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BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON DC 20268-0001

POSTAL RATE AND FEE CHANGES, 2001

Docket No. R2001–1

DIRECT TESTIMONY OF
WILLIAM P. TAYMAN, JR.
ON BEHALF OF
UNITED STATES POSTAL SERVICE

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EXHIBITS

LIST OF ASSOCIATED LIBRARY REFERENCES

The following library references are associated, in whole or in part, with my testimony. Where a library reference is associated in part with my testimony, those portions so associated are indicated.

USPS-LR-J-49	Explanation of Cost Reductions and Other Programs (sections 2–4)
USPS-LR-J-50	Rollforward Expense Factors
USPS-LR-J-51	Workers' Compensation Expense

Direct Testimony

of

William P. Tayman, Jr.

AUTOBIOGRAPHICAL SKETCH

My name is William P. Tayman, Jr. and I am the Manager, Budget & Financial Analysis for the United States Postal Service. I was appointed to this position in September 1995 and my primary responsibilities include the development and administration of national operating budgets.

Prior to this appointment, I was Manager, Strategic & International Finance and Manager, Revenue, Volume and Cost Analysis. I began my career with the Postal Service in 1975. From 1975 through 1978, I held positions at the Postal Service Training & Development Institute and in the Accounting Division at Postal Headquarters. During the period from 1978 through 1980 I was employed by the Pension Benefit Guaranty Corporation (PBGC). At PBGC, I held the position of Deputy Controller.

In 1980, I returned to the Postal Service Headquarters as General Manager and then Office Director of Accounting. In this position, I served as chief accountant of the Postal Service. In 1991, I was selected to attend the Sloan Fellows Program at Stanford University where I received a Master's Degree in Management. I also received a Bachelor Degree in Business and Public Administration from the University of Maryland in 1972. After graduation from the University of Maryland, I was employed at Hoye, Graves, Bailey & Co., a regional Certified Public Accounting firm.

I am a licensed Certified Public Accountant in the State of Maryland. I also am a member of the American Institute of Certified Public Accountants and the Maryland Association of Certified Public Accountants. In Docket Nos. R87-1 and R90-1, I sponsored testimony concerning the estimation of workers' compensation and retirement costs. In Docket Nos. R97-1 and R2000-1 I sponsored the Postal Service's revenue requirement testimony.

I. PURPOSE AND SCOPE OF TESTIMONY AND GUIDE TO SUPPORTING DOCUMENTATION

My testimony presents the Postal Service's revenue requirement for the Test Year (TY)[1]. This testimony was prepared in conformance with the Commission's Rules of Practice and Procedure to support the Postal Service's revenue requirement for the Test Year. The attached exhibits and the material included in Library References J-49, J-50, and J-51 supplement my testimony.

Exhibits A through T are at the end of my testimony and are preceded by an index of Exhibits. These exhibits provide summary components of the revenue requirement. Library Reference J-49, "Explanation of Cost Reductions and Other Programs," supplies the narrative descriptions and fundamental estimating elements of the cost reduction program savings and other programs expense built into the revenue requirement. I am sponsoring sections 2–4 of Library Reference J-49. Library Reference J-50, "Rollforward Expense Factors," supplies the detailed calculations underlying the revenue requirement. Library Reference J-51, "Workers' Compensation Expense," supports the projection of Workers' Compensation liability and expense.

My testimony is organized into five chapters as described below.

Chapter I explains the purpose of my testimony. Chapter II, entitled "Summary of Financial and Operating Results and Current Financial Condition," describes (1) financial and operating results over the last ten years, and (2) the current financial condition of the Postal Service. This chapter reflects the developing deterioration in the Postal Service's financial position. The material presented supports a proposed level of rate increases consistent with management's goals of repairing the Postal Service's financial position, recovering prior years' losses, reducing debt, supporting the Postal Service's capital program, and restoring equity.

Chapter III, entitled "Test Year Revenue Requirement," (1) describes the specific sources of the changes in Postal Service costs which are included in the

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1/ The various fiscal or other periods discussed in this testimony include the following:

The Test Year (FY 2003)	- October 1, 2002 to September 30, 2003
Fiscal Year 2002	- October 1, 2001 to September 30, 2002
Fiscal Year 2001	- October 1, 2000 to September 30, 2001
The Base Year (FY 2000)	- October 1, 1999 to September 30, 2000

revenue requirement, (2) identifies the assumptions used to project cost increases, and (3) defines the change in the revenue requirement by cost segment. This chapter also presents management's rationale for selecting the provisions for contingencies and recovery of prior years' losses; these support the financial integrity and stability of the Postal Service. Considerable additional discussion and analysis has been added to the section on the contingency provision. This chapter also incorporates the Postal Service's testimony on Workers' Compensation expense.

Chapter IV, entitled "Revenues Before and After Rates," describes the level of revenue anticipated during the Test Year on a before-rates and after-rates basis. This chapter unifies the analyses of our revenue estimates by combining a discussion of the revenue anticipated from mail and special services with a discussion of anticipated revenues from appropriations and investment income.

In Chapter V, entitled "Test Year Revenue Deficiency," I calculate the overall revenue deficiency and analyze the effect of the proposed rates on that deficiency.

II. SUMMARY OF FINANCIAL AND OPERATING RESULTS AND CURRENT FINANCIAL CONDITION

In this chapter, I discuss financial results and the financial condition of the Postal Service over the last ten years, from Fiscal Year 1991 through Fiscal Year 2001. Over this ten-year period, the Postal Service provided both reliable service and a reasonable degree of rate stability.

This section also includes certain projected results for the three years underlying this case: FYs 2001, 2002 and 2003. Unless otherwise noted, the historical data used in this analysis are drawn from the Audited Financial Statements of the United States Postal Service for Fiscal Years 1991 through 2000. This analysis will show that, without increased rates in the test year, the Postal Service's already weak financial condition will continue to deteriorate.

Thirty years' experience has demonstrated that the combined pressures of providing universal service as an establishment of the federal government and the increasingly competitive nature of the markets in which the Postal Service functions make the congressionally-mandated goal of break-even extremely difficult to achieve. Over this period there were only two periods of sustained net incomes, one of which was in the most recent ten-year period analyzed in this chapter. By the beginning of Fiscal Year 1995 the Postal Service's equity had dropped to a negative $6.0 billion, reflecting cumulative losses of $9.0 billion. See Exhibit 6L. During much of the period leading into 1995, the Postal Service dealt with unprecedented financial burdens as a result of cost transfers in excess of $8 billion (see Exhibit USPS-6K), resulting from Omnibus Budget Reconciliation Acts (OBRAs). While the continuing obligations are significant, there have been no additional cost transfers since the Omnibus Reconciliation Act of 1993, with the exception of transferring the requirement for funding Post Office Department Workers' Compensation expense in FY 1997 under the Balanced Budget Act of 1997. This absence of additional obligations to the Federal Government, coupled with the benefits of the 1992 restructuring and debt refinancing, extremely moderate increases in the cost of labor and other resources, and healthy volume and revenue growth, led to a temporary period of financial success between FY 1995 and FY 1999. We are now seeing that period come to an end due largely to escalating labor and energy costs and weak revenue growth.

Table 1 presents the net income (loss) and equity by year for the ten-year historical period.

Table 1
Postal Service Net Income/(Loss) and Equity
($ Millions)

Period	Net Income/(Loss)	Equity
FY 1991	(1,469)[2]	(2,747)
FY 1992	(536)[3]	(3,283)
FY 1993	(1,765)[4]	(5,048)
FY 1994	(914)	(5,961)
FY 1995	1,770	(4,191)
FY 1996	1,567	(2,624)
FY 1997	1,264	(1,360)
FY 1998	550	(810)
FY 1999	363	(447)
FY 2000	(199)	(646)
Cumulative Net Income	631	

Losses occurred in five of the ten years. The first net income was achieved in FY 1995. Subsequent net incomes dropped consistently, falling from a high of $1.770 billion down to $363 million in FY 1999. A $199 million net loss was incurred in FY 2000. This unfavorable trend is worsening in FY 2001. Despite the fact that this ten-year period includes a five-year string of net incomes and the three highest net incomes ever earned by the Postal Service, a cumulative net income of only $631 million (an average of $63 million per year or approximately 0.1 percent of total revenue) was earned. This means the Postal Service was unable to make significant progress against its prior years' losses recovery objective during the last decade. The $631 million of recovered equity over this period has not restored the Postal Service's financial strength. Moreover, the projected FY 2001 net loss will significantly exceed this recovered equity.

2/ Includes OBRA 1991 extraordinary retroactive assessment for employee benefits ($1,810 million).
3/ Includes restructuring costs of $1,010 million.
4/ Includes OBRA 1993 ($857 million) and debt refinancing premium ($536.5 million).

Equity is expected to further deteriorate through the test year, in the absence of a rate increase, as shown in Table 2.

Table 2
Postal Service Net Loss and Equity
Including Projections
($ Millions)

Period	Net Loss	Equity
FY 2001	(1,666)	(2,312)
FY 2002	(1,349)	(3,661)
Before Rates FY 2003	(2,451)	(6,112)
Cumulative Net Loss	(5,466)	

Without a rate increase, the Postal Service is projected to incur a cumulative net loss of $5.5 billion for the three-year period, FY 2001 through FY 2003. Equity would drop to a negative $6.1 billion, the lowest level in Postal Service history.

Table 3 presents the year-to-year and cumulative percentage increases in total revenue and expenses for the ten-year period ending September 30, 2000.

Table 3
Comparison of Annual Percent Increase in
Revenue and Expense for the Ten Years
FY 1991 - FY 2000
($ Millions)

Period	Revenue[5]	% Chg.	Expense[6]	% Chg.
FY 1990	40,074		40,948	
FY 1991	44,202	10.3	45,671	11.5
FY 1992	47,105	6.6	47,642	4.3
FY 1993	47,986	1.9	49,751	4.4
FY 1994	49,577	3.3	50,491	1.5
FY 1995	54,509	9.9	52,739	4.5
FY 1996	56,544	3.7	54,977	4.2
FY 1997	58,331	3.2	57,066	3.8
FY 1998	60,117	3.1	59,567	4.4
FY 1999	62,755	4.4	62,392	4.7
FY 2000	64,581	2.9	64,780	3.8
Ten-Year Increase FY 2000 vs. FY 1990	24,507	61.2	23,832	58.2

As shown in Table 3, annual revenues have risen a total of $24.5 billion or 61.2 percent since Fiscal Year 1990. This is marginally greater than the $23.8 billion or 58.2 percent increase in annual expenses over the same period. In

5/ Includes interest income and appropriations.
6/ Includes interest expense and all extraordinary, unusual, and non-recurring expenses.

each year since FY 1995, expense growth has been greater than revenue growth, resulting in a slow and steady deterioration in the Postal Service's net income position.

Table 4 extends Table 3 into the future, using projected revenues and expenses through FY 2003.

Table 4
Comparison of Annual Percent Increase in
Revenue and Expense for the Ten Years
FY 1991 - FY 2003
($ Millions)

Period	Revenue[7]	% Chg.	Expense[8]	% Chg.
FY 1990	40,074		40,948	
FY 1991	44,202	10.3	45,671	11.5
FY 1992	47,105	6.6	47,642	4.3
FY 1993	47,986	1.9	49,751	4.4
FY 1994	49,577	3.3	50,491	1.5
FY 1995	54,509	9.9	52,739	4.5
FY 1996	56,544	3.7	54,977	4.2
FY 1997	58,331	3.2	57,066	3.8
FY 1998	60,117	3.1	59,567	4.4
FY 1999	62,755	4.4	62,392	4.7
FY 2000	64,581	2.9	64,781	3.8
FY 2001	66,344	2.7	68,010	5.0
FY 2002	68,824	3.7	70,173	3.2
Before Rates FY 2003*	70,583	2.6	73,034	4.1

* Excluding contingency.

This table shows the results of Postal Service plans to manage expense growth through the test year. The 3.2 percent expense growth projected for FY 2002 is the second lowest such growth rate over the 13 years in the table, as well as the second lowest such rate since Postal Reorganization in 1971. The 4.1 percent projected expense growth for FY 2003 before rates is lower than eight of the thirteen years displayed in the table. But on the revenue side, two of the three lowest growth rates are the revenue growth rates in FYs 2001 and 2003 before rates.

A significant factor explaining the change in the Postal Service's net incomes and financial outlook from the peak net income year of Fiscal Year 1995

[7] Includes interest income and appropriations.
[8] Includes interest expense and all extraordinary, unusual, and non-recurring expenses.

to the present is the change in unit labor costs. Personnel expenses account for about three-fourths of total Postal Service expenses. This means that personnel costs are the major driver of total Postal Service expenses and overall financial performance. Table 5 displays the growth in unit personnel expense from FY 1995 through FY 2001.

Table 5
Postal Service Net Income and Personnel Expense Growth
Including Projections
Fiscal Years 1995-2001
($ Millions)

Period	Compensation and Benefits[9] (Millions)	Workyears[10]	Cost Per Workyear	Percent Growth Cost/Workyear	Net Income (Millions)
FY 1994	$39,609	857,590	$46,186		
FY 1995	41,931	870,160	48,188	4.3%	$1,770
FY 1996	42,676	887,546	48,083	-0.2%	1,567
FY 1997	43,835	898,384	48,793	1.5%	1,264
FY 1998	45,596	909,578	50,129	2.7%	550
FY 1999	47,333	919,214	51,493	2.7%	363
FY 2000	49,532	917,223	54,002	4.9%	(199)
Projected FY 2001	51,499	900,324	57,201	5.9%	(1,666)

Increases in unit personnel costs were very moderate from 1996 through 1999, including a decrease in FY 1996. These favorable expense growth rates enabled the Postal Service to achieve positive net incomes from 1996 through 1999. The steeper 4.3 percent unit personnel cost increase that occurred in FY 1995, was more than compensated for by the 10 percent rate increase that went into effect on January 1, 1995.

The growth in unit personnel cost over the last two years has accelerated to a cumulative 11.1 percent. This is close to double the 6.0 percent rate increase from the R2000-1 rate proceeding that was implemented in two steps (January 11 and July 1) during FY 2001. Because the last rate increase was so much less than the increase in personnel costs, and because revenue growth has stalled, the Postal Service's financial condition is deteriorating. This deterioration is reflected in the Postal Service's negative equity position and the

[9] Includes Servicewide Costs, excludes Travel and Relocation.
[10] FY 1994 though FY 1996 from USPS Operating Statistics. FY 1997 from LR-H-12. FY 1998 from Exhibit USPS-9P, Docket No. R2000-1. FY 1999 from LR-I-127. FY 2000 from Annual Report of the Postmaster General, FY 2000. FY 2001 from LR-J-50.

need to borrow for operating purposes in FY 2000, the first such borrowing since 1976.

Table 6 displays the Postal Service's outstanding debt from 1972 through the test year.

Table 6
Outstanding Debt
Debt as a Percentage of Statutory Ceiling
FY 1972 - FY 2003
($ Millions)

Period	Total Debt	Debt Limit	Percent Of Statutory Limit
FY 1972	250.0	10,000	2.5%
FY 1973	250.0	10,000	2.5%
FY 1974	750.0	10,000	7.5%
FY 1975	1,750.0	10,000	17.5%
T.Q.	2,998.0	10,000	30.0%
FY 1977	3,498.0	10,000	35.0%
FY 1977	2,431.0	10,000	24.3%
FY 1978	2,364.0	10,000	23.7%
FY 1979	1,837.0	10,000	18.4%
FY 1980	1,770.0	10,000	17.7%
FY 1981	1,538.0	10,000	15.4%
FY 1982	1,471.0	10,000	14.7%
FY 1983	1,404.0	10,000	14.0%
FY 1984	1,337.0	10,000	13.4%
FY 1985	1,940.0	10,000	19.4%
FY 1986	3,104.2	10,000	31.0%
FY 1987	4,603.4	10,000	46.0%
FY 1988	5,842.2	10,000	58.4%
FY 1989	6,445.0	10,000	64.5%
FY 1990	6,947.8	10,000	69.5%
FY 1991	8,420.9	12,500	67.4%
FY 1992	9,903.4	15,000	66.0%
FY 1993	9,731.5	15,000	64.9%
FY 1994	8,973.1	15,000	59.8%
FY 1995	7,264.7	15,000	48.4%
FY 1996	5,906.3	15,000	39.4%
FY 1997	5,861.4	15,000	39.1%
FY 1998	6,413.1	15,000	42.8%
FY 1999	6,913.1	15,000	46.1%
FY 2000	9,313.0	15,000	62.1%
FY 2001	11,313.0	15,000	75.4%
FY 2002	12,913.0	15,000	86.1%
FY 2003 Before Rates*	16,772.6	15,000	111.8%

* Includes Contingency

In absolute terms and as a percentage of the statutory debt limit, the Postal Service's debt is steadily increasing and will be uncomfortably close to the statutory limit in FY 2002. On a test year before rates basis, the Postal Service could reach the statutory limit in FY 2003. The debt trend points to the conclusion that the Postal Service is operating at a greater risk of financial illiquidity than it has at any other time in its financial history, except for the mid-1970's when a billion dollar bailout from the U.S. Treasury was required to restore the Postal Service's financial health.

Two financial indicators discussed in past revenue requirement testimony as examples of worsening financial condition are the current ratio and working capital. These indicators have generally deteriorated over the last decade, indicating that the Postal Service increasingly is exposed to financial risk.

Table 7 compares the ratio of current assets to current liabilities at the end of each fiscal year since 1991. This comparison indicates that the Postal Service's current ratio has declined substantially and consistently from 1991 through 1996. In 1996 the ratio essentially bottomed out and has since fluctuated around 0.1. The slight increase shown for FY 2000 and small increases that may occur in the future are due to the way the Postal Service is managing its cash and debt obligations. Building a small cash reserve at year-end has helped the Postal Service to manage its liquidity in light of the $3 billion annual borrowing limit. Such minor increases in the current ratio reflect this tactic and represent the need for unusual measures to ensure the Postal Service's liquidity. They do not signal a strengthening of the Postal Service's financial position.

Table 7
Comparison of Current Ratios Since FY 1991
($ Millions)

Period	Current Assets	Current Liabilities	Ratio
FY 1991	4,863	7,400	.66
FY 1992	6,027	9,484	.64
FY 1993	4,478	10,140	.44
FY 1994	2,683	11,665	.23
FY 1995	2,775	11,299	.25
FY 1996	1,447	12,573	.12
FY 1997	1,463	13,834	.11
FY 1998	1,528	14,913	.10
FY 1999	1,296	15,436	.08
FY 2000	1,655	18,277	.09

Table 8 shows the Postal Service's debt increasing annually beginning in FY 1998. Taken together, a declining or very low current ratio and an increasing debt level are indicative of worsening financial condition. The Postal Service not only continues to fund its capital program through borrowing, but also borrowed to defray operating expenses in FY 2000. This was the first such borrowing since FY 1976. This is a definite indicator of a worsening financial position.

Table 8
Change in Working Capital and Debt
($Millions)

Period	Increase/(Decrease) In Working Capital	Increase/(Decrease) In Debt
FY 1991	(640)	1,473
FY 1992	(920)	1,483
FY 1993	(2,205)	(172)
FY 1994	(3,321)	(758)
FY 1995	457	(1,708)
FY 1996	(2,601)	(1,358)
FY 1997	(1,245)	(45)
FY 1998	(1,014)	552
FY 1999	(755)	500
FY 2000	(2,482)	2,400

The ratio of total assets to total liabilities shown in Table 9 reflects the net income and net loss trends discussed above. After declining to a low of .73 in Fiscal Year 1994, this ratio rose each year from FY 1995 to FY 1999 and then declined in FY 2000. Without rate increases this ratio will drop rapidly in FYs 2001, 2002 and 2003. The growth in this ratio was temporary and fleeting.

Table 9
Comparison of Total Assets to Total Liabilities[11]
($ Millions)

Period	Total Assets	Total Liabilities	Ratio
FY 1989	15,801	16,814	.94
FY 1990	15,943	17,880	.87
FY 1991	18,069	21,770	.83
FY 1992	20,885	25,231	.83
FY 1993	20,215	26,414	.77
FY 1994	19,169	26,364	.73
FY 1995	19,962	25,499	.78
FY 1996	19,659	23,768	.83
FY 1997	21,209	24,155	.88
FY 1998	22,699	25,215	.90
FY 1999	24,512	26,771	.92
FY 2000	26,100	28,717	.91

[11]/ Excludes the asset Deferred Retirement Costs and the long-term liability Amounts Payable for Retirement Benefits. The current liability portion of Amounts Payable for Retirement Benefits has been included as a liability.

Cost increases, fully described later in my testimony and in Library Reference J-50, are anticipated to have a near term adverse impact on the Postal Service's financial condition. These include: (1) increased labor costs required by negotiated and arbitrated labor contracts; (2) program costs; (3) increases in health benefits; and, (4) increases due to general inflation in the cost of goods and services. Higher costs and the recent shortfalls in funds from operations generally also have an adverse impact on the amount of cash available for debt reduction, which results in higher interest expense.

In my testimony that follows, I project the expected results for the Test Year. The Test Year deficiency, if the proposed rates are not implemented, will be approximately $5.3 billion, which includes a reasonable contingency and prior years' losses recovery. In my opinion, the Postal Service should not allow a deficiency of this magnitude to occur. Instead, rates must be increased to allow for repayment of debt, restoration of equity, and strengthening of the Postal Service's financial position. Without the proposed rate increase, the Postal Service will find it increasingly difficult to fund expenditures critical to the future viability of the Postal Service.

Further, without the proposed rate increase, the Postal Service cannot meet the Board of Governors' policy on equity restoration.[12] Continued, high levels of borrowing would be required and would add significantly to interest expense. Without the proposed rate increase, the already limited capital program would have to be pared down further, undercutting the Postal Service's ability to serve its growing delivery network, to invest in infrastructure, and to invest in future productivity improvements.

Operating at a loss over multiple years, further deferring equity restoration, curtailing investments in infrastructure, and borrowing for operations are not viable financial strategies. In light of the increasing additional costs, which I discuss below, and my financial projections for the Test Year, I conclude that the only prudent course of action is to increase Postal Service revenues through a general increase in rates.

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[12] Board of Governors Resolution No.95-9 (July 10, 1995), filed in Docket No. MC96-3, Library Reference SSR-112.

III. TEST YEAR REVENUE REQUIREMENT

The revenue requirement is developed by estimating changes from a Base Year in which costs and revenues are known. There are three periods involved in development of the revenue requirement: the Base Year (Fiscal Year 2000), the Interim Years (Fiscal Years 2001 and 2002) and the Test Year (Fiscal Year 2003).

A. Summary of Test Year Cost Estimating Procedures

1. Base Year

The Base Year employed by me and by postal cost witnesses in this case is Fiscal Year 2000. Revenues, expenses, net income and balance sheet items developed throughout my testimony are consistent with those in the audited and published financial statements for that year.

2. Fiscal Years 2001, 2002 and the Test Year

Three estimated fiscal years, i.e., Fiscal Years 2001 and 2002, and the Test Year, will be treated separately in my testimony. Cost estimating procedures are applied to each of these years as necessary and direct steps in the development of Test Year costs.

3. Sources of change

Sources of change are classified as cost level, mail volume effect, non-volume workload effect, additional workday effect, cost reductions, other programs, workyear mix adjustments and final adjustments. These sources of change were individually computed for purposes of explaining total cost differences between the Base Year, Fiscal Years 2001 and 2002, and the Test Year in order to establish the basis for the revenue requirement. My testimony explains the derivation of sources of change factors with the exception of mail volume, and final adjustments, including the mail mix adjustment. The rollforward witness utilizes sources of change factors to run the rollforward model. My Exhibit 6B contains rollforward model change reports that summarize each of the sources of change for FY 2001, FY 2002 and the Test Year that result from the factors developed by me and other Postal Service witnesses. The total Test Year revenue requirement is determined by adding final adjustments,[13] the contingency, and the amount included to recover prior years' losses, to the amount reflected on the after rates rollforward model test year change report which has been adjusted for the workyear mix.[14]

a. Cost level

Estimating the increase in the cost of current year resources produces cost level changes for the subsequent year. Year-to-year price changes primarily consist of increases in the unit cost of personnel compensation and benefits and the cost of the previous year's level of non-personnel resources. As detailed in my Exhibit 6Q, cost level changes in salaries are estimated to average 5.0% in FY 2001, 3.9% in FY 2002 and 3.5% in the test year. Cost level changes in benefits are estimated to average 7.1% in FY 2001, 6.2% in FY 2002 and 5.9% in the test year. The derivation of cost level factors is explained in detail in Chapters V, VI, and VII of Library Reference J-50.

b. Mail volume effect

Mail volume effect is cost changes due to increases or decreases in mail volume and special services volume. Cost variability due to the mail volume effect is detailed in the testimony and workpapers of witness Patelunas (USPS-T-12).

c. Non-volume workload effect

These are cost changes that result from variation in measurable workload characteristics other than mail volume. For example, city carrier street costs vary with the number of possible deliveries. Significant non-volume workload factors include the number of possible city deliveries, the numbers of rural boxes and route miles, and the amount of facilities square footage.

[13] Final adjustments are calculated by other witnesses and summarized and sourced in witness Patelunas' Exhibit USPS-12A.
[14] Exhibits 6A, 6B, and 6R.

Additional delivery points are an important expense driver for the postal system. Between the base year and the test year the Postal Service will have added approximately 5 million new delivery points to its network. This is equivalent to three cities the size of Chicago. The Postal Service does not charge for existing or new delivery points. This is very different from other services, such as electric, gas, water, and local telecom, which virtually without exception have some sort of monthly access, hookup, or system charge. Moreover, our pricing structure is not designed to fund network growth. When mail volume growth is less than network growth, as it is currently and is projected to be the case through the test year after rates on a cumulative basis, this limitation of our pricing structure places pressure on rates to rise faster than inflationary pressures otherwise dictate. (See Exhibit 6M.)

Non-volume workload factors are summarized in Table 10. The computation of non-volume workload factors is explained in Chapter IVd of Library Reference J-50. The application of these factors to Postal Service costs is explained in the testimony and workpapers of witness Patelunas (USPS-T-12).

Table 10
Non-Volume Workload Factors
% Change from Previous Year

	FY 2001	FY 2002	Test Year
No. of Post Offices [15]	-(0.0)%	-(0.0)%	-(0.0)%
Possible City Deliveries	0.6%	0.6%	0.7%
Rural Route Miles	2.2%	2.2%	2.2%
Rural Boxes & Route Miles[16]	2.8%	3.0%	3.0%
Contract Stations	3.5%	3.4%	3.3%
Cag L Post Offices	(2.9)%	(3.0)%	(3.1)%
Facilities Sq. Footage (Leased)	0.7%	0.8%	0.8%
Facilities Square Footage (Interior)	2.3%	0.8%	0.9%

d. Additional workday effect

Some costs vary according to the number and composition of days in each Government Fiscal Year. For example, costs are higher on weekdays (except holidays) than Saturdays, and lowest on Sundays and holidays. The derivation of the additional workday factor is detailed in Chapter IV of Library Reference J-50 and the application of these factors to Postal Service

[15] Weighted by Postmaster salaries by class.
[16] Weighted average.

costs is explained in the testimony and workpapers of witness Patelunas. The number of days in each of the relevant years is shown in Table 11.

Table 11
Analysis of Work Days by Fiscal Year

	FY 2000	FY 2001	FY 2002	Test Year
Weekdays	251	250	251	251
Saturdays	53	52	52	52
Sundays	52	53	52	52
Holidays	10	10	10	10
Workday Equivalents	295.06	293.56	294.41	294.41
Total Days	366	365	365	365

e. Cost reductions

Numerous management-initiated cost reduction programs are currently in progress or planned which will result in significant cost savings. Headquarters' financial and operating managers, with the assistance of Area, District, and Plant personnel, develop and implement plans and monitor performance of specific projects and activities aimed at reducing operating expenses. Much of the cost reduction savings impacting FY 2001, FY 2002 and the Test Year derive from automation and other equipment.

Table 12 summarizes the impact of cost reduction programs in the interim years and the Test Year by cost segment. A summary of the major personnel cost related cost reduction programs and the calculation of the workyear and dollar cost savings is included in Library Reference J-50, Chapter Vb. A listing of the major non-personnel cost related cost reduction programs is included in Chapter Vg of Library Reference J-50. Personnel related breakthrough productivity savings are reflected as other programs in Chapter Vd. A narrative description of these programs and the basis for the resource savings is contained in Library Reference J-49.

Table 12
Cost Reductions
($ 000)

Segment	FY 2001	FY 2002	Test Year
2. Supervisors and Technical Personnel	(47,498)	(3,222)	-
3. Clerks and Mail Handlers, CAG A-J	(378,785)	(515,709)	(395,960)
6&7. City Delivery Carriers	(120,130)	(4,341)	(115)
11. Custodial and Maintenance Services	(9,263)	(1,834)	(438)
14. Purchased Transportation of Mail	(193,000)	(166,120)	(60,147)
15. Building Occupancy	(40,000)	(42,000)	(40,000)
Total	(788,675)	(733,226)	(496,660)

Cost savings are projected for supervisory costs between the base year and the test year when considered feasible by the program managers. Supervisory cost reductions are identified for Fiscal Years 2001 and 2002 related to the consolidation of the Remote Encoding Centers. As identified in Section f. below, large Breakthrough Productivity Initiative (BPI) savings or Bold Actions in Cost Segment 2 are identified in Fiscal Year 2002 ($69.0 million) and Fiscal Year 2003 ($50.0 million).

Between Cost Reductions Programs, BPI or Bold Actions, the Postal Service identifies the full range of realizable cost savings for the supervisors and technical personnel. Additional cost savings cannot be captured predicated on theories of volume variability. Cost reduction programs operate differently from volume changes and should not be piggybacked. As was recognized in Docket No. R2000-1, supervisory responsibilities relate to mailflows, networks and operations – not merely to employees. In addition, cost reduction programs frequently require additional supervisory time and attention in order to capture cost savings, to maintain service, and to ensure operating efficiencies. Because of these issues, the Postal Service specifically examines cost savings opportunities relating to Cost Segment 2, rather than making the incorrect assumption that supervisor costs follow in lockstep with programs that affect craft staffing levels.

f. Other Programs

This category includes changes in costs associated with management-initiated actions other than cost reductions that change the status quo (e.g., improve service or satisfy administrative or legal requirements). Some programs satisfy a one-time need and are not intended to continue indefinitely, while others will add additional costs that continue indefinitely.

This category also includes Breakthrough Productivity Initiatives (BPI) or Bold Actions which when added together with the cost reductions in Table 12, sum to management's total commitment to savings between the base year and the test year. The net savings over the three years (FYs 2001 through 2003) for Cost Reduction Programs referenced above, and the portion of other programs that generates cost savings, are $2.6 billion (see LR I-49 Exhibit G).[17]

Other programs also includes changes in expenses not directly linked to operations, such as interest, depreciation and corporatewide personnel costs such as annuitant costs and workers' compensation. Other Programs also includes the impact of accounting and reporting changes and other miscellaneous adjustments that are not appropriate for inclusion in other rollforward change categories. Table 13 summarizes the impact of cost changes reflected as Other Programs for the interim years and the Test Year by cost segment. Summaries of the major Headquarters Administered Other Programs and the calculation of depreciation and nationally accrued personnel related costs are included in Library Reference J-50, Chapters IV-VI. Library Reference J-49 provides a narrative description of each amount included under the Other Program column and the basis for the estimated cost change.

[17] The $2.6 billion in net savings is the sum of Field Operating Programs ($1.1), Breakthrough Productivity ($1.4 billion) and Trend/Base Adjustment ($0.1 billion).

Table 13
Other Programs
($ 000)

Segment	FY 2001	FY 2002	Test Year
2. Supervisors and Technical Personnel	571	(66,898)	(50,000)
3. Clerks and Mail Handlers, CAG A-J	(2,131)	35,928	(84,545)
6.& 7. City Delivery Carriers	(62,895)	(94,296)	(75,866)
10. Rural Carriers	-	(18,568)	(16,579)
11. Custodial and Maintenance Services	39,226	14,365	59,685
12. Motor Vehicle Service	33,902	(28,154)	(25,138)
13. Miscellaneous Local Operations	9,935	26,599	26,000
14. Purchased Transportation of Mail	406,500	223,900	10,247
15. Building Occupancy	120,109	23,045	-
16. Supplies and Services	(9,899)	139,065	(101,388)
17. Research and Development	2,371	1,284	1,388
18. Headquarters and Area Admin.	734,738	118,199	374,114
19. Equip. Maint. & Mgt. Tng. Support	(668)	(12)	-
20. Depreciation, Write-offs, Losses, etc.	304,362	246,875	414,672
Total[18]	1,576,119	621,332	532,590

The expense growth reflected under Other Programs for FY 2001, FY 2002, and the Test Year are $1.6 billion, $0.6 billion, and $0.5 billion respectively, or a total of $2.7 billion. A significant amount of the growth in FY 2001 results from non-recurring costs related to the start up of the Fed Ex contract and bringing the Priority Mail network in house. The remainder of the growth in each year is concentrated in corporatewide personnel costs, depreciation and interest. Reduced program expense reflects management's concern about the Postal Service's financial condition as well as a continuing commitment to control costs. There is long term risk, however, in such an approach, as it requires deferral and cancellation of programs that would otherwise be planned to improve the quality of service, increase responsiveness to customers, and build and maintain our infrastructure.

g. Base Year Unit Cost Adjustment

No adjustment to base year unit costs was necessary.

[18] Includes BPI savings of $351 million, $400 million, and $350 million in Fiscal Years 2001, 2002, and 2003 respectively.

h. Workyear Mix Adjustments

Workyear mix adjustments calculate the dollar impact of changes in the composition of workyears assumed to occur for each individual year between Fiscal Years 2001 and 2003. Changes in the workyear mix are estimated to result in lower personnel costs for Fiscal Years 2001 through 2003. These amounts are relative to the personnel costs that would have resulted if the workyear mix was assumed to remain the same in each estimated year as it was in Fiscal Year 2000 (i.e., the amount of personnel cost calculated by the rollforward model before this adjustment). The net decreases calculated for Fiscal Years 2001 through 2003 before rates are \$56.7 million, \$62.1 million, and \$65.2 million, respectively. The amount calculated for the test year after rates is a decrease of \$68.1 million.

Overtime is based on the FY 2001 operating plan. City carrier and mail handler overtime workyear ratios are assumed to decrease in FY 2001 and then remain at the FY 2001 ratio through the test year. The overtime ratio reflects overtime workyears as a percentage of straight time workyears. The clerk overtime ratio is assumed to continue at the FY 2000 level for FY 2001, as reflected in the FY 2001 operating plan, and then remain at that level through the test year. Clerk transitional employee (TE) workyears for FY 2001 reflect actual data through Accounting Period 9, and are assumed to be little changed from FY 2000, based on year-to-date FY 2001 actual paid employee experience. Clerk TE workyears are assumed to remain at the FY 2001 level through the test year. FY 2001 city carrier transitional employee workyears are also based on actual data through Accounting Period 9 of FY 2001, and are assumed to decline from the FY 2000 level based on FY 2001 actual paid employee data. City carrier TEs are assumed to continue to decline in FYs 2002 and 2003 at the same rate of decline experienced in FY 2001. Casuals are assumed to continue to be utilized at the same level experienced in FY 00 for all years through the test year.

Workyear mix adjustments decrease city carrier and mail handler costs for FYs 2001-2003. These decreases are mainly due to the decreased proportion of city carrier and mail handler overtime workyears in those years relative to the proportion of overtime reflected in the base year. The decreases in clerk costs for FYs 2001-2003 are mainly due to the decreased proportion of career straight time workyears in those years relative to the proportion of career straight time workyears reflected in the base year.

The net impact of the changes due to the workyear mix is reflected as an adjustment to the dollar estimates generated by the rollforward model for clerks, city deliver carriers and mail handlers. The workyear mix adjustment is explained in greater detail in Chapter VIII of Library Reference USPS-LR-J-50.

Table 14
Workyear Mix Expressed As a
Percentage of Straight Time Workyears

	FY 2000 Actual	FY 2001 Estimate	FY 2002 Estimate	Test Year BR Est.	Test Year AR Est.
Clerks A-J					
Career-Base	91.3%	91.0%	91.0%	91.0%	90.9%
Career-Holiday	0.7%	0.7%	0.7%	0.7%	0.7%
Casual	5.4%	5.4%	5.4%	5.4%	5.4%
Transitional	2.5%	2.8%	2.9%	2.9%	2.9%
Subtotal St. Time	100.0%	100.0%	100.0%	100.0%	100.0%
Overtime	8.3%	8.4%	8.4%	8.4%	8.4%
City Carriers					
Career-Base	97.7%	97.8%	97.9%	97.9%	97.9%
Career-Holiday	0.3%	0.3%	0.3%	0.3%	0.3%
Casual	1.7%	1.7%	1.7%	1.7%	1.7%
Transitional	0.2%	0.2%	0.1%	0.1%	0.1%
Subtotal St. Time	100.0%	100.0%	100.0%	100.0%	100.0%
Overtime	12.2%	10.6%	10.6%	10.6%	10.6%
Mail Handlers					
Career-Base	88.4%	88.4%	88.4%	88.4%	88.4%
Career-Holiday	1.3%	1.3%	1.3%	1.3%	1.3%
Casual	10.3%	10.3%	10.3%	10.3%	10.3%
Transitional	N/A	N/A	N/A	N/A	N/A
Subtotal St. Time	100.0%	100.0%	100.0%	100.0%	100.0%
Overtime	12.1%	11.2%	11.2%	11.260%	11.260%

i. Final Adjustments

FY 2000 costs reflect the mail volume mix that existed prior to the Docket No. R2000-1 rate changes that went into effect on January 7, 2001 and July 1, 2001. In order to reflect the cost changes due to those rate changes and certain other volume trends at a finer level of aggregation than represented in the Cost and Revenue Analysis (CRA) report, adjustments were made. The derivations of these and other adjustments are explained in the testimonies and Library References of witnesses Eggleston, Kiefer, Nieto, and Schenk, and are summarized in the testimony of witness Patelunas.

B. Specific Estimating Elements

In order to predict costs, known and reasonably certain cost changes are projected. In addition, estimates based on reasonable assumptions (for costs which will certainly change, but for which the rates of change are not precisely known) are made. Examples of known and reasonably certain cost changes are depreciation on existing plant and equipment, interest expense on debt already outstanding, and the effect of the major labor agreements now in place. Additional estimating procedures cover other salary and benefit and non-personnel cost changes, and general price increases.

1. Labor Contract

The provisions of labor contracts are used to estimate wage increases through the end of the contract periods. Most labor contracts expired in early FY 2001. The exception is the city carrier contract, which expires in early FY 2002. Reasonable and conservative assumptions are made thereafter regarding the new contract provisions that will result from labor arbitrations that are currently in process. For FY 2001, the effective change in bargaining unit employee wages (except city carriers), including the carryover from FY 2000, was set at the Employment Cost Index for Wages and Salaries for Private Industry (ECI). So that the total increase effective for FY 2001 will not exceed the ECI calculated amount, the ECI derived amount is reduced by the FY 2001 general increase and COLA carry-over amounts from FY 2000. This is the same method used by the Postal Service and accepted by the Commission for the Docket R2000-1 Order No. 1294 Update. The new contract money available under this assumption is approximately 2.0 percent.

For FY 2002 and the Test Year, an assumption is made that the total change in wages will equal the rate of change in the Employment Cost Index for Wages for Private Industry (ECI) less one percent. The change in wages assumed to be effective on October 1 reflects the percentage change in the ECI over the previous 12 months, less one percent. Since all ECI related wage estimates effective in FY 01 and 02 are assumed to be effective on October 1, there is no carryover into the subsequent year. These assumptions are not meant to imply that actual labor contract related changes in wages and benefits will be composed entirely of general wage increases or be effective on any specific dates.

The derivation of a Test Year revenue requirement required that the financial impact of wage changes be estimated through FY 03. The annual and effective base wage impacts driving personnel cost level increases are summarized in my Exhibit 6O. Additional details on the derivation of personnel unit cost changes, which include pay increases, lump sum payments, and cost of living allowances, can be found in Chapter VII of Library Reference J-50. The wage and benefit costs estimated in developing the revenue requirement are not intended to imply that these costs are reflective of specific changes in wages and benefits which might result from arbitration or be negotiated in the future.

2. Other Salary and Benefit Changes

Bargaining unit employees receive periodic longevity (step) increases that affect their average compensation. Similarly, performance-based increases, incurred as merit increases and lump sum payouts, affect the average compensation of non-bargaining employees. Estimated effects of these actions are included in appropriate cost level computations and are detailed in Chapter VII of Library Reference J-50. The step increase amounts are offset by savings for new hires who start at the lowest step of the salary schedule. Estimated net step amounts for selected categories of employees are shown in Table 15 below.

Table 15

Step Increase Unit Costs Summary

	FY 2001	FY2002	Test Year
Clerks CAG A-J, Barg.	$81.09	$83.65	$121.41
City Carriers, Barg.	$87.96	$90.73	$181.07
Mail Handlers, Barg.	$225.82	$232.95	$463.81

Federal Employee Health Benefit premiums for covered active employees increased an average of 11.2 percent in January 2000 and

10.7 percent in January 2001. Premium increases of 10.0 percent are expected in January 2002 and January 2003. In addition, covered employees benefited from a change in the methodology for computing the employer share of health benefits expense. The new weighted average formula, required under the labor contracts, shifted about 2 percent of the insurance premium expense from employee to employer. This change was effective in January 2000 for bargaining unit employees except rural carriers. For rural carriers and non-bargaining employees, this shift was effective in January 2001. Cost level computations based on these assumptions are detailed in Chapter VII of Library Reference J-50.

3. General Price Increases

The Postal Service is a significant purchaser of supplies for operations and maintenance, and services such as transportation. Most cost level changes for these items are based upon projections contained in the DRI/WEFA[19] USSIM/Trendlong 0501, and CISSIM/Control 0601. CPI-W estimates from DRI/WEFA served as the basis for computation of cost of living adjustments (COLA) for Fiscal Year 2000 and Fiscal Year 2001 under the existing labor agreements affecting bargaining unit employees.

Major indices used in this case are summarized in the Table 16.

Table 16
Selected DRI-WEFA Forecast Factors
(Percent Change From Previous Year)

	FY 2000	FY 2001	FY 2002	Test Year
CPI-W[20]	3.30	3.31	2.65	2.40
ECI[21]	3.22	4.12	4.16	4.25
Supplies & materials	4.50	2.35	(1.16)	0.19

A more detailed list of the indices used, along with the specific factors for FY 2000 through the Test Year, can be found in Chapter IV Library Reference J-50.

19/ DRI/WEFA is a leading economic forecasting service.
20 CPI-W is the Consumer Price Index for all Urban Wage Earners & Clerical Workers
21 ECI is the Employment Cost Index for Wages and Salaries, Private Industry. The ECI growth factors used in this testimony reflect the September index over the previous September index.

C. Revenue Requirement

The Test Year revenue requirement is presented in the same cost segment format employed in the testimony of witness Patelunas. The total revenue requirement is the sum of accrued costs for eighteen (18) cost segments, plus workyear mix and final adjustments calculated outside the rollforward model (see USPS Exhibit 6R), a provision for contingencies, and an amount for recovery of prior years' losses. Test Year revenue requirements before and after rates are:

Table 17
Test Year Revenue Requirement
($ 000)

	Before Rates	After Rates
Total Cost Segments	73,034,004	72,013,456
Provision for Contingencies	2,191,020	2,160,404
Recovery of Prior Years' Losses	632,809	632,809
Total Revenue Required	75,857,833	74,806,669

1. Accrued Costs

Costs for the eighteen (18) cost segments for the Base Year through the Test Year are:

Table 18
Total Cost Segments[22]
($ 000)

	Amount	% Change
FY 2000	64,780,842	
FY 2001	68,010,372	5.0
FY 2002	70,172,627	3.2
Test Year before rates	73,034,004	4.1
Test Year after rates	72,013,456	2.6

A summary analysis of cost changes is presented here for each cost segment. Included in the analyses are specific reasons for significant cost increases or decreases. A brief description of the costs in each segment is provided.

[22] Includes workyear mix and final adjustments. Excludes contingency and recovery of prior years’ losses.

a. Postmasters (Segment 1)

Costs of this segment for the Base Year through the Test Year are:

Table 19
Postmasters Cost
($ 000)

	Amount	% Change
FY 2000	1,773,011	
FY 2001	1,808,958	2.0
FY 2002	1,890,457	4.5
Test Year before rates	1,971,977	4.3
Test Year after rates	1,963,492	3.9

Costs of the segment are the personnel costs for the following employees:

Postmasters

District manager/postmasters of customer service districts

Some Bulk Mail Center Managers

Officers-in-Charge

Also included is the compensation and benefits for relief or replacement of postmasters. As reflected in Table 20, Postmaster costs are mainly impacted by cost level increases that result from estimated changes in salaries and benefits unit costs. Costs grow more rapidly for Fiscal Year 2002 and the test year than for Fiscal Year 2001. The cost level effects for FY 2001 are less than in FY 2002 and 2003 because the FY 2001 pay-for-performance component is less than it was in FY 2000. This lower level of pay for performance continues in FY 2002 and the test year. More detailed postmaster personnel cost level assumptions and calculations can be found in Chapter VII of Library Reference J-50.

Table 20
Significant Changes in Cost
Postmasters
($ 000)

	FY 2001	FY 2002	Test Year After Rates
Cost Level - Personnel Costs	45,200	75,130	73,390
Mail Volume Effect	-1,505	2,442	162
Additional Workday Effect	-7,410-	4,350	
Non-volume Workload	-338	-423	-517

b. Supervisors and Technical Personnel (Segment 2)

Costs for this segment for the Base Year through the Test Year are:

Table 21
Supervisors and Technical Personnel Cost
($ 000)

	Amount	% Change
FY 2000	3,664,889	
FY 2001	3,668,006	0.9
FY 2002	3,735,443	1.8
Test Year before rates	3,849,712	3.1
Test Year after rates	3,806,894	1.9

Costs of this segment include the compensation and benefits of supervisors, professionals (non-bargaining, non-supervisory personnel), managers of Postal installations other than post offices, and some Bulk Mail Center managers. As reflected in Table 22, Supervisor costs are mainly impacted by cost level increases which result from estimated changes in salaries and benefits unit costs, cost reductions, other programs and final adjustments. The cost level effects for FY 2001 are less than in FY 2002 and 2003 because the FY 2001 pay-for-performance component is less than it was in FY 2000. This lower level of pay for performance continues in FY 2002 and the test year. Cost reductions and final adjustments substantially offset FY 2001 cost level increases. FY 2002 and test year cost level increases are partially offset by breakthrough productivity savings in district professional staff. Final adjustments reflect a shift in the mail mix toward less costly categories. More detailed supervisor and technical personnel cost level assumptions and calculations can be found in Chapter VII of Library Reference J-50. Additional information on segment 2 cost reductions and other programs can be found in LR J-49.

Table 22
Significant Changes in Cost
Supervisors and Technical Personnel
($ 000)

	FY 2001	FY 2002	Test Year After Rates
Cost Level - Personnel Costs	82,838	136,247	130,831
Mail Volume Effect	-6,877	2,981	-4,312
Non-Volume Workload – Indirect Effects	3,129	3,326	3,459
Additional Workday Effect	-8,315)	4,869	
Cost Reductions	-47,498	-3,222	-
Other Programs	571	-66,898	-50,000
Final Adjustments	-20,731	-9,866	

c. Clerks and Mail Handlers, CAG A through J Offices (Segment 3)

Costs for this segment for the Base Year through the Test Year are:

Table 23
Clerks and Mail Handlers, CAG A through J Offices
($ 000)

	Amount	% Change
FY 2000	18,746,408	
FY 2001	19,018,490	1.5
FY 2002	19,215,029	1.0
Test Year before rates	19,723,082	2.6
Test Year after rates	19,318,672	0.5

Costs of this segment include the personnel costs of clerks and mail handlers at CAG A through J offices, including Processing and Distribution Plants and Bulk Mail Centers. As reflected in Table 24, clerk/mail handler costs are mainly impacted by cost level increases which result from estimated changes in salaries and benefits unit costs. Cost level increases are substantially offset by lower workload and cost reduction savings. Total clerk/mail handler workyears are lower in the test year than in the base year. Cost reductions primarily relate to automation and other equipment. For FY 01 and 02 other programs reflect the cost of bringing the Priority Mail Processing Centers in house. These costs are offset by breakthrough productivity savings which are also reflected as other programs. Final adjustments reflect a shift in the mail mix toward less costly categories. More detailed clerk/mail handler personnel cost level assumptions and calculations can be found in Chapter VII of Library Reference J-50. Cost reductions and other programs are detailed in LR J-49.

Table 24
Significant Changes in Cost
Clerks and Mail Handlers, CAG A through J Offices
($ 000)

	FY 2001	FY 2002	Test Year After Rates
Cost Level – Personnel Costs	969,486	772,064	791,498
Mail Volume Effect	-74,462	-6,307	-101,968
Non-Volume Workload Effect	704	642	624
Additional Workday Effect	-22,508	12,945	
Cost Reductions	-378,787	-515,708	-395,960
Other Programs	-2,131	35,928	-84,545
Workyear mix	-20,686	-4,560	-5,816
Final Adjustments	-199,534	-98,465	-100,190

d. Clerks - CAG K Offices (Segment 4)

Costs for this segment for the Base Year through the Test Year are:

Table 25
Clerks, CAG K Offices Cost
($ 000)

	Amount	% Change
FY 2000	7,075	
FY 2001	7,497	6.0
FY 2002	7,843	4.6
Test Year before rates	8,265	5.4
Test Year after rates	8,167	4.1

Costs of this segment include the personnel costs for clerks assigned to CAG K offices. As reflected in Table 26, CAG K Clerk costs are mainly impacted by cost level increases which result from estimated changes in salaries and benefits unit costs.

Table 26
Significant Changes in Cost
Clerks, CAG K Offices
($ 000)

	FY 2001	FY 2002	Test Year After Rates
Cost Level - Personnel Costs	464	373	378
Mail Volume Effect	-27	-36	-54
Additional Workday Effect	-15-	9	

e. City Delivery Carriers (Segments 6&7)

Costs for this segment for the Base Year through the Test Year are:

Table 27
City Delivery Carriers Cost
($ 000)

	Amount	% Change
FY 2000	13,139,989	
FY 2001	13,873,014	5.6
FY 2002	14,599,090	5.2
Test Year before rates	15,324,482	5.0
Test Year after rates	15,193,921	4.1

Costs of this segment include the personnel costs of city delivery carriers. As reflected in Table 28, City Carrier costs are mainly impacted by cost level increases, which result from estimated changes in salaries and benefits unit costs. City carrier cost level increases are particularly high due to the labor contract which included a step upgrade in FY 01. However, city carrier workyears are slightly lower in the test year after rates than in the base year, despite non-volume workload growth in each year. This is mostly due to Delivery Bar Code Sorter cost reductions targeted for FY 2001 and aggressive breakthrough productivity savings reflected under other programs for FY 2002 and the test year. Final adjustments reflect a shift in the mail mix toward less costly categories. More detailed city carrier personnel cost level assumptions and calculations can be found in Chapter VII of Library Reference J-50. Cost reductions and other programs are detailed in LR J-49.

Table 28
Significant Changes in Cost
City Delivery Carriers
($ 000)

	FY 2001	FY 2002	Test Year After Rates
Cost Level - Personnel Costs	987,981	727,665	611,649
Mail Volume Effect	-12,184	36,377	43,460
Additional Workday Effect	-38,108	22,529	-
Non-volume Workload Increases	45,577	49,314	52,212
Cost Reductions	-120,130	-4,341	-115
Other Programs	-62,899	-94,296	-75,866
Workyear mix adjustment	-36,024	-834	-140
Final Adjustments	-31,188	-10,338	-36,369

f. Vehicle Service Drivers (Segment 8)

Costs for this segment for the Base Year through the Test Year are:

Table 29
Vehicle Service Driver Costs
($000)

	Amount	% Change
FY 2000	518,562	
FY 2001	524,196	1.1
FY 2002	542,294	3.5
Test Year before rates	570,528	5.2
Test Year after rates	555,986	-2.5

Costs of this segment include the personnel costs of Vehicle Service Drivers. As reflected in Table 30, Vehicle Service Driver costs are mainly impacted by cost level increases that result from estimated changes in salaries and benefits unit costs and by final adjustments. The final adjustments reflect a shift in the mail mix toward less costly categories. More detailed vehicle driver personnel cost level assumptions and calculations can be found in Chapter VII of Library Reference J-50.

Table 30
Significant Changes in Cost
Vehicle Service Drivers
($ 000)

	FY 2001	FY 2002	Test Year After Rates
Cost Level - Personnel Costs	25,680	20,569	21,181
Mail Volume Effect	1,198	7,284	1,867
Additional Workday Effect	-1,098-	642	
Final Adjustments	-20,146	-10,397	-9,356

g. Rural Carriers (Segment 10)

Costs for this segment for the Base Year through the Test Year are:

Table 33
Rural Carrier Costs
($ 000)

	Amount	% Change
FY 2000	4,233,565	
FY 2001	4,489,870	6.1
FY 2002	4,744,166	5.7
Test Year before rates	5,044,581	6.3
Test Year after rates	5,000,870	5.4

Costs for this segment include the personnel costs of rural carriers and the equipment maintenance allowance (EMA) they receive for their vehicles. As reflected in Table 34, Rural Carrier costs are mainly impacted by cost level increases, which result from estimated changes in salaries and benefits unit costs and estimated changes in the CPI-U for Private Transportation, and non-volume delivery workload growth. Breakthrough productivity savings reflected as FY 02, and other programs in the test year, offset some of the increases. Final adjustments reflect a shift in the mail mix toward less costly categories. More detailed rural carrier personnel cost level assumptions and calculations can be found in Chapter VII of Library Reference J-50. Other programs are detailed in LR J-49.

Table 34
Significant Changes in Cost
Rural Carriers
($ 000)

	FY 2001	FY 2002	Test Year After Rates
Cost Level - Personnel Costs & EMA	221,478	173,454	172,866
Mail Volume Effect	676	24,953	30,153
Additional Workday Effect	-13,038-	7,820	
Non-volume Workload Effects	63,156	70,181	74,707
Other Programs		-18,568	-16,579
Final Adjustments	-15,967	-3,544	-4,443

h. Custodial and Maintenance Services (Segment 11)

Costs for this segment for the Base Year through the Test Year are:

Table 35
Custodial and Maintenance Services Cost
($ 000)

	Amount	% Change
FY 2000	2,560,323	
FY 2001	2,735,249	6.8%
FY 2002	2,872,066	5.0%
Test Year before rates	3,066,237	6.8%
Test Year after rates	3,050,324	6.2%

Costs of this segment include the personnel costs for custodial, operating equipment, and building and plant equipment maintenance. Also included are expenses for contract cleaning services. As reflected in Table 36, the largest impact on Custodial and Maintenance costs is cost level increases. These result from estimated changes in salaries and benefits and the DRI index for rent. Custodial and maintenance services costs are also affected by growth in facilities floor space (non-volume workload), and other programs mostly related to the maintenance of automation and other equipment which reduces costs in other cost segments. More detailed custodial and maintenance personnel cost level assumptions and calculations can be found in Chapter VII of Library Reference J-50. Other programs are detailed in LR J-49.

Table 36
Significant Changes in Cost
Custodial and Maintenance Services
($ 000)

	FY 2001	FY 2002	Test Year After Rates
Cost Level Changes	125,191	106,853	108,845
Mail Volume Effect	-3,773	-1,745	-4,114
Non-volume Workload Effects	34,097	13,126	14,345
Additional Workday Effect	-10,329	6,113	
Cost Reductions	-9,263	-1,830	-438
Other Programs	39,226	14,365	59,686
Final Adjustments	-223	-65	-66

i. Motor Vehicle Service (Segment 12)

Costs for this segment for the Base Year through the Test Year are:

Table 37
Motor Vehicle Service Cost
($ 000)

	Amount	% Change
FY 2000	772,461	
FY 2001	833,180	7.9
FY 2002	819,455	-1.6
Test Year before rates	813,612	-0.7
Test Year after rates	812,248	-0.2

Costs of this segment include the personnel costs of vehicle operating and maintenance personnel and their supervisors, vehicle operating supplies, and vehicle hire. As reflected in Table 38, Motor Vehicle Service costs are mainly impacted by cost level increases and other programs. Cost level increases result from estimated changes in salaries and benefits unit costs, and the forecasted DRI indices for supplies and materials and transportation services which both show smaller increases (or decreases) in FYs 02 and 03 than in FY 01. FY 01 other programs reflects an increase in vehicle supply cost indicated by the current trend. FYs 02 and 03 reflect breakthrough productivity savings in vehicle maintenance workyears. More detailed vehicle maintenance personnel cost level assumptions and calculations can be found in Chapter VII of Library Reference J-50. Other programs are detailed in LR J-49.

Table 38
Significant Changes in Cost
Motor Vehicle Service
($ 000)

	FY 2001	FY 2002	Test Year After Rates
Cost Level Changes	26,395	8,766	14,239
Mail Volume Effect	-114	595	194
Non-volume Workload Effects	3,192	3,481	3,498
Additional Workday Effect	-2,656-	1,587	-
Other Programs	33,902	-28,154	-25,138

j. Miscellaneous Local Operations (Segment 13)

Costs for this segment for the Base Year through the Test Year are:

Table 39
Miscellaneous Local Operations
($ 000)

	Amount	% Change
FY 2000	356,582	
FY 2001	378,531	6.2
FY 2002	418,389	10.5
Test Year before rates	457,818	9.4
Test Year after rates	457,643	9.4

This segment includes the personnel costs for the Mail Equipment Shops, and Facilities and Purchasing Service Centers. Also included are the cost of contract stations, rental allowance for CAG L postmasters, carfare, tolls and ferriage, field operations employee awards, and other miscellaneous expenses. As reflected in Table 40, Miscellaneous Local Operations are mainly impacted by cost level increases, non-volume workload, and other programs. Cost level increases result from estimated changes in salaries and benefits unit costs for the Mail Equipment Shops, Facilities Service Offices and Purchasing Service Centers, and general inflation on contract stations, carfare, tolls and ferriage, field operations employee awards, and other miscellaneous expenses. Non-volume workload changes relate to the impact of changes in the number of CAG L post offices and contract stations. Significant other program increases in FYs 02 and the test year relate to the credit card program. More detailed Mail Equipment Shops and Facilities and Purchasing Service Centers personnel cost level assumptions and calculations can be found in Chapter VII of Library Reference J-50. Other programs are detailed in LR J-49.

Table 40
Significant Changes in Cost
Miscellaneous Local Operations
($ 000)

	FY 2001	FY 2000	Test Year After Rates
Cost Level Changes	9,856	10,289	10,470
Mail Volume Effect	-8	59	50
Non-volume Workload Effects	2,576	2,664	2,734
Additional Workday Effect	-409-	247	
Other Programs	9,934	26,599	26,000

k. Contractual Transportation of Mail (Segment 14)

Costs of this segment for the Base Year through the Test Year are:

Table 41
Contractual Transportation of Mail
($ 000)

	Amount	% Change
FY 2000	4,721,373	
FY 2001	5,091,910	7.8
FY 2002	5,202,851	2.2
Test Year before rates	5,371,685	3.2
Test Year after rates	5,132,336	-1.4

This segment includes the cost of non-Postal Service contractual resources used to transport domestic mail within the United States of America. Also included are the costs of transporting international mail between the United States and foreign countries, and the impact of fluctuations in international currency conversion exchange rates. As reflected in Table 42, Contractual Transportation costs are mainly impacted by cost level changes, mail volume workload, cost reductions, and other programs. Cost level changes result from the level of inflation forecasted by DRI-WEFA. The large cost level change in FY 01 is due mainly to a forecasted change in the highway transportation index of 4.4 percent. The negative cost level change in FY 02 is mainly due to a forecasted decline in the air transportation index of 3.3 percent. Cost reductions include breakthrough productivity savings in all three years, air and rail transportation trend adjustments in FY 01, and air transportation savings in FY 02 related to the Fed Ex network. Other programs include international and highway trend adjustments in FY 01, Fed Ex network costs in FYs 02 and the test year, and air and highway transportation costs related to bringing the Priority Mail Processing Centers (PMPCs) in house in FYs 01 and 02. In Fiscal Years 01 through the Test Year, final adjustments reflect the cost impact of mail mix adjustments as calculated by witness Eggleston. The combination of relatively high inflation and the cost of bringing the PMPCs in house result in a 7.8 percent increase in costs for FY 01. The PMPC in-house costs are offset by PMPC contract cost reductions reflected in cost segment 16. Despite more volume related workload growth in FY 02, cost deflation moderates total cost growth to a 2.2 percent increase. Total transportation costs actually decline in the test year due to a decline in volume workload, low inflation, and breakthrough productivity cost reductions.

Table 42
Significant Changes in Cost
Contractual Transportation of Mail
($ 000)

	FY 2001	FY 2002	Test Year After Rates
Cost Level Changes	167,300	-21,440	56,930
Mail Volume Effect	22,793	107,409	-45,705
Additional Workday Effect	-3,457	1,941	-
Cost Reductions	-193,000	-166,120	-60,147
Other Programs	406,500	223,900	10,247
Final Adjustments	-29,599	-34,749	-31,840

I. Building Occupancy (Segment 15)

Costs of this segment for the Base Year through the Test Year are:

Table 43
Building Occupancy Cost
($ 000)

	Amount	% Change
FY 2000	1,555,946	
FY 2001	1,736,839	11.6
FY 2002	1,764,669	1.6
Test Year before rates	1,766,688	0.1
Test Year after rates	1,766,688	0.1

Costs of this segment include the non-capital related non-personnel costs of occupying and maintaining Postal Service owned and rented facilities. Such costs include rent, heating fuel, building repairs and alterations, and utilities such as gas, electricity, water, and voice telephone communications. As reflected in Table 44, Building Occupancy costs are mainly impacted by cost level increases, non-volume workload, cost reductions and other programs. Cost level increases result from estimated changes in general inflation as forecasted by DRI-WEFA. The fuel/oil/coal and gas indexes show double digit increases for FY 2001, but then decrease for FY 2002 and the test year. Non-volume workload results from changes in rented facilities floor space. In addition to inflation, other programs are also a major cause of the large percentage increase in FY 01. Much of the other program increase relates to the removal of non-recurring prior year credits from the base year and bringing the Priority Mail Processing Centers in house. Cost reductions in all three years result from breakthrough productivity savings on communications costs. Non-personnel related other programs and cost reductions are explained more fully in Library Reference J-49.

Table 44
Significant Changes in Cost
Building Occupancy
($ 000)

	FY 2001	FY 2002	Test Year After Rates
Cost Level Changes	87,621	32,898	30,161
Non-volume Workload Effects	16,821	11,840	11,858
Additional Workday Effect	-3,657	2,046	-
Cost Reductions	-40,000	-42,000	-40,000
Other Programs	120,108	23,046	-

m. Supplies and Services (Segment 16)

Costs for this segment for the Base Year through the Test Year are:

Table 45
Supplies and Services Cost
($ 000)

	Amount	% Change
FY 2000	3,317,281	
FY 2001	3,354,292	1.1
FY 2002	3,466,605	3.3
Test Year before rates	3,341,212	-3.6
Test Year after rates	3,331,917	-3.9

Costs of this segment include the personnel cost of employees at the Label Printing Units and Material Distribution Centers. Also included are most of the supplies and contractual services utilized by the Postal Service, including printing and reproduction and postage stock. Supplies and services included in segments 14 and 18 are identified and are discussed therein. As reflected in Table 46, Supplies and Services costs are mainly impacted by cost level increases, other programs, and final adjustments. Cost level increases result from estimated changes in salaries and benefits unit costs for the Label Printing Units and Material Distribution Centers and general inflation on supplies and contractual services based on the DRI-WEFA forecast for supplies and materials and paper and paper products. The impact of inflation on non-personnel costs is expected to be moderate in FY 01 and the test year, and actually decline in FY 02. Other program increases in FY 01 relate to HQ Administered Programs and Corporatewide Activities and Fed EX start up costs. FY 01 increases are more than offset by reduced Priority Mail Processing contract costs and a reduction in Headquarters activity non-personnel costs which resulted from belt tightening in the FY 01 Headquarters activity budgets. FY 01 also received a base adjustment to remove non-recurring prior year supplies and services' credits from the base. FY 02 reflects an increase in HQ Administered Programs. The largest increases are for E-Business, Infrastructure, and Information Technology. These increases are partially offset by the non-recurrence of the FY 01 Fed Ex start up costs and the elimination of the Priority Mail Processing contract from the base. Other programs reflect a decline in the test year due to a reduction in Information Technology programs. Final adjustments reflect a reduced level of spending for Expedited mail supplies. More detailed Label Printing Units and Material Distribution Centers personnel cost level assumptions and calculations can be found in Chapter VII of Library Reference J-50. Other programs impacting supplies and services are explained in greater detail in Library Reference J-49.

Table 46
Significant Changes in Cost
Supplies and Services
($ 000)

	FY 2001	FY 2002	Test Year After Rates
Cost Level Changes	52,611	-22,488	11,267
Mail Volume Effect	-4,935	-4,647	-7,567
Additional Workday Effect	-767	383	
Cost Reductions			
Other Programs	-9,898	139,065	-101,388
Final Adjustments			-37,000

n. Research and Development (Segment 17)

Costs for this segment for the Base Year through the Test Year are:

Table 47
Research and Development Cost
($ 000)

	Amount	% Change
FY 2000	42,395	
FY 2001	44,766	5.6
FY 2002	46,050	2.9
Test Year before rates	47,438	3.0
Test Year after rates	47,438	3.0

Costs of this segment include contracts for new and existing technology development and applications engineering. Personnel and related costs and other indirect costs are included in other cost segments. As reflected in Table 48, other programs impact Research and Development costs. A narrative description of these programs and the basis for the resource requirements is contained in Library Reference J-49.

Table 48
Significant Changes in Cost
Research and Development
($ 000)

	FY 2001	FY 2002	Test Year After Rates
Other Programs	2,371	1,284	1,388

o. HQ & Area Administration & Corporatewide Personnel Costs (Segment 18)

Costs for this segment for the Base Year through the Test Year are:

Table 49
HQ & Area Administration & Corporatewide Personnel Costs
($ 000)

	Amount	% Change
FY 2000	5,377,065	
FY 2001	6,143,002	14.2
FY 2002	6,295,143	2.5
Test Year before rates	6,706,094	6.5
Test Year after rates	6,706,094	6.5

The costs of this segment include personnel costs for Headquarters and Headquarters related field service units, the money order function, Area Administration, and Law Enforcement. Also included are the Corporatewide personnel-related costs of annual leave repricing, Civil Service Retirement Unfunded Liability Principal, Workers' Compensation, Unemployment

Compensation, Retiree Health Benefits, and CSRS Annuitant COLA principal expense. Remaining costs are supplies and services related to Headquarters activities and miscellaneous support costs. As reflected in Table 50, HQ & Area Administration & Corporatewide Personnel Costs are mainly impacted by cost level increases, and other programs. Amounts included as other programs are mainly the year-to-year change in Corporatewide personnel costs. With the exception of workers' compensation costs, the derivations of Corporatewide Personnel Costs are explained in Chapter VI of Library Reference J-50. The calculation of Workers' Compensation expense is further explained below and in LR J-51.

Cost level increases result from estimated changes in salaries and benefits unit costs for Headquarters and Headquarters related field service units, the money order function, Area Administration, and Law Enforcement. In addition, cost levels increase due to inflation on supplies and contractual services and other miscellaneous items related to Headquarters activities, based on the DRI-WEFA forecast for supplies and materials and the consumer price index. FY 01 reflects a large percentage increase due to one-time costs and transfers which occur in FY 01. These include costs related to the termination of the Emery transportation contract, growth in Headquarters and Field Service unit workyears related to the transfer of the sales function from the field, and a non-recurring credit in FY 2000 for annuity protection. Annuitant health benefits also contribute to the large increase in FY 01 due to a 9.4 percent increase in the Postal Service share of annuitant health benefit premiums and increases in the proportion of annuitant costs borne by the Postal Service. Annuitant health benefits are expected to increase by an additional 10 percent in FY 02 and the Test Year and the cost apportionment share (related to Postal Service versus Post Office Department service) will continue to shift towards the Postal Service.

The Postal Service is projecting an expense of $1,189.9 million for workers' compensation costs in the Test Year. Comparable expenses for fiscal year 2000 were $911.0 million. Estimated expenses for FYs 2001 and 2002 are $949.6 million and $1,026.2 million, respectively. These amounts exclude all costs attributable to Post Office Department employees injured prior to the establishment of the Postal Service on July 1, 1971.

The Postal Service is subject to the Federal Employees' Compensation Act (FECA). Accordingly, the Office of Workers' Compensation Programs (OWCP) of the Department of Labor (DOL) manages the workers' compensation program for Postal Service claimants. The Postal Service is billed annually by the OWCP for reimbursement of all payments made to, or on behalf of, Postal Service workers' compensation claimants over the course of the prior OWCP "chargeback year" (July 1 through June 30). With its reimbursement billing, the OWCP also charges the Postal Service a pro-rata share of its estimated administrative costs.

The annual Postal Service workers' compensation expense is comprised of three components: (1) the net present value of the total estimated long-term liability for those claims which first become active during the current chargeback year, (2) adjustments to the estimate of the existing liability for claims that first became active in prior years, and (3) the pro-rata share of OWCP administrative expenses. Adjustments in the estimated liability result from changes in the number of active claims, cash outlays per claim, and the estimated future duration of claims. Separate liability estimations are made for (1) future costs arising from payments to be provided as compensation to injured postal claimants and their survivors ("compensation" claims) and (2) costs arising from future medical payments on behalf of injured postal claimants ("medical" claims).

The Postal Service and, to a lesser extent, the OWCP are continuing ongoing efforts at cost containment. Efforts undertaken by the Postal Service include the National Workers' Compensation Task Force, the Nurse Coordination Program, the Duplicate Medical Bill Payment Project, contractor review of in-patient hospital expenses, the Limited Duty Task Force and the recent Preferred Provider Pilot with First Health. Initiatives under development by the Postal Service include the National Workers Reassessment Program and an Internet-based Claims Management System. DOL/OWCP efforts include their nurse case manager program, Periodic Roll management review teams, and quality case management initiatives. Taken together, these efforts have served to partially mitigate the trend towards escalation in postal workers' compensation expense.

In reporting its financial results, the Postal Service uses the workers' compensation estimation model to determine the year-end liability. Changes in that liability relative to the end of the prior fiscal year represent an expense component. In its estimations, the model uses payment data provided on tape by the OWCP. These data are processed at the Minneapolis Accounting Service Center to prepare summary data by year of injury and severity of injury. These summary OWCP data, including paid claims, average costs per claim, and a distribution of claimant age at time of injury, are used as estimation model input.

Since Fiscal Year 1991, the Postal Service has used the "extended age" estimation model. This model uses actual historic claimant transition ratios, or derivations of the mathematical likelihood of claims being paid in the next year, to estimate "surviving" claims that will be paid in future years. These transition ratios are used to estimate surviving claims for the first twenty-five payment years. After twenty-five years of payment, claims are deemed to be permanent and the numbers of subsequent surviving claims are estimated using life annuity tables in conjunction with the claimant age at time of injury distribution. Prior to the adoption of the "extended age" model, the Postal Service used a model that assumed all claims became permanent after eight payment years.

An important component of the workers' compensation liability and expense estimation is the net discount factor used to determine the present value of estimated future payments. Since Fiscal Year 1999, the Postal Service used net discount factors of 1.4% for medical claims and 3.0% for compensation claims. The Postal Service periodically reviews the discount factors. Summaries of discount rate analyses for medical and compensation claims over the last ten years are included as Exhibit USPS-6S, page 1 and 5. Our most recent historical and prospective discount rate analyses for medical and compensation claims are included as Exhibits USPS-6S, pages 2 through 4 and 6 through 8. These analyses were based on data published in the Standard & Poor's DRI The U.S. Economy, and its predecessor publication, DRI/McGraw-

Hill's Review of the U.S. Economy, Long-Range Focus. In the opinion of postal management, the discount rates currently used for medical and compensation claims represent a reasonable difference between (a) medical and societal inflation and (b) the rates of return on government debt instruments of terms comparable to the approximate likely lives of medical and compensation claims. It is our opinion that the factors currently used accurately reflect the value of the two individual liability components and the value of the workers' compensation liability as a whole.

Table 50
Significant Changes in Cost
HQ & Area Administration & Corporatewide Personnel Costs
($ 000)

	FY 2001	FY 2002	Test Year After Rates
Cost Level	31,223	33,927	36,837
Additional Workday Effect	-24	14	-
Other Programs (all other not itemized below)	33,604	-80	-600
Unemployment Compensation	22,364	2,500	2,600
Repricing Annual Leave	-17,400	672	9,365
CSRS Unfunded Liability – Principal	64,082	15,517	42,941
Retiree Health Benefits	143,412	160,497	162,645
Annuitant COLA – Principal	137,402	89,495	43,163
Workers' Compensation	38,611	76,590	163,663
HQ & Field Service Unit Pers. Cost	72,303	-26,833	-49,663
HQ Supplies and Services	14,397	25,514	
Misc. Support Cost	225,963	-225,672	-

p. Equipment Maintenance & Management Training Support (Segment 19)

Costs of this segment for the Base Year through the Test Year are:

Table 51
Equipment Maintenance & Management Training Support
($ 000)

	Amount	% Change
FY 2000	21,240	
FY 2001	21,191	-0.2
FY 2002	21,748	2.6
Test Year before rates	22,287	2.5
Test Year after rates	22,287	2.5

Included in this segment are the personnel costs for the Maintenance Technical Support Center and contractual services in support of equipment maintenance and management training. As reflected in Table 52, Equipment Maintenance & Management Training Support costs are mainly impacted by cost level increases and other programs. Cost level increases result from estimated changes in salaries and benefits unit costs for the Maintenance Technical Support Center and general inflation on contractual services based on the DRI-WEFA forecast for the consumer price index. Other program changes relate to changes in Headquarters Administered Programs and personnel resources at the Maintenance Technical Support Center.

Table 52
Significant Changes in Cost
Equipment Maintenance & Management Training Support
($ 000)

	FY 2001	FY 2002	Test Year After Rates
Cost Level	619	569	539
Other Programs	-668	-12	

q. Depreciation, Write-Offs, Claims, and Interest (Segment 20)

Costs of this segment for the Base Year through the Test Year are:

Table 53
Depreciation, Write-Offs, Claims, and Interest
($ 000)

	Amount	% Change
FY 2000	3,972,677	
FY 2001	4,281,381	7.8
FY 2002	4,531,329	5.8
Test Year before rates	4,948,306	9.2
Test Year after rates	4,819,927	6.4

In addition to depreciation on equipment and buildings, this segment includes the following costs:

Domestic and foreign mail indemnities

Insurance and tort claims

Uncollectible receivables and other write-offs

Interest expense

As reflected in Table 54, Depreciation, Write-Offs, Claims, and Interest costs are mainly impacted by cost level increases, and other programs. Cost level increases result from estimated changes in general inflation on indemnities and claims and losses based on the DRI-WEFA forecast for the consumer price index. Other programs consist mainly of estimated changes in depreciation, interest on debt, and interest on retirement liabilities. The before rates increase of 9.2% is higher than the after rates increase of 6.4% due to the greater amount of borrowing that would be required if rates are not increased. Detailed explanations of how these costs were estimated can be found in Chapters V and VI of Library Reference I-50.

Table 54

Significant Changes in Depreciation, Write-Offs, Claims, and Interest Cost

($ 000)

	FY 2001	FY 2002	Test Year After Rates
Cost Level	4,365	3,602	3,338
Mail Volume Effect	-24	-527	2,587
Depreciation Expense	127,723	219,219	194,331
Disposition of Property	45,717	-46,111	-3,982
Interest on Debt	93,151	33,200	69,000
Interest on Retirement Liabilities	37,354	40,521	23,324

2. Provisions for Contingencies and for Recovery of Prior Years' Losses

As shown in my Exhibits and Section II of my testimony, the Postal Service's losses are growing rapidly, equity is negative, cash flows from operating activities are insufficient to satisfy the Postal Service's capital needs, and debt is uncomfortably close to the Postal Service's statutory limit. To rectify these deficiencies and safeguard Postal Service finances from further deterioration, the Postal Service needs a rate increase that includes the contingency provision and the Prior Years' Losses Recovery (PYLR) provision supported in this testimony.

The contingency operates prospectively while the PYLR provision makes up for past shortfalls. A reasonable contingency represents a judgment of an amount to ensure that revenues cover all costs, including those that cannot be estimated. But when losses do occur, the PYLR provision is necessary to restore the Postal Service's financial health. Until prior years' losses are restored, these losses tap the limited sources of funding available to support the Postal Service's capital program.

In response to recent unfavorable financial trends, the Postal Service froze the facilities portion of its capital program and has frozen or deferred other capital infrastructure projects, including delivery vehicle acquisitions.[23] This is a stopgap measure. It cannot indefinitely continue. The assets that are frozen and that otherwise would have been purchased are needed to serve our continually growing customer base. Facilities and infrastructure are used to satisfy our universal service obligations, and support our retail, delivery and processing networks. Investments to improve these facilities and support infrastructure enhance service quality and operating efficiency.

A prime illustration of the need for capital relates to the impact of the growing delivery network. The Postal Service is obligated to serve new delivery points whether or not volume grows commensurately and generates revenue to fund network growth. As stated above each year the Postal Service provides service to approximately 1.7 million new delivery points, which is equivalent in size to the City of Chicago. At 500 deliveries per route, that translates into a need for 3,400 new carrier routes and 4,800 new carriers. At 45 routes per facility, the equivalent of 80 new delivery facilities are required[24] (annexes, stations, branches or associate offices) at an average cost of $5 million. The resulting annual capital need for network growth is approximately $400 million.[25] Due to the capital-spending freeze in FY 2001, these types of projects have not been funded.

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[23] Exceptions to the freeze are available for emergencies, to ensure safety, and to satisfy legal obligations.

[24] The actual number or facilities will vary depending on factors such as shifts in population centers, carrier productivity programs, and specific local needs. Shifts in population centers place demands on the system for growth that is disproportionate to delivery point increases because facilities are not transferable from area to area. In some cases, growth can be served by repair or alteration of an existing facility rather than by building a new facility.

[25] In addition to new facilities, assuming that half the new routes are city routes, there would be a requirement for 1,700 new vehicles, which at $20,000 per vehicle, translates into an additional capital requirement of $34 million.

In its revenue requirement, the Postal Service has included a 3 percent provision for contingencies. Postal Service management and the Board of Governors view this as reasonable and as the minimum amount that is necessary to address inherent uncertainties relating to the Postal Service's projected financial status in the test year. It also better reflects the risky financial standing of the Postal Service than the smaller contingencies in Docket Nos. R94-1, R97-1 and R2000-1. Recovering prior years' losses will assist in retiring debt and restoring the Postal Service's financial health, so that the capital program may be resumed at appropriate levels.

The Postal Service is not relying on rate increases alone to restore its financial health. We have had extremely strong productivity performance in FYs 2000 and 2001, and have aggressive cost savings programs in FYs 2002 and 2003, and continued limitations on capital spending. Together with these restraints, the contingency provision and PYLR amount assist in restoring the Postal Service's financial health. These strategies should result in adequate funding to support operations, even in the face of unanticipated contingencies, and are designed create the ability to restore equity and make necessary capital investments.

a. Framework for Contingency.

The contingency provision deals with the reality that events that affect the Postal Service's financial picture and the impacts of those events are, to varying and unknown degrees, unforeseen and unforeseeable. Because history and recent events teach that there is always the potential for the unknown and the unknowable, an adequate contingency is absolutely essential to achieving long-run break even. An adequate contingency provision is also a foundation for PYLR. If contingencies are inadequate the Postal Service will fail to break even and will therefore be unable to restore Prior Years' Losses as contemplated by Section 3621 of the Postal Reorganization Act and Board of Governors Resolution 95-9.

The contingency provision provides protection against possible adversities. When adversities strike they can affect any part the postal system. Adversities can affect revenues. Adversities can affect costs.

Adversities can relate to the quantity of mail or to the mix of mail. Or adversities may crop up in the context of non-volume workload. Adversities can occur with respect to the cost of resources or the amount of resources consumed. Adversities can be specific to the Postal Service, such as an unfavorable labor contract interest arbitration award, or they may be more broadly based, such as political events, natural disasters, and unexpected inflationary spikes, or sudden economic slowdowns. For instance, the tragic events unfolding as this testimony is finalized will undoubtedly have economic consequences, the magnitude of which cannot be easily predicted. These events are their repercussions are certain to create an even higher level of economic uncertainty and fragility than existed just two weeks ago.

The contingency provision also recognizes that the Postal Service does not control the most important factors and events relating to its revenue and revenue needs. The Postal Service does not control its rates and fees. It must pursue changes through this lengthy and complex regulatory process, whose outcome ten months hence is uncertain. Due process requirements and Postal Rate Commission rules significantly limit the Postal Service's flexibility once the rate-making process has begun. From the time a decision is made concerning the need for rate increases, there is a lag time approximating 18 months to prepare and litigate that rate filing and implement the resulting new rates. The delay in receiving needed revenues can stretch to two years or more if the Governors' modification authority must be exercised, as it was in the last case. In addition, the Postal Service has no ability through the rate making process to react rapidly to shifting market or economic conditions.

The Postal Service does not control wage rates or terms and conditions of employment. For non-management employees, these are subject to negotiation and a binding arbitration process, which leads to uncertain and sometimes surprising results.[26] Also, federal law ties Postal Service into various

[26] An example of an uncertain and surprising result is the outcome of the latest city carrier contract arbitration. That contract gave city carriers a 1.2-percent general pay increase and a 2.9 percent grade level increase in FY 2001. See Exhibit USPS-6O. That contract also provides for FY 2001 COLA increases which sum to $961.03 or 2.7 percent on an effective basis. The total FY 2001 wage increase for city carriers is then 6.8 percent, which is more than twice the rate of inflation.

expense programs (Federal Workers' Compensation and the Health Benefit and Retirement systems). The Postal Service does not have the freedom to shop for less expensive alternatives. The Postal Service's expense base is highly exposed to inflation, particularly including the 76.7 percent of total expenses that relates to labor and the 8.1 percent of total expenses that relates to transportation.[27] When adversities occur with respect to these, the adversities go straight to the bottom line.

In considering contingency amounts, it should be understood that a small rate increase does not make potential adversities any smaller or more remote than does a large rate increase. To the contrary, a small proposed rate increase may reflect aggressive productivity and cost savings goals that translate into increased financial risk. The Postal Service has included aggressive productivity and cost savings objectives in this rate filing. Due to the range of possibilities a contingency is meant to cover, it is unwise to evaluate the reasonableness of a contingency provision by comparing it to the size of a rate increase. The contingency provision is meant to protect the overall operation of the Postal Service, which in the Test Year are projected to be at the level of $75 billion. The size of a given rate increase has no bearing on the magnitude of possible adversities. The only possible relationship is that a smaller increase may represent a greater risk, as noted above.

The Postal Service's 3 percent test year contingency provision implies that the Postal Service's overall revenue and expense projections which forecast from an FY 2000 base year to an FY 2003 test year, must be at least 99.5 percent accurate (a 0.5 percent per year variance on average each for revenue and expense) in order for the contingency not to be fully consumed by adverse variances. This is a very tough standard.

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[27] Using FY 2000 expense, total personnel costs (including servicewide expenses) are $49,696 million or 76.7 percent of the total expense of $64,781 million. Transportation related expenses include Rural EMA ($365 million), Vehicle Hire ($50 million), Transportation of Supplies ($27 million), Carfare, Tolls and Carrier Driveouts ($62 million) and Transportation of Mail ($4,721 million). The total base year transportation expense then is $5,225 million or 8.1 percent of total expenses.

b. Institutional Factors Demonstrate the Need for the Postal Service's Contingency Provision.

There is a range of institutional factors, which support the need for, and the size of the Postal Service's contingency provision.

A major factor is universal service. The Postal Service has an obligation to serve. It may not refuse to serve customers or withdraw from geographic areas merely because they may be more expensive than others may, or are unprofitable. The Postal Service provides delivery service to virtually every household and every business, every day except Sundays and Holidays. It operates some 40,000 post offices, stations and branches.

The postal system must fund delivery-point growth whether or not we receive contribution growth from new mail volume to support those new delivery points. The Postal Service must serve these new delivery points, whenever and wherever they occur. The Postal Service cannot act to tax, channel, limit or control growth, as is frequently done by local and municipal planning and zoning authorities if they do not wish to provide municipal services to serve growth. The direct labor expense for carrier-network growth (non-volume workload) between the base year and the test year is approximately $355 million. This is in addition to capital requirements mentioned above.[28]

The Postal Service also cannot unilaterally impose surcharges (such as UPS does for different delivery types) or negotiate individual contracts in order to ensure the profitability of each of its business segments. The Postal Service cannot charge customers infrastructure costs to serve new communities like utility companies. Many businesses can readily eliminate product options, renegotiate and restructure prices, or pull back from unprofitable customer segments in order to respond to adversity.

The Postal Service does not withhold or reduce its basic services when times are tough financially. We do not have permanent or rolling

[28] I am not testifying that the contingency pays for network growth. We strive to design rates that include adequate markups to compensate for network growth. I am testifying, however, that the Postal Service's obligation to serve its delivery network without regard to volume or revenue growth makes an adequate contingency vitally important. The Postal Service has no realistic options to limit deliveries or eliminate portions of its network to respond to adversity in order to reduce costs.

delivery "blackouts", we do not close money-losing retail outlets at will, and we do not shear off unprofitable portions of the mailstream or refuse to serve or surcharge unprofitable customers. The entire U.S. economy relies on the postal network in the conduct of billions of dollars of commercial and financial transactions every day.

Another factor relating to the contingency is that the Postal Service carries an extremely large liability on its balance sheet. This is for deferred retirement costs and represents financial claims that will be made on the Postal Service. Over time, only adequate contingency provisions ensuring the Postal Service breaks even in the face of unexpected adversities will put the Postal Service in a position to protect its ability to honor the obligations represented by this liability.

The risks of not securing needed revenues in a timely manner and of experiencing adverse revenue or cost variances are magnified by the fact that the break-even requirement allows no margin of safety other than through the contingency provision. Because of the zero net profit margins that result from the Postal Service's breakeven objective, the contingency is an especially critical tool for ensuring the long run financial health and solvency of the postal system.

Because the contingency relates to future events that are unknown either as to their occurrence or degree of impact, there is not always a bright line between what is possible and what is not. Nevertheless, should a contingency provision turn out to be greater than required to fund operations for a period of time, there is no enrichment of executives or employees[29] of the Postal Service. To the contrary, the resulting net income then serves to stabilize postal rates and hasten recovery of the substantial accumulation of prior years' losses.

On the other hand, due to the breakeven requirement, if a contingency provision is inadequate, it can plunge the Postal Service into a financial and operational crisis. With $12.9 billion in debt projected through FY 2002 and debt at the Postal Service's statutory limit a possibility in the test year

[29] The Postal Service's pay-for-performance program for non-bargaining staff, managers and executives indexes out the impact of rate increases from the payment pool. Therefore, these employees and executives receive no credit for rate increases.

before rates, the Postal Service is uncomfortably close to illiquidity. In this context, it would be ill-advised for the Commission to reduce the Postal Service's contingency provision in recommending rates and fees.

c. The Contingency Provision Provides Protection Against Real Risks.

In Docket No. R2000-1, the Postal Service's direct case and the rebuttal testimonies of witnesses Strasser and Zarnowitz advised the Commission that the Postal Service was facing substantial risks from the economy and competition. Responding to our rebuttal witnesses, the Commission concluded, "[T]he short-term outlook for the national economy does not appear to involve any significant risk of unforeseeable financial harm to the Service." PRC Op. R2000-1, para. 2161. The Commission further stated that there was a "comparatively low level of uncertainty regarding potential forecast error in volume estimates for the test year." Id., para. 2163.

Reality has been quite different from the Opinion's assessments. The risks the Postal Service attempted to cover through its contingency provision proved to be real. There has been a sharp, unexpected slowdown in economic growth that placed the economy on the verge of a recession.[30] Also, updated demand research, which supports our volume forecasting, shows that the Internet has made inroads into First-Class Mail and to a lesser degree, Standard Mail volumes. Due largely to the economic slowdown and competitive inroads, the volume and the mix of the mail have varied to the point where it appears that test year R2000-1 revenues will come in $1.4 billion less than projected. This revenue variance alone consumed the contingency recommended by the Commission in R2000-1.[31]

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[30] As of July of 2001 when we locked into the macroeconomic assumptions which drive this filing, the Gross Domestic Product (GDP) growth for the latest quarter (Spring) was estimated at 0.7 percent. In late August this estimate was dropped to 0.2, which was the lowest quarterly growth since 1993.

[31] The Commission's contingency was published in a recommended decision issued on November 13th, after the the R2000-1 test year had already started. This level of revenue mis-estimation so far along in the process belies the notion that the contingency provision should be reduced as the test year becomes closer in time to the close of the record. The Postal Service's contingency is developed with the full awareness that it will be applied in a decision issued ten months after the case is filed. It is developed with the expectation and understanding that it will

(continued…)

The unfolding events of the last two years make it clear that the Postal Service's string of financially successful years in the mid- and late-1990's was atypical. In assessing the reasonableness of the contingency provision in Docket No. R2000-1, it should not have been assumed that success would continue unabated. Risks should not have been assumed away. It would invite disaster to repeat that mistake in this rate case.

d. There Continue To Be Significant Economic Risks.

Risks relating to the economy are clear and pervasive. The Postal Service relies in this rate filing on the macroeconomic forecasts released by DRI-WEFA in June, 2001. The following passage comes from that June Release,

> The risk of an economic forecast being wrong – as soon as it is published – is high under the best of circumstances. Unfortunately, this risk is especially high now, and the range of possible outcomes over the next few years is uncomfortably large.[32]

Adverse shifts in the economy can hurt the Postal Service in at least two ways. First, inflation can accelerate beyond projections and negatively affect the Postal Service's costs. Second, the economy can slow down or contract and reduce the Postal Service's revenue stream. Both of these possibilities are encompassed in the rationale supporting the contingency provision. At this time, the risk of slackening economic growth is particularly high. The baseline economic forecast used in the Postal Service's volume and Revenue projections is assigned merely a 55 percent probability by DRI-WEFA. The other DRI-WEFA scenarios – Late Recession (10 percent probability) and Pessimistic (35 percent probability) – have less economic growth through the test year. This means the macroeconomic risks are badly skewed against the Postal Service.

(continued…)
not be reduced due to the passage of time between now and the issuance of the Commission's recommended decision. Recent experience with the economy has buttressed Postal Service management's view that the passage of time can lead to increased risk, and belies the notion that risk automatically dissipates with the passage of time.

[32] Noriman Behravesh, Andrew Hodge, and Cynthia Latta DRI-WEFA, The U.S. Economy, "Hanging By a Thread", June 2001.

The pessimistic view is reinforced in DRI-WEFA's July release, which asserts the "odds of a recession remain high."[33] In the August release DRI-WEFA reports that new "slower growth potential increases inflation risk" and concludes,

> In the end there are not lifelines for the U.S. economy from the rest of the world. Whether or not the United States suffers through a recession or a protracted slump will depend on the efficacy of its monetary and fiscal policies in keeping consumer spending buoyant and limiting the fallout from the high-tech bust.[34]

In terms of risks to the economy, consumer demand can weaken instead of staying firm long enough to keep the economy out of a recession, and business expenditures and capital expenditures can spiral downward to further reflect declining cash flows and profits. Foreign investment in the U.S. could weaken along with export demand. Fiscal policy changes could backfire and reintroduce large Federal deficits and inflationary expectations. The Fed may exhaust effective monetary policy options. Or a new series of energy shortages or slackening productivity growth could initiate an inflationary spiral. These are all real and substantial risks.

As this testimony was being finalized after the Board approved filing this rate request and the contingency provision included herein, the terrorist attack on the World Trade Center and the Pentagon occurred. Aside from being an enormous tragedy with grave national security implications, it will also apparently have far-reaching and unpredictable economic impacts. It is immediately apparent that unemployment will grow sharply due to layoffs in the transportation and tourism industries, and there are signs that the dollar may weaken.

In a forecast note entitled "Terror and Paralysis", DRI-WEFA's forecasting service said on September 11th,

> The main impact of today's horrible events in New York and Washington is its human toll. It will also have an economic impact, and it is our job to evaluate that more measurable

[33] Noriman Behravesh, Andrew Hodge, and Cynthia Latta DRI-WEFA, The U.S. Economy, "Waiting It Out", July 2001.
[34] Noriman Behravesh, Andrew Hodge, and Cynthia Latta DRI-WEFA, The U.S. Economy, "Still Afloat", August 2001.

> effect for our clients as promptly as possible. Accordingly, we have prepared an alternative forecast based on the assumption that some of the major impacts of the terrible events of September 11 will be on consumer confidence and the financial markets. Short-term, the impacts will be sharply negative as activity comes to a grinding halt while people try to understand and sort out what has happened. Consumers will be glued to their television sets for several days, travel plans will be canceled, business will be interrupted. The loss of the World Trade Center, which was a focus for much financial activity, will leave people wondering about their financial records. Tourism will plunge and businesses will reduce travel. In the longer term, there will be large expenditures for additional security, ranging from construction to computers to telecommunications.

In addition, depending on subsequent military and political actions, there are new risks of oil, energy and other price hikes that could result as subsequent events unfold. One of the sad truths that these tragic events reinforce is that large risks can exist even in the very short term. This proves once again that there is no natural law that risk and uncertainties dissipate as any particular future time approaches.

> Federal Reserve Chairman Alan Greenspan, in his first public comments since the attacks acknowledged yesterday on Capitol Hill that "much economic activity ground to a halt last week." The short-term economic outlook remains unclear, he said, adding that "the shock of September 11, by markedly raising the degree of uncertainty about the future, has the potential" to cause businesses and consumers to delay making financial commitments, such as buying new equipment, houses or cars.[35]

e. Postal Service Assets Do Not Protect Against Financial Risk.

When examining the Postal Service's ability to withstand financial risk, it should be understood that the Postal Service's tangible assets are dedicated to the operation of the postal system and are not available to shore up the Postal Service's financial health when adversities occur. Sometimes opportunities arise to leverage these assets by putting them in whole or in part to

[35] Greg Schneider and Carol Vinzant, *Stocks Fall for 4th Straight Day,* WASHINGTON POST, September 21, 2001, E1.

higher-value commercial uses. These opportunities are rare, and typically are small in dollar amounts, but the Postal Service pursues them aggressively. Returns from real estate sales and development usually have not covered more than one- or two-tenths of a percent of the Postal Service's total revenue needs. The expected proceeds from such projects are included in the Postal Service's financial projections.

From time to time, intervenors have pointed to the existence of these assets as reducing the need for a contingency or other legitimate elements of the revenue requirement. However, beyond their value in the operating system, these assets are not a source of meaningful financial security. The only real source of long-range financial security is equity. But this is instead a source of concern for the Postal Service because our equity is negative: estimated to be $6.7 billion below its starting value going into the test year.

f. Debt Is Not a Substitute for an Adequate Contingency Provision

When debt is used to finance operations, it is used as a stopgap that does not compensate for inadequate revenues. Increased debt reduces the Postal Service's ability to protect itself against financial adversity. Increased debt increases risk.

As was mentioned above, Table 6 displays the Postal Service's outstanding debt. In absolute terms and as a percentage of the statutory debt limit, the Postal Service's debt is steadily increasing and will be uncomfortably close to the statutory limit in FY 2002. This debt trend, coupled with increasing net losses, indicates that the Postal Service is operating at a greater risk of financial illiquidity than it has at any other time in its financial history, with the exception of the mid-1970's, when a billion dollar special appropriation from the U.S. Treasury was required to keep the Postal Service solvent.

The direction of the debt trend and the level of debt support the need for the Postal Service's contingency provision. If, in Docket No. R2000-1, the Governors had not restored the contingency provision, and had not reversed the other reductions in the revenue requirement made by the

Commission, the $12.9 billion FY 2002 debt projection would have tipped over $14 billion, and would have placed the Postal Service less than one payroll away from the $15 billion aggregate debt limit.

g. The Contingency Provision Was More than Fully Consumed in Docket No. R2000-1.

FY 2001 was the Test Year in the last omnibus rate proceeding. Rates conforming to the Postal Service's proposed revenue requirement would have had a potential FY 2001 net income of $2 billion if the Postal Service's 2.5 percent contingency had been maintained and none of the contingency had been consumed. Instead, the projected FY 2001 net loss in this rate filing is $1.7 billion. This is a $3.7 billion swing from what was projected in Docket No. R2000-1. The major elements of that $3.7 billion swing are estimated as shown in Table 51. Of these elements, none was predicted at the time the Postal Service filed its request, except for the effect of delayed implementation after the beginning of the test year.

Table 51
Explanation of Net Loss in FY 2001
($ Billions)

Source Of Net Income/Variance	**Net Income**
Contingency @ 2.5%	1.7
RPYL	0.3
Net Income Potential	2.0
Effect of Implementation After the Test Year	(0.8)
Initial PRC Decision	(0.6)
Revenue: Economy	(1.4)
Revenue: Initiatives	(0.2)
Revenue: Governors' Modification	0.2
Inflation	(0.6)
Transportation Costs Growth	(0.3)
Transportation Network Changes	(0.3)
Workers compensation	(0.2)
BPI savings	0.5
FY 2001 net loss	**(1.7)**

This swing is cited not to mathematically justify the 3 percent contingency provision in this case, but to show that recent experience demonstrates a very real need for a substantial contingency.

h. There Is A Wide Range and Number of Significant Possible Adversities.

This section provides a detailed quantitative analysis of potential adversities. Nevertheless, I would like to emphasize that the Postal Service continues to believe that variance analysis is not an appropriate basis for selecting a contingency provision.[36] This analysis does not indicate a change in our policy. The dominant considerations in selecting a contingency provision remain management judgment and policy with respect to the degree of risk that the Postal Service is willing and able to absorb. This judgment should be upset if and only if it can be shown that the proposed contingency provision, as I have described it, is unreasonable.

This section of my testimony does not mean that the Postal Service agrees with past criticisms or that the contingency provision should be accepted or rejected based on any specific set of calculations. However, due to the Postal Service's precarious financial situation, the Postal Service cannot risk a repeat reduction of the contingency provision.

History can play a role in understanding the need for a contingency. The detailed calculations presented here are plausible calculations based on historical precedent. However, in reviewing these calculations it should be understood that there are significant sources of adversity beyond the specific calculations presented here, as indicated in section h. below. Other sources of uncertainty can play just as great, if not a greater, role in determining the need for a specific contingency provision.

Two calculations were performed for each source of uncertainty – a low estimate and a higher estimate. These two estimates do *not* form upper and lower bounds. More extreme variations are possible and could be justified. The lower and upper estimates simply show *one set* of realistic possibilities based on past experience. These estimates are plausible and illustrative rather than predictive. They show adversities, that could occur in the test year and for which protection needs to be afforded through a reasonable

[36] Though we have not relied on these to develop our three percent contingency provision, the Commission's traditional variance calculations are presented for information purposes in Exhibit USPS-6J.

contingency provision. Only adversities are shown because the purpose of the contingency provision is to protect against adversity.

Sensitivity calculations are applied for two years, representing FYs 2002 and 2003. This takes into account the fact that the revenues and costs for FY 2001 were believed to be well estimated because much of the FY 2001 actual financial experience was available when the revenue requirement was developed. Historical tables for each of the factors analyzed below are given in Exhibit USPS-6T.

Fuel and Utilities Inflation

Fuel and utility prices are highly volatile and are subject to large swings due to rapid and unexpected changes in the supply and demand conditions in energy markets. The base year includes $48 million in heating fuel expense (component 166) which is driven in part by the Fuel, Oil and Coal price index, which assumes a price decrease of 6.8 percent in FY 2002 and no change in FY 2003. It is also driven in part by the gas index with assumed decreases of 0.8 percent and 1.3 percent in Fiscal Years 2002 and 2003, respectively. The Fuel Oil and Coal index rose a precipitous 45.5 percent in FY 2000. Base Year utility costs are $418 million (component 167) and is driven by an Electricity index. The Electricity index grows by 1.0 and 1.1 percent in FYs 2002 and 2003, respectively. It is plausible that these costs would grow an additional 2 to 5 percent or more per year. Based on 2 to 5 percent annual variances, the resulting adverse test year impact ranges from $19 million to $48 million.

Transportation Expenses.

Transportation expenses are also subject to volatility due to changes in the supply conditions in energy markets, but this volatility is muted somewhat by the greater relative stability of capital and labor expenses within this cost area. In the base year, rail transportation accounted for $277 million in expense, highway transportation accounted for $2,155 million in expense, and air transportation accounted for $1,682 million in expense. Since 1985 the changes in the Railroad Freight Cost index have ranged from –0.5 percent to 3.4 percent. It is projected to grow 0.4 percent in FY 2002 and 0.3 percent in FY 2003. Since

1994 the changes in the Interstate Trucking cost index have ranged from 2.0 to 4.4 percent, including the interim year of FY 2001. It is projected to grow 1.8 percent in FY 2002 and repeat at 1.8 percent in FY 2003. Since 1990 the Air Freight cost index growth has ranged from –3.0 to 5.3 percent. It is projected to decline by 3.3 percent in FY 2002 and an additional 0.1 percent in FY 2003. Should these expenses experience additional growth of one to three percent annually, a range of adverse expense impact from $83 to $251 million would result.

Wage Costs

In this case the Postal Service has estimated labor costs using existing contracts where they exist, and ECI (Employment Cost Index) and ECI – 1 assumptions for wages where contracts do not exist. When the ECI and ECI – 1 assumptions are used, there are two sources of possible variation: the new contracts can have terms that depart from the amounts implied by ECI and ECI -1 assumptions; and/or the actual values of ECI can vary from what is projected in this filing. The ECI-1 assumptions are conservative and impose risk in the sense that they assume that postal wage settlements will increase less than labor costs in the economy as a whole. Although, mathematically, the amounts for each type of variation are calculated identically, these variations can compound one on top of the other. Since 1985 the change in the Employment Cost Index has ranged from 2.7 percent to 4.3 percent. As reflected in Exhibit 6Q, wage costs are projected to grow 3.8 percent in FY 2002 and 3.5 percent in FY 2003. Because there are two significant sources of uncertainty, the possibility and amplitude of adverse results are magnified. Assuming $37 billion in base year wages, the total range of variation is calculated as $744 million to $3,019 million (i.e., 1 percent to 4 percent annual variation).

Health Benefits.

Health benefits expense is highly volatile. The Postal Service is contractually and legally bound to the Federal Employees Health Benefit program and the Federal Employees Compensation Act and pays whatever those require each year. Historically, the Postal Service's expense per employee increased by as much as 29.6 percent in FY 1988 and dropped by 5.9 percent per employee in FY 1995. This expense item has since re-accelerated into the double-digit growth range.

Exhibit USPS-6T includes both the ECI – Health Benefits index and the history of health benefits expense growth specifically relating to the Postal Service. In 9 out of the 13 years in which economy-wide and Postal Service-specific data are available, the inflation in health care benefits for the Postal Service exceeded inflation for health benefits in the economy as a whole. In 6 of those 9 years, Postal Service inflation was more than double the inflation experienced in the private sector. This demonstrates the enhanced degree of volatility that the Postal Service is exposed to on this expense item.

Additional expense growth acceleration in the range of one to five percent per year is conceivable. Calculated off of base year health benefit costs of $3,835 million (costs of current employees, annuitants and OWCP health benefits) the range of adversity is from $77 million to $393 million.

Volume and Revenue Projections.

Legal and regulatory issues affect volume and revenue growth rates, as do the state of the economy, competition and changes in technology and attitudes towards the use of the mail. Each of the approximately 100 million households and the 7 million business establishments in this country contribute to volume and revenue growth or decline. Given the variety and number of actors and their diverse motivations and environments, variation between projected and actual mail volume and revenue is inevitable. Two scenarios are considered here – a one-percent-per-year revenue variation from forecast and a three-percent-per-year variation from forecast.

The revenue variance from the Docket R2000-1 estimate was more than two percent. It should be recalled that this was close to being a one-year-ahead forecast by the time it was updated by the Postal Rate Commission. From the base year revenue of $64,581 million, a one-percent-per-year variation equates to a revenue variance of $1,298 million. A three-percent-per-year variation results in a revenue variance of $3,933 million. Using the rule of thumb that approximately half these revenue variances would be offset by lower volume variable costs, the impacts on net income are $649 million and $1,966 million. Volume mix changes (such as those which occurred with respect to the forecasts in Docket No. R2000-1) can result in net income impacts would be substantially more severe for a given revenue variance.

Total Factor Productivity

Total Factor Productivity (TFP) measures the growth or decline in the Postal Service's productivity from year to year. It weighs all the Postal Service's outputs and divides the resulting total output measure by a weighted total input measure. TFP experienced its largest increase in FY 1993, reflecting the impacts of buyouts and early retirement incentives, which decreased staffing more than planned. TFP experienced its steepest decline – 1.9 percent – in FY 1995.

The Postal Service is moving forward with strong productivity increases of 2.5 percent in FY 2000, and through accounting period 12 of FY 2001 a growth rate of 2.0 percent. In light of these most recent productivity increases, there are concerns that there may be a natural wall being approached which will make it difficult to sustain new productivity gains. The Postal Service's experience has been that strong productivity gains are frequently followed by losses or by very sluggish productivity growth. The Postal Service's net loss of $1.349 billion in FY 2002 assumes an additional productivity gain of 1.1 percent. The test year after rates assumption also projects productivity gains. It seems reasonable that actual productivity results could range from 0.5 to at least 1.0 percentage points lower than assumed. Based on total base year costs (revenues could be used as well) of $64.781 billion, this translates into a range of adversity between $649 million and $1,302 million.

Wholesale Price Index

The Wholesale Price Index (WPI) applies to several cost components: Communications (Component 168), Building Projects expensed (Component 169) and Reimbursements (Component 171). The related base year cost is $364 million. Since 1985 annual WPI increases have ranged from a low of –2.1 percent to a high of 5.2 percent. The projected WPI increases 0.7

percent in FY 2002 and increases by 0.8 percent in FY 2003. It is not difficult to imagine a scenario where actual WPI inflation is one to two percent higher than forecast. This translates into an expense impact of $7 million to $15 million.

Consumer Price Index

The Consumer Price Index (CPI) is applied to a number of cost components in the Postal Service's base year. These included individual awards (Component 115), banking fees (Component 125), administrative and area individual awards (Component 1429), Inspection Service Expenses (Component 212), Reimbursements (Component 213), Commission on Money Orders (Component 244), Contract Training Support (Component 220), Domestic Indemnities (Component 239), International Indemnities (Component 240), and Claims & Losses (Component 242). These expenses sum to $288 million in the base year. Since 1985, CPI inflation has ranged from as low as 1.4 percent to as high as 4.9 percent. The FY 2002 and FY 2003 projections, respectively, are for 2.7 and 2.4 percent. It seems plausible that actual CPI increases could be one to two percent higher. This translates into a potential expense impact of $6 million to $12 million. Because there are no labor contracts with COLA clauses known to be in effect through FY 2002 and into the test year, wages are not analyzed with respect to possible variation in projected CPI.

Supplies and Material Index

The Supplies and Materials Price Index (SMPI) applies to a number of cost components including vehicle supplies and materials (Component 99), Components 174 through 177 in Cost Segment 16 (Supplies & Services), operating equipment and supplies (Component 184), reimbursements (Component 189) and supplies and services (Component 210). These sum to $2,795 million in the base year. Since 1985 the SMPI index has increased as much as 5.5 percent and has declined a maximum of 2.6 percent. The FY 2002 and FY 2003 projections are for an SMPI decrease of 1.2 percent and an increase of 0.2 percent, respectively. It is quite possible that actual SMPI inflation could be one to two percent higher annually. This translates into a potential expense impact of $56 million to $113 million.

Rent Index

The Rent Price Index (RPI) is applied to Contract Cleaners (Component 81), Contract Stations (Component 111), Rent Allowances and Rents (Components 112 and 165). The base year expense for these components is $855 million. Since 1985 the largest increase in RPI was 6.2 percent and the smallest increase was 2.4 percent. The projections for FY 2002's and 2003 are 3.3 percent and 2.6 percent, respectively. One to two percent additional expense growths per year could possibly occur, which translates into additional expenses of $17 to $35 million.

Other Factors

There are other factors not identified above which can have a substantial bearing on the Postal Service's financial performance. These include but are not limited to legislative or political actions or natural disasters that impose new costs on the Postal Service or reduce revenues. Also, Workers' Compensation expense has sometimes fluctuated dramatically and exceeded expectations. The Postal Service has also sometimes been overly aggressive in its expectations of new revenues from new products or marketing initiatives, including most recently in Docket No. R2000-1. And there may be sources of variation never before experienced or conceived of.

The sum total of the quantified estimates in sections 1. through 10. above are summarized in Table 52.

Table 52
Sensitivity Analysis
Selected Items
($ Millions)

Contingency Factor	Lower	Higher
Fuel and Utilities Inflation	$ 19	$ 48
Transportation Expenses	83	251
Wages and Salaries	744	3,019
Health Care Benefits	77	393
Volume and Revenue Projections	649	1,966
Total Factor Productivity	649	1,302
Wholesale Price Index	7	15
Consumer Price Index	6	12
Supplies and Material Index	56	113
Rent Index	17	35
Total	$2,307	$7,154

The sum total of quantified possible variances identify above is from $2,307 million to $7,152 million. This range encompasses the reasonable three percent contingency used by the Postal Service in this rate filing.

Conclusion

The 3 percent contingency provision is reasoned and reasonable. The Postal Service's financial situation is worsening and its ability to absorb additional financial risk has all but disappeared. The Postal Service is operating close to the brink. Because the Postal Service lacks control over important revenue and expense drivers and due to the inherent uncertainty of the future, there are significant financial risks that create a need for a substantial contingency provision. We urge the Commission to recognize the risks and recommend rates and fees that include the Postal Service's 3 percent contingency provision.

i. Variance analysis

In deference to the Commission's desire to evaluate forecast errors and their sources, I have continued to include historical variance analyses similar to those included in past filings. Pages 4 through 7 of my Exhibit 9J reflect the results of applying the four sets of historical weighted average cost and revenue variances calculated on pages 1 through 3 of USPS EXHIBIT 9J, to Docket No. R2001-1 Test Year after rates cost and revenue estimates. These produce hypothetical Test Year variances ranging from 2.2 percent, or $1.6 billion to 5.7 percent, or $4.1 billion.

I believe historical variance analyses should not be the primary basis for determining the need for a contingency or its size. In this case variance analysis could be used to justify an even larger contingency than 3.0 percent. The application of the cost and revenue variances from the test year in the last rate case to the test year revenue and cost estimates in this case results in an unfavorable variance of 5.7 percent. I maintain that such a simplistic and mechanistic approach to determining the contingency is inappropriate. No matter what results an historical variance analysis produces, it is not appropriate to use historical data to determine the size of the contingency in lieu of management's judgment about the future and the ability of the Postal Service to assume financial risk.

These calculations are included for informational purposes only. To conclude from any historical variance analysis that a certain level of unforeseen events will occur in the Test Year would be both irresponsible and illogical. No one can predict the future, but the historical record clearly suggests that management's past judgment regarding the size of the contingency required has been good.

I am convinced that variance analysis cannot be relied upon in a vacuum as the basis for determining an appropriate contingency level. Variance analysis can only show us what happened in the past, and should not be relied upon exclusively to determine the prudent amount of cushion against unforeseen events in the Test Year. Regardless of what history shows, management must be allowed to assume its responsibility to determine the amount of contingency most appropriate for achieving its goals.

It is also important to realize that the variance analyses reflected in pages 4 through 7 of my Exhibit 6J attempt to show hypothetically how future costs and revenues would behave if the individual segment variances experienced in the past were to be precisely repeated in the

Test Year.[37] Since this does not allow for management's judgment regarding the future and the influence of management's subsequent actions, these types of analyses can only serve as information to be considered by management in setting Postal Service policy. In consideration of the Postal Service's goals and the risks involved, a contingency of three percent has been used for the purpose of estimating this revenue requirement.

j. Recovery of Prior Years' Losses

When the contingency has been inadequate or events otherwise result in net financial losses for the postal system, the Postal Service accumulates prior years' losses. At this point, prior years' losses have entirely consumed the Postal Service's equity. Entering FY 2001, the Postal Service had accumulated losses of $3.7 billion. The projected losses of over $3 billion in FYs 2001 and 2002 almost double that amount. Application of the 9-year amortization period, which has been used in each rate case starting with Docket No. R80-1, results in a $633 million annual provision for the recovery of prior years' losses. This amount has been computed by summing the net operating income (loss) for all periods from the inception of the Postal Service to the beginning of the Test Year, deducting the funds received under Public Law No. 94-421, and amortizing the total amount over nine years. Computation of the amount included in the revenue requirement for recovery of prior years' losses is shown in Table 53.

The Prior Years' Losses Recovery provision is designed to restore the Postal Service's equity that is dissipated when net losses are incurred. After running a string of net losses from 1986 through 1994, the Postal Service's Board of Governors adopted Board Resolution 95-9. This directs the Postal Service to plan for net incomes over a rate cycle which cumulatively will result in the recovery of prior years' losses during the rate cycle which equal the annual amount included in the rates for the PYLR times the number of years in the rate cycle. The Board's Resolution responded to concerns expressed by the

[37] General ledger account classifications were realigned in FY 1995. Material shifts were made among segments 16, 18, and 20. Weighted average historical percentage variances which are impacted by FY 1995 data were therefore based on the variances for these three segments in total.

Postal Rate Commission that the Postal Service was not using the PYLR provision to actually recover past losses. The Postal Service is committed to restoring past losses, as the Board affirmed in that Resolution.

Through FY 2000, the Postal Service remained ahead of the Resolution's PYLR recovery target included in this resolution (see Exhibit USPS-6N). When the Board was informed of projections that the Postal Service would fall behind the target beginning in FY 2001, the Board, in accordance with the Resolution, ordered management to prepare the current rate filing.

Regarding PYLR, the Postal Service is not satisfied with the progress recently made towards the statutory and policy objectives of breaking even and restoring equity. The related cash shortfall has precipitated the freeze on capital spending.[38] This freeze will have been in place for 20 months by the beginning of the test year. Getting back into a mode of recovering prior years' losses is necessary to restore the Postal Service's financial health and to allow the Postal Service to resume its capital program at appropriate levels. Recovery of prior years' losses will supply funds that can be used to retire debt and free the Postal Service to manage its capital program for the benefit of its customers

The full range of issues relating to Prior Years' Loss Recovery was addressed in the testimony of Postal Service witness Bjorn in Docket No. R94-1 and the ensuing report to Postal Service management, which was filed as Library Reference SSR-112 in Docket No. MC96-3.

The report noted at page 4 the following benefits of a positive equity position:

- A buffer against unexpected costs and economic cycles
- Flexibility in pricing;
- An internal source for financing

[38] As mentioned above, inadequate revenues, large net losses and cash outflows have required the Postal Service to freeze the facilities portion of its capital program. Other capital purchases have been deferred. The Postal Service is not currently able to plan and invest for the long-term benefits of its customers – the Postal Service is limited by the pressing and immediate needs of cash flow and liquidity.

- Enhanced security for future obligations such as retirement and health care benefits;
- A basis from which to pay dividends to stakeholders
- Credibility with outside constituencies; and
- A signal to stakeholders that the enterprise is being well managed.

Mr. Bjorn recommended that equity restoration should become a high priority for the Postal Service. The only means the Postal Service currently has of planning to develop positive equity is through PYLR.

Looking at equity from the other side, the impacts that negative equity is having on the Postal Service are quite predictable.

- Negative equity has made it extremely difficult for the Postal Service to absorb natural economic slowdowns and has significantly reduced its financial flexibility.
- The Postal Service has exhausted its sources of financing. The recent economic slowdown has worked in concert with the lack of equity to reduce the cash available to fund capital.
- Negative equity is driving up the portion of the revenue requirement that represents the past and reduces the extent that rates reflect current and projected operations.
- The Postal Service is not able to time rate cases to coincide with conditions in the competitive environment in which both it and its customers operate.
- Debt is higher than it would otherwise be which magnifies the risks of future obligations and increases interest expense.
- Poor financial performance has drawn attention away from other indicators of strong operational performance, including improvements in service and recent surges in productivity growth.

Table 53

Computation of Prior Years' Loss Recovery

($ 000)

Deficit from Operations since commencement on July 1, 1971 through September 30, 2000	3,679,744
Plus: Estimated net loss in FY 2001	1,666,394
Plus: Estimated net loss in FY 2002	1,349,138
Less: Funds from Public Law No. 94-421	1,000,000
Total Recovery Required	5,695,276
Annual Increment (1/9)	632,808

IV. REVENUES BEFORE AND AFTER RATES

The three sources of postal revenues are operating revenue, appropriations, and interest income. Table 54 provides total revenues, actual and estimated through the Test Year:

Table 54
Total Revenues
($ 000)

FY 2000	64,581,009
FY 2001	66,343,978
FY 2002	68,823,489
Test Year before rates	70,583,310
Test Year after rates	74,839,814

A. Mail and Special Services Revenues[39]

The mail classes, together with special and other services provided to the public, yield the largest portion of total operating revenues. The derivation of mail and special services revenue is explained in the testimony and workpapers of each of the individual pricing witnesses and summarized in the Testimony of witness Moeller (USPS-T-28).

Revenues for mail and special services through the Test Year are shown in the following table:

Table 55
Mail and Special Services Revenue
($ 000)

FY 2000	64,475,556
FY 2001	66,243,790
FY 2002	68,746,770
Test Year before rates	70,523,553
Test Year after rates	74,780,057

B. Appropriations[40]

Prior to Fiscal Year 1983, the Postal Service received annual appropriations for public service costs. However, since Fiscal Year 1982,

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[39]/ Volumes by class of mail and the attendant revenues for FYs 2000, 2001, 2002, and the Test Year before and after rates are shown in my Exhibits 6C and 6D. The development of volume estimates is included in the testimonies and workpapers of witnesses Tolley, Thress, and Musgrave (USPS-T-7,8, & 9). After rates volume adjustments that result from market research or special studies are explained in the testimony of the appropriate pricing witness.

[40]/ My Exhibit 9E shows the components of appropriation revenue for the relevant years.

appropriation revenue has been for revenue forgone only. Currently, revenue forgone results from providing free mail for the blind and for overseas voters.

The appropriation revenue included in this filing consists of two components. The first represents the estimated cost of providing free mail for the blind and visually handicapped and overseas voting. As reflected in my Exhibit 9E, this amounts to $48.999 million for the test year. The second component is a preliminary estimate of $(18.142) million for the reconciliation adjustment relating to Fiscal Year 2000 to reconcile the appropriation received to the amount that would have been authorized if based on the final audited mail volume. (The FY 2000 and 2001 appropriation revenue in my Exhibit 6E also includes a third component of $(.270) million and $(.205) million respectively. These amounts relate to Federal Budget recissions that occurred in those years.

During Fiscal Years 1991-1993, the amounts appropriated were not sufficient to fund the services provided by the Postal Service. The Revenue Forgone Reform Act of 1993 authorized the appropriation of $1.218 billion in 42 annual $29 million payments through Fiscal Year 2035, to reimburse the Postal Service for earned but unpaid revenue forgone for Fiscal Years 1991–1993, and for the estimated revenue forgone during the period Fiscal Years 1994–1998. During FYs 1994–1998, the revenue forgone appropriation was gradually phased out and reduced rates were gradually increased until half of the amount necessary to provide full funding was provided by the rates charged to users for all previously subsidized categories of mail except free mail for the blind and absentee overseas voters, which remain fully subsidized. The remaining one-half of the shortfall is passed on to all mail users through higher rates that result from the rate-making process. Should any amount not be appropriated, the Postal Service can adjust the rates of the subsidized mail categories enough to offset the shortfall.

In recognition of the 42-year extended payment cycle of the Revenue Forgone Reform Act of 1993, on September 30, 1993, the Postal Service recorded as a receivable the present value of earned and unpaid revenue forgone appropriations for FY 1991–1993. During FY 1994–1998 additional amounts were added to this receivable to recognize earned but unpaid revenue as the higher rates were phased-in for certain categories of subsidized mail. As each of the annual $29 million appropriation payments is received, a portion is recorded as imputed interest income (because the account receivable was recorded at a present value discounted at 7%) and the remainder is recorded as a partial collection of the account receivable.

The Postal Service recently requested that this liability be liquidated by a supplemental appropriation of $957 million for FY 2002, or, alternatively, if the full amount cannot be provided immediately, that half be provided in FY 2002 and the balance be appropriated in FY 2003. The impact of this request has not been reflected in the Postal Service's filing.

Additional details regarding the calculation of these amounts can be found in Chapter Xb and Xc of LR J-50.

The following table shows revenue forgone appropriation revenue through the Test Year:

Table 56
Appropriation Revenue
($ 000)

FY 2000	64,165
FY 2001	66,888
FY 2002	47,619
Test Year before rates	30,857
Test Year after rates	30,857

C. Interest Income

Interest income has two components: investment income and imputed interest.

Investment income earned by the Postal Service in any period depends upon prevailing short-term interest rates and the amount of cash invested. Because the Postal Service has adopted a zero cash balance goal as one of its financial management policies, minimal investment income is projected through the test year.

Imputed interest results from the calculation at 7 percent interest of the present value of future payments related to the Revenue Forgone Act of 1993. The calculation of these amounts is discussed above under appropriations and explained in detail in Chapter Xc of Library Reference J-50.

The following table shows Interest income for Fiscal Year 2000 through the Test Year:

Table 57
Interest Income [41]
($ 000)

Period	Investment Income	Imputed Interest	Total Interest Income
FY 2000	14,987	26,300	41,287
FY 2001	7,000	26,300	33,300
FY 2002	3,000	26,100	29,100
Test Year before rates	3,000	25,900	28,900
Test Year after rates	3,000	25,900	28,900

41/ Estimated cash flows for FY 1999, FY 2000 and the Test Year before and after rates, along with projected investment income, are shown in my Exhibits 9F and 9G.

V. TEST YEAR REVENUE DEFICIENCY

The Postal Service's total revenue deficiency in the Test Year at present rates would be approximately $5.3 billion. Changes in postal rates and fees proposed in this filing will eliminate the deficiency as illustrated below:

Table 58
Test Year Revenue Deficiency [42]
($ 000)

Present Rates	**Test Year**
Total Revenue Requirement [43]	75,857,833
Less: Total Revenue [44]	70,583,310
Total Revenue Deficiency	5,274,523
Proposed Rates	
Increase in Revenue	4,256,504
Decrease in Revenue Requirement	1,051,164
Change in Revenue Deficiency	5,307,668
Revenue Surplus (Deficiency)	33,145

The financial impact of present and proposed rates in the Test Year, as represented in the equity section of the balance sheet, is demonstrated in Table 59.

Table 59
Analysis of Changes in Equity [45]
($ 000)

	FY 2001	FY 2002	Test Year Before Rates	Test Year After Rates
Beginning Balance	(645,280)	(2,312,214	(3,661,352)	(3,661,352)
Net Income/(Loss)	(1,666,394)	(1,349,138)	(4,641,714)	665,954
Ending Balance	(2,312,214)	(3,661,352)	(8,303,066)	(2,995,398)

42/ An analysis of changes in income and expenses comparing before and after rates is included in my Exhibit 9H.
43/ From Table 15, the Test Year revenue requirement before and after rates reflects, total accrued cost segment expense, final adjustments, contingency and recovery of prior years' losses.
44/ From Table 54, revenues for the Test Year at present rates.
45/ The contingency is included and the prior year loss recovery is excluded from test year costs when determining net income (loss) and equity.

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