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

NOTICE OF PRICE ADJUSTMENT	Docket No. R2013-1

RESPONSES OF THE UNITED STATES POSTAL SERVICE TO
QUESTIONS 1-6 OF COMMISSION INFORMATION REQUEST NO. 1
(October 23, 2012)

The Postal Service hereby files its responses to questions 1-6 of Commission Information Request No. 1, issued on October 18, 2012. Each question is stated verbatim, and followed by the Postal Service's response.

Respectfully submitted,

UNITED STATES POSTAL SERVICE

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RESPONSE OF THE UNITED STATES POSTAL SERVICE TO COMMISSION INFORMATION REQUEST NO. 1

1. Pursuant to the 2010 Annual Compliance Determination (ACD) (at 107), please provide:

   a. An explanation of how the proposed prices for Standard Mail Flats will move the Flats cost coverage toward 100 percent.

   b. A statement estimating the effect that the proposed prices will have in reducing the intra-class cross subsidy of the Flats product.

   c. All workpapers and data used to respond to subparts a. and b.

RESPONSE:

a.) As the Postal Service explained in its Notice of Market-Dominant Price Adjustment, the proposed pricing initiatives move the Standard Mail Flats product toward 100% cost coverage. As demonstrated in the excel workbook, *StandardFlats.xls*, filed with this response, the Postal Service estimates that Standard Mail Flats' cost coverage will increase to 83 percent in FY 2012 and 86 percent in FY 2013. Simply put, the combination of an at-cap rate increase and anticipated processing savings from, among other things, Network Rationalization, contribute to this result. Though the Postal Service has not given Standard Mail Flats an above-cap price increase, it will still be able to comply with the intent of the Commission's 2010 ACD Order: moving Standard Mail Flats toward 100 percent cost coverage.

b.) As discussed above, the combination of anticipated unit cost savings and a 2.57 percent price increase will improve the cost coverage of the Flats product, thereby reducing the intra-class cross subsidy. In FY 2011, the average unit attributable cost for the Flats product was 46.3 cents. Meanwhile, average revenue per piece was 36.7 cents. This implies a cost coverage of roughly 79 percent. For FY 2012, it is estimated that cost coverage percent will rise to 82 percent. By itself, the 2.57 percent price increase will increase the cost coverage by approximately two percentage points. If the FY 2012 cost coverage projection proves to be correct, an increase from approximately 82 percent to 84 percent, post January 27, 2013. This does not include the improvement that will come from the anticipated cost savings.

c.) See excel workbook, *StandardFlats.xls*, which is filed with this response.

2. The Postal Service states (Notice at 24-25):

> [W]hen taking into account additional cost savings that will be realized from Network Rationalization, the Postal Service believes that the proposed price change sets Standard Mail Flats on a sustainable path toward 100 percent cost coverage. Indeed, the Postal Service estimates that Standard Mail Flats' cost coverage will modestly increase in FY 2012, and continue increasing in FY 2013.

a. Please quantify the additional unit cost savings to the Standard Mail Flats product that will be realized in FY 2013 from Network Rationalization. Provide all supporting workpapers.

b. Please explain and quantify how Network Rationalization cost savings will reduce the intra-class cross subsidies present in Standard Mail in FY 2013.

c. Please provide the empirical bases, *e.g.*, supporting workpapers, for the Postal Service's assertion that Standard Mail Flats' cost coverage will modestly increase in FY 2012 and continue increasing in FY 2013.

d. Please explain whether the estimated "modest increase" is in addition to the improvement to 84.0 percent cost coverage estimated by the Postal Service in its 2011 ACD response to CHIR No. 1 Question 9(d).

Response:

a) As demonstrated in Docket No. N2012-1, Network Rationalization will result in significant cost reductions for the Postal Service. The Postal Service has estimated the full-up savings (annual savings after full implementation) for Network Rationalization to be $2.1 billion.[1] A significant share of these anticipated savings, in processing, maintenance, and transportation, will come from flats products.[2] Based in part on these savings estimates, the Postal

[1] See Docket No. N2012-1, Supplemental Testimony of Michael D. Bradley, USPS-ST-4 at 16.

[2] Of the $2.1 billion in full-up savings, $1.4 billion is savings will come from processing plants due to longer operating windows and consolidation. At least half of these processing savings are estimated to be in flats piece distribution operations and in allied operations, as shown in USPS-LR-N2012-1/92, *Mail Processing Labor Cost Savings.Revised.xls*, tab Calc Labor Cost Savings, column N. Another $585 million of the cost savings are for equipment and facility-related maintenance. A portion of these savings are in flats related maintenance costs which stem from the reduction in flat sorting equipment (over 10 percent reduction as shown in USPS-LR-N2012-1/83 and 91) and reduced facility space for flats

Service expects the attributable costs for the Standard Mail Flats product to decline in the coming years.

The Postal Service estimates the FY 2013 Network Rationalization savings for the Standard Mail Flats product, to be $30.67 million (unit savings of 0.56 cents).[3] The estimate incorporates system-wide Network Rationalization cost reductions of roughly $400 million for FY 2013, based on cost savings targets for FY 2013. These savings were subsequently apportioned to each product based on their share of Function 1 processing costs (excluding NDCs).[4]

b) As shown in the attached excel workbook *StandardFlats.xls*, the Postal Service estimates the Standard Mail Flats unit savings (attributable to Network Rationalization cost reductions) to be 0.56 cents[5]. If the Network Rationalization cost savings were eliminated from the FY 2013 estimates, the unit contribution loss for the Standard Mail Flats product would increase from 6.2 cents to 6.7 cents (tab NR Unit Contrib).

c) As shown in the attached excel workbook, *StandardFlats.xls* (tab FY 11-13 Cost Coverage), the Postal Service estimates that the cost coverage for the Standard Mail Flats product will be 83 percent in FY 2012 and 86 percent in FY 2013. Underlying calculations for respective fiscal years (with the lines for Standard Mail Flats and Letters highlighted) appear in tab PCCEM FY 11-13.

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processing. Finally, net transportation savings of $58 million are related to transportation to and from plants. While some of this reflects greater flying of First-Class Mail, it also reflects higher utilization and route reductions and PVS conversion savings, all of which will lower surface transportation costs for flats.

[3] *See* excel workbook *StandardFlats.xls* (tab NR Unit Cost Savings), filed with this response.

[4] *See, e.g.*, USPS-FY11-7, spreadsheet USPS-FY11-7 part1.xls, tab II-1, Mods 1&2, sum of columns B to AO.

[5] *See* excel workbook *StandardFlats.xls* (tab NR Unit Cost Savings), filed with this response.

d) The “modest increase” referenced by the Postal Service in its notice of Market-Dominant price adjustment does not refer to the 84 percent estimate provided during the 2011 ACD. Rather, the modest increase mentioned by the Postal Service refers to an increase above the 79.5 percent cost coverage reported in FY 2011.[6] As the Postal Service has described above, it currently estimates that Standard Mail Flats’ cost coverage will modestly increase from 79.5 percent to 83 percent in FY 2012, and to 86 percent in FY 2013.

[6] Docket No. ACR2011, *Annual Compliance Determination Report for FY 2011*, Table VII, at 112 (March 28, 2012).

3. Please refer to Standard Mail Contribution.xls to respond to the following requests. The Postal Service's Standard Mail Contribution model uses average annual growth rates from FY 2009 through FY 2011 to project volumes for a future hybrid year (quarter 4 of FY 2012 and quarters 1, 2, and 3 of FY 2013). It also uses proposed price adjustments to calculate future revenues.

    a. Please provide projected estimates of unit attributable costs that correspond with the projected volumes and revenues. Explain all assumptions used to calculate these projected unit costs and provide all supporting workpapers.

    b. Explain why it is appropriate to use growth rates from FY 2009 through FY 2011 rather than using the Postal Service's Demand Analysis and Volume Forecast filed with the Commission on January 20, 2012.

    c. Please confirm that the growth rates used do not isolate the effect of the planned price changes on volumes. If confirmed, please explain why the Postal Service's approach did not isolate the effect of the planned price changes on volume. If not confirmed, please explain.

    d. Please provide separate price elasticities for Standard Mail Letters and Standard Mail Flats, including all supporting workpapers.

RESPONSE:

a) The Postal Service does not forecast attributable costs on a quarterly basis. As a consequence, unit attributable costs are not available for the hybrid year FY 2012 Q4 – FY 2013 Q3. Unit attributable costs are, however, available for FY 2013: $0.445 for Standard Mail flats and $0.103 for Standard Mail letters.

The Standard Mail Contribution Model's hybrid approach is valid because it is not intended to produce stand-alone net contribution estimates on Line 14. Rather, as explained in note (d) of USPS-LR-R2013-1/7, the model is merely intended to illustrate the effect of various pricing scenarios on net contribution when two products have divergent volume trends.[7]

[7] The Standard Mail Flats Contribution Model is designed to show – while controlling for all but one variable (on Line 8) – that the Line 14 impact of Scenario 1a exceeds that of Scenario 1b, and likewise Scenario 1c that of Scenario 1a (Scenario 1c > Scenario 1a > Scenario 1b).

b) So long as the volume trends for each product remain divergent, the choice of "independent annual volume growth rates" is not critical to the model's outcome.[8] Here, the Postal Service used average annual growth from FY 2009 to FY 2011 for two reasons: 1) because FY 2011 was the last full fiscal year for which volume data were available; and 2) because volume prior to FY 2009 was greatly affected by one-time exigencies of the "Great Recession." Moreover, it is not clear that the FY 2012 projections, which were filed in the 2011 ACD nine months ago, are bound to be accurate. In addition, the "Demand Analysis and Volume Forecast" likely sacrifices accuracy at the shape level because it employs a single own-price elasticity of demand for Standard Mail flats, letters, and parcels.

Regardless, the model can be run using the Commission's alternative estimates — also "divergent" — of -5.903 percent for flats and +0.188 percent for letters, or -6.414 percent for flats and +0.326 percent for letters. However, the Postal Service must question the Commission's calculation methodology for the estimates in the "Forecast Vols" tab of *vf2012-md-PRC.xlsx*. It appears that the Commission has ignored nonprofit volume, which in FY 2011 amounted to roughly 1.3 billion pieces for flats and 9.9 billion pieces for letters. These volumes must be considered for comparability to USPS-LR-R2013-1/7 ("Standard Mail Contribution Model"), Line 2, "Average Revenue per Piece," which includes all (both commercial and nonprofit) flats and letters volume. Moreover, the Commission's estimates for flats, -5.903 percent and -6.414 percent, appear to fall short of the anticipated volume decline in FY 2012.

[8] As explained above (in response to question 3a) this is due to the fact that the Standard Mail Contribution Model is not designed to produce a stand-alone net contribution estimate.

c) Confirmed. The model is not intended to be “after-rates.” No attempt was made to gauge the impacts of the prospective price increases on volumes (or to isolate those impacts) because own-price elasticities of demand are not available for flats and letters separately.

d) Separate price elasticities are not available. See the Postal Service’s response to question 3c above.

4. Please see the three attached files: (a) Standard Mail Contribution Model_PRC.xls; (b) vf2012-md-PRC.xlsx; and (c) Standard Contribution.docx.

   a. Please confirm that if the Postal Service's 2012 Demand Analysis is used to project future annual volume growth, assuming the proposed price adjustments went into effect the first quarter of FY 2012, the following changes in contribution can be expected for Standard Mail Letters and Flats in the future hybrid year (quarter 1 of FY 2012 and quarters 1, 2, and 3 of FY 2013).

   b. If not confirmed, explain and provide estimates in changes in contribution using the 2012 Demand Analysis.

RESPONSE:

a) Not confirmed. Scenario 1b (mislabeled as Scenario 1a) in *Standard Mail Contribution Model_PRC.xls* allows two variables, on Line 8 and Line 9, to vary from Scenario 1a. Only one variable (Line 9) should be allowed to vary if, consistent with the original specification of Line 8 as an "*independent* annual volume growth rate," an isolated impact on net contribution (Line 15) is to be obtained. The Commission, in contrast, appears to be attempting an "after rates" analysis relying on a single own-price elasticity of demand specification for flats and letters. The Postal Service does not believe that Flats and Letters are likely to have the same elasticity.

b) A similar result to the Postal Service's can be obtained by holding Line 8 constant. Either one of the Commission's volume stipulations can be applied: -5.903 percent for flats and +0.188 percent for letters, or -6.414 percent for flats and +0.326 percent for letters. In the former case, Line 15 contribution decreases by $2.7 million (Scenario 1b vs. Scenario 1a). In the latter case, Line 15 contribution decreases by $3.0 million (Scenario 1b vs. Scenario 1a).

5. The Postal Service states (Notice at 24):

> [T]he Postal Service's pricing decision for Flats was also influenced by the need to manage the price gap between Standard 5-Digit automation flats and Carrier Route flats. Had the Postal Service given a larger price increase to Standard Mail Flats, it would have been forced to increase Carrier Route prices (which are already increasing by 3.133%) even further. To avoid such an increase, which would have negatively impacted Carrier Route volumes, the Postal Service allowed the gap between these two products to grow from 8.2 cents to 8.3 cents. However, it is not the Postal Service's intention to signal a widening gap in this area.

Please confirm that a worksharing relationship does not exist between Standard Mail 5-Digit automation Flats and Carrier Route Flats and that this is not a legal requirement.

RESPONSE: Confirmed

6. The Postal Service plans to increase Standard Mail Letters by more than the class average and more than Standard Mail Flats.

   a. Please confirm that in FY 2011, the unit contribution for Standard Letters was 8.9 cents and for Standard Flats was -9.5 cents. If not confirmed, please explain.

   b. Please confirm that the planned prices for Standard Mail Flats and Standard Mail Letters in this proceeding (as opposed to planned prices that would give Standard Mail Flats a larger price increase than Standard Mail Letters) will exacerbate the unit contribution gap, between the two products in FY 2013. If not confirmed, please explain and provide all workpapers supporting your response.

RESPONSE:

a.) Confirmed.

b.) If the price of letters were increased by less and the price of flats were increased by more, the unit contribution gap between letters and flats would be smaller. However, the 2.57 percent price increase proposed for flats and the 2.722 percent price increase proposed for letters is expected to reduce the unit contribution gap between these two products (everything else being equal). This is because a 2.57 percent increase applied to an average price level of $0.367 (flats, FY 2011 basis) will produce a greater increase in unit revenue than a 2.722 percent price increase applied to an average price level of $0.192 (letters, FY 2011 basis).

More importantly, the Postal Service's focus here is on total contribution, not unit contribution. The Postal Service believes that it can better support and sustain total contribution by using as much of its price cap authority as in reasonable for Standard Mail letters. Based on reasonable expectations and given recent volume rends, Standard Mail Letters are more likely to have sustained volume going into the future. As flats volume declines, Standard Mail Letters will be increasingly burdened with paying for network costs. Standard Mail Letters would be impaired for this purpose if their price increases are kept in check. This is both a short run, and progressively a long run, issue. In the long run, repeated constraints on the price of letters will impair the ability of letters to pay for its increasing share of network costs.