UNITED STATES OF AMERICA
POSTAL RATE COMMISSION

Before:

Vice Chairman Omas,
Commissioners Covington, Goldway, and LeBlanc

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

OPINION

AND

FURTHER RECOMMENDED DECISION

Washington, DC 20268-0001
February 9, 2001

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I. INTRODUCTION

[1001] The Postal Service Governors have allowed the rates recommended by the Commission on November 13, 2000 to take effect under protest, and returned that decision to the Commission for reconsideration.[1] In Order No. 1301, the Commission set out the seven issues raised by the Governors, and established dates for the Postal Service to elaborate on the Governors' concerns, for participants to file comments, and for the Postal Service to submit a final reply. Those statements now are before the Commission.[2]

[1002] On reconsideration, the Commission finds that adjustments to its earlier decision are called for, and this Opinion and Further Recommended Decision

[1] Decision of the Governors of the United States Postal Service on the Recommended Decision of the Postal Rate Commission on Postal Rate and Fee Changes, Docket No. R2000-1, issued December 4, 2000 (Governors' Decision).

[2] Memorandum of the United States Postal Service on Reconsideration and Request for Expedition, December 20, 2000 (Postal Service Memorandum).

Comments of Alliance of Nonprofit Mailers and Direct Marketing Association on Reconsideration of Standard A Nonprofit Rates, January 12, 2001 (ANM/DMA Comments); Comments of American Bankers Association and National Association of Presort Mailers upon Decision of Board of Governors Requesting Reconsideration, January 12, 2001 (ABA/NAPM Comments); Comments of the Association of American Publishers on Reconsideration, January 12, 2001 (AAP Comments); Comments of the Association for Postal Commerce, January 12, 2001 (PostCom Comments); Association of Priority Mail Users, Inc. Comments Regarding United States Postal Service's Memorandum on Reconsideration, January 12, 2001 (APMU Comments); Consortium Memorandum in Response to USPS Memorandum on Reconsideration, January 12, 2001 (Consortium Comments); Response of Mail Order Association of America to Memorandum of United States Postal Service on Reconsideration, January 12, 2001 (MOAA Comments); Comments of Major Mailers Association Regarding Issues on Remand from the Board of Governors, January 12, 2001 (MMA Comments); Comments of the Office of the Consumer Advocate on Request for Reconsideration, January 12, 2001 (OCA Comments); Comments of the Parcel Shippers Association on Reconsideration, January 9, 2001 (PSA Comments); Comments of Periodical Mailers in Response to Memorandum of United States Postal Service for Reconsideration, January 12, 2001 (Periodical Mailers Comments); Comments of United Parcel Service on Reconsideration, January 12, 2001 (UPS Comments); Val-Pak Direct Marketing Systems, Inc., Val-Pak Dealers' Association, Inc., and Carol Wright Promotions, Inc. Comments Regarding United States Postal Service's Memorandum on Reconsideration, January 12, 2001 (VP/CW Comments).

Reply of the United States Postal Service to Comments of Participants in Response to the Postal Service's Memorandum on Reconsideration, January 19, 2001 (Postal Service Reply).

recommends new rates for Bound Printed Matter and Certified Mail that will provide $83 million additional annual revenue for the Postal Service.

[1003] The Commission is aware that recent Postal Service management statements indicate concern with its financial performance during the early portion of FY 2001, the test year in this case. However, the Postal Service Memorandum filed in response to the Commission's request for comments justifying reconsideration only briefly refers to recent results. Moreover, it specifically states that in the Service's opinion, there is no need to reopen the record to develop further evidence. Postal Service Memorandum at 4. For the reasons set out below, the Commission finds that the evidentiary record, which was closed September 8, 2000, does not justify a more substantial increase in the Postal Service's revenue requirement.

[1004] This does not mean that a new, complete omnibus rate case is the only possible source of additional revenues from rates if the Postal Service believes that information now available shows that it likely will not break even in FY 2001. Two other options also exist.

[1005] First, the Postal Service could provide additional evidence for the record that shows more recent information relevant to expected FY 2001 operating results. In July and August, 2000, the Service provided updated estimates of test year costs and revenues, and the Commission used this information to develop "break even" rates. In its pleadings, the Postal Service implies that its evidence may have been overly optimistic. For example, it chides the Commission for accepting at face value the Service's testimony that it would obtain approximately $300 million in revenues from co-branded advertising, retail sales, and e-commerce programs. *Id.* at 6-7; Postal Service Reply at 24. If the Postal Service now believes its evidence on this or other topics was erroneous, the record could be reopened and corrected. This process would take far less time than prosecuting an entire rate case.

[1006] The Postal Service Memorandum mentions only a few new facts. In a cryptic footnote, Memorandum at 7, the Service states that "actual FY 2000 **revenue** is $236 million less than the amount estimated by the Postal Service in its Request" (emphasis added) and contends that this fact supports a larger contingency. However, this argument appears vitiated by the Governors' Decision's acknowledgement that a more germane financial measure, the Service's FY 2000 actual **net income**, was $126 million better than the Service's July projection that was accepted by the Commission. Governors' Decision at 19. *See also,* the discussion in the OCA Comments, at 18-19, suggesting that FY 2000 results indicate that test year expenses are overstated by more than $400 million.

[1007] The Postal Service also refers to news stories discussing recent uncertainty about the strength of the national economy. Postal Service Memorandum at 19-20. *See also* Postal Service Reply at 16-18. These statements and articles are not record evidence. If the FY 2000 actual results presage a FY 2001 substantially different from on-the-record forecasts, it is incumbent on the Service to provide an on-the-record explanation of these changes. The Service may support a request for reconsideration with evidence designed to clarify the record on its financial condition, or to provide persuasive evidence of financial trends. As the Service itself emphasizes elsewhere, the Commission must base its decisions on record evidence, rather than extra-record speculation. *See*, Postal Service Reply at 41.

[1008] A second option would be more appropriate if the Postal Service believes that it needs more net revenues than it could justify by "correcting" the existing Docket No. R2000-1 record. If a rapid infusion of additional funds is needed, the Service could quickly prepare and submit a request designed to be heard and decided in less than 10 months.[3] The record in Docket No. R2000-1 is sufficiently fresh so that evidence on issues such as costing methodologies, and volume and revenue estimation techniques could be designated for use in the new filing under rule 31(e). Depending on the urgency of the Service's financial situation, relitigation of certain existing Commission precedents

[3] The Board of Governors has complete discretion to decide when to file rate requests, and what to request. This discussion is included for the sole purpose of clarifying that the Commission can and will respond quickly in exigent circumstances.

could be limited or even foregone under rule 54(a)(2).[4] Also, the Service could narrow the scope of a request by refraining from incorporating classification change proposals. These procedures would reduce preparation time and simplify litigation for both the Postal Service and participants.

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[4] 39 U.S.C. § 3624(c) allows the Commission 10 months to evaluate rate requests; however, § 3624(b) authorizes Commission rules allowing it to act more expeditiously when circumstances require.

II. REVENUE REQUIREMENT

A. The Complementary Roles of the Governors and the Commission

[2001] The initial Request authorized by the Board of Governors sought rates designed to generate, as nearly as practicable, $69.027 billion. The Commission directed the Postal Service to update the cost estimates contained in the Request, and made a number of other decisions and adjustments that had the effect of changing the test year revenue requirement in this case. Those changes are displayed in Appendix K to the Opinion and Recommended Decision. The Governors contend that the Commission improperly substituted its judgment for that of the Governors, while emphasizing that the Governors "necessarily [have] responsibility for determining revenue requirements." Governors' Decision at 2-3, and 10. Nonetheless, the Governors accept all but three of the adjustments made by the Commission.

[2002] The three revenue requirement issues sent back to the Commission for reconsideration are: (1) whether the costs for first-line supervision will diminish as the costs for the clerks and carriers they supervise are shed during productivity improvement programs; (2) whether maintaining a reserve against possible failure to achieve expected cost savings is an actual test year expense item; and (3) whether the record supports a contingency equal to 2.5 percent of adjusted test year expenses. These issues will be discussed separately in subsequent parts of this section.

[2003] A few preliminary comments are provided here in response to the Governors' concerns that the Commission may not recognize the breadth of the Governors' responsibilities, and that the Commission's November 13, Decision improperly encroaches on those responsibilities. *Id.* at 2-5.

[2004] The Commission and the Governors have distinct, but complementary roles under the current statutory system. The Governors select the Postmaster General, and thus are accountable for the management of the Postal Service. They also are responsible for assuring that over time, postal revenues will equal postal costs, a duty they discharge by participating in the initiation of, and exercising final decision authority over, rate changes.

[2005] Whenever the Board of Governors chooses to request changes in rates, the Commission is to conduct a public proceeding during which it will review that request against a variety of statutory policies, and return its recommendation to the Governors. The Commission's decision must reflect the evidence collected on the record of this proceeding. The applicable statutory policies include those requiring that the Service have adequate revenues, and those requiring that each of the classes of mail pay no more than a fair portion of necessary revenues. Although the rates recommended in this decision provide less revenues than the Postal Service requested, the Commission finds that these rates will generate the level of revenues needed to break even, as developed on the evidentiary record developed pursuant to 39 U.S.C. § 3624.

[2006] The Postal Service supports rate requests with substantial amounts of information. It chooses a test year beginning no more than 24 months from the date of filing, and estimates what its total expenses will be within that test year. By statute, its total expenses include a reasonable provision for contingencies; and by practice, it also includes an amount to allow recovery of a portion of prior years' losses. The Service requests rates designed to generate sufficient revenues to recover those expenses in that test year.

[2007] A major focus in rate cases is on what type or types of mail cause particular items of costs. Total test year revenue requirements vary directly with findings on what costs vary with the volume changes expected for different categories of mail. The Postal Service test year estimates incorporate sophisticated cost behavior analyses and volume projection techniques supplemented with numerous special studies of specific cost causation factors. Extensive efforts are made to refine estimates and accurately project the reaction of mail volumes and other cost causing characteristics to events expected to occur during the test year. Participants expend significant resources exploring the underlying bases for those estimates, and often present alternative analyses.

[2008] The classes of mail are required to pay rates sufficient to recover the costs caused by their mail together with a reasonable contribution toward overhead costs. Failure to properly attribute costs will distort rates and rate relationships among the classes and types of mail. If, for example, the Service expects to initiate a program such as a subclass-specific advertising campaign, the costs of that advertising are attributable to that subclass, and the rates for that subclass should reflect the costs of that advertising. Recovering that cost through a contingency or a field reserve that is attributed proportionately to all classes would be improper. In particular, several subclasses of mail, such as nonprofits and periodicals, make restricted or relatively modest contributions toward overhead. The rates for these subclasses of mail essentially are set to recover just costs that have been found attributable to that mail. In the previous example, treating product specific advertising costs as partially attributable field reserve expenses would directly harm these subclasses.

[2009] In sum, the participants in rate proceedings, including the Postal Service, take great pains to build an evidentiary record that accurately identifies the causes and levels of projected test year costs by class and subclass of mail. That record is the basis for fair and equitable rates. The Commission must thoroughly review the evidence presented by the Postal Service and the other participants, and evaluate that evidence. In this case, as in all recent rate cases, the Commission has accepted many of the Service's estimates, but in some instances it has concluded that the evidence presented by other participants was more convincing. As a result, in some areas test year revenue requirements have been altered.

[2010] If the Commission were to uncritically accept unreasonably large contingency amounts, it would allow the Service to understate "inconvenient" costs, (such as costs associated with providing competitive products) and essentially negate the extensive efforts of participants to understand and identify test year expenses. It would also undermine the efforts of the Commission to weigh the rate policy evidence presented by the Service and the other participants, and to balance all of the applicable statutory criteria to develop fair and equitable rates. The Commission believes that providing the Governors with rate recommendations that will generate sufficient revenues to allow the Postal Service to recover only those expenses justified on the evidentiary record is consistent with its role in helping to develop appropriate rates for the nation's mailers.

B. Supervisor Costs

[2011] *Introduction.* The Governors ask the Commission to reconsider its decision to reduce supervisors' costs by $97 million. This reduction arose out of the Commission's conclusion that planned labor cost reduction programs will generate proportional supervisory cost savings in the test year.

[2012] The Governors acknowledge that the treatment of supervisors' costs is not an issue of first impression in omnibus rate cases. They note that the Commission made a similar reduction in Docket No. R97-1; characterize that decision as grounded in the "speculation" of an intervenor witness;[5] and state that while they objected to the adjustment in their R97-1 decision, they chose not to challenge it at the time, given the circumstances of that case. Governors' Decision at 6.

[2013] The Governors' instant challenge sets forth several reasons why the Commission's adjustment is invalid. These relate to the testimony of Postal Service witnesses on this record; certain statements the Commission referred to (and the status of the related library reference); and the Commission's observation that supervisor costs are reduced in the long run by craft workhour savings. *Ibid.* The Postal Service Memorandum and Reply expand on these points, and support the Governors' request for reconsideration. The Consortium opposes any change in the Commission's treatment of

[5] The witness referred to is DMA witness Buc.

this issue. Consortium Comments at 18-21[6]. No other participant addresses the specifics of this matter.

[2014] In Docket No. R97-1, DMA witness Buc's review of the Service's rollforward model led him to conclude that there was "an obvious flaw" in the treatment of cost reduction savings. He observed the following inconsistency:

> The rollforward program incorporates a number of upward adjustments in mail volume, nonvolume workload and other programs that increase the costs of supervisors when clerks' and mailhandlers' and carriers' costs increase. However, the cost reduction portion of the rollforward program does not contain a corresponding downward adjustment in supervisors' costs to reflect savings in direct labor when costs for clerks, mailhandlers and carriers decrease.

Tr. 28/15362. Buc asserted that this was illogical, and should be corrected.

[2015] The Commission agreed with this assessment and, in the course of its Opinion, stated that the Service had not effectively rebutted witness Buc's factual premise with record evidence. In particular, it noted that the Service had never discussed why the ratio of firstline supervisors to clerks and carriers should change under cost reduction programs, nor had it explained why an adjustment in supervisors' workhours should not be made when craft employees' work hours are reduced. PRC Op. R97-1, para. 2154.

[2016] In consonance with the Governors' objection to the "Buc adjustment" in Docket No. R97-1, the Service did not include a proportional adjustment in supervisory rollforward costs for cost reduction programs in this case. Postal Service witness Tayman, however, did address the matter in his direct testimony. In brief, he explained that unlike the situation in Docket No. R97-1, the Service was projecting significant cost

[6] Direct Marketing Association, Inc., joined by Advo, Inc.; Alliance of Independent Store Owners and Professionals; Alliance of Nonprofit Mailers; Amazon.com, Inc.; American Business Media; Association of American Publishers; Association for Postal Commerce; Association of Priority Mail Users, Inc.; Dow Jones & Company, Inc.; Magazine Publishers of America; Major Mailers Association; The McGraw-Hill Companies, Inc.; Parcel Shippers Association; and Time Warner, Inc.

savings for supervisory costs between the base year and the test year, and maintained that these were the *only* appropriate savings. USPS-T-9 at 14 (emphasis added). Tayman further asserted that cost reduction programs have different impacts than changes in volume, and therefore should not be piggybacked. He noted, for example, that cost reduction programs may initially require additional initial supervisory time and attention to capture cost savings, to maintain service, and to ensure operating efficiencies. *Ibid.*

[2017] Notwithstanding the Service's position, witness Buc (appearing in this case on behalf of DMA *et al.*[7]) reiterated the proposition he had made in the preceding case.

[2018] Tr. 22/9547-49. He also cited excerpts from a Postal Service library reference to support his contention that the Service realizes that changes in craft labor induce changes in supervisor labor. *Id.*, para. 9548, citing USPS-LR-I-1, Summary Description of USPS Development of Costs by Segments and Components, Fiscal Year 1998, at 2-2.

[2019] On rebuttal, Postal Service witness Patelunas (USPS-RT-4) claimed that the "Buc adjustment" was inconsistent with operational realities, which he said effectively limit the opportunity to reduce supervisor costs in direct proportion to craft workhour savings when implementing cost reduction programs. Tr. 38/17142-43. He also noted that actual supervisor costs for FY 1998 were very close to the original, unadjusted level of supervisor costs estimated in Docket No. R97-1, while the proportionally adjusted estimate showed a greater variance. He suggested this demonstrated that the argument underlying the adjustment is invalid. *Id.* at 17144. Given these considerations, Patelunas contended that supervisor cost savings opportunities should be reviewed in

[7] Direct Marketing Association, Inc.; Alliance of Independent Store Owners and Professionals; Alliance of Nonprofit Mailers; Amazon.com, Inc.; American Business Media; Association for Postal Commerce; Association of Priority Mail Users, Inc.; Dow Jones & Company, Inc.; Florida Gift Fruit Shippers Association; Greeting Card Association; Magazine Publishers of America; Mail Order Association of America; Major Mailers Association; The McGraw-Hill Companies, Inc.; Parcel Shippers Association; and Time Warner, Inc.

the context of the functions, obligations and environment of supervision, not "merely mechanistically piggybacked on direct labor costs." *Id.* at 17145.

[2020] In its Opinion, the Commission acknowledged Patelunas' testimony regarding operational limitations, but indicated that it was influenced by the statements witness Buc had identified in his testimony. These included the following language:

> It is recognized that a change in employee workhours, caused by a change in mail volume, may not be accompanied immediately by a corresponding change in firstline supervisory workhours. *However, for any substantial or prolonged change in the level of non-supervisory employee effort for a given work activity, there will be an accompanying change in firstline supervisory requirements.*
>
> Accrued costs for firstline supervision of mail processing activities are *volume variable to the same degree as the accrued costs of mail processing personnel* in Cost Segment 3.

PRC Op. R2000-1, para. 2058, citing USPS-LR-I-1 at 2-2, §§ 2.1.1, 2.1.3 (emphasis added).

[2021] The Commission indicated it believed these statements lent support to the factual premise of witness Buc's proposed adjustment — namely, that in the long run, developments that decrease craft employee work effort also result in decreases in supervisory work effort, and that both will be reflected in volume-variable cost changes. The Commission acknowledged that there may be exceptions to this linkage — as indicated in witness Patelunas' testimony — but in the absence of more detailed evidence, concluded that the proportional relationship on which the adjustment relies remains valid. PRC Op. R2000-1, para. 2058.[8]

[2022] The Commission therefore decided to retain the approach it had used in Docket No. R97-1, and recognized a corresponding cost reduction of approximately

[8] With respect to Patelunas' argument comparing actual versus estimated supervisor cost results for FY 1998, the Commission said it did not view the reported variances as probative evidence of the invalidity of witness Buc's proposed adjustment. It noted that many factors can influence the amount of cost actually incurred in this category in a given fiscal year.

$97 million. In doing so, however, the Commission also clearly indicated — as it had in its Docket No. R97-1 Opinion — that this subject was not necessarily a closed chapter. It specifically noted that Patelunas' testimony referred to operational limitations that might prevent supervisory costs from decreasing proportionately with craft workhours during the implementation of cost reduction programs, and invited more detailed presentations in future proceedings.

[2023] *Postal Service Memorandum.* The Service contends that while the Commission cites witness Buc's testimony, its decision in this matter ultimately relies on statements contained in USPS-LR-I-1. Its Memorandum, therefore, focuses almost exclusively on reasons why this reliance is inappropriate. It asserts that this document is a library reference that was never formally admitted into evidence, and further contends that the Commission misapprehends its nature. Postal Service Memorandum at 11.

[2024] In pursuing the latter point, the Service says the document explains the process by which accounting information is converted from an historical year "into economically-relevant marginal and incremental costs estimates for individual mail categories and services." *Ibid.*, citing USPS-LR-I-1, Appendices H and I. It says this process presumes a reasonably well-defined and stable set of operating procedures. *Ibid.*, citing Docket No. R97-1, USPS-T-11, at 3-4, 13-17. Moreover, it says that USPS-LR-I-1 relates to the FY 1998 CRA, and does not reflect the various methodological changes proposed by Postal Service witnesses in this case that distinguish base year 1998 from the fiscal year 1998 CRA. *Id.* at 12. Therefore, it says the document's scope "is clearly limited to discussion of the process used to derive cost estimates by product for an historical period, taking as given a stable operating plan, and estimating the effect of changes in *volume* on changes in costs." *Ibid* (emphasis added).

[2025] The Service also emphasizes that USPS-LR-I-1 does not purport to describe the process by which the Postal Service moves from the historical level of accrued costs in the base year to a forecast of accrued costs in the test year. It says this is, instead, the province of the revenue requirement and rollforward witnesses, and their testimonies describe the effects of factors, in addition to changes in mail volume, that will cause accrued test year costs to differ from accrued base year costs. The Service asserts:

> Factors of one type that are very explicitly accounted for in the roll-forward process, in contrast with their deliberate omission from the base year analysis, are changes in the operating plan. In the roll-forward process, changes in the operating plan show up either as cost reduction programs, or as other programs. Both theoretically and practically, cost changes resulting from cost reduction programs and other programs are quite distinct from the cost changes associated with changes in mail volume, as even the most cursory review of the roll-forward testimony shows.

Id. at 12-13.

[2026] The Service further contends that its witnesses addressed these matters on the record in this proceeding. It says that witness Tayman testified on the issue of reductions in supervisor costs, and that the Service included the appropriate amount of supervisor costs in the cost reduction estimates presented in its filing. It also argues that witness Patelunas explained (at Tr. [38]/17142-45) why the cost reduction programs incorporated in the rollforward model cannot be expected to have the additional effect on test year supervisor costs postulated by witness Buc. Postal Service Memorandum at 16.

[2027] The Service also says that, even assuming no change in the operating plan, there may be a substantial lag time between an increase in craft employee hours, and the ability of the organization to put the necessary supervisory resources in place. *Id.* at 15. It contends that in the context of cost causation analysis — which is what USPS-LR-I-1 addresses — it is "entirely appropriate" to allocate to products the costs of the supervisory hours that will be caused by the addition of craft hours to handle those products, even if the additional hours may not appear until time periods subsequent to the year of analysis. *Id.* at 15-16. However, the Service says that when the purpose of the exercise is to estimate accrued costs in a given year, it would be "entirely inappropriate" to include the costs (or, as here, to exclude the costs) of any changes in supervisory hours that will not occur during the year in question. *Id.* at 16 (emphasis omitted).

[2028] *Consortium's position.* The Consortium contends that the supervisor cost savings approved by the Commission were correct; therefore, it says the Service's request that the Commission change its decision upon reconsideration should be denied. Consortium Comments at 18. In particular, the Consortium argues that the Commission's Docket No. R97-1 Opinion affirmatively noted the lack of Postal Service testimony on this issue. It argues that while the Postal Service Memorandum asserts that the cost reduction programs induce changes in the operating plan, it does not cite persuasive record evidence in this case to prove this assertion. The Consortium says that witness Patelunas' testimony simply makes clear that he not only has no first-hand knowledge of how changes in operating conditions affect changes in supervision, but "is testifying that supervisors do not supervise people, but instead supervise mail flow." *Id.* at 20. The Consortium views this as unlikely. *Ibid.*

[2029] The Consortium acknowledges the Service's criticism of the Commission's reliance on statements in the Summary Description Library Reference, but defends this approach. It notes that "nowhere other than in this document" does the Postal Service provide record evidence that would allow evaluation of how the cost reduction programs change the operating plan. Instead, the Consortium says: "We have only Patelunas' description of his second-hand 'inform[ation].'" *Ibid.*

[2030] *Service's reply to Consortium's comments.* The Service dismisses the Consortium's reference to the Commission's Docket No. R97-1 Opinion as having no applicability to this proceeding. It says the portion of the Opinion the Consortium invokes is essentially a recitation of the fact that the Postal Service offered no testimony on this matter in Docket No. R97-1. Moreover, the Service reiterates that it explicitly addressed this matter in the testimonies of witnesses Tayman and Patelunas. Postal Service Reply at 27, citing USPS-T-9 at 14 and Tr. [38]/17142-45. It argues that regardless of their persuasiveness in the earlier docket, the statements from the Commission's R97-1 Opinion have no applicability in this proceeding. *Ibid.*

[2031] The Service also characterizes as "specious" the Consortium's criticism that witness Patelunas appears to lack first-hand knowledge of how changes in operating conditions affect changes in supervision. It defends Patelunas' reliance on information from program managers as something that was "nothing more and nothing less than [what] other analysts . . . routinely do in thousands of instances." *Id.* at 28 (fn. omitted).

[2032] *Commission Analysis.* As the November 13 Opinion made clear, the Commission has not viewed the treatment of supervisors' costs it adopted in Docket No. R97-1 — and incorporated again in Docket No. R2000-1 — as a foregone conclusion. Instead, it has consistently regarded this adjustment as the most appropriate approach in the absence of a detailed explanation of why the proportional relationship that applies to volume changes should not hold true, as well, for cost reductions. In this case, as the Service points out, the referenced statements in USPS-LR-I-1 also influenced the decision.

[2033] Having considered the arguments raised on reconsideration, the Commission continues to believe that resolution of this issue is a close question. Notwithstanding the Service's contention that witness Patelunas' reliance on information provided by program managers should suffice, the Commission shares the Consortium's concern that his testimony actually contains very few details of the reasons why the cost reduction program savings should not be recognized. Thus, the concern is not simply that the information is "secondhand," as the Service suggests, but that it provides very little explanation of what experiences — or expectations — may have led the program managers to their conclusions.

[2034] The Service's Memorandum and Reply provide some additional arguments that address not only this concern, but also the Consortium's observation that it is unlikely that supervisors oversee "mail flow" rather than workers. Significantly, the Service notes:

> Consider a supervisor in charge of three pieces of mechanized mail sorting equipment. Her responsibilities include making sure that each machine is adequately staffed, making sure that there is an efficient flow of mail to and

> from the machines, and addressing and resolving any problems which might arise in sorting the mail through her three machines. If a change from mechanization to automation . . . meant that her new machines needed substantially fewer employees to sort approximately the same volume (and thus had greatly enhanced productivity), it would not necessarily be unreasonable to expect that three machines is still a reasonable number of operations to be under her control, with the same responsibilities as before.

Postal Service Reply at 29, fn. 23.

[2035] This hypothetical, although not provided until this stage of the proceeding, helps bolster the Service's argument against a purely "mechanistic" approach by providing some of the details the Commission has indicated it is interested in evaluating.

[2036] The Service also contends that the analysis in USPS-LR-I-1 is directed toward changes in mail volume, rather than to changes in the operating plan. It would have been helpful if the ramifications of this distinction had been more fully explored at an earlier stage, and the Commission finds that this distinction warrants further examination in a future case. As a result, the Commission views its earlier conclusion that cost reduction programs will achieve proportionate declines in test year supervisor costs as premature and thus questionable. Given the further explanation and clarification provided in the Service's Memorandum, and the unresolved questions related to the applicability of USPS-LR-I-1, in this circumstance, the Commission has decided to reinstate the previously-disallowed supervisors' costs.

[2037] The Commission remains concerned that the test year implications of cost reduction programs on supervisory costs need to be more fully explored. The Postal Service's additional arguments, while marginally more persuasive than the Consortium's position, are not without flaws. For example, the assumption that supervisor costs will not decline at all even when cost reduction programs eliminate craft labor costs appears both simplistic and short sighted. Efforts should be made to identify when supervisory levels can be adjusted while such programs are in progress, and to recognize in future rate cases all potential savings related to reductions in the employee complement.

C. Field Reserve

1. Introduction

[2038] In response to Order No. 1294, the Postal Service submitted, *inter alia*, the supplemental testimony of witness Patelunas, who incorporates actual FY 1999 CRA and accounting data into the Postal Service's test year forecasts. His test year forecasts incorporate updates for numerous cost adjustment factors, including non-personnel and personnel cost level changes, cost reduction programs, workyear adjustment mix, and revenues. *See* USPS-ST-44 at 2-8. Among the cost reduction programs he quantifies is breakthrough productivity, a plan announced by the Postmaster General in March 2000 to reduce the Postal Service's expenses by $4 billion by 2004, including implied test year savings of approximately $1 billion. Tr. 38/17197 and 17188.

[2039] Initially, when queried about the breakthrough productivity savings, the Postal Service estimated test year savings at about $550 million. *See,* Response of witness Tayman to POIR No. 13, Question 1, Tr. 46-D/21855. The Postal Service stated, however, that information concerning these savings would be incorporated in its test year update in response to Order No. 1294. *Id.* at 21856.

[2040] The test year update, as detailed in witness Patelunas' supplemental testimony, projects that if the rate increases requested by the Service were approved, there would be a test year after rates deficiency of $275.3 million. Exhibit USPS-ST-44A. Among other things, the update incorporates breakthrough productivity savings of $744 million.[9] Shortly after the update was filed, Patelunas responded to POIR No. 14, Question 2, breaking out by cost segments and components the savings associated with breakthrough productivity. Tr. 46-D/21595.[10] This response is notable for two reasons. First, it includes an entry for a $200 million field reserve, an apparent offset to estimated

[9] *See* USPS-ST-44 at 5, Exhibit USPS-ST-44Z, and Exhibit USPS-ST-44AA.

[10] The estimated savings are associated with the following four programs: transportation, purchasing, overhead, and operations.

savings. *Ibid.* Second, Patelunas states that "the cost savings amounts in the proposed FY 2001 budget are reflected in [his supplemental testimony] and are also shown in Attachment 1 [to POIR No. 14]." *See* Response of witness Patelunas to POIR No. 14, Question 2, July 12, 2000.

[2041] Subsequently, witness Patelunas submitted a revised response to POIR No.14 indicating that his supplemental testimony inadvertently omitted a $200 million field reserve. As a consequence, witness Patelunas claimed that operations cost reductions were overstated and that if the field reserve were incorporated into the update, the test year deficiency would increase to approximately $475 million. Tr. 46-D/21592-93, 21565.[11] Nevertheless, witness Patelunas' revised response to POIR No. 14 is consistent with what is filed in his supplemental testimony, *i.e.*, it does not reflect the $200 million field reserve, and it shows test year breakthrough productivity cost savings of $744 million.

[2042] The Commission analyzed the updates submitted by witness Patelunas in his supplemental testimony, including projected breakthrough productivity savings, and the additional information he provided in responses to questions from the Presiding Officer. Based on the record, the Commission found that the field reserve was not equivalent to a traditional expense item, but should be recognized as a special purpose component of the contingency. PRC Op. R2000-1, paras. 2010 and 2164. On reconsideration, based on the pleadings submitted as well as a further review of the record, the Commission reaffirms its conclusion that the field reserve is properly recognized as a special-purpose component of the contingency.

2. Postal Service's Position

[2043] The Postal Service contends that the field reserve should be treated as a test year operating expense. In support of its argument, the Postal Service refers to

[11] Witness Strasser cites the same figure in his prepared testimony, USPS-RT-1. Tr. 46-A/20210.

witness Strasser's rebuttal testimony. Postal Service Memorandum at 8-11. Witness Strasser argues that the field reserve is not part of the contingency provision, contending it is "an actual budget expense item that the Postal Service projects it will spend during the test year." Tr. 46-A/20207, fn. 6. On cross examination, witness Strasser explains that the field reserve is a budget strategy involving delaying certain planned investments, in this instance for transportation equipment, information platform infrastructure, and advertising, pending evaluation of breakthrough productivity during the test year. Tr. 46-A/20295-97. According to witness Strasser, if breakthrough productivity succeeds the Postal Service will use the $200 million to fund the foregoing investments. If breakthrough productivity is not successful, the Postal Service will forego those investments and use the $200 million to cover the shortfall. *Ibid.*; *see also* Postal Service Memorandum at 9-10. Based on this testimony, the Postal Service concludes that the $200 million will be spent and therefore cannot be considered part of the contingency. Postal Service Memorandum at 10-11. The Postal Service claims that by including the field reserve as part of the contingency, the Commission's stated 1.5 percent contingency is effectively reduced to 1.2 percent. *Id.* at 11.

[2044] On January 19, 2001, the Postal Service filed its reply comments addressing certain arguments raised by the participants. As a general matter, the Postal Service contends that "the arguments of the parties . . . are unfounded and are based on a complete misunderstanding of the reality of this situation." Postal Service Reply at 25. It dismisses a claim that the field reserve serves to pad the revenue requirement, argues that the field reserve is not part of the contingency, and disputes that any unspent field reserve funds would be used for capital investments. *Id.* at 25-27.

3. Participants' Comments

[2045] Four sets of comments submitted on behalf of more than 20 participants oppose the Postal Service's request for reconsideration of the field reserve issue. The OCA characterizes the field reserve as a hedge against uncertainty indistinguishable from the contingency in any meaningful sense. OCA Comments at 12. The OCA dismisses the Postal Service's claims that the field reserve represents money that will be spent in the test year as implausible given the uncertainty surrounding the issue whether or not the productivity gains will be realized. *Id.* at 13. Similarly, OCA argues that Postal Service suggestions that the field reserve will be used on, for example, capital projects is flawed since it is unlikely that such plans could implemented during the test year. *Id.* at 13-14.

[2046] The fifteen-party Consortium compares witness Strasser's descriptions of the field reserve and the contingency, arguing that the field reserve is more appropriately treated as part of the contingency rather than as a test year expense. Consortium Comments at 16-17. The Consortium notes that the only support for the field reserve is its asserted presence in the Postal Service's FY 2001 operating budget, which was not submitted as part of the record in this proceeding. Thus, the Consortium asserts that the field reserve cannot be treated as a test year expense. *Id.* at 17.

[2047] The Consortium characterizes the field reserve as a hedge to protect against uncertainty, namely whether the projected savings will materialize during the test year. Thus, according to the Consortium, the field reserve is equivalent to an insurance policy. *Ibid.* The Consortium further asserts that if the projected savings are realized during the test year, Strasser's identification of supposed alternative uses for those funds fails to guarantee that the funds will be spent. *Id.* at 18. Finally, the Consortium argues that even assuming that the Postal Service's FY 2001 operating budget were in evidence, the proposed alternative uses would lack evidentiary support because "the budget can not reflect the use of $200 million for more than one purpose." *Ibid.*

[2048] Val-Pak Direct Marketing Systems, Inc., Val-Pak Dealers' Association, Inc., and Carol Wright Promotions, Inc. criticize the Postal Service's treatment of the field reserve as inconsistent. VP/CW Comments at 3-4. Focusing on the possible alternative uses of the funds suggested by Strasser, VP/CW argues that the Postal Service has failed to provide evidence distinguishing between items that properly should be capitalized and those that may be expensed during the test year. VP/CW argues that it would be inappropriate to use the field reserve "to fund capital investments on a pay-as-you-go basis." *Id.* at 4. In addition, VP/CW asserts that funds may not be simultaneously earmarked to fund contingent events and reserved for investment in otherwise unfunded projects. *Id.* at 5-6.

[2049] American Bankers Association and National Association Presort Mailers argue that the Postal Service's attempt to distinguish the field reserve from the contingency is futile, amounting to no more than a hair-splitting exercise that fails to reveal any meaningful difference in the two provisions. ABA/NAPM Comments at 3.[12]

4. Commission Analysis

a. The Postal Service's Theory is Flawed.

[2050] Witness Patelunas presents the Postal Service's test year FY 2001 forecast, which includes, *inter alia*, test year cost reductions reflecting savings of $744 million associated with breakthrough productivity initiatives.[13] The breakthrough productivity initiatives, which witness Strasser indicates pose a significant challenge, are described as "management's attempt to offset adverse inflationary impacts." Tr. 46-A/20207. Subsequent to filing witness Patelunas' supplemental testimony, the Postal Service introduced the concept of the field reserve, representing a $200 million offset to projected test year savings. *See* Revised Response to POIR No. 14, Question 2, Tr. 46-D/21591-96. The field reserve, however, was not linked to specific cost segments and components. Instead, the Postal Service suggests that the field reserve offset test year cost reductions proportionately. *See*, for example, Tr. 35/16784.

[12] Another group of parties, some of whom also were part of the Consortium, submitted comments that make a passing reference to the field reserve. Periodical Mailers, who otherwise urge the Commission to leave Periodical rates undisturbed regardless of the outcome on reconsideration, contend that any modification to the revenue requirement to include the field reserve must treat those expenses as entirely institutional costs. Periodical Mailers Comments at 3, fn. 3.

[13] *See* USPS-ST-44 at 5, Exhibit USPS-ST-44Z, and Exhibit USPS-ST-44AA.

[2051] It fell largely to witness Strasser to defend the concept that the field reserve may be utilized for mutually exclusive alternative uses, namely to cover any shortfall in breakthrough productivity or, alternatively, to fund investments in mail transport equipment, information platform infrastructure, and advertising. *See* Tr. 46-A/20295-97. In sum, his (and the Postal Service's) argument is that in either event the money will be spent and, therefore, that the field reserve could not be considered part of the contingency. *See* Postal Service Memorandum at 10-11; Postal Service Reply at 25-26.

[2052] Strasser begins by attempting to rebut suggestions that the field reserve should be an element of the contingency, arguing that the "field reserve is an actual budget expense item that the Postal Service projects it will spend during the test year." Tr. 46-A/20207, fn. 6. Further, he asserts that the field reserve is "as real as any other expense in the Postal Service's budget[,]" although he acknowledges that "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." *Ibid.* Recognizing this singular status, Strasser argues that field reserve is "similar to a series of other reserved line items in the Postal Service's budget process[,]" citing as examples COLAs and health benefit expenses. *Ibid.*[14]

[2053] The Postal Service's attempt to distinguish the field reserve from the contingency is not persuasive. The field reserve has all the attributes of an item of contingency, serving as a hedge against uncertainty. Moreover, as a ratemaking concept, the field reserve, which is predicated on the Postal Service's budget strategy, is seriously flawed.

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[14] For its part, the Postal Service contends that the field reserve is not similar to the contingency because it is:

> a budget technique or strategy to leverage further cost reductions during FY 2001. The Field is challenged to achieve greater cost reductions than called for by the National budget goal. There is a high degree of risk that the field may not be able to accomplish their aggressive cost reduction targets. In those situations, budget relief can be granted, if warranted, without jeopardizing the national goal. The intent is to push the field to accomplish as much as possible, while still recognizing the magnitude of the challenge.

Tr. 46-C/20927.

b. The Field Reserve Is a Component of the Contingency.

[2054] This is the first Commission proceeding in which the field reserve concept has been presented. Given participant claims that the field reserve should be part of the contingency, the Commission analyzed the issue against the backdrop of its prior findings regarding the contingency. The Commission has previously recognized that the contingency serves a twofold purpose. First, it provides insurance against the possibility of misestimating test year forecasts; second, it protects against the occurrence of unforeseeable events. *See* PRC Op. R84-1, para. 1017; PRC Op. R87-1, para. 2067. The field reserve falls squarely within the former.

[2055] The Commission adopted the breakthrough productivity savings contained in the Postal Service's test year updates. When doing so, the Commission also recognized the mixed signals contained within the Postal Service's presentation. The Postal Service's position is that it intends to achieve its breakthrough productivity goals, but may be unable to achieve these aggressive cost reduction targets. *See*, for example, Tr. 35/16671; Tr. 46-C/20927. Consequently, it proposes the field reserve as a hedge against that uncertainty. The Commission fully appreciates the difficulties inherent in test year projections and commends the Postal Service for aggressively pursuing cost reductions. In recognition of that uncertainty, the Commission specifically recognized the field reserve as a new, additional component of the contingency. This result not only serves to increase the contingency, but it also provides the Postal Service with the protection it sought, *i.e.*, a hedge against uncertainty. Had the Postal Service not pursued such aggressive cost reduction targets, it would not have had the need for a field reserve, and the Commission would not have considered this item in evaluating the justification for the provision for contingencies sought by the Postal Service.

[2056] The Postal Service attempts to distinguish the field reserve from the contingency by emphasizing the field reserve as a budget strategy. *See*, for example, Tr. 46-C/20927 (The field reserve is not "similar" to the contingency because it is a "budget technique or strategy to leverage further cost reductions during FY 2001.") The distinction is essentially meaningless, establishing nothing more than that the Postal Service's budget strategy is different from its test year revenue requirement. It does nothing to detract from the field reserve's central purpose – to serve as insurance against the possibility that projected test year cost savings have been misestimated. Indeed witness Patelunas echoes these points:

> I wouldn't characterize the field reserve as an attempt to do anything with the revenue requirement. The field reserve is a budget strategy used with the field that, if those – all of those cost reductions that were given in the field, if they are not realized, the money will have to be spent where it is not saved.

Tr. 35/16812. The Postal Service addresses this uncertainty by developing, as part of its budget strategy, contingent plans for the field reserve. The Commission, too, addresses this uncertainty, but directly and as contemplated by the statute, by including the field reserve as a special component of the contingency. *See* PRC Op. R2000-1, paras. 2009-10.

[2057] OCA and the Consortium both make the point that the field reserve is the functional equivalent of the contingency. OCA Comments at 12; Consortium Comments at 17. The Consortium puts it this way: "[The field reserve] is an insurance policy against a possible future occurrence that . . . may never come to pass." Consortium Comments at 17. That the Postal Service also perceives the field reserve as an insurance policy against the possibility that projected test year savings have been misestimated is confirmed by the following passage from witness Strasser's testimony. "And the question is whether we distributed them [productivities] in the right proportion to the field as a challenge. So the [field] reserve is being held in case we made mis-allocations in that." Tr. 46-A/20375. In other words, the Postal Service intends to use the field reserve as it would otherwise use the contingency, namely as a hedge against uncertainty.[15] For

[15] It bears noting that neither unforeseen nor unforeseeable events have only negative effects; they could have positive effects on costs. *See* Tr. 38/17188.

the foregoing reasons, the Commission properly reflected the field reserve in the contingency.

c. Neither the Postal Service's Budget Nor Its Budget Strategy is a Surrogate for Its Test Year Revenue Requirement.

[2058] The Postal Service describes the field reserve as a budget strategy under which it holds back "investments" from the field until needed. Tr. 46-A/20296. Whether the Board employs such a strategy, however, is not dispositive of the Commission's consideration of test year expenses. While it may be an acceptable managerial strategy, it is completely immaterial to the Postal Service's test year revenue requirement. Similarly unavailing is witness Strasser's contention that the field reserve represents an "actual budget expense item that the Postal Service projects it will spend during the test year." *Id.* at 20207, fn. 6; *see also* Postal Service Memorandum at 9. Not only do these assertions improperly assume that Postal Service's budgeting process is synonymous with establishing its test year revenue requirement, they ignore an essential point — the Postal Service's FY 2001 operating budget is not in the record. Despite discovery requests as well as requests from the Bench that the Postal Service provide its FY 2001 operating budget, it was not made available. *See, e.g.*, Tr. 46-C/21043-44, Tr. 46-D/21564, 21572, and P.O. Ruling R2000-1/138; *see also* Response of United States Postal Service to Motion of the Office of Consumer Advocate to Compel Production of Documents as Requested in OCA/USPS-ST-44-51, August 25, 2000 (indicating that the proposed FY 2001 operating budget "does not exist.") To paraphrase one party, there is no record support for the field reserve and therefore neither the Commission nor the participants may rely on it. *See* Consortium Comments at 17.[16]

[2059] To establish fair and equitable rates, the Commission determines the Postal Service's revenue requirement (cost of service) based upon data forecast for a test year, in this case FY 2001. Witness Patelunas presents detailed support for the Postal

[16] In a significant omission, the Postal Service did not address this point in its reply comments.

Service's updated test year revenue requirement, and the Commission relies upon that testimony, along with other record evidence, to recommend just and equitable rates in this proceeding. In contrast, the Postal Service's operating budget is a management tool, which may serve a variety of managerial goals. The two serve dissimilar purposes and the Postal Service's attempt to equate the two is unavailing and inappropriate.

[2060] This dissimilarity highlights an additional difficulty related to the field reserve. It creates a moving test year revenue target, blurring the distinctions between the Postal Service's budget and its test year expenses. *See, e.g.*, Tr. 35/16812 and Tr. 41/18304. As noted, in fulfilling its statutory responsibilities to recommend fair and equitable rates, the Commission establishes a revenue requirement based on analyses of the Postal Service's accrued costs. An operating budget is a far less rigorous document, intended to assist ongoing management decision-making. The Commission's recommended rates cannot be based on such uncertain and fluctuating targets. As the Consortium correctly observes: "Amounts that are wholly uncertain, such as the field reserve, defy such quantification. There is a statutory device for dealing with such uncertainties, the provision for contingencies." Consortium Comments at 16.

[2061] Witness Strasser contends that the field reserve is similar to other reserved line items in the Postal Service's budget process, such as budgeted field expenses for projected COLAs, which, he indicates, are not allocated to the field "until well into the budget year, when the actual CPIs . . . are known." Tr. 46-A/20207, fn. 6. Aside from the fact that how the Postal Service internally shifts its funds is irrelevant to whether and when costs can be viewed as accrued, the comparison is inapt for at least two reasons. First, the COLA amounts are not simultaneously earmarked for one or more alternative uses. Furthermore, because the Service has a contractual obligation to pay COLAs, it is irrelevant when the amount needed to cover COLAs is allocated to the field.[17] Second,

[17] Estimated COLAs are specifically included in test year rollforward calculations. Should the estimated costs exceed actual test year COLAs, the year-end surplus may be spent as management deems appropriate. On the other hand, if actual costs exceed estimated COLAs, the contingency is available to fund the shortfall. In neither event, however, is there a suggestion that the amounts have been budgeted for more than one purpose.

the CPI is a known, independently determined, and widely available yardstick. It is, relatively speaking, easy to apply. Thus, as a management prerogative, holding back budgeted field expenses for projected COLAs until the actual CPI is known would appear to be reasonable. No such widely used, independently determined yardstick is available to measure the Postal Service's breakthrough productivity savings. As a practical matter as the test year unfolds, it is difficult to conceive – and the record sheds no light on the subject – how the Postal Service could fairly and accurately measure whether some or all of these savings had been realized or not. Total mail processing costs may be higher or lower than projected for myriad reasons. Realistically, only well after-the-fact could that assessment be made. *See* OCA Comments at 13-14. This underscores the uncertain (or contingent nature) of the field reserve.

d. The Field Reserve Does Not Represent An Appropriate Test Year Expense.

[2062] The Postal Service's revenue requirement consists of the best possible projections of test year accrued cost levels set out by cost segments, components, and sub-components. The record reflects a careful effort to link the cost savings programs, including the breakthrough productivity program, with the cost components and subcomponents that are the basis for distributing these cost savings to the subclasses of mail. Without linking amounts to any specific program, the Postal Service suggests that the field reserve could be distributed as proportional offsets to savings associated with the cost reduction programs. A proportional reduction in savings would effectively increase the Postal Service's revenue requirement by $200 million.

[2063] In the context of suggesting the field reserve as an appropriate test year expense, the Postal Service proposed mutually exclusive alternate uses of the funds. This is inconsistent with accepted ratemaking practice. On the one hand, if the cost reductions are not realized, the Postal Service contends that the money will be spent on field operations. While it would be possible to attribute and assign such costs to various classes of mail based on the theory of proportional offsets, the Commission would have little confidence that the outcomes were appropriate. Furthermore, as discussed below, an entirely different set of attributions and assignments would be required under the second alternative. Depending on which alternative is assumed, the resulting rates will invariably differ. The Postal Service recognizes the difficulty, but dismisses it, contending that the impact may be relatively minor. Tr. 46-D/21593. This contention is not adequately supported. Under the first alternative, cost increases would disproportionately effect flats, particularly Periodicals. This class probably would not be so burdened under the second alternative. Thus, the field reserve creates a moving target antithetical to proper ratemaking. Treating the field reserve as part of the contingency avoids this problem, and as noted above, provides the Postal Service with the protection it requests.

[2064] Witness Strasser states that if breakthrough productivity savings are achieved, the field reserve will be used for mail transport equipment, advertising for Priority Mail Global Guaranteed or for product introductions, and information platform infrastructure. Tr. 46-A/20297. The Postal Service, however, has neither described these contingent expenses (or capital items) in adequate detail, nor developed the record sufficiently to identify attribution or assignment of the associated, but unquantified costs. These items are sometimes characterized as "investments," which suggests capital projects, and on other occasions as "expenses."[18] Each, of course, is subject to different accounting and ratemaking treatment.

[2065] In its reply comments the Postal Service states that each is an expense item. Postal Service Reply at 26-27. The record, however, provides no corroboration. For example, although Strasser mentions, without elaboration, infrastructure expenses, which the Postal Service claims, without citation, "are mainly contractual services and personnel costs[,]"[19] the test year expense projections do not separately identify items of

[18] "What we did in our budget process is that we have a list of investments that should be made . . .." Tr. 46-A/20295. "[A]nd there [are] $100 million in infrastructure expenses that need to be put towards that program." *Id.* at 20296.

[19] *Id.* at 27.

information platform infrastructure.[20] It is the Commission's understanding that the Board of Governors has approved eight capital investment projects involving information platform infrastructure since February 2000. These actions suggest the possibility that, to the extent reflected in the test year, investments in information platform infrastructure may be considered depreciable expenses. Moreover, even as to "expenses," ambiguity exists. For example, Priority Mail Global Guaranteed is identified as a new product included in the advertising budget. Advertising this product would be a product specific cost attributable to international service. Even assuming that the field reserve was not otherwise objectionable, an additional and separate reason supports its rejection — on this record, there is no reasonable basis to identify and properly attribute or assign the costs of these items.

[2066] Although the Commission has reflected the field reserve in the contingency, this does not mean that it has denied the Postal Service funds associated with test year operating expenses for mail transport equipment, advertising, and depreciation. In its update, the Postal Service includes amounts for each of these types of expenses. Each was approved without modification.[21]

[2067] This approval occasions a final concern. Given the Postal Service's equivocal treatment of the funds, this approval raises the possibility, not wholly discounted on the record, that the authorized revenue requirement includes funds for the specific projects witness Strasser declares will be deferred pending a determination of the success of the breakthrough productivity initiatives. This creates the perception of, and gives rise to the possibility for the double counting of these "deferrable" test year expenses if the Postal Service achieves its planned test year savings. This result is implied by the Postal Service's theory that the field reserve represents a test year expense subject to alternative uses. The Consortium and VP/CW correctly observe that

[20] A possible exception may be an entry for POS-1 terminals. Whether this entry is intended to be synonymous with Strasser's "information platform infrastructure" is not clear in the record. Regardless, as noted below, by approving the update, the Commission has provided funds requested by the Postal Service for the POS-1 terminals. *See* USPS-LR-I-421 at 139.

[21] *See* PRC-LR-2.

funds may not simultaneously be earmarked for two purposes. Consortium Comments at 18; VP/CW Comments at 5-6. This is not meant to suggest any limitation on management's prerogative to reprioritize its spending. *See* Tr. 2/580. Rather, it is further indication that the Postal Service's theory of the field reserve as a test year concept is flawed, inappropriately treating a budget strategy as a supplement to its revenue requirement.

e. The Commission Approved a 1.5 Percent Contingency.

[2068] The Commission found the purpose of the field reserve to be indistinguishable from that of the contingency, each serving as insurance against uncertainty. PRC Op. R2000-1, para. 2164. Consequently, the Commission considered the need for a field reserve in evaluating the record support for any particular amount of contingency. *Ibid.* The Postal Service's claim that the Commission "effectively reduce[d] the contingency further to 1.2 percent" misconstrues the Commission's actions. Postal Service Memorandum at 11. The claim has no merit.

[2069] The Postal Service requested a 2.5 percent contingency. USPS-T-9 at 43-44. Participants urged the Commission to provide a contingency ranging from 0 percent to 1 percent. *See* PRC Op. R2000-1, paras. 2080-2118. The concept of a field reserve, however, was not raised until mentioned subsequent to the Postal Service's test year update. The Commission considered the evidence offered by all participants, including the effect of the need for a field reserve, on the level of the Postal Service's contingency.

[2070] The Commission recognized that "[t]he greatest potential source of uncertainty concerning the Postal Service's financial results in the test year appears to be ambitious cost reduction programs." *Id.*, para. 2164. In specific recognition of that uncertainty, the Commission "reflected" the field reserve in the contingency. Stated otherwise, the Commission's contingency allowance was directly influenced by its recognition of the field reserve as an indication that projections of productivity-related cost savings were quite aggressive, and therefore somewhat speculative.

[2071] Had the Commission not been so persuaded, the provision for contingencies undoubtedly would have been smaller.

[2072] The Postal Service's claim that the contingency is 1.2 percent is unfounded. The field reserve is not an item of expense. There is a possibility that the Postal Service will not achieve the full amount of projected breakthrough productivity savings. The field reserve represents management's contingent plans should there be a $200 million shortfall in its cost reduction programs. The field reserve is designed to serve the same purpose as the contingency, i.e., as insurance against test year misestimates. In concluding that the field reserve was a separate, additional item in the contingency, the Commission implicitly treated the Postal Service contingency provision as supplemented by the late-filed field reserve, as if it totaled 2.8 percent. Such a view squares with the Commission's express language as well as with the intended result. In sum, the Commission did not subtract the field reserve from the contingency as the Postal Service avers, rather it expressly increased the amount provided for contingencies in recognition of the purpose of the field reserve.

D. Contingency Provision

[2073] The Governors also ask the Commission to reconsider its recommendation of a contingency provision equal to 1.5 percent of estimated costs, and to adjust recommended rates and fees to provide a contingency of 2.5 percent, as initially proposed. A contingency of the requested magnitude would yield $1.695 billion in revenue. Together with other revenues, adjusted as the Governors propose, a 2.5 percent contingency provision would produce $69.8 billion in aggregate test year revenue, as compared to the revenue requirement of just over $69 billion incorporated in the Postal Service's initial filing.

[2074] There is general agreement among the Postal Service and commenting participants as to the proper purpose of the contingency provision: to provide a cushion of additional revenue "sufficient to ensure that the Postal Service can both operate as required and break even, even in the face of unforeseen events or circumstances." Consortium Comments at 8, *quoting* Postal Service Memorandum at 19. As to the "unforeseen events or circumstances" the contingency provision is intended to ensure against, it is also generally agreed that there are two sources of such perils: (1) misestimates of future financial results; and (2) unforeseeable and unavoidable events with the potential for causing adverse financial impact. The Commission concurs with this analytical approach, and has used it to evaluate the contingency provision in this and prior rate proceedings.[22]

[2075] However, there are persistent disagreements as to the Commission's proper role in reviewing the Postal Service's proposed contingency provision, the standards to be employed in any such Commission review, and the degree of support in the record of this case for specific amounts for this purpose. The Commission will address each of these areas in turn.

[2076] *The Commission's role.* The Postal Service continues to espouse the view that determination of a contingency provision is a policy choice within the exclusive province of the Governors' authority under 39 U.S.C. § 3621. Throughout its institutional history, the Commission has declined to affirm and act upon this interpretation, which would exclude the contingency provision from consideration in its evidentiary proceedings, and render its incorporation in recommended rates a merely ministerial and mechanical act. Rather, as the Opinion of November 13 reiterates,[23] the Commission has consistently adhered to its judgment that the reasonability of a proposed contingency provision is an issue appropriate for exploration in the formal hearings required by

[22] PRC Op. R2000-1, para. 2152.

[23] PRC Op. R2000-1, para. 2147.

§ 3624(a), and for a Commission recommendation consistent with the balance of the evidentiary record so produced.

[2077] In addition to the rationales presented in more recent Commission rate decisions, OCA reminds the Commission of a consideration first cited in the Docket No. R71-1 decision that confirms the soundness of this approach and remains persuasive today. In discussing the Commission's acknowledgement of the primacy of the Governors' authority to assure revenue sufficiency, OCA notes that the Governors exercise this authority in two ways: by approving the filing of requests for rate increases under § 3622, and if deemed necessary by modifying the Commission's revenue recommendations under § 3625(d). OCA Comments at 7. However, OCA further observes that exercise of the latter function is dependent upon the Governors' express finding that such modification is "in accord with the record . . .." *Ibid* (emphasis omitted).

[2078] Unless parties are afforded an opportunity to explore issues raised by a proposed contingency provision, along with other components of the revenue requirement, in a manner that satisfies the procedural requirements of § 3624, the foundation of record evidence required for action under § 3625 would be lacking. Thus, even if the Governors ultimately cannot accept the Commission's findings on a recommended contingency provision, the Commission is obliged to make a procedurally sufficient evidentiary record on the issue, and recommend rates that incorporate the Commission's finding on that record. As the Commission stated more than 30 years ago, "if the Postal Service is not required to justify its estimates on the record, neither the Commission nor the Governors would be in a position to exercise their authority in a meaningful way." PRC Op. R71-1 at I-270.

[2079] *Implementing the "reasonable" standard.* There is also a dispute among the parties regarding the significance of § 3621's inclusion of the word "reasonable" as a modifier in the phrase "reasonable provision for contingencies," as well as disagreement about the effect of that language on the proper conduct of Commission ratemaking proceedings. In light of these controversies, it is appropriate to elaborate on the Commission's understanding of the "reasonable" standard in § 3621.

[2080] Consistent with its views on the Governors' exclusive authority over selection of a contingency provision, the Postal Service de-emphasizes the importance of the "reasonable" standard in the Commission's deliberations. The Service does so primarily by characterizing choice of a contingency amount as a discretionary exercise involving the Governors' subjective assessment of appropriate financial goals and policies. "Absent some extraordinary showing of unreasonableness in the Board's judgment," the Service asserts, "the Commission may not" substitute its assessment of a reasonable contingency provision for the Board's judgment on that subject. Postal Service Memorandum at 21.

[2081] All other participants argue for an objective, rather than subjective, interpretation of the "reasonable" standard. The Consortium argues that determination of the contingency is an integral part of the fact-finding process in Commission rate proceedings, rather than a product of managerial discretion. Consortium Comments at 8-10. It also asserts that "the reasonableness of the contingency must be determined by weighing the financial burden on the mailing public against the financial risks being run by the Postal Service." *Id.* at 10. Similarly, OCA argues that the Commission's consideration of the contingency provision should proceed by objectively assessing the weight of the evidence presented on the issue during hearings, including the probative value and credibility of such evidence. OCA Comments at 8-11. Other parties' comments either advocate or are consistent with this objective approach to assessing what is a "reasonable" contingency provision.[24]

[2082] While all decisionmaking necessarily relies on the perceptions of those making the decision, the Commission has undertaken to implement the "reasonable" standard in § 3621 as an objective criterion in conducting rate proceedings and deliberating on rate recommendations. The Commission does so, as the commenting participants suggest, by receiving and assessing the probative value of testimony proffered by participants on the subject. The evidence consists, in the first instance, of

[24] ABA/NAPM Comments at 2-4; APMU Comments at 1-2; VP/CW Comments at 11.

the testimony and documents presented by the Postal Service to demonstrate the degree of protection it believes necessary to protect against the financial risks associated with misestimates and unforeseeable events. The record is supplemented with the responsive evidentiary presentations of other participants on the same issue, together with other subjects germane to the § 3622(b) factors and the policies of the Act.

[2083] This is the procedure the Commission followed in the earlier stages of this case, as reflected in the extensive discussion at pages 38 through 77 of the Opinion and Recommended Decision of November 13, 2000. The Postal Service is accorded certain deference as to an appropriate level of contingency. It shoulders the burden of making most test year cost estimate projections, and its testimony often identifies areas where it views its estimates as more or less speculative. Thus, in this case, Postal Service concern over the difficulty of achieving the full amount of forecast breakthrough productivity savings led to recognition of a separate special purpose component of contingency, and to allocation of a larger provision for contingencies than would have been allowed absent this item.

[2084] The choice of an amount to protect against unforeseeable events is by its nature subjective to some degree, and again, traditionally the Governors have been accorded deference in this area. When the evidentiary record has not contained persuasive contrary evidence, the Commission has accepted subjectively-based Postal Service recommendations. However, in this case the Postal Service evidence supporting the reasonableness of a 2.5 percent contingency was effectively challenged by several witnesses.

[2085] Following appraisal of the evidence presented by the Postal Service and numerous other participants on the subject, the Commission made an independent finding on a "reasonable" contingency provision in the circumstances of this case as documented in the record. In the Commission's view, to have done less would have been inconsistent with the statutory responsibilities assigned by the Reorganization Act in Chapter 36 of Title 39.

[2086] As the Commission's opinion indicates, the primary standard guiding the choice of a "reasonable" contingency can be stated in the question: "whether, giving due deference to the Postal Service's judgment on the subject, the provision is rationally related to achievement of revenue sufficiency in the period under review."
PRC Op. R2000-1, para. 2150 (footnote omitted). The Postal Service argues, as noted earlier, that any such standard should maximize the emphasis on deference to the Service's judgment, operating to approve its proposal "absent some extraordinary showing of unreasonableness in the Board's judgment." Postal Service Memorandum at 21.

[2087] The Postal Service complains that in past cases, the Commission has accepted contingency amounts supported by statements of justification that were very similar to the statements witness Tayman sponsored in this case. However, as the Commission explained "[v]arying circumstances in different rate proceedings will require different degrees of inquiry and review." PRC Op. R2000-1, para. 2150. In this case, numerous participants have opposed the Service's contingency proposal with evidence that is unprecedented in extent and detail. While significant deference is due the Service's appraisal of its potential financial risks during this rate cycle, the participants' challenges highlighted the absence of evidentiary support to document the factual bases of that judgment.

[2088] In addition to evidentiary considerations in the abstract, there are substantive reasons for scrutinizing a proposed contingency that other participants challenge as excessive. As the Opinion notes at para. 2166, the contingency represents a revenue burden that must be distributed to the various classes of service. As the Consortium's comments suggest, it is appropriate to appraise the reasonability of a proposed contingency in light of the financial burden it would impose on the mailing public. In the Commission's view, in a cost-based ratemaking system close scrutiny of the proposed contingency is especially appropriate when the burden from the contingency is larger than the burden from documented increases in attributable costs.

[2089] *Record support.* The Postal Service also asks the Commission to reconsider the evidentiary support for its proposed 2.5 percent contingency provision in the record made in this proceeding. Postal Service Memorandum at 18-19; Postal Service Reply at 13-24. In the Opinion of November 13, the Commission found that support to be insufficient to justify approval of the Service's proposed amount. PRC Op. R2000-1, paras. 2151-65.

[2090] Initially, the Governors and the Service observe that the record includes the same type and amount of evidence provided by the Postal Service to support proposed contingency provisions in past rate proceedings. In light of the Commission's favorable recommendations in those past cases, the implicit question is posed: why is the Service's presentation unacceptable now?

[2091] In general, the answer to this question lies in the volume and probative value of testimony submitted by participants who opposed the contingency provision sought by the Postal Service. As the Commission found in the Opinion, it was appropriate to consider all germane record evidence in considering the reasonability of the proposed contingency provision. *Id.*, para. 2151. Because of the critical nature of the participants' rebuttal testimony, the Commission's review of record evidence has focused intense scrutiny on the Postal Service's presentation in this case.

[2092] Some of this rebuttal testimony criticized the Postal Service for failure to take a more systematic, quantitative approach to developing the contingency provision. Consortium witness Buc effectively challenged Postal Service witness Tayman's dismissal of the Service's *pro forma* variance analysis as a basis for determining an appropriate contingency level. *Id.*, para. 2081. Even more telling was OCA witness Burns' testimony that the Service's subjective assessment of a reasonable contingency provision was incompatible with the systematic approach to estimating the need for contingency reserves used in the insurance and other industries. *Id.*, para. 2085. OCA witness Rosenberg sponsored an analysis to support his conclusion that a one percent contingency would be more than adequate in the test year. *Id.*, paras. 2093-2102. The

Commission found witness Rosenberg's testimony "particularly convincing." *Id.*, para. 2173.

[2093] Lacking an empirical Postal Service analysis of the magnitude of its contingency need, the Commission evaluated the record from a functional perspective: *i.e.*, it assessed evidence bearing on the potential for forecasting errors and for the likelihood of financial impact from unforeseen events. The Commission and the Postal Service concur that the twofold purpose of the contingency provision is to protect against these sources of potential financial harm. *Id.*, paras. 2152-53. As in past proceedings, the Commission evaluated the Service's subjective claims regarding these risks by examining evidence on the Service's financial condition, the state of the national economy, and other relevant factors. *Id.*, at para. 2160.

[2094] The Commission's assessment of the potential for forecasting error noted that the results of the variance analysis presented by witness Tayman suggested a comparatively low level of risk, and it found that using actual FY 1999 data as the basis for projecting test year costs further reduced the potential for such error. *Id.*, para. 2159. The Service claims that the Commission's use of updated costs does not reduce the risk, arguing that "having more and later information can often demonstrate that there is more risk, not less." Postal Service Memorandum at 20.

[2095] While the use of recent information may or may not reduce the risks associated with the "unforeseeable events" aspect of the contingency, the Commission's use of updated costs does reduce the magnitude of likely forecasting error. As the Opinion states, the Commission used the latest available actual results and forecasts in updating test year costs. Test year labor costs were increased using revised cost level change factors, including substitution of the unreduced Employment Cost Index (ECI) for the previously-used value of ECI minus one. PRC Op. R2000-1, para. 2008. Similarly, the Commission used more recent Consumer Price Index (CPI) values to calculate cost-of-living adjustments. It also used the revised cost level change factors provided by witness Patelunas to estimate the increased costs of highway transportation, motor vehicle gas and oil, heating fuel, equipment maintenance allowances, and other non-personnel and Service-wide programs. *Id.*, para. 2012. The Commission remains confident that the risk of misestimates in projections of the costs of operating the Postal Service in the test year have been reduced by the use of its updated estimates. The Postal Service does not specifically dispute this finding.

[2096] With regard to unforeseen events, the Commission found that the evidentiary record, on balance, indicated that "the short-term outlook for the national economy does not appear to involve any significant risk of unforeseeable financial harm to the Service." *Id.,* para. 2161. Rather, in view of the Service's commitment to ambitious cost reduction programs in the test year, the Commission concluded that these efforts to control costs represented the "greatest potential source of uncertainty concerning the Postal Service's financial results . . .." *Id.,* para. 2164.

[2097] In its pleadings on reconsideration, the Postal Service emphasizes the quite different threat of unexpected financial adversity arising from the uncertain state of the economy. The Service chose not to offer new evidence for the record. Instead it first cites the rather general overview in the testimony of witness Zarnowitz and then refers to selected, recent extra-record press reports in which forecasters discuss the chances of recession. This material is intended as support for an argument that "the economic tide which propelled the Postal Service to financial success in recent years is receding." Postal Service Memorandum at 20; *See also*, Postal Service Reply at 16-18. On this basis, the Service submits that it "needs more protection against financial adversity in 2001 than it needed in 1995 and 1998." Postal Service Memorandum at 20.

[2098] It is of course conceivable that the Postal Service's apprehension may unfortunately prove to be right; however, the record made in this case does not adequately substantiate the potential source or sources of potential harm in the test year to justify the requested contingency. The testimony of witness Zarnowitz deals with potential financial perils to the Postal Service only on the highest plane of generality, *i.e.*, he posits that the economic boom of the mid and late 1990s will not continue forever. He did not predict when or why that boom might end. And witness Zarnowitz agreed that economic projections over the term at issue in this rate case have some reliability.

Tr. 41/18234. While witnesses Tayman and Strasser both express general concern about the prospective strength of volume and revenue growth for the Service, neither presents an analytical approach to assessing the magnitude of the potential impact. Moreover, as the Opinion observes, Postal Service witness Thress provided supplemental testimony that the Service did not perceive a need to update test year volume and revenue forecasts, in part because "'the initial forecast is performing quite well compared with the most recent actuals . . ..'" PRC Op. R2000-1, para. 2163 (citation omitted).

[2099] For these reasons, the Commission confirms its initial finding that a 1.5 percent contingency provision is the outcome best supported by the record made in this proceeding. Postal Service witnesses could have presented new information on the national economy, or revised forecasts of test year volumes or revenues through the end of August, 2000. They did not do so. The Postal Service could have supported its request for reconsideration with new evidence. It did not. In its pleadings on reconsideration, the Postal Service cites extra-record press reports, but contends that there is no need to reopen the evidentiary record. It also cautions the Commission against reliance on extra-record material. Postal Service Reply at 41.

[2100] The Postal Service's emphasis on anticipated financial perils other than those documented on the record suggests that it may now possess information that would, in its view, justify a larger contingency amount. If this is the case, and the Governors wish the Commission to base further recommendations on such materials, the Commission will expeditiously act on the Governors' choice between the options described in the introduction to this decision.

III. SPECIFIC RATE ISSUES

A. First-Class Mail Additional Ounces

[3001] The Governors request that the Commission review the First-Class Mail additional ounce cost calculations upon reconsideration. Governors' Decision at 13. Both the additional ounce cost and revenue calculations require the Commission to make assumptions on the number of additional ounces per piece in the test year. The Commission adopted the assumption from the Postal Service's initially filed proposal that the number of additional ounces per piece would remain constant from base year to test year for both the letter subclass as a whole, and for workshared letters. This assumption has the effect of forecasting an increase in additional ounces per piece for single-piece letters.[25] The Governors question whether the Commission properly applied this forecast of increasing additional ounces to the final additional ounce cost adjustment.[26]

[3002] The Commission calculated the increase in additional ounces per piece for the test year and properly applied this information to determine additional ounce revenue. However, the Commission inadvertently applied base year, and not test year, additional ounce per piece data when calculating test year additional ounce costs. The cost adjustment represents the migration of Priority Mail and Standard A Mail pieces, but does not account for First-Class Mail pieces increasing in weight. When test year additional ounce per piece data are properly applied, the additional ounce cost adjustment is increased by approximately $20 million. The Commission corrects this technical error on reconsideration.

[25] The Commission did not adopt the revised Postal Service assumption presented in response to OCA/USPS-106(d). This assumption results in a forecast of declining additional ounces per piece for the letter subclass as a whole, and is counter to the long-term trend of increasing additional ounces per piece.

[26] *See also,* Postal Service Memorandum at 26-28.

[3003] The proper method to calculate the additional ounce cost adjustment follows a three-step process. First, test year single-piece volumes by ounce increment are calculated using the method described in Section II.B of Workpaper 4 presented by Postal Service witness Thress. Then mail processing, window service, city delivery, vehicle service, rural delivery, and transportation unit costs by ounce increment are estimated using data from the weight study presented by Postal Service witness Daniel. Finally, the cost adjustment is determined by applying the unit costs to the test year volumes and comparing these costs to the projections of the rollforward cost model.

[3004] In that final step, a direct comparison would result in a negative cost adjustment. This result is counterintuitive since the adjustment is supposed to reflect the costs of heavier mail forecast in the test year. It occurs because of unit cost differences between the rollforward model for the test year before rates (TYBR) and test year after rates (TYAR), and because of slight differences between the TYBR unit costs as estimated by the weight study and as produced by the rollforward model. To correct for this anomaly, it is necessary to adjust the TYAR unit costs (reflecting the heavier distribution) from the weight study before comparing them to the results of the rollforward model.[27]

[3005] There are several ways of doing this. The method the Commission adopts is to apply a factor to each TYAR functional unit cost from the weight study. These factors are calculated for each function by dividing the TYAR unit cost from the rollforward model by the TYBR unit cost from the weight study (which reflects the base year weight distribution). The resulting adjusted unit costs are applied to the TYAR volume and the results are compared to those from the rollforward model. The end result is a final cost adjustment of $79.049 million, which is $20 million higher than indicated in the Opinion.[28]

[27] The anomaly did not occur in the Postal Service's initial filing, but first appears in the updated (Order No. 1294) data.

[28] These figures are comparable to the $80.053 million and $21 million calculated by the Postal Service and presented in its Memorandum at 28. The Postal Service did not provide sufficient information to allow the Commission to replicate the development of the Postal Service figures.

B. Bound Printed Matter

1. Introduction

[3006] The Governors state that the Commission's recommended Bound Printed Matter (BPM) rates produce an average revenue increase of 9.8 percent instead of 17.6 percent as stated in the Opinion and Recommended Decision, resulting in a revenue shortfall of approximately $30 million. Governors' Decision at 13-14. The Postal Service identifies certain calculations from the Commission's BPM workpapers, PRC-LR-17, that gave rise to the Governors' concern and requests that, should the Commission conclude that a change in BPM rates is warranted, the worksharing differentials recommended in its original decision be retained. Postal Service Memorandum at 28-31.

2. Parties' Comments

[3007] Four parties filed comments responding to this issue. None disagrees that the BPM workpapers contain errors; each urges the Commission to maintain the current rates.

[3008] The Association of American Publishers (AAP) argues that the status quo should be maintained because the Postal Service did not expressly request that BPM rates be changed, and because it is the least disruptive alternative. AAP Comments at 1-2. As a further rationale for not changing the rates, AAP suggests that the advent of dropshipping discounts will, due to volume shifts, result in greater per piece revenue than projected. *Id.* at 2. Finally, AAP contends that any change would require numerous other adjustments to rates and require a more in-depth inquiry than permissible under the circumstances. *Id.* at 2-3.

[3009] The Association for Postal Commerce (PostCom) acknowledges the computational error, but contends that the rates need not be changed because the methodology on which they are based "fail[s] to account for substantial test year economies that will result from the proposed modifications in the BPM rate design." PostCom Comments at 1. PostCom, like AAP, contends that the newly implemented dropship discounts will likely encourage an increase in destination-entered volumes, which in turn will "result in a greater than projected contribution per piece for BPM . . .." *Id.* at 3. This, it claims, "provide[s] an internal correction for [the] error." *Ibid.*

[3010] The Mail Order Association of America (MOAA) asserts that rates should not be changed for two reasons. First, it characterizes as excessive the 108 percent cost coverage implicit in the 9.8 percent rate increase. Restating arguments it made on brief that the cost coverage for BPM should be similar to that of Periodicals, MOAA concludes that "cost coverage of 108 percent is amply justified." MOAA Comments at 1-2. Second, it endorses the reasoning in PostCom's comments. *Id.* at 2.

[3011] The Parcel Shippers Association (PSA) urges the Commission not to change the rates, arguing that, assuming its accuracy, the 9.8 percent increase is "all the mailers can absorb . . .." PSA Comments at 8.

3. Postal Service Reply

[3012] The Postal Service addresses the principle arguments advanced by the parties. It characterizes as speculative the contentions of AAP, PostCom, and MOAA that rates need not be changed because dropshipping will cause BPM per piece revenue to increase. It cautions the Commission against reliance on such extra-record assumptions. Postal Service Reply at 41. The Postal Service criticizes AAP's argument that the status quo would be least disruptive to BPM mailers as unhelpful, essentially an argument that change is to be avoided. *Id.* at 40-41. In responding to AAP's contention that a more in-depth technical inquiry is required, the Postal Service asserts that it seeks only the correction of mathematical errors, calculations, it argues, that do not necessitate re-opening the record. *Id.* at 41-42. Finally, the Postal Service notes that the Commission previously rejected MOAA's arguments concerning the level of cost coverage that is appropriate for BPM mail. On that topic, the Postal Service reiterates that on reconsideration it is not requesting any adjustment to the cost coverage justified in the Commission's Opinion, but only that the recommended rates conform to that target. *Id.* at 41.[29]

4. Commission Analysis

[3013] Upon review of the BPM workpapers, PRC-LR-17, the Commission finds that the Postal Service is correct. The Commission erred in computing BPM test year revenues, and as a consequence the rates it recommended resulted in lower revenues and a lower cost coverage than it intended.

[3014] The Commission's inadvertent error provides no justification for maintaining the status quo. The Postal Service seeks no more than to correct a mathematical error. Correcting the error, the equivalent of an errata, simply brings BPM rates in line with the Commission's recommendation.[30]

[3015] Moreover, none of the parties various arguments opposing the correction is persuasive. For example, certain suggestions (AAP Comments at 1; MOAA Comments at 1-2) overlook the substantial record evidence supporting the Commission's recommended rates. *See* PRC Op. R2000-1, paras. 5846-5906. A review of the Opinion reveals that the Commission substantially mitigated both its recommended rate levels and its cost coverage based on the significant cost increases reported for BPM. *Id.*, paras. 5887 and 5906. Arguments favoring additional mitigation, are, on this record, unsustainable. Moreover, suggestions (PostCom Comments at 1-3; AAP Comments at 2) that dropship discounts may cause per piece revenues to increase due to mail mix are based on extra-record conjecture, as is PSA's claim about the impact of the current

[29] The Postal Service also criticizes as out of context PostCom's assertion that the Postal Service acknowledged that its proposed BPM rates will cause rate shock. *Id.* at 42.

[30] AAP's argument that something more is entailed which would require re-opening the record is misplaced. The correction simply restores the rates to their recommended levels based upon the record before the Commission.

increase on mailers. *See* PSA Comments at 8. These claims lack necessary record support.

[3016] The Postal Service asserts that the Commission's recommended rates fail to generate intended BPM test year revenues by approximately $30 million. The Commission's review of the relevant workpapers confirms the miscalculation. The Commission finds that the most efficacious means of addressing this unintended result is to adjust the rates to correct the error.

[3017] The Postal Service requests that if the Commission corrects these rates, it not reduce the current worksharing differentials. Postal Service Memorandum at 31. No participant opposes this request; MOAA seconds it. MOAA Comments at 3. Although this request constrains the Commission's ability to precisely match the initial revenue target, the difference is insignificant. Accordingly, while maintaining the current differentials, the Commission has corrected the BPM rates to produce, as nearly as practicable, the intended revenue increase and cost coverage embodied in its Opinion. The BPM rates recommended on reconsideration increase the per piece charge by 5 cents and the per pound charge by up to 2 cents. These rates produce a cumulative average increase of 17.4 percent, and a cost coverage of 113.7 percent.

C. The Nonmachinable Parcel Post Surcharges are Not Before the Commission

[3018] In their Decision, the Governors express approval of the Commission's recommendation to extend the Parcel Post nonmachinable surcharge to intra-BMC and DBMC parcels, while indicating a preference for phasing in those surcharges. Governors' Decision at 14. In Order No. 1301, the Commission recognized these comments, and indicated there was some uncertainty as to whether the Postal Service was seeking reconsideration of this issue. The Postal Service Memorandum, submitted as support for the Governors' request for reconsideration, does not mention the parcel post surcharge.

[3019] In response to Order No. 1301, the Parcel Shippers Association (PSA) submitted comments taking exception to the recommended intra-BMC and DBMC nonmachinable surcharges, which the Commission designed to recover approximately 100 percent of the processing cost differences associated with non-machinable outsides. PSA Comments at 1-7. PSA makes the assumption that the Postal Service's failure to seek reconsideration "was an inadvertence." *Id.* at 2, fn. 1. PSA urges the Commission, on reconsideration, to "carefully weigh the fact that these nonmachinable parcels are not in a separately identifiable rate category; rather they are within two existing rate categories." *Id. at 7.*

[3020] United Parcel Service (UPS) submitted comments, essentially in reply to PSA, contending that the issue of nonmachinable surcharges is not before the Commission, but that even if it is, the Commission's recommended surcharges are fully supported by the record. UPS Comments at 2-4.

[3021] In its reply comments, the Postal Service unequivocally states that the Governors have not sought reconsideration of the Parcel Post nonmachinable surcharges recommended by the Commission. Postal Service Reply at 43. The Postal Service argues that the Commission should not reconsider the surcharges.

[3022] The Commission declines to reconsider its recommended Parcel Post nonmachinable surcharges. Under 39 U.S.C. § 3625, the Governors, as they have done here, may comment on an issue, or return a recommended decision for reconsideration. The Postal Service Memorandum, which supplements and clarifies the Governors' Decision, seeks reconsideration of specific issues, not including the nonmachinable surcharges.

[3023] The Act does not explicitly provide for participants to obtain reconsideration. *See* PRC Order No. 1037 (December 9, 1994) at 1. The Commission has recognized that under certain circumstances it may modify an Opinion and Recommended Decision to correct errors or ambiguities. *See* PRC Order No. 787 (June 13, 1988) at 3-4. PSA, however, has not identified any errors or ambiguities requiring modification of the

Commission's recommended nonmachinable surcharges. Consequently, the Commission has not reconsidered this issue.

D. Standard Nonprofit Rates

[3024] The Governors and the Postal Service believe that the Commission may have recommended rates for Nonprofit and Nonprofit ECR that are not consistent with the intent of the recent legislation. The Governors state:

> that in calculating the average revenue per piece, the before-rates volumes and mix should be used. It appears, however, that the Recommended Decision developed the rates for nonprofit Standard Mail subclasses by using the after-rates volumes, rather than before-rates volumes, for both commercial and nonprofit counterparts.

Governors' Decision at 14.

[3025] The Postal Service adds that "to calibrate the recommended rates to the prescribed relationship, the volumes and mail mix employed shall be those expected 'at current rates in the test year of the proceeding.'" Postal Service Memorandum at 32. According to the Postal Service, the remedy is to compute the average revenue per piece by applying recommended rates for commercial mail to the corresponding test year before-rates (TYBR) volumes rather than test year after-rates (TYAR) volumes as the Commission did. *Id.* at 33-34.

[3026] Alliance of Nonprofit Mailers and Direct Marketing Association state that the Postal Service's interpretation of the legislation is reasonable and do not oppose its use in future rate cases, but contend that its use is unwarranted here for two reasons. First, the modest additional revenue, estimated by the Service at $26 million, does not justify the expenses that would be incurred by nonprofit mailers to adjust postage meters, scales, computers and similar equipment plus other additional expenses for retraining mailroom personnel. ANM/DMA Comments at 2-3. Second, the Commission has discretion to adhere to the newly implemented rates because the new legislation does not require the average revenue per piece for nonprofits to be exactly equal to the commercial average revenue per piece by virtue of the legislative phrase, "'as nearly as practicable.'" They note the same phrase governs the breakeven requirement and both the Commission and the Governors routinely approve rates that produce small surpluses or shortfalls. *Id.* at 3.

[3027] Agreeing with ANM and DMA, the OCA acknowledges that the Postal Service's approach is plausible, but concludes that the Commission should not change rates. The OCA adds that resolution of this issue should be left to the next rate case. OCA Comments at 25. OCA's conclusions appear to rest on three points. First, OCA contends that the wording of the statute in subsection 3626 (a)(6)(B) is imprecise, requiring TYBR volumes for only the commercial subclasses. Second, OCA notes that using TYBR volumes will not produce an actual average revenue for nonprofit mail equal to 60 percent of the commercial actual average revenue. *Id.* at 26. Third, the additional revenue will be "minuscule," estimated by OCA at $26.5 million, and nonprofit mailers would incur the additional expenses outlined by ANM and DMA. *Id.* at 28.

[3028] The Postal Service, in its reply comments, acquiesces to the suggestion that Standard nonprofit rates not be changed unless the Commission changes Standard commercial rates as a result of resolving other matters at issue in this proceeding. Postal Service Reply at 30, 38. However, the Service asserts that the Commission should resolve the interpretation issue now by acknowledging that the Postal Service's interpretation complies with the new legislation. The Service adds that it prefers to have a consensus on the appropriate procedure before the next rate filing. *Id.* at 31.

[3029] *Commission analysis.* The Commission accepts the Postal Service's interpretation of the new legislation as the intent of Congress. The Commission also agrees with ANM and DMA, the OCA, and the Postal Service, that no rate changes are necessary.

[3030] The Commission has calculated revenue per piece to be received using the procedure suggested by the Postal Service, as described at page 35 of its

Memorandum, except that recommended fees have been incorporated rather than R97-1 fees.[31] The results are shown below.

Table 1-1

	Regular	Nonprofit	ECR	Nonprofit ECR
Revenue Per Piece[1]	22.212¢	13.162¢	15.676¢	9.367¢
Nonprofit as a Percentage of Commercial	–	59.26%	–	59.75%

Source: PRC LR-19, Worktable 1, pp. 5 and 6.

[1] The Commission's workpapers replicate most of the Postal Service's revenue amounts (for the Postal Service figures see the Postal Service Memorandum at 35). However, the Commission was unable to replicate the revenue shown by the Postal Service for Nonprofit subclass ($1,505,299). The difference is small and does not effect the Commission's conclusions. See LR PRC-19, Workpaper 1, page 5, line 26.

[3031] The results show that nonprofit ECR rates do not require any adjustment because nonprofit per-piece revenue is 59.75 percent of Standard ECR revenue per piece and thus complies with the new legislation. Nonprofit rates could be altered to achieve per-piece revenue closer to 60 percent of Standard Regular by adding one-tenth of a cent to the per-piece rates. Although the change would generate additional revenues of approximately $11.5 million, it would be disruptive to both mailers and the Postal Service, and as a result, all participants favor not adjusting these rates. Under these circumstances, the Commission finds that the recommended Nonprofit subclass rates already meet the "as nearly as practicable" standard of the new legislation.

[31] The Commission calculates average recommended fees per piece using TYAR volumes, then multiplies the result by total TYBR volumes to compute aggregate recommended fees at current volumes.

IV. RATE RECOMMENDATIONS

[4001] Reconsideration of the seven issues identified in Order No. 1301 has caused the Commission to identify three aspects of the November 13, 2000 Opinion and Recommended Decision that should be changed. These adjustments affect the Commission's finding that the recommended rates and fees would allow the Postal Service to break even with a small ($17.7 million) surplus. Therefore the Commission recommends rate and fee changes that will generate sufficient additional test year revenues to achieve break even on the basis of the evidentiary record developed in this case.

[4002] Reconsideration has shown that test year revenues from Bound Printed Matter rates were overstated by $30 million. The Commission finds that the most appropriate way to correct the overstatement of Bound Printed Matter revenues is to correct the error in the design of Bound Printed Matter rates, and to recommend rates for this subclass that will generate the intended revenue. As both mailers and the Postal Service request that the current dropship and workshare discounts be retained at existing levels, the Bound Printed Matter rates actually recommended will provide slightly less revenue than initially envisioned. However, with these corrected rates, Bound Printed Matter will provide essentially the contribution to institutional costs found fair and equitable in the November Decision.

[4003] Upon reconsideration, two adjustments to test year costs have been made: the costs of First-Class are increased by $20 million; and Segment II, Supervisors, costs are increased by $97 million. These items are offset to some extent by the $17.7 million surplus, and by the Governors' rejection of a Priority Mail classification change. The

Governors describe that decision as causing Priority Mail revenues to be understated by $55 million.[32]

[4004] The understatement of First-Class costs does not have a meaningful impact on the cost coverage of First-Class. Thus there is no necessity to increase First-Class rates to offset this adjustment. The increase in Supervisor costs also does not directly suggest an offsetting rate increase. Supervisor costs related to the test year cost reduction programs are attributable to many subclasses and services, and multiple minor rate changes to offset these costs would be so disruptive as to be counterproductive. *See,* Postal Service Reply at 37-38, explaining why Standard nonprofit rates should not be changed in order to generate de minimus amounts of revenues. A better course of action is to identify a narrow rate adjustment that can generate the necessary funds without unnecessarily causing costs and inconvenience for either the Postal Service or large numbers of mailers.

[4005] The Commission recommends that the fee for Certified mail be increased by 20 cents, from $1.90 to $2.10.

[4006] The Postal Service originally proposed a 50 percent increase in the Certified mail fee to $2.10. The Commission recommended a $1.90 fee. This mitigated the proposed 50 percent increase to 35 percent, and concurrently recognized the increasing cost of this service. As stated in the Opinion, Certified mail should be a high value service justifying a cost coverage above the system-wide average. However, the Commission had to balance the possibility of an adverse impact on mailers, against the rising cost of this service, and against concerns of service problems expressed by intervenors. The recommended rate resulted in only a 119 percent cost coverage.

[32] Decision of the Governors of the United States Postal Service on the Recommended Decision of the Postal Rate Commission on Selected Mail Classification Matters, Docket No. R2000-1, December 4, 2000, at 11. This adjustment is equivalent to the other instances where the Governors have identified evidence of record that supports a change. In contrast, the recent events that show the recovery of prior years' losses amount to be too high, Governors' Decision at 19, are not on the record before the Commission.

[4007] Upon reconsideration, the Commission recommends that the fee for Certified mail be increased to $2.10, as originally proposed by the Postal Service. This results in a 131 percent cost coverage, which is still below the system-wide average. The 20-cents increase will generate an additional $53 million in revenue. Increasing the Certified mail fee is straightforward and easy to understand. The increase affects only one category of mail and generates the required revenue. While this causes a larger than desirable increase — something the Commission sought to mitigate in its initial decision, this increase is substantially less disruptive to the entire mailing community than raising one or more rates that would require extensive modification to more complex rate structures. The revenue impact of the fee increase also can be approximated without much effort.[33]

[4008] A Certified mail fee of $2.10 remains in a reasonable range for this service. A comparison can be made between Certified mail (including First-Class Mail postage and Return Receipt) and Signature Confirmation Manual (including the Priority Mail one pound rate) to show the relative impact of increasing the Certified mail fee by an additional 20 cents.[34] Given the above combination of services, and assuming a $2.10 Certified mail fee, there is a cost advantage in using Certified mail over Signature Confirmation Manual for mailings up to 7 ounces. At the initially recommended fee of $1.90, the advantage extended up to 8 ounces. This comparison demonstrates that increasing the Certified mail rate by 20 cents has a minimal impact on identifiable rate relationships and should result in minimal diversion to other services.

[4009] The recommended fee on reconsideration brings the Certified mail cost coverage closer to the level that the Commission has determined is appropriate for this service. Notwithstanding this recommendation, the Commission strongly reiterates its

[33] Given the limited changes recommended, and the Governors' request for expedition, the Commission finds that there is no need to run all of the various rate, cost, volume, and revenue models used in the first decision. The appearance of precision associated with such an effort would provide no recognizable benefit to the Governors, the Commission, or any party to this proceeding.

[34] Return Receipt is included in the comparison because 82 percent of Certified mail users also include Return Receipt.

concerns that the rising cost of this service, and the deficient service performance identified by intervenors should cause the Postal Service to carefully examine how to reduce the costs associated with this service prior to the next omnibus rate case.

[4010] The recommended increase in the fee for Certified Mail will generate $53.490 million additional test year revenue. When combined with the understated Priority Mail revenue, this will largely offset the understated costs of Supervisors and First-Class extra-ounce pieces, leaving the Postal Service with a projected test year surplus of $10 million.

UNITED STATES OF AMERICA
POSTAL RATE COMMISSION
WASHINGTON, DC 20268-0001

Before Commissioners: George A. Omas, Vice Chairman; Dana B. "Danny" Covington; Ruth Y. Goldway and W.H. "Trey" LeBlanc III

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

FURTHER RECOMMENDED DECISION

(Issued February 9, 2001)

The Commission, upon reconsideration of the record in the above-entitled proceeding, having issued its Opinion on reconsideration, which is attached hereto and made a part hereof,

IT IS ORDERED:

That the Commission's Opinion be transmitted to the Governors of the Postal Service and that the Governors thereby be advised that the rates of postage and fees for postal services set forth in Appendix One hereof are in accordance with the policies of title 39, United States Code and the factors set forth in § 3622(b) thereof; and they are hereby recommended to the Governors for approval.

By the Commission.

(S E A L)

Margaret P. Crenshaw
Margaret P. Crenshaw
Secretary

PACKAGE SERVICES
RATE SCHEDULE 522A

BOUND PRINTED MATTER SUBCLASS
SINGLE PIECE RATES

(dollars)

Weight not Exceeding (Pounds)	Zones						
	1 & 2	3	4	5	6	7	8
1	1.79	1.82	1.86	1.92	1.98	2.05	2.19
1.5	1.79	1.82	1.86	1.92	1.98	2.05	2.19
2	1.83	1.87	1.92	2.00	2.08	2.18	2.36
2.5	1.88	1.93	1.98	2.09	2.19	2.32	2.55
3	1.92	1.98	2.06	2.18	2.30	2.45	2.73
3.5	1.97	2.04	2.13	2.27	2.41	2.58	2.91
4	2.02	2.09	2.19	2.35	2.52	2.70	3.09
4.5	2.06	2.16	2.27	2.45	2.63	2.85	3.27
5	2.11	2.21	2.33	2.53	2.74	2.98	3.45
6	2.20	2.33	2.46	2.71	2.96	3.24	3.80
7	2.28	2.43	2.60	2.89	3.18	3.50	4.16
8	2.38	2.54	2.75	3.07	3.40	3.78	4.52
9	2.47	2.66	2.87	3.24	3.62	4.04	4.88
10	2.57	2.77	3.01	3.42	3.83	4.30	5.23
11	2.66	2.88	3.15	3.59	4.05	4.57	5.59
12	2.75	2.99	3.29	3.77	4.27	4.84	5.95
13	2.84	3.11	3.43	3.95	4.49	5.10	6.31
14	2.93	3.22	3.56	4.13	4.71	5.37	6.67
15	3.03	3.33	3.70	4.31	4.93	5.64	7.03
Per Piece Rate	1.64	1.64	1.64	1.64	1.64	1.64	1.64
Per Pound Rate	0.09	0.11	0.14	0.18	0.22	0.27	0.36

SCHEDULE 522A NOTES

1 For barcode discount, deduct $0.03 per piece.

PACKAGE SERVICES
RATE SCHEDULE 522B

BOUND PRINTED MATTER SUBCLASS
BASIC PRESORT AND CARRIER ROUTE PRESORT RATES

(dollars)

Zone	Per Piece: Basic[1]	Per Piece: Carrier Route[2]	Per Pound
1 & 2	0.96	0.86	0.07
3	0.96	0.86	0.09
4	0.96	0.86	0.12
5	0.96	0.86	0.16
6	0.96	0.86	0.20
7	0.96	0.86	0.25
8	0.96	0.86	0.34

SCHEDULE 522B NOTES

[1] For barcode discount, deduct $0.03 per piece.

[2] Applies to mailings of at least 300 pieces presorted to carrier route as specified by the Postal Service.

PACKAGE SERVICES
RATE SCHEDULE 522C

BOUND PRINTED MATTER SUBCLASS
DESTINATION ENTRY BASIC PRESORT

(dollars)

	DBMC Zone 1 & 2	DBMC Zone 3	DBMC Zone 4	DBMC Zone 5	DSCF	DDU
Per Piece Rate	0.83	0.83	0.83	0.83	0.68	0.62
Per Pound Rate	0.06	0.09	0.12	0.16	0.05	0.03

SCHEDULE 522C NOTES

1 For barcode discount, deduct $0.03 per piece. Barcode discount is not available for DDU and DSCF rates and DBMC mail entered at an ASF (except Phoenix, Arizona ASF).

2 A mailing fee of $125.00 must be paid once each 12-month period to mail at any destination entry Bound Printed Matter rate.

PACKAGE SERVICES
RATE SCHEDULE 522D

BOUND PRINTED MATTER SUBCLASS
DESTINATION ENTRY CARRIER ROUTE PRESORT

(dollars)

	DBMC Zone 1 & 2	DBMC Zone 3	DBMC Zone 4	DBMC Zone 5	DSCF	DDU
Per Piece Rate	0.73	0.73	0.73	0.73	0.58	0.52
Per Pound Rate	0.06	0.09	0.12	0.16	0.05	0.03

SCHEDULE 522D NOTES

1 A mailing fee of $125.00 must be paid once each 12-month period to mail at any destination entry Bound Printed Matter rate.

FEE SCHEDULE 941

CERTIFIED MAIL

Description	Fee (in addition to postage)
Per piece	$2.10