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BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON DC 20268-0001

POSTAL RATE AND FEE CHANGES, 2006

Docket No. R2006–1

REBUTTAL TESTIMONY OF

W. ASHLEY LYONS

ON BEHALF OF

UNITED STATES POSTAL SERVICE

AUTOBIOGRAPHICAL SKETCH

My name is Ashley Lyons. I am the manager of Corporate Financial Planning for the United States Postal Service. As manager of Corporate Financial Planning, I am a direct report to the Chief Financial Officer responsible for a variety of financial analyses, planning and forecasting matters, revenue and volume reporting, cost attribution and other costing matters. Prior to this assignment which began in June of this year, I was the manager of Pricing, a position I had held since 1996. In that position I was responsible for the development of Postal Service pricing proposals for domestic mail classifications and international postal pricing.

I began my career with the Postal Service in August, 1974, working in the Bulk Mail Processing Department. Subsequently, transferred to the Washington Bulk Mail Center's Control and Logistics Department, I later became Safety Manager at the facility. I then returned to the Postal Service's headquarters where I worked in the areas of mail classification and cost analysis. My primary responsibilities in these two functions were to develop regulations and aid in the Postal Service's costing efforts in Docket No. R80-1.

I then served in the Office of Rates. My primary duties were the development of the Postal Service rate level proposals for all domestic mail classifications and the design of First-Class Mail and Priority Mail rates. Other major areas of responsibility were the analysis of postal revenue forgone appropriation and other issues related to preferred postal rates.

In 1993, I became the manager of Workload and Productivity Analysis in the budget function. Along with workload and productivity functions, I was responsible for coordinating the development of budgets presented to the

Congress and the Office of Budget and Management along with the revenue requirement in Docket No. R94-1.

In previous positions, I testified before the Postal Rate Commission twice in Docket No. R84-1, in Docket No. R87-1, twice in Docket No. 90-1, and twice in Docket No. MC96-3. This marks my first appearance as a witness at the Postal Rate Commission in almost a decade.

I received a Bachelor of Science degree in 1974 from the University of Alabama where I majored in transportation and public utilities. In 1984, I received a Master of Business Administration degree from George Washington University.

I. PURPOSE AND SCOPE OF TESTIMONY

My testimony rebuts Direct Marketing Association's witness Buc's (DMA-T-1) proposal to reduce the Postal Service's revenue requirement for the Test Year. I will demonstrate that his testimony does not support changing the revenue requirement.

II. AN APPROPRIATE LEVEL OF SUPERVISORY COST REDUCTIONS HAVE ALREADY BEEN INCLUDED IN THE REVENUE REQUIREMENT.

Witness Buc asserts that the Postal Service has overstated the revenue requirement by understating the cost reduction programs for supervisors. He posits that the supervisory costs vary in direct proportion to the craft labor supervised, and therefore, the cost reduction projection should be increased to include additional supervisory reductions related to specific cost reduction programs identified in LR-49.

Witness Buc fails to demonstrate that supervisory costs, either in general or specifically relative to cost reduction program implementation, are reduced in direct proportion to craft labor costs; in fact, he admits that over certain time periods supervisory costs do not decline in direct proportion to craft labor costs.[1] No evidence has been presented that cost reduction programs generate supervisory savings proportional to craft savings. Witness Buc also fails to recognize the Postal Service's approach to identifying and capturing supervisory cost reductions as outlined in witness Loutsch's testimony:[2]

> 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

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[1] Tr. 22/8044.
[2] USPS-T-6, page 31, lines 5-20.

> 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.

The effect of witness Buc's proposal would increase cost reductions beyond the level that is predicted to occur by the Postal Service in the rate filing and the FY 2007 Operating Budget. Such a reduction would also reduce the revenue requirement for funds already spent in FY 2006. Witness Oronzio (USPS-RT-15) describes the approach used by the Postal Service to identify, plan and capture potential supervisory cost reductions. The approach he describes means that reductions in supervisory costs are already reflected in the program estimates or in the estimates of Breakthrough Productivity Initiatives and Local Management Initiatives (BPI/LMI). To make further reductions, as witness Buc proposes, would be unjustified and would result in an overstatement of expected savings.

III. THE REVENUE SURPLUS, AS ADJUSTED, IS REASONABLE AND CONSISTENT WITH THE REORGANIZATION ACT REQUIREMENTS.

Witness Buc states that the proposed rates lead to a revenue surplus that is excessive. The Reorganization Act requires that: "Postal rates and fees shall provide sufficient revenue so that total estimated income and appropriations to the Postal Service will equal as nearly as practicable total estimated costs of the Postal Service." 39 U.S.C. ¶ 3621.

What constitutes "equal as nearly as practicable" is judgmental. The original revenue requirement had a revenue surplus of $0.8 million. As a result of errata, the surplus increased to $173 million, but was subsequently reduced to $97 million after the changes and reconciliation of revenue provided in response to POIR 16. This corrected estimate of surplus in the test year of $97 million represents just over 0.1 percent of the total revenue requirement. My belief is that 0.1 percent represents a reasonable and good faith attempt to balance revenues and costs as "nearly as practicable." During his cross examination, Witness Buc agreed.[3]

IV. ACTUAL 2006 NET INCOME IS FULLY CONSISTENT WITH THE REVENUE REQUIREMENT TESTIMONY

Witness Buc uses interim financial data in an attempt to anticipate 2006 results, and, based on this analysis, argues that the revenue requirement estimate is "unlikely."[4] Based on actual 2006 audited financial results approved by the Board of Governors, the Postal Service's incurred a net loss of $2.058 billion, after consideration of the escrow.[5] These overall results are consistent with the estimated FY 2006 revenue requirement loss of $2.075 billion.[6]

The financial statements show that while actual revenue was $649 million higher than the rate case estimate, expenses were also higher by $632 million. The primary expense variances are described in the following paragraphs.

Labor costs were $254 million higher than estimated overall, due to increased workyear usage of $602 million, offset by lower-than-expected average labor costs of $349 million. The labor usage increase results from higher-than-expected volume, but it also indicates that the planned cost reductions were not fully achieved. After seven years of significant productivity gains, continued cost reduction can be expected to become more challenging, nevertheless management remains committed to continue the substantial productivity improvement outlined in the revenue requirement.

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[3] Tr. 22/8047. ("if you were at .1 that I would say that's as nearly as practicable.")
[4] DMA-T-1, page 10, line 13.
[5] See Library Reference USPS-LR-195 (FY 2006 Financial Statements and Management Discussion and Analysis).
[6] Postal Service response to POIR 16.

The workers' compensation costs increased $441 million to $1,279 million in 2006 from $838 million in 2005. Even though the revenue requirement estimate included a substantial increase in workers' compensation expense over the base year level, the revenue requirement estimate was $163 million less than the actual 2006 expense. I have been informed by our Accounting management that increases over the amounts included in the revenue requirement may result in 2007 and 2008, as we convert to a new modeling approach.

Finally, transportation costs in 2006 increased by 11.2 percent, or $608 million, when compared to 2005. A portion of this increase, 6.4 percent, was anticipated in the revenue requirement estimate, but the 2006 revenue requirement estimate was approximately $260 million less than the actual results. Approximately half of the 2005-2006 change was due to increased fuel costs, with the remainder due to increased usage as a result of increased mail volume and increased contract costs. While fuel prices have recently moderated, the revenue requirement estimate assumes that a combination of moderate inflation, declining volume workload, and significant cost reduction programs will result in declining transportation costs in after rates 2007 and 2008 of 3.0 to 3.8 percent per year.[7]

On September 18, 2006, the Postal Service submitted the FY 2007 Integrated Financial Plan (IFP) to the Commission. Witness Buc dismisses this plan as "not tested and not gone through the same way that a rate case estimate is."[8] But the fact remains that the 2007 Integrated Financial Plan is the Board of Governors approved Postal Service's budget that establishes the expectations and goals for the coming year. Even without an attempt to update the revenue requirement estimates, a comparison of the 2007 after rates revenue requirement estimate to the 2007 IFP provides insight concerning changes in estimates that have occurred since the finalization of the revenue requirement estimates.

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[7] USPS-T-6, Tables 44 and 45, pages 49-50.
[8] Tr. Vol. 22/8048-8049.

The 2007 IFP projects a worsening of Postal Service finances when compared to the revenue requirement estimates. The IFP budgets a Net Deficiency After Escrow[9] of $1.576 billion versus the revenue requirement 2007 After Rates deficiency of $1.151 billion, a $425 million decline. The 2007 IFP budgets an increase in revenues of $744 million ($75.273 billion – $74.529 billion) on a volume increase of 853 million pieces, when compared to the revenue requirement estimate. The 2007 IFP revenue forecast is based on revenue and volume results through June 30, 2006, and incorporates the revenue increases that occurred during that period. While the increased revenue is a positive development, the IFP continues to project an overall volume decline of approximately 1.2 billion pieces, including a decline in First-Class Mail volume of 2.8 billion pieces, offset by an increase in Standard Mail of 2.0 billion pieces.

Offsetting the better-than-expected revenue is a substantial expense increase. The IFP includes an expense budget of $76.849 billion ($73.564 total expenses plus $3.285 billion escrow). This budget is $1.169 billion over the estimates included in the revenue requirement. The increase is primarily driven by increased personnel costs, resulting from additional workload and the September COLA, and increased transportation costs.

Labor costs were significantly increased by the September 2006 COLA. As mentioned in the Postal Service response to POIR 13, actual COLAs exceeded those included in the revenue requirement estimate. The difference between the estimates is over $500 per bargaining unit employee, and will increase 2007 revenue requirement estimate by more than $400 million. This increase will carry forward into the Test Year resulting in at least a $400 million increase in expense.

In POIR 16, the Commission inquired concerning the impact of the OPM announcement that health benefits premiums would increase by only 1.8 percent in FY 2007. We noted that Postal Service premiums, assuming no open season plan changes, would increase 2.3 percent. Published reports indicated that the

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[9] Integrated Financial Plan FY 2007, Executive Summary, page 1.

premium increases were being reduced 5 percent through the application of OPM health benefit fund reserves. The Postal Service premiums apparently would have increased by more than the 7 percent estimate in the revenue requirement, if reserve funds had not been applied. We reviewed the history of OPM health benefits premium changes, and in FY 1986 and 1987 a similar application of reserves took place. The announced reduction in the premiums was 0.5 percent in 1986, followed by a 12 percent reduction in 1987. In 1988, however, premium rates increased 17 percent, and in 1989 premium increases were over 25 percent. Therefore, based on the reversal of the premium reductions in years subsequent to the buy-down with reserves, I believe any adjustment to estimated health care costs for the Test Year is premature, inappropriate and risky, especially with only a 1 percent contingency.

Transportation costs are expected to increase from the 2006 actual expense, which already exceeded the 2006 revenue requirement estimate by $260 million. The total increase in transportation costs in the IFP exceeds the 2007 After Rates revenue requirement estimate by over $650 million. This is driven by high fuel costs, increased volume on FedEx, and scheduled contract increases.

With the exception of the health benefits premium buy-down in 2007, expense variances experienced in 2006 and those estimated for 2007 generally will flow through to the test year as base expense level changes, thereby increasing costs in the test year. In summary, witness Buc's criticisms of the projected cost estimates underlying the revenue requirement are not supported. Rather, the record and recent events demonstrate that the Postal Service's 2006 revenue requirement estimate was appropriate, but indicates that 2007 may be understated.

V. THE CONTINGENCY OF 1 PERCENT IS REASONABLE UNDER THE CURRENT CIRCUMSTANCES.

Witness Buc urges the Postal Rate Commission to override management's discretion and reduce the Postal Service's proposed 1 percent contingency to zero.[10] He bases this proposal on three arguments. First, witness Buc argues that, with the Postal Service's equity position at the end of the Test Year, "the Postal Service is far better able to absorb the impacts of an adverse financial occurrence than in the past."[11] Second, witness Buc argues that the Postal Service's strong cash position at the end of the test year allows the Postal Service "to cope easily with an adverse outcome."[12] Finally, witness Buc argues that the Postal Service's financial condition is even better than what appears on the books because real estate is carried at book value rather than market value,[13] and that the Postal Service will realize substantial gains on the sales of excess facilities resulting from the END program.[14] Witness Buc's arguments ignore the purpose of the provision for contingencies and are based on inaccurate analysis.

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

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

The contingency provision is designed to maintain stability in achieving the break-even mandate, in light of the largely unpredictable consequences of an interplay among a complicated array of economic, social, and political forces, as well as accidents and natural disasters. Therefore, the ultimate decision to include a provision for contingencies is logically and necessarily judgmental, and

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[10] DMA-T-1, page 11, line13.
[11] DMA-T-1, page 14, lines 5-6.
[12] DMA-T-1, page 15, lines 1-3.
[13] DMA-T-1, page 15, lines 9-13.
[14] DMA-T-1 page 16-17.

represents a major policy choice by the Board of Governors as to the level of risk with regard to unknown developments that the Postal Service is willing to bear in the test year. The Postal Service has rationally reckoned its proposed provision for contingencies pursuant to this judgmental assessment of the need for a cushion against unknown developments in the test year. This assessment appropriately takes account of a variety of factors, including the Postal Service's expected financial condition, historical experience, the potential for unknown future adversities, and the Postal Service's financial, operational, and ratemaking policies.[15]

Historically, the Postal Service has proposed contingencies in traditional rate filings that have varied from 1 percent to 4 percent. In Docket No. R2005-1, a specialized case targeted only to provide revenue to cover the Escrow Expense, the Postal Service proposed a 0 percent contingency. But in all other omnibus rate filings, proposed contingencies have fallen within or below the Kappel Commission's suggested range of 3.0 to 5.0 percent. Also, over the course of 30 years of postal ratemaking, the Postal Rate Commission has recommended all but two of the Postal Service's contingency requests, which have ranged between 1.0 and 5.0 percent.[16]

Witness Buc's argument that given the level of equity the Postal Service is far better able to absorb the impacts of an adverse financial occurrence than in the past ignores the purpose of the provision for contingencies described above.

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[15] See Rebuttal Testimony of Richard J. Strasser, R2000-1, USPS-RT-1, pages 2-4.

[16] Dockets No. R80-1 and R2000-1 were the only instances in which the Commission recommended reducing the contingency provision. In Docket No. R80-1 an appellate court overruled, as an "unlawful intrusion into the policy-making domain of the Board," the Commission's recommendation that the Postal Service's 3.0 percent contingency provision in that docket be reduced to 1.8 percent. In Docket No. R2000-1, the Governors rejected the Commission's analysis and modified the rates, in part, to provide a sufficient provision for contingencies. Decision of the Governors of the United States Postal Service on the Recommended Decision on Further Reconsideration of the Postal Rate Commission on Postal Rate and Fee Changes (May 7, 2001).

Second, the Test Year after rates total equity is $2.247 billion,[17] or $787 less than the U.S. Government's capital contributions of $3.034 billion. This means that, at the end of the Test Year, retained earnings will be negative by $787 million. Implicitly, witness Buc is arguing that, in the case of an adverse event, the Postal Service should and could merely offset the loss with the capital contributions of the U.S. Government. This is inconsistent with the Reorganization Act's concept of breakeven.

Witness Buc also argues that the Postal Service will be able to easily cope with adverse outcomes because at the end of the Test Year the Postal Service will have a cash balance of $5.587 billion.[18] Witness Buc based this opinion on an inaccurate reading of witness Loutsch's Exhibit 6-G. Exhibit 6-G, titled "Investment Income" provides the documentation of the expected interest income. The schedule uses average cash balances for the year, not year end balances. The appropriate schedule that identifies cash on hand at year end is the Summary of Cash Flows, LR-50, page 271. This estimate of year end cash balances indicates that at the end of 2008 After Rates the Postal Service expects to have an unrestricted cash balance of $1.0 billion. I would also point out that the $1.0 billion cash level represents substantially less than a single two week payroll disbursement. In order to have the $1.0 billion ending cash balance in 2008 After Rates, the Postal Service will be required to borrow $3.563 billion over the 2006-2008 period to finance capital acquisitions and escrow contributions. The actual estimated cash balance at the end of the Test Year After Rates is designed to ensure that the payroll can be met and provides absolutely no cushion against adverse events.

Witness Buc contends that the appraised value of postal real estate is higher than its book value, suggesting that negative equity is overstated. He states that the Postal Service's financial position is even better than stated in the

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[17] See Postal Service response to POIR 16.
[18] DMA-T-1, page 15, line 3.

financial statements because real estate is carried at its book value.[19] In other words, he advises us, in effect, not to worry about future deficits resulting from unforeseen events, because the Postal Service is in better financial shape than the books of account would suggest. He also suggests disposing of real estate as an additional source of revenue.

This argument ignores the legal and practical realities of postal operations. The Postal Service has universal service obligation and owns real estate for the purpose of supporting and operating a nationwide service network for the long term to satisfy that obligation. In other words, the Postal Service cannot dispose of its real estate at will in order to realize its market value without ignoring the needs of current and future customers.

Witness Buc also argues that it is likely that real estate sales and profit in the Test Year will likely be higher as a result of the END program. This is extremely speculative. Based on my understanding of the END program, the initial conversions will not begin until at the earliest sometime in 2008. It is very unlikely that, given the time required to sell a major building, that any material real estate gains in excess of those already included in the miscellaneous revenue estimate will be realized in the Test Year.

The Postal Service's contingency provision falls at the lower end of a well-established range of reasonableness and even lower than the range suggested by the Kappel Commission. It is my opinion, as manager of Postal Service Corporate Financial Planning, and based on my years of experience, that witness Buc's proposal to reduce the contingency provision is incompatible with reasonable prudent management.

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[19] DMA-T-1, page 15, lines 9-10.