ORIGINAL

RECEIVED

JUN 7 4 01 PM '99

POSTAL RATE COMMISSION
OFFICE OF THE SECRETARY

DOCKET SECTION

Report of Independent Accountants

United States Postal Service Cost and Revenue Analysis

September 30, 1998

ERNST & YOUNG LLP

ERNST & YOUNG LLP

1225 Connecticut Avenue, N.W.
Washington, D.C. 20036

Phone: 202 327 6000

Report of Independent Accountants

Board of Governors
United States Postal Service

We have examined the following tables of financial information ("the Summary Tables") included in the Cost and Revenue Analysis of the United States Postal Service (Postal Service) for the year ended September 30, 1998:

- Summary of Revenue and Cost for Major Service Categories and
- Summary of Revenue and Cost for Major Service Categories - Volume Statistics.

The Summary Tables are based on information in the postal system of accounts used in preparing the financial statements, as well as various postal operational and statistical information sources. Our examination of the Summary Tables was made in accordance with standards established by the American Institute of Certified Public Accountants and was, therefore, designed primarily for the purpose of expressing an opinion on the Summary Tables taken as a whole. Accordingly, our examination included such procedures as we considered necessary under the circumstances. We believe our examination provides a reasonable basis for our opinion.

In our opinion, the Summary Tables mentioned above present fairly, in all material respects, the allocations of the United States Postal Service revenue and costs among the indicated categories of mail and services provided by the Postal Service during the year ended September 30, 1998, on the basis described in the Notes to the Summary Tables.

Ernst + Young LLP

April 30, 1999

UNITED STATES
POSTAL SERVICE

COST AND REVENUE ANALYSIS

FISCAL YEAR 1998

FINANCE

SUMMARY OF REVENUE AND COST FOR MAJOR SERVICE CATEGORIES
Fiscal Year 1998

Classes and Sub-Classes of Mail (note 1)	(in millions) Revenue (note 6)	Incremental Cost (notes 2&12)	Volume Variable Cost (note 3)	(per piece) Revenue	Marginal Cost (note 4)	Contribution Margin $ (note 5)	Contribution Margin % (note 5)	Cost Coverage (note 5)
	A	B	C	D	E	(D-E)	(D-E)/D	(D/E)
First-Class Mail:								
Letters and sealed parcels	$32,814.5	$16,910.9	$15,673.5	$0.343	$0.164	$0.179	52.24%	209.36%
Cards (note 13)	1,019.3	633.5	620.9	0.184	0.112	0.072	39.09%	164.17%
Fees	148.8	-	-					
Total First-Class	33,982.7	17,655.1	16,294.4	0.336	0.161	0.175	52.05%	208.55%
Priority Mail	4,149.6	2,615.5	2,319.9	3.566	1.993	1.572	44.10%	178.87%
Express Mail	854.5	590.6	372.2	12.900	5.619	7.281	56.44%	229.58%
Mailgram	1.7	1.0	1.0	0.390	0.225	0.165	42.19%	172.99%
Periodicals:								
In-county	79.3	66.0	64.2	0.086	0.069	0.016	19.08%	123.58%
Outside the county:								
Regular publications	1,643.6	1,649.4	1,626.2	0.228	0.226	0.002	1.06%	101.07%
Nonprofit publications	317.0	338.1	333.7	0.148	0.156	(0.008)	-5.25%	95.01%
Classroom publications	12.2	13.0	12.9	0.201	0.212	(0.011)	-5.27%	94.99%
Fees	20.0	-	-					
Total Periodicals	2,072.2	2,071.2	2,036.9	0.201	0.197	0.003	1.70%	101.73%
Standard Mail (A)								
Single piece rate	122.7	211.4	211.2	0.824	1.418	(0.594)	-72.09%	58.11%
Enhanced carrier route	4,952.6	2,106.5	1,998.7	0.145	0.059	0.087	59.64%	247.79%
Regular	7,222.7	5,240.6	5,104.0	0.205	0.145	0.060	29.33%	141.51%
Nonprofit enhanced carrier route	212.6	157.8	157.5	0.080	0.059	0.021	25.92%	134.98%
Nonprofit	1,165.8	1,071.9	1,057.8	0.109	0.099	0.010	9.27%	110.22%
Fees	76.8	-	-					
Total Standard Mail (A)	13,753.2	9,037.2	8,529.2	0.166	0.103	0.063	37.98%	161.25%
Standard Mail (B):								
Parcels zone rate (note 10)	823.6	866.6	852.7	3.091	3.200	(0.109)	-3.54%	96.58%
Bound printed matter	427.4	344.9	341.3	0.876	0.699	0.176	20.13%	125.21%
Special standard	327.3	212.7	211.3	1.729	1.116	0.613	35.44%	154.90%
Library mail	45.3	36.4	36.2	1.648	1.318	0.330	20.02%	125.03%
Fees	2.3	-	-					
Total Standard Mail (B)	1,625.8	1,483.7	1,441.6	1.674	1.484	0.190	11.33%	112.78%

See accompanying notes.

SUMMARY OF REVENUE AND COST FOR MAJOR SERVICE CATEGORIES
Fiscal Year 1998

Classes and Sub-Classes of Mail (note 1)	(in millions) Revenue (note 6)	Incremental Cost (notes 2&12)	Volume Variable Cost (note 3)	(per piece) Revenue	Marginal Cost (note 4)	Contribution Margin $ (note 5)	Contribution Margin % (note 5)	Cost Coverage (note 5)
	A	B	C	D	E	(D-E)	(D-E)/D	(D/E)
Free mail - blind, handicapped & servicemen	-	$31.4	$31.3	-	$0.594	N/A	N/A	0.00%
International mail (note 8)	$1,599.4	1,349.6	1,252.8	$1.694	1.327	$0.367	21.67%	127.67%
Total mail	58,039.2		32,279.1	0.293	0.163	0.130	44.38%	179.80%
Special Services:								
Registry (note 14)	89.0	101.2	81.3	5.862	5.351	0.510	8.71%	109.54%
Ancillary services	3.8							
Total Registry	92.9							
Certified (note 14)	371.4	304.8	335.0	1.366	1.232	0.134	9.79%	110.86%
Ancillary services	265.4							
Total Certified	636.8							
Insurance (note 14)	71.9	56.1	57.5	1.778	1.421	0.357	20.09%	125.13%
Ancillary services	1.4							
Total Insurance	73.3							
COD (note 14)	17.8	14.3	14.8	4.639	3.843	0.795	17.15%	120.70%
Ancillary services	0.0							
Total COD	17.8							
Money orders (note 7)	252.2	158.6	118.6	1.209	0.569	0.640	52.96%	212.60%
Stamped envelopes	17.4	13.0	13.0					
Special handling	0.2	1.4	1.4					
Post office box	617.4	474.5	474.4					
Other	-		112.3					
Total Special Services	1,708.1		1,208.3					
Miscellaneous items (note 9)	300.4		-					
Total mail and services (note 8)	60,047.8		33,487.4					
Appropriations: Revenue forgone	67.3		-					
Total operating revenue	60,115.1		-					
Investment income	1.7		-					
Total (note 7)	60,116.8		33,487.4					
All other costs	-		26,079.1					
Total costs (note 7)	-		59,566.5					

See accompanying notes.

SUMMARY OF REVENUE AND COST FOR MAJOR SERVICE CATEGORIES
Fiscal Year 1998
VOLUME STATISTICS

Classes and Sub-Classes of Mail (note 1)	Pieces (thousands)	Weight in Pounds (thousands)	Weight per Piece (ounces)	Cubic Feet (thousands)	Weight per Cubic Foot (pounds)
First-Class Mail:					
Single-Piece letters	53,781,254	2,566,399	0.8	175,841	14.6
Presort letters	41,866,292	1,573,610	0.6	107,818	14.6
Total Letters	95,647,546	4,140,009	0.7	283,659	14.6
Single-Piece cards	2,944,565	18,409	0.1	1,406	13.1
Presort cards	2,580,716	21,754	0.1	1,661	13.1
Total cards	5,525,281	40,163	0.1	3,067	13.1
Total First Class	101,172,827	4,180,172	0.7	286,726	14.6
Priority Mail	1,163,831	1,962,176	27.0	159,565	12.3
Express Mail	66,244	77,739	18.8	9,786	7.9
Mailgram	4,302	0	0.0	0	0.0
Periodicals:					
In-county	923,865	253,938	4.4	13,905	18.3
Outside the county:					
Regular publications	7,195,006	3,580,405	8.0	196,058	18.3
Nonprofit publications	2,136,927	585,102	4.4	32,039	18.3
Classroom publications	60,793	31,684	8.3	1,735	18.3
Total Periodicals	10,316,591	4,451,129	6.9	243,737	18.3
Standard Mail (A)					
Single piece rate	148,890	27,775	3.0	2,265	12.3
Commercial					
Enhanced carrier route	34,110,504	4,873,782	2.3	273,194	17.8
Regular	35,257,268	4,592,266	2.1	257,414	17.8
Total Commercial	69,367,772	9,466,048	2.2	530,608	17.8
Nonprofit					
Nonprofit enhanced carrier route	2,656,838	196,228	1.2	11,509	17.0
Nonprofit non carrier route	10,701,150	706,494	1.1	41,437	17.0
Total Nonprofit	13,357,988	902,722	1.1	52,946	17.0
Total Standard Mail (A)	82,874,650	10,396,545	2.0	585,819	17.7
Standard Mail (B):					
Parcels zone rate	266,479	1,334,333	80.1	190,184	7.0
Bound printed matter	488,134	1,197,710	39.3	84,411	14.2
Special standard	189,346	305,387	25.8	28,342	10.8

See accompanying notes.

SUMMARY OF REVENUE AND COST FOR MAJOR SERVICE CATEGORIES
Fiscal Year 1998
VOLUME STATISTICS

Classes and Sub-Classes of Mail (note 1)	Pieces (thousands)	Weight in Pounds (thousands)	Weight per Piece (ounces)	Cubic Feet (thousands)	Weight per Cubic Foot (pounds)
Library mail	27,475	52,621	30.6	3,957	13.3
Total Standard Mail (B)	971,434	2,890,051	47.6	306,894	9.4
US Postal Service	376,668	95,453	4.1	6,744	14.2
Free mail - blind, handicapped & servicemen	52,680	26,940	8.2	2,631	10.2
International mail	943,968	244,539	4.1	22,649	10.8
Total mail	197,943,195	24,324,744	2.0	1,624,555	15.0
Special Services:					
Registry	15,191	N/A	N/A	N/A	N/A
Ancillary services	3,402				
Total Registry	18,593				
Certified	271,892	N/A	N/A	N/A	N/A
Ancillary services	234,347				
Total Certified	506,239				
Insurance	40,427	N/A	N/A	N/A	N/A
Ancillary services	1,307				
Total Insurance	41,734				
COD	3,843	N/A	N/A	N/A	N/A
Ancillary services	1				
Total COD	3,844				
Money orders	208,597	N/A	N/A	N/A	N/A
Stamped envelopes	N/A	N/A	N/A	N/A	N/A
Special handling	N/A	N/A	N/A	N/A	N/A
Post office box	N/A	N/A	N/A	N/A	N/A
Other	N/A	N/A	N/A	N/A	N/A
Total Special Services	779,008	N/A	N/A	N/A	N/A

See accompanying notes.

UNITED STATES POSTAL SERVICE
NOTES TO COST AND REVENUE ANALYSIS
Fiscal Year 1998

1. COST AND REVENUE ANALYSIS

The Cost and Revenue Analysis (CRA) is prepared annually by the United States Postal Service (Postal Service) each year commencing October 1 and ending September 30 as an aid in determining that the Postal Service is meeting the statutory requirements under Title 39, U.S. Code, that "each class of mail or type of mail service bear the direct and indirect costs attributable to that class or service...." The CRA presents estimates of the total and unit revenue of the categories of mail and services provided by the Postal Service during the year, as well as their estimated incremental and marginal costs. Such estimates are considered as one element of the Postal rate making process.

CRA data are based on information from the postal system of accounts. The postal system of accounts, however, generally does not accumulate financial data by class and subclass of mail. Apportionment factors are, therefore, required for development of the data for CRA purposes. These apportionment factors are derived from various postal operational and statistical information sources. Some of these, such as the In-Office Cost System and the Revenue, Pieces and Weight System, are dedicated to this purpose and involve extensive statistical sampling of postal activity during the year. New sampling procedures were partially implemented during Fiscal Years 1995 and 1996 for the Revenue, Pieces and Weights System to accommodate the effects of automation implementation. Coincident with implementation of these new sampling procedures, the difference between actual revenue as derived from the Postal Service financial systems and extrapolated revenue derived from the Revenue, Pieces and Weights System (before the routine adjustment for such differences) increased. During 1998, the Postal Service revised certain sampling procedures, which have decreased the difference between actual and extrapolated revenue. Management is continuing to refine and implement the new sampling procedures and explore further refinements and enhancements to sampling and expansion algorithms inherent in the Revenue, Pieces and Weights System. While extrapolated sample revenue should approximate actual Postal Service revenue, the system has been designed to accommodate and adjust for such differences, and the accuracy of apportionment factors used to develop per piece information does not necessarily depend on how close sample revenue are to actual revenues.

In 1997, the Postal Service changed its methodology used in estimating costs related to classes and subclasses of mail, and introduced estimates of incremental, volume variable and marginal costs. Development of such estimates included as one component the use of operational data included in the Management Operating Data System. The Postal Service also developed variability factors intended to estimate the relationship between increases and decreases in mail volume with associated changes in costs. Supporting information essential to the development of the CRA data is generally obtained from special studies. The methods employed to determine variability factors, incremental volume variable, and marginal costs are documented in the Summary Description and in testimony filed by the Postal Service before the Postal Rate Commission. The various criteria and methodologies utilized to develop the information presented in the CRA Report are available from Cost Attribution in Finance.

Beginning with the first quarter of Fiscal Year 1999, the U.S. Postal Service has refined certain RPW estimation methodologies. Nonautomated office (non-PERMIT System) precanceled stamp and metered data for First Class Presort and Standard Mail (A) bulk are estimated with mailing statements from a panel of post offices. Permit imprint Standard Mail (B) Parcel Post estimates are based on data from the PERMIT System.

2. INCREMENTAL COSTS

The incremental cost of a subclass of mail or service is an estimate derived from Postal Service cost models of the cost the Postal Service incurs as a result of providing the entire annual quantity of that subclass or service. Conversely, it is the estimate of the cost avoided by eliminating a product, assuming that all other products continue to be provided at their current volumes. The purpose of this cost category is to provide an indication of whether the customers of one subclass of mail (or group of subclasses) may be subsidizing customers of another subclass (or group of subclasses). Note, the incremental cost of a class of mail is greater than the sum of the incremental costs of its constituent subclasses. Class incremental cost includes common costs that are not caused by any one subclass alone but rather by the entire class.

3. VOLUME VARIABLE COSTS

The estimated volume variable cost (sometimes called total marginal cost) of a subclass is the product of its volume and its marginal cost. The sum of the volume variable cost across all subclasses (total volume variable cost) is the revenue that the Postal Service would earn, at current volumes, if it priced each subclass at its marginal cost. Therefore, the difference between the Postal Service's total cost and its total volume variable cost represents the sum of dollars the Postal Service must earn by setting the price levels of its subclasses above their marginal costs, if the Postal Service is going to break even in a given year. For the year ended September 30, 1998 volume variable costs comprised 56.22% of all costs incurred by the Postal Service.

4. MARGINAL COST

The Postal Service estimates of the marginal cost of subclass or mail category is the change in cost that results from a small change in its volume alone, with the volumes of other subclasses or mail categories remaining constant.

5. CONTRIBUTION MARGIN AND COST COVERAGE

The relation of unit revenue to marginal cost provides a measure of the contribution earned by a subclass or mail category at the margin of production. The measure indicates the rate at which a given subclass offsets all other costs of the Postal Service. The contribution margin percent column gives the same information as a proportion of revenue per piece. The cost coverage column expresses unit revenue as a percentage of marginal cost.

6. FEES

Fees associated with a specific class or subclass of mail are included in the reported revenue for that class or subclass.

7. MISCELLANEOUS ADJUSTMENTS

The following differences exist between the revenues shown in the Fiscal Year 1998 Annual Report of the Postal Service (AR) and the Fiscal Year 1998 CRA:

a) The money order float of $42.1 million included with interest income in the AR is included with special services revenue in the CRA.
b) Mortgage income of $0.7 million included with interest income in the AR is reported as miscellaneous revenue in the CRA.
c) Reconciliation with the Annual Report of the Postal Service (page 57):

(dollars in millions)

Per the Annual Report		Per the Annual Report:	
Operating revenue	$60,072	Operating expenses	$57,778
Interest Income	44	Interest expense on borrowings	167
		Imputed interest on retroactive assessment of employee benefits	16
		POD Worker's compensation expense	8
		Interest Expenses on unfunded retirement liabilities	1,597
Total revenue per the CRA Report (page 2)	$60,116	Total costs per the CRA Report (page 2)	$59,566

8. INTERNATIONAL MAIL

International mail costs include costs of both U.S. origin and foreign origin mail. Volume statistics, however, do not include foreign origin mail.

9. MISCELLANEOUS ITEMS

Miscellaneous items include philatelic sales, fees, fines, unclaimed money from dead letters, sales of services performed for government agencies and private contractors.

10. ALASKA AIR TRANSPORTATION

The Postal Service spent $117.1 million on air transportation within the state of Alaska. $96.1 million of this total was provided for parcel post mailers. Alaska Bypass mail cost $55.4 million. The Postal Service realized $10.4 million in revenue from Alaska bypass service.

11. OTHER

All figures in the CRA are rounded; detail may not add to totals. Percents are rounded to the nearest decimal.
- Denotes zero values.
( ) Denotes negative values.

12. PRODUCT SPECIFIC COST

Of the incremental cost of certain subclasses, a portion consists of product specific cost. Those amounts are as shown below (in millions):

First Class Letters	$18.7
First Class Cards	7.0
Priority Mail	278.5
Express Mail	221.5
International Mail	79.5
Money Orders	40.0

13. CARDS

Volume variable cost includes $3.2 million for stamped cards' printing cost.

14. SPECIAL SERVICES

Excludes ancillary service revenue.