.8	-2.0	-0.1%
Programs & CWA	3,233.3	2,788.0	-445.3	-13.8%
Servicewide	5,070.4	5,713.3	588.3	11.6%
Corp. Transportation	2,723.9	2,786.2	62.3	2.3%
Interest Expense	215.0	240.0	25.0	11.6%
Total Expense	62,695.0	65,324.0	2,629.0	4.2%

Program and corporatewide activity costs will be $445 million, or 13.8 percent below FY 1999 levels. Each program has been reviewed and prioritized. Continuing the FY 1999 management challenge initiative, many of the major programs will be scaled back or delayed to meet our net income target.

The 11.6 percent increase in servicewide activity is driven primarily by two factors. FY 2000 servicewide expenses include $172 million to recognize the incremental cost of an extra workday. This is caused by the government fiscal year (GFY) being 366 days long (due to leap year), while the postal fiscal year (PFY) remains 364 days. The revenue associated with the additional workday in the GFY is included in the revenue plan. The remainder of the servicewide expense increase is driven by a $227 million increase in annuitants' retirement and health benefits costs.

Corporate transportation growth includes inflation and workload, but is held in check by over $100 million in program reductions. These reductions will not impede attainment of Voice of the Customer service goals, which will be maintained.

To gain a different perspective on the FY 2000 operating plan, expense growth can be examined by component. Personnel expense makes up the largest growth segment of the FY 2000 operating plan, at $2.3 billion. Unlike previous years, FY 2000 growth in salaries and benefits is the result of labor contracts, health benefits and other pay related expense drivers, not a growth in work hours. Non-personnel is growing at only $87 million, or 0.8 percent--well below the rate of inflation. This growth has been kept in check by workload

Fiscal Year 2000 Expense by Component
($ millions)

	1999 Est	2000 Plan	Change	% Chg
Personnel	47,324	49,658	2,334	4.9%
Nonpersonnel	10,735	10,822	87	0.8%
Transportation	4,421	4,604	183	4.1%
Interest	215	240	25	11.6%
Total Expense	62,695	65,324	2,629	4.2%

MS. DREIFUSS: Mr. Chairman, --

MR. REITER: I was just going to ask if that included giving me the same opportunity you gave me earlier to file a subsequent objection.

CHAIRMAN GLEIMAN: That is part of Lecture Number 1.

MR. REITER: Okay. I was just checking.

CHAIRMAN GLEIMAN: That is the whole lecture. There is not a Part A and Part B.

MR. REITER: Next time I won't ask. Thank you.

CHAIRMAN GLEIMAN: It is, I think in the interest of moving this along, a standing understanding. Okay.

MR. REITER: Very well. Thank you.

MS. DREIFUSS: Mr. Chairman, I am not going to ask any more questions, but I do have two matters to attend to right now with respect to the transcript. One is I have Witness Thompson's declaration at this point, we got that a little earlier in the day.

CHAIRMAN GLEIMAN: If you would please provide copies to the court reporter.

MS. DREIFUSS: Certainly. And in light of the fact that the Postal Service uses DRI forecasts, although maybe not the calendar year forecasts that I showed Mr. Strasser, but since the Postal Service uses DRI, I assume that they would find them to be a reliable source, I would also like to move Cross-Examination Exhibit Number 2 into evidence.

MR. REITER: There were some questions about the particular report that that came from, and just for the sake of clarity, I would just suggest that if counsel could, that perhaps she provide the cover page or the cover letter or something that I saw in the beginning there, so that we would have a way to reference those numbers as to a time period or a subject.

CHAIRMAN GLEIMAN: Counsel, can you do that in fairly short order?

MS. DREIFUSS: Certainly. If you want to handle it in just a few minutes, I can talk it over with Mr. Reiter. I don't know if this is a good time, or wait till a little bit later.

CHAIRMAN GLEIMAN: It is a cross-examination exhibit, the reporter has two copies of it. It has been properly marked, you are going to give him a second page of it within the next five minutes.

MS. DREIFUSS: Okay.

CHAIRMAN GLEIMAN: So that we get all together before his assistant comes in here and collects the tape and runs off with the tape and the cross-examination exhibits.

MS. DREIFUSS: I sure will.

CHAIRMAN GLEIMAN: And the second piece of paper is going to be the cover page off of the document that you leafed through earlier on.

MS. DREIFUSS: Certainly, I would be happy to do that.

MR. REITER: Whatever page or pages are necessary to show exactly what it is and when it was published.

CHAIRMAN GLEIMAN: It is either the cover page or an inside page that shows exactly the date of the document and the title of it.

MS. DREIFUSS: Why don't I confer with counsel just for a moment?

CHAIRMAN GLEIMAN: No, why don't we do it the way I said. Just make a copy of it and let's get on with it.

MS. DREIFUSS: Okay. We will do that.

CHAIRMAN GLEIMAN: Okay.

MS. DREIFUSS: Yes.

CHAIRMAN GLEIMAN: Fine.

MS. DREIFUSS: Also, could we ask that the declaration be placed in the record alongside Cross-Examination Exhibit Number 1?

CHAIRMAN GLEIMAN: I wasn't paying attention to whether the court reporter's assistant bopped in here and picked up cross-examination exhibits yet or not. If they are still here and it can be done without being disruptive, then we will do that, otherwise, it will appear right here and now.

MS. DREIFUSS: All right, Mr. Chairman.

MR. REITER: Can I ask one brief question? Is the declaration with respect to the Library Reference as well?

MS. DREIFUSS: Yes, the declaration is with respect to the Library Reference.

MR. REITER: Thank you. That is what we had asked for.

CHAIRMAN GLEIMAN: Know as well, it is the Library Reference that we -- Category 2 Library Reference we were putting into evidence.

MR. REITER: Fair enough.

CHAIRMAN GLEIMAN: Okay. Mr. Miles, could you give me a sense of how long you might go for cross-examination?

MR. MILES: Mr. Chairman, I believe I will be somewhere in the 15 to 20 minute range.

CHAIRMAN GLEIMAN: Mr. Strasser, Mr. Court Reporter, do either of you need a break right now?

THE WITNESS: Not if it only takes 15 to 20 minutes.

CHAIRMAN GLEIMAN: Well, we will push on. That is not the end of it.

THE WITNESS: I understand that.

CHAIRMAN GLEIMAN: We can take a break after that.

Mr. Miles, go ahead.

MR. MILES: Thank you, Mr. Chairman.

CROSS EXAMINATION

BY MR. MILES:

Q My name is John Miles and I represent ValPak Companies and Carol Wright Products, which are proceeding jointly in this docket.

A I'm very familiar with your mail.

Q I take it from your previous testimony today that you were not involved in any way in the original Postal Service request?

A No, I was not; I was in the field as a District Manager.

Q So, even with respect to other aspects of the case, not just Mr. Tayman's testimony, you were not consulted?

A That's correct.

Q When did you become involved?

A I assumed the position in the first few days of May of this year.

Q Your present employment.

Did you actually get involved in the case at that time?

A Yes, almost immediately.

Q Did you -- I think you said you consulted with Mr.

Tayman with respect to your rebuttal testimony?

A Yes, he, among others, yes.

Q Did you determine what Mr. Tayman relied on in putting together his testimony?

A I discussed it in general terms. I'm not sure that we got very, very specific. I'm generally familiar with the rate process, and the development of the revenue requirement and things like that, so we didn't have very many detailed discussions.

Q So, in other words, you read his testimony and then asked him questions about it?

A We discussed the situation as the case has unfolded, yes.

Q Are you aware of whether Mr. Tayman considered the impact of the proposed contingency on the Postal Service's economic value-added program?

A The impact of the proposed contingency? I'm not aware that he considered it, although in our EVA computation, it doesn't affect it.

Q It does not?

A No. Our EVA computation is indexed, and it removes the effect of all rate-generated increases in revenue before the economic value-added is calculated.

We only get credit in our EVA computation for business revenue generated from new mail business, not from an increase in rates, either the new revenue requirement or the contingency or the prior year loss recovery.

Q So, that would not have been a factor for Mr. Tayman?

A No, they don't bear any relationship.

Q In comparing your testimony with Mr. Tayman's, did you -- or in preparing your rebuttal testimony, did you find that Mr. Tayman's testimony was deficient in any way?

A No, I don't recall any deficiencies.

Q Did you add to the factors that you felt were left out of his testimony?

A We primarily discussed the factors that needed to be in my testimony.

Q Were they factors that he did not consider and include in his testimony?

A They were variations of pretty much the same subjects, I would guess.

Q For example, Mr. Strasser, at pages 7 and 8 of your testimony, I think you quote a response, a Postal Service response to an OCA question on the contingency, and you add a bunch of information addressing the framework for assessing the reasonableness of the contingency amount.

Was this something that Mr. Tayman included in his testimony?

Do you recall that you have a quote in there?

A I cited the OCA -- the response to the OCA question on the contingency, yes.

Q Right, but Mr. Tayman, did he have that information in his testimony?

A I believe he generally described the situation that resulted in the contingency. To that degree, yes.

Q At page 6 of your testimony, lines 24 through 27, you may have already spoken to this earlier today, but you mention that you have been advised concerning the evolution of the Commission's approach to evaluating the contingency.

Who advised you?

A There were discussions with the people who are on my staff and on the staff of the Pricing and Policy people in Marketing who have much more experience with the rate processes and the rate case history, as well as our internal counsel.

Q And they advised you, and is this what you spoke about earlier today?

A Yes.

Q You already testified to this?

A Yes.

Q Am I to take it that you never, yourself, read the Commission's earlier opinions?

A I have read them over my 31 years of Postal experience. Whether I could take a test on them would be another matter.

Q But with respect to the contingency and the Commission's treatment of the contingency, I take it then that in preparing your rebuttal testimony, you didn't go back and look at what the Commission had said?

A We discussed each -- I had questions of counsel, because I had experience with what we had done in the past on contingencies, and I was an observer when we had filed the previous two rate cases.

And I was curious about the one percent at the time.

Q I want to ask you a couple more questions about the potential impact on the EVA program. You may have already answered these, but they will be short, and you can just confirm, if you already have.

That's the Economic Value-Added Program. To what extent does the Postal Service's revenue request in this docket include the management employee bonuses under the EVA?

A To what extent does the revenue requirement include it? To the extent that it's an estimated cost, it would be built into the revenue requirement.

Q Under salaries?

A I believe so.

Q Is it your testimony these would not be impacted by the contingency amount?

A The amount of the Economic Value Added payouts is determined by -- is not affected by rate increase generated revenue, so the EVA has to be calculated without rate generated -- what it is is a comparison of the expenses and a charge for the capital that we use to handle the volume of business and comparison to the revenue of the volume of business that occurs in that year.

If we can -- to the extent that we can generate economic value, in other words use less resources for more business, we have generated economic value, so now the payout of that is dependent further, in other words taking that Economic Value Added pool of money, the payout is further constrained by the fact that there are specific compensable goals that have to be achieved before they are paid out.

Q The recovery of prior year's loss amount is not an expense, is it, in the Postal Service budget? I mean it is not an accrued expense or a cash expense, is it?

A No, it's only a factor in the revenue requirement.

Q It would simply be a --

A Of the rate -- right.

Q It would be restoration of equity. That is how it would be applied.

A Well, it could be used for, as I said earlier, it could be used for -- its purpose is restoration of equity, yes.

Q Well, take this assumption again and forgive me if I am asking the same question, but I wanted to specify this example to make sure we all understand.

Assume that in the test year the net profit after all expenses including the contingency were paid equalled precisely the amount for RPYL, recovery of prior year's loss, okay? -- so under the -- so you had that, let's say, net profit. Under the EVA program would managers be entitled to share in that in any way?

A No, because when we take the revenue that resulted -- you have got revenue minus expenses is net income. In the EVA computation, the revenue generated by this rate increase, which includes the prior year loss recovery portion, would be factored out of the total revenue before the calculation is made as to whether there is any economic value.

Q Is there a Postal Service publication that explains what you are telling me?

A There is an explanation of EVA and I believe the process by which the EVA pool is derived and what it says is an indexed EVA and it takes out the effect of any rate increase.

It doesn't go to your question on prior year loss recovery but we could provide it to you.

MR. MILES: Mr. Chairman? I have looked for such a document. I haven't found it.

CHAIRMAN GLEIMAN: Mr. Reiter?

MR. REITER: Yes, we'll provide it.

MR. MILES: Thank you.

CHAIRMAN GLEIMAN: Mr. Strasser knows where it is.

THE WITNESS: I am presuming there is -- I remember seeing one.

CHAIRMAN GLEIMAN: If there is not a document to be found you will let us know that also.

THE WITNESS: Indeed I will.

BY MR. MILES:

Q Mr. Strasser, assume in the test year that the revenues and costs of the Postal Service were so accurately predicted that you didn't need the contingency.

How would the contingency that had been, let's say, recommended and approved show up in the Postal Service's budget?

A So what you are saying is that the revenues and expenses are exactly as estimated and what would -- the contingency and the prior year loss recovery would flow to a net income for that test year in the ideal world.

Q They would be called net income?

A Right.

Q Did you ever consider setting -- assuming that hypothetical actually occurred, would the Postal Service set up a contingency reserve for the future?

A Well, no. What we would do is we would make the best management decision we could as to what is the best use of those funds. As I said earlier in my testimony, you could use them to pay down debt. You could decide to hold some in cash for contingency if your cash levels warrant. You could invest in capital. You could do whatever managerially in a businesslike environment is the best thing to do with that cash.

Q Well, you could also establish a reserve fund for the future so that in the next rate case you didn't have to ask for a contingency again, could you not?

Couldn't you set up a trust fund with that money?

Has that ever been discussed? Let me ask you that. I am not sure --

A I am unaware of any discussions in that respect.

Q You weren't involved in any discussions in your career with the Postal Service?

A Not from that angle, no.

Q If the Postal Service were to negotiate wage agreements that exceed the amount estimated in the test year which have the effect of reducing profits in the test year, would that reduction in profits reduce the amount distributed under the EVA program?

A I am thinking about how the computation takes out the revenue -- calculates expense.

I honestly at this point can't recall whether the expenses are factored for inflation and wage rates.

I guess -- is there some way that we can provide that?

Q Well, I am not sure we are on the same page in terms of my question.

My question was if the expenses for wages actually exceeded the amount that you predicted, and so that the net profit was reduced, would that have any impact on the distribution under the EVA program?

A My inclination is to believe that it would reduce it but I honestly can't say that for sure.

Q So that would you also assume that if the wage agreements were less than the amount you have estimated in the test year so that profits increased that would also possibly impact the amount distributed under the EVA program?

A I really can't tell you on that. I just can't remember the computation on the wages.

Q Well, if the answer is possibly yes, isn't that inconsistent with what you told me before about somehow these monies being exempt if they result in net income from

EVA distribution?

A No, that's not inconsistent.

The revenue generated from rate increases is definitely taken out of the revenue line. What you are asking me is there an expense adjustment to neutralize the results of labor negotiations or is it just whatever was spent on labor is included in the expense line. Then the expense line is subtracted from the revenue, the adjusted revenue line, and that is what the calculation is for your EVA with a charge for capital usage.

It's not inconsistent. The revenue is definitely adjusted for the rate increase. I don't know whether the labor costs are adjusted for labor price inflation. That's what I can't definitively tell you at this point.

Q Well, if the -- is there a distinction between what you're telling me about wage expenses and with respect to the proposed allowance for the contingency which is built into the rates and expenses anyway?

In other words, if the net effect of the contingency is to increase net profits, could that amount not be distributed under the EVA program, or impact the EVA program the same way that wage increases or decreases do?

A No, it does not. The contingency amount does not affect the EVA program. There's no relationship between that.

Q Well, the contingency amount really results in -- has an impact on rates; does it not?

A Yes, it does.

Q And the rates have an impact on what the net profit is?

A That's true.

Q And so do expenses. Don't they all end up in the same pot in the final analysis, so at the end what you have is a net profit?

A On the income statement, yes.

Q And isn't the EVA distribution made from that?

A No. The EVA computation is separate from the rote net income statement. And as I said, this rate case -- for example, in an ideal world, if this rate case covered Fiscal Year 2001, the total revenues for Fiscal 2001 would be reduced by this six percent, assuming that's what the outcome of this case is; would reduce by the six point whatever percent, weighted, of course, based on what actually happened with the mail volume mix, would be reduced by that amount in the EVA revenue figure.

Then the expense figure gets subtracted and a capital charge is made, and then that's the economic value-added. So, it's the real economic value; it's not the net income statement that drives the EVA payouts.

MR. MILES: Thank you very much. I have nothing further, Mr. Chairman.

CHAIRMAN GLEIMAN: Mr. McBride indicated that he had two of something in the way of followup. I'm not sure if he had questions, minutes, hours, days. If it's questions or minutes, we're going to let him go ahead, and then we'll take a short break.

MR. McBRIDE: I'm hoping its two or three minutes, Mr. Chairman, thank you.

CROSS EXAMINATION

BY MR. McBRIDE:

Q Good afternoon, Mr. Strasser. My name is Michael McBride and I represent Dow Jones and Company.

I take that you are aware that Dow Jones publishes the Wall Street Journal and Barons, among other publications, and that many of them are carried by the Postal Service?

A Yes.

Q Thank you.

A I've been in discussions with your Chairman and your President over the years.

Q Good.

I take it then that you're also aware from some testimony you've given earlier today, that there is mail in the mail stream that is not captive to the Postal Service?

A Yes, there's significant volume of mail in the mail stream not captive.

Q Fine.

Now, I want to go back to some testimony you gave in response to Mr. Ackerly's questions quite awhile ago.

I wrote down what you said at the time, as fast as I could write it, so you'll correct me if I didn't quite get it right.

But he was asking you about a situation in which the contingency factor might turn out not to be needed, the revenue associated with the contingency factor. And you said under those circumstances, that the customer would still benefit.

You said it's not like it's going away; do you remember that testimony?

A Yes.

Q Good.

So, but if the customer goes away, if the rate increases allowed by the Commission are too high, then neither the customer nor the Postal Service would benefit from rates being too high; would they?

A No, you're correct.

Q All right.

But if the contingency factor allowed were too low and rates were too low, the Postal Service, if it wished, could always come back sooner than planned for another rate increase; isn't that correct?

A Well, if the rates were too low, you would not achieve break-even.

Q Right.

A So you'd end up with having future ratepayers pay for the services that current customers received.

Q But my question was, that if the rates allowed by the Commission turn out to be too low, as opposed to the too high that we just discussed, there's nothing to prohibit the Postal Service from coming back here sooner to ask for rate increases; is there?

A I suppose that's a reasonable statement.

Q And was the policy adopted by the Service a few years ago that it would file for smaller, more frequent rate increases?

A I'm not sure.

Q Okay.

MR. McBRIDE: That's all I have, Mr. Chairman.

CHAIRMAN GLEIMAN: My colleague would like to ask a question on EVA, and then unless there is some other followup, we will take a break.

COMMISSIONER GOLDWAY: I apologize, and it's very complicated, and I'm not sure I understand at all.

THE WITNESS: Don't apologize.

COMMISSIONER GOLDWAY: I think what I understand that what you're saying is that under the EVA, the managers get the benefit of the previous rate increase, but not the current one you're requesting?

Because you're going to subtract the six percent of what's coming in 2001, but not the four percent or whatever it was you got in 1998.

THE WITNESS: No, it's essentially annualized already in the base, the previous rate increase is annualized in the base.

COMMISSIONER GOLDWAY: So in 2001, they won't get the six percent, but in 2002 they will get the six percent?

THE WITNESS: Because it's annualized in the base of the business revenue volume, right.

COMMISSIONER GOLDWAY: Okay, thanks.

CHAIRMAN GLEIMAN: Now, we are going to take a break, ten minutes, and we'll come back with questions from the Bench and proceed from there.

[Recess.]

CHAIRMAN GLEIMAN: Is that a reasonable assumption? The rates you filed, the contingency you asked for and everything else, is that a reasonable assumption?

THE WITNESS: To rubber-stamp it, sir?

CHAIRMAN GLEIMAN: Yeah. I mean I don't mean anything pejorative by that. I mean you would like to have us just recommend back to you what you ask us to recommend.

THE WITNESS: I guess that is just human nature on our part, but, you know, I realize that you have your --

CHAIRMAN GLEIMAN: It is not a trick question. I mean you would prefer -- the Postal Service would prefer what they asked for?

THE WITNESS: Our position is that our filing is our filing, yes.

CHAIRMAN GLEIMAN: Okay. In response to Order 1294, the Postal Service indicate that in the test year they would experience an additional $451.4 million in accrued costs above and beyond those that they anticipated for the test year when they filed the case. Would you accept that subject to check?

THE WITNESS: Yes.

CHAIRMAN GLEIMAN: Okay. Subject to check, in the Postal Service's case as originally filed, they were going to have a deficit of $21.9 million.

THE WITNESS: In the test year, yes.

CHAIRMAN GLEIMAN: Inasmuch as there are additional accrued costs of $450 million for the test year, if we rubber-stamp the Postal Service's case as filed, all the rates that you requested, the Postal Service will, therefore, finish the test year $471.9 million in the red. Is that reasonable, subject to check? Everything else being equal.

THE WITNESS: Well, the update did not include a comprehensive review or update of everything, but if what was updated is all that will change and those forecasts are accurate, then -- what was your statement, it would be $451 million?

CHAIRMAN GLEIMAN: $471.9 million in the red for the test year.

THE WITNESS: Did you account for prior year losses and contingencies?

CHAIRMAN GLEIMAN: Yes. I changed nothing else other than adding those additional accrued costs that were included in Order 1294.

THE WITNESS: You said that 1294 resulted in $471 million?

CHAIRMAN GLEIMAN: $451 and change, and you already and you already just short of $22 million in the case as originally filed, and that is how I came up with my $471.9.

THE WITNESS: That wouldn't be the net income because the net income is also affected by the contingency and the prior year loss recovery portion of the revenue.

CHAIRMAN GLEIMAN: I didn't change any of those. I left the contingency and everything else in there the way you asked for.

THE WITNESS: Let me think about this a minute.

CHAIRMAN GLEIMAN: All I did was add in the additional expenses, which you said, you the Postal Service said would be accrued during the test year.

THE WITNESS: Right.

CHAIRMAN GLEIMAN: There are some other little minor, but there are in --

THE WITNESS: But those computations are based on the estimated revenue and the expenses. They are separate from the prior year loss recovery.

CHAIRMAN GLEIMAN: Did you have prior year loss recovery in the case as originally filed?

THE WITNESS: Yes.

CHAIRMAN GLEIMAN: Okay. I have not changed that. Did you have contingency in the case as originally filed at 2.5 percent?

THE WITNESS: Yes.

CHAIRMAN GLEIMAN: Would you accept, subject to check, that there may be a little noise in there because you are dealing with more expenses, but that, basically, it is a shade under $1.7 billion for the contingency?

THE WITNESS: Yes.

CHAIRMAN GLEIMAN: Okay. The only line that I am saying is changed is the accrued cost line. You now have, as a consequence of what the Postal Service has told us in Order 1294, $451.4 million in additional accrued costs. If you add that to the $21.9 million deficit that you had in the original case for the test year, that gives you a deficit of $471.9. If you want to make it, you know, $10 million or $40 million one way or the other, that is okay, you know, but you think that is a ballpark figure? Subject to check.

THE WITNESS: Yes.

CHAIRMAN GLEIMAN: Okay. Do I understand correctly that if, and I use this term because I have heard it in the hearing room, if none of the unknown unknowns that we all live in fear of occur, those things which cause us to want to have contingencies, if none of those things occur, that will eat up the $1.7 billion contingency that the Postal Service's position is that they will still spend that money during the test year, either to pay down debt or to do something else, but it will disappear during the test year?

THE WITNESS: No, I don't think you can assume that.

CHAIRMAN GLEIMAN: Didn't your case as filed assume that?

THE WITNESS: Well, the case is not an income statement. The case is a statement of revenue and expense, and the contingency and the prior year loss recovery is included in the revenue requirement, in the total revenue estimated, and then what happens is the operating expenses are calculated based on the best estimates we have.

And so the net income, for example, that was filed in our filing, if the contingency did not need to be used and the prior year loss recovery was in fact recovered because the volume forecasts were correct, we would have a net income of $1,926,200,000.

CHAIRMAN GLEIMAN: Okay. But we know that you are committed to taking the $268.3 million in prior year loss recovery and applying that to recovering prior year losses.

THE WITNESS: Right.

CHAIRMAN GLEIMAN: Okay. So that leaves us with the $1,679,800,000 contingency fund that is in play here. And if you didn't use that money, you would have that at the end of the year on your profit and loss statement.

THE WITNESS: If the rates were in effect for the full test year and so on, yes.

CHAIRMAN GLEIMAN: Okay. If some of those unknown unknowns happened, and they could, according to what the Postal Service people tell us, then that $1,679,800,000 is going to disappear.

THE WITNESS: Well, one known that is going to happen is the practicality of implementing the rates later than the beginning of the test year.

CHAIRMAN GLEIMAN: And didn't you testify before in response to questions that, assuming none of the unknown unknowns occur that eat up that contingency money, that is the Postal Service's prerogative to use that money as it sees fit. You gave us several options, one of them was pay down debt. You know, you had a couple of others in there, too, stretch out the rate cycle.

THE WITNESS: Well, if the money is not expended, then it is cash that has to be dealt with in any responsible management's way, you know, managerial manner that an entity, a business-like entity should use it.

CHAIRMAN GLEIMAN: And if you use it in a sensible managerial way, then, at the end of the year, given the fact that you have accrued -- you will be accruing $450 million in additional expenses for the test year, you will wind up $471.9 million in the hole. The only way we can keep you from going $471.9 million into the hole is to cut your expenses, and there is only one place that we can cut your expenses in order to do that, and that is the contingency.

If you don't have that expense there, if you don't have that money laying there to spend at management's discretion, then you can't go $471.9 million into the hole. Would you agree or disagree?

THE WITNESS: Could you repeat the question?

CHAIRMAN GLEIMAN: In management's discretion, it's going to spend that money and that money is part of the revenue requirement, and if you spend that money, given the additional accrued expenses that were reported in 1294, you're going to wind up $471.9 million in the hole.

If you don't have $471.9 million of the contingency that you've requested, then management can't have the discretion to spend it because it won't be there.

THE WITNESS: I'm not -- if I said that management would spend it if it was there, that's an inaccurate statement. What I said was if the cash were there because it wasn't needed for something that occurred during the course of the year, then management's responsibility is to invest it wisely. You don't just hold it in the coffers. It's not necessarily an expense. It could be a drawdown to debt, it could be used for capital investment, it could be used for expenses, or it could just be held in our treasury accounts bearing interest.

CHAIRMAN GLEIMAN: Okay. Thank you.

Commissioner Covington.

COMMISSIONER COVINGTON: Good afternoon, Mr. Strasser.

I would like to follow up on some points that the Chairman just raised and also to get some clarification to some things that you've stated since you took the stand this morning.

We all realize that R2000-1 is all about money. I mean, none of us in here are naive enough not to know that

that's what the bottom line is on this. But I want to know, when the USPS and the Board of Governors look at their budgetary issues, do you know whether they always come up with figures that are supposed to break even, to your personal knowledge?

THE WITNESS: When they're looking at the budget, sir?

COMMISSIONER COVINGTON: Uh-huh.

THE WITNESS: When we do the budget, we generally begin with our anticipated workload and revenue based on the forecast, and then it has been our policy to attempt to generate net income -- in other words, spend money and gain efficiencies and increase productivities such that there's a net income, unless in a situation it becomes obviously that it can't be a net income, in which case you strive to make it the minimum deficit that you can, because our mandate is to break even over time.

COMMISSIONER COVINGTON: Okay. In your testimony, you stated that -- this was your contention -- that 2.5 percent, a 2.5 percent contingency is conservative; am I correct?

THE WITNESS: Yes, in my opinion.

COMMISSIONER COVINGTON: Okay. Now, the Board of Governors has requested a 2.5 contingency, which represents, give or take a few million bucks, as our Chairman just stated, $1.7 billion, correct?

THE WITNESS: Correct, sir.

COMMISSIONER COVINGTON: Coupled with your prior year losses, this accounts for about half of what you're asking us for as far as revenue requirement.

THE WITNESS: Yes, sir.

COMMISSIONER COVINGTON: Okay. Now, is the $3 billion figure that I have been seeing, is that all that represents restoring your prior-year losses?

THE WITNESS: The prior-year loss recovery figure I think is about 3.5 billion.

COMMISSIONER COVINGTON: Oh. So I'm about a half a billion dollars off. Okay.

Tell me, Mr. Strasser, what's the difference between a safety net and a cushion?

THE WITNESS: Safety net and a cushion.

COMMISSIONER COVINGTON: Okay. You referred to the contingency in some respects as being a cushion; Mr. Rosenberg referred to it as being a safety net and you took issue with the fact that he used the term safety net.

THE WITNESS: Well, it --

COMMISSIONER COVINGTON: So what is the difference between a safety net and a cushion?

THE WITNESS: The -- could I refer to --

COMMISSIONER COVINGTON: Yes. Please.

THE WITNESS: -- Mr. Rosenberg's testimony?

Would you know -- I'm not specifically sure if I can identify where he stated that.

[Pause.]

MS. DREIFUSS: If I can be of any help, I do know that Mr. Rosenberg mentions that at page 15 of his testimony, transcript page 9819.

COMMISSIONER COVINGTON: That's correct.

And I think if you would direct yourself, Mr. Strasser, to page 5, you even alluded to that.

THE WITNESS: Right.

COMMISSIONER COVINGTON: Around line -- between lines 3 and 7. And it says, and I read, "In this regard, there is absolutely no reason to reduce the proposed contingency in response to OCA Witness Burns' unfounded concern that the contingency constructs a moral hazard for lax and inefficient management, or Witness Rosenberg's fear that the contingency provision provides a cushion that results in a tendency towards slackness."

So what I'm asking you is, in your opinion, is there a difference between safety net and a cushion?

THE WITNESS: Well, I think the point is that the cushion is, as I said earlier, an insurance against uncertain known -- known items that we don't know the exact outcome at this point as well as things that happen that come at us out of the blue. That's the terminology I would use, a cushion.

What I said about his statements is that he implies that we don't use other measures of management controls, such as total productivity, to determine our efficiency. He implies that since the money is there, it will be spent.

My point is that that's not the way we operate. We operate realizing the competitive pressures we have in the marketplace, realizing that it's our obligation to keep rates as reasonable and competitive and fair as they can be because that's what our existence is based on.

You know, charging for a contingency, and it came up earlier, is not a thing that we just pad our books for; it's a determination we make. I believe in the last case, for example, the one percent was a risk that management decided to take in order to hold down rates.

So the contingency is not something that's just a slush fund that we can go spend. That doesn't make any sense for the future of the organization or the existence of it.

COMMISSIONER COVINGTON: Okay. Well, earlier this morning when Mr. Ackerly was questioning you, you mentioned specifically that first-class volume growth, you know, has been somewhat of an uncertain element and has cast a cloud.

I think you mentioned deceptive advertising and what's happening with the sweepstakes mailing and so forth, and you mentioned fuel prices.

Going back to what the Chairman was saying, I want to know, when it comes to first-class volume growth, deceptive advertising/drop off and sweepstake mailing, fuel prices, which of that is considered unknown unknowns and which of them are considered known unknowns?

THE WITNESS: Well, I think the effect of -- specifically effect of the sweepstakes -- I'm not sure. I wasn't in the budget formulation for this fiscal year, so I honestly don't know whether it was a -- it was known that it was going to occur, but the amount was unknown, I just don't know that.

Fuel prices I can tell you are, in the order of magnitude, on an annual basis, $300 million more than they were anticipated to be at the beginning of this fiscal year that we're in right now, and I think that was an unknown unknown. I don't know that anybody back last fall when the budget was formulating was forecasting fuel inflation on the order of magnitude we've experienced, and so I guess that's the way I would characterize that.

COMMISSIONER COVINGTON: Okay. Another question, Mr. Strasser. When Order 1294 left the Public Rate Commission and was forwarded over to you all and we stated, we said, well, what we want, we want to look at the most current cost revenue analysis data that USPS has available, physically where were you when that order was issued? Were you in Northern Virginia or were you at headquarters?

THE WITNESS: I believe that order was issued the end of May?

COMMISSIONER COVINGTON: That's correct.

THE WITNESS: I was at headquarters.

COMMISSIONER COVINGTON: Okay. What is your position as far as the PRC asking for reformulated base year and/or test year estimates? Do you think that that's illogical? Do you think that that's burdensome. Do you think that maybe the Commission was, you know, trying to go back and get you all to reinvent the wheel? What's your assessment of that?

THE WITNESS: My assessment is that it was very, very challenging. The people who had to respond to it were at the same time responding to interrogatories on the filing and in preparation for testimony and things like that. So it was very, very challenging.

As it relates to the fact that it was -- there was not enough time to create a new fully-integrated case that took advantage of thinking about the pricing and the effects of those CRA '99 costs on individual classes and subclasses as it relates to pricing, what the inflation levels would be, we didn't do any of that when we provided you the update based on the '99 data.

The other aspect is, you know, the opportunity for the people who are affected by this process -- our customers, if we had -- if we even had enough time to reformulate a case, it's like a moving target because all of the work that they were doing on what was filed would be reformulated and have to be reexamined.

So I guess those are my thoughts about the process. What we did was we updated the CRA cost data and we updated some of the major cost elements that we thought required updating.

COMMISSIONER COVINGTON: Okay. Thank you.

Do you know when the Board of Governors adopted Resolution Number 95-9?

THE WITNESS: Based on the number, I believe it was fiscal year 1995.

COMMISSIONER COVINGTON: Okay. Now, Mr. Ackerly also touched on this, and I guess you probably said I really listened to Mr. Ackerly, but he raised some good points. I don't understand why the United States Postal Service can't improve on its equity restoration or why you can't deal with your real estate values more.

Now, do you think USPS manages its real estate holding in a rational manner?

THE WITNESS: Yes, I think they have done a very, very excellent job of managing the real estate assets that we've had. It's been evidenced by some of the sale and some of the investments we've made.

COMMISSIONER COVINGTON: Okay. I think in your testimony you stated that you didn't think it was really a good idea to dispose of more real estate; is that correct?

THE WITNESS: Well, we use virtually all of the real estate we have. It's not our management policy to have real estate that is not necessary to postal operations. So we dispose, as we did in the case, as I mentioned, AP12 -- we had -- we disposed of some property in Los Angeles that generated $33 million in gross revenue. Last year, we disposed of a property in San Francisco that generated slightly more revenue than that.

So we do constantly review our assets, and if they're underutilized or it appears that over time we could vacate or consolidate, we do do that.

COMMISSIONER COVINGTON: Okay. Well, Mr. Strasser, let me ask you this: Has there ever been a timetable, will there ever be a timetable, or has USPS ever thought that they would eliminate being in a negative equity position? You can answer any part of that question any way you would like.

THE WITNESS: Well, to my knowledge, there is no timetable. I believe the policy calls for restoration of equity to the original investment of the U.S. Government level in the Postal Service.

COMMISSIONER COVINGTON: Okay. You know, your PMG has been out trumpeting his cost-cutting measures, and just like the Chairman just said, you know, you can cut costs, but then if you're incurring expenses, it's almost like taking two steps forward and three back at the same time.

Do you know of or what specific budget cuts have been put into place, and if you're cutting the budget or reducing costs, how is all this going to figure into what you're asking for as far as your contingency request is concerned? You know, if you cut a billion dollars, wouldn't that mean you need a billion dollars less?

THE WITNESS: Well, we did, in fact, provide updates in 1294, updated estimates of the cost reductions and the breakthrough productivity, which I believe that's what you're referring to with regard to the Postmaster General. So we have, in fact, provided that as an expense reduction in the update in 1294.

COMMISSIONER COVINGTON: All right. ECI versus ECI 1. You knew I wasn't going to let you get away with that one. I want to know who at USPS -- or I need to know whether any of your colleagues approximated test year labor expenses, and then if so, I think you mentioned something to the effect that you all were preparing for, in your own words, moderate wage restraints. And I know when it comes down to your labor contracts and dealing with the crafts and the various unions that all that's kind of unpredictable. But I'm saying, do you all have a grasp on what test year labor expenses are going to be as we go forward in the future?

THE WITNESS: Well, what's included in our update is in terms of the new contracts that are being negotiated is a target of ECI minus 1.7. That's what's included in our 1294 update.

COMMISSIONER COVINGTON: Between 1.7 and 1.8, right?

THE WITNESS: Right.

COMMISSIONER COVINGTON: Okay. All right.

Somewhere in your testimony or in somebody's testimony I saw where there were cost reductions as it related to periodicals. Now, I need to know, does there exist at this point in time or will there be prior to us rendering a decision in R2001 a dollar figure as far as cost reductions for periodicals are concerned?

THE WITNESS: I believe that was included in the update on 1294 -- I'm losing my -- is it 1294 or 1292? It's 1294?

COMMISSIONER COVINGTON: 1294.

THE WITNESS: Yes. That was included as a cost reduction in 1294. I believe it's -- I can't recall the exact figure.

COMMISSIONER COVINGTON: Okay. So you don't have an exact figure.

My last question to you, Mr. Strasser, is that, you know, I -- you know, being the new Commissioner on the bench, this is all new for me, just as your leaving Northern Virginia and moving into headquarters, you know, to head up the financial aspects.

I have some concerns with the contingency request because when you look at the fact that, you know, you're talking about $1.7 billion and you take that and put it with your prior-year losses which equals to one-half of what your revenue requirement is, that's -- I mean, that's a very integral part of what it is that we're here to do today.

But I want to make sure, and I won't go to the extremes that Mr. Burns did in his testimony with OCA, but I want to make sure that we're not dealing with laxity here, and that there isn't a lot of inefficient management going on over at USPS, and I feel, quite naturally, as we go forward, we'll look at, you know, what the revenue requirements are and we'll let the chips fall where they may.

I appreciate your responses.

That's all I have for this witness, Mr. Chairman.

CHAIRMAN GLEIMAN: Commissioner Goldway?

COMMISSIONER GOLDWAY: Thank you.

I have not had as much time to prepare my comments, so they might jump around a bit and I hope you will be patient with me.

First of all, I guess I'd like to ask you, when you prepare your estimates for future years and consider what your costs are going to be, do you seek professional advice? You say you're not an expert on it. Mr. Zarnowitz' advice seems to have come after the fact, something that was prepared just for this rate case. So are there professionals with whom you work in advance in preparing --

THE WITNESS: Yes, there are a number of economic consultants that we have that assist us. In fact, they have been involved for a number of years.

The key factors that have to be used in developing total costs obviously is the volume forecast and then the assumption with regard to labor costs.

COMMISSIONER GOLDWAY: And when you work with these people, do you give them the current costs to work from so that they can make estimates for you?

THE WITNESS: I think for the most part, we do the cost side in-house. It's more the forecasting side and the effect of what's going on -- we also have in-house forecasters who work on it, so it's a partnership type process.

COMMISSIONER GOLDWAY: When you develop these forecasts, don't you use your most recent cost figures?

THE WITNESS: Oh, certainly. Whatever is known, yes.

COMMISSIONER GOLDWAY: And you do that so that what you are planning will be, will be more precise in the future.

THE WITNESS: To the extent that you know at that point, yes.

COMMISSIONER GOLDWAY: So in the course of your normal business, it's normal business for you to reduce the uncertainty of your projections by using the most current figures.

THE WITNESS: It doesn't reduce the uncertainty of what may occur. What it does is --

COMMISSIONER GOLDWAY: Then why use them?

THE WITNESS: Because they're knowns. You know that the inflation has occurred when you do it, when you update. In other words, I knew --

COMMISSIONER GOLDWAY: Your known unknowns.

THE WITNESS: Let me give you --

COMMISSIONER GOLDWAY: You have a way with language here.

THE WITNESS: No, let me give you an example, if I may. Right now, I know the September COLA was more than twice what we had forecasted it to be last January because I know -- the period for which it's paid, January through June, is completed, so I know the amount and it's twice what it was estimated. So that's a known increase. You would update for that increase.

I don't know whether our estimates for the March COLA are accurate. Now, what we do, as we approach the fiscal year, we use the latest forecast to try to forecast what it will be. But that still doesn't reduce the uncertainty of what it's going to turn out to be.

COMMISSIONER GOLDWAY: So why don't you use two years ago forecast? If it doesn't reduce it, why not go back to two years ago?

THE WITNESS: Because --

COMMISSIONER GOLDWAY: Why not go back to ten years ago?

THE WITNESS: -- presumably it's more accurate --

COMMISSIONER GOLDWAY: Right. It does reduce the uncertainty.

THE WITNESS: Well, I guess let me tell you this. There's increased uncertainty then because the forecasters did not forecast that the September payment would be twice the amount that was forecast in January.

COMMISSIONER GOLDWAY: Because they -- you think there was an error this last time in the forecasters, then they're more uncertain in this next forecast?

THE WITNESS: I think the -- I think that was one of the professors' comments, is that there is increased uncertainty.

COMMISSIONER GOLDWAY: I guess, then, the question is, if you think the economist's forecast a few months ago were too optimistic and they were wrong, why do you think an economist's forecast now that's pessimistic is right? Because you're saying there is more and more uncertainty.

THE WITNESS: That's the reason for the contingency.

COMMISSIONER GOLDWAY: All I'm saying is you're presenting us with one issue after another where you're saying; we're uncertain this way because of one thing, and then let's be uncertain the other way because of the other thing, let's worry about what the labor costs are going to be because, look, we have higher inflation, and therefore we've got to plan for higher labor costs, but we also have to worry about the economy going down the tanks, which of course would mean lower pressure on wages, so we have to worry about demand going down.

You know, you want us to worry on all sides, and you want us to take your updated higher figures but still say there's as much risk as there was with figures from a year and a half ago. I think you can't have it both ways and be consistent.

THE WITNESS: I think that the labor expectations for these negotiations have been formed already. It doesn't matter that the ECI is going down by the end of this year. I think labor has its expectations.

In fact, I have here a notice that the American Postal Workers Union submitted on top of their proposal and it says: In an economy in which there are labor shortages and private sector wages are rising at the fastest pace since 1990, the Postal Service must compensate these employees fairly.

It goes on to say that: APWU proposes a compensation package including COLA that fairly and equitably compensates APWU representative employees for their contributions to the Postal Service and provides a significant wage increase.

COMMISSIONER GOLDWAY: Well, but when you go into negotiations and you demonstrate to them that the economy is going down, then you have a negotiating tool for them. But if the economy isn't going down, then we don't have to worry about volume going down, do we?

I mean, I think you have to realize that we're trying to be consistent in what we are --

THE WITNESS: I think that we can go into negotiations and, in fact, they will expect us to tell them that volume may be going down. That does not in any way diminish their expectations for the outcome of the negotiations, and if the negotiations don't arrive at a reasonable outcome, it goes to a binding arbitration, which is completely outside of management's control.

COMMISSIONER GOLDWAY: Okay. So I think we realize that we're viewing the future with great uncertainty no matter how we look at it. That's what you're saying.

THE WITNESS: I think there's increased uncertainty than there has been in -- certainly in the last four years.

COMMISSIONER GOLDWAY: Are you familiar with Mr. Tulley's estimates on volume that you've been presenting to us in the rate case for '97 and --

THE WITNESS: Yes. I can't cite them exactly.

COMMISSIONER GOLDWAY: And are you aware that his estimates on volume have been coming in within .4 percent every year and more or less on average every quarter through -- for the last four years?

THE WITNESS: Yes. I think that the volume has come in. I think you need to also, though, look at the revenue component because the mixes are what are important in terms of the finances.

Let me give you an example. Total mail volume is growing within about a half percent of our forecast for this year, but our revenue is 1.1 percent below because the volume diminution is occurring in the higher revenue products like first-class.

COMMISSIONER GOLDWAY: Well, that was true up until a couple of quarter -- the last reporting period, but it seems to have shifted?

THE WITNESS: Well, for one accounting period, it did.

COMMISSIONER GOLDWAY: Yes.

THE WITNESS: But year to date, it's still growing --

COMMISSIONER GOLDWAY: And we'll see at the end of the year how close Tulley is.

All I am pointing out is that -- are you aware of what Tulley uses as his basic guideposts for being so accurate on his forecasts?

THE WITNESS: Yes, we are, and, you know, over the course of a year, they can get that accurate.

COMMISSIONER GOLDWAY: So he has had a pretty good record, hasn't he, of using --

THE WITNESS: Right, but what his don't --

COMMISSIONER GOLDWAY: -- economic forecasts, the price elasticity, which is part of the economic forecast, the income, growth of income and growth of population and coming up with revenues. I mean, you do have some very clear demonstration of an expert who can forecast fairly accurately --

THE WITNESS: Fairly accurately.

COMMISSIONER GOLDWAY: -- using economic data that we're all familiar with.

THE WITNESS: Yes, that's true. But what he can't forecast, for example, is what occurred, as I mentioned earlier, with the sweepstakes this year. There was a cutback in the mailings of those as well as the resulting single-piece first-class mail pieces at 33 cents that were customarily returned from those high-volume mailings. I'm talking about a hundred-million piece mailings.

COMMISSIONER GOLDWAY: Nor could he predict the UPS strike --

THE WITNESS: Right.

COMMISSIONER GOLDWAY: -- which resulted in a great benefit for you.

THE WITNESS: Yes, we were very efficient in handling that.

COMMISSIONER GOLDWAY: Okay. Now my questions go more to the insurance aspect of when you plan for the future.

You have this contingency. Some of that

contingency as I understand is because the Postal Service is self-insured. Right? If there is a tornado and a building falls down, you use this contingency to pay for that, or is that funded someplace else?

THE WITNESS: In your example, that would probably be an example of a use of a contingency, if a natural disaster occurred increasing the expenses that would have to be covered. It is an unplanned for event.

COMMISSIONER GOLDWAY: What I am looking for is some record of expenditures over the last few years that demonstrate what a contingency is used for.

If your current operating expenses for facilities, for instance, don't include self-insurance for replacement, and instead you use that contingency for it, have you listed the times and incidences in which you have taken from the contingency to pay for those otherwise uninsured losses?

THE WITNESS: No. We don't have such a list, but just a recent example might be the rate case in R95 with the favorable conditions meaning that we generated net income and that caused the Postal Service to be able to postpone the next rate increase a substantially longer period of time than the normal cycle.

COMMISSIONER GOLDWAY: No, no, that is not -- I am saying normally if you set aside a million dollars to cover losses then at the end of the year you say, well, what did I use that million dollars for? Did I use it because a tornado destroyed a facility? Because some, you know, unexpected weather occurred and we had to do this or that because there was a fire somewhere and we had to switch our transportation to another system?

It seems to me that the contingency, if it is going to be a contingency, that it's used not with moral hazard but used for real purpose, you would have to identify the kinds of reasons you needed the contingency and measure yourself against them year after year to say what a contingency is needed for.

Have you ever listed those unknown unknowns to determine what they are each year and how much on average they would cost?

THE WITNESS: No, we have not done that.

The contingency from my perspective and, you know, I reread the Kappel Commission recommendation, you know, that recommended it be 3 to 5 percent is after you determine as best you can what your expenses are going to end up to be, you determine that and then it says you provide for reasonable contingency on top of those expenses in our proposed rate filing is what it calls for us to do, and so that is what we are doing.

This is not a contingency from an accounting point of view on an annual net income statement. This is a contingency as defined in what we are responsible to provide as our revenue requirement with a contingency to cover what we have not, what is not -- what may happen that is not covered in our estimated forecasts and costs.

COMMISSIONER GOLDWAY: So within your expenses separate from the 2.5 you have already figured in what the average amount is going to be for these unknown unknowns and the contingencies over and above that?

THE WITNESS: No. We haven't figured --

COMMISSIONER GOLDWAY: Because any good operation would include in it, if it is self-insured, what the self-insurance costs are --

THE WITNESS: But --

COMMISSIONER GOLDWAY: -- for, you know, liability in a building and for damage and for weather and for Acts of God, and you don't isolate that out, or it is already part of the operations budget and the 2.5 percent is above that?

THE WITNESS: No, no. In the revenue requirement we have estimated what we know are things that are going to change so we have estimated those, so there's risk there that those estimates are wrong.

What we don't know may occur next year we have not estimated. That is what the contingency is also for.

COMMISSIONER GOLDWAY: It just seems to me that you are being really sloppy about what this contingency is.

When you present your budget, if it ever gets presented to the Board of Governors, does it include spending that 2.5 percent or have you held that back, because it is a contingency for what you don't know, and when you say what the expected expenses are going to be over the next --

THE WITNESS: For fiscal year 2001.

COMMISSIONER GOLDWAY: -- for 2001 and the 13 Accounting Period, do you hold back that 2.5 percent?

THE WITNESS: That 2.5 percent doesn't directly relate to our fiscal year. It relates to the test year, assuming rates were implemented October 1st.

COMMISSIONER GOLDWAY: Well, that portion of the 2.5 percent.

THE WITNESS: That portion of the 2.5 percent --

COMMISSIONER GOLDWAY: Is that factored in for those accounting periods when it kicks in?

THE WITNESS: The Governors would expect to see whether it is there.

They certainly want a crosswalk between the revenue requirement, the rate case, and the fiscal year.

Clearly if the estimated revenue requirement for Fiscal 2001 is accurate without the benefit of the rates for four months, that is going to have a significant impact on the bottom line for Fiscal Year 2001.

COMMISSIONER GOLDWAY: So you don't hold out that 2.5 percent or whatever portion of it has to be adjusted because it is not for the full year. You are assuming that your expenses are going to use up that money in this next year.

THE WITNESS: No. The expense budget is set based on what the anticipated forecast is less the cost reductions that we are attempting to achieve, and it does not assume that we are going to spend all of what is in the revenue line.

It does not assume that, and then we determine whether that net income situation is one that is a challenge enough, depending on the efficiencies and the productivities that are built in.

COMMISSIONER GOLDWAY: So we have no way of knowing as regulators what happens to that 2.5 percent at the end of the year?

You say you need money, you know, and we are supposed to help you break even and get just enough money to break even, and then you want 2.5 percent and we don't know what happens to that 2.5 percent at the end of the year, whether you have kept it as a contingency or not, so that we know in future years -- you don't keep track of it and we are not given the information to determine whether that is really needed to break even or not.

You know, we have an obligation.

THE WITNESS: Whether it turned out to be needed? Well --

COMMISSIONER GOLDWAY: If it is not held back from your budget every year or identified in some way. We have a dilemma here.

Let me ask you another question. You gave us information saying that you are going to do this productivity breakthrough and that is going to result in about 500 million dollars, but the PMG is still talking a billion dollars. Has he seen your $500 million presentation to us?

THE WITNESS: He is talking about $4 billion over four years and this is part of our budget catch-ball process, as we have rolled the breakthrough productivity out, the training for the breakthrough productivity, the estimate for the test year is uncertain at this point but we have put in the best estimate for the test year that we believe is very aggressive and we have informed the senior management of what is in the updated 1294.

COMMISSIONER GOLDWAY: So he has seen your take on the likely productivity gains versus what he says are the likely productivity gains?

THE WITNESS: Well --

COMMISSIONER GOLDWAY: Have you discussed this with him?

THE WITNESS: Productivity, not individually. It was in the management committee meeting.

We informed the management committee what updates resulted from the 1294 process, yes.

The breakthrough productivity is one thing. There's a lot of other cost reductions that are involved in the revenue requirement. I am sure you realize that.

COMMISSIONER GOLDWAY: Okay. I just have one more question. I am sure my colleagues do, and -- not question, actually, just a comment for the record.

With regard to the legislation that impacted retirement benefits, according to the 1998 statistical abstract 2.8 million civilian employees, so the Postal Service is about one-third of that workforce.

Thank you.

THE WITNESS: Thank you.

CHAIRMAN GLEIMAN: Commissioner Omas.

COMMISSIONER OMAS: Mr. Strasser, going back to what you said on that total factor on productivity, you mentioned earlier, you project -- you've rolled in one billion dollars into the 1294 projections; is that correct?

THE WITNESS: No, I think I mentioned that our total factor productivity this year had generated a billion dollars in savings or cost avoidance that would ordinarily have occurred through the inflation fuel prices that we've avoided that much.

COMMISSIONER OMAS: So what is your total factor productivity estimates in the new revised figures?

I thought you said earlier that it was one billion savings?

THE WITNESS: The cost reduction in the update is over a billion dollars in savings, yes.

COMMISSIONER OMAS: Thank you. The other thing I want to ask you is, do you see any difference between budgeted field expenses for COLA and health benefits and a generic budgeted field reserve?

THE WITNESS: Budgeted field expenses for COLA?

COMMISSIONER OMAS: COLAS and the field reserve that we talked about and you talked about earlier on page 13 of your testimony.

THE WITNESS: Yes, the field reserve relates specifically --

COMMISSIONER OMAS: The $200 million.

THE WITNESS: Right.

COMMISSIONER OMAS: And you're saying in one breath that you've budgeted that as a reserve, but you haven't budgeted it as part of the budget. I guess I want to know what the difference is. It's a little confusing.

THE WITNESS: I'm sorry. The budgeted field reserve are those funds that I referred to that are going to be spent. The reason we put in the reserve right now is because we are unsure of the -- we're finishing up the process of distributing those through productivities out to the field.

And the question is whether we distributed them in the right proportion to the field as a challenge. So the reserve is being held in case we made mis-allocations in that.

That reserve is necessary for those other items that I mentioned, the mail transport equipment, the advertising for new product introductions, and the infrastructure for the information platform, things of that nature.

So, during part of the fiscal year, that decision as to whether -- we'll be monitoring the progress of breakthrough productivity efforts.

If it's going along well and according to plan, that reserve will be then released to those originally intended expenses and they will be spent.

COMMISSIONER OMAS: But if they're not needed, what happens to that $200 million?

THE WITNESS: That one is needed. In other words, that one really should be used for those three programs that I mentioned.

If we don't use it -- if we have to use it to cover the breakthrough productivity shortfall or the risk there, then we're going to have to spend that money, either if we're in favorable financial position this year, or do it next year and delay some of those things like the information platform.

That money will be spent. The contingency money is that which is not necessarily spent.

And that's the money that flows through in the sense that it would be followed -- as I said, the best explanation I can give for it is, if it's not necessary, it's not used, and it goes to future fiscal years, and you're able to lengthen the time period between rate cases by doing that.

COMMISSIONER OMAS: Okay. Also in your testimony, you talked about the unknown unknowns, and you refer to the OPRA in 1990 and that you couldn't predict as a probability -- under the probability analysis, which I'm sure you couldn't, but, you know, having worked on the Hill, I know that the Postal Service has people who are covering the budget and the Committees all on the Hill.

And the thing that I find confusing is, you use that example that it hit the Postal Service in 1990, when OPRA in 1985, 1987, and 1989, shifted expenses to the Postal Service.

THE WITNESS: But it --

COMMISSIONER OMAS: So why was 1990 such a surprise?

THE WITNESS: Well, it was a surprise because it -- we thought we were finished. We thought that due to our financial condition at the time, which was in dire straights, that we would not be included in any future ones for the time being.

Then the other thing is that it became -- what it became then, after it became clear that we were going to be swept into it, it became a known unknown in terms of how much it was going to be until that was determined.

COMMISSIONER OMAS: Are there any other indicators that you can share with us that you see on the horizon that you can take into account for what might happen and what this contingency and things like that would be used for?

THE WITNESS: At this point, I honestly have to defer from trying to provide any more. I think that we have, over the course of the morning, provided a number of them.

And, you know, $1.7 billion is a lot of money. It's only 2.5 percent of this operating budget. I mean, it is not the three to five percent that was traditionally asked for in prior cases.

It represents one, two-week payroll of the organization that we operate and manage day-in and day-out. Yet, in the perspective --

And I came back from Virginia and I had to use all these zeros and things, and it's a lot of money. I realize that to any one of us, individually, it's a lot of money, but for an organization that counts on a cashflow of $300 million a day, including money orders and expenditures of $200 million a day, it can disappear very rapidly through a number of events across this broad country of ours.

And I think that in perspective, that's why I concluded that I thought 2.5 percent was conservative.

COMMISSIONER OMAS: All right, thank you, Mr. Strasser.

CHAIRMAN GLEIMAN: Commissioner LeBlanc?

COMMISSIONER LeBLANC: Mr. Strasser, you are aware that at three to five percent that you talked about from the Kapel Commission, came about before PYL was initiated; are you not?

THE WITNESS: Yes, I am.

COMMISSIONER LeBLANC: Okay. Now, let's go back to what Commissioner Goldway was saying, for just a minute, because you -- I have been since 1988 asking for an accounting of 2.5, three percent, 1.5, whatever it may be, and for some reason I keep hearing that it's a moving target.

It refers back to an ongoing plan. I asked for a plan one time and they said the plan keeps changing.

So, you just made a comment that if the -- and I believe it to be a correct statement, and the record can stand on its own.

What happens to the contingency money that is not spent? I mean, what happens to the contingency money that's left over, and you say that it's not spent.

Now, if we are going to be allowing the Postal Service to break even over time, how in the world can we do that if you're going to hide or keep or put away or have as a cushion or a safety net or whatever, one billion, 1.2 billion, whatever it may be, dollars?

COMMISSIONER LeBLANC: Number 1. Number 2, would you explain to me what breakeven over time means from our perspective?

THE WITNESS: Well, we are not hiding the contingency. I mean all of the revenues that are collected after this case is implemented are on the record of our financial statements. As we said, in an ideal circumstance where we have correctly estimated, and all the volumes and all the cost estimates come in correctly, the bottom line should reflect the net income equivalent to the contingency. And then the question is, where does that contingency get invested?

In terms of the breakeven over time, what happens, that contingency, if it is not used, flows through and takes care of investments for the future, or it could reduce debt. So my point was on '95, on the '95 rate case, we were able to hold rates constant until implementing new ones in January of 1999, partially due to the contingency that was in that case.

In other words, over time our costs inflate, over time the cost of our universal system, -- for example, in my testimony, I cited that we have added 1.7 million deliveries this year. That is equivalent roughly to 4,200 carrier routes, 6,000 carriers, because we deliver six days a year, and a requirement to house those 6,000 carriers, which, in rough terms for delivery facilities like mine in Northern Virginia, would equate to $500 million in capital investment.

So that is the type of investment that an unused contingency goes toward rather than us having to come in earlier and file a rate increase. As was said earlier, if you didn't have enough money, you can come earlier and file one. The money doesn't go away, it is there.

COMMISSIONER LeBLANC: Well, that could be explained a different way, as we have heard. But go ahead.

THE WITNESS: But it is used. Now, where the Board holds the organization accountable is that it should not squander it away in lost productivity, but it does not go away. It is a zero sum game, it doesn't get put in anybody's pockets.

COMMISSIONER LeBLANC: Do you, when you make your budget, now I ran a little small $6-8 million business back in the late '70s, early '80s, but when I sat down to do my budget, I would do my cost items, my revenue side, I looked at everything. I built in a little fat on the costing side. I changed a few little things, as most people do.

I have known mayors of cities, I have known people who have run other businesses, associations, et cetera, who always build in a little bit of fat in a costing procedure.

Now, you are going to tell me right now, today, in this Commission, that it is absolutely to the T, there is no extra in any of your costing, anywhere, that wouldn't help you offset that contingency in some capacity?

THE WITNESS: I am going to tell you that what we filed with your revenue requirement and open to anyone interested in commenting, reviewing, challenging, and which you are going to be reviewing, what we filed in the revenue requirement is our best estimate of what the anticipated costs will be for the test year. There is -- the cushion --

COMMISSIONER LeBLANC: So there is no extra fat? There is no extra fat in that at all as far as you know?

THE WITNESS: I don't believe so. The cushion that you are referring to that you put in is, in fact, the contingency, the recognition of a need for a contingency.

COMMISSIONER LeBLANC: Now, we have to give, by law, a reasonable contingency. Now, we don't necessarily have to give a PYL anymore, at least in some people's opinions. That is open to discussion, obviously. But when I look at dealing with, as you say, certain trends, certain uncertainties, and yet we are not allowed to quantify any of the 2.5, you have to grow, and you say your money comes from the revenue side, borrowing side, or unfunded liability side.

So keeping all of that in perspective then, how do we -- again, I come back to the initial question, which I am trying to understand, what is a reasonable amount then? How do we look at what is reasonable on this Commission?

THE WITNESS: Well, I think what you have to do is determine whether our request is unreasonable, that would be my recommended approach.

COMMISSIONER LeBLANC: If there are questions in a lot of people's mind, would you think that there would be questions in the Commission's mind?

THE WITNESS: I think there are questions, and rightfully so, because in the mailing community's mind, it equates to a rate increase, there is no doubt about that. But I think that what we are, as responsible managers, charged to do is to determine with each rate filing what we would recommend to the Board and what the Board would approve for filing as a reasonable contingency.

Believe me, we do not pad like an appropriated function pads because we are subject to market pressures. We make the best judgment we can based on what we think is the future risk to our financial circumstance, given the environment that we operate it.

We recommended, the management team at the time recommended, and the Board approved filing for a 2.5 percent contingency. What I have stated here for you for the record, in my capacity, based on all of my 31 years of experience and my review of financing and the Postal Service, because I got involved in it when I was Chief Planning Officer, I got involved when I was Chief Marketing Officer, what I would submit to you, and with all apologies to the fact that it requires a higher rate increase to our customers, I consider that our best judgment, and I consider it very conservative.

COMMISSIONER LeBLANC: Would you care to respond to Witness, I believe it is Berhowers, from DMA.

CHAIRMAN GLEIMAN: Make that Bernheimer.

COMMISSIONER LeBLANC: Bernheimer. Boy, I blew that one. Okay. All right. You are right. Thank you.

Who says, in effect, that, and this is a paraphrase, but I believe the gentleman's testimony will stand on its own, that USPS revenue requirement, including the contingency and the PYL, shows an 8 percent increase over Fiscal Year 2000 expenses, and I am adding, kind of paraphrasing what he says, a rate of growth that is exaggerated and unreasonable.

Now, he came out with that because he says the projects -- excuse me, I will go the other way, that the USPS plan is 4.7 percent increase, that is Witness Patelunas' update. Now, the rate of growth of expenses, in his opinion, is out of line with the historical rate over the last seven years of 8 percent versus 4.3 percent, of which the contingency and PYL are built in. How do you rationalize that?

THE WITNESS: Did you ask me if I cared to comment on that?

COMMISSIONER LeBLANC: Well, I'm going to ask you to comment on it now.

THE WITNESS: Not having benefit of -- I have not read, nor did I include his comments on his testimony, and I just am not at this point able to focus on what --

I know Patelunas's testimony said 4.7. And what is the eight percent?

COMMISSIONER LeBLANC: The eight percent -- well, I'll tell you what: Rather than we get into a protracted discussion here, I'll get to the other gentlemen later, but I'll let the record stand on its own, that the rate of growth and expenses is about, over the last seven years, 4.3 percent.

And what you are asking for, USPS revenue requirement, including contingency and PYL, shows an eight-percent increase over Fiscal Year 2000 expenses.

And I have trouble with that, as one individual. And if you cannot correlate as the policy witness, the operational witness, then I've got a serious problem with it.

THE WITNESS: Well, I can lend this aspect to it: I mean, that assumes that the contingency is fully spent, the eight percent.

COMMISSIONER LeBLANC: Well, I thought you just told us you were pretty well going to spend it?

THE WITNESS: No, I said we would invest it, if it wasn't spent.

COMMISSIONER LeBLANC: But you've got all those uncertainties out there that you just said that you were going to expend it on, in a comment to Commissioner Goldway.

THE WITNESS: If the uncertainties -- then it's an actually true statement, if the uncertainties occur.

But let me tell you where we're coming from in terms of planning for this. The plan has very aggressive cost reduction, over a billion dollars in it.

That plan equates to what we've been able to achieve this year. There are risks to that plan.

There is the test year that includes, for example, the NALC arbitration costs. That's the first year of that.

And --

COMMISSIONER LeBLANC: But, Mr. Strasser, not to interrupt you, and I do apologize for interrupting you, but if I'm reading the other gentleman's testimony properly, he has built all of that in, and over the last seven years, you have had other rate increases, you've had other labor negotiations, you've had other problems, you've had other unknowns, you've had other problem areas that have come into play, and yet the rate of growth in expenses over the last seven years is a plus or minus 4.3, 4.5 percent.

Patelunas has said 4.7 percent, and the update is now 4.5, so the rate of growth in the expenses over the last seven years is eight percent. It's out of line.

THE WITNESS: Now, because the last seven years has included the historic, the most -- in Postal Service history, CPI has never been as low as it has been in the last seven years.

And that's a driver of costs, driver of our expenses, our COLA payments and things. We have had historic -- we have had volume and revenue growth that has outstripped past years in the last seven years.

And so I think that the period of time that's selected was very unusual. You can go back in Postal history and find years where the rate of expenses were eight percent, because, for example, all of the growth in the delivery network cost a significant amount of money.

COMMISSIONER LeBLANC: But with all due respect, eight percent over 4.3 and 4.5 over the last seven years -- I agree you can pick any timeframe, and that is true, we've heard that for the last two weeks.

You can pick any timeframe you want, but that is almost doubling the expense side, and that is bothersome.

Now, if understood you earlier today, you were talking about the uncertainty regarding Workers Compensation, was another reason that you required a 2.5 percent contingency. And I understood you to say that the Workers Comp expense was not revised in response to Order Number 1294; I believe I got that right.

THE WITNESS: I believe so, yes.

COMMISSIONER LeBLANC: Now, in Witness Kashani's Exhibit USPS-14-K -- and I should have made a copy of it, but I believe it will stand on its own -- which shows test year Workers Comp expense of $780.8 million.

Now, that exhibit was filed with the Postal Service's original filing on January 10th of 2000.

Now, when you look at Patelunas's Exhibit USPS-ST-44(v), it shows a test year Workers Comp expense of $861.4 million.

Now, that was filed in response to our Order Number 1294. So doesn't the updated response to Order 1294 reflect the Postal Service's latest thinking and information available as of July?

In other words, compared to when the Service filed its case in January, hasn't the uncertainty regarding Workers Compensation expenses been reduced?

THE WITNESS: No, it hasn't. We constrained it to the Patelunas entry. In fact, I believe that there were workpapers that were filed with 1294 that indicates that the model forecasted a $1.1 billion Worker Comp expense.

And as I alluded to in my previous remarks --

COMMISSIONER LeBLANC: Excuse me, that was LR what?

THE WITNESS: With the updated -- the workpapers with the update to 1294.

COMMISSIONER LeBLANC: Okay.

THE WITNESS: And as I mention in my remarks, if we had not had the actuarial table change, this year our expenses would have been $1.3 billion, so the 1.1 may be low.

And that's what caused me to set up these meetings and discussions to try to understand from OWCP, why the cases have increased 29 percent.

COMMISSIONER LeBLANC: Let me get to something that I need to find out. Unfortunately, it's kind of an operational question, but coming from Merrifield, possibly you can help me with it.

Can you give me a manager's view on how a decision is made to either add or remove a piece of mechanized or automated equipment in a processing facility? If you assume the equipment reflected current technology, what are the main things that you would consider in making such a decision?

THE WITNESS: To add -- well, we add --

COMMISSIONER LeBLANC: To add or remove a piece of mechanized or automated equipment in the processing facility.

THE WITNESS: There's a lot of scenarios, why one might add or remove. I mean, it might be -- it might have to do -- if it's current technology, it might have to do with a drop-off in workload or a shift to another facility that has a higher need and an opportunity for more throughput in order to --

COMMISSIONER LeBLANC: But in that facility, would you say that it would be volume-driven, possibly?

THE WITNESS: There's a number of factors. It could be service-oriented decisions, too. I just don't know unless we got real specific about the case.

COMMISSIONER LeBLANC: Okay, that's fair.

My last question goes back to Order Number 1294. Now in response to that the Postal Service submitted what supposedly reflected its best estimates of what will actually happen in the test year.

You stated that adverse events, call them what you will, here we call them unknowns and everything else, could occur and this supports a 2.5 percent contingency.

Isn't it possible that the July estimates are on target and in that case doesn't the 2.5 contingency become net income?

THE WITNESS: If everything in the ideal world were achieved and the rates for the test year were implemented October 1st, 1999, then the contingency would show up as net income.

COMMISSIONER LeBLANC: Thank you.

CHAIRMAN GLEIMAN: I will try not to keep you too long.

Page 30, line 5, of your testimony --

THE WITNESS: Can I revise that statement? It was October 1st, 2000.

CHAIRMAN GLEIMAN: Sure.

THE WITNESS: Would have to be the implementation data.

CHAIRMAN GLEIMAN: Saves a transcript correction.

Page 30, line 5, sentence starts, "Witness --"

Could you just read that sentence for me? "Witness Patelunas" -- want me to read it for you?

THE WITNESS: No. I will do it. I just have my laptop transcript and it didn't want to get back to that again.

[Pause.]

THE WITNESS: Line 5 says that, "Care should be taken to include all the updates included in Witness Patelunas's roll-forward."

CHAIRMAN GLEIMAN: Mine doesn't start that way, but mine says, and let me just quote, and I think this is the official copy that is on file with the Commission. It starts at page 30, line 5, two words in from the right-hand column, "Witness Patelunas's supplemental testimony as corrected by his revised response to POIR-14 indicates a test year after rates deficiency of $475 million."

Let me ask you a question I asked you earlier on.

If we rubber-stamp the Postal Service's proposal, does that mean that you are going to finish almost half a billion dollars in the red in the test year?

Is that what that says?

THE WITNESS: In our Fiscal Year 2001?

CHAIRMAN GLEIMAN: " -- indicates a test year after rates deficiency of $475 million." You know, those are what the words are. I don't want to use different words. Those are words in your testimony.

THE WITNESS: Okay. If the rates were implemented October 1st, 2000, and all of the costs were accurate, then the net income reported for the test year would be the total of the contingency, assuming it hasn't been used, and the prior year loss recovery minus the $475,000,000.

That is what would show up in the Postal Service's annual report as net income.

CHAIRMAN GLEIMAN: Okay, so then you wouldn't be $475 million in the red as long as you didn't spend any of the contingency on anything?

THE WITNESS: As long as we -- it would be the contingency plus the prior year loss recovery minus the $475,000,000.

CHAIRMAN GLEIMAN: If you sequestered a smidgeon of money from each letter, flat, parcel, electronic bill-payment, and God knows what else you have got out there and you set it aside in a little cigar box over there in the corner, at the end of the year you would have a billion two, a billion three laying there instead of a hole that said $475,000,000.

THE WITNESS: If the rates had been implemented

October 1st.

CHAIRMAN GLEIMAN: Okay. I just wanted to make sure I understand.

Page 6, line 2 -- excuse me, page 6, line 26.

It is the, "I have been advised that in more recent cases the Commission expressed the view that the evaluation of the contingency should combine subject judgment and objective judgment" and then it goes on to say that it, meaning the Commission, disclaim necessary reliance on quantitative methods.

I don't see any criticism of the Commission using subjective and objective judgment combined. Am I correct that the Postal Service does not have a problem with us using both subjective and objective judgment in evaluating the contingency?

THE WITNESS: I think that that is what I have been advised that the Commission expressed as a view.

CHAIRMAN GLEIMAN: And --

THE WITNESS: If you are asking me how I would recommend the decision be made on the contingency, I have already stated that.

CHAIRMAN GLEIMAN: Okay. Earlier you were asked a question about uncertainties involving mail volume estimates for the test year and you mentioned the danger of volume diversion.

When the Postal Service provided the updates using the actual FY99 data, as requested by Order 1294, it did not revise volume estimates. In fact, it presented testimony of Witness Thress showing that there was no need to update volumes.

Is this still the Postal Service's position or do you now take issue with Witness Thress's position on behalf of the Postal Service?

THE WITNESS: No, we would stand by our filing at this point, but when I was describing the uncertainties I shared you our recent experience and the fact that even in our Fiscal 2001 budget plan we have decided to artificially constrain that forecast.

CHAIRMAN GLEIMAN: I understand, but, you know, your expert told us that didn't make a tinker's darn if we didn't update volumes, that it wasn't necessary, and we like to listen to Postal Service experts every once in awhile, so I just want to make sure that we still are on all fours with that Postal Service expert.

Now you urge us to accept all of Witness Patelunas's additional costs that he has projected for the test year, is that correct?

THE WITNESS: No. What I stated was that if you choose to do so, I recommend you use all of them.

CHAIRMAN GLEIMAN: Okay, and we should use all of them to the degree that he presents them because we can be pretty sure that when we get cost updates like that from a rebuttal witness that they are pretty close to what is going to happen?

THE WITNESS: The ones that we provided were our best judgment of what the realistic costs will be.

CHAIRMAN GLEIMAN: Do you know if anyway urged us to accept all of rebuttal witness Poras's costs that he offered up in his R97 rebuttal testimony, specifically the additional $289 million that was going to be spent in FY98 on Y2K problems?

THE WITNESS: I am not familiar with that at all.

CHAIRMAN GLEIMAN: Would it surprise you to know that only $88.6 million of that $289 million that we were urged to put in there was actually spent?

THE WITNESS: I have no knowledge of it.

CHAIRMAN GLEIMAN: But would it surprise you if I told you that only 88 out of 289 was spent?

THE WITNESS: If fiscal -- what year was that?

CHAIRMAN GLEIMAN: FY98.

THE WITNESS: I don't know. I would have to know the circumstances around the original estimate I guess to tell you whether I would be surprised.

CHAIRMAN GLEIMAN: Well, just so we are all sure that that is what was spent, I got that figure out of the

Postal Service's response to DMA/USPS-T-9-13, the amount of money that was actually spent.

The amount of money that was requested is in R97-1, Transcript Volume 35. It is in the vicinity of page, transcript page 18585, somewhere over the next couple of pages after that.

If someone wanted to check that I wasn't trying to fool you with the numbers.

One last question. In response to one of my colleagues, you talked about how in managing the situation in Northern Virginia -- and as best I can tell, you did a fantastic job out there because before you got out there, there were lots and lots of complaints about service, and I think that, you know, you and your team out there did a great job turning things around, at least judging from the lack of complaints in the newspaper.

But you talked about how some money that was in the contingency pot or line, if you will, might have been used in the case in Northern Virginia, as I recall, and you talked about how there are more delivery points and, you know, you need more carriers, and maybe there's a $500,000 or so capital investment that might have been made.

Now, that seems --

THE WITNESS: That was actually $500 million.

CHAIRMAN GLEIMAN: $500 million. I'm sorry. I have trouble with those zeros every once in a while, too, and I kind of stutter when I get between the m's and the b's.

Now, that would have been money, in your scheme of things, that might have come out of the contingency pot.

THE WITNESS: That would be one of the considered investments if the contingency money wasn't needed to cover unknowns, and it would then defray future years' cost and take the place of borrowing, for example, for capital investment.

CHAIRMAN GLEIMAN: Now, earlier on, somebody mentioned a draft strategic plan that was on the Postal Service Web page that's out there inviting comments from all of your customers and other in the postal community, and I know that the Postal Service in recent years has felt very strongly that they wanted to get customer input, lots of customer input. They like to meet their customers' needs.

Now, I wouldn't quibble with you about the need for additional or updated -- upgraded facilities in Northern Virginia as the community grows. The question becomes whether that kind of money should be built into a rate case at the front end as part of the contingency or whether, if indeed that is something that needs to be done and you know that it might need to be done because everybody knows what's happening in a particular community in terms of its growth, whether that money shouldn't be included somewhere else and not in a contingency.

It seems to me that in this rate case, for example, a pretty fair cross-section of Postal Service's customers are saying, hey, you know, we want the Postal Service to do well, we would like to have good service, but we don't want to have to put a whole bunch of money in a pot that may be used for some unknown unknown event that's going to pop up in the next 13 months, but that if it doesn't pop up, it's kind of an extra little savings account that the Postal Service can use as it sees fit. We'd rather pay less now, and when the Postal Service decides it needs that money, that it can either borrow that money or it can come in in the next rate case and build that into part of its rate base as a capital investment.

Your customers are saying this to you. Don't you think you should listen to your customers?

THE WITNESS: We didn't put the contingency in to fund the facilities for Northern Virginia or any other location. We put the contingency in because under the process that we -- as I perceive it, we're asked to, as best as possible, forecast our revenue requirement and subject that to the process of scrutiny by any and all parties interested. We do not pad those estimates. Those are the estimates that we find most reasonable.

Then there is an insurance factor here that there is 2-1/2 percent of the total as a contingent fund. That is the purpose of the contingency. It is to cover the fact that there is no ideal world in a test year and it doesn't happen the way we said it would happen, and that's the purpose of the contingency.

CHAIRMAN GLEIMAN: I understand we could get hit with, you know, with the first nine plagues. Hopefully we wouldn't deal with the tenth, but the first nine plagues hit and you may have a lot of costs that you didn't expect to have. But if that doesn't happen, then you have all the money there that you've set aside.

I guess my point is that your customers are saying that they think you're putting too much money aside and that if you do need to do things that aren't within the list of the first nine plagues, if you don't have to cover costs associated with events like the first nine plagues, that they would just as soon have you talk to them later and be more straightforward about what your needs are in terms of building buildings or whatever else it is you want to do with that money that's not used to cover disasters and the like.

THE WITNESS: Well, as a matter of practicality, these new rates won't be effective until January, so that will account for upwards of a billion dollars right off the bat because the rates are not implemented October 1st, 2000.

CHAIRMAN GLEIMAN: Who gets to decide when rate cases are filed?

THE WITNESS: The Postal Service.

CHAIRMAN GLEIMAN: And who gets to decide when rate cases go into effect?

THE WITNESS: The Board of Governors.

CHAIRMAN GLEIMAN: Okay. Thank you.

THE WITNESS: I said as a practical matter. I didn't say as a theoretical model or construct.

CHAIRMAN GLEIMAN: One of my colleagues says he has one more question and I'm going to hold him to that, and then we'll get some follow-up to questions from the bench.

COMMISSIONER LeBLANC: Mr. Strasser, you and I have been knowing each other a while, so I'll try to make it as quick as I can here. I just want to say I agree with Ed, you did a wonderful job out there.

But when you were commenting back to him on the contingency, you made the comment borrowing for a strategic investment, you could -- you don't have to borrow for a strategic investment; you can use PYL for strategic investment because PYL goes right to the bottom line. That's just paying back equity and that, in effect, goes in the bank, and that becomes available to use for anything you want it to. So that is over and above an effective contingency, if you will.

THE WITNESS: Correct.

COMMISSIONER LeBLANC: Thank you.

CHAIRMAN GLEIMAN: Follow-up questions.

Mr. McBride.

MR. McBRIDE: Thank you, Mr. Chairman. I'll try to be very brief.

FURTHER CROSS EXAMINATION

BY MR. McBRIDE:

Q Mr. Strasser, I take it that for purposes of the record upon which this Commission must make its decision, that the Postal Service considers the best economic forecaster that it could look at, the words in evidence from the most expert, that is, would be Professor Zarnowitz; is that correct?

A I don't know whether -- I can't answer that definitively.

Q Didn't you refer to his testimony earlier that you were relying on for the uncertainties that you took were inherent in the process?

A I referred to his testimony as a confirmation that the uncertainties confirmed what was a management call that the uncertainties are much more so than they have been in the prior two rate cases.

Q Okay. Now, do you have in front of you what OCA counsel handed you some time back from transcript page 9812? It's figure 1 from the testimony of OCA Witness Rosenberg?

A Yes, I do.

Q I'd like you to take a piece of paper and cover over the right side of figure 1 for all the years past 1980 so that you're only looking at the data from 1970 to 1980 for the moment.

A Yes.

Q I would like you to tell me whether you think Professor Zarnowitz or whoever the world's best economic forecaster is would have been like to predict what the rate of inflation would be in the year 2000 based on the data from 1970 to 1980. What do you think, ball park number, that world's greatest forecaster would have said?

A It depends on what methodology he used.

Q Well, do you think it would have been more like 2 percent, more like 18 percent, or just give me a number.

A I'm sure they were predicting, you know, somewhere within that range.

Q Okay. More like 18 because that's what we've been experiencing in the '70s, right? That's what forecasters do.

A Eighteen was only one year.

Q Okay. Well, now move the piece of paper over to 1986. What do you think the world's best economic forecaster would have said inflation would be in the year 2000, just covering over the years after 1986?

A A more moderate estimate.

Q Okay. In other words, and I seem to recall Professor Zarnowitz' testimony in response to Mr. Ackerly's questions the other day -- I read the transcript -- he said that he wasn't very good at forecasting more than one or two years out, if I recall correctly.

Are you aware that he said that? The record will reflect what he actually said, but that's my best recollection of what I read. Were you aware of that?

A I haven't had a chance to read it.

Q Well, the record, as I say, will stand for whatever he said, but does it sound to you reasonable based on what you just told me about 1980 versus '86 and moving along the line that the closer you get to the year 2000, the more confidence the world's greatest economic forecaster would have in predicting what the rate of inflation would be in the year 2000?

A The exact rate? I don't know.

Q Well, if he were only looking at 1980 data, he might think it was going to be a lot higher than two percent, wouldn't that?

A I think if -- it depends on the methodology he's using.

Q Okay. Anyway, I take it that it is your testimony that the Postal Service does the best possible job it can in forecasting revenues and expenses. You try to hit them right on the head. Isn't that what I think I heard you telling all these Commissioners?

A We try to estimate as best as we can, yes.

Q Okay. So if your forecasting is any good, would it not follow, then, that it is just as likely you'll need less money than you'll need more money and the contingency might as well as negative as positive?

A I don't think that case because I think that, for example, our labor contract assumptions are forecasted very aggressively. Our breakthrough productivity figures and the other cost reductions we put in are high. We added $300 million to the estimate in 1294 for revenues in completely new businesses and new efforts in revenue that I think are at risk.

So if I had to commit, I would believe that there is more probability that our estimated results are low.

Q Okay. Well, let me ask you a question in all seriousness. I don't mean this rhetorically at all. As the acting chief financial officer, is it your understanding that all dollars are green?

A Yes.

Q Okay. In other words, and I know the Chairman and other Commissioners were doing this rhetorically, but you don't have a cigar box over there, do you, where you put the contingency factor? You don't segregate pink dollars from green dollars. All the dollars come in and they go into the revenue stream of the Postal Service; isn't that right?

A That's correct.

Q Okay. So it's -- the contingency factor I think you were also testifying here is not something that really gets reflected on the balance sheet; it's a construct -- no pejorative intent -- for rate case purposes; isn't that right? It's not in a vault in Mr. Strasser's office somewhere?

A That's correct. We are called upon to as best as possible estimate our revenue requirement for the test year. Everybody gets to deal with the facts as it relates to that and discuss and debate and challenge that revenue requirement, and then the Postal Service is enabled to provide a contingency factor that is a cushion in the event that that funding -- that something occurs that that funding was not accurate.

Q And I'll bet based on the comment of the Commissioners, you're pretty good at your job or you wouldn't be where you are, but I'll bet you're not perfect at estimating what you're going to need by way of expenses or a contingency; is that correct?

A Yes.

Q Okay. So therefore, it's either going to be too high or too low, right?

A The estimates.

Q Yes.

A The estimates of the revenue requirement and the outcome?

Q Right. And the contingency.

A No, the contingency is a judgment factor, it's not an estimate.

Q Okay. But your estimate of expenses are either going to be too high or too low.

A Right, and I think that based on what I stated before, I think that the likelihood is that they may be low.

Q Okay. If they're too low, there's nothing to keep you for coming back and asking for more, right?

A Was that a question?

Q Yes. If they're too low, there's nothing to keep you from coming back here the next day and asking the Commission for higher rates.

A That's not the next day; that's a relatively lengthy process, including the ten-month adjudication.

Q But if they're too high, did you know that there's nothing we can do about it? We can't get a stay from a court, we can't do anything about it but pay them.

A Well, if they're too high, my point is they don't go -- the money doesn't go anywhere but back into the system that provides you mail service and in general extends the cycle before the next rate case.

MR. McBRIDE: Thank you very much.

CHAIRMAN GLEIMAN: Anybody else?

MR. ACKERLY: I'll be as quick as I can, Mr. Chairman.

FURTHER CROSS EXAMINATION

BY MR. ACKERLY:

Q Mr. Strasser, in colloquy with counsel for the OCA, there was a discussion of the supplies and services expenses, and if I remember your testimony correctly, you indicated that those expenses had gone down in Fiscal Year 2000 as compared with Fiscal Year 1999; is that correct?

A That's correct.

Q By an amount of something in excess of nine percent; --

A Yes.

Q -- is that correct?

What conclusion did you draw from the fact that there had been a decrease in this year as compared to the previous year?

A Well, I think what's occurred with the severe cost inflation that we've had to absorb with the shortfall in revenue of what is now $640 million from our budget plan and is forecasted to be somewhere between 750 and 800, what has occurred is that we have instituted new review processes for expenditures. Some of them are probably temporary postponements of expenditures and some of them are changes in the way that we have previously done business.

We have set up an entire -- a contract review process for all consultant contracts and questioned extensively the use of consultants and drawn down substantially on that expenditure.

So it's a combination of reductions, some of which are postponements probably and others of which are permanent changes in the way we approach the business.

Q Do you know what the level of supplies and services expenses was in Fiscal Year '98 and Fiscal Year '97 as compared with the Fiscal Year '99 number?

A Well, the -- no, I don't. I honestly don't.

Q So you don't know whether or not, for example, Fiscal Year '99 represented a very substantial increase over that category of expenses over the previous two years?

A Right, I don't know.

Q Okay. Would you accept subject to check that that amount of the increase over that two-year period aggregated pretty close to 50 percent, 5-0?

A Subject to check, sure.

Q Am I correct that the expenses that the Postal Service incurs for its information platform are in that line item known as supplies and services, or is it someplace else?

A The information platform involves capital investment, it involves some supplies and services, it involves training. There's so many components of it that it affects lines up and down. There's even labor costs for training in the information platform.

Q Do you know what percent -- and I don't need a precise number -- what percent of the information platform expenses are capitalized and depreciated?

A No, I don't.

Q Is it at least a substantial amount? In other words, you capitalize every capital expense that you can under generally accepted accounting principles?

A Right. Everything that's appropriate to be capitalized is capitalized.

Q Okay. Again in a colloquy with counsel for OCA, you talked about the impact of small volume shifts, I believe there was a reference to the Merrifield facility, volume shifts in the neighborhood of one and two percent. Do you recall that colloquy?

A Yes.

Q And I believe you testified concerning the ability of managers in facilities to control costs in response to small volume shifts. Do you recall that?

A Yes.

Q Can you remind me what your testimony was with respect to that ability to control costs?

A Well, what occurs in an operation is -- like the Merrifield processing center as we were talking about is the planning is done based on a review of prior years' volume trends for that day of the year, week, of the month, and that such thing. You know, the first of the month has a higher volume than other times during the month and things like that.

But it's essentially a trend plan that's done to generate your staffing pattern, and when you're standing there in the outgoing operation and the trucks are rolling in from 55 delivery units with that day's collection mail, there is no way you really do know whether 98 percent of your forecast has arrived or whether it's 100 percent. You track it against your -- you track your actual cancellations, for example on first-class single-piece, against your forecast. But until the tour is finished and things shut down, you have no notion of what's arriving.

Q But in terms of the ability of a manager of a facility such as that to control costs, there is a substantial overtime element of costs that can be modified at very short notice to respond to volume fluctuations; that's correct, isn't it?

A If you had overtime, you know, but when you get to the -- when you get to an automated facility, there tends not to be as much overtime.

Q In a colloquy, I believe it was with Commissioner Covington, you talked about the current negative equity that the Postal Service shows on its books, and I believe that number we discussed earlier was a negative $468 million? Do you recall that?

A I thought we were talking about prior-year losses.

Q Well, what I would like to clarify for the record is the distinction between the Postal Service's accumulated deficit --

A Right.

Q -- and the Postal Service's negative equity. Perhaps I should phrase the question the following way: Would you clarify for the record the distinction between those two numbers?

A Certainly. The prior-year loss recovery -- the prior-year losses, as I understand it, equate to -- at the end of Fiscal '99 equated to 3.844 billion according to '99's annual report. The net capital deficiency is 447 million, and as it equates to the mention you made as related to the Board resolution, the Board resolution was to restore equity to the amount that has been invested by the Federal Government in the Postal Service, which approximates $3 billion.

Q And that was a number that was determined at the time that the United States Postal Service was created back -- pursuant to the 1970 act; is that right?

A It's a combination. It was -- when it was created, it was 1.7 billion. The Federal Government infused a billion dollars, as I mentioned earlier, in '75 and -- in '76 and '77, so that increased it by a billion. And I think there were -- there has been a few hundred million in some facility -- the Government transferring facilities to the Postal Service.

So the original Government equity position was $3 billion, so equity restoration vis-a-vis the Board resolution that you referred to would require the $3 billion plus the $447 million.

Q So the accumulated deficit number that is used with reference to the Board resolution is not a number that shows up on the Postal Service's balance sheet anywhere?

A The accumulated --

Q Accumulated deficit for prior-year loss recovery purposes.

A Well, it shows up in the annual report, it shows up under the balance sheet data.

Q Okay. But it is not the bottom line negative equity?

A It shows up in changes in net capital equity. It does show up.

Q I think that clarification is useful for the record.

MR. ACKERLY: No further questions, Mr. Chairman.

CHAIRMAN GLEIMAN: Anybody else?

I take it you would like some time to prepare for redirect? Well, we're going to double up today and do redirect and lunch -- or preparation for redirect and lunch at the same time.

I just want to announce that in the table behind Postal Service counsel, there are binders containing copies of the material that have been designated for incorporation into the record. There's a list of designations there also. Counsel are invited to take a look at that material during the break, and if there is a problem that you discover, we can always file a motion requesting an appropriate transcript correction later.

The designated material includes three items filed by the Postal Service last night that responded to requests from the Commission. Included is a response to Presiding Officer's information request 21, a response from Witness Kay to a question from the bench, and a response to a request made during the hearing of August 23.

THE WITNESS: Mr. Chairman, before you adjourn, in case my counsel decides not to do redirect, I would just like to thank you for your cordiality and I appreciate the opportunity to have been here.

CHAIRMAN GLEIMAN: We thank you, but as it turns out, even if your counsel decides not to do redirect, you get to come back while he tells us that so that you can be officially excused.

THE WITNESS: Thank you.

CHAIRMAN GLEIMAN: We're going to come back at five after the hour, a short lunch today, and our next witness will be Witness Bernheimer. We've made a change in the schedule with the agreement of respective counsel.

[Whereupon, at 2:25 p.m., the hearing recessed, to reconvene at 3:05 p.m.]

AFTERNOON SESSION

[3:05 p.m.]

CHAIRMAN GLEIMAN: Mr. Reiter.

MR. REITER: The Postal Service has no redirect, Mr. Chairman.

CHAIRMAN GLEIMAN: Thank you, Mr. Reiter.

Mr. Strasser, that completes your testimony here today. Now, I want to make sure I help you out with your career, so do you want me to say I appreciate your appearance and your contributions to the record and you're a good guy or do you want me to say you're something else?

[Laughter.]

CHAIRMAN GLEIMAN: Whichever way I can help you, sir.

THE WITNESS: I think you've said both in the years that we've known each other.

[Laughter.]

CHAIRMAN GLEIMAN: Well, we do appreciate your appearance here today and your contribution to the record. We thank you and you're excused.

THE WITNESS: Thank you, sir.

[Witness excused.]

CHAIRMAN GLEIMAN: Mr. Ackerly, per agreement, you have the next witness.

MR. ACKERLY: I would like to call Walter

Bernheimer to the stand.

Whereupon,

WALTER BERNHEIMER,

a witness, was called for examination and, having been first duly sworn, was examined and testified as follows:

CHAIRMAN GLEIMAN: Please be seated.

Counsel, you can proceed.

DIRECT EXAMINATION

BY MR. ACKERLY:

Q Mr. Bernheimer, I am handing you a copy of a document previously filed in this proceeding entitled Supplemental Testimony of Walter Bernheimer on Behalf of Direct Marketing Association, Inc., and number DMA-ST-3.

Would you review that document, please?

A Yes.

Q Was this document prepared by you or under your supervision?

A Yes.

Q If this document had been prepared today, would it be the same as it was previously filed with the Commission?

A Well, other than modifying some of the projections based on the actual results of AP12, yes.

Q And you do adopt this document as your testimony in this proceeding?

A Yes.

MR. ACKERLY: Mr. Chairman, I am handing two copies of this document to the reporter. I would ask that it be transcribed into the record and admitted into evidence.

CHAIRMAN GLEIMAN: Is there an objection?

Hearing none, I'll direct that the testimony be transcribed into the record and received into evidence for Witness Bernheimer.

[Supplemental Testimony of Walter Bernheimer on Behalf of Direct Marketing Association, Inc., DMA-ST-3, was received in evidence and transcribed in the record.]

DMA-ST-3

BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON DC 20268-0001

POSTAL RATE AND FEE CHANGES, 2000) Docket No. R2000-1

SUPPLEMENTAL TESTIMONY

OF

WALTER BERNHEIMER, II

ON BEHALF OF

DIRECT MARKETING ASSOCIATION, INC.

Communications Concerning This
Testimony Should Be Addressed To:

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AUTOBIOGRAPHICAL SKETCH

My name is Walter Bernheimer, II, and I am President of Bernheimer Associates, a management consulting group located in Wellesley, Massachusetts, serving clients in the Direct Marketing industry. Prior to becoming a consultant, I served for 29 years in a variety of capacities, including the last 19 as President, of a holding company on the service side of the industry, comprised of a Direct Marketing Agency, a Commercial Printer, a Lettershop (including extensive Data Processing and Personalization operations), and a Fulfillment business. We sold the company in 1989/90. I received an undergraduate degree from Williams College (where I was Phi Beta Kappa), and an MS degree from Massachusetts Institute of Technology.

I have had a long term interest in Postal matters, and have been active in various Trade organizations. From 1984 to 1990, I served on the Board of Directors of The Direct Marketing Association, and since 1990 I have served on the DMA's Government Affairs Committee and Postal Subcommittee. From 1980 to 1990, I served on the Board of Directors of the Mail Advertising Service Association, including a term as President. I am also a member of the Association for Postal Commerce and the Mailers Council.

I. PURPOSE AND SCOPE OF TESTIMONY

The purpose of my testimony is to respond to the U.S. Postal Service's projection of its Revenue Requirement for the Test Year (2001) based on FY1999 results, as presented by USPS witness Patelunas, and, more specifically, to demonstrate that this projection is significantly overstated. This projection, as always, consists of three parts:

- An estimate of Test Year costs "rolled forward" from actual "Base Year" figures
- A contingency
- An amount for "prior year loss recovery"

I am not here to delve into the details of the expense estimates in any of the many cost segments for which the USPS has presented data. That is for other "experts" to accomplish. Nor am I going to comment on the amount included for prior year loss recovery. Rather, I am focusing my primary attention on the contingency included in the 2001 Revenue Requirement, a contingency that is unjustifiable, unnecessary, and uncalled for.

II. THE USPS REVENUE REQUIREMENT IS OVERSTATED

In building its projection of the Test Year Revenue Requirement, the USPS utilizes what could be termed a bottoms up approach - using detailed models of various cost segments, factoring up rolled forward costs from a prior, base year. The contingency request and prior year loss recovery, are added to yield the Revenue Requirement.

I utilize a completely different methodology in estimating revenue needs - more of a top down system, one that is based on historical, actual expense growth. This is a particularly easy method to apply in this Rate Case, because detailed data for the first eleven accounting periods of FY2000 has already been published. In addition, the USPS has chosen FY2001 to be its Test Year. In other words, we have sufficient information to make a very accurate estimate for the fiscal year immediately prior to the new Test Year - just a few weeks before that Test Year is to commence. Clearly, an estimate for FY2001 that is based on FY2000 data will be more reliable than one based on FY1999 data. And since we are close to the start of the Test Year, that FY2000 data, so current and so readily at hand, cannot be ignored when it comes to deciding what the Revenue Requirement for the Test Year should be.

The first step in my top down process is to estimate what Total Expense for FY2000 is going to be. Incidentally, all the data that will be cited below is taken directly from the Postal Service's own Financial and Operating Statements, as published at the end of each Accounting Period (APs 1 - 12) and Fiscal Year (AP13). As of the end of AP11 in FY2000, the USPS reported a Total Expense figure of $54,291.2 billion, representing a 3.8% increase over the previous year's figure, $52,297.6 billion. To arrive at a projection for the full year, we must make an estimate for just two accounting periods, APs 12 and 13. In FY1999, Total Expense for the last 2 Accounting Periods was $9,782.1 billion (AP13 Total Expense, less YTD AP11 Total Expense). By how much should this number be inflated to reach a reasonable estimate for the comparable period this year? In AP11 of FY2000 expense inflation was 3.0%, which was a 1/3 drop from AP10's expense growth rate of 4.5%. As noted, the AP11 YTD number is 3.8%. To be conservative, and for the purposes of this analysis, I have chosen to use the 4.5% figure. But it should be noted that the USPS has been on a cost cutting program, and AP11's 3.0% *number may prove to be more accurate. In any* case, increasing FY1999's expenses in the final two accounting periods by 4.5% yields an estimate of $10,222.3 billion for the same two periods this year, which would bring FY2000's Total Expense to <u>$64,513.5 billion</u>, a 3.9% increase over FY1999.

In the current case, the USPS recently restated its Revenue Requirement for the 2001 Test Year as <u>$69,644.9 billion</u>, comprised of three elements:

Total Accrued Costs	67,642.1
Contingency	1,691.1
Recovery of Prior Year Losses	311.7

The sum, $69,644.9 billion, represents an 8.0% rate of growth over my previously stated estimate for FY2000 of $64,513.5 billion. It should be obvious to even the most biased observer that such a rate of growth is exaggerated and unreasonable.

What could possibly explain such a jump? A sudden increase in the *broad rate of inflation, perhaps to double digit levels?* Not expected. Nor does inflation behave like that; the transitions are generally more gradual. In addition, the general rate of inflation affects only 20% or so of the USPS's costs. Fuel costs? Transportation costs are up by 12.6% in FY2000 according to the AP11 report, or $450 million in total, but fuel is only part of it. In fact, most observers expect fuel costs to fall next year. What about a large surge in employment costs, which represents the lion's share of Total Expense? Not possible. These numbers are contractual and largely known as of today - even with a contract about to be negotiated. And it is this year's rate of inflation that will impact next year's COLA, not next year's rate of inflation. How about a big drop in productivity? While it is true that productivity at the USPS has lagged that of the outside world, the trend this year has been toward productivity improvement, not decline. With investment in automation continuing, why would productivity decline next year? What about a big increase in unit volume, one that would force the USPS to expand employment? Unit volume is up by 2.7% for the first 11 APs of FY2000, and it was up 2.5% last year. Not a big jump, and no sign of such a future jump is in evidence. And employment is down in FY2000, even in the face of higher unit volume. Why, then, would employment not continue to decline in the face of even slower unit growth?

In fact, the USPS is predicting significant <u>deceleration</u> in the rate of growth in unit volume, not acceleration. It has projected 207.6 billion units for FY2001. How will this compare to the current year? Through AP11 of FY2000, the USPS reported processing 175.2 billion units. In the last two Accounting Periods of FY1999, it processed 29.9 billion units. If the rate of volume growth for the last two APs this year slows to the level of AP11 (1.7%), one of the lowest increases of the year, APs 12 and 13 will come to 30.5 billion units, bringing the full year up to 205.6 billion units (2.5% above FY1999). Thus, the USPS Rate Case projection of 207.6 billion units for the Test Year would represent growth over FY2000 of just 1.2%. Interestingly, in the Rate Case, according to the Exhibit USPS-14G, "Cost and Revenue Analysis FY2000 with Workyear Mix Adjustment Statistics by Class of Mail", the units projected for FY2000 add up to 207.1 billion (1.5 billion more than what the USPS will actually be processing). Thus, the projected rate of increase in units for the Test Year embedded in the Rate Case is only 0.3%, far too low a number in and of itself. (I am not going to go into the details of the volume projections, but a possible source for the prediction of overall slow growth appears to relate to Standard A, where the USPS may be estimating that volume will decline.

Why this would happen is not clear.) To arrive at a better estimate of Test Year volumes, more realistic percentages must be applied to FY2000's actual volume results. Otherwise, projected Test Year revenue will be significantly understated. See Exhibit A for the calculation of FY2000 AP 12 and 13 and Full Year numbers, and Exhibit C for a listing of projected volumes by category.

How does the USPS's assertion of higher expense growth combined with lower unit growth compare to its results in the recent past? The following table shows the performance of the Postal Service regarding expense and volume growth since FY1993. As previously mentioned, all figures through FY1999 have been based on data in the Financial and Operating Statements for AP13 of each year. When volume figures have been revised, as they have been on several occasions, I have used the revised figures. Also, FY2000 has been estimated as described above. All of the numbers on which the percentages are based are shown in Exhibit A.

	Expense Growth	Volume Growth
1993 to 1994	4.5%	3.5%
1994 to 1995	4.8%	2.3%
1995 to 1996	3.9%	1.3%
1996 to 1997	3.9%	4.1%
1997 to 1998	4.3%	3.0%
1998 to 1999	4.7%	2.5%
1999 to 2000 est	3.9%	2.5%

The seven year averages are 4.3% annual growth in expenses, and 2.6% growth in unit volume. So where does 8.0% expense growth, coupled with only 1.2% volume growth, come from?

Another way to look at these numbers is to subtract the Volume Growth figure from the Expense Growth figure. The bigger the difference, the more anomalous the USPS's performance. The resulting "Report Card":

	Expense Growth Minus Volume Growth
1993	0.6 points
1994	1.0 points
1995	1.5 points
1996	2.6 points
1997	-0.2 points
1998	1.3 points
1999	2.2 points
2000	1.4 points

The average difference is about 1.3 points. The projected difference for Test Year 2001 is 6.8 points! If this were actually to materialize, management would certainly be due a failing grade.

I believe that the USPS's suggested Test Year Expense scenario does not make sense - and that, very simply, it is not going to happen. The fact of the matter is, the USPS does not need $69,644.9 billion in revenue to cover an equivalent level of expense in Test Year 2001, because that level of expense is not going to occur.

If by the remotest stretch of the imagination it were to develop, it would only be because of the grossest possible mismanagement by the USPS management team and Board of Governors. And by handing down a rate decision that awarded the amount of revenue the USPS is requesting, the Postal Rate Commission would be complicit in the mismanagement. The PRC would be granting the USPS a license to manage badly - a license <u>not</u> to control costs. It would be a license to accept continued underperformance when it comes to productivity improvement. It would be a license for USPS management to continue to pat itself on the back for beating an easy benchmark. It would be a license for the USPS to remain uncompetitive in areas where competition will be necessary for survival.

What am I suggesting? Something very easy to implement. Based on my quasi-macroeconomic methodology, at the very least, reduce the USPS's requested Revenue Requirement by the full amount of the Contingency included in the Rate Case. Remember, as I write this testimony, we are only 6 weeks before the beginning of the Test Year, and we have financial information through the first 11 Accounting Periods of the current year, information that it would be less than responsible to ignore. Stated another way, it is not reasonable to allow a contingency request based on rolled forward estimates tied to FY1999 data, without taking into account intervening data, the FY2000 financial and operating results. Those results are not for a few accounting periods, they are for almost the full year.

By the way, what is the practical effect of entirely eliminating the Contingency. It will reduce the Revenue Requirement by $1,691.1 billion, bringing it down to $67,953.8 billion - still about 5.3% higher than my projection of FY2000's Total Expense number. Again, a reality check: 5.3% would be the highest rate of increase in expenses in the past 8 years. And, based on the USPS's volume projection for FY2001, this would be occurring against the background of a 1.2% increase in units, the lowest rate of increase in that same period. Let me repeat. Completely eliminating the Contingency request would allow the USPS the highest annual rate of increase in costs since the early 1990s, even though volume growth will be lower than in all of the same years. It would also allow the Postal Rate Commission to eliminate the Prior Year Loss Recovery, and leave room to cut the Revenue Requirement by $300 million more based on testimony related to specific cost segments. Or the PRC could leave the Loss Recovery intact, and cut $600 million based on the cost segment testimony. Either way, these actions would reduce the USPS's requested Revenue Requirement to $67.3 billion, a sum that represents a 4.3% increase in costs over FY2000, the average of the past 8 years.

An interesting exercise to go through, given that whatever rates are to be granted will not actually go into effect at the outset of the fiscal year, is to project financial results for the USPS for Fiscal Years 2001 and 2002. The latter year is relevant because, based on past experience, the rates that will go into effect as a result of this rate case will almost surely last through that period. The assumptions underlying the P & L projections for FY2001 and FY2002 are:

- New rates go into effect during FY2001 that will affect 2/3 of the unit volume for the year.
- The rates will be based on a Revenue Requirement that excludes the complete Contingency request. In addition, it is assumed that other cuts will be made, so that rates will be increased by an average of 4.6%. The resulting average revenue per unit after the rate increase will be 31.46 cents (as opposed to the 30.08 cents I am projecting for FY2000).
- Unit volume in FY2000 will be 205.6 billion units.
- Unit volume will increase 2% in both FY2001 and FY2002, a rate that is less than that of the recent past.
- Income not tied directly to rates, which has amounted to over $2 billion through AP11 of FY2000, will reach about $2.5 billion for the year. This figure will rise by about $100 million in each of FY2001 and FY2002.
- Postal Service expenses will increase 4.3% in both FY2001 and FY2002, which matches the average of the recent past.

For a reality check, again note that this combination of 4.3% expense growth and 2.0% volume growth adds up to a difference of 2.3 points. The only year in the last 8 when 2.3 points will have been exceeded is 1996, when the difference was 2.6 points. The detailed P & L numbers resulting from the above assumptions are summarized in Exhibit B. They indicate that the USPS will generate a small loss in FY2000, about $166 million. This compares to the USPS's own current expectations for a more than $300 million loss. In FY2001, my numbers indicate that the USPS would show a profit of about $331 million (based on partial year higher rates - not theoretical full year rates). And in FY2002, the USPS would realize a loss of $309 million. In other words, over the full two year period, the USPS, even with the lower rate increase, would show a cumulative profit.

But even this positive result masks what the USPS would earn in its theoretical Test Year. If the Revenue Requirement is based on the average rate of inflation in expenses for the past 8 years, 4.3%, then Total Expense will come to $67,287.58 billion (i.e., 1.043 x my projected number for FY2000 Total Expense of $64,513.5 billion). Deducting $2.6 billion in "Other Revenue" from this sum yields a total of $64,687.58 billion that has to be covered by revenue brought in from regular unit volume in order to achieve break-even. Applying a 2% growth factor to FY2000's projected unit volume of 205.6 billion yields an estimate for the Test Year of 209.718 billion units. Thus, the revenue per unit required for break-even for the theoretical Test Year can be calculated as follows:

64,687.58/209.718 = 30.85 cents

This number, 30.85 cents, is just 2.6% higher than the average rate that will be generated in FY2000. In other words, if the growth in expenses occurs at the average of the previous 8 years (and remember, the USPS has had lower cost growth in half of those years, and it has exceeded 4.3% in only one of the past 5 years), all that is needed to break even in the theoretical Test Year is 2.6% higher rates.

Given all this information, given a very plausible financial model for the next two years, how can my suggestion about eliminating the Contingency request be deemed unreasonable? Stated another way, how can the USPS's own Contingency request, how can its own scenario, after all, only a model too, be considered sane and supportable? They cannot - and at the very least, the Contingency request should be eliminated - among other reductions. The Revenue Requirement should be cut sharply, and rates should be raised far less than the USPS has requested.

Exhibit A

USPS Data (1)

	Expenses	% Change	Units	% Change
1993	48,096.9	3.7%	170,222.7	3.1%
1994	50,273.9	4.5%	176,188.7	3.5%
1995	52,703.4	4.8%	180,233.2	2.3%
1996	54,739.8	3.9%	182,602.2	1.3%
1997	56,848.9	3.9%	190,009.9	4.1%
1998	59,294.2	4.3%	195,738.2	3.0%
1999	62,079.7	4.7%	200,543.9	2.5%
YTD AP11 1999	52,297.6		170,602.0	
YTD AP11 2000	54,291.2	3.8%	175,154.7	2.7%

Computations Based on USPS Data

AP12/13 1999 (1)	9,782.1		29,941.9	
AP12/13 2000	10,222.3	4.5%	30,450.9	1.7%
2000 Projn	64,513.5	3.9%	205,605.6	2.5%

(1) Source: USPS Financial and Operating Statements

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Exhibit B

USPS Profit & Loss Projections - FY2000 - FY2002

	FY2000	FY2001	FY2002
Operating Revenue	61,847.28	65,018.60	67,171.81
Other Revenue	2,500.00	2,600.00	2,700.00
Total Revenue	64,347.28	67,618.60	69,871.81
Total Expense	64,513.50	67,287.58	70,180.95
Net Profit (Loss)	- 166.22	331.02	- 309.14
Unit Volume	205,606	209,718	213,912
Op Revenue per Unit	0.3008		
Unit Volume before Incrase		69,836	
Unit Volume after Increase		139,882	213,490
Op Rev per Unit before Incr		0.3008	
Op Rev per Unit after Incr		0.3146	0.3146

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Exhibit C

USPS Volumes - 2000 - 2001 (in Millions)

	Actual 2000 Thru AP11 (1)	% Change Over 1999 (1)	USPS 2000 Projn (2)	USPS 2001 Projn (3)	% Change Over 2000
Letters & Parcels			53,685.0	52,877.7	
Presort L & P			45,096.1	46,979.7	
Private Cards			2,855.2	2,770.8	
Private Cds Presort			2,600.1	2,670.2	
Subtotal First Cl	87,710.7	1.2%	104,236.4	105,298.4	1.0%
Priority	1,053.3	3.0%	1,217.6	1,226.2	0.7%
Express	59.8	2.8%	69.9	72.3	3.4%
Mailgrams			3.9	3.3	-15.4%
Periodicals - Total	8,657.5	-1.4%	10,397.2	10,321.2	-0.7%
Standard A - ECR			32,691.2	32,828.2	
Standard A - Reg			41,673.6	40,998.7	
Non Profit - ECR			2,957.3	2,851.9	
Non Profit - Reg			11,255.4	11,425.6	
Subtotal Std A	75,550.9	5.0%	88,577.6	88,104.4	-0.5%
Standard B	922.9	5.5%	1,092.4	1,133.1	3.7%
USPS			359.4	348.5	-3.0%
Free			55.0	56.7	3.1%
International	859.4	-3.6%	1,048.8	1,031.6	-1.6%
All Other	340.2	-8.9%			
Grand Total	175,154.7	2.7%	207,058.2	207,595.7	0.3%

(1) Source: USPS Financial and Operating Statements
(2) Source: USPS-T-14, Exh. 14G
(3) Source: USPS-T-14, Exh. 14M

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CERTIFICATE OF SERVICE

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

August 14, 2000

Dana T. Ackerly II

CHAIRMAN GLEIMAN: One party requested oral cross examination of this witness, the Postal Service. Is there anyone else who wishes to cross examine?

Does the Postal Service still wish to cross examine?

MR. REITER: I'm afraid so, Mr. Chairman.

CHAIRMAN GLEIMAN: Well, then, when you're ready, fire away, Mr. Reiter.

MR. REITER: Thank you.

CROSS EXAMINATION

BY MR. REITER:

Q Good afternoon, Mr. Bernheimer.

A Good afternoon, Mr. Reiter.

Q Would you look at page 2, line 30, of your testimony, please?

A Yes.

Q You state that as of the end of AP11 in FY2000, the USPS reported a total expense figure of 54,291.2 billion? Do you see that?

A Yes, I see it.

Q Isn't that $54 trillion?

A Yes. Correct. It should be 54.2912. The comma should be a period.

Q And would you make a similar change on line 31 --

A Yes. Sure.

Q -- right below?

A Yes.

Q I think there are several more instances in there where you use the word billion and you may have meant either million or to change the comma to a decimal point. There are others where I think you may have meant what you said. Do you want to -- should we go through them and see which is which?

A Why don't we just assume that we're talking about billions here. If you want to make the correction, it's okay with me.

Q On those two lines, yes, I think we're clear on that. There are numbers as I go through your testimony, however, where perhaps we should be clear.

Page 3, line 2?

A Well, you could also change the word billion to million.

Q Your choice, it's your testimony.

A Why don't we change the word billion to million. How's that?

Q Would that be the same on page 3, line 2?

A Yes, and line 12, line 15.

Q Line 11.

A Yes.

Q Line 21. Is that right?

A Yes. If you change billion to million, you'll be okay.

Q You use the word billion a few times on page 4, but I think, if I understood correctly, that you did mean billion there. Could you confirm that for me.

A In talking about units? Yes.

Q Let me give you another example. On page 7, line -- I'm sorry.

A On page 6, line 17 should become million.

Q Okay. Are there any others that you want to correct now?

A It looks like page 7, line 13. It looks like page 9, lines 6 and 7, 8. Six, 7 and 8.

Q Any more?

A There may be. That's enough.

Q All right. Would you please turn to page 2, line 20, please?

A Yes.

Q You state that, clearly, and I'm quoting, an estimate for FY 2001 that is based on FY 2000 data will be more reliable than one based on FY 1999 data. That's what it says there, correct?

A Yes.

Q Does that statement depend on all other things being equal?

A Assuming it's the same forecaster.

Q And all other things being equal as well?

A I would make the assumption that if an individual forecaster looked at 1999 data and 2000 data at the same time, the estimate based on 2000 data would be more accurate than the estimate based on 1999 data.

Q In addition to assuming that it's the same forecaster, is your statement assuming that all other things are equal?

A Well, I'm assuming the same -- looking at it at the same, all other things are equal, yes.

Q Thank you.

You're aware that actual Government Fiscal Year 2000 data are not available yet, are you not?

A Correct.

Q So would not some estimates or assumptions about the end of the year have to be made?

A Yes. Absolutely.

Q And wouldn't an FY 2001 estimate based on FY 2000 estimated data using assumptions that might turn out to be invalid or using estimation techniques, wouldn't that result in a less accurate FY 2000 estimate, all other things being equal, than one based on earlier actual data?

A In fact, we're now twelve accounting periods the way through Fiscal 2000. I believe that the AP data through accounting period 12 -- the data through AP12 generally has been quite reliable. Especially in the last six or eight years, AP13 has been generally consistent. There have been one or two years where the loss was smaller and the loss was -- one year where the loss was larger, but generally, the Postal Service losses about 300 million in AP13. That's been pretty much the average.

So based on real data through AP12 and making some estimates, which was already discussed earlier today, it's pretty -- I think you can make a pretty good estimate for Fiscal 2000, one that is more reliable than using 1999 data.

Q Would you look at your testimony on page 2 beginning on line 31 and carrying over to the next page where you state: To arrive at a projection for the full year, we must make an estimate for just two accounting periods, APs 12 and 13.

Do you see that?

A Yes.

Q Do you know the difference between a postal fiscal year and a Government fiscal year?

A Absolutely, I know what you do, yes.

Q Could you tell me what it is?

A Well, you have to adjust -- the postal fiscal year runs from somewhere in the middle of September to somewhere in the middle of September, and the postal fiscal year is a

September 30th fiscal year. So you have to make some adjustments, deducting some expenses and adding some others at the end in order to come up with the September 30th number.

Q Do you know what accounting period 14 is and how it's used?

A Yes. That's -- AP14 is what the Postal Service uses to build in all the fudge that it wants to at the end of the year.

Q Are you aware that the roll-forward expense projections and the Postal Service revenue requirements are based on Government fiscal year data?

A Yes.

Q And are you aware that the addition of APs 12 and 13 to data for year-to-date AP11 data results in AP13 year-to-date or postal fiscal year data which is not comparable to the Government fiscal year data used in the rate case?

A Yes. But the -- what we're talking about here is establishing a twelve-month period, and I don't care which twelve-month period it is, in which the Postal Service is trying to generate a certain amount of revenue to cover what it deems to be its expenses, and using the historical accounting period 13 statements and some estimates for this year, it's very -- it's not that difficult to derive trends, to look at numbers and to say, well, this is what has been going on for a period of time and it'll probably continue to go on for some more time.

Q Are you aware if Postal fiscal year and government fiscal year expenses may be reported differently?

A Yes.

Q Can you give an example of that?

A Well, not specifically. You are talking about AP 14. Some expenses may occur in the last few weeks which you want to add in, so you add them in. It may be the workers comp adjustment, it depends.

Q What about expense reimbursements, do you know anything about differences in how those are reported?

A No.

Q So you didn't account for that in your estimates, such differences?

A I didn't, no.

Q Did you take into account in your estimates the fact that the government Fiscal Year 2000 is a leap year and contains 366 days?

A I used the real data that you have been reporting for Fiscal 2000, but it would seem to me that since 2001 is not a leap year and does not contain the extra day, that the expenses would be a little less in 2001, relatively, than they are in Fiscal 2000.

Q I was focused on Year 2000 estimates.

A But the leap year has already occurred, that was February 29th, I think that is what constitutes the day that makes it a leap year, so that has already happened. And I assume that you have already accounted for that to some extent. And if you -- if the Postal Service hasn't accounted for yet, then it has a unique method of accounting.

CHAIRMAN GLEIMAN: Excuse me. Could I just get a clarification? There is something that sticks in the back of my mind. I don't have a calendar in front of me, but wasn't this the strange year because it is divisible by some number and it comes out some way that we didn't have a leap year day this year? I can't -- I just want to clarify in my own mind. Anybody can help, I would appreciate it.

MR. McBRIDE: Mr. Chairman, after a 16th Century pope straightened out the calendar, the rule adopted was that if a year was divisible by 400, it would not be a leap year except every 400th year, because the average day is 24-1/4 hours long. So this is --

COMMISSIONER LeBLANC: Where did you learn that?

MR. McBRIDE: In grade school. This is the fourth one.

CHAIRMAN GLEIMAN: So this is the one where there was or wasn't?

MR. McBRIDE: It is a leap year.

CHAIRMAN GLEIMAN: Thank you. Okay. I just wanted to know. I remembered reading about it, and I thought it was a monk somewhere that gave us this situation, but, hey, popes, monks, you know, they get there, I guess, sometimes.

MR. REITER: That is all right, I don't think there were any popes or monks involved in the government fiscal year. They may have affected it, we will try to find out.

CHAIRMAN GLEIMAN: I wouldn't bet on that if I were you. You know, people don't wear frocks all the time anymore.

BY MR. REITER:

Q So I think we were at the point where I can ask you, Mr. Bernheimer, is it your understanding that, compared with Postal Fiscal Year 2000, the government Fiscal Year 2000 has two additional days, one for the leap year and one for the one day difference that is always there?

A Yes.

Q And those two additional days in the government Fiscal Year 2000 would result in additional costs to the Postal Service on that government fiscal year basis, isn't that right?

A Well, yes, in the aggregate, yes.

Q And did your method account for those costs?

A Yes, I took the data that you are reporting and extended it for the full year, yes.

Q Could you tell me how you accounted for those additional days?

A I assumed that the data that had been reported so far counted February 29th.

Q You just -- I'm sorry, go ahead.

A I assumed that February 29th had already occurred and, therefore, it had occurred for the Postal Service, too, and that the costs related to February 29th are already included in the reporting, and then I added data for what I considered to be the rest of the fiscal year.

For example, I assumed that rate -- that expenses would increase in the last two accounting periods by about 4-1/2 percent, compare to Fiscal '99, but, in fact, in AP 12, Postal Service expenses increased by less than that. So there is a little rounding involved that would cover that type of event.

Q Isn't the Postal fiscal year always a 364 day period regardless of whether it is a calendar leap year that it encompasses?

A Well, you report on a 52 week basis, yes, for the simplicity of reporting.

Q Okay. So we are agreed that Postal fiscal years are always 364 days.

A Well, but when you report Accounting Period 13 at the end of the fiscal year, when you delay the reporting of that till you have made the adjustments, you have taken into account what the Postal -- what the government fiscal year will be, generally.

Q Is that done in Accounting Period 13, is that what you said?

A No, it is done in Accounting Period 14, but you don't publish an Accounting Period 14 report. You incorporate it all into the printed version of Accounting Period 13 when you distribute it in December, generally.

Q Did your estimation for 2000 take into account Accounting Period 14?

A Yes. The reason is because I can't know what adjustments you are going to make. I don't know what adjustments, specific adjustments were made in each of the past seven years. I am not -- I didn't analyze the data based on the minutiae that you are driving at, I analyzed the data based on aggregate numbers and percentages, and took a big picture approach. And regardless of what adjustments you have made in the past, the costs have been increasing at a certain rate.

All the adjustments that you have made in the past, whatever they are, and I don't know them all, I know probably very few, you have already done them and that is that is what the reality has been, the 4.3 percent.

Q I wasn't asking about the past, I was asking about 2000, which hasn't passed yet, and I was asking whether you, in coming up with your estimates for 2000, accounted for Accounting Period 14?

A The answer is yes. I didn't analyze Accounting Period 14 specifically. I made an assumption about what the year would, what the final numbers for the year would be and that includes whatever happens in 12 and 13 and whatever the Postal Service and its accountants choose to do for Accounting Period 14.

Q How did you account for that?

A How did I account --

Q In your estimates.

A In my estimates I used aggregate numbers based on past averages to inflate what 1999 numbers were.

Q You took actual year-to-date AP-11 numbers, that was your starting point? Correct?

A Yes.

Q And you added APs 12 and 13 as you estimated them, is that correct?

A Well, I extrapolated by taking what you reported for AP-13 in '99 and deducting what you reported in AP-11 as your year-to-date numbers through Accounting Period 11.

Q I'm sorry, would you say that again?

A I calculated the base 1999 costs for APs 12 and 13, which includes AP-14, obviously, as well, by taking your year-end number, which you reported as of AP-13 in '99 and deducting what you are reporting this year as your prior year-to-date number.

Q What is the basis for your conclusion that 13 includes 14?

A The basis is that those are the final numbers you report and in many of your accounting statements you print an asterisk on the previous year and you say this has been adjusted to match the audited statement or some such wording. I can find it here if you want me to.

Q Did you look at the annual report for Fiscal Year 1999?

A I didn't use the annual reports. I used your AP-13 reports.

Q So you didn't determine whether the final numbers in the annual report for FY 1999 were the same as the AP-13 end-of-year numbers that you looked at?

A No, I made the assumption that since you identified some specific numbers which you modified, which the Postal Service modified based on the audit, that when it printed numbers that were not so identified that those numbers had not been changed by the audit.

Q Would you look at page 1 of your -- I'm sorry, that's not right. I'll get back to you in a second.

[Pause.]

BY MR. REITER:

Q Let me ask you about your discussion of the contingency and I wondered if it considered the possibility of revenue variances in FY 2000 and the test year.

MR. ACKERLY: Do you have a specific reference to his testimony?

MR. REITER: No, I don't. I am asking him whether he considered those in his discussion.

MR. ACKERLY: Can you repeat the question, please?

MR. REITER: Yes.

BY MR. REITER:

Q Does your discussion of the contingency consider the possibility of revenue variances in FY 1999 and the test year? -- I'm sorry FY 2000 and the test year?

A I am not sure what you mean.

Q Do you know what a revenue variance is?

A Well, I am not sure how you are using the term. Are you -- do you mean that revenue may come in short of what I am predicting already or revenue -- I am not sure what you are driving at.

Q Whether it comes in below what the Postal Service planned on.

A Well, in AP-12 revenue was $3 million off or something like that. It is -- I made my own projections about what I thought revenue was going to be, but we are not talking here about revenue in fiscal year 2000. My focus is on costs and how costs have grown over the years and how the Postal Service builds its revenue requirement for a rate case, and it really has nothing to do with what revenue would occur in Fiscal 2000 but if revenue fell short then what you would do is add that to the loss and divide by 9, as you normally do, and add to your prior year loss recovery request by a few million dollars. That's all it would affect it by.

Q Do you believe that in determining the need for and the amount of the contingency possible revenue variances are as important as expense variations?

A You mean past revenue variation or potential revenue variation?

Q In trying to determine the amount that is need for the contingency.

A Well, if you are talking about the future year you have to take into account the likelihood of variation both on the cost and the revenue side. I think that that is a reasonable thing to do.

Q But you didn't consider that in your discussion?

A Well, I don't -- I did to the extent that I believe that the revenue, the unit forecast made by the Postal Service for the test year is not a very accurate forecast and in fact is understated and so I was using, in doing the P&L projections that I include in my testimony I used different assumptions but I am still primarily focused on the cost side and the cost request as built by the Postal Service.

Q So you think the cost variations are more important than the revenue variances?

A I think you have to take into account both factors in trying to project the future.

Q But you focused --

A But the fact of the matter is the way you build your future request for rates is to estimate your costs, add a contingency, and add the prior year cost recovery. Then you divide by the volume you think you are going to generate so the cost is probably more important than the revenue, yes. I guess I would have to say that.

Q So now you are saying that the cost side is more important?

A Yes. Your having pressed me has caused me to conclude that I think costs are more important than the revenue projections.

Q Assume with me hypothetically if you will that an analysis of FY 2000 actual revenue showed that the revenues would be lower than estimated by the Postal Service in its filing. Would that argue in favor of a larger contingency?

A No, not necessarily,.

Q What would you need to consider if it is not necessarily --

A Well, you would have to look at the costs and the Postal Service's cost filing as well and maybe the costs are overstated based on some volume projections, whatever. I mean you can't just look at one item.

Q Let's assume that the costs are the same.

A Well, but if the Postal Service reduced its revenue projection based on a volume shortfall then the costs would also fall and your automatic 2.5 percent contingency request or whatever the percentage is would also fall.

Q That wouldn't necessarily be a proportional change; would it?

A No, of course not.

Q Would you look at page 4 of your testimony?

[Pause.]

I might have the wrong page. Give me a second.

[Pause.]

I'm going to move on to a different question, anyway. If you'd look at page 3, line 21, please?

There you say that the sum, 69, which we now know means 69.6449 billion, represents an 8.0 percent rate of growth over my previously-stated estimate for FY2000 of 64.5135 billion; do you see that?

A Yes, I do.

Q That 69-plus change billion to which you refer, represents the total revenue requirement reflected in the update which includes 1.7 billion for the contingency and over 300 million for recovery of prior years' losses; is that right?

A Yes.

Q Would you accept, subject to check of my arithmetic, that the contingency and the prior years' loss recovery account for 3.1 percent of the eight percent figure you've calculated?

A Close -- I --

[Pause.]

Approximately, yes.

Q I'm sorry, you said approximately?

A Yes.

Q So the percentage increase in estimate accrued costs of 67 billion is less than 4.9 percent; is that right?

A Well, actually, I would revise my own estimates a little bit, based on actual AP-12 data.

Q But your testimony is about the AP-11 data, so let's stick to that.

A Well, but it -- since we have more recent information, it's reasonable to assume, to use that data to re-project some of these numbers.

Q Right, but just looking at the numbers that you filed in your testimony, was I correct that the percentage increase in estimated accrued costs would be less than 4.9 percent?

A Approximately, yes.

Q Let me ask you another hypothetical: If you'd assume that you have underestimated FY2000 expenses by 500 million, and that actual expenses are closer to 65 billion, given that scenario, would you agree that test year accrued costs would be estimated by the Postal Service to grow by approximately 4.1 percent?

A Well, if the AP -- if the final numbers come to 65 billion in expense, that would mean expenses in AP-13 and adjustments of approximately $5.8 billion, which is approximately $800 million higher than the 12 -- the average of the 12 pervious accounting periods.

And if that were to occur, I would consider that bad management.

Q But that figure that I asked you about before, that would be consistent with the numbers in your exhibit on page 5; wouldn't it?

A Well, that's true, but you could have asked me, suppose expenses at the end of the fiscal year came to $70 billion? Then that would mean we had higher inflation than you said we did in Fiscal 2000, and I would say, yes, you're right, so what does that prove?

Q But if you were wrong about what you said earlier, that the number for Accounting Period 13 included 14, and I asked you to assume that it didn't, wouldn't that change your answer?

A No.

Q It wouldn't change your answer?

A No. I didn't -- I was inflating last year's data. And last year's data for AP-13 includes the AP-14 adjustments that -

Q But -- I'm sorry, I didn't mean to interrupt.

I was asking you to assume that it does not include it.

A Well, I wouldn't assume that.

Q But if it did not --

A No, I wouldn't assume it.

Q Well, I'm asking you to assume it.

A Let me say this: If that were to be the number, and that's the way the Postal Service does business, then I would say it does a poor job of budgeting and reporting its information.

Q Because you misunderstood it?

A No, because the Postal Service should not have that many adjustments at the end of the year. It knows about them earlier; it should take them earlier.

[Pause.]

Q Would you look at your testimony on page 3 and over to 4? And there you discuss expense drivers, and I wondered if I am correct that expense drivers such as inflation and labor costs are used to estimate the level of test year accrued costs but not the contingency or the prior year loss recovery; do you agree with that?

A Again, I'm not sure what you mean.

Q About -- what are you not sure about?

A I'm talking about items that affect accrued costs in that paragraph, yes.

Q Right. And I'm asking you that such items are used to estimate the level of test year accrued costs, but not the contingency or prior year loss recovery amount.

A Okay, correct.

Q Okay.

And is it correct that more than $2 billion of the total that you say the Postal Service does not need and is not going to incur is made up of the contingency and the prior year loss recovery amount?

A Well, it calculates that way, yes.

Q And is it correct that the prior year loss recovery amount is not an accrued cost, but represents additional revenue required to recover prior years' losses over nine years; is that right?

A I don't agree with that statement. You used the term, required, and to the best of my knowledge, that number, that amount of money is not required; it's an optional amount that may or may not be added.

The Postal Service may request it, but I do not believe it's written in law that it is required.

Q All right.

A You could also use a 27-year period to amortize it as opposed to a nine-year period, or you can say we want it all back now in one year.

Q I didn't mean that as a legal question, but I --

A I'm not a lawyer, so -- and you are, so I assume everything you say is a legal question.

Q Is it your testimony that the Postal Service should not recover prior years' losses?

A I wouldn't say that; I would say that there is no mandate for it, and, in fact, the Postal Service could forego it many years.

There is no need to recover prior year losses.

Q So your advice to the Postal Service would be not to recover them?

MR. ACKERLY: Objection, Mr. Chairman. This goes well beyond the scope of Mr. Bernheimer's testimony.

THE WITNESS: Actually, Todd, I'd like to answer the question in my own way.

MR. ACKERLY: Objection withdrawn.

[Laughter.]

THE WITNESS: Postal Service management has lots of different ways to generate -- to pay for its expenses, both current expenses and capital expenses.

And it could use a prior year loss recovery to help build its revenue need, but it doesn't necessarily have to apply its cash that way.

For example, as was pointed out earlier today, the Postal Service has paid off about $20 billion -- excuse me, they have made about $20 billion in capital outlays in the last seven years, at the same time that they have paid off roughly -- they've reduced their term debt by about $5 billion. Let's say it all adds up to $25 billion.

They have applied funds that they have generated from operations to pay for $20 billion in capital outlays, and reduced debt by $5 billion.

So, what they basically have done is charged higher rates than were necessary, because management also has the option, like many businessmen or businesspersons, I should say -- I lost my head -- to finance their capital outlays by borrowing money.

If I'm a businessman and I have to build a new plant, I have to mortgage, I have to get a mortgage to do that. So, I go out and borrow the money. The Postal Service has chosen not to do that.

The Postal Service has decided to finance the building of plant by taking money they generate from operations and applying it toward covering the capital outlays. Management doesn't have to do that. Management could do it differently. They could charge lower rates. They could borrow money, because there's nothing wrong with debt in this particular type of operation.

There are lots of options in financing the cash needs, and one of them is to recover prior year losses, but that's not -- it's not necessary.

BY MR. REITER:

Q Is it your understanding, then, that the reason the Postal Service attempts to recover prior year losses is to generate cash for those purposes?

A That's the practical effect. It generates more cash by including those numbers, those dollars, in its rate requests and getting higher rates than it would if the number -- if the dollars weren't there. So the practical effect is to have higher rates which result in more revenue. Assuming it doesn't drive away demand, it results in more revenue which the Postal Service can apply in many ways.

Q It also results in restoration of equity, doesn't it?

A Well, and what's the big deal about restoring equity? What's the big deal about that? Whose equity? What's the real equity of the Postal Service, and what's the impact if it's $3 billion or $3.1 billion? I don't see what the big deal is about that.

Q I can refer you to information on the record that might answer your question, but I'll wait till the brief to do that.

A I'm talking philosophically.

Q I understand.

A I understand the Governors think it's a big deal.

MR. REITER: Lately, it seems the witnesses have been asking me questions, and I try not to answer them, because the Chairman doesn't like it when I testify, so I was just looking for another way to answer your question.

[Laughter.]

BY MR. REITER:

Q Look at your testimony on page 7, please, line 2. Beginning there, you say: "At the very least" -- I'm sorry -- you say that at the very least, you're suggesting that the Postal Service has requested revenue requirement be reduced by the full amount of the contingency. That's your recommendation.

A Well, if I were sitting on the Postal Rate Commission, I would eliminate the contingency request entirely, but that's not all I would do. But in this case, I would throw out the contingency request completely.

Q I know you're not a lawyer, but how would you reconcile that with the Postal Reorganization Act, which does seem to contemplate that there be a reasonable contingency?

A Contingency can be zero.

Q That's your interpretation?

A Or $1. Contingency does not have to be any specific percentage.

Q Would you agree that eliminating the contingency, as you recommend, would increase the odds of a loss in the test year?

A Yes; I would agree that reducing the Postal Service's revenue would increase the risk of a loss, yes.

Q And that a loss in the test year would result in future ratepayers having to pay for the costs of current operations.

A If the Postal Service were to experience a loss, yes.

Q And I think based on our discussion before -- you may have touched on this, but just let me confirm that whether you're aware that none of the volume and expense data reflected in Postal fiscal year 2000 financial operating statement reports that you've used have been audited.

A Yes, I realize that.

Q And that those audits do result in changes in the data very often if not always.

A That's what audits are for.

Q Are you aware that the Postal Service expense estimates are based on detailed assumptions regarding workload, inflation, wage and benefit changes, cost reduction, program savings, nonpersonnel inflation and planned changes due to other programs?

A Yes.

Q And is it also correct that your expense estimates make no specific assumptions or estimates for any of these individual cost drivers?

A That's the point; in other words, my approach is different. We live in parallel universes. You build a rate case revenue requirement one way, but as I heard a discussion a little bit earlier, the profit and loss statement for the Postal Service doesn't relate to what the rate case looks like. They're two different universes, and I live in the universe in which revenue and costs, real revenue and real costs relate to each other, and you end up with a real profit or a real cash flow, and I don't live in the world of -- the rate case world.

But if you look at what's gone on in the real world, you can apply that to the Postal Service's continuing existence and come up with logical conclusions.

Q You didn't mean to say this was not the real world, did you?

A For some of us, it is, and for some of us, it isn't.

[Laughter.]

Q Would I be correct to say that your methodology for estimating revenue and expenses simply looks at history and assumes that that trend will continue regardless of what we actually know or forecast about the future?

A No, that would be an incorrect assumption. I look at history, which provides a guideline. But then, you have to take into account other factors; for example, that -- I believe in my projections, I stated that I don't expect unit volume to increase as much as it has in the recent past. I recognize that that's an issue. I recognize that inflation today is a little higher than it was last year but not much higher, and I take into account things like, for example, oil prices increased a lot during fiscal 2000. Are they likely to stay at this level? Are they likely to decrease?

So you take into account other factors. You don't just take the past and project it into the future.

Q Could show me where in your testimony you took into account those possible changes in expenses, what they do to inflation or fuel or whatever else you mentioned?

A They're all in the final number.

Q In which number?

A 4.3 percent.

Q And how did they get there?

A Based on my thinking.

Q And could you explain that for us?

A I just explained it. I looked at what the history has been. I look at what other factors are going on in the real world, and then, I adjust accordingly in my mind, and I put it on paper.

Q There is no calculation we have.

A There is no calculation. I did no research; I didn't do any market research; I didn't refer to anybody else's documents.

Q It's just in your head.

A It's just me.

May I add to that a little bit, or do you not want me to?

Q I wasn't going to ask anymore.

A Okay.

MR. REITER: That was all the questions I had.

CHAIRMAN GLEIMAN: Follow-up? Questions from the bench?

Commissioner Goldway?

COMMISSIONER GOLDWAY: Can I make an inference from your discussion about prior year losses and the options that the Postal Service has used to fund all of their capital expenditures out of cash that you think that they would actually increase their asset base more efficiently if they used their borrowing power more?

THE WITNESS: Yes, I believe that, yes. I believe that what they're doing is asking the ratepayers to pay for capital outlays on a current basis. That's a very unusual way to finance capital outlays.

COMMISSIONER GOLDWAY: So if they were really interested in increasing the equity value of their operation for its owners, who are the citizens --

THE WITNESS: Right.

COMMISSIONER GOLDWAY: -- they would use their borrowing power because you pay back, but your assets increase more --

THE WITNESS: Right.

COMMISSIONER GOLDWAY: -- over time.

THE WITNESS: Yes, as evidenced by real estate sales, in which they make big profits.

COMMISSIONER GOLDWAY: Right; so, the fact that the Postal Service has switched in the last 10 years to do more and more of its operations in cash may not have been in terms of the long term a good decision. It may have been initially one when they were paying back debt at a very high rate.

THE WITNESS: Yes.

COMMISSIONER GOLDWAY: But it may not be in these two years or in the coming two years when interest rates are fairly low relative to what they were when they changed this pattern. Is that what you're --

THE WITNESS: Yes.

COMMISSIONER GOLDWAY: -- saying?

THE WITNESS: Yes, I am. It's possible for a business or any operation, government, to have too much debt, but it's also possible to have too little debt, and having no debt makes -- is generally not the best way to manage a business in my opinion, and the Postal Service has to be looked on as roughly a $70 billion business.

COMMISSIONER GOLDWAY: So if the Postal Service somehow didn't get all the revenue and break even in this next year the way it hopes, given its requests, and it had to go out and borrow some money, that might actually be good for the operation if they did it wisely.

THE WITNESS: If they did it wisely, it would certainly do no harm, and it might be pretty good to have -- actually, I would like to see a private market lender lend some money to the Postal Service rather than the government and have a private market lender look over the shoulders of the management in the Postal Service. That would probably be a very good thing for the American public.

COMMISSIONER GOLDWAY: Okay; thank you.

CHAIRMAN GLEIMAN: All right; any other questions from the bench? Follow-up to questions from the bench?

MR. REITER: I have brief follow-up to Commissioner Goldway's question.

CHAIRMAN GLEIMAN: Certainly.

FURTHER CROSS-EXAMINATION

BY MR. REITER:

Q If the Postal Service were to borrow money in the test year, isn't it true that there are costs associated with that that future ratepayers would have to --

A Yes.

Q -- pay interest appreciation?

A Sure.

MR. REITER: Okay; thank you.

CHAIRMAN GLEIMAN: Anyone else?

[No response.]

CHAIRMAN GLEIMAN: Would you like some time to prepare for redirect?

MR. ACKERLY: Just a few minutes, Mr. Chairman, please.

COMMISSIONER GOLDWAY: Certainly.

[Recess.]

CHAIRMAN GLEIMAN: Mr. Ackerly?

MR. ACKERLY: I just have a few questions on redirect, Mr. Chairman.

REDIRECT EXAMINATION

BY MR. ACKERLY:

Q In his cross-examination, counsel for the Postal Service asked you whether, in your opinion, eliminating the contingency would increase the odds of the Postal Service losing money in the test year. Do you recall that?

A Yes.

Q Do you have a view as to what the extent of those odds is? In other words, is it likely that the Postal Service is going to have a loss in the test year?

A Well, if you look at historical numbers and then, using my methodology, my top-down methodology of doing some inflating of those numbers, you come out with an expense budget that would be -- if you assume the continuing rate of 4.3 percent, you come out with a need for a certain amount of revenue, and if you assume that volume is going to go up less than it is this year, which is 2.7 percent but goes up about 2.5 percent, without a rate increase, the Postal Service would theoretically lose about 1.8 percent. Without a rate increase, on paper, the Postal Service would lose about 1.8 percent, which, based on $66 billion or whatever the number is would be maybe $1.4 billion.

But that's before some special programs that the Postal Service is trying to implement to save money. For example, in this fiscal year -- I just read this; I saw it in the Wall Street Journal yesterday, and then, I actually got a copy of the AP article -- PMG Henderson was interviewed on Tuesday, and he talked about the savings. Because they had budgeted -- what he did was he talked about the fact that the Postal Service had hoped to make a $100 million profit this year, but certain costs occurred which were unforeseen, about $800 million in unforeseen costs between fuel and a couple of other things like that.

And in addition, there's about a $600 million shortfall in revenue; what they had projected from revenue was less than -- it was more than what they've actually experienced. So it was about $1.4 billion in extra costs and revenue shortfall. But, in fact, he said that they might lose up to $300 million as opposed to making a $100 million profit. That would be probably more than I would project, but even if that number was accurate, that means they've made up about $1 billion of the loss this year, of the shortfall this year.

In other words, the Postal Service management has been able to make adjustments for unforeseen contingencies that existed at the start of the year. Now, if you take that billion dollars, again, which is what PMG Henderson is saying they're trying to drive at for extra savings each year, and you apply that, you would come out to -- and they're able to accomplish that next year, then, you would come out to a number that would be a very, very nominal loss even without increased rates.

So I'm not predicting that the Postal Service could break even next year without rates, but it is conceivable that the Postal Service would lose a very, very small sum of money even without increased rates in the next fiscal year, and I can't put a number on it for odds, because I'm not an oddsmaker, but it's within the realm of possibility. Management can adjust. They did it this year; they can do it again next year.

Q Do you know if the Postal Service has a budget for fiscal year 2001 that includes some of these cost savings that management has been able to -- has been able to realize?

A Well, I believe Mr. Strasser just testified that they don't have a budget for fiscal year 2001. I believe that a request was made for that, and no document was presented. So I don't -- I have to assume that there is no such budget. If that's true, I find it preposterous, but if it is true, it would be the only $70 billion business in the world without a budget one month before the start of the next fiscal year. There has to be a working budget somewhere, and I'll leave it at that.

Q In your colloquy with counsel for the Postal Service, you were talking about results for AP13. You talked a little bit about what is known as AP14, and I believe that in the course of that discussion, you mentioned that you had come up with a projection, a number that is the likely loss this year for AP13. Would you explain how you calculated -- well, first of all what that number was and how you calculated it?

A Well, I simply took the average of the last 7 years. I added up the losses. The Postal Service has always -- not always; there may be some year in the distant past when the Postal Service made a profit in AP13, but in the recent past, the Postal Service has always lost money in AP13, and I simply took the last 7 years, 1993 through 1999, and added them together, divided by seven, and that gave me about a $290 million average loss.

There was one year, 1998, when the loss was $500 million, and that looks like it was because of some year-end shenanigans in part because of that; for example, supplies and services in AP13 was up 50 percent or some silly number like that. There was also a year, 1995, in which the Postal Service lost just over $100 million in AP13. So it's possible that it can do reasonably well in AP13.

Q But the $290 million number is simply --

A That's the average.

Q -- an arithmetic average --

A That's just an average.

Q -- of the last 7 years.

A That is correct, yes.

MR. ACKERLY: No further questions, Mr. Chairman.

CHAIRMAN GLEIMAN: Any recross?

[No response.]

CHAIRMAN GLEIMAN: That being the case, Mr. Burnheimer, that completes your testimony here today. We appreciate your appearance and contributions to the record. We thank you, and you're excused.

THE WITNESS: Thank you. It's been worth the wait.

CHAIRMAN GLEIMAN: For us, too.

[Witness excused.]

CHAIRMAN GLEIMAN: Mr. Hollies, I believe you have the next witness.

MR. HOLLIES: The Postal Service calls William J. Dowling.

CHAIRMAN GLEIMAN: Mr. Dowling, before you settle in, if I could get you to raise your right hand.

Whereupon,

WILLIAM J. DOWLING

was called as a witness herein and, after being duly sworn, was examined and testified as follows:

CHAIRMAN GLEIMAN: Please be seated.

Counsel, whenever you're ready.

MR. HOLLIES: Thank you.

DIRECT EXAMINATION

BY MR. HOLLIES:

Q Mr. Dowling, my co-counsel has just handed to you a document styled rebuttal testimony of William J. Dowling on behalf of United States Postal Service and denominated USPS-RT-3. Was this document prepared by you or under your direction?

A Yes.

Q Were you to testify orally today, would your testimony be the same?

A Yes, it would.

MR. HOLLIES: The Postal Service moves for the admission of its testimony and its acceptance into the record, and I believe the norm would be also to transcribe it into the record.

CHAIRMAN GLEIMAN: Is there any objection?

[No response.]

CHAIRMAN GLEIMAN: Did you get those copies over there to the court reporter?

MR. HOLLIES: Yes.

CHAIRMAN GLEIMAN: That being the case, the testimony of Witness Dowling will be transcribed into the record and received into evidence.

[Rebuttal Testimony and Exhibits of William J. Dowling, USPS-RT-3, were received into evidence and transcribed into the record.]

USPS-RT-3

BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, DC 20268-0001

POSTAL RATE AND FEE CHANGES, 2000	Docket No. R2000-1

REBUTTAL TESTIMONY OF
WILLIAM J. DOWLING
ON BEHALF OF
UNITED STATES POSTAL SERVICE

CONTENTS

Rebuttal Testimony

of

William J. Dowling

AUTOBIOGRAPHICAL SKETCH

My name is William J. Dowling. I have been Vice President of Engineering since August 21, 1992. Previously, I served as the Assistant Postmaster General for Engineering and Technical Support, and before that I was Regional Director of Operations Support for the Postal Service's Northeast Region.

As the Vice President for Engineering, I oversee all engineering and development efforts focused on internal processes. I also direct all engineering and acquisition support functions, including the design and development of new automation, material handling systems, and vehicles

I joined the Postal Service as an industrial engineer in 1970 and later served in regional management positions in both maintenance and logistics. In 1980, I was appointed as District Director of Mail Processing in New York City, and later Senior Director of Operations.

Following a year as a Sloan Fellow at the Massachusetts Institute of Technology, in 1986, I was assigned to be Field Division General Manager/Postmaster of the Hartford, Connecticut Division. I assumed my role as Regional Director in 1988.

I hold a bachelor's degree from the Polytechnic Institute of Brooklyn and a master's degree in management from the Massachusetts Institute of Technology.

I. PURPOSE OF TESTIMONY

The purpose of this testimony is to respond to ANM witness Haldi regarding the Postal Service's investment in automation technology (ANM-T-1). Throughout his testimony, witness Haldi asserts that the Postal Service has: (1) chronically under-invested in flats processing capacity; and (2) undertaken inadequate research and development of flats processing technology. In both cases, he is wrong. This is not only incorrect when examining our activities in both of these areas throughout the 1990s, but also when reviewing our current and planned activities for the future.

II. INTRODUCTION

The Postal Service's ultimate objective for flats automation has been to bring it as far along as letter automation. In this regard, we require OCR's, Barcode Readers and sortation equipment that will ultimately allow delivery point sequencing. Contrary to witness Haldi's assertions, the Postal Service's record in pursing this goal has been one of responsibly seeking out and implementing improvements in flats processing technologies. We have traveled the world looking for solutions, literally to Switzerland, Germany, France, Japan, and Italy. In this search, we have actively engaged cutting edge firms in the mail processing equipment industry, as well as our own customers. We have undertaken extensive developmental efforts internally. Where feasible and appropriate, we have enlisted our suppliers to fund developmental efforts. Our suppliers have also initiated efforts on their own.

Witness Haldi's testimony and conclusions portray an overly simplistic picture of the significant obstacles facing us in these efforts. As discussed earlier in this docket in the testimony of Walter O'Tormey (USPS-T-42), variations in physical and readability characteristics of flats are greater than for letters, as are the variations in material handling characteristics. Consequently, the quest for full-blown flats automation has been more challenging. Dealing with these challenges, and pursuing our vision have required balancing the promise of new, emerging technologies against the need to continuously improve our processes and enhance efficiencies, while maintaining acceptable levels of service. I believe we have done that. We have worked at upgrading and expanding the capability of our existing equipment base, while testing and developing new technologically advanced alternatives.

In the early and mid 1990's, issues concerning flats automation were also clouded by the uncertainty of projected flats volume growth. The Standard A letter/flats rate differential introduced in 1991 initially reduced non-carrier route flats volume. It was unclear whether that trend would continue. It did not. The introduction of the Enhanced Carrier Route subclass in Standard A and drop ship incentives for Standard A and Periodicals attracted additional flats volume to destination SCF and delivery units, thereby bypassing flats distribution or bundle sorting operations. Because we were currently not delivery point sequencing flats, carrier route presorting and drop shipment combined to reduce the potential return on investment for flats sorting equipment and flats automation. Despite these rate incentives, moreover, non-carrier route flats volumes continued to grow. Rather than serve this growth by adding flats distribution capacity using outmoded technology, we elected to increase capacity using next-generation technology that is more than twice as fast, is more space efficient, and offers the potential to sort mail to even finer levels, including in the order in which it is delivered.

Looking back, It is certainly possible to hypothesize that we could have invested more in flats processing equipment during the 1990's. The advantage of hindsight no doubt gives rise to Witness Haldi's simplistic conclusions. During this time, however, we aggressively pursued enhancements designed to increase the capacity of existing machines. I believe the level of investment we made was reasonable and effective.

III. THE POSTAL SERVICE HAS CONTINUOUSLY INCREASED CAPACITY AND EXPANDED THE CAPABILITIES OF ITS FLATS HANDLING TECHNOLOGIES THROUGHOUT THE 1990s

A. Witness Haldi's Claim that the Postal Service Has Chronically Failed to Address FSM 881 Flats Sorting Capacity Needs During the 1990s Is Wrong.

The model 881 flats sorting machine is our present workhorse for sorting individual pieces of flats shaped mail. Today, we have just over 800 of these machines deployed nationwide. Witness Haldi is particularly critical of what he characterizes generally as a failure to invest in procuring more 881s, as well as other equipment. See Tr. 22/9632-34.

Witness Haldi appears to believe that the only logical way to increase model 881 processing capacity was to purchase additional machines. He seems to ignore the possibility that processing capacity can also be increased by enhancing the processing speed of an existing machine. This latter method has the advantage of being more cost and space efficient. Since the first purchase of these machines about 20 years ago, we have been continuously implementing improvements to enhance their capacity, performance, and capabilities.

These improvements included a significant configuration change in 1990. The original flats sorter model (FSM 775) consisted of four induction stations on one side of the machine. By relocating two of these induction stations to the opposite side of the machine, we effectively "split" the machine into two, improving its operating throughput, and thereby increasing its processing capacity. While the theoretical throughput of the machine increased substantially, our investment in this change was based on an expected increase in operational throughput of 13 percent.

In the early 1990s, we initiated automated processing on the FSM 881. We invested substantially in the latest barcode recognition technology to further improve throughput and productivity. Over 1600 barcode readers were installed on these machines (one for each side of the machine). The combination of these barcode readers, along with increased volumes of pre-barcoded flats generated by the incentives offered to flats mailers, enabled us to eliminate manual keying for these mailpieces. Investment in this latest automated technology was based on an expected increase in throughput of over 50 percent.

The FSM 881 barcode reading automation effort at first relied on customer barcoding. Early on in this program, it became apparent that the volume of customer-barcoded mail pieces was falling short of expectations. Recognizing the advantages of automating the non-barcoded portion of this mail led to the pursuit of a flats mail optical character reader (OCR). In 1997, the Postal Service invested in OCR retrofits to the FSM 881. This investment was based on an expected increase in machine throughput of 50 percent or more.

The above three major improvements to the FSM 881 during the 1990s reflect the Postal Service's ongoing efforts and commitment to increase processing capacity and lower processing costs for flats mail. There were various other enhancements to the machine during the 1990s, including modifications that allowed the machines to handle flimsy pieces and pieces with smaller dimensions, including "digest-sized" pieces. Also, by working with mailers and plastics producers, we developed FSM 881-compatible polywrap specifications, which further expanded the mail that could be handled by the machine.

B. The Postal Service Has Appropriately Addressed Flats Processing Capacity Needs Via the FSM 1000

Witness Haldi contends that, in addition to, or instead of acquiring more FSM 881s, the Postal Service should have acquired more FSM 1000s, a model of flats sorter that is capable of handling flats with physical characteristics considered "non-machineable" for FSM 881s. See Tr. 22/9633. Contrary to Witness Haldi's suggestion that we have underutilized this technology, however, we employed it effectively, as it was developed and became available for use. In my opinion, furthermore, the Postal Service acted reasonably and responsibly under the circumstances in maintaining an appropriate balance of FSM 881s and FSM 1000s.

One significant limitation of the model 881 is its inability to handle about one-fourth of the flats mail base due to the physical characteristics of flats. In the summer of 1992, the Postal Service began testing the FSM 1000, which was designed to handle these difficult-to-handle, "non-machineable" flats mail pieces. Success of these tests led to the initial purchase of 102 FSM 1000s in 1994. Subsequent analysis supported the need to increase FSM 1000 flats sorting capacity, and, in 1996, 240 additional machines were purchased.

Initially the FSM 1000s were operator-paced mechanical sorters. We have subsequently developed, invested in, and deployed barcode reading capability to these machines. Moreover, at this time, we have just developed and tested both automatic feeders and OCR upgrades. We expect to begin deploying these enhancements late next year.

C. AFSM 100s Will Enhance Current and Future Processing Capacity Needs

Perhaps the most significant recent development in flats sorting equipment is our recent purchase of new AFSM 100 machines that we will be deploying during the next two years. Witness Haldi suggests that the Postal Service has touted the promise of this equipment in order to mollify criticism or excuse the effects of the alleged failure to invest adequately in flats sorting equipment during the last decade. See Tr. 22/9648. Contrary to this suggestion, however, the AFSM 100 did not recently arrive on the scene to save us from unwanted criticism. Rather, we promoted the development of this technology during a substantial part of the same period time on which Witness Haldi has focused his criticism.

Our involvement with this new technology dates back to the mid-1990s. We actually purchased two different European designed machines, and placed them in two of our processing plants to see if they could process our significantly more difficult-to-handle flats mail base. At the same time, we also discovered two other machines that looked to be suitable for our mail processing needs. After extensive testing, we were able to select the best of these machines and incorporate various design changes, making them the most advanced flats sorting machines in the world, and best suited for our mail base. The AFSM 100 offers several features not available on the FSM 881, including an automatic feeder, a tray take-away conveyor with adaptability to robotic handling, and on-line video coding for processing non-readable flats mail. Expected operational throughput is more than double that of our existing FSM 881s, which these machines will be replacing.

D. The Postal Service Has Responsibly Pursued Investment in Other Technologies to Address Flats-Related Processing Costs

Witness Haldi's criticisms ignore other measures we have pursued and are pursuing to improve the effectiveness and efficiency of flats processing. As noted above, our goal for flats is to build upon our letter automation successes and eventually move to delivery point sequencing. While the AFSM 100 represents the first technology deployed with the potential also to sequence flats, we have several other alternatives under development and review. In the coming months, we will begin field-testing three different designs of a flats bundle collator. These machines are designed to merge multiple bundles of walk-sequenced mailings into a single bundle to enhance carrier handling of this mail. There are also efforts underway to develop a new machine that could prove to be a viable candidate for sequencing flats mail.

Furthermore, our efforts to develop and invest in flats processing equipment have not been limited to piece distribution machines. During the last 10 years, we have purchased 340 small parcel and bundle sorters (SPBSs). Currently bundles of flats mail make up about 60 percent of the mail handled. Flats will therefore benefit from productivity gains generated by these machines. We have also recently upgraded these machines with advanced automatic feed systems, further enhancing their performance. Later this year, we plan to begin testing a new generation of bundle sorters, which will include automatic singulation and feeding, OCR and on-line video encoding, and greater sorting capabilities. Overall expectations are that these machines will provide the kind of performance improvement over our existing SPBSs that we have seen from the AFSM 100 and its FSM 881 baseline machine.

IV. THE POSTAL SERVICE AND ITS SUPPLIERS HAVE CONTINUOUSLY UNDERTAKEN RESEARCH AND DEVELOPMENT OF ADVANCED FLATS-BASED PROCESSING TECHNOLOGIES

Witness Haldi claims throughout his testimony that the Postal Service's research and development efforts have been deficient. See Tr. 22/9637-38. He suggests that this deficiency has been particularly acute for flats-related processing technologies. His criticisms, however, substantially distort the Postal Service's accomplishments and efforts in research and development.

While I would agree that technological advancements in processing flats have lagged behind letter automation, it is not been due to a lack of commitment. Throughout the 1990s and today, both the Postal Service and its suppliers have been, and are continuing to aggressively develop new flats processing technologies. Indeed, the flats-related technological improvements that we have been implementing during the last decade (discussed above) are the outcomes of significant research and development efforts.

I believe it is commonly understood that, in general, technology development has risks, and that not all research activities lead to viable alternatives. This is also true of postal technologies. While we seek to avoid failures in this area, we, along with our suppliers, have continuously invested in various flats processing developmental efforts.

There have been various developmental efforts during the 1990s specifically addressing the limitations of the FSM 881. In the early 1990s, an advanced flats sorting machine that included multiple automatic feeders along with automatic tray removal and replenishment was prototyped and field-tested. Unfortunately, the size, performance, and costs of this new machine failed to justify further developmental efforts. Automatic feeders for the FSM 881 were also developed and tested in the 1990s. While they were somewhat successful, analysis showed that the expected benefits were insufficient to justify the investment required, particularly given the prospects of newer advanced technologies under development. In spite of these shortfalls, both of these developmental efforts contained design features that were being incorporated into newer advanced flats sorting equipment under development around the world.

IV. SUMMARY

In summary, witness Haldi's claims that the Postal Service has chronically constrained its investment in flats sorting technology, ignored and failed to address capacity needs, and limited its research efforts in flats processing technologies are without merit. To the contrary, we have continuously sponsored and sought out the best flats sorting technology available in the world. We have done this responsibly, however, by only investing when the economics of such decisions made sense, given all available information. In fact, I would argue that the biggest constraint in our capital investments in flats handling technologies has been the shortage of available viable technological opportunities.

During the last 10 years, the Board of Governors, along with senior postal management, have strongly supported virtually all technological improvements available for our flats mailers. Since my appointment as head of Engineering in 1991, I have presented more than a dozen flats-related capital projects to senior management for funding approval. Every one of them has been approved. During the 1990s, we have taken the necessary steps to more fully automate and increase capacity of our FSM 881s by adding both barcode reading and optical character reading capabilities. We have added new FSM 1000s and enhanced them with barcode reading capabilities; and we have invested substantially in flats bundle handling technologies. In my view, we have responsibly pursued flats processing technologies in the past, and are even more committed to that goal in the future.

CHAIRMAN GLEIMAN: One party has requested oral -- well, wait a minute. Only one party still wishes to cross-examine this witness: the Alliance of Nonprofit Mailers. Is there any party of which I'm not aware who wishes to cross?

[No response.]

CHAIRMAN GLEIMAN: If not, then, Mr. Levy, you may proceed.

MR. LEVY: Thank you, Mr. Chairman.

CROSS-EXAMINATION

BY MR. LEVY:

Q Good afternoon, Mr. Dowling.

A Good afternoon.

Q David Levy for the Alliance of Nonprofit Mailers, and I want to start by expressing my appreciation for your agreement to change your date of appearance.

I'd like to start out with page 5 of your testimony.

A Yes.

Q On lines 12 to 14 appear the statement: "The above three major improvements to the FSM-881 during the 1990s reflect the Postal Service's ongoing efforts and commitment to increase processing capacity and lower processing costs for flats mail." Now, that sentence is referring to the 1990s; is that correct?

A That is correct.

Q Now, in fact, in the 1990s, the unit costs for processing flats mail rose from 1993 through 1998, did they not?

A I don't have that data. I didn't review that data in preparing this testimony, sir.

Q So, you don't know --

A I did not review that data in preparing this testimony, so I could not answer this question.

Q And you don't have any other knowledge as to the direction of the unit costs of processing flats during the 1990s?

A I would be hesitant to quote data concerning that, sir.

Q Fine; if you would turn to page 6 of your testimony. Now, on lines 19 through 21, you're talking about the most significant recent development in flat sorting equipment is the recent purchase of new AFSM-100 machines. Do you see that?

A Yes, sir.

Q Now, this deployment of the AFSM-100 machines will occur during what two-year period?

A It began in the spring of this year. I believe we deployed the first one in March, and we will complete in April of 2002.

Q So the deployment will not be completed by the end of the test year; is that correct?
A I believe that's correct.
Q And that deployment did not begin before the end of the base year; is that correct?
A I believe that is correct.
Q So it would not have any effect on base year costs.
A That is correct.
Q Do you have any sense of what effect it will have on test year costs, order of magnitude?
A It will lower our distribution costs. I'm not sure how many will all be -- will be deployed during the test year. I mean, I can make an estimate if -- I guess we'll have 300 to 400 of the machines deployed during the test year. And the distribution costs associated -- distribution costs will go down.
Q And the distribution costs would have gone down even further if the equipment had been deployed prior to the beginning of the test year, correct?
A Yes.
Q Now, would you turn to page 3 of your testimony? On lines 21 and 22, you make the statement: "looking back, it is certainly possible to hypothesize that we could have invested more in flats processing equipment during the

1990s.

A Yes.

Q Do you see that?

A Yes.

Q And then, in the next sentence, you characterize the conclusions of ANM witness Haldi as simplistic; do you see that?

A Yes.

Q Do you know how much more the Postal Service would have invested in flats equipment processing, flats processing equipment during the 1990s if it had carried out its own capital investment plans?

A I can't quote a number on that. I'd have to go back and examine data.

Q Prior to preparing your testimony here -- let me back up. The purpose of your testimony here is in large part to rebut the testimony of Alliance witness Haldi on the level of capital investment; is that correct?

A The level of capital investment concerning flats; that is correct.

Q Yes; and I assume prior to preparing your testimony, you read his testimony.

A Yes, I did.

MR. LEVY: Just for the convenience, I'm going to mark as ANM/USPS RT-3 Cross-Examination Exhibit No. 1 a page from Dr. Haldi's testimony which is already in the record.

[Witness examines document.]

BY MR. LEVY:

Q Let me identify this first. I will represent that this is page 47 of the Dr. Haldi's testimony for the Alliance/ANM-T-1 and that it was recorded in the transcript at page 9659. Do you recognize this page, Mr. Dowling?

A Yes.

Q I want to direct your attention to column four, shortfall plan versus actual. Do you understand what those numbers purport to represent?

A Yes.

Q And they purport to represent the difference between the amount that the Postal Service committed to invest in capital for mail processing equipment versus what it actually incurred; is that correct?

A Yes, all mail processing equipment, not just flat equipment.

Q And that was my next question: of these numbers order of magnitude, how much of the shortfall was for flats processing the equipment?

A I would think less than 10 percent. I think the predominant portion of the shortfalls were deferral in the letter automation program and deferrals in material handling spending.

Q So approximately $500 million, again, just order of magnitude was a shortfall for flats processing the equipment.

A That is correct.

Q Would you turn to page 3 of your testimony at lines 6 through 8? There, you make the statement that -- there, you referred to a drop in flats volume beginning in 1991. Do you see that?

A Yes.

Q Did non-carrier route flats volume fall in the next year, from 1992 versus 1991?

A Non-carrier route volume fell and then rose again.

Q When did it rise again?

A I don't have that data in front of me.

Q Wasn't the drop in volume just a one-year drop?

A Yes, but we didn't know it would be a one-year drop.

Q The decline in spending, capital in spending, lasted from 1992 through 1995, didn't it?

A There was a reduction in capital spending from Nineteen Ninety -- yes, that's true, 1992 through 1995.

Q What years was Mr. Runyon Postmaster General?

A I believe it was 1992 through 1996, 1997.

Q Did he have any role in the decision to cut back on the committed capital investment for mail processing equipment during the years 1992 to 1995?

A Mr. Runyon was requested by the Board to re-examine the basis of the letter automation program and revalidate that program before proceeding, which he did. We also received favorable pricing on a good deal of our mail automation program, which resulted in some of the shortfall.

Q How much?

A Oh, in excess of 10 percent.

Q Wasn't the shortfall in the capital expenditure program for mail processing equipment during the 1992 to 1995 period due in large part to a shake-up or reshuffling of top management at headquarters during that period?

A No, I don't think so.

Q Not at all?

A I think in 1992, there was an impact. I don't think there was a substantial impact in 1993 and 194.

Q Were you at headquarters during those years?

A Yes.

Q Have you read the testimony of Postal Service witness Tayman in this case?

A No.

MR. LEVY: May I approach the witness? I'm going to refer to something which is already in the transcript.

THE WITNESS: Thank you.

BY MR. LEVY:

Q I will read this -- it's short -- rather than putting it in the transcript.

For the record, this is from page 201 of the transcript, and it's Mr. Tayman's response to ANM/USPS-T9-49. I'm going to read the answer to part question A and then have a question for the witness.

"In fiscal year 1992, the Postal Service had aggressive mail processing equipment capital plans. As a result of the organizational restructuring in fiscal year 1992, the Postal Service decided to re-evaluate all of its automation plans, including mail processing equipment. The re-evaluation of the capital decisions was delayed until the new management team and the new organizational structure was in place."

Did I read that correctly?

A You read it correctly, and there was discussion during that period. It revolved around a letter automation program and specifically the remote barcoding portion of the letter automation program.

Q Would you read the answer to part B?

A "During the time period from FY 1993 through 1994, the organizational changes and new management team discussed in part a continued impact on the Postal Service's capital program."

Q Thank you.

Would you turn to page 3 of your testimony, line 12? In those lines, there is a sentence which reads: "Because we were currently not delivery-point sequencing flats, carrier route presorting and drop shipment combined to reduce the potential return on investment for flat sorting equipment and flats automation." I want to direct your attention to the phrase reduce the potential return on investment.

A Right.

Q To what level was the potential return on investment reduced?

A It would cut the volume that we could put on the machines in half, so in that sense, it would cut the potential in half.

Q What did you mean by the phrase return on investment in that sentence? Did you mean it in the financial accounting, the corporate finance sense?

A Yes.

Q To what percentage return on investment did you believe that these trends reduced?

A It wouldn't reduce the return on investment on a machine that we bought for volume that was going to travel through the network, but if that volume was not going to be available to the network, there would be no return on a machine that could not run mail. If it was simply going to be dropped at the carrier for delivery, there was no opportunity to put that on a machine, and therefore, there would be no return.

Q So it's your testimony -- so what you really mean by the sentence is not that -- what you really mean by the sentence -- and correct me if I'm wrong -- is that this trend reduced the number of locations where you could make an investment that would cover your hurdle rate.

A Yes; that would be a fair statement. The opportunity to put more mail onto flat-sorting machines was reduced substantially by our rate structures, which encouraged carrier rate sortation for flats.

Q Now, the Postal Service has never -- let me back up. Prior to buying large increments of flat sorting machines or machinery, the Postal Service generally commissions some sort of study of the expected return on the investment; isn't that correct?

A Yes, that is correct.

Q And that's often called a DAR or decision analysis report.

A Yes.

Q During the 1990s, the Postal Service did not perform any analysis of the -- formal analysis of that kind of the potential return on additional equipment beyond what the Postal Service actually purchased for flat sorting;

isn't that correct?

A A DAR is produced when we make a decision that we want to make a change in our equipment, either additional equipment or a modification to that equipment which would increase its productivity, throughput, et cetera. During -- continuously during this period, we conducted analyses and presented DARs to our Board which procured in the midnineties additional equipment in the early part of the 1990s, modifications to the 881 machine which increased throughput; effectively increased capacity.

Q Now, perhaps my question wasn't clear.

A Okay.

Q Suppose that in a given period, you bought 100 copies of a particular kind of flat sorting machine. The DAR would explain why you thought that buying 100 rather than buying zero made economic sense.

A That is correct.

Q But the Postal Service never did any comparable analysis to see whether buying 150 or 200 would make economic sense.

A Well, when we do the DAR, we do look at available data and make a determination as to how many machines make economic sense.

Q There was nothing in the DAR, is there, which examines the potential return of buying an extra increment of investment beyond what was actually made; isn't that correct?

A Well, the DAR looks at a bundle of machines, some of which have extraordinarily high returns and some of which don't have returns which do not meet the hurdle rate. The stated return on investment in the DAR is the average return on investment, not the return on the last machine we buy.

Q But the Postal Service has never performed an incremental analysis of the incremental returns on buying more equipment than you actually bought; isn't that correct?

A I think that's what a DAR is.

Q So if we look -- if we looked at someplace in the DAR, we could find a place where it says if you had bought 100 plus X machines instead of buying 100 machines, this would be the incremental costs, and this would be the incremental return?

A When we present a DAR to the Board of Governors, we represent to the Board of Governors that we have on a site-specific basis generally looked at the return on investment and included all opportunities which will exceed the hurdle rate and in fact, sometimes, include opportunities which just exceed cost of capital.

Q Let me try this again. There's nothing in the DARs which has a kind of incremental return analysis of buying more machines than --

A Why would I buy machines that don't cover the cost of capital? Do I want to buy machines that have negative returns?

Q I'll repeat the question. There's nothing in the DAR which contains any analysis of the returns on any incremental quantity of machinery beyond which you are seeking authority to purchase; isn't that right?

A Our DAR considers all opportunities for that equipment on an incremental basis.

MR. LEVY: Mr. Chairman, I'd like to have the witness directed to answer the question.

CHAIRMAN GLEIMAN: Would you restate your question again, please?

MR. LEVY: Yes.

BY MR. LEVY:

Q There was nothing in any of the DARs for the flat sorting equipment which contains an incremental return analysis of the expected return on any additional quantities of equipment beyond that for which you were seeking authority to acquire.

A The DAR does not show the returns that would be achieved for machines we are not seeking to acquire.

CHAIRMAN GLEIMAN: Mr. Dowling, I'm not quite sure that's the question that was asked, unless you're implying that you weren't planning to buy flat sorters, if I understand the question. I think you are being asked about whether there was information in the DAR involving the incremental savings.

If I'm mischaracterizing it, speak up, but you want the witness to answer the question, and -- did you get an answer that you're happy with.

MR. LEVY: I thought I did until you asked the question, and now, I'm not sure I have.

[Laughter.]

CHAIRMAN GLEIMAN: I've confused it.

MR. LEVY: Well, I'm sorry about that. In that case -- if you're confused, then, the record is going to be confused, and let me take another stab at it.

BY MR. LEVY:

Q Let's start off. When I'm talking about an incremental analysis, I'm talking about an additional increment of machines beyond the amount that you were seeking permission to acquire.

A Okay.

Q Are we agreed on that in terms of definition for the question?

A Okay; right.

Q Okay; none of the DARs for the flat sorting machines acquired by the Postal Service in the 1990s contained a hurdle rate analysis or a profitability analysis or a return on investment analysis for any increment of equipment beyond the increment for which you were seeking permission to acquire; is that correct?

A Yes.

CHAIRMAN GLEIMAN: Now, I understand, and you have an answer to your question.

BY MR. LEVY:

Q And if -- I'll go back. Would you turn to line 16 of page 3? I'm going to read a sentence. "Rather than serve this growth by adding flat distribution capacity using outmoded technology, we elected to increase capacity using next generation technology that has more than twice as fast; is more space efficient and offers the potential to sort mail to even finer levels, including in the order in which it is delivered.

I want to focus on the word outmoded. By outmoded technology, are you referring to the FSM 775, 881 and 1000 series?

A I'm specifically referring to the 881.

Q And by the more up-to-date technology referred to in the last half of the sentence, you're referring to the AFSM 100s?

A That is correct.

Q Now, the Postal Service first deployed the FSM 775 around 1982; is that correct?

A Yes.

Q And it began converting the FSM 775s to FSM 881s around 1990; is that correct?

A That is correct.

Q And how many 775s were converted to 881s beginning in 1990?

A If you're referring to that specific year, I don't know. We converted all of them to 881s.

Q What's the approximate total number?

A It's a little over 800 of them?

Q And roughly how much did the conversion cost?

A I'd have to go back and examine my records.

Q Order of magnitude is fine.

A It's a couple of hundred million dollars.

Q And this expenditure was commenced in 1990 or so.

A Yes.

Q As converted, was the FSM 881 outmoded in 1990?

A The reason the FSM 881 or 775 is outmoded is that the design was initially designed to handle an envelope, and we had a great deal of pressure from our mailers, specifically from our publishers and newspapers, to handle product that wasn't in an envelope and that had plastic wrap on it and that was digest-sized, and there was newspapers. And the 881 is not designed for that, and we've kind of force-fit it into that mode. And we did that with a number of modifications to the machine during the 1990s and then replaced it -- not replaced it but supplemented it with the FSM 1000.

Q So the ~~Postal Rate Commission~~ Postal Service beginning in 1990 spent roughly $200 million on upgrading something that was outmoded?

A It was outmoded, but it was the only machine available at the time despite the pressure on engineering to find additional machines, and by the modifications we put on it enabled us to increase its throughput by about 13 percent and changed the control system out so that we could add barcode recognition and subsequently optical character recognition, all of which were good things to do and made economic sense but didn't change the basic character flaw of the machine: that it was initially designed and ran best enclosed envelope flats.

Q So even though it was outmoded, it was a worthwhile investment.

A Yes, it was a worthwhile investment; that's true.

Q And the Postal Service would not have been better off if it had foregone the investment.

A No, it would not.

Q Conversely, if there were additional opportunities for using the upgraded 881s in 1990, the Postal Service would have been better off if it had made the investment.

A Had we known the direction of flats in 1990 with better vision than we did, considering the shape-based rates and considering the rates that encouraged mailers to drop ship all the way to the carrier level, it may have been in our interest to add capacity at that time. We chose to defer it by increasing the capacity of the machine through the 881 modification and in 1992 bought the first FSM 1000 prototype and began the efforts to start deploying that machine. And I think we started deploying that machine in 1994 and 1995.

Q In 1994 and 1995, was the FSM 1000 outmoded?

A The FSM 1000 is still not outmoded in the sense that it is the best machine to handle a newspaper or a very flimsy or very thick piece of mail. Things that we call nonmachinable can be machined by an FSM 1000, and in that sense, it's still not outmoded. But it did not achieve throughput -- substantial throughput improvement or productivity improvement over the 881, and so, we sought to find a newer machine that would do that, and in the midnineties, 1994 and 1995, we signed a contract to bring over a machine from France and began testing that. That ultimately became the AFSM 100.

Q Now, in 1997, the Postal Service added optical character readers to its FSM 881s.

A That is correct.

Q Now, I assume you're going to tell me that that upgrading investment was on equipment that was immediately outmoded.

A It was outmoded before we started in terms of the product it could handle.

Q And it was outmoded after you finished.

A In terms of the product we could handle, but we knew that it would not take a very long window to pay off an OCR on that machine.

Q And again, with that particular upgrade, there was no cost-benefit analysis performed in any DAR of whether a larger amount of equipment should have been upgraded.

A We upgraded all of the available equipment.

Q There was no cost-benefit analysis of the costs and benefits of buying some additional 881s, new ones equipped with OCRs?

A We can -- we did not do a cost-benefit analysis. We considered at that point whether or not it would make sense to go back and buy additional 881s and concluded that it would not, given that in the midnineties, we knew that the FSM 1000 would begin deployment, and some of those were dedicated to the shortfall in capacity that had become apparent in 881s and with the belief that machines that we were beginning to see in laboratories would become available for production in the late nineties.

Q Now, in deciding at any point what's an optimal amount of money to invest in technology, you have to consider the -- not only the cost of the equipment and its carrying cost but also the labor costs that are thereby avoided. Is that what --

A Yes, yes, that is correct.

Q And that would entail -- were you at any point in the 1990s alerted, you personally alerted to the phenomenon of rising unit costs of processing flats for labor?

A Yes; I was generally aware that we were having rising costs of processing flats.

Q Did you or anyone under you or anyone at your direction in the late 1990s perform any kind of study whether you might save money as an interim measure by buying more 881s and avoiding some labor costs?

A In the late 1990s?

Q In the mid to late 1990s.

A In the mid to late 1990s. We discussed and looked at the issue of capacity. We concluded in the mid 1990s that we did need additional capacity. We chose to respond to that capacity by adding additional FSM 1000s rather than 881s, because FSM 1000s had roughly equivalent throughputs and productivities but could handle a wider mail base than an 881. There was -- I have never -- this is -- I find it -- nobody ever asked me to buy another 881 that I could recall. Certainly, no mailer ever asked me to buy another 881, but they were asking me to meet with equipment manufacturers from the publishing and newspaper industries to find machines that would handle a broader range of mail.

Q In the mid or late 1990s, did anyone at the Postal Service undertake any cost-benefit analysis to see whether buying even more FSM 1000s might be justified by the savings and labor costs?

A The DAR that purchased the second buy of FSM 1000s considered shortfall and capacity on a site-by-site basis using all data that we had available in the Postal Service; discussing that data with our field organizations; and doing economic analyses on those machines down to the point where we were buying FSM 1000s at below the hurdle rate. So while the DAR may not have a specific section that says there was an incremental analysis done, the incremental analysis is done by my staff.

Q Was that incremental analysis ever reduced to writing?

A It may be in the files in the organization.

MR. LEVY: Mr. Chairman, I would request that. We filed multiple discovery requests during the discovery phase requesting this kind of cost-benefit analysis, and we were told nothing existed except the DARs that were produced, and they did not have this kind of down to the below the hurdle rate cost-benefit analysis.

CHAIRMAN GLEIMAN: Yes?

MR. LEVY: So I request that -- if the Postal Service -- that the Postal Service produce it if it is -- the witness and his subordinates can find it. Without checking, I'm quite certain that that is responsive to a discovery request or several discovery requests we've filed.

CHAIRMAN GLEIMAN: Mr. Hollies?

MR. HOLLIES: It might assist us if we were to know more specifically which you had in mind. On the other hand, it sounds as though we've already searched for those things, assuming those previous interrogatories are on the same terms as what you're asking for today, in which case a further search is not likely to be fruitful.

The answer provided by Mr. Dowling was to the effect that we may have such a thing, and it's not clear to me whether he knows exactly what steps have already been taken by other officials to locate other materials that might exist.

MR. LEVY: Mr. Chairman, I've often represented large organizations in defending against discovery, and I have found that often, if two or three requests don't turn something up, sometimes, a fourth or fifth does when it's phrased a little differently, and that's without any deliberate intent to hide material on anyone's part.

CHAIRMAN GLEIMAN: Mr. Hollies, you're absolutely correct in that the witness may not know all of the efforts that have been made. On the other hand, because he indicates that there may be something there, perhaps you should consult with your witness, and if the witness feels that after being informed of the extraordinary efforts that have been made by the Postal Service that perhaps something still may be around, I would respectfully request that you entertain his views on which other file cabinets one might look in or computers or what have you and please get back to us by the 6th and let us know whether anything turned up.

Mr. Levy?

MR. LEVY: Thank you.

CHAIRMAN GLEIMAN: Is that satisfactory?

MR. LEVY: That's all I can ask for.

MR. HOLLIES: Could we nonetheless ask for identification of the interrogatories informally at a later point in time?

MR. LEVY: Sure.

BY MR. LEVY:

Q Two more lines of questioning. Mr. Dowling, you mentioned a French machine.

A Yes.

Q And that brings me to page 6 of your testimony at the bottom and carrying over to the top of page 7.

A Yes.

Q There, you indicate that you checked out four different machines, two European --

A Yes.

Q -- and two others. Could you identify the models of those four machines?

A I could identify the manufacturers is the best way to identify them. The machine developed by a company in France called Alcatel ended up winning the competition, and that became the AFSM 100. We tested a machine presented by the Siemens Company, and that was designed in Germany for manufacture in the United States. We tested a machine from an Italian company named Elsag Bailey.

Q Could you spell that?

A E-L-S-A-G capital B-A-I-L-E-Y, which is an Italian company. And we tested a machine that was produced by a consortium of IBM and Mueller Martini. Mueller Martini is a Swiss firm.

Q Could you spell the IBM's partner?

A I'll try: M-U-E-L-L-E-R capital M-A-R-T-I-N-I.

Q That must be Swiss.

A That is Swiss, and they are a supplier to the bindery and printing industry as well.

Q In what years were you offered these models to test?

A I think they were first offered to us -- well, let me back up. I first saw the first one in a lab in 1992. I believe we began negotiations for a contract on bringing a prototype over in 1994. It could have been 1995.

Q Do you know whether any of these four machines are currently deployed?

A Yes.

Q In any other Postal Authority?

A Yes. Yes. Yes, they are.

Q For sorting flats?

A Yes.

Q Any major countries?

A The Siemens machine is deployed in Germany and the same machine we bought is deployed in Canada.

Q And what about the Elsag Bailey machine?

A It is deployed in Italy and I think Spain and Korea.

Q And the IBM Mueller Martini machine?

A I believe that is only deployed in Switzerland, and I think there is only one copy, perhaps two.

Q When did Canada deploy the Alcatel machine?

A They deployed them about the same time that we bought a prototype machine.

Q Which was around '94?

A I believe that is right. They had substantial problems with them.

Q And how long did they take to fix the problems?

A Several years.

Q The Siemens machine, when was that deployed in Germany?

A That was deployed about the time that we were -- just as we were making the test, I believe, in 1997, '98, it was deployed in Germany.

Q And the Elsag Bailey machine?

A I am not sure of the dates of deployment on that.

Q And the IBM machine, you said that there was only one copy?

A Right.

Q One other line, on page 8 and 9 of your testimony, you are talking about the Postal Service's research and development efforts being aggressive and so forth.

A I'm sorry, page?

Q Page 8 and 9.

A Excuse me. All right.

Q Section Roman IV.

A Yes.

Q In the last 10 years, how much has the Postal Service spent on research and development on flat sorting machinery?

A We have spent in excess of $10 million, and in

1992 we made a decision that we wanted our suppliers to invest more in development than we did, and they have also made substantial investments in development.

Q Roughly, how much money, how much revenue has the Postal Service taken in from flats during the same period? Postage.

A In a 10 year period? I'm sorry, I don't know.

Q Any one year?

A I want to guess $15 billion.

Q So your R&D investments is less than one-tenth of 1 percent of your revenue from this product line?

A Our R&D investment is low, it is essentially shared investment with our suppliers. We believe that we get product faster by incenting suppliers to invest and bring us equipment.

Q But the fact is the Postal Service has put this equipment on line at least a couple of years slower than both Germany and Canada, isn't that right?

A Yeah, ours worked.

Q Does their work?

A Barely. It does not, it did not when they deployed. Both countries slowed up their deployment because of performance problems.

Q Do you have any idea what percentage of Alcatel or Siemens revenue is spent on R&D for flat sorting equipment?

A No, I don't.

MR. LEVY: Thank you. That is all I have, Mr. Dowling.

Thank you, Mr. Chairman.

CHAIRMAN GLEIMAN: Is there any follow-up?

[No response.]

CHAIRMAN GLEIMAN: Questions from the bench?

[No response.]

CHAIRMAN GLEIMAN: I have a couple, Mr. Dowling. Total factor productivity during the last decade has average about two-tenths of a percent annually. Those gains came primarily as a result of a hiring freeze in 1990, which resulted in plus 3 percent in restructuring in '93, which resulted in a plus 3.8 percent. Without those two events, TFP during the period may have been negative.

Now, firms normally experience TFP growth because of application of new technology and more modern equipment to their operations, and I was wondering if you could describe the Service's goal for TFP during the previous decade and whether you feel it has been met.

THE WITNESS: Well, I know that the Postal Service had more aggressive goals for TFP than we achieved, that is certainly true. And so I guess my answer is I don't think we have met our goal in terms of achievement in TFP during the decade.

CHAIRMAN GLEIMAN: Interestingly, during the past four quarters, there has been a significant increase in total factor productivity growth. Can you explain what suddenly happened to turn things around? Was it the result of equipment deployment?

THE WITNESS: Equipment deployment only enables management to increase productivity and TFP. So, to the extent that the equipment was deployed and available to do that, management improved the total factor productivity. But the equipment itself only enables management.

CHAIRMAN GLEIMAN: Has your department generally been given some responsibilities to develop programs that allow the Service to meet specific TFP targets or goals?

THE WITNESS: I think the answer to that is yes, except it is not expressed to us in terms of a TFP goal. It is expressed to us in terms of producing a budgeted level of capital that will exceed the hurdle rate.

CHAIRMAN GLEIMAN: I'm sorry, the --

THE WITNESS: Exceed the hurdle rate.

CHAIRMAN GLEIMAN: A specific ROI?

THE WITNESS: Yeah. Well, you know, bring in a portfolio of investments in technology that will exceed 20 percent.

CHAIRMAN GLEIMAN: Thank you.

Any follow-up as a result of questions from the bench?

[No response.]

CHAIRMAN GLEIMAN: If not, then that brings us to the point where you may to get together with your witness to prepare for redirect, Mr. Hollies.

MR. HOLLIES: I would like a couple of minutes, but maybe we ought to just sit tight, unless you are ready for a break.

CHAIRMAN GLEIMAN: I actually think that I am ready for a break. I don't know about anybody else, but I would like to take 10 right about now.

[Recess.]

CHAIRMAN GLEIMAN: Yes, sir.

MR. HOLLIES: I do have one area of inquiry.

REDIRECT EXAMINATION

BY MR. HOLLIES:

Q In developing a DAR, do you consider the marginal benefit of each machine?

A Yes, we do. Generally when we develop DARs the first time we buy a piece a equipment we will buy a limited number of them, as in the FSM 1000 -- I think we bought 100 or 102 in the first one. We knew the benefit associated with every one of those. In the second DAR we did an incremental analysis of every opportunity in the country and we bought machines down to below the hurdle rate in order to assure that we had taken every opportunity to utilize that equipment.

Q How do you decide when the last one is enough?

A Well, we certainly don't want to go below cost and capital and we do want to leave ourselves some small benefit for risk, some small cushion if you will for risk, but we certainly would go below 20 percent on the last one.

MR. HOLLIES: Thank you.

CHAIRMAN GLEIMAN: Recross?

MR. LEVY: Yes, Mr. Chairman.

RECROSS EXAMINATION

BY MR. LEVY:

Q Same line, sir. The second DAR you were referring to, was that for the FSM-1000s?

A Yes.

Q You didn't perform a similar analysis down below the hurdle rate for the FSM-~~381s~~ 881s or their retrofits?

A There were two, I believe there were two buys of the 881. I was not in this job at that time. That was back in very early '90s or late '80s.

I would assume that they did do that kind of analysis for the second DAR but I didn't do it myself.

Q You don't personally know whether in fact it was done?

A I don't have personal knowledge, because I wasn't there.

Q Now during this period the hurdle rate was 20 percent?

A The hurdle rate was changed to 20 percent some time in the mid '90s. It was changed by the Board and before that it was in the high teens.

I believe it was 12 percent.

MR. LEVY: That's all I have, Mr. Chairman, and I would ask that the Cross Examination Exhibit Number 1 be transcribed into the record. It is already in evidence in its original location.

CHAIRMAN GLEIMAN: Did you hand two copies to the reporter?

MR. LEVY: I believe I did.

CHAIRMAN GLEIMAN: If you did, then it will be transcribed into the record, and if you didn't, it will be if you give him two copies.

Mr. Reporter, do you have two copies of the ANM Cross Examination Exhibit?

THE REPORTER: Yes.

CHAIRMAN GLEIMAN: Thank you, sir.

If there is nothing further, then Mr. Dowling, we want to thank you. We appreciate your appearance and your contributions to the record, and you are excused.

THE WITNESS: Thank you.

[Witness excused.]

CHAIRMAN GLEIMAN: And we are glad we don't have to ask you to come back tomorrow -- even gladder than you are.

Now let's see if we can pull the same thing off with the rest of the witnesses that we have for today.

Our next witness is your witness, Mr. McKeever. It is Mr. Neels, the first of Mr. Neels' two appearances today and while you all are settling in, this appears to be a convenient to enter designated written responses into the evidentiary record.

Material was put out for counsel's perusal before the lunch break. Are there any changes that anyone wishes to make note of at this point?

[No response.]

CHAIRMAN GLEIMAN: If not, I believe the reporter has been provided with two copies of that material and I will direct that it be received into evidence and transcribed into the record and if there is a problem with any of that material, please let me know and we will make appropriate changes as may be required.

[Collection of Designated Written Responses were received into evidence and transcribed into the record.]