

BEFORE THE
POSTAL REGULATORY COMMISSION

PERIODIC REPORTING)
(UPS PROPOSALS ONE, TWO AND THREE)) Docket No. RM2016-2

**DECLARATION OF SANDER GLICK
ON BEHALF OF
AMAZON FULFILLMENT SERVICES, INC.**

January 25, 2016

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AMAZON FULFILLMENT SERVICES, INC.**

1. My name is Sander Glick. I am a Vice-President and co-founder of SLS Consulting, Inc., a Washington, D.C. consulting firm specializing in postal economics. I have testified before the Postal Regulatory Commission and its predecessor, the Postal Rate Commission, in Docket Nos. R97-1, R2000-1, and R2006-1, and C2009-1, and submitted declarations in Docket Nos. CP2013-75 and MC2013-57. My previous testimony has generally related to estimating Postal Service costs and designing postal rates.

2. I attended the Maxwell School of Citizenship and Public Affairs at Syracuse University, where I received a Masters of Public Administration in 1994, and Carleton College, where I received a Bachelor's Degree, magna cum laude, in Physics in 1993.

A. Introduction

3. In the Report of Dr. Kevin Neels Concerning United Parcel Service, Inc. ("UPS") Proposals One, Two, and Three, dated October 8, 2015, (the "Neels Report"), Dr. Neels states, "[t]he [inflation-adjusted reported fixed] costs that form the dependent variables in these regressions are the costs remaining after the *effects of all other costs drivers* have, at least according to the Postal Service, been appropriately taken into account. These are supposed to be fixed costs, and so there is not supposed to be *any other source of variation* left to be taken into account." Neels Report at 46 (emphasis added).

4. As discussed in more detail in the Declaration of Dr. T. Scott Thompson on Behalf of Amazon Fulfillment Services, Inc., dated January 25, 2016 (“Thompson Declaration”), Dr. Neels’ statement argues essentially that the only factors that affect costs are changes in volume and input prices. According to Dr. Neels, once inflation and volume effects are accounted for, the remaining – *i.e.*, fixed – costs should not change over time.

5. This argument is incorrect. The traditional roll forward approach for forecasting Postal Service costs, through which Postal Service costs are projected from a historical base year to a future test year through the application of numerous cost change factors, recognizes that cost changes over time are caused by a variety of factors other than changes in mail volume. These other factors include the effect of non-volume workload, cost reduction/other programs, and work year mix adjustments. *See, e.g.*, Docket No. R2013-11, Nick.Statmnt.Attach.Rev.11.2.13.xls, "Attach 6 CSSummaryFY2014BR."

6. Indeed, the mutability of fixed costs over time is recognized even in an earlier section of the Neels Report –

In calculating [systemwide] fixed costs I have excluded cost segments 18.3.4 (Workers Compensation) and 18.3.6 (Annuitant Health Benefits and Earned CSRS Pensions), two categories that have experienced large fluctuations in [fixed] cost that are unrelated to the Postal Service’s current operations.

Neels Report at 35-36.

7. Furthermore, a 2014 study by Robert Cohen and John Waller for the Postal Regulatory Commission concerning the “Postal Service Variability Ratio” – the ratio of attributable to institutional costs – identified categories of factors that influence the Variability Ratio, many of which, while unrelated to volume, can affect the level

of reported fixed costs over time. Robert Cohen & John Waller, *The Postal Service Variability Ratio and Some Implications* (2014). These categories include:

- Productivity increases. *Id.* at 3.
- Exogenous, non-operational changes – “[c]hanges to the income statement for non-operational reasons [that] will increase or decrease institutional cost,” such as “Congressional Omnibus Budget Reconciliation Acts (OBRA), restructuring costs, recalculating workers compensation liabilities, the PAEA mandate to escrow payments for future retiree health benefits (RHB), and accounting rule changes.” *Id.* at 3 and 10.
- Cost methodology changes occurring on an ongoing basis in rulemaking proceedings before the Commission. *Id.* at 12.

8. The main 2006-2013 examples identified by Cohen and Waller – required payments to the Retiree Health Benefit Fund (p. 11), prior year Workers Compensation adjustments (p. 12), and Individual Awards (p. 19) – relate to cost components with no hidden variable costs according to Dr. Neels.¹ These three factors, however, are not the only non-volume factors affecting the magnitude of fixed costs over time.

9. In this Declaration, I provide examples of several non-volume factors that affect component-level inflation-adjusted “reported fixed costs.” These examples

¹These examples relate to cost components 203, 205, and 1430. These components do not appear in Tables 12-14 of the Neels Report, which identify components that, according to Neels, contain hidden variable costs.

affect components containing \$1.8 billion² – i.e., more than half of Dr. Neels' hidden variable costs. Moreover, these examples should be viewed as illustrative, not comprehensive or exhaustive. I expect that an in-depth analysis of all 84 cost components modeled by Dr. Neels would uncover many more non-volume factors that affect reported fixed costs over time.

B. Cost Component 169: Building Projects Expense

10. As explained in recent Postal Service Form 10-K annual reports and a USPS Office of Inspector General Audit Report, cash constraints caused the Postal Service to slash its capital and facility maintenance expenditures from FY 2007 to FY 2014:

Annual capital expenditures have declined from approximately \$2.7 billion in 2007 to approximately \$781 million in 2014 to conserve cash. The present level of capital expenditures is not sustainable. Our delivery fleet includes approximately 140,000 vehicles that are at least 20 years old and nearing the end of their useful life. Repair and maintenance costs for these vehicles have risen significantly in recent years. Some facilities maintenance has been deferred in recent years to save cash and the backlog needs to be addressed.

USPS FY 2014 Form 10-K at 31.

The Postal Service has conserved capital in recent years by spending only what it believed essential to maintain its existing facilities and service levels. However, an increase of capital investment is necessary to upgrade its facilities, existing fleet of vehicles and processing equipment in order to remain operationally competitive.

USPS FY 2015 Form 10-K at 46.

In order to conserve cash, we have reduced our capital expenditures by approximately 43% from an annual average of approximately \$1.5

²Hidden variable costs: \$180 million (component 169), \$1.38 billion (component 202), and \$208 million (component 70). Neels Report at 47-48.

billion in years 2009 through 2011 to an annual average of approximately \$850 million in years 2012 through 2015. Priority has been given to projects:

1. Needed for safety and/or health or legal requirements;
2. Required to provide service to our customers; and
3. Initiatives with a high return on investment and a short payback period.

The source of funds needed to fulfill these commitments was generated from our operating activities. However, we will need to increase our capital expenditures in order to address our aging facilities and delivery fleet and to upgrade our equipment to remain competitive in the marketplace and to ensure that we will be able to continue to meet our statutory obligation to provide prompt, efficient and reliable postal services to the nation.

Id. at 31.

Budget constraints have affected the Postal Service's ability to fund repairs, alterations, and capital improvements. In FY 2012, the Postal Service spent \$266 million (29 percent) below the industry average on facility repairs, spending \$2.69 per square foot versus \$3.81 per square foot. As a result, during FYs 2011 and 2012, Facilities did not complete 19,033 repairs (18 percent) estimated to cost more than \$271 million. Fifty percent of these incomplete repairs represented safety, security, and potential future major repairs. Future costs for these unfunded repairs could reach \$1.4 billion.

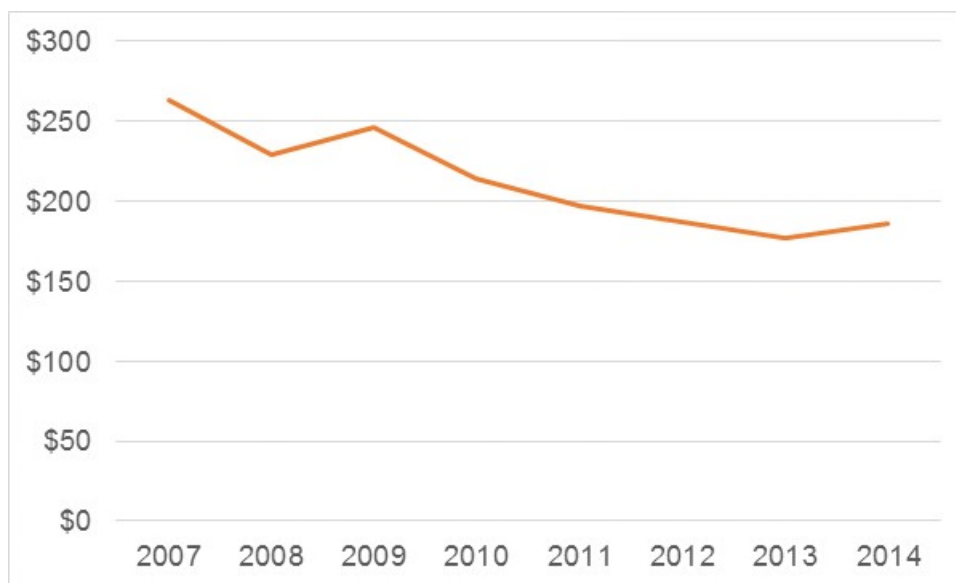
Sixteen percent of these repairs represented potential Occupational Safety and Health Administration (OSHA) violations, which could result in fines estimated at about \$2.9 million.

USPS Office of Inspector General Report No. SM-AR-14-002, *Spending Trends for Maintaining Postal Service Facilities* (November 27, 2013) at 1.

11. I believe that this deferral of facility spending to conserve cash has reduced the magnitude of costs reportedly incurred in many cost components, in

particular Building Projects Expense, an entirely fixed cost component identified by Dr. Neels as supposedly having \$180 million of hidden variable costs. This cost component consists of costs for “noncapitalized facility improvements.” Most of the FY 2014 costs were incurred to repair USPS-owned buildings. Summary Description of USPS Development of Costs by Segments and Components, Fiscal Year 2014 (filed on July 1, 2015) (Summary Description) at 15-5; USPS-FY14-5, RealTB14 USPS-FY-14-5 Redacted.xlsm, tab “seg15.”

Figure 1. Building Project Expense (in Millions of FY 2014 Dollars)



Source: AFSI-LR RM2016-2/2, AFSI-LR RM2016-2-2.xlsx, “Figure 1”

12. Thus, declines in Building Project Expenses are not evidence of hidden variable costs. As the Office of Inspector General audit report cited above makes clear, the rate of aging and deterioration of USPS facilities, and thus the need to perform facility repairs, have not declined. Hence, the actual economic costs have not declined, even if the USPS has minimized its cash outflows through a strategy of deferred maintenance and replacements. Indeed, the deferral of maintenance may actually increase the Postal Service’s overall costs over time.

C. Annuitant Health Benefits and Earned CSRS Pensions (Cost Components 202 and 203)

13. Despite excluding component 18.3.6 (Annuitant Health Benefits and Earned Civil Service Retirement System (CSRS) Pensions) from his systemwide analysis, Dr. Neels includes this component in his component-level analysis of hidden variable costs. In fact, more than 40 percent of the supposedly hidden variable costs are for the current portion of annuitant health benefits and earned CSRS pensions, component 202. Below, I discuss non-volume factors affecting costs in both the current year portion (component 202) and prior year portion (component 203) of 18.3.6.

14. The Annuitant Health Benefits and Earned CSRS Pensions (Current) component is the cost component with the largest amount of supposedly hidden variable costs according to Dr. Neels. Neels Report at 48, Table 13. Specifically, the \$1.4 billion of FY 2014 hidden variable costs for this component comprise approximately 41 percent of Dr. Neels' \$3.4 billion of hidden variable costs. *Id.* at 48, 50.

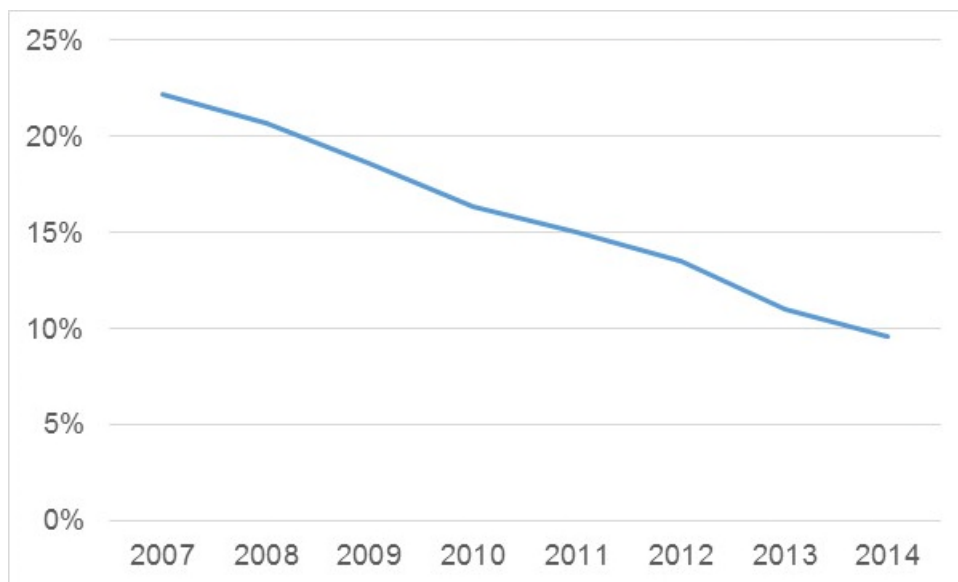
15. Included in component 202 are “[t]he benefits earned during the fiscal year by current employees, benefits not contained in the labor cost segments of 1-13, 16, 18, and 19, [and] include both the retiree health benefits of \$2.606 billion and CSRS pensions of \$0.547 billion. The sum of these two benefits is \$3.153 billion.” Summary Description of USPS Development of Costs by Segments and Components, FY 2014 at 18-6.

16. Importantly, this component does not include the pension costs for Federal Employee Retirement System (FERS) employees. The FERS costs are

included in the labor cost segments. *See, e.g.*, USPSFY14-5, RealTB14 USPS-FY14-5 Redacted.xlsm, seg 3.

17. The downward trend from 2007 to 2014 in the percentage of employees that are covered by the CSRS pension program is a major factor unrelated to mail volume or input prices affecting CSRS benefit costs.

Figure 2. CSRS/Dual CSRS Employees (as Percent of Career Employees)

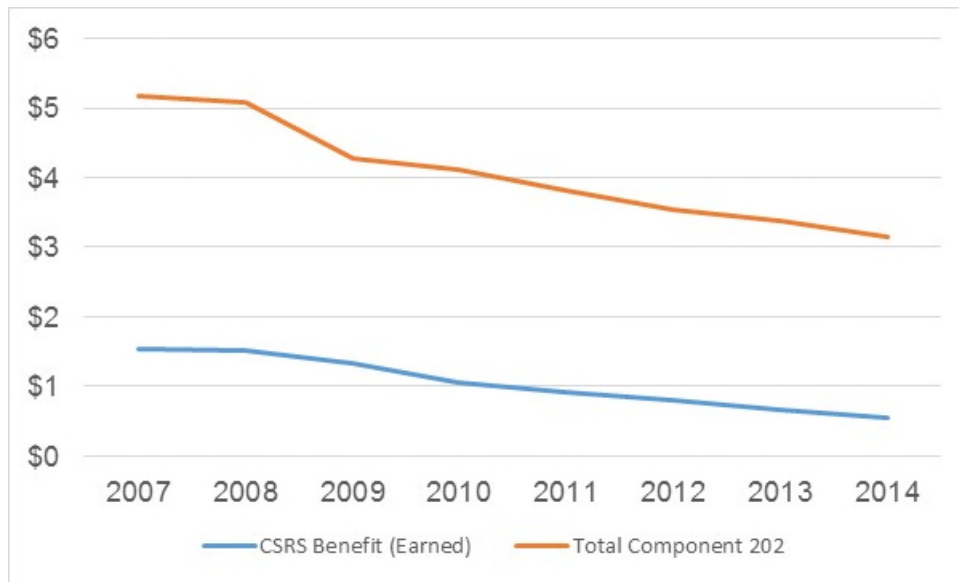


Source: AFSI-LR RM2016-2/2, AFSI-LR RM2016-2-2.xlsx, “Figures 2 & 3”

18. Mail volume did not cause the downward trend in the percentage of employees covered by CSRS. The trend would have occurred anyway because “[CSRS] was replaced by the Federal Employees Retirement System (FERS) for Federal employees who first entered covered service on and after January 1, 1987” and thus CSRS employees leaving the Postal Service would be replaced, if at all, by FERS employees. <https://www.opm.gov/retirement-services/csrs-information>.

19. As Figure 3 shows, the trend in the CSRS benefit (earned) is a substantial cause of the reduction in the accrued cost for the component as a whole.

Figure 3. Accrued CSRS Benefit Earned and Total Cost Component 202 Cost (in Billions of FY 2014 dollars)



Source: AFSI-LR RM2016-2/2, AFSI-LR RM2016-2-2.xlsx, “Figures 2 & 3”

20. Furthermore, Dr. Neels’ hidden variable cost adjustment for this component would produce an anomalous result. Specifically, costs in this component are currently attributed in the same manner as those for current-year workers’ compensation costs,³ a component discussed by UPS in its response to CHIR No. 1. With respect to current-year workers’ compensation costs, UPS stated:

It is apparent that the workers’ compensation costs relating to incidents in the current year are likely to be an increasing function of the size of the Postal Service workforce, and the number of hours worked, which will in turn be a function of the volume and weight of mail and parcels being moved....These considerations suggests that while there may be a

³ Summary Description at 18-7.

fixed portion of the costs in this component, the variable portion of the costs in this component is clearly substantial.

Accordingly, Dr. Neels believes that the fixed-variable split for this component under current costing procedures (approximately 45% fixed and 55% variable) is far more plausible than that suggested by the split that would result after adjusting for the supposedly “hidden fixed costs” (approximately 96% fixed and 4% variable).

UPS Response to CHIR No. 1 Response at 40.

21. In that response, UPS cites Dr. Neels’ belief that the 45% fixed and 55% variable split for the workers’ compensation component under current procedures seems more appropriate than the result after adjusting for “hidden fixed costs.” I agree with Dr. Neels that current procedures for attributing current-year workers’ compensation costs are more appropriate. Additionally, adopting Dr. Neels’ hidden variable cost adjustment to the attributable costs for annuitant health benefit and CSRS Earned Pensions costs (Current) would produce a similarly implausible result.

22. Specifically, Dr. Neels’ adjustment for hidden variable costs in cost component 202 would result in current-year annuitant health benefits and CSRS Earned Pensions being treated as 100 percent variable, Neels Report at 48, Table 13, much higher than the more plausible “approximately 45% fixed and 55% variable” split under current procedures, which is based upon the fixed-variable split for the underlying direct labor.

23. In FY 2014, the cost for Cost Component 203 (the prior year portion of annuitant health benefit and CSRS pension costs) is equal to the Postal Service’s “accrued [retiree health benefit] costs of \$8.685 billion, which is the sum of the \$5.7 billion payment owed for the Postal Retirees Health Benefit Fund, as per PAEA, and \$2.985 billion payment for health benefits for current retirees (footnote omitted)”

minus the retiree health benefit and CSRS benefits earned by current employees during the year. This component is treated as an institutional cost and a reported fixed cost in the Neels Report analysis. FY 2014 Summary Description at 18-6; UPS Response to CHIR No. 1 at 38.

24. As has been well-documented, the statutorily required payment owed to the Postal Retirees Health Benefit Fund (“PSRHBF”) has varied dramatically during the FY 2007-2014 period. As Figure 4 below shows, the changes in this statutorily required PSRHBF payment, not changes in volume, are the cause of changes in costs for this component.⁴

⁴ Similarly, while Miscellaneous Personnel Compensation costs (component 1430) are fixed with respect to volume, they are affected by other factors, such as the timing of when the Postal Service chose to offer an incentive for early retirement, the amount of the monetary incentive, and the number of employees accepting the offer. While also unaffected by volume, “[p]rior-year workers’ compensation costs represent the difference between the estimated current-year costs accrued in the year of the accident and updated estimates of those expenses” and change substantially over time. Summary Description at 18-6. AFSI-LR RM2016-2/2 contains charts (located in “Footnote 4 – MPC” & “Footnote 4 – WC”) illustrating the extent to which costs in these two entirely fixed cost components changed over time from FY 2007 to 2014.

Figure 4. Statutorily Required Payment to PSRHBF and Cost Component 203 (in Billions of FY 2014 Dollars)



Source: AFSI-LR RM2016-2/2, AFSI-LR RM2016-2-2.xlsx, “Figure 4”

D. Cost Component 70: Rural Carrier – Other Routes

25. Dr. Neels identified \$208 million of supposedly hidden variable costs for the Rural Carrier—other routes category and a negative (albeit insignificant) relationship between weighted volume and reported fixed costs for Rural Carrier—evaluated routes. Neels Report at 48; UPS Response to CHIR No. 1 at 38. His analysis, however, failed to control for other factors, such as changes in the composition of Rural Carrier costs between evaluated routes and other routes during the FY 2007 to 2014 period.

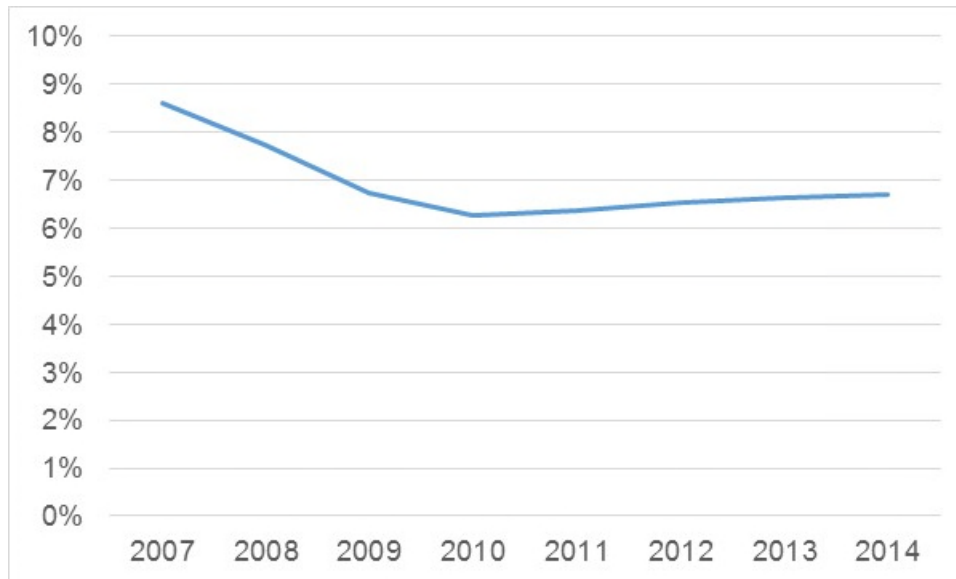
26. As background, rural routes are classified into two categories: evaluated routes and other routes. Evaluated routes represent over 90 percent of the combined cost for the two categories. FY 2014 Summary Description at 10-1.

- Evaluated routes are comprised of “‘H,’ ‘J,’ or ‘K’ route[s]. An ‘H’ route is carried entirely, six days a week, by the regular carrier. ‘J’ routes are carried 11 days out of 12 by the regular carrier and one day by the replacement carrier. ‘K’ routes are carried five days out of six by the regular carrier and one day by the replacement carrier.” *Id.*
- Other routes are comprised of rural routes that are evaluated at less than 35 hours per week and “M” routes: “existing routes for which the rate of compensation on the basis of the mileage compensation schedule exceeds the rate of compensation based on the evaluated schedule. ‘M’ routes are being phased out through conversion to evaluated status.” *Id.* at 10-2.

27. Importantly, while the work performed on both evaluated and other routes—rural delivery – is similar, the mix of accrued costs between evaluated and other routes can and did shift between evaluated and other routes during the FY 2007-2014 period. As Figure 5 below shows, other route costs dropped substantially – by 22 percent – as a percentage of evaluated plus other route costs from FY 2007 to FY 2014.⁵ This trend has caused a downward trend in other route costs.

⁵ The percentage of evaluated plus other routes costs that other routes comprise declined by 22 percent from FY 2007-2014, from 8.6 percent to 6.7 percent. *See* AFSI-LR RM2016-2/2.

Figure 5. Rural Carrier -- Other Routes Accrued Cost as Percentage of Rural Carrier -- Other Routes Plus Evaluated Routes Accrued Cost



Source: AFSI-LR RM2016-2/2, AFSI-LR RM2016-2-2.xlsx, "Figure 5"

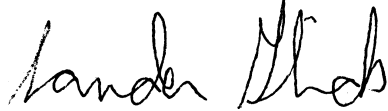
28. To ensure an apples-to-apples comparison unaffected by the shift of costs from other routes to evaluated routes, evaluated and other routes should be analyzed together, rather than as separate components.

29. Finally, Dr. Neels' hidden variable cost adjustment to other routes costs, *i.e.*, increasing other routes attributable costs by \$208 million, would produce an anomalous result. Specifically, the adjustment would increase the percentage of other routes costs that are attributable to 81 percent,⁶ more than twice that for evaluated routes despite the similarity in functions included in the two cost components. FY 2014 Summary Description at 10-1.

⁶ In FY 2014, other routes attributable costs were \$141 million. Neels' hidden variable cost adjustment would increase this figure by \$208 million to \$359 million, 81 percent of "other routes" accrued costs. Evaluated routes costs are less than forty percent attributable. FY 2014 Summary Description at 10-1.

VERIFICATION

I, Sander Glick, declare under penalty of perjury that the foregoing is true and correct. Executed on January 25, 2016.

Handwritten signature of Sander Glick in cursive script.
