

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

NOTICE OF PRICE ADJUSTMENT

Docket No. R2009-3

RESPONSE OF THE UNITED STATES POSTAL SERVICE
TO CHAIRMAN'S INFORMATION REQUEST NO. 1
(May 15, 2009)

Chairman's Information Request (CHIR) No. 1 was issued on May 8, 2009. The request sought answers no later than May 15, 2009. Attached are the Postal Service's responses to Questions 1-7.

Respectfully submitted,

UNITED STATES POSTAL SERVICE

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1. Please identify the metrics and measures the Postal Service plans to employ to measure the success of the Summer Sale. Please indicate the information that will be collected to measure possible volume migration from other classes or time periods, the actual cost of administering the program, and the effect on cost coverage of Standard Mail products.

RESPONSE:

The primary success measure will be incremental revenue and volume growth over the threshold for the universe of eligible participants (approximately 3,200). Other qualitative aspects of the program will be monitored, such as the Postal Service's ability to efficiently and effectively administer the program, and the feedback received from customers in order to help the Postal Service shape potential future promotional pricing offers.

Volume migration from June into July is expected to be negligible because of the short window of time available to mailers to modify mailing plans and the threat of penalties that might be incurred from suppliers for changing production schedules. By creating a minimum volume threshold for October, the Postal Service submits that there is sufficient protection against most migration that could occur by moving volume up to September. While the Postal Service will evaluate the program in relation to performance for the year as a whole, no specific plans have been made to attempt measurement of volume migration. Please also see the Postal Service's response to Question 2, CHIR No. 1, Docket No. R2009-3.

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Additional out-of-pocket costs for administering the Summer Sale Program will be measured by evaluating the additional expenditure on outside resources incurred as a result of the program.

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2. Please identify the steps taken to ensure that Summer Sale qualifying volume is incremental and does not come from the following:

- a. First-Class advertising mail;
- b. Volume shifted from June or earlier;
- c. Volume shifted from mail service provider permits to mailer-owned permits;
- d. Volume shifts between subsidiaries holding separate permits; and
- e. Volume from other permits owned and/or used by a qualifying mailer.

RESPONSE:

- a. Generally speaking, users of First-Class Mail for sending promotional messaging choose it over Standard Mail for reasons of impact, ease of use, or free forwarding. A substantial price difference already exists between the two services. The Postal Service believes that most customers who would shift to Standard Mail for price reasons have made the shift already, and that the Summer Sale program will have little impact on that decision.
- b. No specific actions have been taken to protect from this occurring, as the Postal Service believes this type of shift will be negligible. See the response to CHIR No. 1, Question 1.
- c. Every customer (mail owner) who participates in the Summer Sale is provided a detailed breakdown, by permit, of the volume history used to produce their volume thresholds. Along with the history, they are required to sign a certification document declaring that to the best of their knowledge this accurately represents all of the Standard Mail volume their company has sent during the time periods used to calculate the thresholds. See CHIR.1.Q.2.Attach.A.doc (part of the Zip filed attached to this response

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electronically) for an example of what the customer receives as part of the certification process.

If the customer needs to declare additional volume sent through a Mail Service Provider's account on their behalf, the Postal Service has established guidelines for providing this information. See ChIR.1.Q.2.Attach.B.doc and ChIR.1.Q.2.Attach.B.xls (parts of the Zip filed attached to this response electronically)

- d. The offer to participate in Summer Sale is being made to 'Parent' organizations. Mailing activity for subsidiary organizations was rolled up under the parent.
- e. All permits held by the enterprise are identified and included in calculating volume thresholds and Summer Sale discount qualifying volume. Further, the mailer will be provided with the volume history, by permit, used to establish their thresholds, and must certify that this represents all of the Standard Mail sent by the company.

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3. The Postal Service indicates that it has "current excess capacity to deliver additional volume at relatively low cost during the summer months." United States Postal Service Notice of Market-Dominant Price Adjustment, May 1, 2009, at 3 (Notice). Please discuss and quantify this excess capacity. In addition, please discuss and quantify systemwide excess capacity, if any.

RESPONSE:

Excess capacity arises when the Postal Service's capacity to handle volume is larger than the volume presented to it. Excess capacity can arise if the capacity to handle volume is growing faster than volume, or if volume is falling faster than capacity. It is this latter situation that will occur in the summer of 2009.

To understand why excess capacity will arise, it is first necessary to understand the nature of volume movements. Observed volume changes in a given period of time can be decomposed into three types of movements: secular, cyclical, and seasonal. Secular volume changes reflect long-term trends that have a cumulatively important impact but a small influence in a given month. Secular volume movements are considered to be permanent. Cyclical variations in volume arise because of expansion or contraction in general economic conditions. These can be large, small, or zero in any month depending on the state of the business cycle. These volume movements are temporary, in the sense that they will be reversed when the business cycle moves into its next phase. Seasonal variations in volume are recurring volume changes that occur throughout the year and reflect seasonal variations in mailing patterns. These

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volume movements are considered to be temporary as they disappear as the year moves into the next season.

Like many parts of the economy related to either advertising or the financial sector, the Postal Service is suffering strong cyclical declines in volume. In addition, mailing patterns provide a strong seasonal variation in mail volume with relatively high volumes in PQ1 and relatively low volumes in PQ4. Taken together, these two effects mean that during the summer of 2009, Postal Service volumes will decline because of both negative seasonal and negative cyclical volume movements.

Seasonal excess capacity comes from the fact that the Postal Service is in a network industry and thus does not have complete flexibility in matching resources to volumes. For example, the Postal Service has little ability to adjust its building space over the course of the year. This means that there will be excess building capacity in the summer months when volumes are low. There are similar inflexibilities in labor hours in some activities.

Evidence on this characteristic can be found by fitting a seasonal regression model to both volumes and work hours and examining the magnitude of the seasonal variations in each. If the decline in hours is proportionately less than the decline in volume, then excess capacity can arise. The relevant seasonal regression model is given by:

$$X_t = \beta_1 + \sum_{i=2}^4 \beta_i D_i + \beta_5 t$$

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X_t represents either work hours or volume. The D_i are indicator variables taking the value of one in the relevant quarter and zero otherwise. Note that the last term, a time trend, is included to account for any non-seasonal movements in volumes during the time period of estimation. This ensures that secular movements are not inadvertently ascribed to seasonal movements. Given this model, the seasonal factors are given by:

Postal Quarter 1:	β_1
Postal Quarter 2:	$\beta_1 + \beta_2$
Postal Quarter 3:	$\beta_1 + \beta_3$
Postal Quarter 4:	$\beta_1 + \beta_4$

This seasonal regression model was estimated on quarterly data from 2006 through 2008 for system wide direct hours and RPW volumes,¹ and the resulting seasonal factors are presented below. An easy way to interpret these factors is to express them as a percentage of the baseline quarter, here PQ2. The percentages in the table illustrate how much higher or lower volumes and direct hours are in the other quarters:

¹ The system wide direct hours measure is calculated as the sum of hours in mail processing, city carriers, rural carriers, and customer service.

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Table 1
Percentage Seasonal Variations in Hours and Volumes

	System Wide Direct Hours	RPW Volumes
Postal Quarter 1	2.8%	5.8%
Postal Quarter 3	0.0%	-2.9%
Postal Quarter 4	-1.1%	-3.5%

A comparison of the “system wide direct hours” column with the RPW column shows that labor hours have a smaller seasonal pattern, in percentage terms, than do volumes. This is evidence suggesting the existence of excess capacity in labor.

However, one reason that hours would be less variable than volumes is the characteristic, in some activities, for the variability of labor to be less than one. To account for the variability effect, we use the variability for direct hours to predict the seasonal variation in hours that would accompany the variation in hours if perfect adjustment of resources were available.² In other words, the following equation predicts the long-run response to the volume changes. That formula is:

$$\hat{\% \Delta HRS} = \eta (\% \Delta V),$$

² The variability of direct hours was found by dividing the attributable cost for segments 3, 7, 6, and 10 by the accrued cost for those four segments. The resulting variability is 64 percent.

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where η is the long-run variability of direct hours. This equation can be used to predict the system wide hours changes that *should* occur if capacity varied in proportion to volume.

Table 2
Predicted and Actual Response in Hours to Volume Declines

	RPW Volume	Predicted Long Run Response	Actual Response
Postal Quarter 1	5.84%	3.74%	2.80%
Postal Quarter 3	-2.87%	-1.84%	0.00%
Postal Quarter 4	-3.46%	-2.21%	-1.10%

Note that in all three quarters the actual seasonal variation in hours is less than the predicted variation. This suggests that even adjusting for variabilities, the fluctuation in system wide hours is less than the fluctuations in volume. This indicates the existence of excess capacity, most relevantly for our purposes, in Postal Quarter 4.

The previous analysis suggests that there will be seasonal excess capacity in the summer of 2009, but does not provide any insight into where in the postal value chain it will occur. To gain further insight, the seasonal regression model was estimated for three major functions: mail processing, city delivery and rural delivery. The results show that while mail processing hours have substantial seasonal fluctuations, there is very little movement in either city or rural carriers

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hours by season. This suggests that excess capacity arises in both rural and city delivery in the summer.

Table 3
Seasonal Variations in Hours by Function

	Mail Processing	Rural Delivery	City Delivery
Postal Quarter 1	7.37%	-0.30%	2.72%
Postal Quarter 3	-1.81%	0.89%	0.85%
Postal Quarter 4	2.72%	0.84%	-0.09%

Another piece of evidence on seasonal fluctuations in capacity is given by Total Factor Productivity, which takes into account all factors of production. A seasonal reduction in TFP means that the amount of inputs used relative to output rises during that season. In other words, this is evidence of excess capacity. Estimation of the seasonal model for TPF also indicates that there is excess capacity available during the summer months.

Table 4
Seasonal Fluctuations in TFP

Postal Quarter 1	3.5%
Postal Quarter 2	0.0%
Postal Quarter 3	-0.8%
Postal Quarter 4	-3.0%

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In addition to seasonal variation, the Postal Service is also going to have temporary excess capacity in the summer of 2009 because of the large cyclical volume declines. These sharp volume contractions have been induced by the current serious economic recession. Recent data exhibit a startling decline in Postal Service volumes. For example, the four quarters from the second quarter of 2008 through the first quarter of 2009 show an alarming acceleration in year-over-year declines. When volumes are declining this rapidly, it is difficult, if not impossible, for the Postal Service to reduce capacity at the same rate. Moreover to the extent this is a cyclical phenomenon, and thus temporary, it is not clear that it is prudent to reduce the network by as much as the decline in volume.

A review of the data shows that system wide delivery hours have not fallen as rapidly as volume. This means that temporary excess capacity is arising. In addition, a review of hours in the different Postal Service operational functions shows that this excess capacity is not uniform across functions. Hours have fallen relatively rapidly in mail processing, for example, but not quickly in delivery. This suggests that there is material temporary excess capacity in delivery.

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Table 5
SPLY Comparisons for Volume and Hours

PQ	SPLY RPW Volume Decline	SPLY System Hours Decline	SPLY Rural Delivery Hours	SPLY City Delivery Hours
2008.02	-3.3%	-2.2%	3.3%	-1.1%
2008.03	-5.6%	-4.6%	-1.9%	-3.1%
2008.04	-6.4%	-4.4%	-1.9%	-2.9%
2009.01	-8.8%	-7.5%	-3.1%	-5.2%

This comparison may understate the growth in excess capacity in delivery because delivered volumes have been falling faster than originating volume.³ For example, most advertising mail is delivered, and if advertising mail volumes are falling more rapidly than average, delivered volumes may also be declining faster than average. This is supported by a comparison of RPW and DOIS volume declines in recent months. DOIS is a volume and hours counting system run out of city carrier delivery based on non-statistical measures while RPW volumes are based on a probability-based sampling system used to report the Postal Service's official volumes.

³ In this context, delivered volume is that delivered by city or rural carriers, as opposed, for example, to volume destined for firm pickups or post office boxes.

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Table 6
Comparison with SPLY for Two Volume Measures

	RPW Volume	DOIS Volume
OCT 2008	-2.7%	-9.9%
NOV 2008	-19.4%	-22.0%
DEC 2008	-5.6%	-10.7%
JAN 2009	-16.3%	-15.1%
FEB 2009	-17.1%	-18.7%
Average	-12.2%	-15.3%

Analysis of DOIS volumes and hours provides more insight into the temporary excess capacity in city carrier delivery. Both office hours and street hours are falling less sharply than delivered volume. In addition, the actual declines in both office hours and street hours are less than the predicted long-run response. This indicates the existence of short-run excess capacity.

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Table 7
FY 2009 SPLY Comparisons of DOIS Data and Carrier Hours

	Volume	Predicted LR Response in City Office Hours	Response in City Office Hours	Predicted LR Response in City Street Hours	Response in City Street Hours
OCT 2008	-9.9%	-8.3%	-7.1%	-3.7%	-1.0%
NOV 2008	-22.0%	-18.4%	-15.5%	-8.1%	-5.9%
DEC 2008	-10.7%	-8.9%	-6.1%	-3.9%	2.3%
JAN 2009	-15.1%	-12.6%	-11.7%	-5.6%	-1.2%
FEB 2009	-18.7%	-15.7%	-15.9%	-6.9%	-6.6%
MAR 2009	-22.5%	-18.9%	-19.7%	-8.3%	-10.0%
Average	-16.47%	-13.78%	-12.69%	-6.09%	-3.73%

For further details on the analyses supporting this response, please see the Technical Appendix relating to this question in the Zip file attached to this filing electronically, and the associated Excel files.

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4. Please estimate the cost coverage of the incremental volume by product.

Please show all calculations and identify and discuss all assumptions made.

RESPONSE:

This response is organized as follows. First, calculation of the relevant attributable costs is described. Second, these costs are then compared with estimated revenues to derive the requested cost coverages. Please see the Technical Appendix to this answer in the Zip file attached electronically for details of the calculations, which are shown in the associated Excel files also included in the Zip file.

Calculation of attributable costs:

The concept of cost arises from scarcity. It is the existence of scarce resources that gives rise to costs, and the term "cost" is actually shorthand for the more complete term "opportunity cost." Moreover, it is well known that in the absence of scarcity, opportunity cost falls to zero.

This is the reason that under temporary excess capacity, the resulting short-run marginal cost for a firm will be lower than its long-run marginal cost or even zero.⁴ If there are idle resources available, additional output can be provided

⁴ This situation should not be confused with long-run excess capacity in an industry. For example, under monopolistic competition, long-run excess capacity will occur because firms are producing at a level which is smaller than the cost-minimizing level. The difference between the current level of production and the cost-minimizing level is known as long-run excess capacity.

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without incurring any (opportunity) cost. For example, if a contract requires a firm to hire two workers for a week and during the first 3 days of that week there is only sufficient volume to keep one of the workers busy, then adding a small amount of volume for the next two days does not cause any additional costs for the firm. The additional volume is handled by the second, previously idle worker. In this case, the marginal cost of the additional volume is zero.

The general implication of excess capacity for the Postal Service is that temporary additions to volume can be worked through the network without generating very much or any additional attributable cost. Rather, unused or underused capacity can be employed to handle any temporary increases in volume. This means that the resulting short-run marginal cost of temporary additional volume will be less than long-run marginal cost of sustained volume increases under normal capacity conditions. In the lexicon of postal costing, temporary excess capacity means that the short-run attributable cost per piece of any temporary increment to volume will be below the measured long-run attributable cost per piece for the same product.

The attributable costs used in the ACR are long-run attributable costs, in the sense that they are based upon sustained changes in volume and timely adjustment of all inputs.⁵ Because any volume increases that would take place

⁵ In PRC proceedings, long-run marginal costs are defined as those that arise after allowing for the adjustment of all inputs that would take place over a three-year period. While this does not comport precisely with the formal definition of long-run marginal costs, the practical results are close enough that the usage is

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as a result of the Standard Mail Volume Incentive Program would do so in a condition of excess capacity, the long-run attributable costs from the ACR are not appropriate for estimating cost coverage. To estimate cost coverage, the temporary short-run attributable costs per piece for this additional volume must be estimated. The long-run attributable cost per piece (or "unit attributable cost") for product "j" can be expressed as:

not problematic. The Commission (R97-1 Op. & Rec. Dec. at 79) has explained its position on the nature of marginal costs that should be measured without necessarily reconciling the terminology:

The Commission's understanding of the time period that is appropriate for volume-variable cost analyses is that the volume-variability of costs should reflect the length of time that the Commission's recommended rates would be expected to be in effect. This position is consistent with the testimony of Postal Service witnesses Baumol and Panzar in Docket Nos. R87-1 and R90-1. See Response of witness Bradley to POIR No. 4, Question 1. The Commission was advised to adopt the position that marginal costs should be "actual" marginal costs as they arise over the span of time in which a set of rates are in force. This span of time is the length of a rate cycle, which historically has been approximately three years. Witness Bradley is correct when he asserts that this position corresponds to the economic definition of "short run" rather than "long run" cost. The usual economic definition of long run costs is that they are the costs that arise when all inputs are variable. If some inputs are variable, but others are not, then costs are short run. However, there are many flavors of short run depending upon what inputs can be varied over the length of time considered. Witness Bradley's operational definition given in his response to P.O. Information Request No. 4 is consistent with the Commission's view of the correct time period for postal cost studies. "One should attempt to base prices on the marginal costs that will actually be incurred by the firm to serve a sustained increase in volume over the time period during which the prices will be in effect." Tr. 11/5417-18.

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$$UAC_j^{LR} = \frac{\sum_{i=1}^{19} C_i \varepsilon_i^{LR} \theta_{ij}}{V_j}$$

In this equation C_j represents the accrued cost in each of the nineteen cost segments, ε^{LR} is the associated long run variability, θ_{ij} is the share of attributable cost in segment "i" caused by product "j," and V_j is the volume of product "j." In similar fashion, the short-run attributable cost per piece could be expressed as:

$$UAC_j^{SR} = \frac{\sum_{i=1}^{19} C_i \varepsilon_i^{SR} \theta_{ij}}{V_j}$$

Thus, the difference between the long-run and short-run attributable costs per piece depends upon any differences between the long-run and temporary short-run variabilities. This implies that for at least some cost segments, variabilities need to be reviewed and adjusted.

A reasonable approach to determining the likely impact on costs of any added volume caused by the Standard Mail Volume Incentive Program is to review the historical evidence on where excess capacity is arising and to discuss with operational experts which portions of the Postal Service network have the most excess capacity. Doing so suggests that while there will be some excess capacity in virtually all areas of operations, there are some areas that stand out. Focusing on just those areas yields the following key points:

1. Due to seasonal and cyclical volume declines, the Postal Service will have excess capacity in buildings, equipment, and vehicles in the summer of 2009. The excess capacity is sufficiently large so that an increase in volume created by the Standard Mail Volume

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Incentive Program will not cause additional costs to be incurred in these areas.

2. The delivery networks for both city and rural delivery have also material excess capacity. As result, they can absorb the increase in volume caused by the Standard Mail Volume Incentive Program in the summer of 2009 without creating much additional cost.
3. The postmaster network has material excess capacity and the additional volume created by Standard Mail Volume Incentive Program would not cause any additional postmaster costs.

These key points can be embodied in a costing analysis by considering their implications for the relevant variabilities. When the Standard Mail Volume Incentive Program volume can be absorbed without any additional cost, the temporary short-run variability will be zero. For those activities in which there may be a relatively small adjustment in the amount of resources needed to handle the additional volume, the temporary short-run variability will be below the long-run variability. Note that only those cost segments in which there is clear operational support for excess capacity are considered in this cost analysis. In other words, there are other areas of possible excess capacity that have not been included, suggesting that the estimated attributable costs per piece presented below are likely to have an upward bias. The cost segments with temporary short-run variabilities which are different from their long-run variabilities are presented below. They come in two groups: 1) direct cost, in which variability is a result of the activities performed; and 2) indirect or "piggyback" costs, in which the variability is based upon the variability in one or more direct cost segments.

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Direct Costs:

CS 1: Postmasters

Despite the declines in volume, the postmaster network has remained largely unchanged. Thus, additional volume caused by the Standard Mail Volume Incentive Program will not affect Postmaster Costs.

CS 6: City Delivery Carriers, Office Activity

City carrier in-office costs will be affected by excess capacity, but there will not be sufficient excess capacity in the summer of 2009 to absorb all of the volume caused by the Standard Mail Volume Incentive Program without any increase in cost. Operational experts have assisted in reaching the judgment that additional summer volumes would lead to increases in cost at about three-fourths the typical rate. This means that the temporary short-run variability is expected to be seventy-five percent of its long-run value.

CS 7: City Delivery Carriers, Street Activity

There is and will continue to be material excess capacity in city carrier street activities and operational experts are confident the additional volume caused by the Standard Mail Volume Incentive Program can be handled without incurring additional city carrier street time costs.

CS 10: Rural Carriers

There is and will continue to be material excess capacity in rural carrier activities and operational experts are confident the additional volume caused by the Standard Mail Volume Incentive Program can be handled without incurring additional rural carrier costs.

Piggyback or Indirect Costs:

CS 2: Supervisors and Technicians

City and Rural carrier supervision costs have the same variability as the labor they supervise. Because the temporary short-run variabilities for city and rural carrier direct hours are below their long-run variabilities, the temporary short-run variability for carrier supervisors is also below its long-run variability.

CS 11: Custodial and Maintenance Services

This cost segment includes maintenance of equipment, building maintenance and custodial costs. These custodial and maintenance cost will be unaffected by additional summer discount volume because this work is driven by the amount of facility space and equipment to maintain, which will not increase in response to any additional volume caused by the Standard Mail Volume Incentive Program.

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CS 12: Motor Vehicle Service

The costs for motor vehicle service (both labor and supplies) are driven by the number of vehicles to be serviced. Because the Postal Service currently has an excess capacity in vehicles additional volume caused by the Standard Mail Volume Incentive Program will not cause it to acquire any additional vehicles. As a result, there will be no increase in motor vehicle service costs.

CS 15: Building Occupancy

Building occupancy includes rents and utilities. The Postal Service currently has more than enough building space so additional volume caused by the Standard Mail Volume Incentive Program will not increase the number of buildings it has or rent payments it makes. Similarly, the utilities associated with lighting, cooling, or heating current facilities will not be increased.

CS 16: Supplies and Services

A portion of this cost segment is for custodial supplies. Like other custodial costs, the cost of custodial supplies will be unaffected by additional volume caused by the Standard Mail Volume Incentive Program.

CS 18: Administration and Area Operations

Personnel benefits costs are a part of the overall compensation for labor and therefore have the same variability as labor costs in the aggregate. Because of temporary excess capacity, the temporary short-run variability of aggregate labor costs is below the long-run variability. Thus, the temporary short-run variability for personnel benefits is also below its long-run variability.

CS 20: Other Accrued Expenses (Service Wide)

This cost segment includes depreciation and interest expense for facilities, equipment and vehicles. Because additional volume caused by the Standard Mail Volume Incentive Program will not cause any increases in facilities, equipment or vehicles, it will not cause any increase in these costs.

The resulting short-run variabilities are presented in the Table 1. Both the long-run and temporary short-run attributable costs are based upon FY2008 accrued costs. Applying the estimated short-run variabilities in the equation for temporary short-run attributable cost yields the appropriate costs for calculating cost coverage for any additional volume created by the Standard Mail Volume

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Incentive Program. Those temporary short-run attributable costs per piece, along with the respective long-run attributable costs per piece, for all the products included in the Standard Mail Volume Incentive Program are presented in Table 2. The largest percentage amounts by which the temporary short-run attributable costs are below the long-run attributable costs are for High Density and Saturation products. This is because these products incur over half of their attributable costs in delivery. The smallest percentage reduction in cost from temporary excess capacity is for Standard Regular flats, which have only a quarter of their attributable cost incurred in delivery.

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Table 1: Long-Run and Temporary Short-Run Variabilities

Cost Segment	Long-Run Variability	Temporary Short-Run Variability
C/S 1 Postmasters	17.8%	0.0%
C/S 2 Supervisors and Technicians	55.7%	46.4%
C/S 3 Clerks and MH – CAG A-J Offices	84.3%	84.3%
C/S 4 Clerks – CAG K Offices	59.5%	59.5%
C/S 6 City Delivery Carriers – Office Activity	83.7%	62.8%
C/S 7 City Delivery Carriers – Street Activity	37.1%	0.0%
C/S 8 Vehicle Service Drivers	60.4%	60.4%
C/S 10 Rural Carriers	39.1%	0.0%
C/S 11 Custodial and Maintenance Services	72.6%	0.0%
C/S 12 Motor Vehicle Service	27.6%	0.0%
C/S 13 Miscellaneous Local Operations	14.1%	14.1%
C/S 14 Transportation	88.3%	88.3%
C/S 15 Building Occupancy	70.3%	0.0%
C/S 16 Supplies and Services	49.6%	45.5%
C/S 17 Research and Development	0.0%	0.0%
C/S 18 Administration and Area Operations	34.1%	22.6%
C/S 19 General Management Systems	0.0%	0.0%
C/S 20 Other Accrued Expenses (Service Wide)	69.7%	0.0%

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Table 2: Long Run and Temporary Short-Run Attributable Costs Per Piece

Product	Temporary SR Attributable Cost	LR Attributable Cost
High Density and Saturation Letters	\$0.023	\$0.057
High Density and Saturation Flats and Parcels	\$0.020	\$0.062
Carrier Route	\$0.079	\$0.150
Standard Regular Letters	\$0.054	\$0.096
Standard Regular Flats	\$0.260	\$0.389

Calculation of Cost Coverage:

Cost coverage for the incremental volume is calculated in two steps. First, the average revenue per piece for the incremental volume is calculated by multiplying the average revenue per piece by product from "CAPCALC-STD-FY2009.xls" from LR-USPS-R-2009-2/2 by 0.7 to estimate the average discounted revenue per piece on the incremental volume. Second, this discounted revenue per piece is divided by the temporary short-run attributable cost calculated above to calculate the cost coverage on the incremental pieces.

Table 3 below summarizes the result.

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Table 3: Cost Coverage of Summer Sale Incremental Volume

Product	Base Revenue per Piece	Discounted Revenue per Piece	Temporary SR Attributable Cost	Cost Coverage
High Density and Saturation Letters	\$0.134	\$0.094	\$0.023	408%
High Density and Saturation Flats and Parcels	\$0.165	\$0.115	\$0.020	576%
Carrier Route	\$0.241	\$0.169	\$0.079	213%
Standard Regular Letters	\$0.196	\$0.137	\$0.054	254%
Standard Regular Flats	\$0.376	\$0.263	\$0.260	101%

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5. The following questions concern eligibility requirements of the Summer Sale program.
- a. Please provide the analysis referenced in the Notice at page 5 that led the Postal Service to conclude that “including all permit holders was not financially and administratively practical.”
 - b. Please discuss whether the Postal Service considered the effect on small mailers when deciding to use one million Standard Mail letters and flats as the threshold for eligibility and to exclude mail service providers from the program. If the Postal Service considers these effects small enough to be justifiable, please discuss how this conclusion was reached.
 - c. Did the Postal Service consider extending the program to First-Class advertising mail? If so, please discuss why First-Class advertising mail was not included in the program. If not, why not?

RESPONSE:

- a. There were approximately 347,000 customers that mailed less than 1 million pieces from October 1, 2007, to March 30, 2008. The total volume sent from these customers during that time period was 7.73 billion. Between October 1, 2008, and March 30, 2009, the volume mailed by these customers was 8.2 billion. This means that this group of customers experienced a growth trend of 1.061 percent.

When the 1.061% growth trend is applied to the volume sent between July 1, 2008, and September 30, 2008—which was 4.4 billion—the result is a Summer Sale volume threshold of 4.67 billion. Assuming that all of these customers averaged a five percent incremental increase in their Standard Mail volume during the Summer Sale, the Postal Service would realize a 230 million piece increase in mail volume.

After dividing the incremental volume from the Summer Sale (230 million pieces) by the number of customers (347,000), the Postal Service will have

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averaged 663 pieces of new volume per customer. Assuming the average per piece price is about 21 cents, the Postal Service would gain about \$139 per customer, or only an additional \$48.3 million in gross revenue from all 347,000 customers.

When one deducts 30 percent from the \$48.3 million to pay for rebates there remains \$33.8 million in net revenue. After deducting the temporary short run variable costs of \$16.6 million (7.2 cents x 230 million pieces), only \$17.2 million would remain to cover program administration costs. Program administration costs would exceed \$17.2 million to serve 347 thousand customers. The Postal Service would expect the program administration cost to be in excess of \$20 million in this scenario, mostly to cover additional labor, since there would not be enough time to create a technology solution to help administer the program. In addition, the complexity of administering a program with this many potential participants in such a tight window of time would be extremely challenging. Thus, the Postal Service concluded that including all permit holders in the Summer Sale would not be financially or administratively practical.

- b. Starting from the analysis described in the response to part (a), the Postal Service calculated that the Summer Sale rebate on 663 pieces (assuming each piece is charged an average of 21 cents in postage) would be about \$42 (663 pieces X .21 cents = \$139.23 x .30 = \$41.76). In our judgment, the

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opportunity to save this small amount of postage over a three month period would not be worth most businesses time and trouble.

The rationale for not allowing mail service providers (MSP) to participate directly in the Summer Sale was to protect the Postal Service from MSP participants from combining volume from multiple mail owners permits onto MSPs' permits in order to optimize discount-qualifying volume, and thus, merely shifting existing volume around to receive discounts.

- c. Including First-Class Mail in this initiative was not considered because there is no reliable way to discern what is advertising content and what is not. For example, statement mailings that contain advertising inserts are a blend of both advertising and business transactions. Additionally, there is no requirement for mailers to segregate First-Class Mail pieces that contain only advertising content by any means (such as Permit number) that would allow for easy identification.

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6. In its FY 2008 Annual Compliance Report at 23, the Postal Service states that it "does not want to diminish the importance of each product making a positive contribution, and will work to achieve that result." Given the current cost coverage for Standard Mail flats, please explain the product's inclusion in the Summer Sale.

RESPONSE:

The Postal Service continues to believe that each product, including Standard Mail flats, should make a positive contribution toward overhead. However, given the structure of this program, its temporary nature, and its goals, the Postal Service believes that including flats, even though they have a relatively low cost coverage, makes sense. The primary goal of this program is to increase mailing during a period of depressed volumes. This program can help postal customers offset declines in their businesses caused by the challenging economic climate. Flats mailers are among those hardest hit by the downturn, and the Postal Service submits that by giving them a chance to stabilize, this program can help provide a base for growth in the future that will aid in improving the profitability of the product. Additionally, given the excess capacity in the system, the Postal Service believes that the incremental volume generated through the program will cover its additional costs, and should not exacerbate cost coverage problems.

Beyond these factors, exclusion of flats from the program would likely lead customers to convert flat-sized pieces to "slim-jims," or other letter-sized pieces. Such a conversion would defeat the intent of the program (which is to increase volume), would reduce revenue (as pieces that would have been mailed at flats prices instead pay a lower letter price), and, to the extent that converted pieces

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are not well-suited to processing on letter automation equipment, may actually increase costs. The additional administrative burden that would be placed on both the Postal Service and its customers as a result of attempting to eliminate this conversion would make the program untenable.

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7. Please provide all documentation, spreadsheets, and assumptions used to calculate the expected incremental revenue between \$38 million to \$98 million and administrative costs of \$977,000.

RESPONSE:

ChIR.1.Q.7.Revenue projections.xls is a spreadsheet (part of the Zip file attached to this response electronically) which contains the analysis that yielded the estimated range of incremental revenue (between \$38 and \$98 million) that is expected to result from the Summer Sale after the 30 percent rebate is deducted.

The administrative cost of the program (\$977,000) assumes the following:

- Program Support – Dedicated USPS personnel
 - Up to 6 full time USPS employees for four months - \$300,000
 - Up to 10 half time USPS employees for four months - \$250,000
- Up to 4 contract analysts for four months - \$400,000
- Development of Website for customers to register their interest in participating in the program - \$7,000
- Production of letters to customers inviting participation in program - \$20,000