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POSTAL RATE COMMISSION
WASHINGTON DC 20268-0001

POSTAL RATE AND FEE CHANGES, 2006

Docket No. R2006–1

DIRECT TESTIMONY OF

RICHARD G. LOUTSCH

ON BEHALF OF

UNITED STATES POSTAL SERVICE

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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-L-49	Explanation of Cost Reductions, Other Programs, and Corporatewide Activities (Sections 1B, 2B, and 3)
USPS-LR-L-50	Rollforward Expense Factors

Direct Testimony

of

Richard G. Loutsch

AUTOBIOGRAPHICAL SKETCH

My name is Richard G. Loutsch. I am a financial analyst and the acting manager of Financial Forecasting for the United States Postal Service. As acting manager of Financial Forecasting, I am a direct report to the Manager of Corporate Financial Planning responsible for a variety of financial analysis, planning and forecasting matters.

Postal Related Experience

My initial postal experience was as a part time carrier from late 1967 through the spring of 1969 while attending college. After completing military service, college, and working in several positions in private industry, I returned to the Postal Service in 1980. From 1980 to 1985, I held several Headquarters accounting staff positions including senior accountant, accounting officer, and culminating in the position as general manager, National and International Accounting Division from 1984 until my departure to private industry in April 1985. In these accounting positions, I was responsible for a variety of accounting and systems related tasks including the development of the workers' compensation accruals, development of rate case testimony and documentation, accounting systems planning and definition efforts, and international accounting. In 1998 I returned to the Postal Service as a contractor with IPFC, Inc. I was primarily engaged in financial analysis and other support efforts for the Postal Service's transportation, accounting and pricing functions. Additionally, I was assigned to several projects with other government agencies dealing with financial control processes and research and development product selection evaluations. I returned to the Postal Service in my current position as a financial analyst in late 2003.

Postal Rate Case Experience

I sponsored testimony in the Docket No. R84-1 concerning the estimation of workers' compensation liabilities and expenses and the modifications to the estimation model. In Docket Nos. R2000-1 and R2001-1 as a postal contractor, I provided financial analysis support for the development of Special Services and Express Mail pricing proposals. In Docket No. R2005-1, I provided financial analysis, documentation, and testimony development support to the revenue requirement witness. Also, as an independent consultant, I provided analysis support for an intervenor in Docket No. R90-1.

Private Sector Experience

As an intern and after graduation from the University of Maryland in 1974, I was employed as an auditor with Arthur Andersen & Co. I was initially engaged in performance of audits of financial and non-profit institutions. I subsequently transferred to their Administrative Services division serving as a senior consultant specializing in the evaluation and development of construction project management and construction cost estimating processes in the railroad and electric utility industries. In early 1978, I left Arthur Andersen to accept the position as Director, Financial Analysis for the Public Broadcasting Service. In this position I was responsible for the annual budget, monthly analysis of performance against the budget, and program production cost analysis and audit. In early 1979, I accepted a position as the Corporate Controller for a hotel management company headquartered in St. Martin, Netherlands Antilles that operated two hotels and a car rental company on St. Martin, a resort reservation company in New York City, and a resort management company located in Hollywood, Florida.

Upon leaving the Postal Service in the spring of 1985 and until 1989, I served as the Director, Information Resources Management for the Government Information Systems Division of Planning Research Corporation. In this position I was responsible for the development and operation of the internal information systems and the internal network. From 1989 until 1998, I invested in, and was employed by, a small business, Museum Services Corporation, focused on the development, manufacturing, and sales of art conservation equipment primarily to government archives and museums around the world. My role at the company encompassed product development, procurement, contractor relations, production, and sales. While at Museum Services, I was also engaged at various times as an independent consultant. In late 1998 I sold my interest in Museum Services and returned to government contracting with IPFC, Inc. where I was employed until returning to the Postal Service as an employee.

Education, Certification and Military Service

In 1974 I received a bachelor’s degree in accounting from the University of Maryland, and I attended graduate courses in Public Financial Management at American University from 1984 to 1985. I am a Certified Public Accountant licensed in the State of Maryland. I served in the Air Force from 1969 until 1972 as an aircraft radar and inertial navigation systems technician.

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

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 L-49 and L-50 supplement my testimony.

Exhibits A through P are at the end of my testimony and are preceded by an index of Exhibits. These exhibits provide the summary components of the revenue requirement. Library Reference L-49, "Explanation of Cost Reductions, Other Programs, and Corporatewide Activities," supplies the narrative descriptions and fundamental estimating elements of the cost reduction program savings, other programs expense, and corporatewide activities expense built into the revenue requirement. I am sponsoring sections 1B, 2B, and 3 of Library Reference L-49 while Sections 1A and 2A of LR-L-49 are being sponsored by witness McCrery (USPS-T-42). Library Reference L-50, "Rollforward Expense Factors," supplies the detailed calculations underlying the revenue requirement. My testimony is organized into the four additional chapters described below.

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 between the base year and the test year on a before rates basis. The material presented supports the proposed level of rate increases consistent with management's goals of maintaining the Postal Service's current financial position and breaking even over time, minimizing additional debt, and supporting the Postal Service's capital program.

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

The Test Year (FY 2008)	- October 1, 2007 to September 30, 2008
Fiscal Year 2007	- October 1, 2006 to September 30, 2007
Fiscal Year 2006	- October 1, 2005 to September 30, 2006
The Base Year (FY 2005)	- October 1, 2004 to September 30, 2005

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

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, assuming implementation of new rates on May 6, 2007. This chapter unifies the analyses of the 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.

Witnesses providing input to the Revenue Requirement are identified in Table I-1, below.

Table I-1
Witnesses Providing Input for the Revenue Requirement

Providing Witness	**Witness Number**	**Data/Information Provided**
Waterbury	USPS-T-10	Rollforward output reports
Milanovic	USPS-T-9	Reallocated Trial Balance account reallocations to cost component
Smith	USPS-T-13	Final adjustment piggyback factors
Page	USPS-T-23	Final adjustments
O'Hara	USPS-T-31	Revenue and volume
McCrery	USPS-T-42	Cost reduction program workhour savings and program costs included in USPS Library Reference L-49, Exhibit A,B, E, and F.
Pifer	USPS-T-18	Non-volume workload weighting

Witnesses utilizing the Revenue Requirement output information are identified in Table I-2, on the next page.

Table I-2
Witnesses Utilizing Revenue Requirement Data

Using Witness	Witness Number	Data/Information Provided
Waterbury	USPS-T-10	▪ Rollforward model expense factors ▪ Workyear mix adjustment ▪ Program cost savings
O'Hara	USPS-T-31	▪ Interest income ▪ Investment income ▪ Other income ▪ Appropriation revenue ▪ Escrow ▪ Total revenue requirement
Smith	USPS-T-13	▪ Depreciation expense ▪ Productive hourly wage rates ▪ Cost reduction program savings and costs ▪ Non-volume workload space factors ▪ Global Insight rental cost index
Mayes Abdirahman Stevens Miller Page Cutting Talmo Van-Ty-Smith	USPS-T-25 USPS-T-22 USPS-T-19 USPS-T-20 USPS-T-23 USPS-T-26 USPS-T-27 USPS-T-11	▪ Productive hourly wage rates

There were several methodological changes to the revenue requirement estimation process that are listed in Appendix 7 of Library Reference L-50. These changes include a change in the method used to estimate the workers' compensation expense, which is described at Chapter VI d of Library Reference L-50 and in Chapter III of this testimony. Also, the calculation of annuitant COLA expense was eliminated since the calculation is no longer relevant, and a separate estimate of the Annuitant Health Benefits has been included to replace the calculation formerly included as part of the annuitant COLA worksheet. Third, the unit cost workbook has been reformatted to simplify the presentation and data input. Finally, the workyear mix for rural carriers has been consolidated with the workyear mix calculations for other employee groups.

There are no material methodological differences between the Postal Service revenue requirement estimation process and that used for the PRC version of the revenue requirement. The differences between the two revenue requirements result from the application of volume workload factors used in the rollforward model, the workyear mix adjustment, and the final adjustments.

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

In this chapter, I discuss the Postal Service's financial results and changes in the financial condition since Fiscal Year (FY) 1996, and include projected financial results for the base year and the three estimated years underlying this case, interim years FY 2006 and FY 2007, and the test year FY 2008. 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 1996 through 2005.

The Postal Service's financial condition has followed an uneven path over the last ten years. It experienced noteworthy financial success in the early part of this period; suffered losses driven by external events in the middle part of the period; and ended the period with financial success driven by Postal Civil Service Retirement System Funding Reform Act of 2003 (Public Law 108-18) and cost reductions related to the initiatives described in the *Transformation Plan, April 2002*. However, Public Law 108-18 imposed on the Postal Service new and continuing financial obligations in the form of its escrow requirement. The introduction of the escrow requirement in FY 2006 was the basis for Docket No. R2005-1, and the continuing escalation of this requirement will impact postal finances for the foreseeable future.

Table 1 shows the Postal Service's financial performance, equity position, capital outlays, and debt balances over the last ten years. In the first part of the ten-year period, from FY 1996 through FY 1999, the Postal Service experienced low, but increasing cost inflation, combined with volume growth in both First-Class Mail and Standard Mail, resulting in net incomes. Net income began to decline in FY 1998 due to inflationary pressure on compensation and benefits costs, particularly benefits costs, leading to a small net loss in FY 2000.

New rates were implemented in both FY2001 and FY2002. There were also several extraordinary negative events beyond the Postal Service's control, including the terrorist attacks on September 11, 2001, the subsequent anthrax attacks, and a recession. Additionally, a shift in modes of communication emphasizing the Internet and other electronic alternatives to the mail accelerated. The combined result was that in FY 2001 First-Class Mail volume growth stagnated and began to decline in FY 2002. This combination of trends resulted in net losses in those years, even with the new rates.

Table 1

Postal Service Net Income/(Loss), Equity, Capital Outlays, and Debt
FY 1996 - FY 2005
(See Exhibit USPS-6I)
($ Millions)

Period	Net Income/(Loss)	Cumulative Net Income/(Loss)	Equity[2]	Capital Outlays	Debt
FY 1996	1,567	(5,658)	(2,624)	2,340	5,906
FY 1997	1,264	(4,394)	(1,360)	3,233	5,861
FY 1998	550	(3,844)	(810)	3,055	6,413
FY 1999	363	(3,481)	(447)	3,917	6,913
FY 2000	(199)	(3,680)	(646)	3,337	9,313
FY 2001	(1,680)	(5,360)	(2,326)	2,961	11,315
FY 2002	(676)	(6,036)	(3,002)	1,705	11,115
FY 2003	3,868	(2,168)	866	1,314	7,274
FY 2004	3,065	897	3,931	1,685	1,800
FY 2005	1,445	2,342	5,376	2,317	0

From FY 2003 through FY 2005, the Postal Service generated $8,378 million of net income and finished FY 2005 with $2,342 million of cumulative net income since reorganization. Mail volume growth in FY 2004 and FY 2005, the enactment of the Public Law 108-18, and productivity improvement were the prime contributors to this improved financial performance. Public Law 108-18 temporarily (FY 2003-FY 2005) lowered Postal Service funding of its Civil Service retirement obligations to prevent continued over-funding of these obligations. However, for FY 2006, this same law requires that the difference between the corrected funding levels for Civil Service retirement obligations and the over-funding levels be treated as an “escrow expense.” The escrow expense must be funded by the Postal Service, thus creating annual expenses equivalent to those prior to enactment of Public Law 108-18. The cash flow resulting from the FY 2003-FY 2005 net incomes, combined with historically low capital outlays in FY 2002-FY2004, provided the financial resources needed to eliminate debt by the end of FY 2005.

[2] Equity includes capital contributions of the United States government of $3,034 million.

The positive financial performance over the last three years is not expected to continue, as several trends will adversely impact financial performance in the coming years. These trends include continuing electronic diversion, challenges capturing cost reductions, continued inflationary pressure on salaries and benefit cost for employees, continued increases in retiree health benefit costs, and escalation of the escrow expense. In addition to these trends, the Postal Service must also maintain and expand its delivery network to meet the universal service obligation.

These trends have influenced Postal Service financial performance for FY 2006, compared to the test year projections in Docket No. R2005-1,[3] as shown in my Exhibit 6J, page 1 of 8. The impact of recent trends is illustrated by comparing the estimated results for the FY 2006 test year in Docket No. R2005-1 with the forecast results in this case. In addition to $819 million projected reduction in revenues due to the delayed implementation of rates from October 1, 2005 to January 8, 2006, recognized in Docket No. R2005-1, costs have increased by $1.6 billion. This cost increase is primarily a result of increased COLAs (cost of living adjustments), lower-than-planned productivity improvements, and increasing fuel and energy related costs, exacerbated by oil and natural gas shortages resulting from hurricanes Katrina and Rita. While cost reduction efforts will continue, they will only partially mitigate the negative effects of the above cost trends. Therefore, after considering the escrow expense, I expect losses to begin in FY 2006, and to increase annually through the test year before rates. As illustrated in Table 2, the forecasted before rates losses after escrow will eliminate the FY 2005 cumulative net income by FY 2007, and there will be a significant increase in debt requirements.

[3] See witness Tayman's testimony in Docket No. R2005-1, USPS-T-6, Exhibit USPS 6A.

Table 2
Postal Service Net Income/(Loss), Equity, Capital Outlays, and Debt
Projected FY 2006 - FY 2008
($ Millions)

Period	Net Loss, After Escrow	Cumulative Net Income/(Loss)	Equity	Capital Outlays	Debt
FY 2006	(2,095)	248	3,282	2,249	1,898
FY 2007 before rates	(3,289)	(3,041)	(7)	2,797	5,522
FY 2008 before rates [4]	(4,819)	(7,860)	(4,826)	3,066	11,285

Without a rate increase, the Postal Service is projected to incur combined net losses of $10.199 billion for the period FY 2006 through FY 2008. This will result in cumulative net loss of $7.860 billion and borrowing requirements that exceed the authorized annual debt limit in both FY 2007 and FY 2008.

A. Revenue and Volume Trends

Table 3 presents the year-to-year and average annual percentage increases in total actual revenue for the period FY 1996 to FY 2005, and revenue projected through FY 2008 BR. Using FY 1995 revenue as the base, annual revenues maintained a positive, but slowing, growth trend, increasing from $54,509 million to $69,993 million in FY 2005, for a total of $15,484 million or a 2.5 percent average annual growth rate over the last ten years. Over the last five years, revenues have increased $5,412 million, for a 1.6 percent average annual growth rate. Revenue growth during the first four years of this period resulted mainly from increased volume. During the period FY 2001 through FY 2003, revenue growth was influenced by two rate increases. Revenue was again influenced primarily by volume growth in FY 2004 and FY 2005. Four of the lowest annual growth rates occurred over the last five years, and the projected before rates revenue growth is expected to continue this pattern after the improvement in FY 2006 that arose primarily from the Docket No. R2005-1 rate increases.

[4] Excludes contingency.

Table 3
Comparison of Annual Percent Change in Revenue for the Ten Years
FY 1995 - FY 2008
($ Millions)

Period	Revenue[5]	% Chg.
FY 1995	54,509	
FY 1996	56,544	3.7
FY 1997	58,331	3.2
FY 1998	60,117	3.1
FY 1999	62,755	4.4
FY 2000	64,581	2.9
FY 2001	65,869	2.0
FY 2002	66,688	1.2
FY 2003	68,764	3.1
FY 2004	69,029	0.4
FY 2005	69,993	1.4
FY 2006 estimated	72,147	3.1
FY 2007 before rates estimated	72,748	0.8
FY 2008 before rates, estimated	73,568	1.1
	Revenue[6]	Average Annual Increase
Ten-Year Increase	15,484	2.5%
Five-Year Increase	5,412	1.6%
FY 2005-Test Year	3,575	1.7%

As illustrated in Table 4, First-Class Mail volume peaked in FY 2001 and declined through FY 2004. Despite recent strengthened economic growth, and after a small volume increase in FY 2005, First-Class Mail volume is expected to begin declining again in FY 2006. This overall declining trend results primarily from electronic diversion.

Historically, the Postal Service has relied on First-Class Mail and its continued growth as a primary source of contribution to support the universal service requirement. The stagnation and decline of First-Class Mail will have a significant impact on the Postal Service's ability to support both the operation of the existing distribution and delivery network and future network expansion, thereby placing continued upward pressure on postal prices.

[5] Includes interest income and appropriations.
[6] Includes interest income and appropriations.

Table 4
Summary of First-Class and Standard Mail Volume
FY 1996 - FY 2008

Period	Total Mail Volume	First-Class		Standard Mail	
		Volume	% Total	Volume	% Total
FY 1996	183,440	98,216	53.5%	71,686	39.1%
FY 1997	190,888	99,660	52.2%	77,254	40.5%
FY 1998	197,943	100,434	50.7%	82,508	41.7%
FY 1999	201,644	101,937	50.6%	85,662	42.5%
FY 2000	207,882	103,526	49.8%	90,057	43.3%
FY 2001	207,463	103,656	50.0%	89,938	43.4%
FY 2002	202,822	102,379	50.5%	87,231	43.0%
FY 2003	202,185	99,059	49.0%	90,492	44.8%
FY 2004	206,106	97,926	47.5%	95,564	46.4%
FY 2005	211,743	98,071	46.3%	100,942	47.7%
FY 2006 estimated	212,296	95,866	45.2%	103,677	48.8%
FY 2007 before rates estimated	212,936	93,561	43.9%	106,755	50.1%
FY 2008 before rates, estimated	216,242	92,551	42.8%	110,839	51.3%

Standard Mail volume exceeded the level of First-Class Mail volume for the first time in FY 2005. Continued Standard Mail volume growth is projected through FY 2008 before rates, as a result of the positive economic outlook and the continuing strength of this medium in direct marketing channels. But growth in contribution from Standard Mail volume on a piece-for-piece basis does not offset the contribution lost as a result of the decline in First-Class Mail volumes. Additionally, as the Postal Service relies more heavily on Standard Mail as a source of contribution to support the delivery network, Postal finances will become more vulnerable to business cycles.

Significant declines in Priority Mail volumes were experienced from FY 2001 through FY 2004. In FY 2005, Priority Mail volume increased and is expected to continue to increase through the test year before rates. Similarly, Express Mail volume increased in FY 2005 after four years of volume losses. Volume losses are expected to resume beginning in FY 2006 and continue through the test year before rates. Periodicals volumes have also declined since 2001 and are expected to continue to decline through FY 2007. Package Services volume growth has varied over the last five years and this classification is expected to exhibit moderate growth over the forecast period.

Without a rate increase, the limited growth in volumes and revenues for the period from FY 2006 through FY 2008 will not produce sufficient incremental contribution to fund expected postal cost inflation and maintenance and expansion of the postal delivery network.

B. Expense Trends

As illustrated in Table 5, total expenses have increased $15,809 million, resulting in a 2.7 percent average annual growth rate from the FY 1995 base period through FY 2005. Expense growth slowed to an average 1.1 percent annual rate over the last five years due primarily to: (1) reductions in retirement expense beginning in FY 2003, resulting from Public Law 108-18; (2) reduced volume workload in FY 2002 and FY 2003 after the September 11, 2001 terrorist attacks, the subsequent anthrax attacks, the recession, and the FY 2001 and FY2002 rate increases; and (3) cost reductions. The passage of Public Law 108-18 reduced postal costs between FY 2003 and FY 2005, and will substantially increase costs in FY 2006 and future years. When expense growth is adjusted to omit the reduction in retirement expense during FY 2003 through FY 2005, the longer-term expense trend is more clearly illustrated with ten-year annual growth averaging 3.1 percent and five-year growth averaging 2.0 percent.

Table 5
Comparison of Annual Percent Change in
Expense for the Ten Years
FY 1995 - FY 2008
($ Millions)

Period	Expense[7]	% Change	Expenses Without P.L 108-18 Savings	% Change
FY1995	52,739		52,739	
FY 1996	54,977	4.2	54,977	4.2
FY 1997	57,066	3.8	57,066	3.8
FY 1998	59,567	4.4	59,567	4.4
FY 1999	62,392	4.7	62,392	4.7
FY 2000	64,780	3.8	64,780	3.8
FY 2001	67,549	4.3	67,549	4.3
FY 2002	67,364	(0.3)	67,364	(0.3)
FY 2003	64,896	(3.7)	68,377	1.5
FY 2004	65,964	1.6	68,677	0.4
FY 2005	68,548	3.9	71,356	3.9
FY 2006 estimated	74,242	8.3	74,242	4.0
FY 2007 before rates estimated	76,037	2.4	76,037	2.4
FY 2008 before rates, estimated	78,387	3.1	78,387	3.1
	Expense	Average Annual Increase	Expense	Average Annual Increase
Ten-Year Increase	15,809	2.7%	18,617	3.1%
Five-Year Increase	3,768	1.1%	6,576	2.0%
FY 2005-Test Year	9,839	4.6%	7,031	3.2%

1. Escrow Expense

Public Law 108-18 has a significant effect on the requirement to increase postal rates and fees. As discussed in the Docket No. R2005-1 revenue requirement testimony,[8] Public Law 108-18 changed the way the Postal Service funds Civil Service Retirement System (CSRS) obligations and altered the related schedules for payments to the Civil Service Retirement and Disability Fund (CSRDF). The law recognized that postal ratepayers would ultimately over-fund the Postal CSRS pension obligations by $105 billion, if the then-current funding mechanisms continued in place.

Public Law 108-18 remedied the over-funding by transferring, from the United States Treasury to Postal Service ratepayers, approximately $27 billion in

[7] Includes interest expense.
[8] Docket No. R2005-1, witness Tayman, USPS-T-6, page 9-12.

CSRS obligations, retroactive to 1971, related to current and former employees' military service. If the military service obligation had not been transferred, the Postal Service would have had fully funded its CSRS obligations and no further employer payments to CSRS would have been required. Public Law 108-18 established two mechanisms for continued payments into the fund. First, the Postal Service is required to continue to pay the CSRS employer contribution using a "normal cost contribution rate"[9] based on dynamic assumptions.[10] Dynamic normal cost based contributions are designed to fully fund the CSRS pension benefit obligation allocable to the current year of service. This provision increased the employer normal cost contribution for CSRS participants from 7.0 percent (based on static assumptions[11]) to 17.4 percent (based on dynamic assumptions) of current CSRS employee base wages. (The employee contribution remains at 7.0 percent.) Second, the law established a supplemental liability that represents the estimated excess of the actuarial present value of Postal Service CSRS obligations over the fund balance and future normal cost payments, including earnings on those payments. The Postal Service is required to amortize the supplemental liability in a manner that will liquidate the liability by September 30, 2043. The supplemental liability was calculated to be $4.2 billion at September 30, 2004, and annual supplemental liability amortization payments were $290 million in FY 2005. The supplemental liability amount is recalculated by the Office of Personnel Management (OPM) each year and reported in June of the following year.

In addition to the above payments, Public Law 108-18 defines "savings" as the annual difference between what the Postal Service would have paid annually into the CSRDF prior to Public Law 108-18 and the amount paid after application of the new funding provisions of the law.[12] The "savings" represent the projected annual Postal Service over-funding of CSRS pension obligations under the

[9] Normal cost contribution rate is the contribution rate as a percentage of base wages required to fund pension benefits earned for the current year of service.
[10] Dynamic assumptions include interest earnings on pension fund assets, wage inflation, and benefit inflation.
[11] Static assumptions only include interest earnings on pension fund assets. No assumptions are included for either future wage or benefit inflation.
[12] See Exhibit 6O for computation of "savings" for FY 2003-FY 2008.

former law. The overfunding described as “savings” is in addition to the new obligations and costs related to the funding the military service credit that was transferred from the Treasury to the Postal Service under this law. The annual ”savings” related to Public Law 108-18 from FY 2003 through FY 2015 are summarized in Table 6 and the full schedule of “savings,” as estimated by OPM, is included at Library Reference L-50, Chapter VI h. The annual “savings” or escrow amount is expected to increase through FY 2024, when the annual amount peaks at $7,601 million.

The escrow expense will have a significant effect on financial performance in the future. As discussed in Docket No. 2005-1, the escrow expense is a legislated expense, over which management has no control, and provides no economic benefit to the Postal Service. The amount of the escrow expense is arbitrarily determined, in the sense that it represents the difference between the funding requirement relating to a legitimate estimate of Postal Service’s CSRS obligations and an estimate of these obligations that was determined to be substantially in error.

Table 6

Summary of CSRS “Savings” and Escrow Funding Requirements
(See Exhibit USPS-6O)
($ Millions)

Year	“Savings” Amount
FY 2003	3,481
FY 2004	2,713
FY 2005	2,862
FY 2006	2,993
FY 2007	3,262
FY 2008	3,588
FY 2009	3,800
FY 2010	4,125
FY 2011	4,486
FY 2012	4,723
FY 2013	5,124
FY 2014	5,523
FY 2015	5,616

From FY 2003 through FY 2005, the “savings” were not required to be escrowed. Rather, the reductions in the annual payments to the Civil Service Retirement and Disability Fund (CSRDF) reduced postal expenses. thereby producing substantial net incomes in each of the three years. The net incomes provided the cash necessary to liquidate Postal Service debt and hold rates steady.

The continuing effect of Public Law 108-18 on Postal Service finances is summarized in Table 7, based on the above-referenced annual valuation prepared by OPM as of September 30, 2004, which is their most recent evaluation. The escrow expense will be funded for the first time in FY 2006. In FY 2007 and FY 2008, the escrow expense is estimated to escalate by $269 million and $326 million, respectively.

Table 7

Future USPS Cost of Public Law 108-18
($000,000)

	FY 2006	FY 2007	FY 2008	Total
Escrow Expense	2,993	3,262	3,588	9,843
Continuing CSRS Contribution[13]	1,576	1,467	1,350	4,394
Supplemental Liability Expense	290	290	290	870
Total Impact of PL 108-18	4,859	5,019	5,228	15,107
% of Before Rates Accrued Costs	6.5%	6.6%	6.7%	

2. Productivity

Management has continued to focus on improving productivity and efficiency in all areas of postal operations. These efforts have made FY 2005 the sixth consecutive year of productivity gains. During this period, Total Factor Productivity (TFP)[14] has increased an average of 1.7 percent[15] annually. These productivity gains are estimated to be equivalent to over $6.8 billion in cost savings and allowed the reduction of career complement through attrition, from 797,795 at the beginning of FY 2000 to 704,716 at the end of FY 2005.

[13] The continuing CSRS contribution is the Postal Service portion of the “Employee + Agency Contrib” listed on the OPM calculation. The amount is computed as 17.4/24.4 times the combined contribution. The 17.4 represent the Postal Service’s contribution as a percentage of wages. The 24.4 represents the combined employer and employee contribution as a percentage of wages. See LR L50, Chapter VI h.

[14] TFP measures the change in the relationship between outputs, or workload, and all the resources used in producing these outputs. The main output is delivered mail and special services to an expanding delivery network. TFP calculations include inputs for all resources including labor, materials, transportation and capital investments.

[15] This average is a straight average based on TFP Annual percentage increases for FY 2000 through 2003 obtained from the Comprehensive Statement on Postal Operations, FY 2003, page 98. Those for FY 2004 and FY 2005 were obtained from Comprehensive Statement on Postal Operations, FY 2005, page 72.

As the Postal Service enters the seventh year of its productivity improvement effort, identifying and capturing productivity gains becomes more challenging. Recently, the Postal Service published the *Strategic Transformation Plan, 2006-2010.* This plan calls for continued cost reduction efforts[16]. The revenue requirement includes gross cost reductions of $1,006 million in FY 2006, $1,197 million in FY 2007, and $1,121 million in the Test Year. When the gross cost reductions are offset with related Other Programs expenses[17], the net cost reductions are $885 million for FY 2006, $1,004 million in FY 2007, and $1,004 in 2008, or $2,939 million over the three year period. But even with these cost reductions, expenses are expected to grow at an average annual rate of 4.6 percent from the end of the base year to the test year, and 3.2 percent if the escrow "savings" were to be considered an expense in FY 2005.

3. Compensation and Benefits

Control of personnel costs is one of postal management's greatest challenges. Because personnel expenses account for about three-fourths of total Postal Service expenses, they generally are the major expense driver of overall financial performance. Table 8 displays compensation and benefits expenses and the annual changes in compensation and benefits expense for the period FY 1996 - FY2005.

Table 8
Compensation and Benefits Cost
FY1996 - FY2005
($ Millions)

Period	Total Operating Expense[18]	Compensation and Benefits	Compensation and Benefits Growth Percentage
FY 1996	53,113	42,676	1.8%
FY 1997	55,131	44,093	3.3%
FY 1998	57,786	45,596	3.4%
FY 1999	60,642	47,333	3.8%
FY 2000	62,992	49,532	4.6%
FY 2001	65,640	51,351	3.7%
FY 2002	65,234	51,557	0.4%
FY 2003	63,902	50,428	-2.2%
FY 2004	65,851	52,134	3.4%
FY 2005	68,283	53,932	3.4%

[16] See the testimony of witness McCrery, USPS-T-42, and Library Reference L-49.
[17] See Library Reference L-49.
[18] Operating expense excludes interest expense.

Postal Service workyear usage varies with changes in workload due to changing volumes, delivery network growth and other non-volume workload, changes in the number of workdays in a year, and management and cost reduction programs to control costs (see Exhibit 6L). As illustrated in Table 9, after moderate increases in the FY 1996 to FY 1999, workyears declined until FY 2005 due to volume losses, volume mix changes (as illustrated in Table 4, Summary of First-Class and Standard Mail Volume), and productivity gains.

Table 9
Postal Service Net Income and Compensation and Benefits Expense Growth
FY 1996 – FY 2005
($ Millions)

Period	Comp. and Benefits[19] (Millions)	Workyears[20]	Percent Change in Workyears	Percent Change in Total Mail Volume	Comp. and Benefits Per Workyear	Percent Change Cost per Workyear	CPI-W
FY 1996	42,676	887,546	2.0%	1.5%	48,083	-0.2%	2.8%
FY 1997	44,093	898,384	1.2%	4.1%	49,080	2.1%	2.7%
FY 1998	45,596	909,578	1.2%	3.2%	50,129	2.1%	1.4%
FY 1999	47,333	919,214	1.1%	2.4%	51,493	2.7%	1.9%
FY 2000	49,532	917,223	-0.2%	3.1%	54,002	4.9%	3.3%
FY 2001	51,351	899,351	-1.9%	-0.2%	57,098	5.7%	3.2%
FY 2002	51,557	860,309	-4.3%	-2.2%	59,928	5.0%	1.2%
FY 2003	50,428	832,312	-3.3%	-0.3%	60,588	1.1%	2.3%
FY 2004	52,134	820,157	-1.5%	1.9%	63,566	4.9%	2.2%
FY 2005	53,932	821,684	0.2%	2.7%	65,636	3.3%	3.4%

Removing the effect of workyear usage, compensation and benefits cost per workyear exhibited moderate increases from 1996 through 1999, and these favorable growth rates in compensation and benefits cost contributed to the Postal Service's net incomes during those years. In FY 2000 and through FY 2002, compensation and benefits cost per workyear increases accelerated and served as a major contributor to the net losses experienced in those years and the need for the increased rates in Docket Nos. R2000-1 and R2001-1. The effect of Public Law 108-18 significantly reduced the growth in cost per workyear in FY 2003, but the growth trend in compensation and benefits cost returned in FY 2004.

[19] Includes personnel related Servicewide Costs. Excludes travel and relocation costs.
[20] Docket No. R2005-1, witness Tayman (USPS-T-6, Table 8, page 14). FY 2005 from LR-L-50, Chapter III.

In six of the last eight years, compensation and benefits cost per workyear increased at a rate exceeding that of inflation measured by the CPI-W. The exceptions to this were in FY 2003, when the reduction in pension funding requirements attributable to Public Law 108-18 resulted in a one-time reduction in benefits costs, and in FY 2005, when the cost increase and the CPI were roughly equal.

The overall increase in compensation and benefits is more heavily influenced by increases in benefit costs. Table 10 separates compensation and benefits expense by workyear into the two major components and provides the CPI-W for comparative purposes. With the exception of FY 2003,[21] benefits cost growth exceeded both compensation cost growth and CPI-W growth by a wide margin from FY 1998 through FY 2005. The benefits cost increases resulted from increases in health benefit premium expense for active and retired employees, retirement programs' expense, workers' compensation costs, and unemployment compensation expense.

Table 10
Compensation and Benefits Cost by Workyear
FY 1996 – FY 2005
($)

Period	Comp. and Benefits Per Workyear	Comp. per Workyear	% Chg	Benefits* per Workyear	% Chg	CPI-W
FY 1996	48,083	36,692	-0.7%	11,391	1.4%	2.8%
FY 1997	49,080	37,807	3.0%	11,274	-1.0%	2.7%
FY 1998	50,129	38,154	0.9%	11,975	6.2%	1.4%
FY 1999	51,493	39,040	2.3%	12,453	4.0%	1.9%
FY 2000	54,002	40,318	3.3%	13,684	9.9%	3.3%
FY 2001	57,098	42,229	4.7%	14,868	8.7%	3.2%
FY 2002	59,928	42,865	1.5%	17,064	14.8%	1.2%
FY 2003	60,588	44,627	4.1%	15,960	-6.5%	2.3%
FY 2004	63,566	46,181	2.0%	17,384	8.9%	2.2%
FY 2005	65,636	46,986	1.7%	18,650	7.3%	3.4%

*Excludes interest on deferred retirement.

C. Debt

Table 11 displays the Postal Service's outstanding debt from FY 1996 to FY 2005, and debt levels projected through the Test Year Before Rates. In absolute terms and as a percentage of the statutory debt limit, the Postal

Service's debt declined substantially beginning in FY 2003. In FY 2003 through 2005 the Postal Service reduced debt by amounts exceeding the amounts set forth in Public Law 108-18. In FY 2005, Public Law 108-18 indicates that the "savings" should be used to hold postage rates unchanged and to reduce postal debt. The Postal Service held rates constant until the beginning of calendar year 2006, and management decided in late September, 2005 to eliminate the remaining debt.

Table 11
Capital Outlays and Outstanding Debt
Debt as a Percentage of Statutory Ceiling
FY 1996 - FY 2006
($ Millions)

Period	Capital Outlays	Total Debt	Debt Limit	Percent Of Statutory Limit
FY 1996	2,340	5,906	15,000	39.4%
FY 1997	3,233	5,861	15,000	39.1%
FY 1998	3,055	6,413	15,000	42.8%
FY 1999	3,917	6,913	15,000	46.1%
FY 2000	3,337	9,313	15,000	62.1%
FY 2001	2,961	11,315	15,000	75.4%
FY 2002	1,705	11,115	15,000	74.1%
FY 2003	1,314	7,274	15,000	48.5%
FY 2004	1,685	1,800	15,000	12.0%
FY 2005	2,317	0	15,000	0.0%
FY 2006, estimated	2,249	1,898	15,000	12.7%
FY 2007, before rates, estimated	2,797	5,522	15,000	36.8%
FY 2008 before rates, estimated	3,066	11,285	15,000	75.2%

Beginning in FY 2006, $1.9 billion of borrowing will be required to fund a portion of the capital investments. In FY 2007 $3.6 billion of borrowing would be required to finance capital investments and to fund operations. This level of borrowing would exceed the statutory annual borrowing limits of $2 billion for capital improvements and $1 billion for operating expenses.[22] In FY 2008, if rates are not changed, Postal Service borrowing requirements would be $5.8 billion, which would again exceed the annual limit.

(continued…)

[21] FY 2003 includes the initial effect of Public Law 108-18.

[22] Title 39, §2005.

Incurring debt to finance current operations transfers the funding of current year expenses to future years. During a time when First-Class Mail volumes are expected to continue to be stagnant or decline and in a period of rising interest rates and increases in other postal costs, repayments of funds borrowed to finance operations places an unreasonable claim on future revenues and an unfair burden on future ratepayers.

D. Conclusion

In Table 63, I estimate that FY 2008 operations will result in a deficiency of $5.830 billion before rates, after consideration of the provision for contingencies and a provision for the recovery of prior years' losses. The Postal Service should not allow a deficiency of this magnitude to occur. Instead, the Postal Service has sought an increase in rates. Without the proposed rate and fee increases, the Postal Service will find it impossible to fund ongoing operations or to finance expenditures critical to the future viability of the Postal Service. In light of the increasing costs which I discuss below, and my financial projections for the Test Year, I conclude that the only course of action that will allow the Postal Service to fulfill its obligations under the Postal Reorganization Act is to increase Postal Service revenues through a general increase in rates.

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 2005), the Interim Years (Fiscal Years 2006 and 2007) and the Test Year (Fiscal Year 2008).

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 2005. 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 2006, 2007 and the Test Year

Three estimated fiscal years, i.e., Fiscal Years 2006 and 2007, and the Test Year, will be treated separately in my testimony. Cost estimating procedures are applied to each of these years as necessary as 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, corporatewide activities, servicewide costs, 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 2006 and 2007, 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. The rollforward witness, witness Waterbury (USPS-T-10), 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 2006, FY 2007, 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,[23] 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.[24]

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 6P, cost level changes in salaries are estimated to average 3.8% in FY 2006, 3.7% in FY 2007 and 2.5% in the test year. Cost level changes in benefits are estimated to average 5.1% in FY 2006, 5.0% in FY 2007 and 4.3% in the test year. The derivation of cost level factors is explained in detail in Chapters V, VI, and VII of Library Reference L-50.

b. Mail volume effect

Mail volume effect is cost change 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 Waterbury (USPS-T-10).

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

[23] Final adjustments are calculated by other witnesses and summarized and sourced in witness Waterbury's' Exhibit USPS-10B and my Library Reference L-50, Chapter XIV.
[24] Exhibits 6A, 6B, and 6N.

include the number of possible city deliveries, the numbers of rural boxes and route miles, and the amount of facilities square footage.

Additional delivery points are an important expense driver for the postal system. Between the base year and the end of the test year, the Postal Service will have added roughly six million new delivery points to its network. The Postal Service does not charge separately for existing or new delivery points. This is very different from other services, such as electric, gas, water, and local telecom, which generally have some sort of monthly access, hookup, or system charge.

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

Table 12
Non-Volume Workload Factors
% Change from Previous Year

	FY 2005	FY 2006	FY 2007	FY 2008
No. of Post Offices [25]	-0.4%	-0.4%	-0.3%	-0.3%
Possible City Deliveries	0.8%	0.6%	0.6%	0.7%
Rural Route Miles	1.6%	1.6%	1.6%	1.6%
Rural Route Boxes[26]	3.5%	3.6%	3.6%	3.5%
Rural Boxes & Route Miles[27]	2.7%	2.8%	2.8%	2.8%
Contract Stations	7.9%	7.7%	6.5%	7.3%
Cag L Post Offices	-7.8%	-6.3%	-5.4%	-6.5%
Facilities Sq. Footage (Leased)	0.2%	1.8%	1.9%	0.4%
Facilities Square Footage (Interior)	0.2%	0.6%	0.6%	0.5%

d. Additional workday effect

Some costs vary according to the number and composition of days in each 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 V m of Library Reference L-50 and the application of these factors to Postal Service costs is explained in the testimony and workpapers of witness Waterbury (USPS-T-10). The number of days in each of the relevant years is shown in Table 13.

[25] Weighted by Postmaster salaries by class.
[26] The method for determining the number of rural boxes was changed in FY 2004.
[27] Weighted average.

Table 13
Analysis of Work Days by Fiscal Year

	FY 2005	FY 2006	FY 2007	Test Year
Weekdays	251	250	250	252
Saturdays	52	53	52	52
Sundays	52	52	53	52
Holidays	10	10	10	10
Workday Equivalents	297.20	296.93	296.34	298.20
Total Days	365	365	365	366

e. Cost reductions

Numerous management-initiated cost reduction programs related to automation, materials handling, other equipment programs, and Breakthrough Productivity Initiatives (BPI) are currently in progress or planned, and will result in significant cost savings. Headquarters' financial and operating managers, with the assistance of Area, District, and Plant personnel, develop and implement plans for projects and activities aimed at reducing operating expenses.

This category represents management's commitment to savings between the base year and the Test Year. The total cost reductions are $1.006 billion in FY 2006 and $1.197 billion in FY 2007 and $1.121 billion in the test year. (Library Reference L-49). Total cost reductions, when offset by increases in related Other Program costs, below, are $0.885 billion in FY 2006, $1.004 billion in FY 2007, and $1.004 billion in the test year (Library Reference L-49).

Table 14 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 L-50, Chapter Ve. Cost reductions by individual program are included in of Library Reference L-49, along with a narrative description of these programs and the basis for the resource savings.

BPI cost savings are projected for supervisory costs between the Base Year and the Test Year and for other cost reduction programs when considered feasible by the program managers. Supervisory and professional/technical cost reductions for FY 2006 through the test year are related to BPI, and EAS reductions related to the EEO program reorganization in FY 2006 and the Human Capital Enterprise HR Shared Services effort in FY 2007 and FY 2008.

Table 14
Cost Reductions
($ 000)

C/S	Segment	FY 2006	FY 2007	Test Year Before Rates
2	Supervisors & Technicians	(34,775)	(72,012)	(79,847)
3	Clerks and Mailhandlers	(710,500)	(755,689)	(508,864)
6&7	City Delivery Carriers	(81,625)	(115,825)	(231,318)
8	Vehicle Service Drivers	(261)	0	0
10	Rural Carriers	(36,781)	(29,468)	(53,312)
11	Custodial and Maintenance Services	(25,897)	(48,221)	(16,608)
12	Motor Vehicle Service	(9)	(205)	(1,255)
14	Transportation	(102,289)	(157,233)	(220,362)
16	Supplies and Services	(9,985)	(15,025)	(9,135)
19	General Management Systems	(3,564)	(2,821)	(0)
	Total All C/S	(1,005,687)	(1,196,499)	(1,120,702)

Between specific cost reduction programs and BPI, the Postal Service identifies realizable cost savings for technical personnel and supervisors. Cost reduction program implementations and supervision of operations frequently require additional supervisory time and attention in order to capture cost savings, to maintain service, and to ensure operating efficiencies. Therefore, the Postal Service specifically examines a program's cost savings opportunities, including those relating to Cost Segment 2, rather than making assumptions that supervisor costs follow in lockstep with estimated changes in craft staffing levels. Most cost reduction programs result in changes to the work environment. While a supervisor may have less people to supervise in the new environment, other responsibilities related to the new equipment and/or a changed environment add to a supervisor's workload. There are also ongoing responsibilities that do not change as a result of fewer employees, e.g., budget, safety, operating performance data monitoring, and coordination of mail flows. While not directly related to specific programs, supervisory, technical, and administrative savings are being pursued via the BPI/LMI processes.

f. Other Programs

The Other Programs category includes changes in program related costs, as defined in Library Reference L-49. Corporatewide activities and Servicewide costs, which are discussed separately below, were, prior to Docket No. R2005-1, included in the Other Programs category.

The Other Program category now includes “programs” which have life cycles, as opposed to “activities,” which tend to be less discretionary and ongoing. Examples of the types of program costs included in this category are: the offsetting cost increases associated with cost reduction programs; programs costs for certain field related efforts that are not cost reduction programs, such as the Bio-Hazard Detection System and the Ventilation and Filtration System for Mail Processing Equipment; and other Headquarters’ administered programs.

Table 15 summarizes the impact of cost changes reflected as Other Programs for the interim year and the Test Year by cost segment. Program summaries are included in Library Reference L-50, Chapter V, and Library Reference L-49 provides a narrative description of each amount included under the Other Program column and the basis for the estimated cost change.

Table 15
Other Programs
($ 000)

C/S	Segment	FY 2006	FY 2007	Test Year Before Rates
2	Supervisors & Technicians	148	0	0
3	Clerks and Mailhandlers	41,121	120,491	57,920
6&7	City Delivery Carriers	40	0	0
10	Rural Carriers	2,559	446	0
11	Custodial and Maintenance Services	63,107	30,525	19,233
12	Motor Vehicle Service	2,512	74	0
13	Miscellaneous Local Operations	235	0	0
14	Transportation	43,800	0	0
15	Building Occupancy	(10,844)	(808)	3
16	Supplies and Services	(105,036)	956	0
17	Research and Development	(3,982)	2,614	0
18	Administrative and Area Operations	(25,475)	38,016	39,049
19	General Management Systems	5,592	0	0
20	Other Accrued Expenses	61,209	0	0
	Total All C/S	74,986	192,314	116,206

g. Corporatewide Activities

Corporatewide activities, summarized in Table 16, include the costs of Headquarters and field service unit initiatives and activities. Corporatewide activities generally tend to be less discretionary and ongoing, as opposed to programs, which have a life cycle. Examples of costs included in corporatewide activities are expedited mail supplies, advertising, mail transport equipment purchases, telecommunications/network operations, corporate software, debit/credit card fees, and stamp manufacturing.

FY 2006 Corporatewide Activities increase primarily as a result of planned Headquarters' information technology costs related to network and system enhancements, personnel costs related to the transfer of EEO staff from the Districts to Headquarters, and increases related to Human Capital Enterprise HR Shared Services program.

Table 16
Corporatewide Activities Cost Effects
($ 000)

C/S	Segment	FY 2006	FY 2007	Test Year Before Rates
11	Custodial and Maintenance Services	(3)	0	0
12	Motor Vehicle Service	(9)	0	0
13	Miscellaneous Local Operations	748	0	0
15	Building Occupancy	(11,970)	(3,975)	0
16	Supplies and Services	41,538	(0)	0
17	Research and Development	(1,334)	3,975	0
18	Administrative and Area Operations	(2,968)	0	0
19	General Management Systems	5,173	0	0
20	Other Accrued Expenses	(39)	0	0
	Total All C/S	31,136	(0)	0

h. Servicewide Costs

Servicewide costs, summarized at Table 17, include costs which cannot be easily allocated to other segments. Such costs include depreciation, interest, and service-wide personnel costs such as of Workers' Compensation costs, Unemployment Compensation, Annuitant Health Benefits, and the Public Law 108-18 escrow cost introduced in FY 2006. A summary of these costs is located in Library Reference L-50, Chapter Vj and I with detailed workpapers included at Chapter VI.

Table 17
Servicewide Costs
($ 000)

C/S	Cost Segment	FY 2006	FY 2007	Test Year Before Rates
18	Administrative and Area Operations	3,484,776	499,724	617,367
20	Other Accrued Expenses	119,110	138,846	319,120
	Total All C/S	3,603,886	638,570	936,487

i. Workyear Mix Adjustments

Workyear mix adjustments calculate the dollar impact of changes in the composition of workyears used in FYs 2006 through the Test Year. Changes in the workyear mix are estimated to result in higher personnel costs for FYs 2006 through the Test Year. 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 FY 2005 (*i.e.*, the amount of personnel cost calculated by the rollforward model before this adjustment). Costs are adversely affected in FY 2006 by a reduction in transitional employees located at facilities other than Remote Encoding Centers and from reductions in mailhandler casuals. In the Test Year after rates it is assumed that clerk and mailhandler overtime decreases in response to the volume workload decline. The lower overtime offsets most of the other increases resulting from fewer transitional employees and casuals. The workyear mix adjustment is expected to result in net cost increases relative to FY 2005 costs for FYs 2006, 2007, and the Test Year Before Rates of $103 million, $198 million, and $78 million, respectively, and a net cost increase for FY 2007 after rates of $282 million and for the Test Year after rates of $44 million.

The net impacts of the changes due to the workyear mix are reflected as an adjustment to the dollar estimates generated by the rollforward model for clerks, city carriers, and mailhandlers. No adjustment was made to Rural Carriers, because the previous trend towards more non-career bargaining employees has abated. The workyear mix adjustment is explained in greater detail in Chapter VIII of Library Reference L-50.

Table 18
Workyear Mix Expressed As a
Percentage of Straight Time Workyears

	FY 2005 Actual	FY 2006 Estimate	FY 2007 Before Rates Estimate	Test Year Before Rates Estimate	FY 2007 After Rates Estimate	Test Year After Rate Estimate
Clerks A-J						
Career-Base	92.0%	92.6%	93.6%	92.7%	94.4%	93.0%
Career-Holiday	0.6%	0.7%	0.7%	0.7%	0.7%	0.7%
Casual	4.4%	4.4%	3.5%	4.4%	2.6%	4.1%
Transitional	3.0%	2.3%	2.2%	2.3%	2.3%	2.3%
Subtotal St. Time	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Overtime	9.9%	9.9%	9.8%	9.9%	9.8%	7.3%
City Carriers						
Career-Base	97.9%	97.9%	97.9%	97.9%	97.9%	97.9%
Career-Holiday	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%
Casual	1.8%	1.8%	1.8%	1.8%	1.8%	1.8%
Transitional	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Subtotal St. Time	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Overtime	13.9%	13.9%	13.9%	13.9%	13.9%	13.9%
Mail Handlers						
Career-Base	90.0%	92.9%	93.3%	91.3%	94.1%	91.3%
Career-Holiday	1.1%	1.2%	1.2%	1.1%	1.2%	1.1%
Casual	8.8%	5.9%	5.5%	7.5%	4.7%	7.6%
Transitional	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Subtotal St. Time	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Overtime	16.3%	16.3%	16.2%	16.3%	16.2%	12.9%
Rural Carriers						
Career-Base	68.7%	68.7%	68.7%	68.7%	68.7%	68.7%
Non-career Barg.	28.3%	28.3%	28.3%	28.3%	28.3%	28.3%
Casual	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%

j. Final Adjustments

In order to reflect the cost changes due to certain volume trends at a finer level of disaggregation than represented in the Cost and Revenue Analysis (CRA) report, final adjustments were made. The final adjustments are summarized in Table 19, below. The derivations of these and other adjustments are explained in the testimony of witness Page (USPS-T-23) and are summarized by cost segment in Chapter XIV of Library Reference L-50 and by class of mail in the testimony of witness Waterbury (USPS-T-10).

Table 19
Final adjustments

C/S	Cost Segment	FY 2006	FY 2007	Test Year Before Rates	FY 2007 After Rates	Test Year After Rates
2	Supervisors & Technicians	(7,934)	(12,841)	(16,014)	(13,423)	(18,350)
3	Clerks and Mailhandlers	(53,917)	(86,924)	(104,802)	(85,787)	(111,900)
6&7	City Delivery Carriers	(19,387)	(31,830)	(37,118)	(38,626)	(57,710)
8	Vehicle Service Drivers	(1,315)	(2,011)	(3,129)	(1,995)	(3,416)
10	Rural Carriers	(5,896)	(10,008)	(39,371)	(15,305)	(26,178)
11	Custodial and Maintenance Services	(5,439)	(8,851)	(10,593)	(9,030)	(11,907)
14	Transportation	1,298	(3,043)	(8,695)	3,053	(28,518)
16	Supplies and Services	156	189	204	174	175
	Total All C/S	(92,433)	(155,319)	(219,518)	(160,940)	(257,803)
	Not Allocated to C/S	7,288	12,148	18,802	4,335	(3,640)
	Total	(85,144)	(143,171)	(200,717)	(156,604)	(261,443)

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 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 existing labor contracts are used to estimate wage increases for FY 2006. Current labor contracts for all major bargaining units will expire in November 2006. Beginning in FY 2007, the effective change in wage rates are estimated, based on the Wages and Salaries for Private Industry (ECI) index, calculated on a September to September basis, minus one percent, with a one year lag. Also included is the carryover from FY 2006 related to the current contracts.

The derivation of a Test Year revenue requirement required that the financial impact of wage changes be estimated through FY 2008. The annual and effective base wage impacts driving personnel cost level increases are summarized in my Exhibit 6K. Additional details on the derivation of personnel unit cost changes, which include pay increases, lump sum payments, and cost of living adjustments, can be found in Chapter VII of Library Reference L-50. The wage and benefit costs estimated in developing the revenue requirement for the Test Year 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, pay for performance increases, incurred as pay increases and lump sum payouts, and other non-bargaining pay increases, 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 L-50. The step increase amounts are offset by savings from replacement of retirees at the top end of the salary schedule with 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 20 below. The negative amounts for Clerks CAG A-J Bargaining in FY 2006 and FY 2007 result from sufficient attrition from the top step and the hiring of new personnel at the bottom step of the pay scale to offset the impact of step increases.

Table 20
Step Increase Unit Costs Summary

	FY2006	FY 2007	Test Year
Clerks CAG A-J, Bargaining	(30.12)	(36.12)	$30.79
City Carriers, Bargaining	73.77	86.20	$172.67
Mail Handlers, Bargaining	25.98	78.80	$177.83

Federal Employee Health Benefit premiums for covered active bargaining unit employees and non-bargaining unit employees increased 7.9 percent for bargaining employees and 7.0 percent for non-bargaining staff in January 2005. In January 2006 premiums increased an estimated 6.6 percent for bargaining and non-bargaining employees. Further increases of 7.0 percent, before the impact of employee changes in plans, are estimated in January 2007 and 2008.

Cost level computations based on these assumptions are detailed in Chapter VII of Library Reference L-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 Global Insight[28] CISSIM/Trendlong 1105, and USSIM/Control 1205. CPI-W estimates from Global Insight served as the basis for computation of cost of living adjustments (COLA) for FY 2006 under the existing labor agreements affecting bargaining unit employees.

Major indices used in this case are summarized in Table 21. A more detailed list of the indices used, along with the specific factors for FY 2006 through the Test Year, can be found in Chapter Vc Library Reference L-50.

Table 21
Selected Global Insight Forecast Factors

	FY 2006	FY 2007	Test Year
CPI-W[29]	3.22	1.17	1.66
ECI[30]	2.23	3.05	3.18
Supplies & materials[31]	7.55	-3.31	-1.43

C. Revenue Requirement

The Test Year revenue requirement is presented in the same cost segment format employed in the testimony of witness Waterbury (USPS-T-10). 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 6N), a provision for contingencies, and an amount for recovery of prior years' losses in the before rates calculation. Test

28/ Global Insight is a leading economic forecasting service. This service was formerly known as DRI/WEFA.
29 CPI-W is the percent change from the previous year of the Consumer Price Index for all Urban Wage Earners & Clerical Workers
30 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, applied to the subsequent year.
31 The Producer Price Index for Intermediate Materials, Supplies, and Components from Global Insight USSIM/WPISOP2000 is used for estimating the cost change of Supplies and Materials.

Year revenue requirements before and after rates are:

Table 22
Test Year Revenue Requirement
($ 000)

	Before Rates	After Rates
Total Cost Segments	78,387,266	76,743,176
Contingency Losses	783,873	767,432
Recovery of Prior Year Losses	226,792	0
Total Revenue Required	79,397,931	77,510,608

1. Accrued Costs

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

Table 23
Total Cost Segments[32]
($ 000)

	Amount	% Change
FY 2005	68,547,664	
FY 2006	74,241,921	8.3%
FY 2007 before rates	76,037,092	2.4%
Test Year before rates	78,387,266	3.1%
2007 after rates	75,665,541	1.9%
Test Year after rates	76,743,176	1.4%

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.

a. Postmasters (Segment 1)

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

Table 24
Postmasters Cost
($ 000)

	Amount	% Change
FY 2005	2,136,853	
FY 2006	2,260,823	5.8
FY 2007 before rates	2,363,914	4.6
Test Year before rates	2,482,694	5.0
2007 after rates	2,359,738	4.4
Test Year after rates	2,468,028	4.6

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

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 25, Postmaster costs are mainly impacted by cost level increases that result from estimated changes in salaries and benefits unit costs. More detailed postmaster personnel cost level assumptions and calculations can be found in Chapter VII of Library Reference L-50.

Table 25
Significant Changes in Cost
Postmasters
($ 000)

	FY 2006	FY 2007 Before Rates	FY 2007 After Rates	Test Year After Rates
Cost Level – Personnel Costs	132,568	112,336	112,336	104,628
Mail Volume Effect	(2,268)	(2,813)	(6,995)	(6,157)
Non-Volume Workload Effect	(4,666)	(2,666)	(2,661)	(2,572)
Additional Workday Effect	(1,662)	(3,765)	(3,765)	12,391

b. Supervisors and Technical Personnel (Segment 2)

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

Table 26
Supervisors and Technical Personnel Cost
($ 000)

	Amount	% Change
FY 2005	4,107,156	
FY 2006	4,268,960	3.9
FY 2007 before rates	4,357,777	2.1
Test Year before rates	4,483,636	2.9
2007 after rates	4,333,816	1.5
Test Year after rates	4,400,619	1.5

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 27, Supervisor costs are mainly increased by cost level increases in salaries and benefits unit costs. These cost increases are partially offset by mail volume changes and cost reduction programs. For Fiscal Year 2006 through the test year, cost reductions are the result of Breakthrough Productivity Initiatives (BPI) in the supervision of delivery and mail processing functions, and reductions in administrative and support costs due to the reorganization of the EEO field staff to Headquarters and the Human Capital Enterprise HR Share Services programs. More detailed supervisor and technical personnel cost level assumptions and calculations can be found in Chapter VII of Library Reference L-50. Additional information on Segment 2 cost reductions and other programs can be found in Library Reference L-49.

Table 27
Significant Changes in Cost
Supervisors and Technical Personnel
($ 000)

	FY 2006	FY 2007 Before Rates	FY 2007 After Rates	Test Year After Rates
Cost Level – Personnel Costs	211,486	178,124	178,124	162,795
Mail Volume Effect	(12,497)	(15,826)	(39,205)	(33,441)
Non-Volume Workload Effect	7,299	7,748	7,748	8,280
Additional Workday Effect	(1,922)	(4,309)	(4,309)	13,942
Cost Reductions	(34,775)	(72,012)	(72,012)	(79,847)
Other Programs	148	0	0	0
Final Adjustments	(7,934)	(12,841)	(13,423)	(18,350)

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 28
Clerks and Mail Handlers, CAG A through J Offices
($ 000)

	Amount	% Change
FY 2005	18,861,014	
FY 2006	18,843,324	(0.1)
FY 2007 before rates	18,880,655	0.2
Test Year before rates	18,968,420	0.5
2007 after rates	18,800,648	(0.2)
Test Year after rates	18,381,036	(2.2)

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 29, clerk and mail handler costs are mainly increased by cost level increases resulting from estimated changes in salaries and benefits unit costs, other programs and the workyear mix adjustment. These effects are partially offset by cost reduction programs, final adjustments, and mail volume changes. Cost reductions primarily relate equipment programs including Automated Package Processing System, the Integrated Dispatch and Receipts Systems, Flats Recognition Improvement and the Flats Identification Code Sort programs, and the Letter Recognition Enhancement Program. Also included as cost reductions are BPI savings and the Periodicals Cost Reduction Initiative. More detailed clerk and mail handler personnel cost level assumptions and calculations can be found in Chapter VII of Library Reference L-50. Cost reductions and other programs are detailed in Library Reference L-49.

Table 29
Significant Changes in Cost
Clerks and Mail Handlers, CAG A through J Offices
($ 000)

	FY 2006	FY 2007 Before Rates	FY 2007 After Rates	Test Year After Rates
Cost Level – Personnel Costs	713,739	745,096	745,096	510,364
Mail Volume Effect	(108,589)	(126,805)	(292,788)	(246,059)
Non-Volume Workload Effect	2,114	2,265	2,265	2,418
Additional Workday Effect	(4,239)	(9,359)	(9,359)	29,726
Cost Reductions	(710,500)	(755,689)	(755,689)	(508,864)
Other Programs	41,121	120,491	120,491	57,920
Corporatewide Activities	0	0	0	0
Servicewide Costs	0	0	0	0
Workyear mix	102,576	196,915	281,755	42,751
Final Adjustments	(53,917)	(86,924)	(85,787)	(111,900)

d. Clerks - CAG K Offices (Segment 4)

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

Table 30
Clerks, CAG K Offices Cost
($ 000)

	Amount	% Change
FY 2005	5,974	
FY 2006	6,240	4.5
FY 2007 before rates	6,536	4.7
Test Year before rates	6,810	4.2
2007 after rates	6,494	4.1
Test Year after rates	6,673	2.8

Costs of this segment include the personnel costs for clerks assigned to CAG K offices. As reflected in Table 31, CAG K Clerk costs are mainly impacted by cost level increases which result from estimated changes in salaries and benefits unit costs.

Table 31
Significant Changes in Cost
Clerks, CAG K Offices
($ 000)

	FY 2006	FY 2007 Before Rates	FY 2007 After Rates	Test Year After Rates
Cost Level – Personnel Costs	308	344	344	233
Mail Volume Effect	(39)	(41)	(84)	(73)
Additional Workday Effect	(3)	(6)	(6)	19

e. City Delivery Carriers (Segments 6&7)

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

Table 32
City Delivery Carriers Cost
($ 000)

	Amount	% Change
FY 2005	15,673,637	
FY 2006	16,208,337	3.4
FY 2007 before rates	16,680,241	2.9
Test Year before rates	17,134,152	2.7
2007 after rates	16,600,691	2.4
Test Year after rates	16,848,941	1.5

Costs of this segment include the personnel costs of city delivery carriers. As reflected in Table 33, City Carrier costs are mainly increased by cost level increases due to estimated changes in salaries and benefits unit costs and non-volume workload. City carrier cost level increases are due to the labor contract and to the Global Insight forecast for employee wages based on the Employment Cost Index for Wages and Salaries for Private Industry (ECI), calculated on a September to September basis, minus one percent for FY 2007 and FY 2008, applied with a one year lag. Non-Volume workload cost increases are delivery activities related to the expansion of the network. Cost level increases are offset by mail volume changes and cost reductions. Cost reduction savings are mostly due to Delivery Bar Code Sorter equipment and BPI as detailed in Library Reference L-49.

More detailed city carrier personnel cost level assumptions and calculations can be found in Chapter VII of Library Reference L-50.

Table 33
Significant Changes in Cost
City Delivery Carriers
($ 000)

	FY 2006	FY 2007 Before Rates	FY 2007 After Rates	Test Year After Rates
Cost Level – Personnel Costs	626,021	605,218	605,218	485,564
Mail Volume Effect	(28,864)	(36,625)	(109,405)	(91,965)
Non-Volume Workload Effect	45,061	47,936	47,936	51,987
Additional Workday Effect	(7,277)	(16,327)	(16,327)	53,028
Cost Reductions	(81,625)	(115,825)	(115,825)	(231,319)
Other Programs	40	0	0	0
Workyear mix	728	699	724	763
Final Adjustments	(19,387)	(31,830)	(38,626)	(57,710)

f. Vehicle Service Drivers (Segment 8)

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

Table 34
Vehicle Service Driver Costs
($000)

	Amount	% Change
FY 2005	607,259	
FY 2006	633,244	4.3
FY 2007 before rates	660,006	4.2
Test Year before rates	690,188	4.6
2007 after rates	651,141	2.8
Test Year after rates	661,811	1.6

Costs of this segment include the personnel costs of Vehicle Service Drivers. As reflected in Table 35, Vehicle Service Driver costs are mainly impacted by cost level increases that result from estimated changes in salaries and benefits unit costs and changes in mail volume workload. More detailed vehicle driver personnel cost level assumptions and calculations can be found in Chapter VII of Library Reference L-50.

Table 35
Significant Changes in Cost
Vehicle Service Drivers
($ 000)

	FY 2006	FY 2007 Before Rates	FY 2007 After Rates	Test Year After Rates
Cost Level – Personnel Costs	23,301	26,216	26,216	17,544
Mail Volume Effect	4,487	1,758	(7,123)	(7,126)
Non-Volume Workload Effect	0	0	0	0
Additional Workday Effect	(229)	(516)	(516)	1,672
Cost Reductions	(261)	0	0	0
Other Programs	0	0	0	0
Corporatewide Activities	0	0	0	0
Servicewide Costs	0	0	0	0
Workyear mix	0	0	0	0
Final Adjustments	(1,315)	(2,011)	(1,995)	(3,416)

g. Rural Carriers (Segment 10)

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

Table 36
Rural Carrier Costs
($ 000)

	Amount	% Change
FY 2005	5,598,392	
FY 2006	5,915,309	5.7
FY 2007 before rates	6,235,258	5.4
Test Year before rates	6,494,302	4.2
FY 2007 after rates	6,206,453	4.9
Test Year after rates	6,419,487	3.4

Costs for this segment include the personnel costs of rural carriers and the equipment maintenance allowance (EMA) some of them receive for their vehicles. As reflected in Table 37, Rural Carrier costs are mainly impacted by cost level increases, which result from estimated changes in salaries and benefits unit costs, estimated changes in the CPI-U for Private Transportation, and non-volume delivery workload growth. Cost reduction productivity savings are related to the program to provide used, right-hand drive vehicles to rural carriers and BPI/LMI. Non-Volume workload cost increases are the addition of rural carriers related to the expansion of the network. More detailed rural carrier personnel cost level assumptions and calculations can be found in Chapter VII of Library Reference L-50. Cost reduction and other programs are detailed in Library Reference L-49.

Table 37
Significant Changes in Cost
Rural Carriers
($ 000)

	FY 2006	FY 2007 Before Rates	FY 2007 After Rates	Test Year After Rates
Cost Level	253,092	253,844	253,844	164,090
Mail Volume Effect	13,794	8,245	(15,262)	(15,258)
Non-Volume Workload Effect	93,495	98,659	98,659	103,044
Additional Workday Effect	(3,345)	(7,665)	(7,665)	25,342
Cost Reductions	(36,781)	(29,468)	(29,468)	(53,312)
Other Programs	2,559	446	446	0
Corporatewide Activities	0	0	0	0
Servicewide Costs	0	0	0	0
Workyear mix	0	0	0	0
Final Adjustments	(5,896)	(10,008)	(15,305)	(26,178)

h. Custodial and Maintenance Services (Segment 11)

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

Table 38
Custodial and Maintenance Services Cost
($ 000)

	Amount	% Change
FY 2005	3,125,027	
FY 2006	3,284,085	5.1
FY 2007 before rates	3,401,117	3.6
Test Year before rates	3,531,916	3.8
FY 2007 after rates	3,391,508	3.3
Test Year after rates	3,497,881	3.1

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 39, the largest impact on Custodial and Maintenance costs is cost level increases. These result from estimated changes in salaries and benefits unit costs and the Global Insight index for rent. Custodial and maintenance services costs are also affected by mail volume workload, growth in facilities floor space (non-volume workload), cost reductions and other programs. Cost reduction programs are related to BPI programs and a variety of equipment programs from FY 2006 through the test year. More detailed custodial and maintenance personnel cost level assumptions and calculations can be found in Chapter VII of Library Reference L-50. Cost reduction and other programs are detailed in Library Reference L-49.

Table 39
Significant Changes in Cost
Custodial and Maintenance Services
($ 000)

	FY 2006	FY 2007 Before Rates	FY 2007 After Rates	Test Year After Rates
Cost Level	128,105	140,094	140,094	97,375
Mail Volume Effect	(9,314)	(9,072)	(18,503)	(14,572)
Non-Volume Workload Effect	10,542	11,742	11,742	8,951
Additional Workday Effect	(2,043)	(4,623)	(4,623)	14,870
Cost Reductions	(25,897)	(48,221)	(48,221)	(16,608)
Other Programs	63,107	30,525	30,525	19,233
Corporatewide Activities	(3)	0	0	0
Final Adjustments	(5,439)	(8,851)	(9,030)	(11,907)

i. Motor Vehicle Service (Segment 12)

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

Table 40
Motor Vehicle Service Cost
($ 000)

	Amount	% Change
FY 2005	1,016,829	
FY 2006	1,065,872	4.8
FY 2007 before rates	1,109,552	4.1
Test Year before rates	1,157,658	4.3
FY 2007 after rates	1,105,555	3.7
Test Year after rates	1,144,163	3.5

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 41, Motor Vehicle Service costs are mainly impacted by cost level increases and non-volume workload. Other programs also have an impact in FY 2006. Cost level increases result from estimated changes in salaries and benefits unit costs, and the forecasted costs based on Global Insight indices for auto repairs and maintenance and transportation services. Other programs reflect the Vehicle Route Carriers cost scheduled for FY 2006. More detailed vehicle maintenance personnel cost level assumptions and calculations can be found in Chapter VII of Library Reference L-50. Cost reductions and other programs are detailed in Library Reference L-49.

Table 41
Significant Changes in Cost
Motor Vehicle Service
($ 000)

	FY 2006	FY 2007 Before Rates	FY 2007 After Rates	Test Year After Rates
Cost Level – Personnel Costs	41,225	40,074	40,074	32,381
Mail Volume Effect	655	(388)	(4,385)	(4,075)
Non-Volume Workload Effect	5,393	5,759	5,759	6,213
Additional Workday Effect	(722)	(1,634)	(1,634)	5,344
Cost Reductions	(9)	(205)	(205)	(1,255)
Other Programs	2,512	74	74	0
Corporatewide Activities	(9)	0	0	0

j. Miscellaneous Local Operations (Segment 13)

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

Table 42
Miscellaneous Local Operations
($ 000)

	Amount	% Change
FY 2005	320,136	
FY 2006	339,751	6.1
FY 2007 before rates	353,897	4.2
Test Year before rates	369,695	4.5
FY 2007 after rates	353,861	4.2
Test Year after rates	369,564	4.4

This segment includes the costs of contract stations, carfare, tolls and ferriage, field operations employee awards, and other miscellaneous expenses. Cost level changes include salaries and benefits for Mail Equipment Shop, Facilities and Purchasing field employees. Cost level increases also result from estimated changes in 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 post offices and contract stations. More detailed assumptions and calculations can be found in Chapter VII of Library Reference L-50. Other programs and corporatewide activities are detailed in Library Reference L-49.

Table 43
Significant Changes in Cost
Miscellaneous Local Operations
($ 000)

	FY 2006	FY 2007 Before Rates	FY 2007 After Rates	Test Year After Rates
Cost Level	12,884	8,853	8,853	8,158
Mail Volume Effect	(14)	(18)	(54)	(45)
Non-Volume Workload Effect	5,866	5,546	5,546	6,826
Additional Workday Effect	(104)	(235)	(235)	764
Other Programs	235	0	0	0
Corporatewide Activities	748	0	0	0

k. Contractual Transportation of Mail (Segment 14)

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

Table 44
Contractual Transportation of Mail
($ 000)

	Amount	% Change
FY 2005	5,436,765	
FY 2006	5,784,319	6.4
FY 2007 before rates	5,726,811	(1.0)
Test Year before rates	5,781,051	0.9
FY 2007 after rates	5,611,903	(3.0)
Test Year after rates	5,398,368	(3.8)

This segment includes the cost of non-Postal Service contractual resources used to transport domestic mail. 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 45, contractual transportation costs are mainly impacted by cost level changes, mail volume workload, cost reductions, and other programs. Cost level changes result from the forecasted Global Insight indices for air, highway, rail transportation, and transportation services. Cost reduction items include Periodicals Cost Reduction Initiatives for FY 2006, the TOPS program in FY 2006 and FY 2007, and Surface Visibility program from FY 2006 through the test year. Other programs for FY 2006 include removal of a non-recurring prior year adjustment from the base. Witness McCrery (USPS-T-42 addresses the cost reductions and related other programs in his testimony with details provided in Library Reference L-49.

Table 45
Significant Changes in Cost
Contractual Transportation of Mail
($ 000)

	FY 2006	FY 2007 Before Rates	FY 2007 After Rates	Test Year After Rates
Cost Level	420,959	131,694	131,694	165,086
Mail Volume Effect	(15,451)	(25,944)	(146,948)	(132,031)
Additional Workday Effect	(764)	(1,684)	(1,684)	5,343
Cost Reductions	(102,289)	(157,233)	(157,233)	(220,362)
Other Programs	43,800	0	0	0
Final Adjustments	1,298	(3,043)	3,053	(28,518)

I. Building Occupancy (Segment 15)

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

Table 46
Building Occupancy Cost
($ 000)

	Amount	% Change
FY 2005	1,832,132	
FY 2006	1,970,035	7.5
FY 2007 before rates	1,980,134	0.5
Test Year before rates	1,995,593	0.8
FY 2007 after rates	1,980,134	0.5
Test Year after rates	1,995,593	0.8

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 47, Building Occupancy costs are mainly impacted by cost level increases, non-volume workload, other programs and corporatewide activities. Cost level increases result from estimated changes in general inflation as forecasted by Global Insight. The fuel/oil/coal and gas indexes show double digit increases for FY 2006, but then decrease for FY 2007 and the test year. Non-volume workload increases result from changes in facilities floor space. Other program costs relate to the cost of the Ventilation & Filtration System for Mail Processing Equipment, the Bio-Hazard Detection program, non-recurring base adjustments, and facilities costs related to modernization and replacement efforts incorporated in Decision Analysis Reports (DAR). Increases are offset by reductions in

Headquarters' funded program costs and corporatewide activities. Non-personnel related other programs and cost reductions are explained more fully in Library Reference L-49.

Table 47
Significant Changes in Cost
Building Occupancy
($ 000)

	FY 2006	FY 2007 Before Rates	FY 2007 After Rates	Test Year After Rates
Cost Level	140,970	(5,773)	(5,773)	3,447
Non-Volume Workload Effect	20,473	22,186	22,186	7,258
Additional Workday Effect	(727)	(1,532)	(1,532)	4,751
Other Programs	(10,844)	(808)	(808)	3
Corporatewide Activities	(11,970)	(3,975)	(3,975)	0

m. Supplies and Services (Segment 16)

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

Table 48
Supplies and Services Cost
($ 000)

	Amount	% Change
FY 2005	2,887,397	
FY 2006	2,999,871	3.9
FY 2007 before rates	2,892,879	(3.6)
Test Year before rates	2,865,969	(0.9)
FY 2007 after rates	2,883,578	(3.9)
Test Year after rates	2,832,877	(1.8)

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 49, Supplies and Services costs are mainly impacted by cost level increases, mail volume, cost reductions, other programs, and corporatewide activities.

Cost level increases in FY 2006 and the decreases in FY 2007 and FY 2008 result from estimated increases in salaries and benefits unit costs for the Label Printing Units and Material Distribution Centers and changes in supplies and contractual services costs based on the Global Insight forecast for supplies and materials and paper and paper products. Other program cost decreases in FY 2006 relate to reductions in Headquarters Administered Programs.

More detailed Label Printing Units and Material Distribution Center personnel cost level assumptions and calculations can be found in Chapter VII of Library Reference L-50. Other programs impacting supplies and services are explained in greater detail in Library Reference L-49.

Table 49
Significant Changes in Cost
Supplies and Services
($ 000)

	FY 2006	FY 2007 Before Rates	FY 2007 After Rates	Test Year After Rates
Cost Level	191,612	(83,536)	(83,536)	(34,016)
Mail Volume Effect	(9,499)	(12,073)	(21,358)	(17,658)
Non-Volume Workload Effect	4,672	4,540	4,540	4,233
Additional Workday Effect	(986)	(1,888)	(1,888)	5,873
Cost Reductions	(9,985)	(15,025)	(15,025)	(9,135)
Other Programs	(105,036)	956	956	0
Corporatewide Activities	41,538	(0)	0	0
Final Adjustments	156	189	174	175

n. Research and Development (Segment 17)

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

Table 50
Research and Development Cost
($ 000)

	Amount	% Change
FY 2005	40,727	
FY 2006	35,412	(13.1)
FY 2007 before rates	42,001	18.6
Test Year before rates	42,001	-
FY 2007 after rates	42,001	18.6
Test Year after rates	42,001	-

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 51, other programs and Corporatewide Activities impact Research and Development costs. A narrative description of these programs and activities, and the basis for the resource requirements, is contained in Library Reference L-49.

Table 51
Significant Changes in Cost
Research and Development
($ 000)

	FY 2006	FY 2007 Before Rates	FY 2007 After Rates	Test Year After Rates
Other Programs	(3,982)	2,614	2,614	0
Corporatewide Activities	(1,334)	3,975	3,975	0

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

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

Table 52
HQ & Area Administration & Corporatewide Personnel Costs
($ 000)

	Amount	% Change
FY 2005	4,328,557	
FY 2006	7,859,057	81.6
FY 2007 before rates	8,437,587	7.4
Test Year before rates	9,146,653	8.4
FY 2007 after rates	8,437,587	7.4
Test Year after rates	9,146,653	8.4

The costs of this segment include personnel costs for Headquarters and Headquarters related field service units, the money order function, Area Administration, Office of the Inspector General, and Law Enforcement. Also included are the Corporatewide personnel-related costs of annual leave repricing, Civil Service Retirement Supplemental Liability Principal, Workers' Compensation, Unemployment Compensation, Retiree Health Benefits expense, and the Public Law 108-18 escrow expense. Other costs include supplies and services related to Headquarters activities and miscellaneous support costs.

As reflected in Table 53, HQ & Area Administration & Corporatewide Personnel Costs are mainly driven by the introduction and subsequent escalation of the escrow expense required by Public Law 108-18. While this is the primary cost change, there are also annual increases in annuitant health benefits costs and workers’ compensation costs, as discussed below. Other 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 level increases due to inflation on supplies and contractual services, and other miscellaneous items related to Headquarters activities are based on the Global Insight forecast for supplies and materials and the consumer price index.

Table 53
Significant Changes in Cost
HQ & Area Administration & Corporatewide Personnel Costs
($ 000)

	FY 2006	FY 2007 Before Rates	FY 2007 After Rates	Test Year After Rates
Cost Level Change	75,105	43,475	43,475	41,777
Non-Volume Workload	446	479	479	370
Additional Workday	(1,381)	(3,165)	(3,165)	10,504
Other Programs	(25,475)	38,016	38,016	39,049
Corporate-wide Activities	(2,968)	-	-	-
Miscellaneous Support	(29,230)	-	-	-
Repriced Annual Leave	18,303	(24,875)	(24,875)	4,209
Civil Service Retirement Supplemental Liability	1,864	1,806	1,806	1,920
Workers Compensation [33]	282,870	51,501	51,501	53,974
Unemployment Compensation	23,450	(2,612)	(2,612)	2,084
Annuitant Health Benefits	192,774	203,651	203,651	227,499
Annuitant Life Insurance	1,356	1,400	1,400	1,700
Civil Service Retirement Reform Escrow Expense	2,993,389	268,853	268,853	325,981

Annuitant Health Benefits

Annuitant health benefits cost increases of 12.9 percent in FY 2006, 12.1 percent in FY 2007 and 12.0 percent in FY 2008 result primarily from increased numbers of annuitants and from projected premium cost increases of 6.6 percent in FY 2006 and 7.0 percent in FY 2007 and the test year. The cost increases also are driven by declines in the portion of annuitant health benefit premiums attributable to Post Office Department service and paid by the Federal Government.

[33] Includes Post Office Department claims costs and OWCP health benefits costs.

Annuitant health benefits are expected to continue to increase in FY 2006 and through the Test Year as premiums continue to increase and the cost apportionment share (related to Postal Service versus Post Office Department service) continues to shift towards the Postal Service. Supporting information for this item can be found in Chapter VI b of Library Reference L-50.

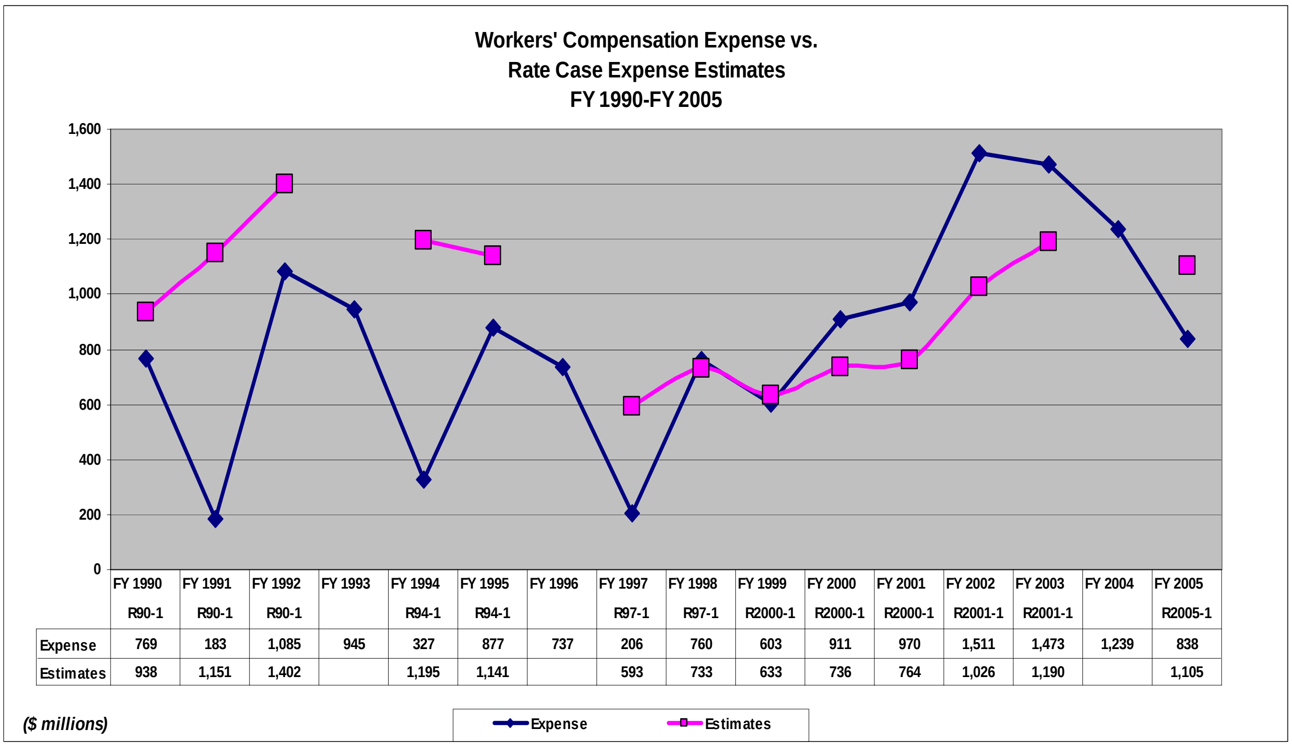
Workers' Compensation Expense

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). 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 main components: (1) the net present value of the total estimated long-term liability and current year payments for those claims which first become active during the current chargeback year, (2) adjustments to the estimate of the liability for claims that first became active in prior years, and (3) the pro-rata share of OWCP administrative expenses.

The workers' compensation expense is estimated for financial reporting purposes using the workers' compensation model with assumptions concerning the number and cost of medical and compensation claims. This claims related data is combined with assumptions concerning the cost inflation, interest rates, probabilities that cases will continue on the rolls, and life expectancy forecasts to develop an estimate of the workers' compensation liabilities and expense. 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). I believe that the current model provides a reasonable annual estimate of the liabilities and expenses related to the workers' compensation program for financial reporting purposes.

Historically, the workers' compensation expense has fluctuated significantly from year to year. Over the last fifteen years, the expense has fluctuated from $ 191 million in FY 1991 to $1,511 million in FY 2002. The year-to-year variations in the expense are illustrated in the chart below that graphically compares the workers' compensation expense by year since FY 1990 and the estimates that were used in previous rate proceedings.[34]



	FY 1990	FY 1991	FY 1992	FY 1993	FY 1994	FY 1995	FY 1996	FY 1997	FY 1998	FY 1999	FY 2000	FY 2001	FY 2002	FY 2003	FY 2004	FY 2005
	R90-1	R90-1	R90-1		R94-1	R94-1		R97-1	R97-1	R2000-1	R2000-1	R2000-1	R2001-1	R2001-1		R2005-1
Expense	769	183	1,085	945	327	877	737	206	760	603	911	970	1,511	1,473	1,239	838
Estimates	938	1,151	1,402		1,195	1,141		593	733	633	736	764	1,026	1,190		1,105

After significant increases in workers' compensation expense from FY 1999 to FY 2002, the expense declined slightly in FY 2003. During this period the estimates used for the test years in Docket Nos. R2000-1 and R2001-1 underestimated the workers' compensation expense. In FY 2004 the expense declined $234 million, and in FY 2005 declined an additional $401 million. These declines were driven by reductions in number initial year medical and

[34] The estimate used for FY 2001 is the R2000-1 test year estimate. R2001-1 overlaps this period, and included an estimate of $950 million for FY 2001.

compensation claims; expense reductions resulting from decreases in the expected number of prior year compensation claims that continued as active from FY 2004 to FY 2005; and a reduction in the average liability for initial year compensation claims in both FY 2004 and FY 2005. Offsetting the declines in FY 2004 was an increase in the liability of $214 million resulting from changes in the net discount factors used to determine the present value of the workers' compensation liabilities. For FY 2005, the R2005-1 rate case included an estimate that was $267 million higher than the actual result.

A number of factors drove the FY 2003 through FY 2005 improvements in the workers' compensation expense including improved safety programs, the joint effort with the Department of Labor to increase the number of injured employees returned to work, and more rigorous reviews of medical billings by the Department of Labor. While these efforts have contributed to the recent downward trend in workers' compensation liabilities and expenses, the efforts may have varying impacts on the future expense. For instance, if a number of employees injured in previous years return to work or are offered and accept private sector employment, the liability for prior years' claims and the related expense will be reduced the following year and the probabilities that cases will remain on the rolls through future years will decline. But if this effort does not yield the same or improved results in future years, all else being equal, the liability and expense will increase since the offsetting reduction due to the removal of the case liabilities will be lower. A possible additional example is weather. At the end of FY 2005, the Postal Service employed over 290,000 career employees as city carriers, motor vehicle drivers, and as rural carriers. These employees are subjected each day to the local weather conditions. Changes in weather conditions, particularly during the holiday season and winter, would logically affect the workplace risk for these employee groups. Assuming the number of injuries in a given year reflects the workplace risk, significant changes in weather patterns may either increase or decrease the occurrence of new injuries, thereby impacting the workers' compensation liabilities and expense for the year.

The workers' compensation model relies primarily on historical data and projects the total liability without regard to anticipated future changes in risk exposure, case management activities, accident prevention efforts, or any of the other potential trends that drive the number or cost of claims in future years. Therefore, future changes in external factors and other trends that may significantly influence the frequency and severity of workers' compensation claims are not reflected in the model estimates until after the effects have occurred. The limited ability to predict or to reflect the impact of underlying trends in the workers' compensation model limits its usefulness when developing projections of liabilities and expenses for future years. This situation was clearly demonstrated in the workers compensation estimates for FY 2005 that were included in Docket No. R2005-1. Although the estimates were developed with the workers' compensation model less than a year in advance, a significant decline in paid claims, primarily during the fourth quarter of the DOL reporting year, resulted in the $401 million reduction in the expense for the year.

In addition to the Postal Service's questions concerning how and to what extent its program management efforts and external factors will affect the workers' compensation expense and liabilities estimates for future years, there exists a significant difference between the Postal Service's FY 2005 liability and expense estimates and those prepared by the Department of Labor (DOL) for disclosure in the financial statements of the United States Government. The DOL estimates the Postal Service workers' compensation liability at the end of FY 2005 as $8.664 billion, approximately $ 1.143 billion[35] above that estimated by the Postal Service. Additionally, the FY 2005 annual expense is estimated by DOL at $1,125,[36] approximately $286 million over that estimated by the Postal Service. Some differences between the estimates prepared by DOL and those prepared by the Postal Service can be expected because the two models use different, but actuarially acceptable, approaches to estimating the workers' compensation liabilities. There are also differences between the approach to

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[35] *Special Report Relating To The Federal Employees' Compensation Act Special Benefits Fund, as of September 30, 2005*, U.S. Department of Labor, Office of the Inspector General, Office of Audit, Report Number 22-06-006-04-431, page 15. Date Issued October 21, 2005. page 15
[36] *Ibid.* page 19.

determining discount rates, inflation rates, weighting of current year experience, and life expectancies. Relatively small differences in these assumptions may have a significant impact on these long term liability estimates.

In response to management's concern regarding the difference between the Postal Service's liability estimate and that of the DOL, as well as the concern about the effectiveness of the current model as a forecasting tool and the responsiveness of the model to management programs and external influences, an analysis by an independent actuary has been initiated. The objectives of this review are to identify the trends driving the workers' compensation expense, determine the impact of these trend on the past several years and on future years' workers' compensation expense, determine the cause of the difference between the Postal Service and the Department of Labor liability estimates, identify the source data that should be obtained, define the appropriate analyses to be performed to better understand the underlying trends, and to recommend approaches to either improve or replace the existing model. As this testimony is being filed, this review is in process. Until this review is completed and the recommendations are reviewed and acted on by management, I have decided not to rely on the current workers' compensation model for the development of the workers' compensation expense estimates for future years. Instead, I have used an alternative approach for the estimation of future year workers' compensation expenses.

The selected alternative approach uses long-term averages to estimate the liability and the related expense. The future years' expense estimates are based on the average annual growth rate for number of medical and compensation claims and the average growth in liability per claim since FY 1990. The estimates incorporate averages developed from (1) the total estimated long-term liability for initial year claims which first become active during the current chargeback year, (2) re-assessment of the estimate of the previously estimated liability for claims that first became active in prior years, and (3) the pro-rata share of OWCP administrative expenses charged to the Postal Service. Additionally, through the use of the averaging, the estimates incorporate the effects of the recurring changes to model parameters such as the discount rate, the life expectancy table, and the smoothing constant since 1990. The workers' compensation estimates are included at Library Reference L-50, Chapter VI d.

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

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

Table 54
Equipment Maintenance & Management Training Support
($ 000)

	Amount	% Change
FY 2005	59,799	
FY 2006	69,004	15.4
FY 2007 before rates	67,110	(2.7)
Test Year before rates	68,331	1.8
FY 2007 after rates	67,110	(2.7)
Test Year after rates	68,331	1.8

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 55, Equipment Maintenance & Management Training Support costs are mainly impacted by cost level increases, cost reduction programs, other programs, and corporatewide activities. 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 Global Insight forecast for the consumer price index. Other program and corporatewide activity changes relate to changes in Headquarters Administered Programs, personnel resources at the Maintenance Technical Support Center, and other corporatewide activities.

Table 55
Significant Changes in Cost
Equipment Maintenance & Management Training Support
($ 000)

	FY 2006	FY 2007 Before Rates	FY 2007 After Rates	Test Year After Rates
Cost Level	2,007	937	937	1,189
Additional Workday Effect	(5)	(10)	(10)	33
Cost Reductions	(3,564)	(2,821)	(2,821)	0
Other Programs	5,592	0	0	0
Corporatewide Activities	5,173	0	0	0

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

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

Table 56
Depreciation, Write-Offs, Claims, and Interest
($ 000)

	Amount	% Change
FY 2005	2,510,006	
FY 2006	2,690,990	7.2
FY 2007 before rates	2,829,468	5.1
Test Year before rates	3,149,395	11.3
FY 2007 after rates	2,828,988	5.1
Test Year after rates	3,064,789	8.3

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 57, Depreciation, Write-Offs, Claims, and Interest costs are mainly impacted by servicewide costs and other programs. Servicewide costs consist mainly of estimated changes in depreciation, interest on debt, and interest on retirement liabilities. Interest expense in the test year after rates increases due to borrowing to finance both capital expenditures in FY 2006, FY 2007 and FY 2008 and operations in FY 2007. Detailed explanations of how these costs were estimated can be found in Chapters V and VI of Library Reference L-50. Other program increases in FY 2006 are due to a non-recurring reversal of bad debt expense in FY 2005.

Table 57
Significant Changes in Depreciation, Write-Offs, Claims, and Interest Cost
($ 000)

	FY 2006	FY 2007 Before Rates	FY 2007 After Rates	Test Year After Rates
Cost Level	2,124	1,496	1,496	2,109
Mail Volume Effect	(1,420)	(1,864)	(2,344)	(2,182)
Other Programs	61,209	0	0	0
Corporatewide Activities	(39)	0	0	0
Servicewide Costs	119,110	138,846	138,846	235,874
Final Adjustments	0	0	0	0

2. Provision for Contingencies

Consistent with the statutory requirement, a provision for contingencies has been included in the Test Year. 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 teaches that there is always the potential for the unknown and the unknowable, an adequate contingency is essential to achieving financial stability and long-run break even.

The contingency amounts are $784 million in the Test Year before rates and $767 million in the Test Year after rates. These amounts are equal to one percent of the total segment expense including final adjustments.

Although there is a level of risk related to many of the assumption made when developing this testimony, there are several elements of this forecast that involve significant unknowns. Examples are included below.

a. The revenue deficiency calculation includes interest income on the funds escrowed under Public Law 108-18. Public Law 108-18 does not specify which agency will maintain control of escrowed funds, whether or not the funds may be invested, or if use of interest on invested escrow funds is to be restricted. By the end of the Test Year, approximately $9.8 billion will be escrowed, and the escrow fund is expected to generate $297 million of interest income during the test year. The revenue requirement assumes that the interest income related to the escrow fund will be unrestricted and available to the Postal Service. Therefore, the escrow interest income is treated as a component of investment income for purposes of calculating the revenue deficiency. There is a risk that this favorable interpretation of Public Law 108-18 may prove wrong.

b. Another consideration is that the revenue requirement includes net cost reductions totaling $2.9 billion through FY 2008. Although this is a reasonable cost savings target, the ability to capture the savings in the designated years is subject to a variety of factors including for example: capital program approvals; capital funds availability; timely completion of design, construction, implementation, and testing; and mail volumes by class, shape and location consistent with those assumed in the program evaluation.

c. Postal labor contracts expire in early FY 2007, and the revenue requirement assumes that total labor cost increases (including general increases COLAs and any other adjustments resulting from negotiations) will equal the employment cost index change minus one percent. The assumed changes are 2.0 percent in FY 2007 and 2.2 percent in FY 2008. To the extent that these assumptions were not to prove accurate, very significant changes in the revenue deficiency would result.

d. Fuel and energy costs, particularly gasoline, aviation fuel, and electricity, have a significant impact on transportation costs, heating and utility costs, and eventually, on the cost of living adjustments. The Global Insight energy cost indices forecast that energy-related costs generally will decline or increase slowly in FY 2007 and FY 2008. As this testimony is being prepared, oil has increased to over $70 a barrel and gasoline exceeds the $3.00 per gallon level. To the extent that energy costs increases do not reverse in FY 2007 and FY 2008, the energy cost related components of the revenue requirement may be significantly understated.

e. An actuarial review of the workers' compensation liabilities and expense is in process. To the extent that changes are made in the estimation process or that adjustments are made to the overall liability significant, single year or ongoing changes may be required to expense and the cumulative net income or loss to reflect the adjustment of this liability.

In addition to the above items that deal with potential effects of both internal and external changes on the assumptions used in the revenue requirement, there are other events that are not considered in the revenue requirement. Over the last five years, the Postal Service has been impacted by the September 11, 2001 terrorist attacks, the anthrax attack, and last year's hurricanes. Although I cannot forecast what specific events will occur during the interim and the test years, I do recognize that there is a continuing risk such events, or similarly disruptive events, will occur during the forecast period.

In deference to the Commission's desire to evaluate forecast errors and their sources, I have included historical variance analyses similar to those included in past filings. Pages 5 through 8 of my Exhibit 6J reflect the results of applying the four sets of historical weighted average cost and revenue variances calculated on pages 1 through 4 of USPS EXHIBIT 6J, to Docket No. R2006-1 Test Year after rates cost and revenue estimates. These produce hypothetical Test Year variances ranging from 1.6 percent, or $1.229 billion to 3.2 percent, or $2.466 billion.

Even though the historical variance analysis would support a substantially higher contingency provision than that selected in this case, 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. The variance analyses reflected in pages 5 through 8 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. 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. Regardless of what history or variance analyses show, management must be allowed to assume its responsibility to determine the amount of contingency most appropriate for achieving its goals.

In future cases management's judgment concerning a reasonable contingency may differ as the Postal Service's financial position and other circumstances change. Therefore, it may very well be necessary to return to higher levels of contingency historically deemed prudent to provide the protection intended by the provision for contingencies.

3. Recovery of Prior Years' Losses

In accordance with the break-even requirement of the Postal Reorganization Act and previous Postal Rate Commission Recommended

Decisions, the revenue requirement provides for the recovery of losses incurred prior to the Test Year. The Prior Years' Loss Recovery provision is designed to restore the Postal Service's equity that is dissipated when net losses are incurred. Without the provision for recovery of prior years' losses, the Postal Service would have no mechanism to ultimately meet the statutory requirement to break even.

I believe that the recovery of prior years' losses is essential to the ultimate, long-term maintenance of the Postal Service's financial condition. The provision for recovery of prior years' losses enables the Postal Service to restore equity and meet the goals set by management and the Board of Governors in Resolution No. 95-9 adopted July 10, 1995.[37] A report on equity restoration prepared by Price Waterhouse LLP for the Board of Governors provides significant advice as background to the Board's policy Resolution. The Report recommended that "the Board of Governors adopt a Policy Statement affirming a commitment to the goals of breaking even over time and taking actions to improve the Postal Service's equity position."[38]

The Postal Service had a cumulative net income of $2,342 million at the end of FY 2005, as shown in Table 58. At the end of FY 2007 after rates, the Postal Service will have a cumulative net loss of $941 million. After consideration of the $1 billion of funds received under Public Law 94-42, no prior year loss recovery is indicated. Therefore, I have not included a provision for the recovery of prior years' losses in the Test Year revenue requirement.

[37] Docket No. MC96-3, Library Reference SSR-112
[38] Docket No. MC96-3, Library Reference SSR-112

Table 58
Computation of Prior Years' Loss Recovery
($ 000,000)

	After Rates
Cumulative Net Income from Operations since commencement on July 1, 1971 through September 30, 2005	2,342
Less: Estimated net loss in FY 2006	(2,095)
Less: Estimated net loss in FY 2007	(1,188)
Plus: Funds from Public Law No. 94-421	1,000
Total Recovery Required	0
Annual Increment (1/9)	0

IV. REVENUES BEFORE AND AFTER RATES

The three sources of postal revenues are operating revenue, appropriations, and interest income. The revenue estimates are based on an assumed implementation date of May 6, 2007. The actual implementation date will be determined by the Board of Governors after receipt of a recommendation by the Postal Rate Commission. Table 59 provides total revenues, actual and estimated through the Test Year:

Table 59
Total Revenues
($ 000)

FY 2005	69,992,841
FY 2006	72,147,390
FY 2007 before rates	72,748,054
Test Year before rates	73,568,380
FY 2007 after rates	74,477,135
Test Year after rates	77,683,166

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 O’Hara (USPS-T-31).

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

Table 60
Mail and Special Services Revenue
($ 000)

FY 2005	69,753,520
FY 2006	71,791,355
FY 2007 before rates	72,346,294
Test Year before rates	73,024,608
FY 2007 after rates	74,051,332
Test Year after rates	77,005,951

[39/] Volumes by class of mail and the attendant revenues for FYs 2005, 2006, 2007, 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 witness Thress (USPS-T-7). After rates volume adjustments that result from market research or special studies are explained in the testimony of the appropriate pricing witness.

B. Appropriations[40]

1. Revenue Forgone Appropriation

Prior to Fiscal Year 1983, the Postal Service received annual appropriations for public service costs. However, since FY1982, appropriation revenue has been for revenue forgone and emergency preparedness. 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 6E, this amounts to $83.518 million for the test year. The second component is a preliminary estimate of $18.075 million for a reconciliation adjustment to reconcile the appropriation received to the amount that would have been authorized if based on final audited mail volume. The FY 2005 and 2006 appropriation revenue in my Exhibit 6E also includes Federal Budget rescissions of $292,000 and $761,000 respectively.

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 Fiscal Years 1991-1993, the amounts appropriated were not sufficient to fund the services provided by the Postal Service. 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.

In recognition of the 42-year extended payment cycle of the Revenue Forgone Reform Act of 1993, on September 30, 1993, the Postal Service

[40]/ My Exhibit 6E shows the components of appropriation revenue for the relevant years.

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 percent) and the remainder is recorded as a partial collection of the account receivable. Should any amount not be appropriated, the Postal Service can adjust the rates of the subsidized mail categories enough to offset the shortfall.

2. Emergency Preparedness Appropriations

In FY 2002, the United States was subjected to biological terrorism, utilizing the mail as the delivery medium. In response, process changes and technology applications were implemented to reduce the risk to both postal employees and customers. The President of the United States and Congress authorized funding of $762 million in FY 2002 to assist in paying for some of these safety measures, and to replace or repair postal facilities in New York City damaged or destroyed as a result of the terrorist attacks on September 11, 2001. Congress appropriated an additional $503 million in FY 2005 for the protection of postal employees and postal customers from exposure to hazardous materials in the mail.

In FY 2002 and FY 2003, the majority of emergency preparedness expenses were for one-time activities, such as plant decontamination. The Postal Service recognized these expenses as non-operating expenses and the corresponding appropriation revenue offset as non-operating revenue.

But due to the ongoing nature of the remaining expenses, such as depreciation, supplies, and maintenance, beginning in 2004 all emergency preparedness items are treated as operating expenses and the associated appropriation revenue as operating revenue. The Postal Service recognizes these appropriations as revenue in the year in which the related expenditure is recognized as an expense, or when the Government approves the reimbursement of a previously incurred expense.

Emergency Preparedness appropriations revenue is also included on Exhibit 6E. During FY 2005 $44.680 million of emergency preparedness appropriations were recognized as operating revenue. In FY 2006, FY 2007 and the Test Year, Emergency Preparedness appropriations to be recognized as operating revenue are estimated at $87.495 million, $108.680 million and $120.180 million, respectively. These revenues match appropriations previously received by the Postal Service to the depreciation expenses incurred for equipment purchased primarily for the Biohazard Detection System (BDS) and the Ventilation and Filtration System (VFS) for Mail Processing Equipment (Library Reference L-49 Section 1A).

Not all emergency preparedness expenditures are covered by these appropriations. Ongoing operating expenses, including items such as BDS consumables and equipment maintenance are not covered and are categorized as Other Programs (Library Reference L-49, Section 2A).

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

Table 61
Appropriation Revenue
($ 000)

	Revenue Forgone	EPP	Total
FY 2005	109,190	44,680	153,870
FY 2006	82,424	87,495	169,919
FY 2007 before rates	78,137	108,680	186,817
Test Year before rates	101,593	120,180	221,773
FY 2007 after rates	78,137	108,680	186,817
Test Year after rates	101,593	120,180	221,773

C. Interest Income (Exhibit USPS-6G)

Interest income has three components: investment income, interest income on invested escrow funds, 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. The escrow interest results from the investment of Public Law 108-18 escrow funds at prevailing short-term interest rates. Imputed interest results from the calculation of the present value at 7 percent interest of future payments related to the Revenue Forgone Act of 1993.

The interest on escrow funds is a newly introduced line item in this case. Public Law 108-18 does not define the method of escrowing funds, the organization that will control escrowed funds, whether escrow funds may be invested, or the use of any investment income escrow funds. The Postal Service has developed the revenue requirement assuming favorable resolution of the above questions. The assumptions upon which the escrow interest is based are that the Postal Service would retain control of the escrowed funds, will be allowed to invest those funds in a manner similar to other postal funds, and that use of interest earned will be unrestricted.

The estimated investment income amounts are included in the following table and calculation of these amounts is discussed in detail in Chapter X of Library Reference L-50.

Table 62
Interest Income [41]
($ 000)

	Investment Income	Escrow Interest	Imputed Interest	Total Interest Income
FY 2005	60,012	-	25,440	85,451
FY 2006	160,916	-	25,200	186,116
FY 2007 before rates	47,857	142,186	24,900	214,943
Test Year before rates	257	297,142	24,600	321,999
FY 2007 after rates	71,900	142,186	24,900	238,986
Test Year after rates	133,700	297,142	24,600	455,442

[41]/ Estimated cash flows for FY 2005, FY 2006, FY 2007 and the Test Year before and after rates, along with projected investment income, are shown in my Exhibits 6F and 6G.

V. TEST YEAR REVENUE DEFICIENCY

The Postal Service's total revenue deficiency in the Test Year at present rates would be $5.830 billion. Changes in postal rates and fees proposed in this filing will eliminate the deficiency as illustrated below:

Table 63
Test Year Revenue Deficiency [42]
($ 000)

Present Rates	Test Year
Total Revenue Requirement [43]	79,397,931
Less: Total Revenue [44]	73,568,380
Total Revenue Deficiency	5,829,551
Proposed Rates	
Increase in Revenue	4,114,786
Decrease in Revenue Requirement	1,887,323
Change in Revenue Deficiency	6,002,109
Revenue Surplus (Deficiency)	172,558

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 64
Analysis of Changes in Equity [45]
($ 000)

	FY 2006	FY 2007 Before Rates	Test Year Before Rates	FY 2007 After Rates	Test Year After Rates
Beginning Balance	5,376,365	3,281,834	(7,204)	3,281,834	2,093,428
Net Income/(Loss)	(2,094,531)	(3,289,038)	(5,602,759)	(1,188,406)	172,558
Ending Balance	3,281,834	(7,204)	(5,609,963)	2,093,428	2,265,986

42/ An analysis of changes in income and expenses comparing before and after rates is included in my Exhibit 6H.
43/ From Table 22, 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 59, 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.