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BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, D.C. 20268–0001

RATE ADJUSTMENT DUE TO EXTRAORDINARY OR EXCEPTIONAL CIRCUMSTANCES	Docket No. R2010-4

RESPONSES OF THE UNITED STATES POSTAL SERVICE
TO QUESTIONS FROM THE BENCH AT THE HEARING FOR DR. KIEFER
(August 19, 2010)

The United States Postal Service hereby provides its response to the oral question posed from the bench at the August 12 hearing on the statement of Dr. Kiefer. The relevant portion of the transcript is quoted, and is followed by the response.

Respectfully submitted,

UNITED STATES POSTAL SERVICE

By its attorney:

David H. Rubin

475 L'Enfant Plaza West, S.W.
Washington, D.C. 20260-1137
(202) 268-2986, FAX: -5402
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RESPONSE OF THE UNITED STATES POSTAL SERVICE TO ORAL REQUEST AT THE HEARING ON AUGUST 12, 2010 (KIEFER)

TR. 3/382.

For each discount, where you do assert in your filing the rate shock exception, could you please file with the Commission your planned timeline for phasing out the excess discount?

RESPONSE:

While a simple formula could be used to develop the requested timeline, such an exercise would not accurately reflect the multi-faceted and complex statutory pricing requirements, factors and objectives. Moreover, without having a perfect knowledge of the future, we cannot determine how these criteria will be balanced and what prices will be approved by the Governors for future price changes.

Passthroughs for First-Class Mail Letters

In its filing in Docket No. R2010-4, the Postal Service justified the passthrough for First-Class Mail between automation mixed AADC letters and Bulk Metered Mail (BMM) letters, and between AADC letters and mixed AADC letters, using 39 U.S.C. § 3622(e)(2)(B) (the “rate shock” exception). At the August 12, 2010 hearing, the Commission requested a timeline for moving these passthroughs to 100 percent.

39 U.S.C. § 404(b) authorizes the Postal Service’s Governors to establish reasonable and equitable rates of postage and fees for postal services. These determinations are made by the Governors after considering all statutory

requirements, the business environment for customers, and current organizational requirements and strategies.

As discussed below, substantial uncertainties exist regarding the regulatory requirements and costing methodology to be used for pricing presort First-Class Mail. Essentially, the Postal Service cannot develop a plan to meet a regulatory requirement that has not yet been defined. While the Commission indicated in the 2009 ACD that the current methodology should be used until a new methodology is adopted, as Mr. Kiefer discussed, “Given the importance to the Postal Service of this category in terms of revenue and contribution, and its fragility, especially its vulnerability to electronic diversion as discussed above, the Postal Service believes that any larger increase would be too large at this time, as it would raise unacceptable risks of damage to the automation letters mail category. As described above, the Postal Service seeks to avoid adjusting prices in a way that may seriously damage customers.”[1] In this docket, despite substantial concerns, the Postal Service has proposed prices that reduce the “gap” (measured in cents per first ounce) between single-piece First-Class Mail prices and presorted First-Class Mail prices.

Moreover, the Commission’s Docket No.RM2009-3 (Consideration of Workshare Discount Methodologies) has remained open since its initiation on March 16, 2009. The Commission’s order stated that the docket fulfills a “commitment to

[1] Statement of Dr. Kiefer at p. 24.

institute a rulemaking proceeding to examine methodologies underlying the calculation of workshare discounts" for First-Class Mail. Order No. 192 at 1 (March 16, 2009). As this docket is still pending, and its outcome may significantly affect the concept of how First-Class Mail workshare discounts are determined, it would be too speculative to make any determination of the timeframe needed to bring these passthroughs to 100 percent.

Additionally, the Commission indicated in the same docket that it will examine the appropriate costing methodology to be used when First-Class Mail customers workshare. As discussed by several parties, changes in the estimation of costs avoided could alter the calculated passthroughs for First-Class Mail letters.[2]

The Postal Service and its customers have expressed concerns about the potential consequences of "inflexibly pricing presort First-Class Mail as simply a workshared variant of single piece mail" (Kiefer statement at p. 20). This view is consistent with the Commission's own categorization of single-piece and presorted First-Class Mail as separate products when it established the current product list in Docket No. RM2007-1.[3] They are used for different purposes by different types of customers and have different cost characteristics and different demand curves. Given that the Commission has yet to issue its final Order on worksharing methodologies, it would not be prudent to jeopardize the most

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[2] Annual Compliance Determination 2009 at p. 66.
[3] Order No. 43, Appendix A

profitable segment of First-Class Mail by insisting a rigid regulatory requirement be met today despite the existence of a controversial and unresolved proceeding designed to address this question.

Significant changes to the identified workshare discount passthroughs cannot be made without consideration of the effect of these changes on other rate relationships within First-Class Mail automation letters. Because passthroughs are set on a "ladder;" a change at the mixed Automation AADC level filters to the Automation AADC level and down to the Automation 3-digit and Automation 5-digit levels.[4] The two latter categories are of critical importance to First-Class bulk letter mailers, as over 84% of presorted First-Class Mail volume is in those categories.[5] As the National Postal Policy Council stated in its comments filed on August 17, 2010:

Two passthroughs exceed 100 percent. It is important to understand what would be the rate consequences of a rigid application of a 100 percent passthrough. First, by reducing the Automation Mixed AADC letter discount to 4.6 cents, it would raise the Mixed AADC rate by 0.9 cents *more* than the Postal Service has already proposed.

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[4] While the Postal Service does not agree with many points raised by interveners, the issue of driving First-Class Mail letter passthroughs to 100% under current economic conditions is an issue on which the Postal Service and the National Postal Policy Council (NPPC) and other customers concur.

[5] For the hybrid year FY 2009Q3 – FY 2010Q2, 3-Digit automation letters comprised 36.7% of Fist-Class Mail presorted Letter volume, and 5-digit automation letters comprised 47.7% of the First-Class Mail presorted Letter volume. See USPS-R2010-4/1 First-Class Mail Worksheets.

Because the Mixed AADC rate sets the benchmark on which the other discounts are set, raising the Mixed AADC by 0.9 cents would, in turn, also raise all of the other rate categories by an additional 0.9 cents as well, resulting in substantially more than the 5.9 percent increase the Postal Service proposed. An additional 0.4 cents increase would come if the Automation AADC letters discount were reduced to 100 percent, with a cumulative increase of 1.3 cents beyond the already-excessive increases proposed by the Postal Service. Such an increase could only be offset at only one rate category, and only in part, were the Automation 5-digit discount passed through 100 percent. The net effect of both would be to raise the 5-digit rate by 0.9 cents above the 6.2 percent increase already proposed by the Postal Service. As Automation 5-digit comprises nearly half of the volume in the First-Class Bulk letter/card product, that increase alone would have drastic negative effects on Bulk volumes.[6]

In the same document, NPPC notes that the Annual Compliance Review period is the appropriate time for review of passthroughs, and that to do otherwise in this docket would result in a timing mismatch (*i.e.,* comparing 2011 prices to 2009 costs).[7]

[6] National Postal Policy Council, August 17, 2010, pp. 25 -26
[7] Ibid, p. 27.

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In its proposed exigent pricing in this docket, the Postal Service has moved in the direction of narrowing the gap between presort and single piece pricing in First-Class Mail (with the 5.9 percent average proposed price increase for presort mail being well above the single-piece increase). Looking ahead, First-Class Mail workshare passthroughs will depend on many important factors, including a fragile and rapidly evolving marketplace vulnerable to electronic diversion; pending regulatory decisions by the Commission which impact the methodologies behind the calculations; and ultimately, the consideration of the Postal Service's Governors.

Passthroughs for First-Class Mail Flats

In its filing in Docket No. R2010-4, the Postal Service justified the excess passthrough for First-Class Mail automation Area Distribution Center (ADC) flats, using 3622(e)(2)(B) (the "rate shock" exception).

As explained in the statement of Dr. Kiefer, the large size of this passthrough reflects corrections made to the cost model, which in turn caused significant reductions in the cost avoidances as reported in the 2009 Annual Compliance Determination.

In its proposed exigent pricing, the Postal Service has reduced the passthrough by 50 percent. While the Postal Service intends to continue reducing these passthroughs over time, as discussed above, the actual timeline for these changes will depend on the specific circumstance surrounding each of the proposed future price changes.

Passthroughs for Media Mail and Library Mail

In its filing in Docket No.R2010-4, the Postal Service justified the passthroughs greater than 100 percent of avoided costs for 5-digit presorted Media Mail and Library Mail using 3622(e)(2)(B) (the "rate shock" exception) and 3622(e)(2)(C) (the ECSI exception). The Commission requested that the Postal Service provide a timeline for adjusting prices such that the passthrough for discounts justified based on the "rate shock" exception of 39 USC 3622(e)(2)(B).

First, we note that under the ECSI exception, these passthroughs need not be set at or below 100 percent.

Second, as discussed in the First-Class Mail section, pricing decisions are reserved to the Governors under 39 USC § 404(b). In general, the Governors evaluate pricing proposals in the context of all of the factors surrounding the specific price change. These factors include the evaluation of the workshare provisions of 39 U.S.C. § 3622(e) as well as factors such as general economic conditions, the financial situations of mailers who use this product, the impact of price changes on customers, the Postal Service's business goals and the signals that price differentials send to mailers. Rate relationships between all parcel classes and products also need to be taken into account.

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As illustrated in the table below, since the passage of the PAEA the Postal Service has been steadily adjusting these discounts towards avoided costs.

Passthroughs for 5-Digit Presort: Media Mail and Library Mail

	Media Mail	**Library Mail**
2007 ACD	275.4 %	258.9 %
2008 Price Adjustment	264.3 %	253.3 %
2009 Price Adjustment	154.2 %	145.8 %
Proposed Price Adjustment	145.8 %	137.5 %

Generally, the Postal Service expects to continue to move the 5-digit presort Media Mail discount towards 100 percent in roughly equal steps over future price adjustments, although the specific circumstances surrounding each price change will require careful evaluation.

Lastly, under 39 U.S.C. § 3626(a)(7), Library Mail pieces pay postage that is 5 percent less than the comparable commercial category of mail, which has been defined as Media Mail. Consequently, the passthrough for 5-digit presort Library Mail is not independent of the passthrough for 5-digit presort Media Mail.

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TR. 3/403-04.

With regard to your response to POIR-3, question 4, you identified the source of retained pre-sort volume of 53 million pieces is based on management judgment. Again, could you elaborate on your management judgment? I mean, why was it 53 million pieces, as opposed to, say, 50 million pieces? This is for free reply, reply [rides] free program.

RESPONSE:

According to the rules of the Reply Rides Free program, participants would have to mail at least 2.5 percent above their trend volumes to be in the program (see Statement of James M. Kiefer, Appendix A, page 2).

In the analysis of the Reply Rides Free program provided in response to POIR No. 2, question 4c, (POIR2.Q.4c.FCM75.xls, "Reply Rides Free" tab), the Postal Service assumed that the Transaction and Statement volume would be 26,500 million pieces and that 8 percent of this volume would participate. This means that 2,120 million pieces (= 26,500 * 0.08) would be mailed by participating mailers (Program Volume or trend volume). Mailers would have to mail at least 2.5 percent above this Program Volume, or 53 million incremental pieces, to be in the program: 53 million = 2,120 million * 0.025.

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TR. 3/416.

Is there some kind of information that you can provide to us [on the amount of co-mailing for periodicals]? . . . We would really like to know what kind of data the Postal Service keeps, and if it does, to obtain it in some form.

RESPONSE:

Since no Periodicals prices are specifically linked to co-mailing, the Postal Service does not have data that show the amount of co-mailing for Periodicals. Mail.dat information can be used to estimate the amount of co-mailing, by isolating those mailings that list two or more entities as postage payers. For Quarter 1 of FY 2009 (the most recent readily available data), about 8 percent of total Periodicals RPW flats were co-mailed. If there are co-mailers that do not submit Mail.dat files, the percentage might be somewhat higher.

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TR. 3/416-17

Why did the CRA unit cost of periodicals mail increase by more than double the rate of inflation between 1996 and 2009, despite the deployment of the AFSM-100, and the increased amount of worksharing performed in the periodicals class?

RESPONSE:

As estimated in official CRAs for FY 1996 and FY 2009, the reported Periodicals unit cost rose 82 percent. This compares to the change in the CPI of 37 percent. The deployments of AFSM 100s began in the late 1990s and ended by 2003, and it can be said that worksharing by Periodicals mailers rose during this time period.

Before entering into an explanation of these unit cost changes, it is important to note there were two substantial methodology changes during this period which raised the CRA measure of Periodicals unit costs, the first being changes in mail processing cost distribution procedures in Docket No. R97-1, and the second being IOCS redesign. The best available estimates of the effect of the Docket No. R97-1 methodology change suggest there was about a 3.5 percent unit cost increase for Periodicals.[8] An estimate of the impact of IOCS

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[8] The impact of the Docket No. R97-1 methodology change on Periodicals unit costs can be approximated as follows. The Postal Service Base Year FY 1996 unit cost for Periodicals of 18.3 cents (see witness Alexandrovich's Exhibit USPS-5C) was approximately 1 percent lower than the FY 1996 CRA unit cost of 18.5 cents. However, the Commission methodology ultimately adopted was approximately 4.6 percent higher than that of the Postal Service (this is based on the ratio of PRC test year unit costs to USPS test year unit costs – which were 20.5 and 19.6 cents respectively. For this exercise, PRC test year unit costs are from Op and Rec. Dec., page 223 and Appendix G, and USPS test year costs are from witness Patelunas, Exhibit USPS -15G, revised 8/22/97.) The product

redesign presented in Docket No. R2006-1 is a 7.6 percent increase in Periodicals measured unit costs.[9] The combined impact of these is an 11 percent increase in unit costs. Had these methodology changes been in place for the FY 1996 CRA, the observed change in unit costs (over the time period discussed in this question) would have been about 64 percent, rather than 82 percent. While it is impossible to know the precise impact of the methodology changes, their directional impact is clear. Making CRA unit cost comparisons across a thirteen year period, such as 1996 to 2009, will of course always be fraught with uncertainties, thereby making a true apples-to-apples comparison difficult – but in the case of Periodicals, the uncertainty is even larger due to these significant methodology changes.[10]

To explain this roughly 64 percent increase in unit costs, it is important to consider that CPI is a measure of consumer price inflation (i.e., increases in the price level for consumer expenditures including housing, personal transportation, and consumer goods and services), not inflation in postal input prices which are dominated by labor costs. An index of price change covering postal labor and other resources used by the Postal Service is available as part of the Total

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of these two changes – a one percent decline and a 4.6 percent increase -- is a 3.5 percent increase.

[9] This is the difference between the Periodicals unit cost change for FY2003 to FY2005 (of 14 percent) versus all postal products (of 6 percent). The latter is determined by holding the mix of mail constant using the FY2003 volumes. IOCS Redesign is discussed at length in Docket No. R2006-1, Testimony of A. Thomas Bozzo, USPS-T-46.

[10] Another potentially significant methodology change was the major revision in city carrier costing first employed by the Commission in Docket No. R2005-1.

Factor Productivity (TFP) measurement.[11] Between FY 1996 and FY 2009, the "postal inflation" measure from TFP increased 52 percent, exceeding CPI growth by approximately 0.8 percentage points per year.

It is helpful to divide FY 1996 to FY 2009 into two periods. In particular, taking the period FY 2007 to FY 2009 shows that unit costs rose 12.5 percent, while CPI rose only 4.1 percent. The TFP-based measure of postal inflation indicates an increase of 9 percent in the cost of labor, fuel, capital goods, materials, and other resources used by the Postal Service in this time period. Just as important as “postal inflation” is the extraordinary volume declines recently experienced by the Postal Service, particularly for flats. During FY 2007 to FY 2009, total mail volume declined about 17 percent. There was an even larger decline in total flats volume of nearly 23 percent; and the decline in non-carrier route presort flats volume was 33 percent. This led for a time to excess capacity in delivery costs and in plant and equipment costs, as indicated in the Postal Service’s recent Summer Sale filing. Docket No. R2010-3, United States Postal Service Notice of Market-Dominant Price Adjustment, at 6-7 (Feb. 26, 2010). Going forward, as excess capacity is squeezed out, there should be some offsetting reductions in unit costs.

For the period before FY 2007, the official CRA Periodicals unit costs rose 62 percent (from FY 1996 to FY 2007). Adjusting for methodology change as described above provides a 45 percent unit cost increase. The CPI rose by 31.6

[11] *See* FY 2009 Total Factor Productivity tables filed with the Commission on March 2, 2010, Table 49.

percent in this period, and the “postal inflation” associated with labor costs and other resources rose by 39.5 percent.

The implications or benefits of AFSM 100s and other postal mechanization (e.g. SPBS, APPS), as well as worksharing changes, are complex subjects which we are trying to address in the report on Periodicals requested in the PAEA.

In summary it is important to consider that there were significant cost methodology changes, along with “postal inflation” which exceeded the growth in the CPI. These are important factors underlying the rise in Periodicals unit costs.

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TR. 3/433-36.

Does your plan for gradual improvement include bringing bundle and container price cost ratios close to a hundred percent as soon as practicable? . . . If we did get cost coverages that were close to -- or passthroughs that were close to 100 percent, how much would that improve the price cost ratios for periodicals?

And while you are at it, do you have a guess as to how many years you are talking about when we are talking about a gradual process of getting [the price/cost ratios for bundles, sacks, and pallets up to 100 percent]?

RESPONSE:

In witness Masse's Attachment 12, the full-year effect of the proposed exigent prices for Periodicals would be to increase revenue per piece by $0.021. The resulting cost coverage is 87 percent.

Raising bundle and container prices to 100 percent of their costs would increase revenue per piece by an additional $0.034. The combined increase of $0.055 would produce a 21 percent average increase for the Periodicals class, and many publications (especially smaller ones) would face increases well above 21 percent. The resulting cost coverage would be approximately 97 percent, assuming any mailer response does not affect unit costs or revenues disproportionately.

Increasing the percentage of cost reflected in the bundle and container prices has been a Postal Service objective since this price structure was introduced. The May 2009 price increases were near 50 percent for most pallets, about 20-30 percent for dropshipped sacks, and over 100 percent for many bundles.

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The price cap itself need not be a major barrier to further progress in this area. With the proposed exigent prices, bundles will generate 6 percent of Outside County Periodicals revenue, sacks 2.5 percent, and pallets 2.5 percent. With these low percentages, above-cap price increases for bundles, sacks and pallets can be offset by below-cap increases for piece and/or pound prices, at least in the early stages of moving toward 100 percent of costs.

A major reason for moving these prices closer to 100 percent cost is to give mailers appropriate incentives to change their mail preparation in ways that reduce combined mailer-USPS costs for handling Periodicals. We are concerned, however, that especially for small publications, flexibility to reduce the numbers of bundles and sacks may be limited, even if the prices for bundles and sacks increase significantly. Thus, moving toward 100 percent "passthroughs" might result in onerous price increases for some publications. Any mailer response to greater reflection of cost in prices could reduce Periodicals' attributable unit cost, but we have no basis for estimating how big the response might be.

Periodicals rate design is sufficiently complex that the net effect on different types of publications is difficult to predict without detailed analysis. One possibility to be explored would focus on sack prices initially – the percentage of cost reflected in sack prices is lower than for bundles or pallets, and mailers have some flexibility in the number and presort level of sacks they use. In some cases mailers may be able to participate in co-palletization programs that reduce the need for sacks when bundles from several different printers are combined.

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To limit the increase in overall postage paid by mailers that use sacks for most of their mail, reductions in piece or pound prices might be focused on the price cells they use for most of their mail, such as mixed ADC and ADC piece prices or pound prices for more distance zones. This would of course require some departures from the framework currently used to develop Periodicals prices, and also would tend to lower the Periodicals cost coverage from what is estimated above.

Extensive analysis during the development of prices for subsequent price cap increases may generate additional ideas and/or reveal significant drawbacks in the ideas sketched out in this response. We therefore are unable to specify a timeline for achieving prices that reflect 100 percent of costs for bundles, sacks, and pallets.

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TR. 3/462.

What I would like from you is, if it's at all possible, is some specific answer with regard to standard mail flats and letters that addresses the concerns raised in the annual compliance determination and gives us some idea of a time line that includes both cost efficiencies and prices. . . .t I'm taking this opportunity to ask you to provide a document for us that gives us some indication that you're looking at the nexus of cost savings and pricing and that you have a commitment that's measurable to addressing those concerns in the next few years, two or three years.

RESPONSE:

The proposed price increase in this docket would bring the annualized cost coverage for Standard Mail flats to 91.8 percent in FY 2011. Masse Statement, Attachment 12. Dr. Kiefer summarized the Postal Service's position regarding the cost coverage for Standard Mail Flats.

> "Clearly, we cannot continue to price Standard Mail Flats below costs for an extended period of time; however, it is prudent to take a judicious step in this price increase and to move gradually towards the goal of full cost coverage."

Kiefer Statement at 30, lines 11-13.

Over the long run, all products should cover their costs (although the statutory requirement embodied in the PAEA is that classes not products must cover their costs). 39 USC 3622 (c)(2). This pricing proposal makes substantial progress towards that goal.

Going forward, the Postal Service intends to close the remaining gap through a combination of cost savings and price increases. In discussing a potential timeline which involve future pricing, it must be remembered that all pricing decisions are made by the Governors, following a careful consideration of the statutory and regulatory requirements as well as an evaluation of market and business strategy considerations. These decisions can only be made within the context of the circumstances that exist at the time a specific price change is approved.

Standard Mail Flats costs have been available as a separate category for only two years, and it is uncertain whether those two years are typical. First, in addition to unprecedented volume declines, weight also declined on a per piece basis. Because Standard Mail Flats prices for pieces weighing over 3.3 ounces are based, in part, on weight, this resulted in less revenue per piece on average. In contrast, the majority of postal costs are driven by volume and are less susceptible to weight. At the same time, the prices resulting from Docket No. R2006-1 incented conversion of smaller, lighter weight flats to letter-shaped pieces. These converted flats (new letters) were the least expensive flats which resulting in the average cost per remaining flat to increase. This may have resulted in increases in flats costs that were greater than the increases that would have been observed if the mail mix did not change. Going forward, therefore, we assume that the mail mix does not continue to change and Standard Mail unit costs change at the rate of CPI from the projected FY2011 cost level of $0.426 per piece (Masse Statement, Attachment 12).

Further, for illustrative purposes, we have assumed that, in the future,Standard Mail Flats prices increase annually at a level of CPI plus two percent. As Dr, Kiefer observed, the Postal Service has the flexibility under the PAEA to hold the overall increase for the class to CPI while combining below CPI increases for, say, Standard Mail letters with above CPI increases for Standard Mail flats. Tr. 3/419-20. This clearly is a hypothetical – as recent experience suggests, unexpected economic and market place changes may make this scenario inappropriate given the actual conditions in the market at the time potential price changes are evaluated. The net result is a positive cost coverage approximately 5 years after the proposed 5.1 percent exigent increase would take effect, as illustrated in the chart below.

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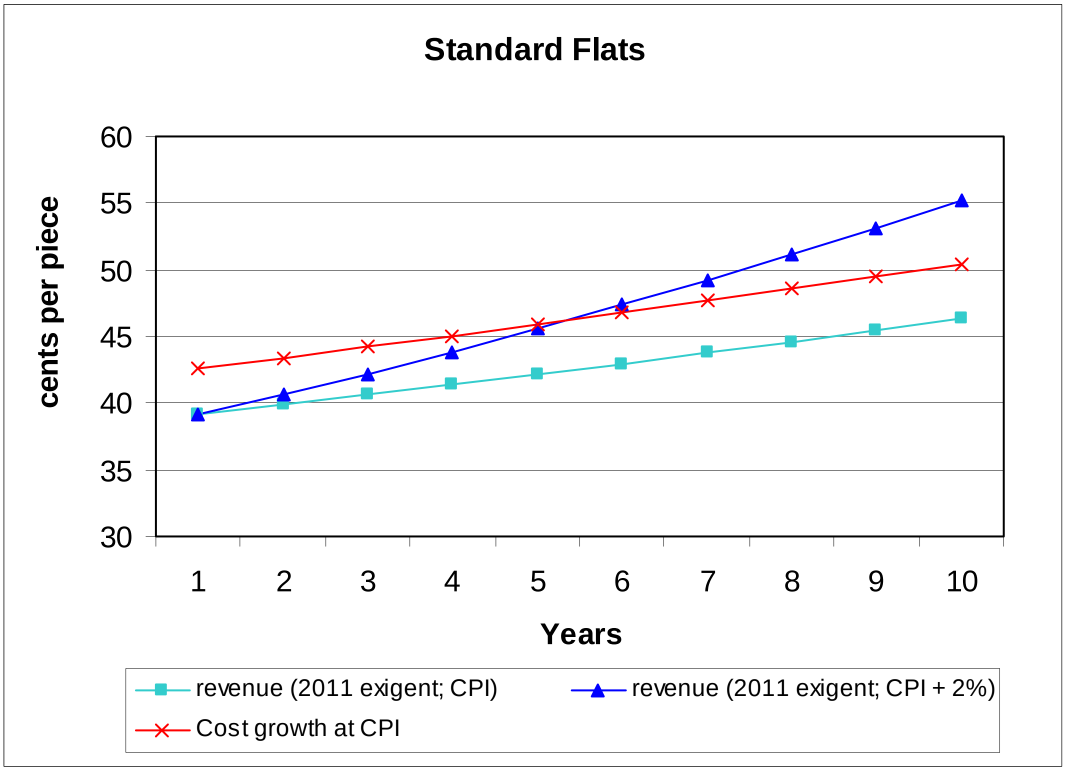

As the Postal Service has recognized, flats costs have increased because costs are not reduced as quickly as volumes have fallen (Kiefer Statement, p.28). Some lags exist as operational processes are adjusted to new lower volumes. As compared to the FY 2009 costs, we expect to capture additional cost savings both through operational improvement programs and through ongoing adjustments to the reduced volume levels. In the financial projections presented by Mr. Masse, the approximately $500 million dollars in savings from “breakthrough productivity initiatives” are included. See Masse Statement Attachments 6-8. In his testimony, Mr. Neri outlined a range of additional cost savings initiatives that are in various stages of development, from conceptual to planned for implementation, and, in most cases, their cost savings apply to more than just flats. See Tr. 3/292-93.

Since the Flats Strategy cost savings are part of the Breakthrough Productivity Initiative (BPI), the total cost savings for Standard Mail flats from the

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Flats Strategy initiatives are limited to a portion of $500 million in FY 2011. It is highly doubtful that cost savings from the Flats Strategy initiatives alone would close the gap, in the short run, or even the medium run. Quantifying the impact of programs in various stages of development and refinement is an inherently difficult process. We are continuing to focus on operational improvements and believe that programs such as those outlined in the Flats Strategy will enable the Postal Service to implement operational improvements affecting flats costs. Nevertheless, they are unlikely on their own to be sufficient to advance Standard Mail flats to full cost coverage.

For example, over the most recent decade (FY2000-2009), the overall TFP growth for the Postal Service was approximately 1.0 percent per year (which is roughly double the average over the entire period going back to Postal Reorganization in 1971). Many of these productivity improvements were focused on letter-shaped mail as the Postal Service implemented its letter automation program. To evaluate the whether the Flats Strategy initiatives could close the gap on their own going forward, one could, predicated on those initiatives, plausibly assume TFP growth for flats specifically of 1.0 percent per year, continuing the recent level of overall TFP growth. The question then becomes, over an assumed 10-year period in which revenues for Standard Flats are hypothesized to rise at the same rate as CPI, and postal input costs are hypothesized to rise in proportion to CPI at the same rate they have historically[12], would such a productivity improvement in and of itself be sufficient to push the cost coverage to 100 percent or greater? Based on such an assumption, over 10 years, the cumulative TFP increase for flats would be approximately 9.4 percent (arithmetic growth rate). This implies an 8.6 percent decline in real input cost per unit of output, but that decline would be partially offset by the above-CPI inflation in postal input costs. As the attached spreadsheet (Tr.3.462.TFP.xls) shows,

[12] Historically, from FY96 through FY09, postal input inflation (including wages and benefits) has exceeded CPI inflation by around 0.8 percentage points per year.

when we start with the 91.8 percent cost coverage estimated by Mr. Masse for Standard Flats on an annual After-Rates basis, and play out these two offsetting effects over a 10-year period against the backdrop of CPI-level increases in revenue, the cost coverage improves a few percentage points, but does not approach full cost coverage. Standard Flats would require some combination of even higher effective productivity improvements relative to the system (as measured by TFP), or lower input price inflation to close the remaining gap.

Thus, raising the cost coverage may also depend on other cost savings that require action by parties other than the Postal Service, such as relief from further Retiree Health Benefit prefunding payments, labor agreements that reduce overall labor costs, and 5-day delivery. For example, the Postal Service calculates that gaining access to the CSRS surplus identified by the Commission's outside actuary and using it to pay Retiree Health benefits would, in combination with the requested 5.1 percent price increase, improve the cost coverage for Standard Mail flats to 98 percent (assuming that CSRS “normal” costs and RHB “normal” costs are no longer attributed, since the cost pool would be zero).

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TR. 3/481-82.

So my staff is concerned that you don't yet know what your budget is for 2011, and these prices would go into effect in 2011, and that there might be significant additional expenditures for new data storage. If you're just pricing up to what was expended in 2009 do you have any indication that these new prices are in fact going to cover the costs of 2011?. . . But we hate to see more loss making products. So could you perhaps provide an answer to my question about your planned expenditures for IT and data collection with regard to confirm service in 2011?

RESPONSE:

Regarding Confirm service, the Postal Service does foresee some IT efforts in FY 2011, but the scope and nature of any IT changes has not been fully defined at this time. It is possible that the current budget for IT will cover any modifications; however, as the nature of any changes becomes better defined it is also possible that expenditures outside the existing budget would be required. The Postal Service believes there is adequate data collection capacity for FY 2011. However, if capacity became a concern additional hardware would have to be purchased.