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BEFORE THE

POSTAL RATE COMMISSION

Docket No. R2006-1

POSTAL RATE AND FEE CHANGES, 2006

JOINT BRIEF

CONCERNING THE REVENUE REQUIREMENT

OF

DIRECT MARKETING ASSOCIATION, INC.
ALLIANCE OF NONPROFIT MAILERS
ASSOCIATION FOR POSTAL COMMERCE
CONTINUITY SHIPPERS ASSOCIATION
DMA NONPROFIT FEDERATION
DOW JONES & COMPANY, INC.
MAGAZINE PUBLISHERS OF AMERICA, INC.
THE MCGRAW-HILL COMPANIES, INC.
MAIL FULFILLMENT SERVICES ASSOCIATION
MAIL ORDER ASSOCIATION OF AMERICA
NATIONAL NEWSPAPER ASSOCIATION, INC.
NATIONAL POSTAL POLICY COUNCIL
PARCEL SHIPPERS ASSOCIATION
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TABLE OF CONTENTS

I. INTRODUCTION 1

II. THE COMMISSION'S RECOMMENDED RATES SHOULD MEET THE "AS NEARLY AS PRACTICABLE" BREAK-EVEN TEST. 2

III. THE USPS UNDERESTIMATES THE SAVINGS CREATED BY THE ROLLFORWARD PROGRAM FOR SUPERVISORS. 4

- **A. The Commission Should Reject the USPS Ad Hoc Approach for Estimating Cost Reductions for Supervisors.** 5
  - **1. The Approach is Inconsistent with the Postal Service's Rollforward Method.** 5
  - **2. The Available Evidence Does Not Indicate that Most Cost Reduction Programs Result in Changes to the Work Environment.** 6
  - **3. Supervisors' "Fixed" Responsibilities Comprise Only a Minor Portion of their Time.** 7
  - **4. The Postal Service Method of Estimating Cost Reduction Savings is Inconsistent with the Rebuttal Testimony of USPS Witness Oronzio.** 7
- **B. The Record Shows that Cost Reductions for Supervisors for Clerks and Mailhandlers for Mail Processing and for Carriers Should be Piggybacked on the Cost Reductions of the Craft Employees Supervised.** 8

IV. A CONTINGENCY OF ZERO PERCENT IS REASONABLE IN THIS CASE. 8

- **A. The Commission Has the Legal Responsibility to Approve a Provision for Contingencies No Larger than the Commission Determines to be Reasonable.** 9
- **B. The Size of a Contingency Provision Must be Supported by Substantial Record Evidence.** 13
- **C. Witness Buc Demonstrates that a Contingency Provision of Zero Percent is Reasonable in this Case.** 13
- **D. The Recently Enacted Postal Accountability and Enhancement Act Adds Additional Reasons for a Zero-Percent Contingency.** 16

V. CONCLUSION 20

TABLE OF AUTHORITIES

Direct Marketing Ass'n, Inc. v. U.S.P.S., 778 F.2d 96 (2d Cir. 1985) 12

Mail Order Ass'n v. U.S.P.S., 2 F.3d 408 (D.C. Cir. 1993) 10

Newsweek, Inc. v. U.S.P.S., 663 F.2d 186 (2d Cir. 1981) *aff'd sub nom. National Ass'n of Greeting Card Pubs. v. U.S.P.S.*, 462 U.S. 810 (1983) 11

United Parcel Serv., Inc. v. U.S.P.S., 184 F.3d 827 (D.C. Cir. 1999) . . .. .12

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POSTAL RATE COMMISSION
WASHINGTON, D.C. 20268-0001

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CONCERNING THE REVENUE REQUIREMENT

I. INTRODUCTION

On behalf of itself and the other parties identified on the front cover (referred to collectively as the "Consortium"),[1] Direct Marketing Association, Inc. ("DMA") respectfully submits this joint brief, which sets forth our views on several important issues affecting the size of the revenue requirement requested by the Postal Service. In particular, the Service has: (1) requested rate changes that are estimated to yield revenue substantially greater than estimated costs, (2) failed to correct a flaw in the cost reduction estimates generated by the rollforward program for supervision of clerks/mailhandlers and city delivery carriers, and (3) requested a contingency that is unreasonable and not supported by substantial evidence. In the proper exercise of its statutory authority and responsibility, the Postal Rate Commission (the "Commission") should reduce the revenue requirement accordingly.

[1] DMA has been authorized to state that these parties wish to associate themselves with the views expressed herein.

II. THE COMMISSION'S RECOMMENDED RATES SHOULD MEET THE "AS NEARLY AS PRACTICABLE" BREAK-EVEN TEST.

As an initial matter, the Consortium would like to address an issue that has raised more controversy in this proceeding than is typical -- the meaning of the "break-even" requirement, *i.e.*, the provision in Section 3621 of the Postal Reorganization Act of 1970 (the "Act") that requires estimated revenues to equal estimated costs "as nearly as practicable."

In his testimony,[2] DMA *et al.* witness Buc pointed out that, after this case was filed, the Postal Service made certain adjustments that had a substantial impact on TYAR estimates. As a result, at the time Mr. Buc filed his testimony the USPS-proposed rates were estimated to produce revenues great than estimated costs by $173 million. Mr. Buc testified that a discrepancy of this size violated the standard embodied in Section 3621 of the Act that "Postal rates and fees shall provide sufficient revenues so that the total estimated income and appropriations to the Postal Service will equal <u>as nearly as practicable</u> total estimated costs of the Postal Service."[3] Mr. Buc presented a table showing that the Commission has come quite close to break-even in the rate recommendations it has made over 35 years, and he concluded by recommending that "the Commission should reduce rates by enough so that there is no surplus in TYAR."[4]

Surprisingly, the Postal Service has chosen to challenge this straightforward proposition. On cross-examination, USPS counsel engaged Mr. Buc in a dialogue as to how close to absolute break-even was close enough,[5] and in his rebuttal testimony USPS witness Lyons argued the

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[2] DMA-T-1 at 8-10.

[3] 39 U.S.C. §3621 (emphasis supplied).

[4] DMA-T-1 at 10.

[5] Tr. 22/8021, 8045-8047.

issue further.[6] Mr. Lyons pointed out that changes made in response to POIR 16 modified the TYAR results to shrink the estimated surplus to $97 million TYAR.[7] He then stated that this amount "represents just over 0.1 percent of the total revenue requirement," and he went on to claim that this amount "represents a reasonable and good faith attempt to balance revenues and costs as 'nearly as practicable.'"[8]

The Consortium is surprised that the Postal Service is arguing this point. The Consortium is not claiming that the Postal Service did not initially make a good faith attempt to meet the statutory break-even requirement. On the contrary, in its initial filing the Postal Service came to within less than $1 million of break-even.[9] It was only later adjustments that caused the substantial discrepancy between estimated costs and estimated revenues. The Consortium simply wishes to alert the Commission that it needs to do its best, as it has in the past, to produce break-even when it makes its Recommended Decision.[10]

One final point requires correction. In his rebuttal testimony, USPS witness Lyons asserted that witness Buc had agreed with him that a discrepancy of nearly $100 million meets

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[6] USPS-RT-3 at 5-6.

[7] *Id.* at 6.

[8] *Id.*

[9] In its initial filing, the USPS showed an estimated surplus of $0.8 million. *Id.* at 5.

[10] The recent enactment of the Postal Accountability and Enhancement Act ("PAEA") increases the importance of the Commission recommending rates that produce estimated revenues that are as close as possible to TYAR estimated costs. As is discussed in more detail below, Section IV.D, this case may form the benchmark for future rate increases under a new rate-making scheme that provides the Postal Service with broad authority to raise rates subject only to a per-class index equal to the CPI. Any excess revenues that the Commission may give the USPS in this case may be paid by mailers *ad infinitum*.

the "nearly as practicable" test.[11] This assertion was based on a serious distortion of Mr. Buc's testimony, as well as a truncated quotation that conveniently deleted an important word – "not."

When Mr. Buc was on the stand, USPS counsel attempted to draw him into a numbers game, but Mr. Buc refused to play. At one point Mr. Buc said, ". . . twice the Postal Service has gotten to within $1 million. I think that's pretty good."[12]

Then, USPS counsel asked him whether, in comparison with 0.222 percent (*i.e.*, the portion of the total revenue requirement that $173 million represents), 0.1 percent was "a better ratio." This was Mr. Buc's response:

> "A. I think that's a better ratio. I'm not sure that looking at the past where the numbers look like .082, .083, .047, that even if you were at .1 that I would say that's as nearly as practicable.
>
> "People have gotten much closer in the past, and it seems to me that what the statute says is to get as close as practicable."[13]

Clearly, Mr. Buc was <u>not</u> saying that 0.1 percent is close enough.

III. THE USPS UNDERESTIMATES THE SAVINGS CREATED BY THE ROLLFORWARD PROGRAM FOR SUPERVISORS.

In this case, the Postal Service has once again overestimated its revenue requirement by underestimating cost reductions for supervisors.[14] Rather than relying on the method it consistently uses in its rollforward program for estimating Test Year costs, the Service employs an ad hoc approach for estimating these cost reductions, ungrounded in attribution theory and

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[11] *Id.* at 6.

[12] Tr. 22/8046.

[13] Tr. 22/8047.

[14] Buc, DMA-T-1 at 2-8.

contrary to the best available record evidence. In contrast, DMA witness Buc relies on consistent methods supported by record evidence. His approach should be accepted.

A. The Commission Should Reject the USPS Ad Hoc Approach for Estimating Cost Reductions for Supervisors.

As USPS witness Loutsch explained, cost reductions "represent[] management's commitment to savings between the base year and the Test Year."[15] And for supervisors cost reductions, ". . . the Postal Service specifically examines a program's cost savings opportunities . . . rather than making assumptions that supervisor costs follow in lockstep with estimate changes in craft staffing levels."[16]

Loutsch goes on to explain that the Service follows this procedure because,

> "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."[17]

There are numerous problems with this approach: (1) it is inconsistent with the Postal Service's rollforward method concerning supervisory costs, (2) the available evidence does not indicate that most cost reduction programs result in changes to the work environment, (3) the available evidence indicates that the ongoing responsibilities which do not change comprise a minor share of a supervisors time, and (4) it is inconsistent with the rebuttal testimony of USPS witness Oronzio.

1. The Approach is Inconsistent with the Postal Service's Rollforward Method.

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[15] USPS-T-6 (revised) at 30.

[16] *Id.* at 31.

[17] *Id.*

The Postal Service's model for estimating Test Year Costs – often called the rollforward model – piggybacks the supervision of crafts on the crafts supervised. Thus, when clerk and mailhandler or carrier costs change in response to changes in volumes, supervisory costs for these crafts change in exactly the same proportion.[18] This reflects the recognition that supervisory costs are a function of the craft costs.

However, as described above, the Postal Service uses a very different approach for estimating changes in the costs of supervisors in response to cost reduction programs. If the Postal Service applied that approach to estimating the effect of mail volumes on supervisor costs, it would simply ask around Headquarters as to what the relevant program office believed the cost changes should be. The fact that this approach would not be credible illustrates the fact that the approach to measuring variations in supervisor costs based on cost reductions is also not credible.

2. The Available Evidence Does Not Indicate that Most Cost Reduction Programs Result in Changes to the Work Environment.

Critical to the validity of the Postal Service's approach is the assumption that most cost reduction programs result in changes to the work environment. However, in spite of the importance of this assumption, the Postal Service provides absolutely no evidence to indicate that this assumption is correct. The only record evidence on this point came from DMA *et al.* witness Buc, who provided examples of two cost reduction programs thatdo not appear to change the work environment and described how his reading of all cost reduction programs does not support the position that any substantial portion of them do so.[19]

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[18] DMA-T-1 at 2.

[19] *Id.* at 5.

3. Supervisors' "Fixed" Responsibilities Comprise Only a Minor Portion of their Time.

Equally critical to the validity of the Postal Service's approach is the assumption that supervisors have a substantial burden of "fixed" responsibilities – those unrelated to the number of employees supervised. Again, the only record evidence on this point came from DMA *et al.* witness Buc, who analyzed the job descriptions provided by the Postal Service. His review indicated that supervisors' major responsibility, not surprisingly, is supervising employees and that there is no indication that any substantial portion of their responsibilities remains static as the number of employees changes.[20]

4. The Postal Service Method of Estimating Cost Reduction Savings is Inconsistent with the Rebuttal Testimony of USPS Witness Oronzio.

On rebuttal, USPS witness Chris Oronzio presented testimony "to explain the relation between changes in mail processing craft work-hours and subsequent changes in mail processing supervisory work-hours."[21] He explained,

> "Purchase and deployment of most new mail processing equipment are justified by savings in clerk and mail handler work-hours. When a plant receives a new piece of equipment, the estimated craft savings are removed from the plant's operating budget. In theory and on the average, there should be an accompanying change in supervisory hours – perhaps a reduction in floor supervision and an increase in maintenance supervision. At the plant level, a new piece of equipment might, for example, save two craft positions. As an empirical matter, the ratio of craft positions per supervisor has been approximately 22 to 1 in recent years. If, for the sake of discussion, that 22 to 1 ratio is applicable to this hypothetical piece of equipment, then it would call for the elimination of 0.09 supervisors."[22]

Thus, witnessOronzio actually supports DMA's position. Perhaps recognizing this, he went on to add,

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[20] *Id.* at 5-6; *see also* Tr. 22/8002, 8003, 8009.

[21] Oronzio, USPS-RT-15 at 4, Tr. 36/12272.

[22] *Id.* at 5-6, Tr. 36/12273-74.

> "In the same year, there would be other equipment changes, volume changes, changes in network responsibilities, changes in supervisory administrative duties, etc.; all impacting the need for supervision."[23]

Volume changes, however, are accounted for in the rollforward model; other equipment changes will be accounted for in the estimates for those pieces of equipment; and as discussed above, the evidence relating to administrative duties does not indicate that they substantially impact the supervisor/craft relationship.

B. The Record Shows that Cost Reductions for Supervisors for Clerks and Mailhandlers for Mail Processing and for Carriers Should be Piggybacked on the Cost Reductions of the Craft Employees Supervised.

DMA *et al.* witness Buc described why cost reductions for supervisors should be piggybacked on the cost reductions for the craft supervised.[24] As he observed, "it is manifest in the data that reductions in craft labor are accompanied by reductions in supervisory hours."[25] Moreover, witness Oronzio's testimony that, "As an empirical matter, the ratio of craft positions per supervisor has been approximately 22 to 1 in recent years"[26] supports this position. It should be adopted by the Commission.

IV. A CONTINGENCY OF ZERO PERCENT IS REASONABLE IN THIS CASE.

Section 3621 of the Act provides that the revenue requirement include "a reasonable provision for contingencies."[27] In this case, the Postal Service has requested a contingency of 1.0 percent, which is admittedly low in comparison with contingencies that the Commission has

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[23] *Id.* at 6, Tr. 36/12274.

[24] Buc, DMA-T-1 at 2-8.

[25] *Id.* at 7.

[26] Tr. 36/12274.

[27] 39 U.S.C. §3621.

approved in the past. However, the Commission has an obligation to consider this request based on the evidence of record in this case, including the Postal Service's strong financial condition. For the reasons summarized below, the facts of this case support a contingency provision of 0.0% of total USPS estimated costs.

A. The Commission Has the Legal Responsibility to Approve a Provision for Contingencies No Larger than the Commission Determines to be Reasonable.

As an initial matter, the Consortium regrets that the Postal Service has, yet again, taken the erroneous position that the size of the contingency falls somehow within the "management discretion" of the Postal Service. The Consortium would have thought that the Commission's responsibility to determine the size of a "reasonable" contingency had been so firmly established over the past 35 years that there was no doubt about it. Apparently, the Postal Service is not convinced,[28] and we are compelled to repeat the established legal principles.

To summarize, the Commission has both the authority and the obligation to review the Postal Service's revenue requirement request, including the contingency portion of that request, based on the evidence of record. We agree with the Postal Service that the matter of determining the size of a "reasonable" contingency requires the exercise of judgment. We strongly disagree, however, that it is a matter of policy to be determined by the Board of Governors in its discretion. To the contrary, determining the size of a reasonable contingency involves evaluating risks and determining how much extra financial resources the Postal Service needs in order to

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[28] *E.g.*, Loutsch, USPS-T-6 at 64 ("Management must be allowed to assume its responsibility to determine the amount of the contingency most appropriate for achieving its goals."); Lyons, USPS-RT-3 at 10-11 ("Therefore, a decision to include a provisions for contingencies is logically and necessarily judgmental, and 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.").

meet those risks before it has an opportunity to raise rates in a subsequent proceeding. As the Commission wrote in its R2000-1 Opinion:

> "Once again, to the extent that the Postal Service is advancing the argument that the estimates of required revenue contained in its Request are immune from inquiry and appraisal on the record, or that the Commission's recommendations must approve them regardless of their record support, the Commission must respectfully agree to continue disagreeing in this area. The Supreme Court's decision in NAGCP IV, also cited by the Postal Service, states:
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>> 'Although the Postal Reorganization Act divides ratemaking responsibility between two agencies, the legislative history demonstrates "that ratemaking . . . authority [was] vested primarily in [the] Postal Rate Commission." [Citations omitted.] The structure of the Act supports this view. While the Postal Service has *final* responsibility for guaranteeing that total revenues equal total costs, the Rate Commission determines the proportion of the revenue that should be raised by each class of mail.'
>
> "462 U.S. at 821. (Emphasis added.) (Footnote omitted.) The Commission's view of its and the Governors' statutory responsibilities regarding the revenue requirement is fully compatible with this declaration. The Governors, in consultation with postal management, decide the magnitude of required revenues to include in Requests, in accordance with §3621. They also exercise discretion to act on the Commission's recommendations pursuant to §3625; should they find, after resubmission of the Request, that the rates recommended in the decision on reconsideration will yield insufficient total revenues, they may modify the Commission's recommendations in accordance with the record and the policies of Chapter 36. In the intermediate process that the Commission is directed to conduct, revenue requirement matters are subject to the same substantive, on-the-record review as are other issues, and the Commission will make substantive, but not final, determinations and construct its recommendations accordingly." PRC Op. R2000-1 at para. 2149 (footnotes omitted).

Moreover, the law is clear that the Commission may adjust all Postal Service revenue estimates, as long as it does so for valid reasons and bases its conclusions on substantial evidence in the record.[29] Thus, it is well within the scope of the Commission's authority, and it is the

[29] *E.g., Mail Order Ass'n v. U.S.P.S.*, 2 F.3d 408, 420 (D.C. Cir. 1993) (stating that Commission revenue adjustments will be upheld if they are based on "such relevant evidence as a reasonable mind might accept as adequate to support the conclusion." (internal quotation marks omitted)).

Commission's responsibility, to base its recommended decision on an estimate of revenues needed in the Test Year, including a provision for contingencies no larger than the Commission determines to be reasonable.

In a footnote in his rebuttal testimony, USPS witness Lyons challenges this legal principle. He states:

> "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 [requested] contingency provision in that docket be reduced . . .."[30]

The case to which Mr. Lyons refers is *Newsweek, Inc. v. U.S.P.S.*, 663 F.2d 1186 (2d Cir. 1981) ("*Newsweek*"), *aff'd sub nom. National Ass'n of Greeting Card Pubs. v.U.S.P.S.*, 462 U.S. 810 (1983). The *Newsweek* case involved a unique set of circumstances that bear no resemblance to the instant proceeding. In *Newsweek*, the Court held that the Commission's decision to reduce the Service's revenue requests, including the contingency provision, was unlawful because it constituted an attempt to "punish" the Postal Service for its refusal to file rate cases as frequently as the Commission wanted.[31] This action was deemed arbitrary by the Court because it "had the effect of undermining the Board's exclusive authority in timing changes in postal rates."[32]

The *Newsweek* decision, however, did not in any way modify the Commission's basic authority to determine, within the constraints of the record in each proceeding, the size of a reasonable contingency. The Commission discussed at some length the implications of the *Newsweek* decision in the succeeding omnibus rate case, R84-1, and concluded:

> ". . . the Commission has both the authority and the responsibility to make adjustments in the Postal Service's proposed revenue requirement, so long as our adjustments are not

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[30] Lyons, USPS-RT-3 at 11, fn 16.

[31] *Newsweek*, 663 F.2d at 1204.

[32] *Id.*

> arbitrary, our reasoning is fully articulated and based upon substantial evidence in the record, and where our adjustments have neither the intent nor the effect of causing more frequent rate filings nor constitute an intrusion into the policy-making domain of the Board in accordance with the holding in Newsweek.[33]

Since R84-1, the Commission has regularly reduced revenue requests and contingency requests when it concluded that the evidence of record merited such reductions, and it has received judicial approval when so doing.[34] The Commission should exercise its statutory responsibility in this case, as well.[35] It should carefully consider the evidence of record and include in the revenue requirement a contingency provision that it determines to be reasonable.

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[33] PRC Op. R84-1 at 25. In past cases, the Postal Service has argued that <u>any</u> reduction in the USPS-requested revenue requirement (including the contingency) would be unlawful, because it would have the effect of causing the next rate case to be filed sooner than it would have been otherwise. This assertion, always dubious, is not applicable in this case given the Postal Service's strong financial position. A careful reading of the Commission's Opinion in R84-1, and the Court's decision in *Newsweek*, reveals that, before it can be concluded that a Commission reduction in the requested revenue requirement impinges improperly upon USPS managerial authority, such a reduction must "<u>necessarily</u> have the effect" of causing more frequent rate filings. PRC Op. R84-1 at 25 n.17, *citing Newsweek*, 663 F.2d at 1204. The meaning of "necessarily" must be seen in the (rather extreme) context of the R80-1 case. The *Newsweek* court focused on the Governors' assessment that the Commission's reduction was so severe that "even in the short term, the Commission's recommendation simply would not yield enough revenues to cover postal costs, [leading] to a rate filing as soon as possible by the Postal Service." *Id.*, *quoting* Governors' Decision at 7. The facts of this case, and the extent of the reduction in the USPS-requested contingency advocated by the Consortium, are totally different.

[34] *E.g.*, *United Parcel Serv., Inc. v. U.S.P.S.*, 184 F.3d 827, 832-33 (D.C. Cir. 1999) (noting that the Commission in R97-1 approved a provision for contingencies of 1%, in spite of a USPS request for a contingency of 1.5%).

[35] The Commission should not lose sight of the fact that it is an <u>independent</u> regulatory agency. *See Direct Marketing Ass'n, Inc. v. U.S.P.S.*, 778 F.2d 96, 99 (2d Cir. 1985). It was created for the express purpose of providing a check on the postal management in all rates and classification matters, for the express purpose of NOT allowing postal management to exercise unilateral discretion in these areas, including the critical issue of how much money the USPS needs to break even in the Test Year.

B. The Size of a Contingency Provision Must be Supported by Substantial Record Evidence.

The principles governing the size of a contingency are well-established. A contingency cannot be based on mere intuition or "judgment." It must be based on solid evidence of record and must reflect the facts of each particular case.

To justify a contingency provision of a particular size, the Commission has repeatedly stated that the Postal Service must offer more than just its managerial intuition about potential unforeseen financial risks. This concept was articulated by the Commission in its R87-1 Opinion, as follows:

> "[t]he Postal Service argues that unforeseeable risks, because they are unknown, by their very nature cannot be articulated or analyzed, but must remain in an intuitive realm. But in our view, if such risks are to be the predominant basis of the Postal Service's contingency determination, management's perception of those risks must be articulated to a reasonable degree in order to satisfy the substantial evidence requirement."[36]

Thus, the Commission has looked to objective criteria such as a variance analysis, the financial condition of the Postal Service and its ability to weather adverse outcomes, and the general state of the economy to assess a proposed contingency.[37] While none of these individual factors is dispositive, each has an important role in informing the Commission's exercise of its discretion.[38]

C. Witness Buc Demonstrates that a Contingency Provision of Zero Percent is Reasonable in this Case.

In his direct testimony, DMA *et al.* witness Buc demonstrated that the Postal Service has ample financial resources to cope with any under-estimate of costs or over-estimate of revenues

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[36] PRC Op. R87-1 at 36.

[37] *E.g.*, Op. R94-1 at II-13; Op. R76-1 at 53-57.

[38] *E.g.*, Op. R84-1 at 27; Op. R80-1 at 21-22.

without imposing upon mailers the additional financial burden of a contingency provision. As he pointed out, the contingency proposed by the Postal Service ignores this important reality. Quite simply, the Postal Service is already in a financial position to absorb the impact of misestimates or unforeseen events, without the need for new rates to provide an additional financial cushion. For example, if it were given a full one percent contingency, the Postal Service's After Rates 2008 equity would be a (very substantial) $2.266 billion. The only other time the Service requested a one percent contingency was in R97-1, when its projected TYAR equity was a negative $1.499 billion. Thus, with over $3.75 billion in additional equity in the Test Year in this case as compared to R97-1, the Postal Service is certainly in a much better position to absorb the consequence of any adverse outcomes that might occur.

On cross examination, USPS witness Loutsch first opined that cash rather than equity is a more important aspect of the Service's ability to withstand adverse outcomes.[39] However, he later conceded that cash is related to equity: ". . . as the equity goes up likely your cash balances are available or you have more financial flexibility going forward."[40]

Moreover, assuming that cash is the correct measure of the Service's ability to cope with adverse outcomes, the Postal Service is also able to cope easily with adverse outcomes since its projected cash balance at the end of the Test Year is $3.820 billion (disregarding the escrow balance and assuming a zero contingency in this case).[41] This strong cash position is almost identical to the cash balance projected for R2005-1, $3.826 billion, when the Service requested

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[39] Tr. 2/208.

[40] Tr. 2/212.

[41] *See* DMA-LR-1, Tab 8, Comparative Analysis of USPS Revenue Requirement Requests.

no contingency. Further, this projected cash balance is almost five times the size of the contingency request.

Finally, the financial condition of the Postal Service is even stronger than the numbers that appear on its books – for three reasons. First, real estate is carried on Postal Service books in accordance with generally accepted accounting principals so any appreciation in real estate values does not appear on the books.[42] And while the Postal Service has not conducted any studies comparing book value to market value,[43] real estate values have increased over the years and market values are certainly higher than book. In fact, the ratio of market value to book value was 1.7 for the real estate that the Postal Service sold from 2001 to 2006, and there is no reason to believe that this relationship does not hold for all Postal Service real estate.[44] Second, the Postal Service is likely to recognize more value from sales of real estate than is estimated in this case.[45] Third, there is value in the Postal Service's real estate that can be captured even without sales. Under questioning by Commissioner Goldway, witness Buc agreed that air rights could provide a substantial stream of revenue.[46]

As witness Buc accurately summarized,

> "With so much cash, so much equity, no Prior Year's Losses to recover, the prospect of more frequent price changes, real estate worth more than its book value, and perhaps more revenue from real estate sales than is estimated in the Test Year, the Postal Service needs no contingency."[47]

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[42] *See* DMA/USPS-T6-8, Tr. 2/115. *See also* Tr. 2/235.

[43] DMA/USPS-T6-7, Tr. 2/114.

[44] Buc, DMA-T-1 at 16.

[45] *Id.* at 16-17.

[46] Tr. 22/8055 ("There's a stream of revenue that one could derive past the market value from sale. That's correct.")

[47] DMA-T-1 at 17.

D. The Recently Enacted Postal Accountability and Enhancement Act Adds Additional Reasons for a Zero-Percent Contingency.

In assessing the size of a "reasonable" contingency in this case, the Commission should take official notice of the recent passage of the Postal Accountability and Enhancement Act (the "PAEA") and consider carefully the implications of the new postal rate-making system ushered in by the PAEA. In fact, the PAEA adds several important reasons why the Commission should recommend rates in this case based on a contingency of zero percent.

In his rebuttal testimony, USPS witness Lyons makes a telling statement, "The contingency provision is designed to maintain stability in achieving the break-even mandate . . .."[48]

As a strictly legal matter, of course, this statement is not correct. The contingency provision was not designed to maintain rate stability. The legislative history of the Act provides little or no learning on this issue,[49] but it is reasonable to conclude that the contingency was intended to provide assurance that the Postal Service would not suffer substantial losses in the test year, *i.e.*, that it would break-even in fact, as well as in rate-case estimates. A prime goal of Congress was for the Postal Service to be financially self-sustaining; losses, especially on a

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[48] Lyons, USPS-RT-3 at 10 (emphasis added).

[49] The addition of a "reasonable provision for contingencies" to Section 3621 was accomplished without any significant analysis in the legislative history. The concept originated in the Report of the Kappel Commission, which analogized the subject of the "Standards for Postal Rates" with public utility rate-making, identified a "budgetary standard" and pointed out that, "Privately-owned utilities are entitled to recover all of their legitimate economic costs, such as operating expenses, [and] a reserve for contingencies . . .." Towards Postal Excellence, The Report of the President's Commission on Postal Organization (1968) at 129. This "budgetary standard" was incorporated into the early drafts of the legislation that was to become the Postal Reorganization Act of 1970 and was included in the final version of Section 3621 -- all without apparent analysis by Congress of the role that a provision for contingencies would play in postal finances or how a "reasonable" contingency was to be determined.

consistent basis, would undermine the financial viability of the institution and force a return to the need for substantial Congressional subsidies.

As a practical matter, on the other hand, Mr. Lyons is correct. Over the past 35 years, the contingency provision has played an important role in promoting rate stability. Generally speaking, the Postal Service has had to increase its rates only once every three years, thanks in large part to the financial cushion that the contingency has provided. In very general terms, the Postal Service has operated at a surplus in the test year; it has broken even in test-year-plus-one; and it has operated at a loss in test-year-plus-two – at which point the cycle has begun again.

From the mailers' point of view, this contingency-produced rate stability has entailed a trade-off, favored by some, opposed by others. Mailers overpay in the first year, but recoup their "investment in rate stability" in the third year, when rates are lower than overall USPS costs. Over the years, some mailers have supported this trade-off, because it reduces the number of times that rates need to change, while others have opposed it, because the large increases every three years make mail less competitive vis-à-vis other marketing media. However, even those mailers who prefer smaller-but-more-frequent increases have acknowledged that they do "get their money back" in those years when the Postal Service has operated at a deficit.

With the enactment of the PAEA, this calculus has changed. The PAEA is based on the smaller-but-more-frequent approach to postal rate-making. Three-year rate stability is a thing of the past, effective immediately. From now on postal rates are expected to increase annually. As a result -- and this is the most critical point -- mailers can no longer expect ever to receive a return on any investment they might be forced to make in USPS finances in the form of a contingency.

Another rate case is expected within the next 12 months, and in that case the break-even revenue requirement will apply. Thereafter, rates may be increased annually in amounts large enough to keep pace with inflation. Thus, any financial cushion incorporated into this case, or next year's case, will remain in the USPS bank accounts. Starting with this case, mailers will no longer be able to realize a return on their investment in postal rate stability. This phenomenon will apply with even greater force to the extent that any contingency amount flows over into benchmark rates from the previous rate-making scheme. If that happens, all mailers will be paying rates in excess of costs *ad infinitum*. Such a result is contrary to the intent of the PAEA.

Moreover, granting a contingency in this case would operate contrary to the incentives that are central to the basic purpose of the PAEA. Under the PAEA, the break-even mandate will be eliminated, and the Postal Service will be able to retain any net profits that it will be able to earn. The very first objective of this new rate-making system is "to maximize incentives to reduce costs and increase efficiency."[50] Under this new system, "The Postal Service would no longer operate under a break-even mandate. By maximizing gains and minimizing costs, the Postal Service could generate earnings that would be retained . . .."[51] Among other things, the Postal Service would be able to pay bonuses and provide other incentives to its employees.

Providing the Postal Service with a financial cushion in the guise of a "contingency" is contrary to that basic premise. This "fat" in the USPS revenue stream will simply operate to reduce the incentive for the Postal Service to operate in a lean, efficient manner. Building in a

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[50] HR 6407 (109th Cong., 2d Sess.) Sec. 201, amending 39 U.S.C. § 3622(b)(1). *See also* H. Rept. 109-66 [to accompany H.R. 22] (April 22, 2005) at 44, 48 ("Under the new system, the Postal Regulatory Commission will have the flexibility to design a system that will improve efficiency and control costs.").

[51] H. Rept. 109-66 at 43.

revenue cushion in the form of a contingency will guarantee that the Postal Service will realize positive net revenues, and be able to reward employees with bonuses, even it if fails to keep costs below inflation. Such a result is simply contrary to the fundamental purpose of the PAEA.

Finally, the PAEA makes it virtually certain that the impact of any adverse financial developments (either "known unknowns" or "unknown unknowns")[52] in the test year, FY 2008, will be very short-lived – either because the USPS will choose to treat R2006-1 as the "benchmark" for rate increases under the new system, or because the USPS will file another case within the 12-month transition period.[53] Either way, the Postal Service's exposure to misestimates or unknown events will be limited.

Assuming that the USPS files another major rate case (hereinafter "R2007-1") sometime in 2007, the record in that case will close sometime in mid-to-late FY 2008. Thus, any adverse developments that will have occurred in the Test Year in this case, and their financial impact, will be clear to the Commission by the time it issues its Recommended Decision in R2007-1. Accordingly, the revenue requirement in R2007-1 can be adjusted to provide whatever additional revenue may be appropriate. Moreover, as was discussed at length on this record, the Postal Service has ample cash reserves to cope with any such developments until the R2007-1 rates become effective.[54]

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[52] *E.g.*, Loutsch, Tr. 2/182, 189-193.

[53] HR 6407 (109th Cong., 2d Sess.) Sec. 201, amending 39 U.S.C. §3622(f).

[54] The ability of the Postal Service to cope with "unknowns" is, of course, a critical factor when determining a "reasonable" contingency. *See, e.g.*, PRC Op. R76-1 at 57. Concerning the size of the Postal Service's financial "cushion," *see* Loutsch, Tr. 2/192-202, 206-212; Buc, DMA-T-1 at 13-17.

V. CONCLUSION

For the reasons stated above, the Commission should reduce the Postal Service's estimated revenue requirement for the Test Year by reducing supervisors' costs and incorporating a provision for contingencies of zero percent. It should then recommend rates that are estimated to produce revenues the equal the total revenue requirement "as nearly as practicable."

Respectfully submitted,

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