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Postal Regulatory Commission

Annual Compliance Determination

POSTAL REGULATORY COMMISSION

U.S. Postal Service Performance
Fiscal Year 2007

MARCH 27, 2008

Dan G. Blair
Chairman

On behalf of the Postal Regulatory Commission, I am pleased to present the first *Annual Compliance Determination* (ACD) of the performance of the U.S. Postal Service for Fiscal Year 2007, pursuant to the Postal Accountability and Enhancement Act (PAEA). This ACD represents the first effort of the Commission to assess the Postal Service's activities under the framework of the PAEA. This assessment represents an important part of the Commission's mission to bring transparency and accountability to the U.S. Postal Service's performance and finances, and provides a status report using data submitted by the Postal Service on December 28, 2007.

Fiscal Year 2007 was an eventful year. R2006-1 was the last litigated omnibus rate case under the former cost-of-service structure of the Postal Reorganization Act of 1970. The Commission issued its new ratemaking rules in October 2007, setting forth a new structure for rate adjustments under the PAEA. An important aspect of future ACDs will be to gauge postal product pricing for compliance against this framework.

We commend the Postal Service for this effort in compiling essential cost and volume data required for this report. This will be an evolving process, and we look forward to working with the Service to improve the quality and timeliness of the data. Our determination and future reports will serve as action-forcing mechanisms in shedding light on postal operations and finances. These reports will provide customers, stakeholders, and the Postal Service with valuable information on which to assess annual performance.

Future ACDs will benefit from formal Commission rules that will govern Postal Service compliance submissions. Those rules will be forthcoming and the content will reflect the experiences of this first compliance proceeding. It is important to point out that the findings contained in this report reflect the criteria as established by the PAEA. Importantly, this report does not contain any formal direction to change or adjust postal rates or pending increase requests.

In closing, I wish to thank Vice Chairman Mark Acton, and Commissioners Goldway and Hammond for their valuable work and input in preparation of this report. On behalf of my fellow Commissioners, I want to acknowledge the Commission's dedicated and committed staff for the timely completion of this analysis while reviewing and analyzing the rate adjustments proposed by the Service in February and March of this year. Our efforts to perform our new tasks as required by the PAEA could not be accomplished without the significant and substantial contributions of the Commission's staff.

Dan G. Blair

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Principal Findings

This report is issued pursuant to 39 U.S.C. § 3653 of the Postal Accountability and Enhancement Act (PAEA). It is a written determination that analyzes and evaluates the Postal Service's financial and service performance based on its FY 2007 Annual Compliance Report (ACR). The Commission findings are summarized here and discussed in greater detail in later sections.

FINANCIAL RESULTS

- The Postal Service had a $1.6 billion profit on operations, however statutory funding requirements for retiree health benefits resulted in a net loss of $5.1 billion.
- Total First-Class Mail volume declined by 1.6 percent and First-Class single piece volume dropped 4.5 percent to continue a nine-year decline.
- Total factor productivity improved by 1.7 percent, exceeding the Postal Service goal of a 1.0 percent improvement.Five market dominant postal services did not cover their attributable costs.
  - Periodicals;
  - Single-Piece Parcel Post;
  - Media/Library Mail;
  - Registered Mail; and
  - First-Class Mail International (inbound).

Rate increases and rate design improvements were implemented during the second half of the year to eliminate such deficiencies in the future.

- Two competitive postal services did not cover their attributable costs.
  - Parcel Return Service; and
  - International Surface Parcel Post at non-UPU rates (inbound).
- Competitive Products as a group slightly exceeded the requirement that they contribute at least 5.5 percent of Postal Service institutional costs.
- Negotiated service agreements provided a $2.5 million net benefit, largely through reduced forwarding and return costs.

SERVICE PERFORMANCE

- First-Class single piece service exceeded the Postal Service plan, but future compliance reports should provide annual performance results without exclusionary periods.
- Delivery performance information is available for approximately one fifth of the mail. Establishing reliable service measurement systems for all mail should be a high priority goal.
- The Postal Service should provide more information on the “tail of the mail.” It also should provide narrative information regarding new initiatives to improve service performance.
- The customer satisfaction data provided by the Postal Service with its ACR is limited.
- The Postal Service goal of fostering a more “customer-focused culture” is measured by employee survey results, employee safety records, and equal employee opportunity performance. While these may be good indicators of employee satisfaction, they are not appropriate indicators of customer relations.

DATA SUFFICIENCY

- The Postal Service made a good first effort to provide the Commission with essential cost and volume data. Improvements are needed, especially in the area of International Mail, where reliable data are still unavailable.
- A number of workshare discounts exceeded avoided costs. The Postal Service should have addressed whether and how specific statutory exceptions may have justified such situations.
- In future reports the Postal Service must provide additional information to explain anomalies in data, and how its operations and rate designs are intended to advance statutory policies.
- Future presentations must be timely, accurate, self-explanatory, and not rely on undocumented calculations.

Chapter I—Executive Summary

VOLUME AND FINANCE TRENDS

The Postal Service experienced a net loss of $5.1 billion in FY 2007, primarily due to obligations imposed by the PAEA. Before PAEA expenses are taken into consideration, net income is $1.6 billion. The PAEA requires the establishment of a Postal Service Retiree Health Benefit Fund (PSRHBF) that results in a new FY 2007 expense of $8.5 billion. This is somewhat offset by the elimination of planned FY 2007 Civil Service Retirement System payments of $1.6 billion.

The PAEA requires the Postal Service to make payments of between $5.4 and $5.8 billion a year into the PSRHBF for the next 10 years, after which a new payment schedule will be established. The Postal Service's first Form 10-Q filing with the Commission for the first quarter of FY 2008 notes that meeting revenue goals for the year will be challenging.

SERVICE PERFORMANCE

During 2007, the Postal Service, in consultation with the Commission and the Mailer's Technical Advisory Council, revised delivery standards for all classes of mail between all 3-digit ZIP Code pairs. The new standards match current system capabilities and allow an increased number of days to delivery for a significant number of ZIP Code pairs. The new standards took effect after FY 2007. Performance data presented in the ACR are relative to the old standards.

Delivery performance information is provided for approximately one fifth of the FY 2007 mail. Results are available for:

- Single-Piece First-Class
  - Domestic: 95.6, 92.6, and 90.4 percent on-time for overnight, two-day delivery, and three-day delivery areas, respectively; and
  - International: 91.4 percent for domestic portions.

- Parcel Post: 57.7 percent on-time per standards.

No performance data exist for the remaining 80 percent of the mail due to the lack of measurement systems. Proposals are pending with the Commission for establishing systems that will measure all mail and many Special Services. The broader measurement results will be available starting in FY 2009. Until that time, it will not be possible to make assessments of performance for the majority of the mail.

REVENUE COVERING COSTS

The system for regulating rates of market dominant products includes the requirement that each class of mail or type of mail service bear its attributable costs, subject to the Consumer Price Index-based cap on rate changes. This requirement applies without limitation to all competitive products.

Market dominant products. Five market dominant postal services did not cover their attributable costs during FY 2007; that is, revenue as a percent of costs is less than 100 percent. First-Class Mail International (inbound) revenue is 73.1 percent of costs, Periodicals is 83 percent, Parcel Post retail is 98.7 percent, Media and Library Mail is 91.4 percent, and Registered Mail is 96.3 percent.

Competitive products. Two competitive products did not cover attributable costs: inbound surface parcels not subject to Universal Postal Union rates, and Parcel Return Service. The loss on inbound surface parcels was incurred by the international bilateral agreement with Canada. Under the criteria of the PAEA, that agreement must be adjusted at the next opportunity for renegotiation. New Parcel Return Service rates that are scheduled to go into effect on May 12, 2008 provide an opportunity to address this problem. Sufficient data to evaluate International Customized Mail agreements were not made available in a timely fashion.

The Commission calculates the revenue from competitive products minus their attributable costs equals 5.66 percent of total institutional costs for FY 2007. This is over the minimum 5.5 percent the Postal Service is required to generate.

POSTAL SERVICE STRATEGIC GOALS

The PAEA requires the Commission to evaluate whether the Postal Service has met strategic goals established in compliance with the Government Performance and Results Act. For FY 2007, these goals were to Improve Service, Generate Revenue, Increase Efficiency, and Establish a Customer-Focused Culture. Significant progress has been made, but the results are mixed.

Improve Service. The 2007 goal was to achieve First-Class single piece performance scores in overnight, 2-day, and 3-day delivery areas of 95, 92, and 90 percent, respectively. These values were exceeded slightly and have improved over the last three years. No performance goal had been set for Parcel Post, but on-time delivery was achieved only 57 percent of the time. Goals for all classes of mail are to be set in consultation with the Commission by June 20, 2008.

Generate Revenue. New products, such as the Priority Flat Rate Box, Confirm Service, Premium Forwarding Service, and Customized MarketMail have been introduced over the last several years, but the revenue from these is relatively small.

Increased Efficiency. Efficiency has increased over the last several years as measured by annual increases in Total Factor Productivity. Since 2000, the average annual increase is 1.5 percent. This has allowed operating expense growth to stay under the Consumer Price Index.

Customer-Focused Culture. The Postal Service measures achievement of this goal through employee survey results, employee safety records, and equal employment opportunity performance. While these measures may be good indicators of employee satisfaction, they are not appropriate indicators of customer relations.

WORKSHARING

39 U.S.C. §3622(e) requires the Commission to ensure that worksharing discounts do not exceed the relevant avoided costs unless justified by at least one of four exceptions. Using the discounts in effect at the end of FY 2007 and the avoided costs calculated for the entire fiscal year, the Postal Service identifies worksharing discounts that exceed avoided costs in all classes.

The Postal Service did not provide with its annual report explanations of which exceptions apply to these discounts. This type of supporting analysis must be part of future annual compliance reports submitted by the Postal Service.

NEGOTIATED SERVICE AGREEMENT

The ACR provides very limited discussion of these arrangements. Separately, the Postal Service has submitted annual data collection reports on all five of its current negotiated service agreements. The Commission analyzes this data and concludes that the current agreements generated little new volume, but provided a net benefit of $2.5 million to the Postal Service, largely in reduced costs. The Postal Service is urged to review this analysis and provide similar information in future compliance reports.

DATA AND ANALYSIS ISSUES

The Commission had not issued new data submission rules to guide the ACR submissions. This resulted in cost, volume, revenue, and performance data typically submitted with a rate case and without analysis relative to the factors and objectives of the PAEA. The Commission will soon issue proposed rules to establish the form and content of information that should be provided in future Postal Service reports to the Commission. In the meantime, this report provides a status report on Postal Service finances and service performance using the data that were provided.

The analysis has been hindered by problems that should be remedied in future filings. Two examples are the late submission of some data, and the format of the Excel worksheets. Corrected cost and revenue analysis data became available as late as March 20, 2008, one week before the deadline for submission of the Commission's report. Hopefully, with more experience, fewer errata will be necessary and all data can be provided in the initial compliance report 90 days after the close of the fiscal year. Finally, the transparency of the Postal Service filing will be greatly enhanced if the practice of hard coding calculated values in Excel spreadsheets is abandoned and all calculated values are presented as formulae in the cells with links to other cells involved in the calculation.

Chapter 2—Background

INTRODUCTION

The United States Postal Service filed with this Commission on December 28, 2007, the first Annual Compliance Report (ACR) required by the Postal Accountability and Enhancement Act, Public Law 109-435 (2006). The Postal Service is required to report to the Commission, within 90 days after the end of each fiscal year, a variety of data on "costs, revenues, rates, and quality of service" in sufficient detail to demonstrate that all products during each year complied with all applicable requirements of title 39 and, in such year, for each market dominant product, provide product information and measures of quality of service.

39 U.S.C.§ 3653(b) provides that the Commission shall make a written determination not later than 90 days after receiving the Postal Service's ACR filed pursuant to 39 U.S.C. § 3652. That determination shall include whether any rates or fees in effect, during the year for products individually or collectively were not in compliance with applicable provisions of chapter 36 of title 39 or regulations thereunder, or whether any service standards in effect during the year were not met. If no instance of noncompliance is found for such year, the written determination shall be to that effect. A written determination finding no instance of noncompliance creates a rebuttable presumption of compliance with the matters regarding rates and fees and service standards in effect during such year in any complaint proceedings filed pursuant to § 3662 of the PAEA. 39 U.S.C. § 3653(e).

The PAEA further provides in § 3653(d) that the Commission shall evaluate annually whether the Postal Service has met the goals established under §§ 2803 and 2804 of title 39. Those sections require the Postal Service to prepare annual performance plans establishing performance goals by program activity (§ 2803) and to prepare a report on program performance each fiscal year to be included in the Postal Service's annual comprehensive statement which is filed as part of the ACR (§ 2804). 39 U.S.C. § 3653(d) further states the Commission may provide recommendations to the Postal Service related to the protection or promotion of the public policy objectives set out in title 39.

This report provides the written determination mandated by § 3653 of the PAEA and includes the first annual evaluation of whether the Postal Service has met the specified goals of §§ 2803 and 2804. It also includes recommendations related to the protection or promotion of public policy objectives of title 39.

CONTEXT OF THIS ACR PROCEEDING

The Postal Service's FY 2007 ACR is the first ACR filed with this Commission and represents a period of transition. The Commission commends the Postal Service for undertaking to file this ACR. The breadth and scope of this transitional filing is a worthy effort. The ACR will provide the opportunity for all stakeholders to consider the type of substantive information that will be necessary, in the future, for Commission assessment of the Postal Service rates and services. The Postal Service filing will also assist the Commission in drafting regulations prescribing format and detailed filing requirements of future ACRs. In the near future, the Commission expects to issue proposed and, after opportunity for public comment, final regulations for ACRs to be applicable for the next ACR, the first full fiscal year after the passage of the PAEA.

During FY 2007, the Postal Service's rates and fees in effect were subject to change under the provisions of the Postal Reorganization Act (PRA). The data collecting and reporting in the ACR are based primarily on methodologies followed to support rate cases under the PRA. Consequently, the ACR includes Cost and Revenue Analysis (CRA) and the International Cost and Revenue Analysis (ICRA) formats used under the PRA. These analyses have not yet been modified to organize the data around the new "products" assigned to the market dominant and competitive services. The Postal Service anticipates the CRA and ICRA will correspond in the future to the new product listing. Some data presented in this ACR may not be provided in future ACRs. The Commission's rulemaking will determine the appropriate data and types of material to be provided in the future.

The service performance and customer satisfaction data provided in the ACR are limited. The requirements of 39 U.S.C. § 3691 pertaining to development and implementation of a complete set of service standards for market dominant products had not been implemented during FY 2007. Similarly, the customer satisfaction survey data was not designed for the PAEA. Service performance information has been provided for First-Class single piece and for Package Services mail.

COMMISSION EVALUATION BASED UPON PAEA POLICIES

The PAEA does not clearly indicate whether Congress expected the Commission to apply the rate setting standards of the PRA or the PAEA to the various rates charged during FY 2007, the first year to be subjected to annual compliance review. Section 3622(f) of the PAEA addresses the problem of making the transition from the former regulatory regime under the PRA to the new regulatory regime under the PAEA. It made the rate-changing mechanism of the PRA available to the Postal Service for one year after enactment of the PAEA, while the building blocks of the PAEA rate-cap rate adjustment mechanism were being assembled.

Section 3622(f), however, is silent on the issue of what rate setting standards should apply when the Commission determines whether the myriad rates that were actually charged during FY 2007 complied with applicable law. The Commission's duty is located in section 3653. It directs the Commission to review the rates and service that were experienced during the most recent historical year for compliance with "this chapter." Nothing in the PAEA suggests that "this chapter" refers to anything other than chapter 36 of the PAEA, since section 3653 is located in chapter 36 of the PAEA, and chapter 36 contains all of the rate setting procedures and most of the ratesetting standards of title 39.

Nevertheless, it is the position of the Postal Service and numerous other commenters that where section 3653 refers to "this chapter," the reference is to chapter 36 of the former law—the PRA. They infer that because section 3622(f) made the rate-changing mechanism of the PRA available for a year after the PAEA was adopted, Congress must have also intended that the Commission base its compliance determinations on chapter 36 of the PRA during the first year after the PAEA was adopted. (FY 2007 coincides largely, but not entirely, with the first year of experience under the PAEA).

The Commission prefers a more straightforward reading of section 3653. Where that section refers to compliance with "this chapter" it is likely that Congress meant what it said, and that the chapter to be applied is the one in which section 3653 is actually found—chapter 36 of the PAEA. Congress was aware of the possibility that the rate adjustment mechanism of the PAEA might not be available to the Postal Service in time to adjust any rates during the first full year of experience under the PAEA. It could have provided that rates charged during the first full year of experience under the PAEA should be reviewed for compliance with “chapter 36 of the Postal Reorganization Act,” but it did not.

This decision should not have far-reaching effects for a number of reasons. First, by the terms of the PAEA, Commission review of service performance is limited to those areas where service standards are in effect. For many of its products, the Postal Service did not have service standards and service measurement procedures in effect during FY 2007.

Second, with regard to rates, there is no controversy that the rates charged in FY 2007 were established under the PRA. They were intended to satisfy a similar, but nonetheless different combination of policies. Furthermore, under the PRA domestic rates were prospective, that is, they were designed to recover costs and reward worksharing savings achieved in a future fiscal year. The domestic rates in effect at the end of FY 2007 were actually designed with projected FY 2008 costs in mind. The Commission has reviewed FY 2007 data as the PAEA directs with these unique and non-recurring factors in mind.

Third, the Postal Service ACR was prepared without benefit of Commission rules keyed to evaluating the numerous standards established by the PAEA. The Commission appreciates the good faith effort of the Postal Service to provide useful available information to allow the Commission to fulfill its section 3653 obligations. In future years, when the Postal Service has the benefit of such rules, a more rigorous level of scrutiny will be more justifiable.

Finally, comments on this topic seemed particularly concerned lest the Commission take action under 39 U.S.C. § 3653(c) to correct some particular rate or rates to make them consistent with PAEA policies. This concern has been obviated by events. On February 11, 2008, the Postal Service filed market dominant product price adjustments with the Commission, and with one exception those new prices were found by the Commission to be consistent with PAEA policies in Order 66, issued March 17, 2008. On March 12, 2008, the Postal Service filed competitive products price adjustments with the Commission. In the normal course of events the Commission will respond to assure that rates for these products will be consistent with PAEA policies. To the extent rates during FY 2007 failed to meet the standards of PAEA policies, under the circumstances described above, sufficient remedial steps already have been undertaken.

INCORPORATING CHANGES IN ANALYTICAL METHODS

This docket provides a difficult context for evaluating changes in analytical methods by which the Postal Service estimates its costs, volume, and revenues. The Postal Service does not have experience producing annual cost, revenue, and volume figures so quickly after the close of the fiscal year. In addition, the Commission has not yet established the procedures that should be followed before changes in analytical methods are incorporated into the Postal Service's periodic reports. Without such guidance, it is difficult for the Postal Service to anticipate the protocol that the Commission will ultimately settle upon for vetting changes in analytical methods before they may be relied on in producing the standard periodic reports that will be required by the Commission.

The dilemma of deciding what changes in inputs and analytical methods should be embraced in the unusual context of the Postal Service's first annual compliance report is most pronounced with respect to Periodicals costs where the most far reaching changes have been employed. The public has had an opportunity to participate in two informal technical conferences on the issue of how best to model the costs of Periodicals. It has also had several weeks to comment on the vast amount of data and analyses that the Postal Service has submitted on Periodicals costs as well as all other aspects of postal operations and finances.

As the Postal Service and other commenters have pointed out, these opportunities would normally be sufficient to vet only simple, non-controversial changes in analytical methods. For this reason, in the Commission's view, those who would advocate introducing changes in analytical methods in the Postal Service's first annual compliance report bear the burden of persuasion. In this docket, the Commission follows a general policy that only changes that are reasonably balanced updates of input data, straightforward reflections of operational changes, or simple, non-controversial changes to analytical methods will be approved. The Commission will approve a change that does not meet this description only if it has been shown that making an asymmetrical update of input data, or changing an analytical method from that which prevailed in the most recent fully-litigated rate case (Docket No. R2006-1) is necessary to avoid a much greater distortion that would result from rejecting the update or change.

Several parties have argued that there needs to be an opportunity to vet nonperfunctory changes to input data and to analytical methods in a more thorough and deliberate procedure than has been available here before they are relied upon in the Postal Service's standard financial reporting to the Commission. NAPM Comments at 3-4, MMA Comments at 6, APWU Comments at 1, Valpak Comments at 36. The Commission is in complete agreement. In conjunction with future regulations articulating the Postal Service's periodic reporting duties, the Commission is preparing proposals for regulations that require changes to analytical methods that the Postal Service uses to produce its periodic reports to be publicly proposed and evaluated in informal rulemaking proceedings, well in advance of the filing of its annual compliance report. The Commission also envisions a process that begins with a systematic inventory of research areas in which data samples or collection systems need to be updated or improved, or analysis of the data needs an overhaul, followed by a series of informal rulemakings designed to address these areas in sequence, according to an agreed-upon timetable.

DESCRIPTION OF POSTAL SERVICE FILING

The Postal Service's December 28, 2007 ACR filing consists of a 34-page narrative, together with a substantial amount of detailed appended materials, both public and nonpublic, in formats similar to the library reference information previously provided in omnibus rate proceedings. The materials appended to the narrative consist of four distinct areas—the CRA report; the ICRA; intra-subclass cost analyses needed for workshare discount analysis; and billing determinants, including international mail, heretofore filed on an annual basis. The Postal Service explains it has included only a minimal number of new methodologies that differ from the Commission's methodologies used in Docket No. R2006-1 or, if applicable, data reported in FY 2006. ACR at 4. They are identified in the materials appended to the ACR and in the separate comprehensive roadmap document, library reference USPS-FY07-31, designed to assist in navigating the materials appended to the ACR. The required FY 2007 Comprehensive Statement was submitted on January 11, 2008.

The appended material includes 30 data compilations plus the above-mentioned roadmap. Library references USPS-07-1 through USPS-07-30. In addition there are 10 designated items in a nonpublic annex, including FY 2007 Competitive Product Billing Determinants, library reference USPS-FY07-NP1, and the remainder of the documents included provide international mail information.

A significant proportion of the ACR narrative is comprised of a list of market dominant products and an indication of where and how the categories of mail under the PRA "match" the products in order to decompose the costs for FY 2007 into the new product list. For many products, the CRA does not isolate the FY 2007 costs. For those products the Commission is unable to determine precisely whether their revenues recover their attributable costs. On the other hand, an estimation of product volumes and revenues for FY 2007 may be approximated using billing determinants.

One new methodology included in the ACR involves corrections and refinements to the Periodicals cost model used in Docket No. R2006-1. The Commission scheduled two technical conferences to facilitate understanding of the reasons for and nature of these changes. These open conferences were held on January 11, 2008, and January 23, 2008, and useful and informative dialogues took place.[1] The Postal Service filed correcting and explanatory comments and spreadsheets resulting from updating calculations with data from FY 2007. The Postal Service subsequently filed a notice of additional materials requested relating to the measurement of Periodicals cost avoidance and enhanced documentation to facilitate tracking of cost estimates.[2]

The Postal Service filed seven notices of revisions to its ACR with the final changes being submitted on March 20, 2008, only seven days before this report was due. Each of the notices details

[1] *See* Notice of Technical Conferences Supplementing Postal Service Annual Compliance Report, December 27, 2007.

revisions to the materials appended to the filing. The first errata involved the inclusion of SAS programs in library reference USPS-FY07, correction of minor errors in the Parcel Cost Models, library reference USPS-FY07-15, and a misclassification of Rest of World (ROW) Priority Mail costs in the nonpublic annex.[3] In the second errata, revisions to the non-automation presort letters volumes were noted and the addition of a negative sign corrected non-automation and nonmachinable additional costs from 31.90 cents and 53.412 cents to 7.78 cents and 24.964 cents for cards and letters, respectively, but did not impact the summary page. Also bundle probabilities were corrected and adjustments to bundle breakage rates and bundle handlings were made. Small errors in the Periodicals model were corrected.[4]

The third errata notice included small changes in previously revised workshare avoided costs. Minor errors were corrected and additional documentation was provided for First-Class Mail, library reference USPS-FY07-10 (revised January 18, 2008), and changes to Periodicals Outside County, Periodicals Bundle/ Container were made and a new Within County tab was added to library reference USPS-FY07-11 (rev. 1/18/08). Also, internal links were added to library reference USPS-FY07-4, and minor corrections for actual data errors were corrected in First-Class Mail Cards; Bound Printed Matter (an error in Presort Flats and Presort Parcels billing determinants that slightly overstated revenues); Special Services (small errors); and Periodicals (with minor corrections to formulas for Regular Rates and Nonprofit and Classroom).[5]

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[2] Notice of the United States Postal Service of Filing Additional Materials Requested at the January 23, 2008, Technical Conference on Periodicals Costs, January 28, 2008. The record also includes written summaries of the two technical conferences as well as three written comments from participants at the technical conferences.

[3] Notice of the United States Postal Service of Minor Revisions to Materials Accompanying its FY 2007 Annual Compliance Report—Errata (Items 7, 15, NP2, NP3, NP4, NP6, and NP7), January 16, 2008.

[4] Second Notice of the United States Postal Service of Minor Revisions to Materials Accompanying its FY 2007 Annual Compliance Report—Errata (Items 10, 11), January 18, 2008.

[5] Third Notice of the United States Postal Service of Minor Revisions to Materials Accompanying its FY 2007 Annual Compliance Report—Errata (Items 3, 4), January 22, 2008.

The fourth notice of errata updated the nonpublic international mail settlement calculations to reflect more recent Universal Postal Unit (UPU) Circulars and properly capture inbound rates associated with Inbound Surface Parcel Post. This impacted both outbound and inbound letterpost products and Inbound Surface Parcel Post.[6]

The fifth notice of errata conformed First Class Auto 5-digit CSBCS/Manual sites for letter and cards to the DPS percentages in library reference USPS-FY07-10, causing very minor changes in the unit delivery costs.[7]

The sixth notice of errata revised Cost Segment 14, Purchased Tranportation, to change library references USPS –FY07-32 and USPS-FY07-NP2 due to adjustments in FedEx contract general ledger accounts. Also, library reference USPS-FY07-NP14 was revised for changes in ICRA costs.[8]

The seventh notice of revisions to the compliance report involved revisions to the domestic CRA and associated material caused by revisions to Cost Segment 14 arising from adjustments to certain FedEx accounts in the general ledger as indicated in the sixth notice of revisions.[9] Specifically, the seventh notice involved revisions in four items: library reference USPS-FY07-1 (CRA); library reference USPS-FY07-2 (Costs Segments and Components); library reference USPS-FY07-5 (CRA Model); and library reference USPS-FY07-6 (CRA “B” Workpapers). The impact of shifting accrued FedEx costs from Night Turn to Day

[6] Fourth Notice of the United States Postal Service of Minor Revisions to Materials Accompanying its FY 2007 Annual Compliance Report—Errata (Item NP2), February 4, 2008.

[7] Fifth Notice of the United States Postal Service of Minor Revisions to Materials Accompanying its FY 2007 Annual Compliance Report—Errata (Item 19), March 12, 2008.

[8] Sixth Notice of the United States Postal Service of Revisions to Materials Accompanying its FY 2007 Annual Compliance Report – Errata (Items NP2 and NP14), March 17, 2008. *See also*, Notice of the United States Postal Service of Filing of USPS–FY07-32, March 17, 2008, noting non-trivial effects of the revision on at least one category of domestic mail.

[9] Seventh Notice of United States Postal Service of Revisions to Materials Accompanying its FY 2007 Annual Compliance Report – Errata (Items 1, 2, 5, and 6), March 20, 2008 (Seventh Notice of Errata).

Turn was to reduce Express Mail costs by $13 million and International Mail costs by $11 million and to increase First-Class Mail costs by $9 million and Priority Mail costs by $16 million.

PROCEDURAL HISTORY

Notice. The Postal Service's ACR was noticed on December 31, 2007, requesting comment on "the degree to which the Postal Service's operations and financial results comply with the policies of title 39."[10] By notice, pursuant to 39 U.S.C. § 3653, a public representative was appointed on January 8, 2008. Comments were due to be filed on January 30, 2008, and reply comments were due on February 13, 2008.

Commission Requests For Additional Information. The Commission submitted three sets of information requests to the Postal Servic[11]e. Technical conferences on matters relating to Periodicals, noted above, were held on January 11, 2008 and on January 23, 20[12]08. In addition, the staff has informally questioned the Postal Service to clarify ambiguities in the ACR. The Commission appreciates the Postal Service's responsiveness to the questions posed and information requested. The responses have been helpful in the Commission's evaluation.

However, responses to two questions posed January 25, 2008 were not received by the Commission until March 12, 2008, when the Postal Service filed library reference USPS-FY07-NP14. The delay in the responses has impeded the Commission's ability to promptly and satisfactorily resolve important issues related to International Mail. The first question relates to important information regarding International Customized Mail (ICM).[13] The Commission requested the FY 2007 revenue, pieces, weight, volume variable cost, and product specific cost for each ICM contract by accounting period, separated by product. The

[10] Notice of Filing of Annual Compliance Report by the Postal Service and Solicitation of Public Comment, December 31, 2007.

[11] Commission Information Request No. 1, January 25, 2008; Commission Information Request No. 2, February 1, 2008; and Commission Request No. 3, February 15, 2008.

[12] See Notice of Technical Conferences Supplementing Postal Service Annual Compliance Report, December 27, 2007.

[13] Commission Information Request No. 1, question 1, January 25, 2008.

Commission requested revisions showing revenue, cost, and volume data without including ICM data. Further, the Commission requested a description of the volume variable cost computation for each ICM contract, worksheets and any revised initiative data that exclude ICM data.

The second question requested a table summarizing FY 2007 International Mail Billing Determinants for Market Dominant and Competitive Products. *Id*., question No. 26. The table is to include for each mail category and special service: Volume, Postage Revenue, Fees, Total Revenue (Postage Revenue plus Fees), and Revenue per Piece (Total Revenue divided by Volume). The Postal Service was requested to provide the number of transactions and revenue for each international mailing fee listed in an attachment, and how they are distributed to mail categories separately from the rest of the fees. The Postal Service was also asked to add mail categories, special services, or mailing fees, or assign them to different groupings, if needed.

Chapter III—Summary of Public Comments

Comments and reply comments were received from 21 participants. (*See* Table III-1 at the conclusion of this chapter.) The comments cover a wide variety of issues, many of which involve matters of first impression concerning the Commission's procedures, the policies of the PAEA, and the application of those policies in evaluating this first Postal Service ACR. Several comments offer views of a general nature as to the impact of the procedures in this case upon the rate adjustment process, as well as upon future Postal Service ACRs.

Following is an evaluation of the comments that raise general issues such as the Commission's approach to evaluating the ACR, the lack of discussion in the ACR regarding costs and changes in costs, and the limited opportunity for discovery. Other comments are discussed in the appropriate context throughout this report. Those comments relate primarily to costs (including costs avoided), revenues, volumes, pricing (including workshare discounts), and competitive product issues.

Some comments express concern about information and explanations the Postal Service has not included in its ACR. Valpak requests that the Commission's future rules require sufficient information to be filed with the ACR to reduce the amount of information the Commission will need to seek from the Postal Service during review. Valpak Comments at 7. It points out that the ACR is devoid of any testimony or discussion of the costing results presented, with no comparisons with previous costs, no explanations of costs that appear out of line, and no information on changes in operations. *Id*. at 36. Valpak expresses concern about future rate increases if the Commission does not provide mailers with an opportunity to inquire into anomalies in reported Postal Service costs. *Id*. at 34-35. These comments will be considered in formulating proposed rules to govern the subsequent Postal Service reports.

The National Association of Presort Mailers (NAPM) raises the related concern that partial updates (of avoided costs) raise fairness and accuracy issues, particularly as the workpapers are just data summaries with pasted values. It fears that because of the overlap in the timing of ACRs and price adjustments, mailers may have no opportunity to weigh in on these issues. NAPM Comments at 3-4. MMA also notes that partial updating results in changed model outputs. It, too, fears there may be no opportunity to adequately explore the matter. MMA Comments at 6.[14] Therefore, MMA suggests that new methodologies and other changes should be subject to advance review in a separate forum between ACR filings. MMA Comments at 7. *See also* NAPM Comments at 4, APWU Comments at 3, and Postal Service Reply Comments at 8 and 15. The Commission will give that new procedural approach very close consideration during deliberations on the forthcoming ACR rules.

The Public Representative expresses concern about the lack of specific explanations to demonstrate that all products comply with applicable requirements. *See* 39 U.S.C. § 3652(a)(1). It contends that because 39 U.S.C. § 3622(c)(14) requires the modern system of regulation to factor in the policies of title 39, the ACR should include a discussion of the manner in which costs attributed and assigned to products comply with 39 U.S.C. § 101. Section 101(a) requires that costs not be apportioned to impair the overall value of service, and § 101(d) requires rates that "apportion the costs of all postal operations to all users of the mail on a fair and equitable basis." It notes that the ACR also lacks a narrative explaining how the rates and fees are reasonable and equitable as required by 39 U.S.C. § 404(b). Public Representative Comments at 3-4 and Valpak Reply Comments at 2. Further, it suggests the Postal Service should have described the steps it is taking to ensure

[14] Valpak suggests the Commission should consider allowing a period of discovery during the annual review. Valpak at 7. The 90-day time constraint of 39 U.S.C. § 3653 leaves little opportunity for discovery during the annual compliance review, although the Commission stands ready to moderate its current process if this proves to be necessary, such action should await the accumulation of experience to determine the extent and seriousness of this problem, and the sufficiency of alternative means of obtaining clarification of Postal Service data.

future compliance with the policies and provisions of the PAEA. *Id*. at 6. *See also* Valpak Reply Comments at 4.

The Postal Service agrees that 39 U.S.C. § 3652 provides for an explanation of why the market dominant products met polices and provisions of the PAEA, although it believes there is no need for a narrative explanation this year. Postal Service Reply Comments at 6-7.

The Commission appreciates the Postal Service's recognition of the benefits of such a narrative in future ACRs. As for the present requirement for a narrative, the unique transitional nature of this proceeding allows for omission of the requested discussion. The rates and fees in effect during FY 2007, and under review here, were recommended by the Commission in Docket Nos. R2005-1 and R2006-1. Those cases were conducted pursuant to the policies of the PRA including sections 101 and 3621. Section 101 of the PRA was not amended by the PAEA, and section 3621 of the PRA (repealed) contained the reasonable and equitable mandate reiterated in the current § 404. Therefore, the rates in effect during FY 2007, and under review here pursuant to the PAEA, were found to meet the policy standards referred to by the Public Representative. Furthermore, the Commission is familiar with the application of the statutory requirements that costs not be apportioned so as to impair the overall value of service, that costs be apportioned in a fair and equitable manner, and that rates and fees be reasonable and equitable. The Commission has been able to perform its review and to evaluate any specific violation of these standards presented by participants in this proceeding. Again, the prospective rules on Postal Service reports to the Commission should address this topic.

Several comments express the view that the rates established pursuant to the PRA are not subject to review in this proceeding. ANM-MPA Comments at 1-3, Pitney Bowes Comments at 2, NPPC Comments at 1-6 and GCA Reply Comments at 1. The National Postal Policy Council, Inc. (NPPC) and Major Mailers Association (MMA) posit that the lawfulness of the rates previously approved by the Commission in Docket Nos. R2005-1 and R2006-1 are not in question and should not be re-litigated. NPPC Comments at 3-6 and MMA Comments at 8.

The Commission agrees that existing rates should not be re-litigated. Nonetheless, the PAEA added many new and modified considerations for the Postal Service to consider in designing rates and operations. The Commission's findings are most useful as guides for future action. This review focuses upon the policies of the PAEA and providing guidance for the future. As suggested by the American Postal Workers Union, AFL-CIO (APWU), the Commission's findings should encourage improvements in future Postal Service rate design and service performance. APWU Comments at 3.

This first ACR is transitional and necessarily has not included information that will be available in the future after the product lists are matched to the CRA and other documentation.

It has been useful to identify data reporting needs and potential procedures for reviewing changes to established methodologies and analyses. Time Warner Comments at 29-30. The Commission will soon be proposing rules prescribing the information to be filed in future ACRs. The rules will foster simplifying and expediting the setting of postal rates, one of Congress's main motives in enacting the PAEA. *See* Order No. 43, ¶ 2025.

Comments to Annual Compliance Report, 2007

Commenter	Comment Citation	Citation Short Form
ANM-MPA Alliance of Nonprofit Mailers Magazine Publishers of America, Inc.	Comments of Alliance of Nonprofit Mailers and Magazine Publishers of America, Inc., January 30, 2008.	ANM-MPA Comments
ANM, et al. Alliance of Nonprofit Mailers American Business Media Dow Jones & Company, Inc. Magazine Publishers of America, Inc. The McGraw-Hill Companies, Inc. National Newspaper Association, Inc.	Reply Comments of Alliance of Nonprofit Mailers, American Business Media, Dow Jones & Company, Inc., Magazine Publishers of America, Inc., The McGraw-Hill Companies, Inc., and the National Newspaper Association, Inc., February 13, 2008.	ANM, et al. Comments

Comments to Annual Compliance Report , 2007 (cont'd)

Commenter	Comment Citation	Citation Short Form
ABM American Business Media	Supplemental Reply Comments of American Business Media, February 13, 2008.	ABM SupplementaComments
APWU American Postal Workers Union, AFL-CIO	Comments of the American Postal Workers Union, AFL-CIO on Postal Service Annual Compliance Report, January 31, 2008.	APWU Comments
DMA Direct Marketing Association, Inc. Parcel Shippers Association, Inc.	Comments of Direct Marketing Association, Inc. and Parcel Shippers Association, Inc. Pursuant to PRC Notice of Filing of Annual Compliance Report, January 30, 2008.	DMA Comments
GCA Greeting Card Association	Reply Comments of the Greeting Card Association, February 13, 2008.	GCA Comments
MMA Major Mailers Association	Initial Comments of Major Mailers Association, January 30, 2008.	MMA Comments
NAPM National Association of Presort Mailers	Initial Comments of the National Association of Presort Mailers on the 2007 Annual Compliance Report of the United States Postal Service, January 30, 2008.	NAPM Comments
NPPC National Postal Policy Council, Inc.	Comments of National Postal Policy Council, January 30, 2008.	NPPC Comments
Pitney Bowes Inc. Pitney Bowes	Initial Comments of Pitney Bowes Inc. in Response to Notice of Filing of Annual Compliance Report by the Postal Service and Solicitation of Public Comment, January 30, 2008.	Pitney Bowes Comments
	Reply Comments of Pitney Bowes Inc. in Response to Notice of Filing of Annual Compliance Report by the Postal Service and Solicitation of Public Comment, February 13, 2008.	Pitney Bowes Reply Comments

Comments to Annual Compliance Report , 2007 (cont'd)

Commenter	Comment Citation	Citation Short Form
Public Representative	Public Representative Initial Comments on FY 2007 Annual Compliance Report, January 30, 2008.	Public Representative Comments
	Public Representative Reply Comments on FY 2007 Annual Compliance Report, February 13, 2008.	Public Representative Reply Comments
	Reply Comments of Time Warner Inc. on FY 2007 Annual Compliance Report, February 13, 2008.	Time Warner Reply Comments
The *Nation* The Nation Company, L.P.	Comments of the Nation Magazine, L.P. Teresa Stack, President Pursuant to PRC Notice of Filing of Annual Compliance Report, January 31, 2008.	The *Nation* Comments
	Reply Comments of the Nation Company, L.P.	The *Nation* Reply Comments
Time Warner Time Warner Inc.	Initial Comments of Time Warner Inc. on FY 2007 Annual Compliance Report, January 30, 2008.	Time Warner Comments
	Reply Comments of Time Warner Inc. on FY 2007 Annual Compliance Report, February 13, 2008.	Time Warner Reply Comments
United Parcel Service	Reply Comments of United Parcel Service on the United States Postal Service's FY 2007 Annual Compliance Report, February 13, 2008.	United Parcel Service Comments
Postal Service United States Postal Service	Reply Comments of the United States Postal Service, February 13, 2008.	Postal Service Reply Comments
Valassis Valassis Direct Mail, Inc.*	Reply Comments of Valassis Direct Mail, Inc. Concerning the Postal Service's FY 2007 Annual Compliance Report, February 13, 2008.	Valassis Reply Comments
Valpak Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc.	Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. Initial Comments on the United States Postal Service FY 2007 Annual Compliance Report, January 30, 2008.	Valpak Comments

* Formerly knowns Advo, Inc. See Valassis Direct Mail, Inc. Notice of Name Change from Advo, Inc., February 13, 2008.

Chapter IV—Postal Service Financial Condition

SUMMARY OF COST AND REVENUE BY SUBCLASS

Table IV-A-1 is a version of the Appendix G, Schedule 1 table presented in the Commission's Opinion and Recommended Decision in previous rate cases under the Postal Reform Act (PRA) of 1970. It has been modified to show separately the Market Dominant classes and Competitive classes. However, the same information that has been historically shown in the Appendix G, Schedule 1 tables is retained.

Several results are problematic.

Periodicals Within County has a cost coverage, after fees, of 85.8 percent while Periodicals Outside County has a cost coverage of 82.9 percent. Total Periodicals has a cost coverage of 83.0 percent. A cost coverage below 100 percent indicates that revenues failed to cover attributable costs in FY 2007. In the case of Periodicals, the contribution to institutional costs as a class was a negative $448 million. New rates went into effect in the fourth quarter of FY 2007. If these rates had been in effect for the entire year then the contribution would have been higher. However, it is unlikely that a full year of new rates would have resulted in a positive contribution.[15] The recommended rates in R2006-1 did include a number of incentives designed to encourage efficiencies. While it is too early to assess the impact of these incentives, the Commission is hopeful that they will result in lower overall costs for Periodicals as a whole.

As a class, Package Services has a cost coverage of 102.3 percent and thus covers its attributable costs. However, Bound Printed Matter is the only product within the class that has a cost coverage above 100 percent. Media Mail has a cost coverage of 91.4 percent and Market Dominant Parcel Post has a cost

[15] The average increase for periodicals was 11 percent, which is not high enough to raise an 83 percent cost coverage to over 100 percent.

coverage of 98.7 percent. The Commission believes that this situation must be carefully monitored to avoid cross-subsidization among products.

Two competitive products fail to cover attributable costs. International Inbound Bulk Surface Parcels has a cost coverage of 90.1 percent and Parcel Return Service has a cost coverage of 97.7 percent.[16] The Postal Service will need to address these two products in order to conform to the requirements of the PAEA.

All other market dominant and competitive products cover attributable costs.

Table IV-A-1
Fiscal Year 2007 Volume, Cost, Revenue, and Cost Coverage by Class

	Volume (000)	Revenue ($ 000)	Attributable Cost ($ 000)	Contribution to Institutional Cost ($ 000)	Rev./Pc. (Cents)	Cost/Pc. (Cents)	Contribution to Institutional Cost/Pc. (Cents)	Cost Coverage
COMPETITIVE MAIL								
Priority Mail	896,865	5,233,793	4,059,098	1,174,696	583.566	452.588	130.978	128.9%
Express Mail	54,764	950,570	608,230	342,340	1,735.771	1,110.648	625.123	156.3%
Parcel Select 1/	237,297	475,346	426,104	49,242	200.317	179.566	20.751	111.6%
Parcel Return Service (PRS) 1/	11,032	31,380	32,135	(755)	284.440	291.281	(6.841)	97.7%
Competitive International Mail	430,958	1,217,812	997,465	220,347	282.582	231.453	51.130	122.1%
Total Competitive Mail	**1,630,916**	**7,908,902**	**6,123,032**	**1,785,870**	**484.936**	**375.435**	**109.501**	**129.2%**
MARKET DOMINANT MAIL								
First-Class Mail								
Letters	90,100,184	36,279,353	18,324,235	17,955,118	40.266	20.338	19.928	198.0%
Cards	5,797,959	1,281,904	791,920	489,984	22.110	13.659	8.451	161.9%
Periodicals								
Within County	736,458	73,423	85,556	(12,132)	9.970	11.617	(1.647)	85.8%
Outside County	8,059,373	2,114,512	2,550,327	(435,814)	26.237	31.644	(5.408)	82.9%
Standard Mail								
Regular	56,555,118	13,026,450						
Nonprofit	12,113,798	1,680,819						
Regular and Nonprofit	**68,668,917**	**14,707,268**	**9,964,963**	**4,742,306**	**21.418**	**14.512**	**6.906**	**147.6%**
Enhanced Carrier Route (ECR)	32,177,311	5,787,178						
Nonprofit ECR (NECR)	2,669,884	285,884						
ECR and NECR	**34,847,195**	**6,073,062**	**3,188,202**	**2,884,859**	**17.428**	**9.149**	**8.279**	**190.5%**
Package Services								
Parcel Post	100,299	701,422	710,732	(9,309)	699.334	708.615	(9.282)	98.7%
Bound Printed Matter	637,595	690,563	602,111	88,452	108.308	94.435	13.873	114.7%
Media Mail	164,088	378,567						
Library Rate	12,527	28,342						
Media and Library	**176,615**	**406,909**	**445,319**	**(38,410)**	**230.393**	**252.141**	**(21.748)**	**91.4%**
USPS Penalty Mail	1,008,380							
Free-for-the-Blind Mail	68,501		61,168	(61,168)		89.295		
Market Dominant International Mail	401,629	817,982	782,252	35,730	203.666	194.770	8.896	104.6%
Total Market Dominant Mail	**210,603,104**	**63,146,400**	**37,506,784**	**25,639,615**	**29.984**	**17.809**	**12.174**	**168.4%**
Total All Mail	**212,234,020**	**71,055,302**	**43,629,817**	**27,425,485**	**33.480**	**20.557**	**12.922**	**162.9%**
Special Services								
Registry	4,321	53,320	55,397	(2,077)	1,233.974	1,282.032	(48.058)	96.3%
Certified	280,226	698,219	508,749	189,471	249.163	181.549	67.614	137.2%
Insurance	57,005	156,685	129,331	27,354	274.863	226.877	47.985	121.2%
COD	1,407	9,563	6,514	3,049	679.908	463.106	216.801	146.8%
Money Orders	162,899	251,473	148,923	102,550	154.374	91.421	62.954	168.9%
Stamped Cards	106,164	2,123	1,320	804	2.000	1.243	0.757	160.9%
Stamped Envelopes	331,874	15,064	14,860	203	4.539	4.478	0.061	101.4%
Box/Caller Service	15,263	836,931	601,541	235,391	5,483.573	3,941.293	1,542.280	139.1%
Other Special Services		686,972	483,164	203,808				
Other Income		949,351		949,351				
Total Mail & Services	**212,234,020**	**74,715,005**	**45,579,615**	**29,135,390**	**35.204**	**21.476**	**13.728**	**163.9%**
Institutional Costs			31,577,171					
Escrow Funding Reconciliation			2,958,427					
Appropriations		63,075						
Investment Income		194,734						
Total Revenues		**74,972,813**						
Total Costs			**80,115,213**					
Net Income (Loss)		**(5,142,399)**						

1/ Attributable costs for Parcel Select and Parcel Return Service were calculated outside the CRA using a method proposed by the Postal Service in USPS-FY07-9
Source: PRC-ACR2007-LR1

[16] To the extent that there are carrier cost savings for parcel return service, the coverage may higher. However, the Postal Service did not provide these data.

FINANCIAL RESULTS

Much of the following discussion is developed from the FY 2007 Postal Service Annual Report at pages 21 through 31, and the FY 2007 Cost and Revenue Analysis Report submitted to the Commission in ACR FY 2007, which was filed on December 28, 2007. Other data come from the FY 2007 audited financial statements and other reports filed by the Postal Service with the Commission over the course of FY 2007.

Overall Financial Condition. The Postal Service incurred a net loss of $5.1 billion in FY 2007 based on revenues of almost $75 billion and expenses of $80.1 billion. The primary cause of such a large financial loss is the funding requirements of the Postal Service Retiree Health Benefits Fund (PSRHBF) established under the PAEA. The new law, which was enacted in the first quarter of FY 2007, established specific funding requirements for postal retiree health benefits. These included the establishment of the PSRHBF within the purview of the Office of Personnel Management (OPM).

The PAEA also eliminated two provisions of Public Law 108-18 by transferring back to the Treasury Department the portion of Civil Service Retirement System (CSRS) pensions attributable to postal employees' military service time. This eliminated the deficit in the CSRS, and OPM has estimated that those retirement obligations of the Postal Service are fully funded. With the Postal Service's CSRS obligation now fully funded, the PAEA eliminated the matching CSRS payment of 17.4 percent of basic compensation, saving approximately $1.3 billion. Eliminating the CSRS unfunded liability obviates the need for an interest and principal payment saving an additional $250 million. The PAEA also mandated that any surplus in the CSRS fund be transferred to the new PSRHBF fund. OPM estimated the surplus at $17 billion as of September 30, 2006, and these funds were transferred to the PSRHBF in FY 2007.

The PAEA also eliminated the escrow requirement that had been established by PL 108-18 in FY 2003 and mandated that the funds escrowed be placed into the PSRHBF. The Postal Service placed into the escrow $2.958 billion in FY 2006, and subsequently transferred the escrow requirement to the PSRHBF in FY 2007.

While the Postal Service recognized the escrow in the FY 2006 Cost and Revenue Analysis report, because there was no declared purpose for the funds at the time, Generally Accepted Accounting Principles would not allow the Postal Service to recognize these funds as an expense. The escrow in FY 2006 was treated as a restricted asset (cash) on the balance sheet. However, the enactment of P.L. 109-435 established a purpose for the restricted asset, and it was then recognized in the income statement as an expense.

Beginning in FY 2007 and over the next 10 years, the Postal Service is required to pay into the PSRHBF an annual amount ranging from $5.4 billion to $5.8 billion. The FY 2007 payment of $5.4 billion was paid into the PSRHBF at the end of the fiscal year.

The above actions mandated by the PAEA had a significant effect on the Postal Service's FY 2007 financial statements. Total expenses for the year increased over $6.7 billion, despite significant cost savings from increased productivity and workhour reductions, in addition to savings from the elimination of the CSRS matching payment. The Commission has restated the Postal Service's FY 2007 Income Statement to highlight the effects of PAEA in Table IV-B-1.

Table IV-B-1

USPS Income Statement
FY 2007
($ Millions)

	FY 2007	FY 2006	$ Variance	% Variance
Mail & Special Services Revenue	$ 74,715	$ 72,551	$ 2,164	3.0%
Appropriations	63	99	(36)	-36.3%
Investment Income	195	167	28	16.6%
Total Revenue	$ 74,973	$ 72,817	$ 2,155	3.0%
Expenses:				
Compensation & Benefits	$ 55,768	$ 54,896	$ 872	1.6%
Retiree Health Benefits	1,726	1,637	89	5.4%
Transportation	6,502	6,045	457	7.6%
Other Expenses	9,343	9,339	4	0.0%
Total Expenses before PAEA	$ 73,339	$ 71,917	$ 1,422	2.0%
Net Income prior to PAEA	$ 1,634	$ 900		
PAEA Changes:				
Expense FY 2006 Escrow	$ (2,958)			
FY 2007 PSRHBF Payment	(5,400)			
FY 2007 CSRS Savings	1,582			
Total Net PAEA Changes	$ (6,776)			
Net Loss After PAEA	$ (5,142)	$ 900		

Source: USPS Annual Report, FY 2007, Item 7, Management's discussion and analysis of financial condition and results of operations

Valpak Comments at 16-17 note that the operating deficit in FY 2007 indicates that the Postal Service is "… not in a long-run sustainable financial 'equilibrium' and that if continued will eventually be a significant liability to the federal government." Summarizing the FY 2007 CRA, Valpak states that before accounting for the FY 2006 escrow the Postal Service had an operating deficit of $2.184 billion and that this result represented a revenue shortfall of 2.9 percent. Furthermore, actual operating expenses for FY 2007 exceed the Commission's Docket No. R2006-1 estimated accrued expenses for FY 2008 by 0.5 percent, intimating that the CPI-capped rate increases expected to be implemented in May 2008, may not provide revenues sufficient to cover FY 2008 operating expenses.

Valpak's concerns regarding the large financial loss of the Postal Service in FY 2007 are legitimate, even though the reasons for the loss are readily apparent and have been known since the passage of the PAEA. The additional cost burden imposed by the funding requirements of the PSRHBF will continue into FY 2008.

The Postal Service, in its presentation of the FY 2008 Integrated Financial Plan (IFP) to the Board of Governors in September 2007, estimated that the PAEA would have a direct negative impact on net income of $1 billion compared to the assumptions used in Docket No. R2006-1. Yet, the bottom line estimate in the FY 2008 IFP is a net loss of only $600 million, which does not include any additional revenues from the proposed new rate increase. A different estimate of FY 2008 finances included in the FY 2009 Federal Budget projects the Postal Service will have a net income for FY 2008 of $160 million.[17] Whether this new estimate includes additional revenues from an additional rate adjustment is not known, but the Postal Service has filed with the Commission notices of rate adjustments under the new rules promulgated by the Commission in October 2007.

Whether the additional revenues provided by the new rates will be adequate will be determined in the future as there are many uncertainties for the remainder of FY 2008. The economy is in the midst of a significant slowdown and the Postal Service's mail volume is already feeling the cumulative effects of the housing

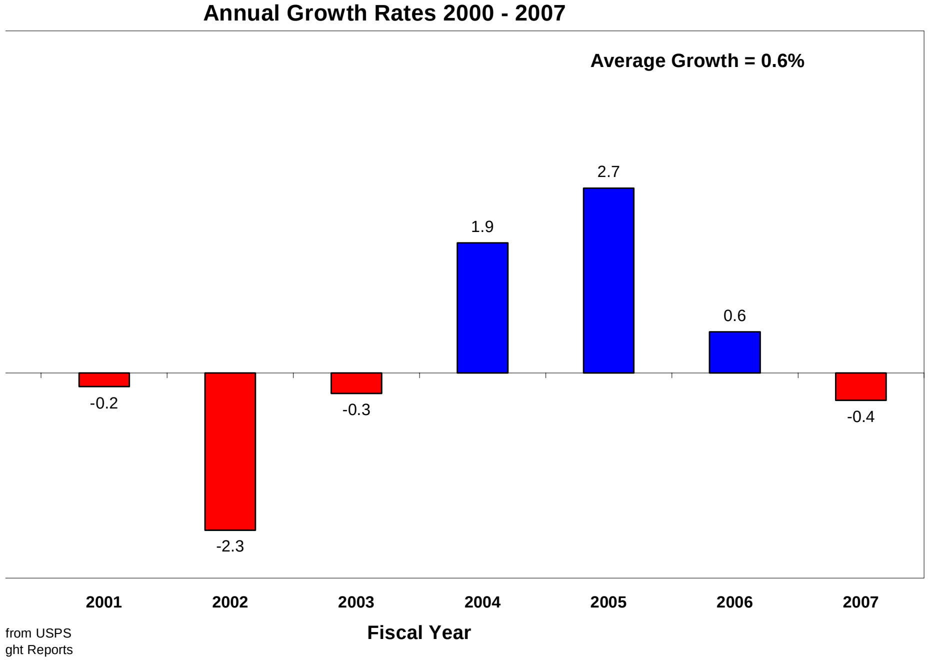
[17] U. S. Federal Budget for FY 2009, Appendix at 1219.

market downturn and problems in the financial industry. In the Postal Service's first Form 10-Q filing with the Commission for the first quarter of FY 2008, it notes that meeting revenue goals for the year will be challenging.[18]

Revenues and Volumes. Total revenue of $74.973 billion in FY 2007 was 3 percent better than in 2006, despite a decline in total volumes of 0.4 percent. This increase in revenue was due to the increase in rates from both Docket No. R2005-1 and Docket No. R2006-1.

Chart IV-B-1 depicts annual mail volume changes since FY 2000.

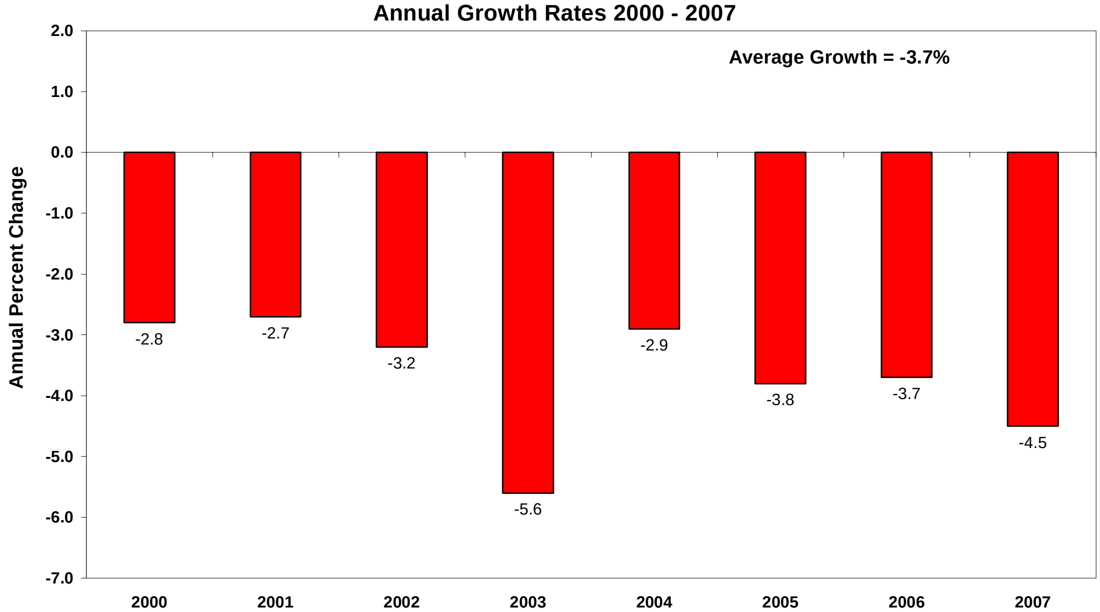
Chart IV-B-1
Total Mail Volume
Annual Growth Rates 2000 - 2007



[18] Quarterly Report 10-Q, Quarter 1, FY 2008 at 20, filed February 11, 2008.

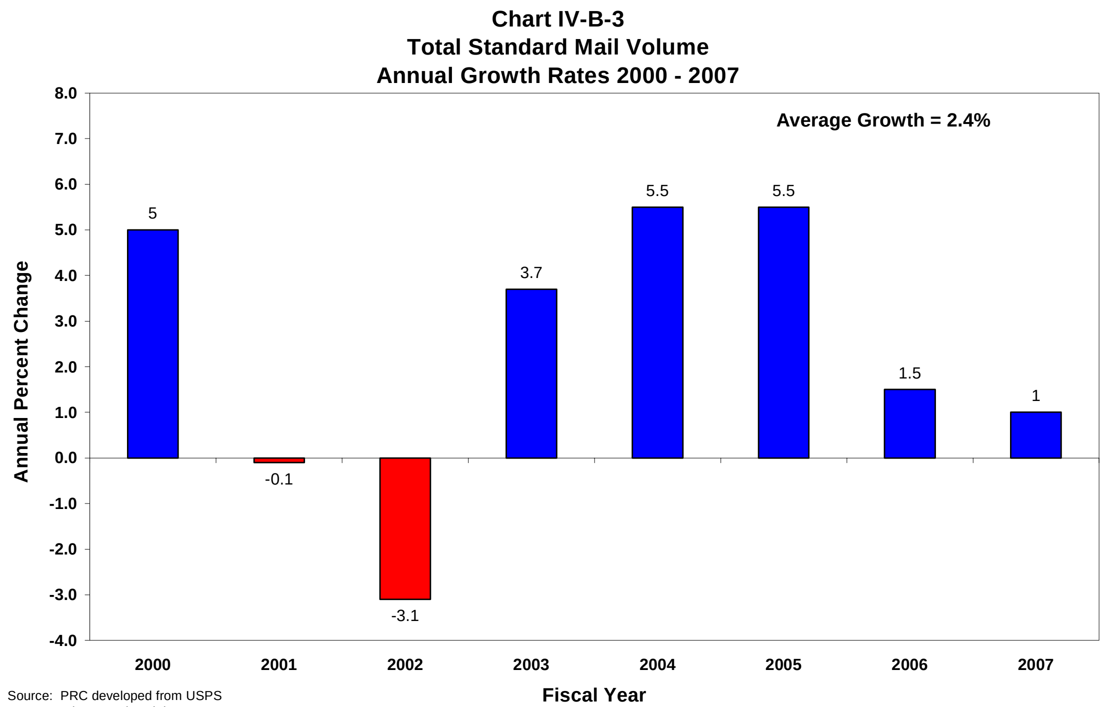
Chart IV-B-2 illustrates the continuing decline in First-Class single-piece mail volumes. Single-piece volumes dropped 4.5 percent and led to total First-Class volume decline of 1.6 percent during 2007, despite offsetting increases in presorted First-Class letters and cards. First-Class revenues benefited from the rate increases and increased 1.6 percent during 2007.

Chart IV-B-2
First-Class Single-Piece Volume
Annual Growth Rates 2000 - 2007



Source: PRC developed from USPS Revenue Pieces and Weight Reports

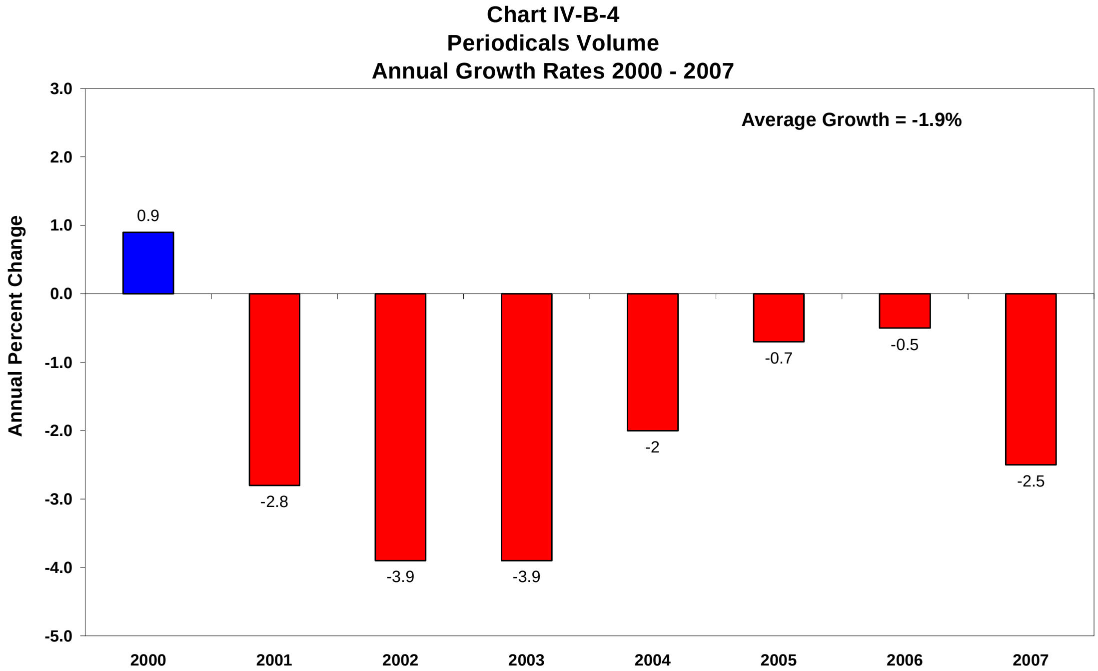
Standard mail volumes continued to increase, albeit at a much slower rate than in FY 2007, as shown on Chart IV-B-3. The increase of 1.0 percent occurred despite a decrease of 2.3 percent in Enhanced Carrier Route volumes. Standard Mail revenues, also benefiting from the effects of increased rates, increased 4.5 percent during 2007.



Source: PRC developed from USPS Revenue Pieces and Weight Reports

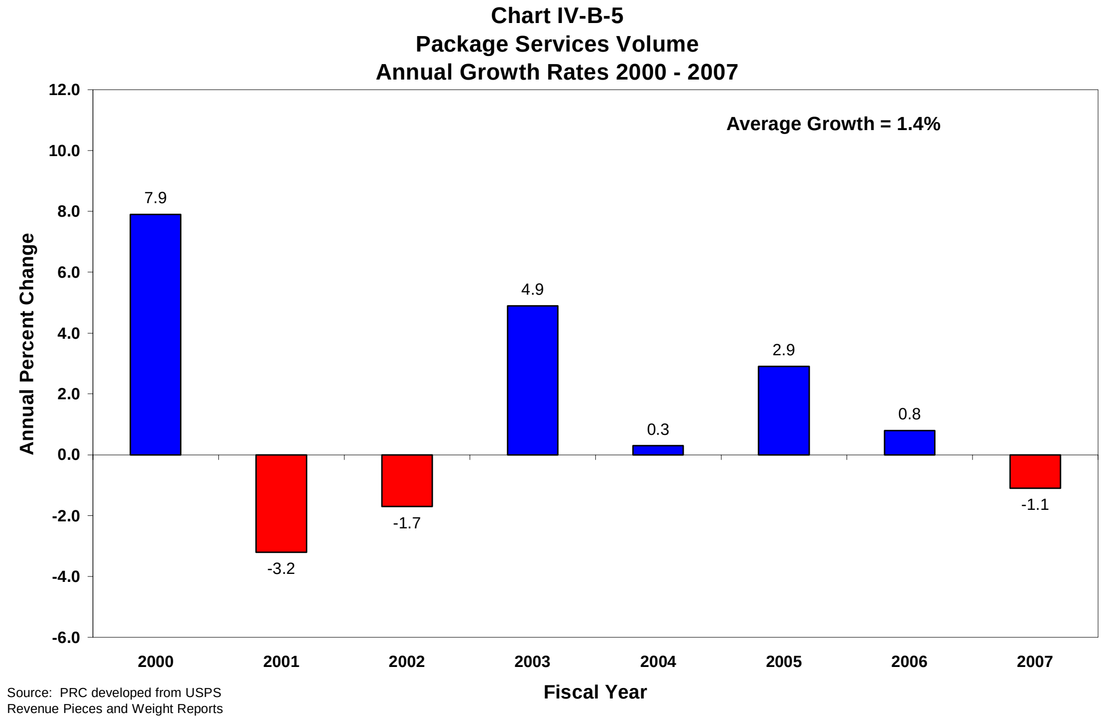
Priority and Express Mail revenues increased 3.2 percent and 3.5 percent respectively. Again, the effect of the rate increases benefited Priority and Express Mail even though their volumes declined, 3.2 percent for Priority Mail and 2.1 percent for Express Mail. These drops in volumes follow two consecutive years of volume increases.

Periodicals mail volumes continued to decline in FY 2007, falling 2.5 percent from 2006. *See* Chart IV-B-4. Revenues also declined 1.2 percent from 2006.



Source: PRC developed from USPS Revenue Pieces and Weight Reports

Package Services volumes dropped 1.1 percent from 2006 levels, as shown on Chart IV-B-5. Bound Printed Matter volumes increased, but not enough to offset reductions in volumes for Parcel Post and Media Mail.



International Mail volumes and revenues showed healthy growth in FY 2007, with volume increasing 5.0 percent over 2006 and revenues increasing 13.3 percent. The Postal Service attributes this healthy growth to the May 2007 simplification of the International mail product list as much as the rate increases that took effect in FY 2007. ACR at 23.

Expenses. The Postal Service's total expenses of $80.115 billion for FY 2007 were $8.198 billion, or 11.4 percent, greater than 2006. The primary cause of the significant increase in expenses was the employee and annuitant retirement financing requirements under the PAEA. Other major increases in expenses were for transportation and utilities, driven in part by increases in the price for fuel.

The Postal Service generally divides its expenses into six major categories: Compensation and Benefits, Retiree Health Benefits, Transportation, Supplies and Services, Depreciation and Amortization, and Other Expenses.

Appendix B of this report discusses cost attribution and distribution issues faced by the Commission in developing FY 2007 cost results.

Compensation and Benefits. Personnel compensation and benefits are the largest expense component of the Postal Service comprising about 70 percent of total expenses. During FY 2007, compensation and benefits expenses decreased $479 million primarily due to the effect of the PAEA and a reduction of workers compensation expenses. As noted earlier, the CSRS obligations of the USPS are now fully funded. This eliminates the need for the matching CSRS contribution, which was 17.4 percent of basic compensation, and the principal and interest payments on the now non-existent unfunded retirement obligations. The savings associated with these CSRS payments are $1.582 billion.

Workers Compensation expenses declined $399 million from 2006, a result of a decrease in claims and the adoption of new actuarial valuations and changes to inflation and discount rates used to estimate the total liability.

While total compensation and benefits costs decreased compared to 2006, there were some significant increases in components of the expenses. Total wages increased $1.118 billion, primarily driven by increases of $871 million in cost-of-living adjustment (COLA) costs. Additionally, the new labor contracts included general pay increases which contributed to the increased labor costs. These increases were mitigated by a reduction of 36 million workhours.

Retiree Health Benefits. Prior to the passage of PAEA the Postal Service recognized as an expense only the cost of its share of the premium payments paid annually for Postal Service annuitants health benefits. These costs amounted to $1.726 billion in FY 2007, a 5.4 percent increase over 2006.

With the passage of the PAEA, however, the method of funding and recognizing retirement health benefits changed significantly. As noted earlier, the Postal Service must now fund the future obligations for retiree health benefits through the OPM managed PSRHBF. The total obligation for retiree health benefits, as estimated by OPM, amounted to almost $81 billion as of the end of FY 2007. Under the PAEA these obligations are to be funded by the surplus funding of the CSRS obligations, transfer of the FY 2006 escrow obligation, and a specified schedule of payments over 10 years ranging from $5.4 to $5.8 billion. The Postal Service must continue paying separately its annual share of retiree health benefits premiums over the next ten years, after which the annual amount of the premiums will be paid out of the PSRHBF.

The Postal Service FY 2007income statement expansed FY 2006 escrow of $2.958 billion and the scheduled payment of $5.4 billion to the PSRHBF, adding $8.4 billion to the retiree health benefits expense.

Transportation. Total transportation expenses increased $457 million, or 7.6 percent, over 2006. This increase was driven largely by increases in air transportation of $219 million, highway transportation of $173 million, international air transportation and international terminal dues.

Most of the increase in air transportation was due to the increasing amount of mail transported by air during the peak mailing season and the increase in the Christmas network costs to improve service during the peak mailing season. During the non-peak season, the Postal Service transports more mail by highway, leading to an increase in costs for highway transportation. Fuel cost increases also drove expenses for transportation higher in FY 2007.

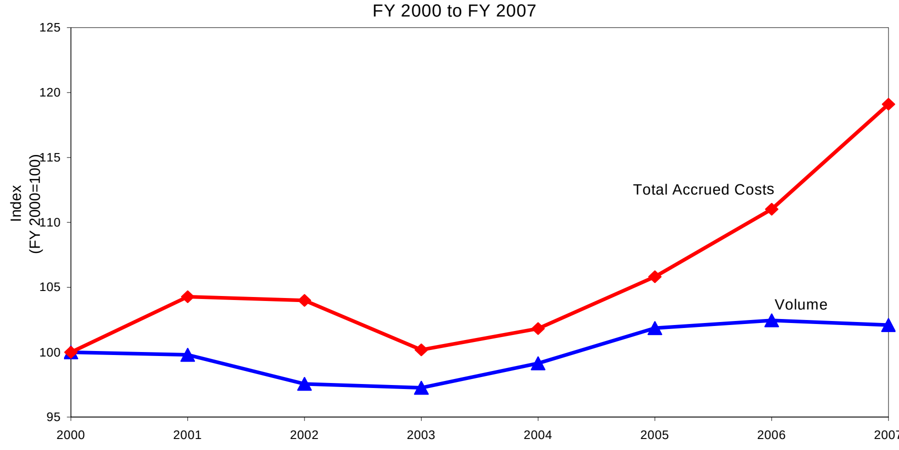
Total other expenses in FY 2007 remained almost equal to other expenses for 2006. Increases in vehicle maintenance and utilities due to higher fuel costs were mitigated by decreases in supplies and services, rents, IT and communications. Depreciation costs increased slightly over 2006 as more postal operating equipment and equipment enhancements came on line.

Chapter V—Postal Service Strategic Goals

The Commission is required to include in this report a review of the Performance Plan and the Program Performance Report prepared by the Postal Service pursuant to 39 U.S.C. §§ 2803 and 2804; and to evaluate whether the Postal Service has met its goals. The Postal Service provided this documentation in the 2007 Comprehensive Statement at 51-53. The Commission also reviewed the Postal Service's *Strategic Transformation Plan 2006-2010* and the 2007 Update to gain a better understanding of the Postal Service's goals.

The Postal Service faces many challenges in the years to come. First-Class single piece volume, long the mainstay of the Postal Service's business model, continues to decline. Chart V-1 shows the trend in total mail volume and accrued expenses since FY 2000. It can be seen that volume in FY 2007 was slightly higher than in FY 2000 while expenses have grown substantially. Under the PAEA, the Postal Service must now limit its rate increases on a class level to CPI. To remain viable, the Postal Service must reduce its operating expenses and generate revenue from additional sources.

Chart V-1
Trends in Total Volume and Accrued Costs
FY 2000 to FY 2007



In its Performance Plan, the Postal Service identifies four primary strategic goals, each supported by several measures of advancement toward those goals. Comprehensive Statement at 53. The four goals are:

- Generate Revenue;
- Increase Efficiency;
- Customer-Focused Culture; and
- Improve Service.

Table V-1 provides a summary of the Postal Service's progress toward those goals.

Table V-1

Postal Service Goal	Met Goal?
Generate Revenue	Marginally
Increase Efficiency	Yes
Customer-Focused Culture	Unknown
Improve Service	Yes

GENERATE REVENUE

In the Strategic Transformation Plan 2007 Update, the Postal Service outlines seven approaches it will take to grow revenue: (1) improve the value of mailing service; (2) tailor shipping services to market requirements; (3) create recipient-based products and services; (4) build on domestic strengths to grow international business; (5) streamline acceptance for commercial mailers; (6) make online services a key competency; and (7) strengthen customer outreach.

Improve the Value of Mailing Service. Currently, First-Class and Standard Mail represents 94 percent of all mail volume and 83 percent of postal revenues. *Id*. at 2. Even though there are alternatives to First-Class Mail such as online bill payments and direct debits, the Postal Service will continue building customer relationships while conveying the benefits of hard copy mail in regards to its security and reliability.

When expounding on the benefits of mail reliability, the Commission recommends that the Postal Service consider mailers' expectations on the number of days-to-delivery and the reliability of those standards as it formulates the performance goals which are due to be published in June 2008.

The Postal Service plans to promote Standard Mail as a method for mailers to promote their products. "Market research has shown that those receiving mailpieces typically buy more items and consequently, spend more money. In fact, a revenue lift of 163 percent was reported for Web sites supported by catalogs as opposed to those that were not." *Id*. at 3. To ensure mailpieces reach their intended audience, the Postal Service plans on working with the direct mail industry to improve the quality of mail and their mailing lists.

At present, the complexity of Standard Mail preparation deters many potential mailers from using Standard Mail. "With a simplified Standard Mail option, more mailers could benefit from the targeted value that direct mail offers for acquiring and retaining customers." *Id*. Therefore, in FY 2008, the Postal Service plans to conduct market research to determine which Standard Mail features and prices attract the most advertising dollars, in order to better target mailers needs.

The Postal Service plans on developing new mailing opportunities that integrate mail and marketing opportunities. For example, recently mail has been used to vote by mail and to rent games and movies. The Postal Service will investigate more means of capitalizing on the complementary nature of ordering merchandise online and having the Postal Service deliver it.

The Postal Service believes that under the PAEA it has more opportunities to add new and experimental services to allow for more rapid product testing and introduction. The Postal Service plans to explore "strategic alliances to encourage innovation and identify new applications." *Id*. While the PAEA may facilitate rapid product testing and the addition of new experimental services, the Commission recommends that the Postal Service continue to exercise caution when contemplating the rapid introduction of experimental services to minimize product failures and subsequent financial losses. Setting new product hurdle rates with regard to return on investments may facilitate the implementation of realistic opportunities, diminish losses, and result in financial gains.

Currently, approximately 200 postal customers are using the Intelligent Mail Barcode (IMB), and by May 2009, all mailers must use the IMB to receive automation discounts. The benefit of the

IMB is the ability to track mail as it moves through the postal mailstream. The Postal Service indicates that it is developing new products based upon the Intelligent Mail infrastructure. *Id*. at 4.

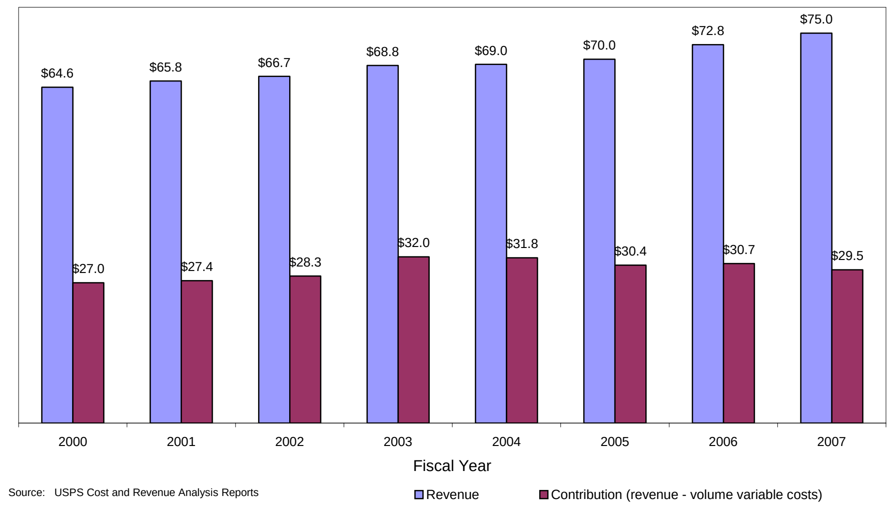
The Postal Service may offer a First-Class Mail service for businesses that omits the automatic forwarding and return service. The advantage for businesses is “a lower priced First-Class Mail offering … [that] may offer advertisers a better value for specific campaigns or targeted customers.” *Id*. at 5.

Tailor Shipping Services to Market Requirements. To better serve customer needs, the Postal Service expects that it must enhance shipping operations and pricing to meet customer needs. The Postal Service plans to design new shipping services that take advantage of its first and last mile competency. Id. at 5. The Postal Service plans to introduce more shape-based pricing to reflect shape-based costing. Consequently, the Postal Service anticipates revising its product structure to align costs, pricing, and customer incentives in an effort to increase revenue and expand market share. The Postal Service realizes customers expect payment options and terms. Therefore, the Postal Service will explore invoicing and credit alternatives when revenue growth outweighs the cost of providing and managing credit payment options. *Id*. at 6.

While ensuring that pricing proposals cover costs and make a contribution to institutional costs, new sales skills and marketing tools will be developed to enable the sales force to respond quickly to customer requests for pricing proposals.

The Commission is encouraged by the Postal Service’s views regarding meeting more of its clients’ needs, while maintaining a pricing structure that ensures cost coverage, in addition to making a contribution to institutional costs. Chart V-A-1 shows the growth in revenue and the contribution to institutional costs postal products made from FY 2000 to FY 2007. While there has been a slow but steady increase in revenue ($64.6 billion in FY 2000 to $75.0 billion in FY 2007), the contribution to institutional costs has been declining since FY 2003 ($32 billion in FY 2003 to $29.5 billion in FY 2007).

Chart V-A-1
Revenue and Contribution
FY 2000 to FY 2007



Create Recipient-Based Products and Services. Approximately 73 percent of all mail destinates in households. Consequently, the Postal Service anticipates developing new household shipping services to accommodate customer needs. For example, the Postal Service is considering the expansion of Premium Forwarding Service (PFS) to allow for more than one mail forwarding shipment each week and/or the possibility of upgrading the weekly shipment to Express Mail. *Id*. at 6. Also, a temporary PFS international option could provide customer convenience for those individuals traveling overseas. Another opportunity to increase revenues is the development of more relationships with retailers so that they offer the Postal Service as an option for delivering purchases to individual homes.

Package Return Services are expected to grow as the Postal Service plans on taking advantage of the 20 percent return rate for merchandise ordered online. Allowing customers to return packages through the Postal Service offers household mailers the convenience of giving the package to the local carrier or taking it to the nearest post office. *Id*. at 7.

Product malfunctions, recalls, and the shipment of items for repair offers further opportunities for the Postal Service to expand its service options. Given current environmental concerns, the Postal Service is investigating the possibility of expanding its package services to handle recycling and disposal of used products such as ink and toner cartridges, cell phones, compact fluorescent light bulbs, consumer electronics, and pharmaceuticals. *Id*.

Build on Domestic Strengths to Grow International Business. In FY 2007, the Postal Service redesigned its international product line. Eight products were reduced to four thereby eliminating product redundancy and reducing customer confusion. Now, international products are linked to their domestic counterparts, and the Postal Service intends to use its domestic strengths to grow international revenues.

Streamline Acceptance for Commercial Mailers. The Postal Service will continue its efforts to streamline postage payments, documentation, and verification of commercial mail entered through the business mail entry system. Service performance will be enhanced by creating an infrastructure that allows mailers to send their manifests electronically. The Postal Service can capture scans of containers, trays, and mailpieces with Intelligent Mail Barcodes throughout the mailstream and determine service performance by mailer and by mailing.

Make Online Service a Key Competency. The Postal Service will update *www.usps.com* with more convenient features and services in an effort to remain competitive in the growing electronic environment. The Postal Service partnered with eBay for postal shipping services and due to that partnership success, the Postal Service will seek additional partnerships to ensure that e-commerce sites offer the Postal Service as a method of shipment.

Given the growth and dependence of the public on online services, the Commission believes that the Postal Service is correct in seeking additional e-commerce partnerships and updating its online services to be more user friendly.

Strengthen Customer Outreach. The entire postal workforce will be tasked with growing business through the use of new tools, training, and teamwork. Small business markets will be handled by the Customer Connect and Business Connect programs, which encourage carriers, postmasters, and station and branch managers to promote the convenience and value of postal services. The cooperative efforts of employees and employee organizations are expected to boost revenue generation particularly from small business mailers.

Additional Business Development teams will be formed for local sales initiatives and to conduct face-to-face meetings and seminars with businesses to help them understand the value and convenience of U.S. mail.

Approximately three-quarters of total postal revenues are generated by high-volume commercial customers. *Id*. at 11. Consequently, the Postal Service sales force will continue to work closely with both the mailer and the service providers to match postal solutions with corporate business objectives.

With the advent of the Intelligent Mail Barcode, the Postal Service sales force will work with mail owners and service providers to improve mail identification and tracking and to foster the flow of information between the Postal Service and its clients.

Finally, the Postal Service and its customers benefit from collaborations through local organizations such as the Postal Customer Councils, and national groups like the Mailers' Technical Advisory Committee. The Postal Service plans to promote greater participation, new structures and programs to ensure that participants get the most value for their investment in mail. *Id*. at 12.

INCREASE EFFICIENCY

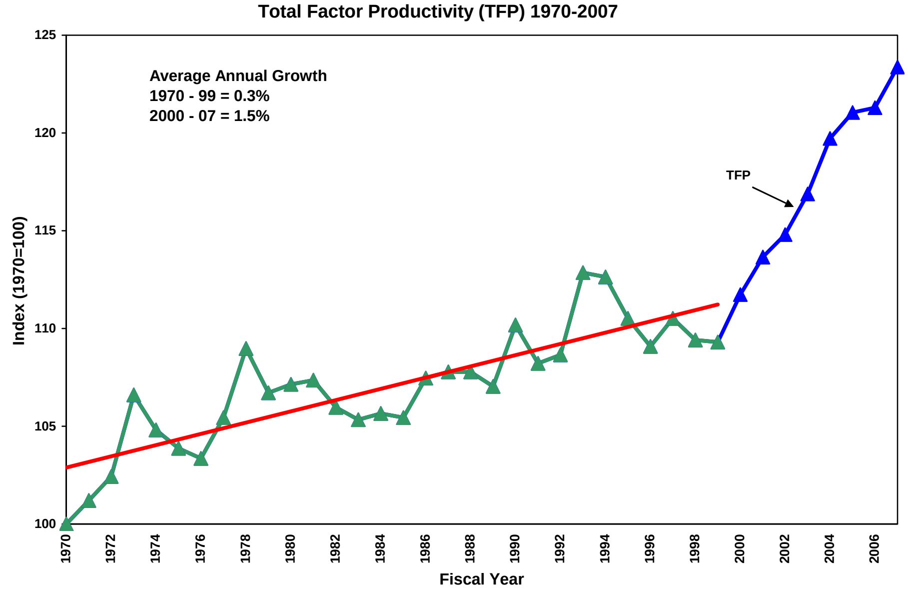
The Postal Service uses a multifactor productivity measurement known as Total Factor Productivity (TFP) to measure postal efficiency. TFP measures the changes in selected outputs per unit of inputs and is expressed as an annual percentage. The Postal Service stresses that due to lag factors such as efficiencies gained through capital investments, TFP is best judged over a longer period of time. As such, the Postal Service frequently references cumulative TFP gains.

In chapter 5 of the Postal Service's Comprehensive Statement of Postal Operations, the Postal Service notes that TFP measures productivity while distinguishing controllable factors from those, such as the price of fuel or the volume of mail, that are largely externally driven. *Id*. at 53.

In the 2007 Comprehensive Statement on Postal Operations, the Postal Service states it planned to increase TFP by 1 percent for FY 2007; however, it actually achieved 1.7 percent. This is credited largely to a reduction of 36 million workhours – a $1.2 billion cost savings. *Id*. at 28. For FY 2008, the TFP goal again is 1 percent. *Id*. at 53. The Strategic Transformation Plan sets a goal of saving $1 billion each year. *Id*.

As illustrated in Chart V-B-1, the increase in TFP continues an impressive trend that began in FY 2000.

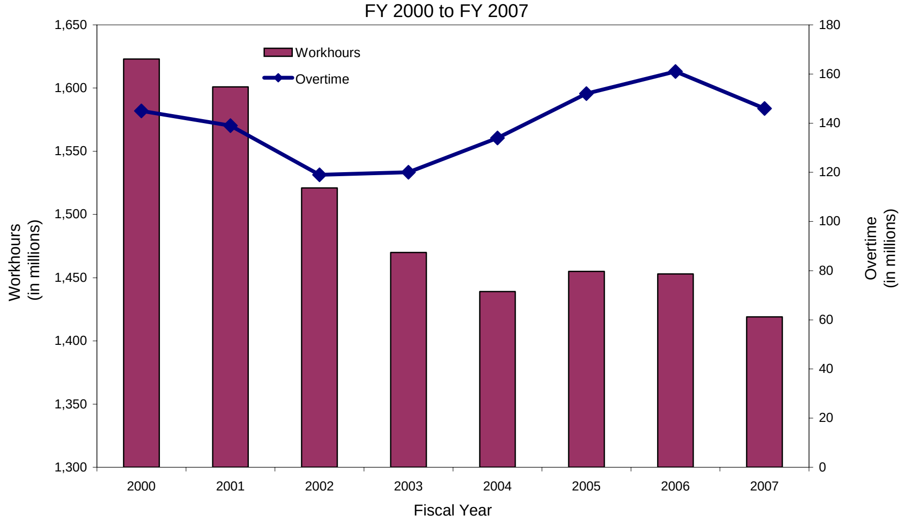
Chart V-B-1
U.S. Postal Service
Total Factor Productivity (TFP) 1970-2007



Source PRC developed

The Postal Service has been successful in lowering total workhours as shown in Chart V-B-2. However, overtime hours have increased slightly during the same period. Overtime hours in FY 2000 were 145 million, peaking in FY 2006 to 161 million and then declining to 146 million in FY 2007.

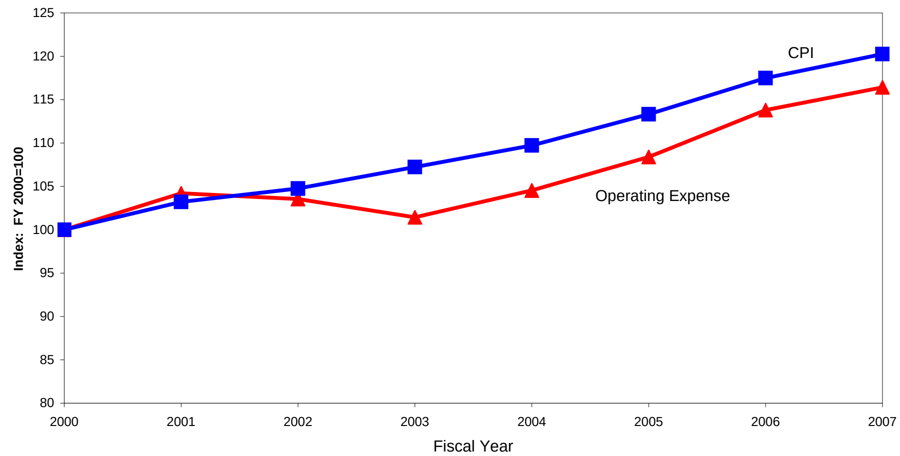
Chart V-B-2
Total Workhours
FY 2000 to FY 2007



Source: USPS National Payroll Hour Summary Reports.

As shown in Chart V-B-3, the Postal Service has managed to keep increases in total operating expenses below the rate of inflation since FY 2002. The task will become more difficult over the next few years due to the funding requirements for the retiree health benefit costs.

Chart V-B-3
Operating Expense and Consumer Price Index
FY 2000 to FY 2007



Source: USPS Cost and Revenue Analysis Reports and Bureau of Labor Statistics.

CUSTOMER-FOCUSED CULTURE

The Postal Service will continue to create a more "customer-focused culture—employees with the right skills and behaviors for today's customer-centric environment." Strategic Transformation Plan 2007 Update at 43. The Postal Service recognizes that in order to meet customer needs, the Postal Service must continue to train, offer leadership opportunities, and reward the valued performance of its employees. *Id*. The future of the Postal Service is dependent on its employees being "committed stakeholders with a mutual and vested interest in fulfilling the Postal mission and vision." *Id.* at 45. Currently, postal employees are "engaged with postal customers through Customer Connect and Business Connect." *Id.* The programs allow employees to become involved in the growth of the business, workplace safety, and security.

Under the customer-focused culture, the Postal Service reports three forms of evaluation: (1) Voice of the Employee (VOE); (2) Safety Performance; and (3) Equal Employment Opportunity (EEO). These reports provide important information on employee satisfaction. However, as can be seen from the descriptions of these reports, they provide little information on whether employee behavior reflects a customer focus, or on what steps the Postal Service may be taking to identify and incent such behavior.

Voice of the Employee. On a quarterly basis, the Postal Service surveys approximately one-fourth of its career employees. The survey, known as the VOE survey, consists of six questions that measure the employee's perception of recognition, accountability, harassment, discrimination, supervisory communications, and treatment (referring to dignity and respect). The Postal Service plans to update the survey in FY 2008 to include measurements on entrepreneurship, innovation, customer focus, and employee engagement. Comprehensive Statement at 53. The survey methodology and a description of how the VOE Index is used by postal management is not described. Therefore, it is difficult to draw conclusions regarding the efficacy and utility of the VOE Index.

Safety Performance. The FY 2007 planned safety performance goal for Occupational safety and Health Administration's (OSHA) illness and injury rate was 5.5 per 100 full-time employees. *Id.* The Postal Service met its plan.

Equal Employment Opportunity. The PAEA requires the Postal Service to begin tracking the number of EEO complaints it receives. Prior to the PAEA, the Postal Service did not specify a target for formal EEO investigations per 100 full-time employees. Instead, the goal was expressed as one of "continuous improvement." The per capita rate of EEO investigations has slowly declined. Throughout FY 2007, the Postal Service provided EEO training to its supervisors stressing the importance of open communications and resolving complaints at the lowest level of management possible.

SERVICE IMPROVEMENT

The Postal Service has identified Service Improvement as an important goal for FY 2007. Toward that end, the Service measures the percentage of domestic First-Class single-piece letters delivered on-time. Separate scores are presented for mail designated with an overnight, 2-day, or 3-day delivery standard. The 2007 Comprehensive Statement on Postal Operations, at page 51, reports the following:

Table V-D-1
Percentage of First-Class Mail On-Time

	FY 2007 Plan	FY 2007 Actual	FY 2008 Plan
Overnight	95	95.6	96
2-Day	91	92.6	92.75
3-Day	90	90.4	90.5

For FY 2007, the First-Class on-time performance exceeded the plan. The plan for FY 2008 is to build on this achievement and provide still better performance. The practice of gradually raising and then meeting goals is an appropriate way to improve service and increase customer satisfaction.

In a separate section of this report, chapter VI, the Commission reviews progress toward extending service goals and performance measurement to all classes and services. This important step should become a performance goal in future years.

ADDITIONAL GOALS

The Strategic Transformation Plan 2007 Update included two additional strategic goals the Postal Service will address: enhanced sustainability, and regulatory studies and reporting obligations.

Enhance Sustainability. The Postal Service defines sustainability as the ability to meet present needs without compromising the future. To date, the Postal Service has measured its success via the awards it has received. For example, for the eighth year, the Postal Service won the Environmental Protection Agency's highest award – "WasteWise Partner of the Year." The Postal Service plans on focusing future efforts in two areas: (1) expanding environmentally-friendly business practices, and (2) accelerating energy conservation. Strategic Transformation Plan 2007 Update, at 49.

Expanding Environmentally-Friendly Business Practices. In its 2007 Environmental Impact of Mail study, the Postal Service found that advertising mail has a net benefit to the environment by encouraging people to shop from home which reduces travel time, fuel usage, and the resulting automobile pollutants. In 2007, the Postal Service reinstated a former "Greening of the Mail Task

Force" which consists of industry groups, suppliers, and regulators. The goal is to improve mailpiece design and addressing. An additional goal is to improve the quality of mailing lists and expand recycling and waste disposal of mail-related products and report the impact on the economy and society. *Id*.

Accelerating Energy Conservation. The Postal Service delivers to 148 million addresses and approximately 2 million more delivery points are added annually. *Id*. at 52. The Postal Service is committed to reducing the miles driven while maintaining service to each address. Computer modeling is being used to create more efficient routes and thus use less fuel, and mail processing improvements are expected to facilitate the reduction of the number of vehicles on the road.

Currently, the Postal Service has a fleet of 36,000 E85 flux-fuel vehicles and is working with the Department of Energy's National Renewable Energy Laboratory and Clean Cities Programs to determine where the best places are for using the E85 vehicles. *Id*. at 52-53.

The Postal Service has partnered with General Motors to determine the applicability of using fuel cell vehicles for mail delivery. The partnership is generating information on several issues, one of which is the infrastructure needed to support hydrogen-fueled vehicles. Information gleaned from the partnership may provide multiple benefits for the nation regarding fuel efficiency, energy dependence, and emissions reduction. *Id*. at 53.

Comprehensive energy audits are being conducted in postal plants and facilities and the Postal Service is developing an energy management system to quickly identify areas needing repairs and modifications. In facility design and alterations, the Postal Service is using concepts that are intended to be more energy efficient and have less of an impact on the environment. *Id*. at 54.

The Commission commends the Postal Service's attention to energy conservation and the environment.

Regulatory Studies and Reporting Obligations. Over the next 10 years, the Postal Service will be required to adjust financial practices and prepare several studies as part of PAEA.

Compliance With the Sarbanes-Oxley Act of 2002. Compliance involves "identify[ing], assess[ing] and report[ing] on internal controls affecting financial reporting." *Id*. at 57. The Postal Service will follow best practices and guidance as published by the Public Company Accounting Oversight Board (PCAOB) and the Securities and Exchange Commission. PAEA requires the Postal Service to achieve compliance by 2010.

Annual Reporting. PAEA requires the Postal Service to prepare and file several new reports regarding postal operations, including: (1) the Annual Compliance Report; (2) SEC-Formatted Financial Reports; (3) Competitive Products Fund; and (4) Financial Firewall and Competitive Products Fund. Table V-E-1 identifies each required annual report and its purpose.

Table V-E-1

Annual Reports	Purpose
Annual Compliance Report	Provided to the Postal Regulatory Commission (PRC) to present analysis of costs, revenue, pricing, and quality of service for all products. For market dominant products, the report presents measures of customer satisfaction, and information about discounts and market tests.
SEC-Formatted Financial Reports	Provided to the PRC to present detailed financial information: quarterly (10-Q format), yearly (10-K format), and significant financial events (8-K format).
Competitive Products Fund	Provided to both the U.S. Treasury and the PRC to account for withdrawals from revolving Competitive Products Fund to pay costs attributable to competitive products and all other costs incurred by Postal Service.
Financial Firewall and Competitive Products Fund	Provided to the U.S. Treasury, the PRC, and the Office of Inspector General (OIG) to show separation of financial accounting between competitive and market dominant products.

Source: Strategic Transformation Plan 2007 Update at 58.

Additional Reports and Studies. PAEA requires the Postal Service and various agencies to prepare additional reports with designated timelines. While most of the reports have a December

2007 timeframe, the entire list of reports, their purpose and the due dates are shown in Table V-F-2.

Additionally, the PAEA requires the Postal Service to prepare and/or consult on several additional studies. Work on several of these topics was ongoing in 2007.

Chapter VI—Service Standard Performance

SPEED OF DELIVERY

39 U.S.C. § 3652(a)(2)(B) requires the Postal Service to provide information on the quality of service provided each market dominant product, including the speed and reliability of delivery, and the degree of customer satisfaction provided.

The Postal Service's ACR2007 filing provides limited information from its existing service performance measurement systems. The Postal Service is currently developing, in consultation with the Commission, systems for measuring the performance of all market dominant products. The existing measurement systems are: (1) the External First-Class Measurement System (EXFC) for Single-Piece First-Class Mail; (2) the International Mail Measurement System (IMMS) for Single-Piece First-Class International Mail; and (3) the Delivery Confirmation service for retail Package Services.

EXFC measures delivery performance from the collection box to mailbox. The system is managed by an independent contractor, and uses test mailpieces sent to a nationwide panel of receivers[19]. In FY 2007, the Postal Service's on-time performance for Single-Piece First-Class overnight delivery areas was 95.6 percent. Two-day and three-day on-time delivery performances were 92.6 and 90.4 percent, respectively. *Id*. at 14-15.

Results in 2007 exclude ZIP Code areas 700 and 701 due to the suspension of testing there following Hurricane Katrina. *Id*. at 17, n.1. The results in 2007 also exclude the period December 2–29, 2006, because those dates involve heavy holiday mail volumes. The 2007 First-Class performance results without the exclusionary periods are: 95.6 percent (overnight), 92.4 percent (2-day), and 89.6 percent (3-day). Response to CIR No. 3, question 1. The

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[19] The ZIP Code areas are selected on the basis of geographic and volume density. By 2009, the Postal Service plans to expand the sampled ZIP Code areas to virtually all 3-digit areas. ACR at 15.

Commission finds that future annual compliance reports should provide annual performance results without exclusionary periods.

The IMMS measures performance based on domestic transit times. Outbound International Mail is measured from the collection box to the designated U.S. International Mail processing center. Areas measured conform to the areas tested in EXFC. The transit time measured for Inbound International Mail begins when the mailpiece arrives at the international processing center and ends when the mailpiece is delivered. For FY 2007, the IMMS Single-Piece First-Class international on-time service performance for letters, cards, and flats was 91.4 percent.

Delivery Confirmation is used to measure on-time delivery performance for retail package services. When retail clerks receive parcels with the Ancillary Delivery Confirmation Service, they scan the Delivery Confirmation barcode at a point-of-service terminal or with an intelligent mail handheld scanning device to “start-the-clock.” At the delivery point, the barcode is scanned again to “stop-the-clock.” For FY 2007, the actual on-time retail Package Service performance was 57.7 percent. ACR at 17.

In its initial comments, Valpak indicates its belief that the Postal Service is making a good faith effort to comply with 39 U.S.C. § 3653(b)(2). However, Valpak states that a 57.7 percent on-time performance level is unacceptable. Further, Valpak notes that no mention has been made regarding the service provided to the remaining 42.3 percent (also known as the “tail of the mail”). *Id*. at 12. Valpak opines that more in-depth information regarding the disposition of the tail of the mail is important and should be reported. *Id*. at 13. Valpak recommends that performance measurements should provide year-to-year comparisons, thereby allowing evaluation of the improvement or degradation in service performance.

NPPC states that mailers are concerned about the impact of the price cap on the quality of postal services and whether the Postal Service will require additional uncompensated mail preparation and worksharing activities from mailers to help it achieve its goals. NPPC posits that “cost-of-service regulation” for a price cap regulated firm provides the firm with an incentive to reduce its quality of service in an effort to reduce costs and increase profits. NPPC Reply Comments at 2-3. NPPC recognizes that the

Commission has stated it will defer consideration of any adjustment to the price cap to reflect service performance until after the promulgation of rules for the collection of service performance data. *Id*. at 3. *See* Order No. 26, ¶ 2068.

Although the Postal Service is working to develop more complete service performance measurement systems, the implementation date for these new systems is somewhat uncertain. In the interim, the Commission is concerned about the level of service performance detail provided for each of the market dominant products.

The Postal Service should provide days-to-delivery data on tail of the mail in its filings. Data reflecting days-to-delivery until 99 percent delivery is achieved would be extremely useful. Tail of the mail is a substantial concern of the Commission due to its disproportionate effect on perceived service quality. It is also an important measure of service consistency. In future annual compliance reports, the Postal Service also should provide year-to-year performance comparisons, and include narrative information regarding any new initiatives to improve service performance.

CUSTOMER SATISFACTION

The Postal Service is required to measure the level of customer satisfaction with the service provided by each market dominant product. However, the FY 2007 year-to-date data collected through the Postal Service's Customer Satisfaction Measurement System were not designed to meet the requirements of 39 U.S.C. § 3652(a)(2)(B)(ii). Consequently, the Postal Service plans on redesigning its surveys so that the data better reflect the needs of the PAEA. ACR at 19.

Currently, the Postal Service relies on two surveys when evaluating customer satisfaction. One survey evaluates small business satisfaction on a quarterly basis. Small businesses with 1 to 19 employees are surveyed about Parcel Post and Media Mail services. Businesses base their responses on actual experience. For 2007, the rating, which is the sum of the excellent, very good, and good responses, was 91 percent.

The second survey measures the satisfaction of large business accounts—those with 500 or more employees. The independent external measurement survey consists of questions addressing client satisfaction with both retail and delivery services. In addition, the survey provides the Postal Service with information regarding how it measures up to its competitors' performance. *Id*. at 18.

The combined excellent, very good, and good responses reflecting FY 2007 year-to-date large business ratings, are: (1) First-Class Mail – 96 percent; (2) Standard Mail – 91 percent; and (3) Periodical mail – 85 percent.

The Commission is aware of the limited scope of the Customer Satisfaction Measurement System and withholds conclusions until the Postal Service redesign is complete. The Postal Service is advised to include a copy of each questionnaire or measurement instrument as a library reference in the next and subsequent annual compliance report filings. This will facilitate evaluation of whether the Postal Service is meeting the needs of its customers. Additionally, the Commission anticipates that the Postal Service will survey households, in addition to small and large businesses, so that all mailers are given the opportunity to evaluate Postal Service performance.

Chapter VII—Market Dominant Classes

INTRODUCTION

For each class of mail, the Commission presents its analysis of the financial results and rate design. The financial analysis focuses on cost coverage and pricing issues, including whether the class and its products or subclasses generate adequate revenue to cover attributable costs.[20] The analysis of each class also contains a discussion of rate design issues. Methodological issues affecting the development of estimates of worksharing related cost avoidances are addressed, the resulting cost avoidances are compared with the corresponding discounts, and the discounts and other rate relationships are analyzed. Rate design and worksharing issues relevant to several classes are discussed below, followed by the analysis of each class.

Several commenters address issues related to evaluating the consistency of rates with the worksharing limitations of the PAEA that are not specific to any class. The comments address three main topics: (1) updating inputs to the cost avoidance models; (2) the temporal mismatch between the discounts at the end of the fiscal year and the cost avoidances based on the full fiscal year; and (3) a suggestion that estimated cost avoidances from an annual compliance report should be adjusted for inflation when used in a notice of rate adjustment.

The Postal Service updated several inputs in the worksharing cost avoidance models, including mail characteristics and volumes, MODS productivities, and some (but not all) read/accept rates. Other inputs, including downflow densities, are not updated from those used in Docket No. R2006-1. Pitney Bowes, NAPM and MMA are critical of the approach, which Pitney Bowes contends "has denigrated the accuracy of the models [.]" Pitney Bowes Comments at 7; *see also* NAPM Comments at 3-4 and MMA Comments at 6.

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[20] The Postal Service's data systems have not yet been reconfigured to report financial data by product. In many cases, it is not possible to perform the analysis of products.

In response to these criticisms, the Postal Service points out that practical considerations make it unrealistic to expect that all of the inputs can be simultaneously updated, and that preventing the use of updated data because updates for all other relevant data are not available "would make the perfect the enemy of the good." Postal Service Reply Comments at 10-11. The Public Representative agrees with the Postal Service, concluding that the argument against partial updating "is really a demand for no upgrading, ever." Public Representative Reply Comments at 4.

The Commission uses the updated inputs in its analysis of worksharing cost avoidances. As a general matter, the estimates of costs for a given year will be more accurate if all inputs reflect, as nearly as practicable, the year in question. The Commission intends to propose rules that will require inputs to be updated with some minimum level of frequency.[21] However, preventing the update of *any* input because it is not possible to update *every* input simultaneously would be more likely to reduce the accuracy of the cost estimates than to improve the accuracy.

In response to Commission Information Request No. 1, question 14, the Postal Service provided one additional updated accept rate (for the MLOCR-ISS operation) which is incorporated into the models.[22] *See* response to CIR No. 1, question 14. The Postal Service also stated that it considers the actual FY 2007 MODS productivities for ATHS operations to be reliable. Response to CIR No. 1, February 1, 2008, question 17. Therefore, the Commission uses the actual productivities for these operations in place of the proxies used in the Postal Service's filing.[23]

Pitney Bowes and Direct Marketing Association, Inc. (DMA)/Parcel Shippers Association (PSA) point out the Postal Service's filing compares discounts that were in effect for only part of the year

[21] A further discussion of the Commission's plans for developing rules governing the Postal Service's ACR filing appears in the section on Background.

[22] Response of the United States Postal Service to Questions 8, 9, 11, 14, 15, 22, and 24 of Commission Information Request No. 1, February 11, 2008.

[23] The Postal Service developed proxies based on non-ATHS AFSM 100 productivities. This was the approach used by the Commission in Docket No. R2006-1 because the ATHS equipment had not been fully deployed in the base year, and therefore reliable actual productivities were not available.

(post-Docket No. R2006-1 implementation) with cost avoidances that reflect the full fiscal year. They argue in favor of comparing the weighted average discounts over the full fiscal year to the avoided cost estimates. Pitney Bowes Comments at 3-4 and DMA-PSA Comments at 2-3. The Postal Service responds that an exact temporal alignment of discounts and costs are not required, and that the comparison with the discounts at the end of the year serves the intent of highlighting discounts that are, or may be getting, out of line with costs. Postal Service Reply Comments at 21.

The Commission agrees that the year-end discounts are the more relevant discounts to be evaluated in the ACR. If a discount is found to be inconsistent with the requirements of the PAEA and corrective action were to be ordered, the year-end discounts would have to be modified. In addition to providing a backward-looking review of the results of the past year, the ACR is intended to provide some degree of forward-looking guidance. Focusing on the (as nearly as practicable) current state of affairs helps to ensure that the report will be useful in this regard. However, in some situations, a comparison of avoided costs with weighted average discounts might provide relevant information.

Pitney Bowes and DMA-PSA also discuss the use of cost avoidance estimates from the ACR to design worksharing discounts in the Notice of Rate Adjustment. They urge the Postal Service to inflate the cost avoidances by the rate of inflation to adjust for cost level changes in the intervening time between the basis of the ACR and the period when the new rates will be in effect. Pitney Bowes Comments at 5 and DMA and PSA Comments at 5. The Public Representative opposes this argument. Public Representative Reply Comments at 3.

The Commission does not endorse the suggestion that estimated cost avoidances from the ACR be adjusted exclusively for inflation in the subsequent Notice of Rate Adjustment. It has not been demonstrated that a simple inflating of the cost avoidances would accurately approximate the combination of changes that affect actual cost avoidances from one year to the next. In Docket No. R94-1, the Commission rejected a similar proposal by the Postal Service. PRC Op. R94-1, ¶ 5304.

The rates for market dominant mail are discussed in the following sections. Each class includes a discussion of a financial analysis, methodological issues raised by commenters, and the findings on worksharing discounts and other rate design issues.

FIRST-CLASS MAIL

Financial Analysis. The table below presents selected First-Class Mail financial data. First-Class Mail rates recovered 196.6 percent of attributable costs in FY 2007. Financial data were not yet aligned with the new product designations, so it is not possible at this time to perform analysis of the pricing relationships within the class by product. The discussion of International First-Class Mail appears in the section on International Mail.

Table VII-B-1
First-Class Mail
Fiscal Year 2007 Volume, Revenue, Cost, Contribution, and Cost coverage

	Volume (000)	Revenue ($ 000)	Attributable Costs ($ 000)	Contribution to Institutional Costs ($ 000)	Rev./Pc. (Cents)	Cost/Pc. (Cents)	Contribution to Institutional Costs/Pc. (Cents)	Cost Coverage
MARKET DOMINANT MAIL								
First-Class Mail:								
Single-Piece Letters, Flats & Parcels	40,121,742	19,773,536	12,417,026	7,356,511	49.284	30.948	18.335	159.2%
Workshared Letters, Flats & Parcels	49,978,441	16,505,817	5,907,210	10,598,607	33.026	11.820	21.206	279.4%
Total Letters, Flats & Parcels	**90,100,184**	**36,279,353**	**18,324,235**	**17,955,118**	**40.266**	**20.338**	**19.928**	**198.0%**
Single-Piece Cards	2,141,669	556,971	508,093	48,878	26.006	23.724	2.282	109.6%
Workshared Cards	3,656,291	724,933	283,827	441,106	19.827	7.763	12.064	255.4%
Total Cards	**5,797,959**	**1,281,904**	**791,920**	**489,984**	**22.110**	**13.659**	**8.451**	**161.9%**
Total First Class	**95,898,143**	**37,561,257**	**19,116,155**	**18,445,102**	**39.168**	**19.934**	**19.234**	**196.5%**

Source: PRC-ACR2007-LR1

Several commenters address the relative contributions to institutional costs of single-piece and workshared letters. NAPM asserts that the higher unit contribution of First-Class presort letters, as compared with single-piece letters, "demonstrates that First-Class Mail presort letters, as a group are contributing more than their fair share of the costs of the Postal Service." NAPM Comments at 4. NPPC makes a similar argument, and further asserts that the difference in unit contribution cannot be justified based on elasticity differences, because the elasticities are "virtually identical [.]" NPPC Comments at 6-7.

GCA responds that there is no basis to assume that ECP pricing principles, which lead to a preference for equal unit contributions, continue to apply now that the Postal Service has classified single-piece and presort letters as separate products. It goes on to argue that the elasticities provided by the Postal Service reflect an analysis of the demand when the two were not separate products, and are therefore inappropriate to use for future pricing decisions. GCA also asserts that the relative price-elasticities are not as important as how the demand for each "is affected by the increasing competition from nonpostal alternatives." GCA Reply Comments at 2-6.

At this time it is premature to comment extensively on these issues. The unit contributions in question combine data from several different products, and the demand differences between the recently designated products has yet to be evaluated.

Worksharing and Rate Design.

Methodology. MMA raises several objections to the cost avoidance methodology adopted by the Commission in Docket No. R2006-1 and used in this report. Specifically, it objects to the use of a single CRA adjustment factor for automation and nonautomation presort letters, and to the use of modeled DPS percentages to estimate in-office delivery cost differences between rate categories. MMA Comments at 10-17.

The Postal Service points out that MMA made very similar arguments in Docket No. R2006-1, and that the Commission did not accept the alternatives proposed by MMA. It argues that the comparisons MMA draws between various types of mail are not valid, and that the arguments about DPS seem to be "largely a results-driven criticism" that should not be accepted in the Compliance Report. Postal Service Reply Comments at 12-13.

While the Commission has taken notice of some apparently anomalous aspects of the letter cost avoidance models identified by MMA and others,[24] it did not accept the solutions proposed by MMA in Docket No. R2006-1, which are reprised here. Prior to Docket No. R2006-1, the Commission used separate CRA adjustment factors for automation and nonautomation presort letters because the models used two separate CRA cost inputs for automation and nonautomation presort letters.

Over time, the use of two CRA costs (and adjustment factors) led to increasingly counterintuitive results, including estimates of

[24] *See*, *for example*, PRC Op. R2005-1, ¶ 6027.

negative cost avoidance for nonautomation presort letters. In Docket No. R2005-1, the Postal Service explained that it attributed the problem to difficulty in distinguishing nonautomation and automation letters in the IOCS sampling process. *See* PRC Op. R2005-1, ¶¶ 6018-6024. The solution it proposed, which the Commission ultimately accepted in Docket No. R2006-1, was to develop worksharing cost avoidance estimates from a single presort letter CRA cost. This decision led directly to the use of a single CRA adjustment factor.

MMA's proposed alternative was not accepted by the Commission in the last rate case because of flaws enumerated in the Postal Service's Docket No. R2006-1 reply brief, including flawed assumptions about the cost similarities of Bulk Metered Mail (BMM), metered letters, and non-automation presort letters. The Commission also found the Postal Service's criticism of MMA's proposed delivery cost adjustment convincing, including the observation that MMA's unit delivery cost estimates did not reconcile with total delivery costs. This Compliance Report is not the appropriate forum to revisit these methodological decisions. The section on Background contains a discussion of the Commission's intentions regarding the development of rules to address potential methodological changes.

In its presentation of worksharing passthroughs, the Postal Service, taking its cue from the language of 39 U.S.C. 3652(b) which calls for the provision of worksharing data "with respect to each market-dominant product[,]" does not present an analysis of passthroughs for inter-product worksharing discounts. For First-Class Mail, this means that the cost avoidances for automation mixed AADC letters and non-automation presort letters, both of which were compared to a BMM benchmark in the past, are not presented. ACR at 20-22.

In the case of non-automation presort letters, the Postal Service submits an analysis of the cost and rate differences between non-automation letters and an automation mixed AADC letter benchmark. The method of estimating the additional cost of non-automation is different from most of the other worksharing analysis, in that the costs are adjusted to reflect differences in the mix of presort levels, and delivery cost differences are excluded.

DMA and PSA support the intra-product approach, as does Pitney Bowes, which asserts that products are "analogous to separate 'subclasses' under the prior nomenclature." Pitney Bowes Comments at 8, DMA/PSA Comments at 2. In its response to NPPC's arguments in favor of equal unit contributions, GCA also suggests that separate products are equivalent to separate subclasses. GCA Reply Comments at 4. NAPM argues that incremental passthroughs are not the proper approach, and that 3-digit presort should be the starting point for the analysis. NAPM Comments at 2.

APWU argues in favor of maintaining BMM as the cost benchmark for workshared First-Class letters, calling the Postal Service's presentation "inconsistent with the Commission's Docket No. R2006-1 decision[.]" APWU Comments at 2-3. The Postal Service points out that it did provide the information necessary to perform the "linked" passthrough analysis used by the Commission, but reiterates its interpretation of section 3652(b) as suggesting that the proper analysis is done on an intra-product basis. Postal Service Reply Comments at 19-20.

For this report, the Commission is using the same analytical framework for evaluating worksharing discounts as it used to design the worksharing discounts in Docket No. R2006-1. Therefore the passthroughs for each presort level are based on a comparison with the next-least workshared rate category including automation mixed AADC and non-automation presort, each of which is compared to the BMM benchmark. The Commission also presents the comparison of non-automation presort letters to automation mixed AADC letters calculated using the methodology used by the Postal Service.

A decision to change the framework used for measuring worksharing cost avoidance should await a more complete airing of the pros and cons of the alternatives. The logic of restricting worksharing analysis to intra-subclass rates does not necessarily translate directly into restricting analysis to intra-product rates. Whereas subclasses under the PRA were defined as having distinct cost *and* demand characteristics, products are defined in the PAEA as having distinct cost *or* demand characteristics. Whether or not a rate differential is a worksharing discount may depend, in part, on whether the categories in question have substantially similar demand characteristics.[25]

Findings. The results of the Commission's analysis of First-Class worksharing discounts are presented in Table VII-B-2 (Letters, Flats, and Parcels) and VII-B-3 (Cards).

Table VII-B-2
First-Class Mail Letters, Flats and Sealed Parcels
Workshare Discounts and Benchmarks

Type of Worksharing (Benchmark)	ACR 2007 Year-End Discount (cents)	ACR 2007 Unit Cost Avoidance (cents)	ACR 2007 Pass-through
First-Class Mail Automation Letters			
Barcoding & Presorting			
Automation Mixed AADC Letters (Bulk Metered Mail (BMM) Letters)	5.0	5.0	100.3%
Automation AADC Letters (Automation Mixed AADC Letters)	1.9	1.8	103.1%
Automation 3-digit Letters (Automation AADC Letters)	0.7	0.5	147.4%
Automation 5-digit Letters (Automation 3-digit Letters)	2.2	2.2	101.1%
First-Class Mail Automation Flats			
Barcoding & Presorting			
Automation ADC Flats (Automation Mixed ADC Flats)	11.9	13.8	86.0%
Automation 3-digit Flats (Automation ADC Flats)	8.3	9.6	86.8%
Automation 5-digit Flats (Automation 3-digit Flats)	10.1	11.9	85.0%
First-Class Mail Presorted/Business Parcels			
Barcoding & Presorting			
Presort ADC Parcels (Presort Mixed ADC Parcels placeholder)	16.4	50.9	32.2%
Presort 3-digit Parcels (Presort ADC Parcels)	5.4	19.4	27.9%
Presort 5-digit Parcels (Presort 3-digit Parcels)	13.3	47.1	28.2%
First-Class Mail Nonautomation Letters & Flats			
Presorting [1]			
Nonautomation Presort Letters (Bulk Metered Mail (BMM) Letters)	3.7	5.5	66.8%
Nonautomation Presort Letters (Automation Mixed AADC Letters)	1.3	2.2	59.7%
Qualified Business Reply Mail			
Barcoding			
QBRM [2] (Handwritten Reply Mail)	3.0	2.5	122.2%

Source: PRC-ACR2007-LR3.

Notes
Where discounts are equal to unit avoided costs, the calculated passthroughs may deviate from 100% because passthrough percentages are based on unrounded unit avoidable costs.

[1] USPS treats Nonautomation Presort Letters price and cost differentials as surcharges over Automation Mixed AADC letters.

[2] The QBRM cost avoidance presented here is estimated using the USPS methodology. The Commission found in R2006-1 that this underestimated avoided costs, but that the alternative on the record overestimated avoided costs.

[25] For example, a Standard ECR Basic letter is more finely sorted than a Standard Regular 5-digit automation letter, but the rate distinction between these categories reflects more than a worksharing cost avoidance.

Table VII-B-3
First-Class Mail Cards
Workshare Discounts and Benchmarks

Type of Worksharing (Benchmark)	ACR 2007 Year-End Discount (cents)	Unit Cost Avoidance (cents)	Pass-through
First-Class Mail Automation Cards			
Barcoding & Presorting			
Automation Mixed AADC Cards (Nonautomation Presort Cards)	**2.1**	**2.5**	84.0%
Automation AADC Cards (Automation Mixed AADC Cards)	**1.2**	**1.0**	120.0%
Automation 3-digit Cards (Automation AADC Cards)	**0.4**	**0.3**	133.3%
Automation 5-digit Cards (Automation 3-digit Cards)	**1.3**	**1.2**	108.3%
First-Class Mail Nonautomation Cards			
Presorting [1]			
Nonautomation Presort Cards (Automation Mixed AADC Cards)	**2.1**	**1.0**	204.3%
Qualified Business Reply Mail			
Barcoding			
QBRM [2] (Handwritten Reply Cards)	**3.0**	**2.5**	122.2%

Source: PRC-ACR2007-LR3.

Notes

Where discounts are equal to unit avoided costs, the calculated passthroughs may deviate from 100% because passthrough percentages are based on unrounded unit avoidable costs.

[1] USPS treats Nonautomation Presort Cards price and cost differentials as surcharges over Automation Mixed AADC cards.

[2] The QBRM cost avoidance presented here is estimated using the USPS methodology. The Commission found in R2006-1 that this underestimated avoided costs, but that the alternative on the record overestimated avoided costs.

The automation AADC and 3-digit presort discounts for letters and the automation AADC, 3-digit, and 5-digit presort discounts for cards are greater than the associated cost avoidances. For each of these discounts, the excess discount is either 0.1 or 0.2 cents. The movement away from avoided cost is due to cost changes (methodological and empirical), and to the fact that existing rates were set with reference to estimated cost avoidances for 2008.

Both the letter and card QBRM discounts also exceed the computed cost avoidances using the methodology proposed by the Postal Service in Docket No. R2006-1, which the Commission found to understate the actual cost avoidance.[26]

The PAEA does not impose a minimum passthrough of avoided costs for worksharing discounts, although 39 U.S.C. § 3622(b)(1) encourages maximization of incentives to increase efficiency. Full recognition of avoided costs is generally viewed as consistent with this objective. Because the business parcel categories were new and flats bundles were used as proxies to develop estimated avoided costs, the presort passthroughs were set at 33 percent. The Commission anticipates that the Postal Service will collect actual cost data for business parcels and consider moving discounts towards 100 percent of avoided costs.

PERIODICALS

Prior to Docket No. R2006-1, Periodicals rates were based on pieces and pounds. Discounts were offered to reflect the costs avoided by presorting, barcoding, and dropshipping. In Docket Docket No. R2006-1, the Commission recommended a new rate structure to reflect additional cost drivers, including bundles, containers, automation, and machinability, whose effects had been obscured in the prior rate structure. Rates reflecting these cost drivers give Periodicals mailers incentives to avoid certain costs. The Commission believed that these incentives would increase efficiencies in mail handling and bring down the costs of Periodicals overall.

[26] As the Postal Service notes in its ACR, the Commission did not endorse either the Postal Service proposal or the alternative endorsed by some commenters. In the absence of a Commission endorsed methodology, the Postal Service reverted to its proposed approach; it should have reverted to the previously accepted approach.

The new rate structure requires a more complete cost model to accurately capture the costs imposed by the larger set of cost drivers. While the new rate structure was clearly a conceptual improvement, implementation of that structure involves estimates in lieu of direct data concerning some aspects of Periodicals handling. Some of the assumptions and cost data relied on in the cost model have become obsolete. Accordingly, the Postal Service "made several improvements to the Commission's model, undertaken in order to resolve internal inconsistencies and permit transparent updates of the inputs …." Library reference USPS-FY07-11 at 1.

Improvements adopted by the Commission are: (1) changes made to the bundle flow model that better reflect the proportion of 5-digit bundles that are likely to receive mechanized sorting at various entry points in the system; (2) an adjustment to the Automated Package Processing System (APPS) and Small Parcel Bundle Sorters (SPBS) productivities to account for sweeping time; (3) accounting for the time spent opening containers at Destination Sectional Center Facilities (DSCFs) in container handling costs rather than in the calculation of container flows; (4) changing the proportion of pallets that are assumed to be opened at DSCFs; and (5) using the unit delivery cost of Standard Mail Regular flats rather than using the unit delivery cost of Periodicals as a whole, as a proxy for the unit delivery cost of non-carrier route Periodicals.

To achieve at least a partial vetting of the changes that the Postal Service incorporated in its Periodicals cost model, and to help determine whether those changes should be employed by the Commission in its evaluation of FY 2007 rates, the Commission held two informal technical conferences in which the Postal Service and mailers discussed the issues raised by the Postal Service's modifications of the Docket No. R2006-1 cost model. Oral and/or written comments were received from The *Nation*, Magazine Publishers of America (MPA), American Business Media (ABM), Alliance of Nonprofit Mailers (ANM), Dow Jones & Company, Inc. (Dow Jones), The McGraw-Hill Companies, Inc. (McGraw-Hill), National Newspaper Association (NNA), and Time Warner Inc. (Time Warner). Time Warner presented an Outside County Periodicals model with its initial written comments. The general principles that the Commission followed in accepting the five changes to the Periodicals cost model described above, and not accepting other proposed changes, are described in Section II.D. of this report.

Subsection 1 below contains analysis of the FY 2007 financial performance of the Periodicals class. Subsection 2 contains analysis of proposed changes to costing methods. Subsection 3 contains analysis of current worksharing discounts.

FY 2007 Financial Analysis. *Cost Coverage.* In FY 2007, the Periodicals class did not generate revenue sufficient to cover attributable costs, achieving only an 83.0 percent cost coverage. Table VII-C-1 details the financial performance of Periodicals in 2007.

Table VII-C-1
Periodicals
Fiscal Year 2007 Volume, Revenue, Cost, Contribution, and Cost coverage

	Volume (000)	Revenue ($ 000)	Attributable Costs ($ 000)	Contribution to Institutional Costs ($ 000)	Rev./Pc. (Cents)	Cost/Pc. (Cents)	Contribution to Institutional Costs/Pc. (Cents)	Cost Coverage
Periodicals:								
Within County	736,458	73,423	85,556	(12,132)	9.970	11.617	(1.647)	85.8%
Regular Rate	6,220,157	1,760,792			28.308			
Nonprofit	1,783,472	338,835			18.999			
Classroom	55,744	14,885			26.702			
Outside County	**8,059,373**	**2,114,512**	**2,550,327**	**(435,814)**	**26.237**	**31.644**	**(5.408)**	**82.9%**
Total Periodicals	**8,795,831**	**2,187,936**	**2,635,882**	**(447,946)**	**24.875**	**29.967**	**(5.093)**	**83.0%**

Source: PRC-LR-ACR07-1

Participants' comments. The comments submitted by Valpak argue that the failure of Periodicals to cover attributable costs violates the statute. It asserts that "Periodicals continue to be cross subsidized by other classes despite the PRA and PAEA requirement that each class cover its attributable costs." Valpak Comments at 44-51. It proposes that the Commission take immediate remedial action. In arguing that immediate action must be taken, it characterizes the requirement in both the PRA and PAEA that each class of mail bear its direct and indirect attributable costs as "not a vague criterion which can be either tempered or disregarded depending on other circumstances, but a firm requirement imposed on both the Commission and the Postal Service." *Id*. at 45. Valpak asserts that the requirement that each class must cover its attributable cost is not being met, and the Commission must find the Periodicals class in violation of this requirement.

Specifically, Valpak takes issue with the proposal made by ANM-MPA in Docket No. RM2007-1 that:

> [I]f a particular class or service is not bearing its attributable costs, the Postal Service (or, under procedures authorized by the Act, the Commission) may continue to increase the rates for that class or service by the full amount of the CPI until full coverage of attributable costs is attained.

ANM Comments at 6.

Valpak argues that this proposal would “need to be in effect for at least a decade—and perhaps far longer—before the cross-subsidy would be corrected ….” Valpak Comments at 50.

As a possible immediate solution, Valpak proposes that rate increases be concentrated in those components of the Periodicals mailstream that are the largest per-piece contributors to the deficit in Periodicals cost coverage. It asserts that these are primarily low volume, high-cost magazines. *Id*. at 50-51. Doing this, it argues, would produce either “supply side” benefits for the system as a whole, as high-cost publications dropped out of the mailstream, or “demand side” benefits, as publications with inelastic demand for postal services provided a greater contribution to overhead. Valpak Reply Comments at 12-14.

ABM, ANM, Dow Jones, MPA, McGraw-Hill, and NNA disagree. *See generally*, ANM, et al. Reply Comments. They argue that this issue was decided by the Commission when it recommended Periodicals rates in Docket No. R2006-1. In their joint comments they state:

> Valpak gains nothing by citing CRA data purporting to show in hindsight that Periodicals revenue did not cover attributable costs in FY 2007. Valpak at 21 & 46. The PRA required the Commission and the Governors to establish rates based on a reasonable projection that revenues would cover costs in the rate case test year. The Commission and the Governors used a test year of FY 2008, not FY 2007—a choice that Valpak did not challenge. The Commission and the Governors had no obligation to project that revenues would cover costs in FY 2007, or to revise the FY 2008 projections in light of subsequent developments.

ANM, et al. Reply Comments at 6. Time Warner concurs. *See* Time Warner Reply Comments at 2-3.

These commenters also take issue with the 83 percent cost coverage estimate relied on by Valpak. They contend that cost coverage for FY 2007 would have been at least 90 percent if the rates implemented on July 15, 2007 had been in effect for the entire fiscal year. They echo comments made separately by ANM-MPA and Time Warner that the CPI-based rate cap requirement is the fundamental statutory objective of the PAEA and overrides all others where a conflict among objectives and factors arises. Accordingly, ANM, et al. reiterate their proposal made in Docket No. RM2007-1 that:

> [I]t would be reasonable for the Commission to require that a class of mail that fails to recover attributable cost take the full amount of the CPI-based and banked increase authority.

ANM-MPA Comments at 10.

Commission evaluation. As explained in the Introduction to this report, 39 U.S.C. § 3653 requires the Commission to apply PAEA rate setting standards, rather than those of the prior law (the PRA), in conducting its annual review of rates and service, including its initial review. Under either law, however, there is a requirement to consider whether rates generate revenue in excess of attributable costs in the year under review. The attributable costs of Periodicals in FY 2007 clearly exceeded their revenues.

In addition to increasing efficiencies, the rates implemented in July 2007, were designed to generate a very substantial increase in revenue. The recent further rate increases approved for the Periodicals class in Docket No. R2008-1 reasonably approximate the allowable CPI cap. At this point in time, it is most appropriate to allow the recently adopted strategy for overcoming the Periodicals revenue-cost relationship a reasonable interval of time to succeed.

Incorporating Updates and New Analytical Methods in the Periodicals Cost Model. An important objective of this report is to analyze the rates of each product for their consistency with the PAEA in order to provide guidance to the Postal Service.

To perform its analysis, the Commission had to make tentative decisions about the merits of alternative proposals for calculating

Periodicals costs. Unfortunately, the Postal Service did not have sufficient time in this transition period to prepare a filing that was thorough and complete, nor did the mailers and the Commission have sufficient time to evaluate all aspects of the Postal Service's filing. With respect to the Postal Service's modifications of the Periodicals cost model, trade-offs had to be made between improving the apparent accuracy of the estimates in the Commission's annual compliance report and allowing a full measure of public input and Commission deliberation.

Changes to the Docket No. R2006-1 bundle flow model. Library reference USPS-LR-I-88, which the Postal Service filed in Docket No. R2000-1, is the most recent available study of bundle flow density that is based directly on sample data. Since the data for this study was collected in 1998, the results of the study reflect the flat processing environment that existed before deployment of the AFSM 100. Deploying the AFSM 100 allowed a dramatically higher percentage of bundled flats to receive a mechanical incoming secondary sort in processing plants, instead of being forwarded to delivery units, where the bundles were broken and sorted manually. *See* Docket No. R2006-1, Direct Testimony of Halstein Stralberg on Behalf of Time Warner, September 6, 2006, at 11-14 (TW-T-2).

To ameliorate this problem in its FY 2007 compliance report, the Postal Service judgmentally altered the results of the LR-I-88 study. A key assumption underlying the Commission's Periodicals flats processing cost estimates in Docket No. R2006-1 was that 85 percent of incoming secondary piece sorts would be mechanical. This assumption was based on a number of qualitative arguments accepted by the Commission in Docket No. R2006-1 that such an adjustment was needed to reflect the proportion of flats known to have been sorted manually. See PRC Op. R2006-1, ¶ 5734, referencing TW-T-2 at 11-14 (Stralberg).

In order to be consistent with this assumed 85/15 ratio of mechanized to manual sorting at the incoming secondary stage, the Postal Service adjusted its model of how incoming 5-digit bundles would be sorted if they entered the system at various processing plant levels in the network. The Postal Service further adjusts the 85 percent of mechanized incoming secondary sorting to reflect the fact that not all facilities are equipped to perform incoming secondary flat sorts on a machine,[27] which reduces the overall mechanized/manual split at the incoming secondary to .747/.253. It then applies this split factor to the number of 5-digit bundles that are entered at DSCFs. *See* Table VII-C-2, column (3).

Table VII-C-2

Bundle Density

Entry Point	Operation	I-88 Distribution	FY07 Bundles	Modified ACR2007 Distribution	FY07 Bundles
MADC	**Direct to Piece Sort**	0.75%	10,295	10.32%	142,423
	DDU Bundle Sort	13.07%	180,309	3.49%	48,164
			1,380,064		1,380,064
ADC	**Direct to Piece Sort**	9.41%	3,809,875	55.62%	22,518,107
	DDU Bundle Sort	65.05%	26,333,971	18.84%	7,627,493
			40,485,629		40,485,629
SCF	**Direct to Piece Sort**	21.69%	28,019,001	74.70%	96,496,975
	DDU Bundle Sort	78.31%	101,160,350	25.30%	32,682,376
			129,179,351		129,179,351
	Total FY07 Bundles		171,045,044		171,045,044
All	**Direct to Piece Sort**	18.61%	31,839,171	69.66%	119,157,505
	DDU Bundle Sort	74.64%	127,674,630	23.59%	40,358,033
		93.26%	159,513,801	93.26%	159,515,537

NOTES
Source: USPS-LR-I-88 Flats Bundle Study, 'FINAL_DENSITY.XLS.'
Docket No.ACR2007 USPS-FY07-11, file: PEROC flats 07ACR011608 errata.xls

Under this assumption, roughly 75 percent of flats arriving at DSCFs in 5-digit bundles are assumed to be broken out and given a mechanized incoming secondary sort, and 25 percent are assumed to be sent to delivery units to be broken out and manually sorted. *See* Table VII-C-2, column (1). This assumed 75/25 ratio is almost the inverse of the 20/80 mechanized/manual ratio that was observed at the DSCF in the Docket No. R2006-1 flat processing flow model. The Postal Service assumes that the 75/25 ratio better reflects the current flat sorting environment, which is dominated by the AFSM 100 technology.

[27] The flat-sorting machine coverage factor is 87.88 percent. *See* library reference USPS-FY07-11, PER OC, flats 07ACRv011608errata.xls, tab ‘Bundle Density’, cell 072.

Because most flats are entered in 5-digit or carrier route bundles and are not processed upstream of the DSCF, the Postal Service's modified assumption about what happens at the DSCF accounts for most of the total cost of processing flats. *See* TW-T-2 at 11. To account for the minority of flats that are entered upstream of the DSCF, however, the Postal Service modifies the distribution that flats in 5-digit bundles are shown to receive in the Docket No. R2006-1 flow model when they are entered at the MADC and the ADC. For both facility types, it sums the number of flats receiving piece distribution and the number being forwarded to the delivery unit and then multiplies that sum by the same 75/25 split factor that it applies to 5-digit bundles entered at the DSCF level. This increases the overall percentage of 5-digit-bundle flats receiving a piece sort if entered at a MADC from less than 1 percent to roughly 10 percent. If entered at an ADC, 55 percent are assumed to receive a piece sort under the Postal Service's modification of the Docket No. R2006-1 model. *See* Table VII-C-2, column (3).[28] The Postal Service asserts that without the above-mentioned modifications, the cost of sorting 5-digit bundle flats will be overstated.[29]

The Commission accepts the Postal Service's modifications to the Docket No. R2006-1 bundle flow model. It concludes that this is an instance in which changing an analytical method from that prevailed in the most recent fully-litigated rate case (Docket No. R2006-1) is necessary to avoid a much greater distortion that would result from rejecting the update or change. Reinforcing this decision is the fact that no commenter objected to the Postal Service's modifications to the Docket No. R2006-1 bundle flow model.

[28] The Postal Service's modification intends to provide a plausible scenario by which only 25 percent of 5-digit bundle flats receive a manual sort at the delivery unit. It appears to assume that 5-digit bundles that the Postal Service was sorting to the ADC or 3-digit level under the Docket No. R2006-1 model were not eligible for an incoming secondary sort by either manual or mechanized means. Therefore, the Postal Service's modification of the Docket No. R2006-1 model does not change that model's distribution of 5-digit bundle flats sorted to ADC and 3-digit level in a MADC, or sorted to the 3-digit level in an ADC.

[29] This overestimate of bundles broken and sorted at delivery units is reduced somewhat when the assumptions about the accidental breakage of bundles meant to be mechanically sorted is factored in.

The Docket No. R2006-1 model used 10-year-old sample data to identify what proportion of bundles at each level of entry would flow to various particular mechanized manual operations. It is undisputed that since these flows were sampled in 1998, there has been a sea change in the flat processing environment. The Postal Service has not sampled these proportions for a decade. The testimony of Postal Service operations witnesses in recent rate cases has confirmed that the large majority of incoming secondary flat sorting was done in delivery units when data underlying the Docket No. R2006-1 model were sampled. *See* Order No. 1446, ¶ 4009. Experts have also testified that the majority is now done at DSCFs on AFSM 100s. *See* TW-T-2 at 11. There is a wide difference between the costs of breaking 5-digit bundles at SCFs and sorting flats on the AFSM 100 and doing it manually at the delivery unit. Consequently, continuing to employ a ratio of mechanized/manual sorting of roughly 20/80 would grossly overstate the costs of breaking and sorting 5-digit bundles to carrier routes in FY 2007, as the Postal Service asserts. The Commission accepts the 75/25 ratio as the Postal Service applies it, but without imbuing it with the weight of precedent.

While this avoids the gross and obvious distortion that a 20/80 ratio represents, the 75/25 ratio that it hypothesizes generates some implausible results of its own. Of particular concern is that when this ratio is applied to 5-digit-bundle distribution at the ADC level, it indicates that 55 percent of such bundles are broken there and sorted manually. This implies that the typical ADC functions as a DSCF with respect to the majority of delivery units in its service area. This is a questionable assumption. However, the error that results from applying the assumed 75/25 ratio to the distribution of 5-digit bundles at the ADC is a good deal less serious than the error of applying the obsolete 20/80 ratio at the DSCF, as the Docket No. R2006-1 model did, because there are far fewer 5-digit bundles processed at ADCs than at DSCFs.

This illustrates the urgent need for sample data that records bundle flows that reflect current operations as one element of a comprehensive plan to model current flat processing and delivery costs. Such a modeling effort is needed to provide an appropriate framework for designing an unbundled rate structure. It is also needed to satisfy the requirement of section 708 of the PAEA, which mandates a study of the costs of Periodicals.

APPS/SBPS productivity adjustment. The Postal Service adjusted the APPS and SPBS productivities in the Docket No. R2006-1 model to reflect time associated with the sweeping function. In the LR-I-88 study that witness Stralberg relied on in Docket No. R2006-1, SPBS staffing was estimated to be allocated 1/7th to dumping, 3/7th to sweeping, and 3/7th to keying. Witness Stralberg excluded both the dumping and sweeping hours in the development of a pure keying productivity for the SPBS and APPS. The dumping activity was modeled separately, but the sweeping activity was not explicitly modeled.

It is apparent that sweeping time should be included in developing the SPBS productivities, although the validity of including sweeping time in the APPS productivities is less clear. Time Warner states that more study of this matter is needed, but accepts these new productivities in this instance. Time Warner Comments at 27-28. No other commenter objects to this change.

Container flows. The Postal Service shifts the time associated with DSCF container opening from the calculation of container flows to the calculation of container handling costs. This is a change in the model's mechanics, but not a change in the model's results. No commenter has objected to this change.

5-digit pallet opening at the DSCF. Less than 2.5 percent of the mail on 5-digit pallets is prepared in 5-digit bundles; the remainder is in firm or carrier route bundles. Opening and processing bundles on 5-digit pallets would result in two bundle sortations whereas only one sortation is necessary if the pallet is not opened. The Postal Service asserts that the assumption that 21 percent of these pallets are opened at the DSCF is not supported. The Commission agrees. No commenter has objected to this change in the Docket No. R2006-1 cost model.

Delivery cost calculation. In Docket No. R2006-1, library reference USPS-LR-67 was used to estimate unit delivery costs (UDC) by rate category. It contained a UDC for Periodical flats as a whole. In an effort to use the best available data, the Commission used the UDC of Periodicals flats as a whole as a proxy for non-carrier route presorted Periodicals. It used the Standard ECR UDC as a proxy for carrier route presorted Periodicals. In Docket No. R2006-1, the UDC of Periodicals as a whole nearly equaled that of

Standard Mail Regular flats. Therefore, using the UDC of Standard ECR as a proxy for the UDC of presorted carrier route Periodicals provided a valid basis for estimating the costs avoided by presorting Periodicals to carrier route. In library reference USPS-LR-FY07-19, however, the Standard Mail Regular flats UDC is 1.77 cents larger than the Periodicals flats UDC. Because they now differ substantially, MPA, Time Warner, and the Postal Service propose a change in the method for calculating the delivery costs avoided by presorting Periodicals to carrier route.

MPA hypothesizes an ideal environment where a proxy is not needed, stating:

> [I]deally, the delivery costs avoided by Periodicals Carrier Route Basic flats relative to non-Carrier Route flats would be estimated using Periodicals delivery cost data by presort level. However, for the reasons discussed at the technical conference held at the Commission on January 23, 2008, such data are not available.

MPA Comments at 12. In the Postal Service's worksharing cost avoidance model, which was replicated in the comments and model proffered by Time Warner, the Standard Mail Regular flats UDC is used as a proxy for the non-carrier route Periodicals flats UDC when calculating the cost avoided by presorting to carrier route. The Commission finds that using the Standard Mail Regular flats UDC as a proxy for the UDC of non-carrier route Periodical flats is now more appropriate.

MODS operation 140 costs. Both Time Warner and ANM-MPA propose a change to the mail processing model to reflect a change in the current mail processing environment. Summarizing this change, Time Warner states:

> In particular, MODS data indicate that a very substantial number of workhours were spent at operation 140, which is part of the AFSM 100 cost pool and is used by employees that prep bundles and feed flats to machines via the AI attachments that have been installed on many AFSM 100 machines in the past couple of years. The associated costs are not represented anywhere in the model, causing the model to understate the piece-sorting costs that the CRA charges to Periodicals flats.

Time Warner Comments at 15. ANM-MPA proposed two possible methods to include the operation 140 costs in the current model. The first proposal would alter the productivity of the AFSM 100. MPA Comments at 18. The second proposal would allocate the operation 140 hours to rate categories in the same fashion as the traditional flats preparation hours in operation 035 are currently allocated.

Time Warner proposes two different changes in methodology whose purpose is the same as the ANM-MPA proposals. Time Warner Comments at 20. In response to these proposals, the Postal Service states:

> Time Warner (as well as ANPM/MPA) has specific concerns regarding the AFSM 100 cost pool, operation 140 costs, and the CRA cost adjustments. The Postal Service agrees that the cost model, as it currently stands, does not provide the best cost estimates because of the inclusion of OP 140 flats prep costs in the AFSM 100 pool. There are dozens of short-term solutions that could be applied, and all would be imprecise. At this time, the Postal Service has not evaluated the merits of each possible solution. The long-term solution will require more investigation to find the best possible method to address flats prep costs in the model.

Postal Service Reply Comments at 15 (footnote omitted).

The Commission finds that the burden of persuasion for altering the model to adjust for operation 140 costs in the context of this truncated docket has not been met.

Cost and Revenue Analysis (CRA) adjustment. The Periodicals mail processing cost model disaggregates cost pools by rate category to develop unit costs. However, before the modeled unit costs can be considered accurate, they need to be modified (as a whole) to conform with the costs reported by the CRA. In Docket No. R2006-1, the CRA adjustment was calculated for other modeled costs (bundles, containers, and allied piece costs), but the CRA adjustment factor is set to 1.0. This *pro forma* setting of the CRA adjustment factor for direct piece sorting operations to 1.0 is equivalent to determining that the direct piece costs are equal to the CRA costs.

The Postal Service considers setting CRA adjustment factors equal to 1.0 to be anomalous. In the Preface to library reference USPS- FY-07-11 it states:

> The Postal Service notes that it is unusual in engineering models like these to assume that the costs for a single component, direct pieces, are perfectly modeled, while costs of other components (bundles, containers and allied piece operations) are subject to error and require the CRA adjustment.

Library Reference USPS-FY-07-11 at 2.

Time Warner agrees and suggests several changes in the calculation of the CRA adjustment. They propose including direct piece costs in the adjustment calculation, creating a CRA adjustment with two parts. In comments at the first technical conference, Halstein Stralberg, speaking for Time Warner, states "[m]y intention in developing two parts of the CRA adjustment was to minimize the distortion caused by an overall adjustment." Comments on the USPS Filing of FY 2007 Annual Compliance Review Data, January 11, 2008, at 2. Time Warner reiterates these comments in its initial comments in its initial comments at 11-14.

Before determining what changes should be made to the CRA adjustment, it is important to recognize the role of the CRA adjustment. Changing the nature of the CRA adjustment in the instant docket would ignore the significant change that has occurred in Periodicals costs. The following table details the change in unit direct piece mail processing costs.

Table VII-C-3
Periodicals Unit Direct Piece Mail Processing Cost
By Bundle Presort, Barcode and Machinability

	R2006-1 (Cents)	ACR 2007 (Cents)	Percent Change
Non-Barcoded Non-Machinable			
MADC	41.4	40.7	-1.7%
ADC	31.8	31.4	-1.5%
3-Digit	25.5	25.1	-1.8%
5-Digit	11.4	10.4	-9.2%
Barcoded Non-Machinable			
MADC	36.4	35.2	-3.6%
ADC	27.9	26.7	-4.2%
3-Digit	22.4	21.4	-4.8%
5-Digit	11.3	10.1	-11.2%
Non-Barcoded Machinable			
MADC	24.5	22.2	-10.1%
ADC	18.7	16.4	-13.7%
3-Digit	16.2	13.9	-16.2%
5-Digit	8.8	7.1	-24.4%
CR	0.1	0.3	76.2%
Barcoded Machinable			
MADC	21.6	19.4	-11.5%
ADC	16.6	14.4	-14.7%
3-Digit	14.4	12.2	-17.5%
5-Digit	8.0	6.3	-26.8%

Source:R2006-1 from USPS file: R2006-1_PER_PRC_-_R06_Replication.xls tab 'Summary' submitted in ACR2007; ACR2007 from Docket No.ACR2007 USPS-FY07-11, file: PEROC flats 07ACR011608 errata.xls tab 'Summary'

As a class, modeled direct piece costs decreased 17.9 percent. Table VII-C-4 details the change in the relationship between modeled costs and CRA costs between Docket No. R2006-1 and Docket No. ACR2007. In TY 2008, the gap between modeled and reported costs was projected to be just over $ 30 million. In FY 2007, this difference increased to over $180 million. It is reasonable to assume that unit modeled cost and unit CRA cost should move in the same direction. This seemingly inconsistent result has many possible causes, many of which have been raised in the instant docket. These costs should be re-examined. After the deficiencies recognized in the model can be corrected, a fresh look at the CRA adjustment methodology is certainly appropriate. Work required under section 708 of the PAEA to study Periodicals attributable cost may provide the appropriate forum for examining these effects.

Table VII-C-4
Comparison of Periodicals Direct Mail Processing Costs

	FY 2007		TY 2008	
	Model	CRA	Model	CRA
Direct Piece Costs	$ 403,282,924	$ 584,730,319	$ 507,250,283	$ 537,737,504
Volume	7,976,359,505	7,976,359,505	8,231,944,062	8,231,944,062
Unit Direct Piece	$ 0.051	$ 0.073	$ 0.062	$ 0.065
Change from TY 2008	-17.9%	12.2%		

Source:R2006-1 from USPS file: R2006-1_PER_PRC_-_R06_Replication.xls tab 'Summary' submitted in ACR2007; ACR2007 from Docket No.ACR2007 USPS-FY07-11, file: PEROC flats 07ACR011608

Allied piece costs. In Docket Nos. C2004-1 and R2006-1, Time Warner witness Mitchell proposed a rate design based on cost avoidances calculated using the current Periodicals mail processing model. In those dockets, witness Stralberg calculated both “direct” and “allied” piece and bundle costs. In both dockets, witness Mitchell included the direct piece costs in the rate design, but excluded the allied cost differences. However, as Periodicals’ costs continue to evolve, an unexpected drop in modeled direct piece costs has occurred simultaneously with an increase in modeled allied piece costs. In the instant docket, both Time Warner and ANM-MPA propose to include allied piece and bundle costs in the analysis of worksharing passthroughs. Time Warner states:

> In its FY 2007 ACR model, the Postal Service confirms the existence of [allied] costs. In fact it proposes changes that increase the "allied" piece costs. But it did not include these costs in the LR-3 worksharing discount table.
>
> Yet these are marginal costs …. The fact that such costs were not used in previous rate designs, and in fact were not identified in the Postal Service's earlier models (and still are not identified in their First Class or Standard flats models), does not mean that they are not costs which additional worksharing will help avoid. So in providing, for the ACR, a comparison between worksharing discounts and actual costs avoided, the Postal Service should include these costs in its avoidance estimates.

Time Warner Comments at 22.

ANM-MPA argues for the same outcome, but for the opposite reason.

> [E]xcluding allied costs is inconsistent with the general cost avoidance approach used by the Commission in Docket No. R2006-1 to estimate presort and prebarcoding cost avoidances. Specifically, in Docket No. R2006-1, the Commission included allied costs in First-Class Mail and Standard Mail worksharing cost avoidances by treating allied cost pools as piggyback cost pools in the CRA adjustment, i.e., worksharing-related proportional to the same extent as all direct cost pools.

ANM-MPA Comments at 14.

The Postal Service believes that this is not the appropriate proceeding to make such a fundamental change. It states:

> [T]his entire line of discussion merely underscores the need, in the context of the still relatively new Periodicals price structure, for a comprehensive re-evaluation that seeks both a sound theoretical construct for the concept of “cost avoidance,” and the identification of practical means to provide the best available empirical estimates of the parameters necessary to implement the appropriate theoretical framework.

Postal Service Reply Comments at 17.

The Commission agrees with the Postal Service. The appropriate treatment of allied costs in cost avoidance models is an issue that should be resolved in a more deliberative manner than is possible in the context of this docket. It is better dealt with in the context of the joint Postal Service/Postal Regulatory Commission study of Periodicals costs that section 708 of the PAEA requires.

Worksharing. The current rate structure contains four fundamental cost drivers: pieces, bundles, containers, and pounds. Of these basic elements, three are considered to be worksharing related (pieces, bundles, and containers) and the other is not (pounds). The recent introduction of the bundles and containers rate elements necessitates a period of limited passthroughs to mitigate rate shock and allow the mailing industry time to adapt. Nevertheless, the Commission believes that the traditional ECP discount tree for the piece rate element is consistent with the worksharing standards articulated in 39 U.S.C. § 3622(e) and should be retained.

Table VII-C-5 contains the FY 2007 piece worksharing discount passthroughs.

Table VII-C-5
Periodicals Per Piece Worksharing Discounts
By Bundle Presort, Barcode and Machinability

	ACR 2007 Cost Avoidance (Cents)	Discount (Cents)	Passthrough
Non-Barcoded Non-Machinable			
MADC			
ADC	9.4	10.2	109%
3-Digit	6.3	5.9	94%
5-Digit	14.7	8.4	57%
Barcoded Non-Machinable			
MADC	5.6	3.0	54%
ADC	8.4	9.2	109%
3-Digit	5.4	5.0	93%
5-Digit	11.2	7.7	69%
Non-Barcoded Machinable			
MADC	18.5	10.3	56%
ADC	5.8	6.1	105%
3-Digit	2.5	2.2	88%
5-Digit	6.8	7.2	105%
CR	9.6	10.7	111%
Barcoded Machinable			
MADC	21.3	13.0	61%
ADC	5.0	5.4	109%
3-Digit	2.2	1.9	86%
5-Digit	5.9	6.3	106%

Source:R2006-1 from USPS file: R2006-1_PER_PRC_-_R06_Replication.xls tab 'Summary' submitted in ACR2007; ACR2007 from Docket No.ACR2007 USPS-FY07-11, file: PEROC flats 07ACR011608 errata.xls tab 'Summary'

The diverse range of cost drivers recognized in the current rate structure makes analysis of worksharing discounts difficult. In the current environment of fluctuating Priodicals costs, it is important for the Postal Service to give mailers the incentives to minimize cost. In practical terms, this means maintaining a reasonable set of discount opportunities.

Tables VII-C-6 through VII-C-8 detail the bundle and container worksharing discounts.

Table VII-C-6
Bundle Pricing by Container Level

Container Level	Bundle Level	ACR 2007 Cost	Price	Price as Percent of Cost
Mixed ADC				
	MADC	$0.360	$0.100	27.8%
	ADC	$0.580	$0.129	22.2%
	3-D/SCF	$0.628	$0.134	21.3%
	5-D	$0.594	$0.161	27.1%
	Firm Bundle	$0.713	$0.079	11.1%
ADC				
	ADC	$0.223	$0.038	17.0%
	3-D/SCF	$0.351	$0.063	18.0%
	5-D	$0.315	$0.095	30.1%
	CR	$0.448	$0.104	23.2%
	Firm Bundle	$0.442	$0.048	10.8%
3-D/SCF				
	3-D/SCF	$0.216	$0.039	18.1%
	5-D	$0.274	$0.084	30.6%
	CR	$0.411	$0.095	23.1%
	Firm Bundle	$0.404	$0.045	11.1%
5-D/CR				
	5-D	$0.182	$0.008	4.4%
	CR	$0.182	$0.039	21.4%
	Firm Bundle	$0.181	$0.027	14.9%

Source: Docket No.ACR2007 USPS-FY07-11, file: PEROC flats 07ACR011608 errata.xls tab 'Summary'

Table VII-C-7
Sack Pricing by Container Level

Container Level	Bundle Level	ACR 2007 Cost	Price	Price as Percent of Cost
Mixed ADC				
	OSCF	$2.275	$0.420	18.5%
	OADC	$1.889	$0.420	22.2%
ADC				
	OSCF	$5.229	$1.800	34.4%
	OADC	$5.097	$1.800	35.3%
	OBMC	$4.497	$1.800	40.0%
	DBMC	$3.375	$1.100	32.6%
	DADC	$1.889	$0.600	31.8%
3-D/SCF				
	OSCF	$5.599	$1.900	33.9%
	OADC	$5.342	$1.900	35.6%
	OBMC	$4.669	$1.900	40.7%
	DBMC	$3.474	$1.200	34.5%
	DADC	$2.928	$1.000	34.2%
	DSCF	$1.889	$0.600	31.8%
5-D/CR				
	OSCF	$6.360	$2.240	35.2%
	OADC	$6.079	$2.240	36.8%
	OBMC	$5.321	$2.240	42.1%
	DBMC	$4.040	$1.500	37.1%
	DADC	$3.418	$1.300	38.0%
	DSCF	$2.419	$0.900	37.2%
	DDU	$2.084	$0.700	33.6%

Source: Docket No.ACR2007 USPS-FY07-11, file: PEROC flats 07ACR011608 errata.xls tab 'Summary'

Table VII-C-8
Pallet Pricing by Container Level

Container Level	Bundle Level	ACR 2007 Cost	Price	Price as Percent of Cost
ADC				
	OSCF	$57.187	$18.610	32.54%
	OADC	$51.075	$18.610	36.44%
	OBMC	$45.093	$18.610	41.27%
	DBMC	$37.529	$13.000	34.64%
	DADC	$19.823	$8.900	44.90%
3-D/SCF				
	OSCF	$69.364	$22.980	33.13%
	OADC	$64.454	$22.980	35.65%
	OBMC	$53.903	$22.980	42.63%
	DBMC	$41.769	$14.400	34.47%
	DADC	$36.290	$12.200	33.62%
	DSCF	$19.447	$6.700	34.45%
5-D/CR				
	OSCF	$88.136	$26.950	30.58%
	OADC	$77.370	$26.950	34.83%
	OBMC	$67.728	$26.950	39.79%
	DBMC	$56.503	$17.500	30.97%
	DADC	$53.280	$15.500	29.09%
	DSCF	$36.117	$8.000	22.15%
	DDU	$3.525	$1.200	34.04%

Source: Docket No.ACR2007 USPS-FY07-11, file: PEROC flats 07ACR011608 errata.xls tab 'Summary'

These price-to-cost ratios are based on estimates of direct costs of various drivers. Therefore, they are not identical to workshare passthroughs, but conceptually are very similar. They show cost differentials caused by worksharing activity.

STANDARD MAIL

Financial Analysis. Standard Mail's cost coverage as a class, for FY 2007 is 158 percent. As Table VII-D-1 shows, total revenue from Standard Mail for FY 2007 was $20.8 billion, which covered its attributable cost of $13.2 billion and contributed $7.6 billion to institutional cost. The Postal Service did not submit data that were aligned with the new product designations, so the Commission was unable to perform analysis by product of the pricing relationships within the Standard Mail class. The Commission anticipates that the Postal Service will provide this data in future filings. No commenters addressed the financial data or the lack of data at the product level.

Table VII-D-1
Standard Mail
Fiscal Year 2007 Volume, Revenue, Cost, Contribution, and Cost coverage

	Volume (000)	Revenue ($ 000)	Attributable Costs ($ 000)	Contribution to Institutional Costs ($ 000)	Rev./Pc. (Cents)	Cost/Pc. (Cents)	Contribution to Institutional Costs/Pc. (Cents)	Cost Coverage
Standard Mail:								
Regular	56,555,118	13,026,450			23.033			
Nonprofit	12,113,798	1,680,819			13.875			
Regular and Nonprofit	**68,668,917**	**14,707,268**	**9,964,963**	**4,742,306**	**21.418**	**14.512**	**6.906**	**147.6%**
Enhanced Carrier Route (ECR)	32,177,311	5,787,178			17.985			
Nonprofit ECR (NECR)	2,669,884	285,884			10.708			
ECR and NECR	**34,847,195**	**6,073,062**	**3,188,202**	**2,884,859**	**17.428**	**9.149**	**8.279**	**190.5%**
Total Standard Mail	**103,516,112**	**20,780,330**	**13,153,165**	**7,627,165**	**20.074**	**12.706**	**7.368**	**158.0%**

Source: PRC-LR-ACR07-1

39 U.S.C. § 3626(a)(6) requires nonprofit rates to be set in relation to their commercial counterparts regardless of nonprofits' independent costs. Nonprofit rates are set to yield per-piece revenues that are 60 percent of commercial revenues. The Commission calculates that in FY 2007 the actual per-piece revenue from Standard nonprofit pieces was 62 percent of Standard commercial per-piece revenues.

The law does not require the actual, nonprofit revenues to equal exactly 60 percent of commercial revenues. It instead requires a forward-looking estimate in setting rates. Thus, the Commission's review of nonprofit revenues in the Annual Compliance Report is somewhat limited. However, if over the span of several compliance reports, there is a discernable pattern whereby the actual nonprofit per-piece revenues are consistently too high or too low, the Commission may find that the methodology used in setting rates to achieve the nonprofit revenue target should be changed or improved.

Worksharing/Rate Design.

Methodology. The Commission made three changes to the Postal Service's filing which affect Standard Mail costs. As a result of the Postal Service's response to the Commission's Information Request No. 1, Questions 14 and 16, the Commission updated the MLOCR-ISS Accept Rate from 86.79 percent to 94.53 percent in the letter cost model. In the flat cost model, the Commission updated the AFSM100 ATHS productivities. *See* section VII.A for a more complete discussion of these changes. The unit delivery costs used by the Commission in its calculations also differs from the Postal Service's filing. *See* Appendix B for a complete discussion of this change. Additionally, the Postal Service updated transportation costs from the original filing on March 20, 2007 through the 7th Notice of the United States Postal Service of Revisions to Materials Accompanying Its FY 2007 Annual Compliance Report – Errata (Items 1, 2, 5 and 6) (Seventh Notice of Errata).

In its initial comments, Valpak contends that many of the FY 2007 ECR costs in the Postal Service's report are anomalous. In particular, Valpak compares the costs of several rate categories and questions the changes in cost from prior years. Valpak highlights the following perceived anomalies:

- The combined mail processing and carrier cost of saturation letters has increased 16.3 percent, while that of basic carrier route letters has increased 23.3 percent;
- The combined mail processing and carrier cost of saturation flats has declined 2.0 percent, while the cost of basic carrier route flats has increased 9.6 percent;
- The unit cost for high-density parcels has increased 1,700.3 percent, and that of saturation parcels has increased 67.7 percent;

- Although they are processed in different mailstreams, the carrier cost for saturation letters is shown to be 3.708 cents, nearly the same as that of saturation flats at 3.749 cents; and
- Street-time cost for saturation letters on city routes is 1.64 cents, and saturation flats, which, unlike letters, always require individual handling, is 1.55 cents.

Valpak Comments at 38-39.

Valpak also contends that it is unclear whether the volume and revenue data for Detached Address Labels (DALs) in the FY 2007 Billing Determinants reflect all DALs in FY 2007 or just those which were subject to the surcharge established in Docket No. R2006-1. Valpak raises a question about there being a greater number of DALs associated with parcels than the number of saturation parcels. Valpak believes that occasionally, "fundamental changes occur with data recorded in and made available only via the Billing Determinants, and transparency necessitates explanation, because the new data do not speak for themselves." *Id.* at 41 to 42.

In reply comments, both Valassis and the Postal Service attempt to explain the data in question and offer several reasons for the changes in cost noted by Valpak. In response to Valpak's concern about potential anomalies in ECR costs, Valassis offers the following explanations:

- The FY 2007 DAL volume estimate is now derived from data collected as part of the City Carrier Cost System (CCCS) and Rural Carrier Cost System (RCCS). Previously, in Docket No. 2006-1, DALs were estimated and distributed to their respective cost systems on the basis of an industry estimate multiplied by its respective ECR saturation letter distribution factor.
- The FY 2007 proportions of ECR saturation letters and flats on city routes that are sequenced are now estimated using data directly from the CCCS. Previously, this was estimated using IOCS costs in conjunction with saturation casing productivities.

- The FY 2007 rural boxholder volume is now distributed to shape based on new information collected as part of the RCCS. Previously, boxholder volume was distributed to shape based on RPW proportions.
- Due to the introduction of the DAL surcharge, the number of DALs in the system has declined, thus the total delivery cost of saturation flats declined.
- The Postal Service has disaggregated the dropship-adjusted mail processing costs to reflect the large differences in average piece-weight among the various ECR rate categories.

Valassis Reply Comments at 3-4.

In reference to Valpak's concerns about changes in unit costs for ECR parcels between the Docket No. R2006-1 estimates and FY 2007 actuals, Valassis notes that ECR parcel costs are likely to be affected by sampling errors, by costing improvements in the allocation of delivery cost among ECR rate categories, and by the development of the ECR dropship-adjusted mail processing costs. *Id.* at 4-5.

Valassis also addresses the similarity between the delivery cost of saturation letters and flats with the following observations:

- Saturation flats (without DALs) correctly show a slightly lower unit city delivery cost than saturation letters because only about 65 percent of saturation letters bypass carrier casing and are delivered in pre-sequenced bundles while over 74 percent of saturation flats bypass carrier casing.
- Conversely, rural delivery cost is slightly higher for saturation flats than for saturation letters because a greater share of saturation letters are delivered as either DPS or boxholder mail (the lowest cost mail to deliver).
- Thus, when city and rural carrier unit costs by shape are averaged together on a weighted-volume basis, the results for saturation letters and saturation flats are similar.

With respect to the questions Valpak raises regarding DALs and parcels, the Postal Service provides the following explanation:

> For Standard Mail flats, detached address labels may only be used with pieces mailed at Saturation rates. (DMM 602.4.1.2) In contrast, for Standard Mail parcels, detached address labels are required on city delivery routes for merchandise samples mailed to at least 25 percent of the addresses in any 5-digit ZIP Code delivery area. This requirement applies to pieces qualifying for ECR Basic, ECR High-Density, and ECR Saturation rates. (DMM 602.4.1.3) For this reason, the number of DALs for ECR parcels may well exceed the number of Saturation parcels.

Response to Commission Information Request No. 2, question 14.

While the explanations offered by Valassis and the Postal Service may be legitimate, Valpak raises an important issue. The Postal Service should support its annual report with more complete explanations, and discuss data which may be perceived as anomalous, such as large variations in unit costs. With only 90 days available for the Commission to make its findings and even less time for interested parties to analyze the data and submit comments, it is crucial to the process that the data filed by the Postal Service is accompanied by accurate descriptions and a thorough analysis.

The Postal Service's first annual report does offer some explanation of methodological changes as well as the flow of inputs and outputs, but more complete explanations in the future will be very helpful.

Findings. The Commission has reviewed the passthrough calculations submitted by the Postal Service in USPS-FY07-3 and has updated the costs as discussed above. Table VII-D-2 below shows the passthroughs based on the updated costs for the Standard Mail Class.

Table VII-D-2
Standard Regular and Standard Nonprofit Regular
Workshare Discounts and Benchmarks

Type of Workshing (Benchmark)	ACR 2007 Discount (cents)	ACR 2007 Unit Cost Avoidance (cents)	ACR 2007 Pass-through
Standard Mail Regular Automation Letters			
Presorting (dollars / piece)			
Automation AADC Letters (Automation Mixed AADC Letters)	1.4	1.3	104.0%
Automation 3-digit Letters (Automation AADC Letters)	0.5	0.3	145.4%
Automation 5-digit Letters (Automation 3-digit Letters)	1.5	1.6	94.9%
Pre-barcoding (dollars / piece)			
Automation Mixed AADC Letters (Nonautomation Machinable Mixed ADC Letters)	0.3	(0.0)	-2184.9%
Standard Mail Regular Nonautomation Letters			
Presorting (dollars / piece)[1]			
Nonautomation AADC Machinable Letters (Nonautomation Mixed AADC Machinable Letters)	0.9		
Nonautomation ADC Nonmachinable Letters (Nonautomation Mixed ADC Nonmachinable Letters)	8.0	10.1	79.6%
Nonautomation 3-digit Nonmachinable Letters (Nonautomation ADC Nonmachinable Letters)	2.9	2.3	125.4%
Nonautomation 5-digit Nonmachinable Letters (Nonautomation 3-digit Nonmachinable Letters)	8.3	9.5	87.2%
Standard Mail Regular Letters			
Drop Ship (dollars / pound)			
DBMC Letters (Origin Letters)	15.9	18.6	85.7%
DSCF Letters (Origin Letters)	20.3	22.5	90.1%
Standard Mail Regular Automation Flats			
Presorting (dollars / piece)			
Automation ADC Flats (Automation Mixed ADC Flats)	5.3	6.8	78.0%
Automation 3-digit Flats (Automation ADC Flats)	3.2	5.4	58.5%
Automation 5-digit Flats (Automation 3-digit Flats)	5.7	10.0	57.2%
Pre-barcoding (dollars / piece) [2]			
Automation Mixed ADC Flats (Nonautomation Mixed ADC Flats)	3.8	2.3	162.6%
Standard Mail Regular Nonautomation Flats			
Presorting (dollars / piece)			
Nonautomation ADC Flats (Nonautomation Mixed ADC Flats)	5.4	7.0	76.6%
Nonautomation 3-digit Flats (Nonautomation ADC Flats)	3.4	3.2	107.1%
Nonautomation 5-digit Flats (Nonautomation 3-digit Flats)	6.4	8.5	74.9%

Source and Notes displayed on the following page.

Table VII-D-2 (continued)
Standard Regular and Standard Nonprofit Regular
Workshare Discounts and Benchmarks

Type of Worksharing (Benchmark)	ACR 2007 Discount (cents)	ACR 2007 Unit Cost Avoidance (cents)	ACR 2007 Pass-through
Standard Mail Regular Flats			
Drop Ship (dollars / pound)			
DBMC Flats (Origin Flats)	15.9	18.6	85.7%
DSCF Flats (Origin Flats)	20.3	22.5	90.1%
Standard Mail Regular Parcels			
Presorting (dollars / piece)			
BMC Machniable Parcels (Mixed BMC Machniable Parcels)	19.3	17.9	107.6%
5-digit Machniable Parcels (BMC Machniable Parcels)	37.0	34.4	107.6%
ADC Irregular Parcels (Mixed ADC Irregular Parcels)	21.5	104.0	20.7%
3-digit Irregular Parcels (ADC Irregular Parcels)	26.1	104.0	25.1%
5-digit Irregular Parcels (3-digit Irregular Parcels)	4.6	17.6	26.2%
Pre-barcoding (dollars / piece)[3]			
Mixed BMC Machniable Barcoded Parcels (Mixed BMC Machniable Nonbarcoded Parcels)	5.0		
Mixed ADC Irregular Barcoded Parcels (Mixed ADC Irregular Nonbarcoded Parcels)	5.0		
Standard Mail Regular NFMs			
Presorting (dollars / piece)			
BMC/ADC NFMs (Irregular Parcels) (Mixed BMC/ADC NFMs (Irregular Parcels))	26.1	104.0	25.1%
3-digit NFMs (Irregular Parcels) (BMC/ADC NFMs (Irregular Parcels))	26.1	104.0	25.1%
5-digit NFMs (Irregular Parcels) (3-digit NFMs (Irregular Parcels))	4.6	17.6	26.2%
Pre-barcoding (dollars / piece)[3]			
Mixed ADC Barcoded NFMs (Mixed ADC Nonbarcoded NFMs)	5.0		
Standard Mail Regular Parcels, NFMs			
Drop Ship (dollars / pound)			
DBMC Parcels, NFMs (Origin Parcels, NFMs)	15.9	18.6	85.7%
DSCF Parcels, NFMs (Origin Parcels, NFMs)	20.3	22.5	90.1%
DDU Parcels, NFMs (Origin Parcels, NFMs)	24.8	26.7	92.8%

Source: PRC-ACR2007-LR5.

Notes

[1] The Postal Service letters mail processing cost model only estimates costs for the combined nonautomation machinable AADC and Mixed AADC categories.

[2] Standard Regular discount is shown. Nonprofit discount is $0.035 resulting in a passthrough of 150 percent for ACR 2007. All other commercial and nonprofit discounts are equal

[3] The Postal Service Standard Mail NFM / Parcel mail processing cost model does not estimate costs separately for pre-barcoded and non-barcoded pieces.

The Commission identifies several presort discounts that, when compared with avoidable cost, produce passthroughs that were over 100 percent in FY 2007. Three letter categories have above 100 percent passthroughs: Automation AADC Letters, Automation 3-digit Letters, and Non-automation 3-digit Nonmachinable Letters. They have passthroughs that are 104.0 percent, 145.4 percent, and 125.4 percent, respectively.

Non-automation 3-digit Flats, BMC Machinable Parcels, and 5-digit Machinable Parcels presort discounts also produce passthroughs above 100 percent, 107.1 percent, 107.6 percent, and 107.6 percent, respectively. The pre-barcoding discount for Automation Mixed ADC Flats had a passthrough of 162.6 percent in FY 2007.[30] In Docket No. R2006-1, the Commission found it appropriate for the differential between the MAADC non-automation flat and the MAADC automation flat to be greater than 100 percent to alleviate rate shock from classification changes that disaggregated the “basic” rate category into a Mixed ADC rate category and an ADC rate category. PRC Op. R2006-1, ¶ 5594.

For each of the other categories, the Commission had set passthroughs in Docket No. R2006-1 at or below 100 percent. The Commission’s passthroughs were based on estimated unit cost avoidances for FY 2008. The FY 2007 cost avoidances necessarily differ from the Docket No. R2006-1 projections for FY 2008. Future annual compliance reports will be comparing actual data between fiscal years which will make comparisons of passthroughs more meaningful.

In its passthrough calculation, the Postal Service calculates the cost avoidance for pre-barcoding letters using only the difference in mail processing unit costs for Non-automation Machinable Mixed ADC letters and Automation Mixed AADC letters. The accepted methodology for calculation of cost avoidances identifies unit cost differences consisting of both unit mail processing costs and unit delivery costs. The Postal Service should use the accepted methodology or provide a convincing explanation for

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[30] The corresponding nonprofit pre-barcoding discount differed from the commercial discount in this instance. The nonprofit pre-barcoding had a passthrough of 150 percent. The Commission’s rationale and discussion of this passthrough in this ACR applies to both commercial and nonprofit discounts.

deviating from accepted practice of including both mail processing and delivery cost in calculating cost avoidance.

Standard Mail dropship discounts are shown in Table VII-D-3.

Table VII-D-3
Standard Mail Enhanced Carrier Route and Nonprofit Enhanced Carrier Route
Workshare Discounts and Benchmarks

Type of Worksharing (Benchmark)	ACR 2007 Discount (cents)	ACR 2007 Unit Cost Avoidance (cents)	ACR 2007 Pass-through
Standard Mail Letters, Flats, Parcels			
Drop Ship (dollars / pound)			
DBMC Letters (Origin Letters)	15.9	18.6	85.7%
DSCF Letters (Origin Letters)	20.3	22.5	90.1%
DDU Letters (Origin Letters)	24.8	26.7	92.8%
DBMC Flats (Origin Flats)	15.9	18.6	85.7%
DSCF Flats (Origin Flats)	20.3	22.5	90.1%
DDU Flats (Origin Flats)	24.8	26.7	92.8%
DBMC Parcels (Origin Parcels)	15.9	18.6	85.7%
DSCF Parcels (Origin Parcels)	20.3	22.5	90.1%
DDU Parcels (Origin Parcels)	24.8	26.7	92.8%

Source: PRC-ACR2007-LR5.

Table VII-D-4 shows the presort cost differentials and resulting passthroughs for ECR categories of Standard Mail.

Table VII-D-4
Standard Mail Enhanced Carrier Route and Nonprofit Enhanced Carrier Route Workshare Discounts and Benchmarks

	ACR 2007		
	Unit Cost Avoidance (cents)	**Discount (cents)**	**Pass-through**
Letter Presort Cost Differentials			
Basic Letter	11.5		
High Density Letter	4.9		
Presort Differential	6.6	4.0	61%
High Density Letter	4.9		
Saturation Letter	5.1		
Presort Differential	-0.2	0.9	-416%
Flat Presort Cost Differentials			
Basic Flat	12.7		
High Density Flat	8.1		
Presort Differential	4.6	4.4	96%
High Density Flat	8.1		
Saturation Flat	5.3		
Presort Differential	2.8	1.8	64%
Parcel Presort Cost Differentials			
Basic Parcel	113.7		
High Density Parcel	362.2		
Presort Differential	-248.6	12.1	-5%
High Density Parcel	362.2		
Saturation Parcel	34.5		
Presort Differential	327.7	0.9	4%

Source: PRC-ACR2007-LR5

For the ECR categories, the Commission calculated the passthroughs for presorting and its analysis found that the passthroughs for High density letter-Saturation letter and Basic parcel-High density parcel are negative. Additionally, the passthrough for High density Parcel-Saturation Parcel is only 4 percent. Further analysis indicates that the mail processing unit costs may be causing the seemingly anomalous results.

In Docket No. R2006-1 the Commission used both mail processing and delivery costs in determining the cost avoidance for ECR mail. In the Postal Service's filing in that case, the mail processing costs were only disaggregated between the basic and high-density/ saturation rate categories. In the Commission's Docket No. R2006-1 Opinion, the Commission urged the Postal Service to disaggregate these costs. PRC Op. R2006-1, ¶ 5598.

In its submission in this year's compliance report, the Postal Service submitted separate mail processing costs for high-density and saturation rate categories. The Commission appreciates the Postal Service's responsiveness in this area. However, the disaggregated costs appear to contain anomalies. In particular, the mail processing cost for high density parcels and saturation parcels was 328.996 cents and 1.278 cents, respectively. The mail processing unit cost for high density letters (1.128 cents) is less than that of saturation letters (1.435 cents). The Postal Service should take a closer look at these costs, identify the source of these seemingly anomalous results and take steps to correct them, if necessary.

For the entire class, there are several passthroughs that are significantly below 100 percent. Although the requirements of the PAEA do not directly address workshare discounts that are below 100 percent of avoidable costs, the first objective in 39 U.S.C. § 3622(b) is "[t]o maximize incentives to reduce costs and increase efficiency." Passthroughs below 100 percent typically indicate inefficiencies. The Postal Service should examine such potential inefficiencies and work to set rates which more fully reflect efficient component pricing.

The Postal Service did not calculate passthroughs for shape-based differences citing the definition of worksharing established by PAEA Section 3622(e)(1) which defines the term "workshare discount" as "rate discounts provided to mailers for the presorting, pre-barcoding, handling, or transportation of mail . . . ." *See* Order No. 43 in which the Commission provided that "workshare discounts, as defined in the PAEA, do not include shape-based differences."

In its comments, The National Postal Policy Council (NPPC) agrees with the Commission's decision in Docket No. R2006-1 to recognize shape-related differences between letters and flats in its recommended rates. Additionally, NPPC contends that "progress toward full recognition of the cost effects of shape is still incomplete." NPPC Comments at 8. NPPC compares the cost differential for Test Year 2008 in Docket No. R2006-1 with the cost differential in the Postal Service's report for FY 2007. It then analyzes the difference in unit revenue between Standard Regular letters and flats produced by the Docket No. R2006-1 rates. NPPC argues that not only has the cost differential between Standard Regular letters and flats increased since Docket No. R2006-1 but that the FY 2007 cost differential "exceeds by approximately 20 percent the difference in unit revenue between Standard Regular letters and flats". NPPC also asserts that there is no evidence to indicate a sizable difference in demand elasticities which some may argue justifies the difference in unit contribution made by letter-shaped and flat-shaped pieces. *Id.* at 9.

In Docket No. R2006-1, the Commission set forth the principle that within a subclass, the postage paid for each mailing should cover the corresponding attributable cost plus make the same contribution per piece as every other mailing within the same subclass. *See* Docket No. R2006-1 PRC Opinion at ¶4001-4037. By virtue of this principle, the Commission extended an ECP approach to all mail characteristics because it would promote end-to-end cost minimization, *i.e.*, productive efficiency. In the section above on First-Class worksharing, the Commission discusses the benefits of product demand information when determining how to reflect cost differences in rates.

PACKAGE SERVICES

Under the Postal Reorganization Act, Package Services mail consisted of four subclasses as follows: Parcel Post, Bound Printed Matter, Media Mail, and Library Mail. The PAEA classifies Bound Printed Matter, Media Mail, and Library Mail as market dominant. It bifurcates Parcel Post between market dominant and competitive, classifying single-piece Parcel Post as market dominant. In addition, the PAEA classifies single-piece Parcel Post International Mail as market dominant. 39 U.S.C. § 3621.

In Order No. 43, the Commission accepted the Postal Service's proposal that Package Services mail consists of the following five products: Single-Piece Parcel Post, Bound Printed Matter Flats, Bound Printed Matter Parcels, Library/Media Mail, and Inbound Surface Parcel Post (at UPU rates).[31] *See* PRC Order No. 43, October 29, 2007, ¶¶ 3029-31; Appendix A at 5.

Financial Results. As reported by the Postal Service, FY 2007 financial results for Package Services are shown in Table VII-E-1.

Table VII-E-1
Package Services
Fiscal Year 2007 Volume, Revenue, Cost, Contribution, and Cost coverage

	Volume (000)	Revenue ($ 000)	Attributable Costs ($ 000)	Contribution to Institutional Costs ($ 000)	Rev./Pc. (Cents)	Cost/Pc. (Cents)	Contribution to Institutional Costs/Pc. (Cents)	Cost Coverage
Package Services:								
Market Dominant Parcel Post:								
Inter-BMC	70,885	547,527	549,128	(1,602)	772.412	774.671	(2.260)	99.7%
Intra-BMC	29,413	153,896	161,603	(7,708)	523.218	549.422	(26.205)	95.2%
Total Market Dominant Parcel Post	**100,299**	**701,422**	**710,732**	**(9,309)**	**699.334**	**708.615**	**(9.282)**	**98.7%**
Bound Printed Matter	637,595	690,563	602,111	88,452	108.308	94.435	13.873	114.7%
Media Mail	164,088	378,567			230.710			
Library Rate	12,527	28,342			226.245			
Media and Library	**176,615**	**406,909**	**445,319**	**(38,410)**	**230.393**	**252.141**	**(21.748)**	**91.4%**
Total Package Services	**914,509**	**1,798,895**	**1,758,162**	**40,732**	**196.706**	**192.252**	**4.454**	**102.3%**

Source: Docket ACR2007, PRC-ACR2007-LR1

An examination of Table VII-E-1 reveals the following:

Single-Piece Parcel Post attributable costs exceed revenues, resulting in a cost coverage of 98.7 percent.[32] As a point of reference, at the rate category level, the Inter-BMC and Intra-BMC cost coverages are 99.7 percent and 95.2 percent, respectively.

FY 2007 revenues for Bound Printed Matter (BPM) exceed attributable costs, producing a cost coverage of 114.7 percent. Pursuant to Order No. 43, BPM now consists of two products, Flats and Parcels. The Postal Service reports BPM revenue and volume data separately by shape for flats and parcels.

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[31] Inbound Surface Parcel Post (at non-UPU rates) is discussed in Chapter IX on International Mail.

[32] Docket No. ACR2007, USPS-FY07-9, File: PP_contribution.xls contains a methodology for calculating separate mail processing and transportation attributable costs for each rate category within Parcel Post, Parcel Select, and Parcel Return Service. Distributing "other" attributable between market dominant and competitive products on a per-piece basis provides a basis for computing contribution.

Attributable costs, however, are reported on a consolidated basis. Accordingly, cost coverage by BPM product is not available for FY 2007. The Commission anticipates that costs, too, will be reported separately for BPM Flats and BPM Parcels in subsequent ACR filings.

As a result of Public Law 106-384, 114 Stat. 1460 (2000), the Postal Service collects cost data for Media Mail and Library Mail on a consolidated basis. Thus, since that time cost coverage has been calculated for the combined product. For FY 2007, Media/Library Mail costs exceed revenues, resulting in a cost coverage of 91.4 percent.[33]

Only the Public Representative raises any compliance issue regarding Package Services products. Noting that Media/Library Mail rates did not cover attributable costs, the Public Representative concludes that Media/Library Mail is being cross-subsidized by other market dominant products and contends that such cross-subsidization raises questions of compliance with a number of policies and provisions of the PAEA.[34] The Public Representative suggests that the Postal Service should provide a narrative explanation describing how market dominant products comply with the PAEA. *Id*.

The Postal Service dismisses any need for a narrative in this proceeding as irrelevant, based on its interpretation that the PRA, not the PAEA, is the applicable legal standard in this proceeding. Postal Service Reply Comments at 5-7.

The issues raised by the Public Representative's suggestion and the Postal Service's response may be disposed of briefly. As discussed above, the Commission did not adopt the legal standard advocated by the Postal Service. The Commission interprets the Public Representative's suggestion for a narrative as forward-looking, *i.e.*, what the Postal Service should be required to submit in ACR proceedings. That issue and others may be appropriately considered in a future proceeding to develop the Commission's regulations under 39 U.S.C. §§ 3652 and 3653.

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[33] In Docket No. R2006-1, the cost coverage for Media/Library Mail was set at 103.7 percent. PRC Op. R2006-1, ¶ 5972.

[34] Public Representative Comments at 5-6 (footnote omitted).

With respect to the reported cost coverages for Single-Piece Parcel Post and Media/Library Mail, subsequent events obviate the need to take further action with respect to those products. In Docket No. R2008-1, the Postal Service increased the rates for both products, on average, by more than the applicable price cap, 2.9 percent. The Postal Service indicates that these increases, 3.30 percent of Single-Piece Parcel Post and 4.54 percent for Media/Library Mail, are designed to improve the profitability of both products. ACR at 19; see also Postal Service Reply Comments at 6, n.9 The changed rates are scheduled to become effective May 12, 2008. In Order No. 66, the Commission addressed the planned rate changes for these products, and, for purposes of that proceeding, did not find them inconsistent with applicable provisions of the PAEA. PRC Order No. 66, at 43-44. Accordingly, for purposes of Docket No. ACR2007, the Commission finds that no further action is necessary.

Worksharing Discounts. Section 3652(b) requires that the Postal Service report, with respect to each market-dominant product for which a workshare discount was in effect during the reporting year, (1) the per-item cost avoided by the Postal Service by virtue of such discount (2) the percentage of such per-item cost avoided that the per-item workshare discount represents, and (3) the per-item contribution made to institutional costs. The passthrough percentages for BPM Flats, BPM Parcels and Media/Library Mail reported by the Postal Service in Docket No. ACR2007 are shown on Table VII-E-2, Table VII-E-3, and Table VII-E-4, respectively.

Table VII-E-2
Bound and Printed Matter Flats
Workshare Discounts and Benchmarks

	ACR 2007		
Type of Worksharing (Benchmark)	**Year-End Discount (Cents)**	**Cost Avoidance (Cents)**	**Pass-through [3]**
BPM Flats			
Presorting (cents / piece)[1]			
Basic Flats (Single Piece Flats)	40.1	See Note [1]	
Carrier Route Flats (Basic Flats)	11.1	10.7	103.8%
Presorting (cents / pound)[1]			
Basic, Carrier Route Flats (Single Piece Flats)			
Zones 1&2	5.8	See Note [1]	
Zone 3	6.2	See Note [1]	
Zone 4	5.5	See Note [1]	
Zone 5	5.1	See Note [1]	
Zone 6	3.9	See Note [1]	
Zone 7	4.1	See Note [1]	
Zone 8	3.3	See Note [1]	
Pre-barcoding (cents / piece)[2]			
Single Piece Automatable Flats (Single Piece Nonautomatable Flats)	3.0	See Note [2]	
Basic Automatable Flats (Basic Nonautomatable Flats)	3.0	See Note [2]	
Carrier Route Automatable Flats (Carrier Route Nonautomatable Flats)	3.0	See Note [2]	
Drop Ship (cents / piece)			
Basic, Carrier Route DBMC Flats (Basic Origin Flats)	31.7	18.7	169.3%
Basic, Carrier Route DSCF Flats (Basic Origin Flats)	70.0	57.3	122.2%
Basic, Carrier Route DDU Flats (Basic Origin Flats)	78.4	74.4	105.4%

Source: PRC-ACR2007-LR6.

Notes:

[1] The BPM cost model does not estimate cost differences between single piece and presorted BPM. Single piece BPM is a residual category with low volume and adequate data are not available. Previously, rate differences between single piece and presorted BPM were based on an assumption that unit mail processing costs for single piece BPM were twice that of presorted BPM. See Docket No R2006-1, USPS-T-38, p. 8.

[2] Separate estimates of pre-barcoding cost savings are not available for BPM flats. Based on the cost savings for Parcel Post parcels, the pre-barcoding discount for BPM flats implies a passthrough of 96.8%. See Docket ACR2007 USPS-FY07-15, 'Parcel Post MP.xls'

[3] Where discounts are equal to unit avoided costs, the calculated passthroughs may deviate from 100% because passthrough percentages are based on unrounded unit avoidable costs.

Table VII-E-3
Bound and Printed Matter Parcels
Workshare Discounts and Benchmarks

Type of Worksharing (Benchmark)	**ACR 2007** Year-End Discount (Cents)	Cost Avoidance (Cents)	Pass-through [2]
BPM Parcels / IPPs			
Presorting (cents / piece)[1]			
Basic Parcels / IPPs (Single Piece Parcels / IPPS)	40.3	See Note [1]	
Carrier Route Parcels / IPPs (Single Piece Parcels / IPPS)	11.1	$ 10.7	103.8%
Presorting (cents / pound)[1]			
Basic, Carrier Route Parcels / IPPs (Single Piece Parcels / IPPs)			
Zones 1&2	5.8	See Note [1]	
Zone 3	6.2	See Note [1]	
Zone 4	5.5	See Note [1]	
Zone 5	5.1	See Note [1]	
Zone 6	3.9	See Note [1]	
Zone 7	4.1	See Note [1]	
Zone 8	3.3	See Note [1]	
Pre-barcoding (cents / piece)			
Single Piece Barcoded Parcels / IPPs (Single Piece Nonbarcoded Parcels / IPPs)	3.0	$ 3.1	95.3%
Basic Barcoded Parcels / IPPs (Single Piece Nonbarcoded Parcels / IPPs)	3.0	$ 3.1	95.3%
Carrier Route Barcoded Parcels / IPPs (Single Piece Nonbarcoded Parcels / IPPs)	3.0	$ 3.1	95.3%
Drop Ship (cents / piece)			
Basic, Carrier Route DBMC Parcels / IPPs (Basic Origin Parcels / IPPs)	31.7	$ 18.7	169.3%
Basic, Carrier Route DSCF Parcels / IPPs (Basic Origin Parcels / IPPs)	70.0	$ 57.3	122.2%
Basic, Carrier Route DDU Parcels / IPPs (Basic Origin Parcels / IPPs)	78.4	$ 74.4	105.4%

Source: PRC-ACR2007-LR6.

Notes:

[1] The BPM cost model does not estimate cost differences between single piece and presorted BPM. Single piece BPM is a residual category with low volume and adequate data are not available. Previously, rate differences between single piece and presorted BPM were based on an assumption that unit mail processing costs for single piece BPM were twice that of presorted BPM. See Docket No R2006-1, USPS-T-38, p. 8.

[2] Where discounts are equal to unit avoided costs, the calculated passthroughs may deviate from 100% because passthrough percentages are based on unrounded unit avoidable costs.

BPM workshare discounts for flats and parcels are available for presorting (Presorted and Carrier Route), for dropshipping (to the DBMC, DSCF and DDU) and for barcoding.

The BPM cost model does not estimate cost differences between single-piece and presorted BPM; however it is assumed that mail processing costs for single-piece BPM is twice that of presorted BPM. The Postal Service notes in USPS-FY07-3, that single-piece BPM is a residual category with low volume and adequate data are not available. Nonetheless, single-piece BPM flats and parcels serve as the benchmark for basic and presorted BPM flats and parcels. The proxy used is inadequate for determining the relationship between the discount offered for basic presorting and the costs avoided by the workshare activity. To enable such a determination to be made, the Postal Service should undertake a study of the costs avoided by the workshare activity from the relevant benchmark.

In Docket No. R2006-1, the Commission recommended a $0.111 discount for Carrier Route Flats, passing through 100 percent of the costs avoided. In Docket No. ACR2007, the Postal Service reports that the avoided costs have decreased to $0.107, resulting in a passthrough of 103.8 percent.

In Docket No. R2006-1, none of the dropshipped discounts recommended by the Commission passed through more than 100 percent of the estimated test year FY 2008 avoided costs. *See* PRC Op. R2006-1, ¶¶ 5142-47. In this proceeding, the Postal Service reports that during FY 2007 the discount for carrier route flats, and each of the dropship passthroughs for BPM flats and parcels exceeds 100 percent.

Table VII-E-4
Media/Library Mail
Workshare Discounts and Benchmarks

Type of Worksharing (Benchmark)	ACR 2007 Year-End Discount (Cents)	ACR 2007 Cost Avoidance (Cents)	ACR 2007 Pass-through [1]
Media Mail			
Presorting (cents / piece)			
Basic (Single Piece)	33.0	33.4	98.7%
5-digit (Basic)	50.0	18.2	275.4%
Pre-barcoding (cents / piece)			
Single Piece Barcoded (Single Piece Non-barcoded)	3.0	3.1	95.3%
Library Mail			
Presorting (cents / piece)			
Basic (Single Piece)	31.0	33.4	92.7%
5-digit (Basic)	47.0	18.2	258.9%
Pre-barcoding (cents / piece)			
Single Piece Barcoded (Single Piece Non-barcoded)	3.0	3.1	95.3%

Source: PRC-ACR2007-LR6.

Notes:

[1] Where discounts are equal to unit avoided costs, the calculated passthroughs may deviate from 100% because passthrough percentages are based on unrounded unit avoidable costs.

Media/Library Mail workshare discounts are available for presorting (Basic and 5-Digit) and for barcoding. In Docket No. ACR2007, all the passthroughs are (slightly) below 100 percent except for 5-Digit. Regarding the discount for 5-Digit presort, in Docket No. R2006-1, the Commission found that reducing passthroughs would result in significantly higher rates for this mail. *See* PRC Op. R2006-1 at ¶¶ 5986-5988. Passthroughs reported for 5-Digit Media/Library Mail, however, are less than those in the last rate case.

SPECIAL SERVICES

Pursuant to Order No. 43, the Commission approved the list of postal products to be included in the Mail Classification Schedule (MCS). Within market-dominant products, certain “ancillary” Special Services are grouped into one product, while other special services are classified as separate products. Special Services within the Ancillary Services product can be purchased only in conjunction with the purchase of mail services. Other Special Service products can be purchased on a “stand-alone” basis.

The Postal Service acknowledges that it is unable to isolate FY 2007 costs, revenues or volumes for the Ancillary Services product or certain “stand-alone” Special Services products. ACR at 12-14. Nor is the Postal Service able to segregate costs, revenues or volumes for Ancillary Services and “stand alone” products between market-dominant and competitive, where such products are offered as both. As a result, the Commission will review domestic special services individually for consistency with the applicable requirements of the PAEA.[35]

The Postal Service’s Annual Compliance Report provides costs, revenues, and volume data for the following special services: Registered Mail, Certified Mail, Insurance, COD, Money Orders, Stamped Cards, Stamped Envelopes, Special Handling, Post Office Box/Caller Service, and Other Special Services collectively. Other Special Services include Address Correction Services, Certificate of Mailing, Delivery/Signature Confirmation, and Return Receipt, among others.

[35] International special services are discussed elsewhere in this report in the section on International Mail.

During FY 2007, special services as a whole provided a contribution to the institutional costs of the Postal Service, generating a cost coverage of 139.1 percent. Money Orders, Stamped Cards, and COD generated a cost coverage of 168.9 percent, 160.9 percent, and 146.8 percent, respectively. With the exception of Registered Mail, all special services—including Other Special Services—made a contribution to institutional costs.

Registered Mail cost coverage was 96.3 percent. For FY 2006, the Registered Mail cost coverage was 55.9 percent. The improvement results from a change in the Postal Service's treatment of Cost Segment 3 mail processing costs. The change is consistent with the Commission's Opinion and recommended Decision in Docket No. R2006-1.

In Docket No. R2006-1, the Commission found that mail processing costs for Registered Mail increased substantially between FY 2005 and FY 2006, as a result of Postal Service redesign of its data collection system—the In-Office Cost System (IOCS). According to the Postal Service, the redesigned IOCS would more accurately distinguish mail processing costs associated with Registered Mail sent by the Postal Service from Registered Mail sent by the public. However, the Commission concluded that the resulting distribution of Registered Mail costs was unreliable. Instead, the Commission applied an adjustment factor used in previous rate proceedings to remove mail processing costs associated with the Postal Service's use of Registered Mail.[36]

For FY 2007, the Postal Service applied the Commission-recommended adjustment factor. The effect of this change is to reduce unit attributable mail processing costs for Registered Mail by 50.6 percent, from $13.75 to $6.80, between FY 2006 and FY 2007, thereby improving the Registered Mail cost coverage for FY 2007.

For Stamped Envelopes, the Commission revised the Postal Service's initial estimate of revenue from $14.8 million to $15.1 million, based upon the Postal Service's response to CIR No. 1, Question 25. The effect of this change increased the cost

[36] PRC Op. R2006-1, ¶ 5276.

coverage for Stamped Envelopes from 99.6 percent initially estimated by the Postal Service to 101.4 percent, as revised.

With respect to service performance, the Postal Service acknowledges that service performance measurement systems are not fully operational. ACR at 15. Consequently, the Postal Service did not provide any service performance measurement data for special services.

Chapter VIII—Competitive Products

LEGAL STANDARD

Section 3653(b)(1) of title 39 requires the Commission to determine "whether any rates or fees in effect during [the prior fiscal] year (for products individually or collectively) were not in compliance with applicable provisions of this chapter (or regulations promulgated thereunder)[.]" Section 3633(a) of title 39 sets forth the legal standards applicable to rates for competitive products, directing the Commission to promulgate regulations to:

- Prohibit subsidization of competitive by market dominant products;
- Ensure that each competitive product covers its attributable costs; and
- Ensure that collectively competitive products cover an appropriate share of institutional costs of the Postal Service.

The Commission implemented section 3633 in Order No. 43, adopting regulations establishing standards for determining the lawfulness of competitive products' rates (prices). PRC Order No. 43, October 29, 2007[37]. In brief, these regulations: (1) identify the tests the Commission will apply to determine whether or not market dominant products are subsidizing competitive products; (2) require each competitive product to recover its attributable costs as defined in section 3631(b[38]); and establish the requirement that competitive products collectively recover, at a minimum, 5.5 percent of the Postal Service's total institutional costs. *See* 39 C.F.R. § 3015.7.

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[37] These regulations became effective December10, 2007. 72 Fed. Reg. 64155 (November 15, 2007).

[38] Section 3631(b) defines attributable costs to mean "the direct and indirect costs attributable to such product through reliably identified causal relationships." In Order No. 43, the Commission concluded that negotiated service agreements, including International Customized Agreements, meet the definition of separate products. It recognized, however, the possibility that functionally equivalent agreements could be grouped as a single product. PRC Order No. 43, ¶ 2177.

In Order No. 43, the Commission identified the following as competitive products:

TABLE VIII-A-1
Competitive Products

Express Mail
Domestic Express Mail
Inbound International Expedited Services
Outbound International Expedited Services
Priority Mail
Domestic Priority Mail
Outbound International Priority Mail
Parcel Select
Parcel Return Service
International
International Priority Airlift (IPA)
Internatioal Surface Airlift (ISAL)
International Direct Sacks—M-Bags
Global Customized Shipping Services
Inbound Surface Parcel Post at non-UPU rates
International Money Transfer Service
International Ancillary Services
Competitive Negotiated Service Agreements (NSAs)
Domestic NSAs
Outbound International
Source: PRC Order No. 43, Appendix A, Part B – Competitive Products, §§ 2000-01.
The Postal Service states that "[w]ith the proposed grouping of international customized agreements, section 2520 (Global Customized Shipping Services) no longer has relevance and should be eliminated from the MCS." *See* United States Postal Service Submission of Additional Mail Classification Schedule Information in Response to Order No. 43, Docket No. RM2007-1, November 20, 2007, at 5, n.7.

In its report, the Postal Service identifies 16 competitive products.[39] ACR at 24-26. In related library references, it provides cost, revenue, and volume data for these products, noting that the new products do not always directly match the previous categories of mail under the PRA. *Id.* at 23.

The Postal Service takes the position, as it did with respect to market dominant products, that domestic and international competitive products' rates in effect during FY 2007 were governed by the provisions of the Postal Reorganization Act and, thus, for purposes of section 3653, fully complied with the applicable requirements of the PRA. *Id*. at 22. As discussed above, the Commission does not find the Postal Service's interpretation persuasive.

^^The prohibition against cross-subsidies

Rule 3015.7(a), which implements section 3633(a)'s prohibition against cross-subsidies by market dominant products, establishes the standards the Commission will employ to test for cross-subsidies. The Commission has expressed its intention to use the incremental cost test, but acknowledges that it presently lacks the data necessary to conduct that test. Until reliable incremental cost data are available, the Commission has stated that it would test for cross-subsidies by comparing whether revenues from competitive products were greater than the sum of their attributable costs, plus causally related, group-specific costs.

The Postal Service provides revenue and attributable cost data for competitive products, but indicates that no estimate of group-specific costs is available. The Postal Service states that it has begun the process of identifying causally related, group-specific costs. *Id*. at 27. Until this analysis is completed, the Commission can not compare revenues and to more than attributable costs.

[39] The Postal Service distinguishes between Inbound and Outbound International Direct Sacks–M-Bags on the basis of the cost, revenue, and volume data underlying each product. Under the MCS, these two "products" constitute a single product called "International Direct Sacks–M-Bags." Omitted from the Postal Service's listing on pages 24-26 of the ACR are two further competitive products that are included in the MCS: Global Customized Shipping Services and Domestic Negotiated Service Agreements. As noted, *infra*, the latter product, Domestic Negotiated Service Agreements, is discussed by the Postal Service on page 14 of the ACR.

Thus, no separate analysis of potential cross-subsidy is provided. The Commission anticipates that such data will be available in future Postal Service ACR filings.

ATTRIBUTABLE COST RECOVERY

By statute and regulation, each competitive product must recover its attributable cost. 39 U.S.C.§3633(a)(2); 39 C.F.R. § 3015.7(b). The Postal Service indicates that available FY 2007 cost and revenue data do always match the new product list. Thus, while it is confident that "major competitive products" recover their attributable costs, the Postal Service states that whether some smaller competitive products failed to do so cannot be determined from the available data. *Id*. at 27-28.

Revenue and cost data submitted by the Postal Service filed with its annual report suggest that each competitive product except two recovers its attributable cost. With respect to international negotiated service agreements (or International Customized Mailing Agreements), information provided by the Postal Service is insufficient to enable the Commission to make a definitive determination.

FY 2007 data for Parcel Return Service (PRS) indicate that attributable costs exceed revenues, yielding a cost coverage of approximately 98 percent. On March 12, 2008, the Postal Service filed a notice of changes in rates of general applicability for competitive products, including PRS.[40] In Docket No. CP2008-3, the Commission issued an information request regarding the sufficiency of the planned PRS rate changes.[41] Rates for Parcel Return Service must be set to recover to attributable costs of that product.

Inbound Surface Parcel Post (at non-UPU rates) data indicate that attributable costs exceeded revenues in FY 2007. Rates for this product are set through bilateral agreement. It is the

[40] *See* Notice of United States Postal Service of Governors' Decision No. 08-03, March 12, 2008. The Commission docketed the Postal Service's filing as Docket No. CP2008-3.

[41] *See* Commission Information Request No. 1, Docket No. CP2008-3, March 19. 2008 and Response of the United States Postal Service to Commission Information Request No. 1, March 26, 2008. To the extent that there are carrier cost savings for parcel return service, the coverage may higher. However, the Postal Service did not provide these data.

Commission's understanding that the agreement may be subject to periodic adjustment. At the next opportunity for renegotiation, rates under this agreement must be adjusted so that revenues for this product recover its attributable costs consistent with applicable PAEA requirements.

International Customized Mail (ICM) agreements are a form of Negotiated Service Agreement. These are reviewed in chapter IX.

COMPETITIVE PRODUCTS CONTRIBUTION

In implementing § 3633(a)(3), the Commission established the initial contribution from competitive products collectively at 5.5 percent of the Postal Service's total institutional costs. 39 C.F.R. § 3015.7(c). The Postal Service estimates that the aggregate competitive products share of institutional costs for FY 2007 is 5.66 percent. ACR at 28; USPS-FY07-9.

Based on its review of the data FY 2007 data submitted by the Postal Service, the Commission confirms that competitive products' contribution to institutional cost exceeded the threshold established in rule 3015.7(c).

COMMENTER ISSUES

Only one public comment addressed competitive products issues. DMA and PSA suggest that there may be a need for the Commission to reevaluate competitive products' contribution based on the "razor thin margin" reported by the Postal Service in this proceeding as well as the general findings offered by the Federal Trade Commission in its recent report.[42] In addition, Joint Commenters suggest that possible changes to Postal Service costing systems may have an effect on the estimated costs for competitive products and thus affect their share of institutional costs. Joint Commenters urge the Commission "to hold competitive products harmless for the impact of adjustments in how costs are measured." *Id*. at 7.

This proceeding is not the forum for considering Joint Commenters' suggestion that the Commission reevaluate competitive products' current contribution. Nor is it necessary for the Commission to speculate on what it might do in the future in

[42] DMA-PSA at 6, citing "Accounting for Laws that Apply Differently to the United States Postal Service and Its Private Competitors," *A Report by the Federal Trade Commission* (December 2007) at 55.

response to possible changes in costing methods. The Commission recognizes that, pursuant to section 3633(a), regulations applicable to competitive products may be revised from time-to-time.

Chapter IX—International Mail

INTRODUCTION

The Commission's Annual Compliance Determination marks the first Commission report to publicly review the financial and service performance (where applicable) of the international mail services offered by the Postal Service.[43] Appendix A describes international mail services, organizes such services into market dominant and competitive products as listed in the MCS, and briefly discusses the origin and development of international mail volumes, revenues and costs. The rates and fees in effect for international mail during FY 2007 were set by the Postal Service without prior Commission review pursuant to the provisions of the PRA.

SUMMARY AND FINDINGS

The distinction between outbound rates and inbound rates has important ramifications for the Postal Service's financial performance. The Commission's major findings for FY 2007 follow:

- Revenues exceeded attributable costs for international mail as a whole, providing a contribution of $256.1 million;
- Revenues for each outbound product exceeded their corresponding attributable costs;
- Revenues from market dominant inbound First-Class Mail International were substantially less than their corresponding attributable costs;
- Revenues for competitive inbound Surface Parcel Post (at non-UPU rates) did not cover their corresponding attributable costs by a relatively small amount.

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[43] Pursuant to section 3663 of the Postal Reorganization Act, the Commission issued eight annual reports to Congress, covering Fiscal Years 1998 through 2005. *See* Docket Nos. IM99-1, IM2000-1, IM2001-1, IM2002-2, IM2003-1, IM2004-1, IM2005-1 and IM2006-1. However, the content of these reports are not public. *See* 112 Stat. 2681-527.

Since the Commission began issuing its Reports to Congress on the revenues, volumes and costs of international mail in FY 1998, the revenues for inbound mail have been problematic. The non-compensatory nature of market dominant inbound mail means that domestic mailers are subsidizing foreign mailers who use the same postal infra-structure, but bear none of the burden of contributing to its institutional cost. This problem stems primarily from the rate-setting procedure for inbound letter post[44], the largest inbound category of mail. Rates for this category are established by international agreement through the UPU,[45] of which the United States is a member. However, changes in rates embodied in the agreement (*i.e.*, the UPU Convention) are only made once every four years and must be approved by a majority of the UPU's 191 member countries. While the UPU is moving, in principle, towards more cost-based, country specific rates, progress has been slow.

In accordance with the UPU Convention, the Postal Service (or any postal administration) can opt out of the UPU-established rates by negotiating bilateral or multilateral rate agreements with other countries for some or all of its international mail. As noted above, inbound Surface Parcel Post at non-UPU rates do not provide revenues that cover attributable cost. While the resulting loss of contribution is relatively small, the non-compensatory nature of the non-UPU rates for inbound Surface Parcel Post is particularly troublesome as these rates were negotiated on a bilateral basis.

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[44] The term "letter post" refers to mail that is not Parcel Post or Express. Thus, letter post, also referred to as LC/AO mail, basically contains mail similar to domestic First-Class Mail, Periodicals, Standard Mail, Bound Printed Matter, and Media/Library Mail, weighing up to four pounds.

[45] The Universal Postal Union (UPU) is a United Nations technical agency through which international treaties governing the exchange of international mail, including rates, are negotiated among its 191 members. The U.S. is a member of the UPU.

ANALYSIS OF INTERNATIONAL MAIL

Market Dominant Products.

Outbound Mail. For FY 2007, the Postal Service reports that outbound First-Class Mail International generated a net contribution to institutional costs of $188.8 million on revenues of $680.3 million and costs of $491.5 million. ACR at 8. Outbound International Ancillary (Special) Services, covered their costs and generated a small contribution to the institutional costs of the Postal Service during FY 2007.

In the Postal Service's ACR, service performance for First-Class Mail International is reported with, but separately from, domestic First-Class Mail. According to the Postal Service, on-time service performance is measured for the "domestic leg of transit" for both outbound and inbound single-piece First-Class Mail International "using the same set of service standards as domestic First-Class Mail."[46] For outbound mail, the transit time begins when test letters are retrieved from collection boxes, etc., and ends when the letters are sorted at designated international mail processing facilities in the U.S. For inbound mail, the transit time begins with "arrival at the international processing center and ends with delivery to the intended recipient." *Id*. at 16.

The Postal Service reports on-time delivery performance of 91.4 percent for single-piece First-Class Mail International. *Id.* at 17. As with domestic First-Class Mail service performance, the reported percentage represents the performance of single-piece First-Class Mail letters, cards, and flats, combined. Unlike domestic First-Class Mail, this percentage is a composite of overnight, 2-day, and 3-day performance, as well as performance for both outbound and inbound First-Class Mail International.

The Postal Service did not provide any service performance measurement data for outbound International Ancillary (Special) Services.

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[46] *Id.*, at 16. Service performance for First-Class Mail International letters is measured by the International Mail Measurement System (IMMS), operated by an external service performance measurement contractor, using methods comparable to EXFC. *See* "United States Postal Service: Service Performance Measurement," November 2007, at 28-29, incorporated in *Notice of Request for Comments on Service Performance Measurement Systems for Market Dominant Products*, December 4, 2007.

Based upon the financial results discussed above, the Commission finds the rates and fees for outbound First-Class Mail International to be consistent with the applicable provisions of chapter 36 of the PAEA. With respect to service performance, the Commission can not evaluate outbound First-Class Mail International service performance against the established overnight, 2-day, and 3-day service standards using the performance score of 91.4 percent, as the reported score is a composite of the overnight, 2-day, and 3-day performance for both outbound and inbound First-Class Mail International service. The Postal Service should revise its reporting of First-Class Mail International service performance and provide overnight, 2-day, and 3-day performance for both outbound and inbound, separately.

Inbound Mail. In contrast with outbound First-Class Mail International, however, inbound First-Class Mail International revenues did not cover costs, and therefore made no contribution to institutional costs. For FY 2007, the Postal Service reports a loss from inbound First-Class Mail International of $72.8 million on revenues of $197.9 million and costs of $270.7 million. *Id*. at 9. In addition, revenues from inbound Registered Mail did not cover costs.[47] Consequently, market dominant inbound products as a whole did not make any contribution to the institutional costs of the Postal Service.

Losses in inbound First-Class Mail International and Registered Mail were offset slightly by a positive contribution from inbound Surface Parcel Post at UPU rates. Although representing a very small amount of volume, inbound Surface Parcel Post at UPU rates not only generated sufficient revenues to cover costs, but produced the highest cost coverage of any international mail product—market dominant or competitive—during FY 2007.

For inbound First-Class Mail International, the net loss in contribution is caused by the failure of revenues from foreign postal administrations, with the exception of Canada, to cover

[47] The Postal Service's ability to increase revenues for inbound Registered Mail is limited in the short term because reimbursement rates are subject to negotiations in the UPU. Those negotiations occur once every four years. The Commission understands that the Postal Service plans to press for more compensatory rates for inbound Registered Mail during future negotiations in the UPU.

attributable costs. Such revenues, also known as terminal dues, are determined by rates set by the UPU, and are not compensatory. Revenues from Canada, on the other hand, are determined by a bilateral agreement, whose rates are compensatory. The fact that UPU terminal dues rates are insufficient to cover costs is exacerbated by the Postal Service's failure to obtain the maximum terminal dues revenues as a result of its failing to meet UPU quality-of-service "targets" for inbound First-Class Mail International, as discussed below.

The impact of non-compensatory UPU terminal dues rates on Postal Service revenues is a long-standing problem identified by the Commission in previous international mail reports to Congress. The Commission here reiterates the recommendation provided in its most recent international mail report to Congress:[48]

> The Postal Service should negotiate compensatory bilateral or multilateral rates with industrialized countries and those developing countries that are sources of significant volume.

Non-compensatory terminal dues revenues cause domestic mailers to cross-subsidize foreign mailers of inbound First-Class Mail International.

With respect to service performance, measurement of the domestic leg of inbound First-Class Mail International is incorporated into the composite performance of all First-Class Mail International, and is not separately provided by the Postal Service. Service performance data for inbound Surface Parcel Post and International Ancillary (Special) Service is not yet available from the Postal Service.

Quality of Service-Linked Terminal Dues Revenues. Terminal dues revenues are derived from payments for handling and delivering inbound letter post. Under the UPU's "quality of service link to terminal dues" system, payments are adjusted for the quality of delivery service provided in the country of destination for inbound letter post coming from other countries participating in the system. The United States

[48] Docket No. IM2006-1 (Non-Public), *Report to the Congress: FY 2005 International Mail Volumes, Costs, and Revenue*, June 30, 2006, at 3.

participates in a quality of service-linked terminal dues system with other industrialized countries, and a few developing countries. Service performance is measured by the UNEX monitoring system, which is operated by the International Post Corporation, a cooperative association of 24 member postal administrations in Europe, North America and Asia-Pacific. The UNEX monitoring system is separate from the IMMS that is used to develop the composite service performance score for outbound and inbound international mail.

In accordance with the quality of service-linked terminal dues system, each participating country receives, as an incentive, a 2.5 percent increase in their terminal dues payments for participation. In addition, each participating country is eligible for another 2.5 percent increase if service performance for inbound mail achieves the UPU-established annual performance "target"—the percentage of inbound mail delivered within the service standard of the recipient country. Based upon these bonuses, each participating country could earn up to 105 percent of its otherwise expected terminal dues revenues for achieving the established target when delivering inbound mail. However, each participating country can also be penalized if the annual service performance target is not met. The penalty is a 1/3 percent (0.0333%) reduction of their expected terminal dues payment for each percentage point that service performance falls below the annual service performance target, not to exceed 5 percent.[49]

Service performance is measured based upon the elapsed time between the time of entry with, or transfer to (after customs clearance), the Postal Service, whichever is later, and delivery of the inbound mail to the intended recipient. In addition, measurement is undertaken only on inbound mail delivered to addresses in a select number of metropolitan areas. For the Postal Service then, quality of service performance is measured based upon the percentage of inbound First-Class Mail International delivered to those metropolitan areas that achieves

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[49] Universal Postal Union, *Quality of Service Link to Terminal Dues for Countries in the Target System: Users Manual* (24 March 2007), Module 3 – Remuneration Principles. The remuneration formula is: Remuneration = 100% - [(Quality of Service Target – Actual Quality of Service) x Penalty Factor] + 2.5% Participation Incentive. If, for example, Actual Quality of Service were 70%, remuneration would be 100% - [(85% - 70%) x 1/3%] = 95% + 2.5% = 97.5%. *Id.*

the service “targets” for overnight, 2-day, and 3-day First-Class Mail. The UPU-established quality of service “targets” that determine bonuses and penalties were set at 85 percent and 86 percent for calendar years 2006 and 2007, respectively.

In FY 2007, terminal dues payments to the Postal Service for delivering inbound First-Class Mail International from participating countries did not to cover attributable costs, producing a cost coverage far below 100 percent. Because the Postal Service did not meet the UPU quality of service target for calendar year 2006, it received less than the 5 percent maximum terminal dues bonus payment for the first quarter (October-December, 2006) of FY 2007. Moreover, preliminary service performance data for January through November 2007 suggests that the Postal Service will likely not meet the UPU quality of service target for calendar year 2007.[50] Failure to meet the UPU quality of service target for calendar year 2007 means that the Postal Service will fail to receive the maximum terminal dues revenues, equal to 105 percent, for the last three quarters of FY 2007, which would improve the cost coverage for inbound First-Class Mail International by a relatively small amount.

Competitive Products.

Outbound Mail. During FY 2007, competitive outbound products, including outbound International Ancillary (Special) Services,[51] generated sufficient revenues to cover costs, and therefore made a contribution to the institutional costs of the Postal Service. Among competitive outbound products, Priority

[50] It should be noted, however, that the Postal Service does not consider the quality of service performance results for purposes of terminal dues payments comparable to any other data heretofore reported in its Annual Compliance Report. More specifically, the Postal Service does not consider this service performance data, which is compiled on a calendar year basis, as strictly comparable to the FY 2007 period covered by this report. As a result, the year-to-date performance omits data for the October-December 2006 period and includes data for the October-November 2007 period.

[51] In the draft MCS, International Money Orders, both outbound and inbound, are classified as services within the separate "stand alone" competitive product, International Money Transfer Service (MCS § 2530). *See* Order No. 43, Appendix A, at 3. International Money Orders as a whole covered its costs and generated a positive contribution to the institutional costs of the Postal Service. For analysis, however, Money Orders are included with all other competitive special services.

Mail International ranked highest in contribution. International Expedited Services, consisting of Global Express Guaranteed and Express Mail International, ranked second highest. International Parcel Airlift (IPA) Service ranked third highest among competitive outbound products, followed by International Surface Airlift (ISAL). Global Direct Outbound and International Direct Sacks-M-bags ranked fifth and sixth, respectively. Collectively, however, IPA, ISAL, M-Bags, and Global Direct Outbound provided a relatively small amount of contribution to institutional costs.

Within competitive outbound products, International Customized Mail (ICM) agreements as a whole provided a positive contribution to institutional costs. Based upon additional data provided by the Postal Service, however, the Commission found ICMs in the competitive product, International Direct Sacks-M-Bags, did not to cover costs. Moreover, the additional data permitted the Commission to make a preliminary determination as to whether individual ICMs, as separate competitive products in the Mail Classification Schedule, covered costs. This matter is discussed more fully below.

Inbound Mail. Inbound competitive products collectively comprise the smallest source of contribution to the institutional costs of the Postal Service. While inbound competitive products as a whole generated a positive contribution to institutional costs, revenues for inbound Surface Parcel Post at non-UPU rates did not cover costs. Given that revenues for inbound Surface Parcel Post at non-UPU rates are derived from inward land charges established through bilateral negotiations, the Postal Service should direct its efforts in upcoming negotiations to conclude an agreement that ensures all inward land charges for competitive inbound Surface Parcel Post at non-UPU rates are compensatory.

International Customized Mail Agreements. ICM agreements made a positive contribution to the institutional costs of the Postal Service. However, each ICM is classified as a separate competitive product in the Mail Classification Schedule (MCS). Order No. 43, ¶¶ 2177, 3001. As such, each ICM must be evaluated for its consistency with section 3633(a)(2) of the PAEA, which requires that each competitive product cover its costs attributable.

To make this evaluation, the Commission asked the Postal Service to provide “revenue, pieces, weight, volume variable cost, and product-specific cost for each ICM contract” in effect during FY 2007[52]. The Postal Service provided the requested information on March 19, 2008, just prior to the statutory publication data for this report. This was not sufficient time to permit a complete Commission analysis. The Commission’s analysis was hampered further by difficulties in reconciling differences between specific revenue, cost and volume data provided by the Postal Service for each ICM and summary data for those same ICMs.

Nevertheless, the Commission’s preliminary analysis suggests that in FY 2007, about 10 percent of active ICMs produced a loss. These ICMs reduced the total contribution from ICMs by approximately 45 percent.

These preliminary results suggest that more vigorous oversight and management of certain ICM agreements is warranted. The Commission finds that the Postal Service must negotiate more favorable contract terms in successor ICM agreements so that those agreements that did not recover their attributable costs will do so as soon as legally possible.

Furthermore, it is evident that in the past the Postal Service did not collect, maintain, and review international operations data with the same attention as was given domestic services. Neither the Commission nor Postal Service management can exercise their respective responsibilities without timely access to sufficient, reliable data on costs and performance. The Commission views correction of these deficiencies as a matter of highest importance.

[52] Commission Information Request No. 1, question 1, January 24, 2008, at 1-2.

Chapter X—Negotiated Service Agreements

In 2002, the Postal Service proposed the first Negotiated Service Agreement (NSA) with Capital One Services, Inc. (Docket No. MC2002-2). The agreement combined two main elements: (1) declining block rates intended to encourage additional use of First-Class Mail for soliciting customers, and (2) the substitution of electronic notices in lieu of the physical return of undeliverable solicitations. The Commission approved the NSA with the addition of a stop loss provision that limited discounts to the estimated savings from the electronic return provision. Since then, the Commission has approved five additional NSAs, with HSBC North American Holdings Inc., (HSBC); Bank One Corporation, (Bank One);[53] Discover Financial Services, LLC (Discover); Bookspan; and Bank of America Corporation. Two more, with Life Line Screening and The Bradford Group, are pending.

In the past year, the Commission has received data collection reports from the Postal Service for Bookspan (August 14, 2007 covering June 2006-May 2007); Capital One (January 31, 2008 covering October 2006- August 2007); Bank One/Chase (February 25, 2008 covering April 2006-March 2007); HSBC (February 25, 2008 covering January 2007-December 2007); and Discover (February 26, 2008 covering January 2007-December 2007). Each of these agreements includes declining block rates to encourage additional use of solicitation mail. All but Bookspan also contain provisions to substitute electronic notices for physical return of undeliverable solicitations.[54]

The Postal Service's annual compliance report addresses NSAs in a very limited way, presenting the discounts paid to the one company that earned them (Discover) during the fiscal year. *See*

[53] As a result of a merger, the successor NSA partner is referred to as Bank One/ Chase.

[54] The Bookspan NSA is designed to encourage Standard Mail volume, which is not entitled to forwarding and return service without an additional fee.

Response of the United States Postal Service to Questions 15-16 of Commission Information Request No. 2, February 26, 2008, question 15. In the short time between the filing of the data collection reports and the Commission's deadline, some limited analysis could be done, the results of which follow.

For two of the NSAs (Capital One and HSBC), the volumes sent by the mailer failed to achieve the levels anticipated, and no discounts were awarded. Capital One continued to utilize the electronic return provisions, which resulted in an estimated net benefit of $2.2 million for the Postal Service. HSBC did not utilize electronic returns, and therefore it did not generate any benefit for the Postal Service.

The remaining three NSAs (Bookspan, Discover, and Bank One/ Chase) did achieve volumes above the thresholds for the declining block rates. The following table presents a comparison of actual NSA volumes with the pre-implementation forecasts of the volume each mailer would send in the absence of an NSA (before rates volume).

TABLE X-1
Summary of NSA Volumes
(millions)

	Forecast Volume	Actual Volume	Variance	Percent Variance
Capital One	1,109	1,061	(49)	-4%
HSBC	856	582	(274)	-32%
Discover	441	424	(17)	-4%
Bank One/Chase	944	1,104	160	17%
Bookspan	78	97	19	24%

These variances influence the evaluation of the impact of the declining block rates on each mailer's behavior. The Postal Service's data collection reports make a simplifying assumption that all variance from the forecast before-rates volume is a direct result of the discounts. This approach can distort the results of the analysis because it does not control for the effects of changes in non-price (exogenous) factors that can influence mail volumes.[55] The Postal Service acknowledges this problem in its report on the Discover NSA.

The Commission has previously suggested an alternative approach to estimating the effect of marginal discounts (or declining rates) which uses the price elasticity of the mailer, or a reasonable proxy. *See* PRC Op. and Further Recommended Decision, MC2004-3, ¶¶ 5001-38. The Postal Service included this type of analysis in its report on the Bookspan NSA, and the result is that the discounts are estimated to have benefited the Postal Service by generating new volume for a $92 thousand net increase in contribution. This estimate uses the average elasticity of all mail in the same subclass (-0.296) to identify the amount of new volume that is attributable to the discounts.[56] It is substantially different than the results of the Postal Service method, which estimates a $1.5 million net increase in contribution from the discounts. The higher estimate relies on the volume forecast at the time of the original filing of the NSA, and implies an own-price elasticity of -1.93 for Bookspan. While it is not possible to know with certainty the effects of discounts on the behavior of any given mailer, the Commission finds the estimation method which utilizes reasonable proxies for a mailer's elasticity to be more likely to generate reasonable results than simply assuming that the forecast made before the filing of the NSA remains valid despite constantly shifting economic conditions.

The Discover NSA actual volumes fell just short of the before-rates forecast, but just above the threshold to earn discounts. Therefore, the analysis in the data collection report indicates that there was no additional volume sent in response to the discount

[55] The potential for exogenous factors to alter mail volume and result in a net loss in contribution due to the payment of discounts on mail that would have been sent absent the NSA was the primary reason for the Commission's adoption of stop loss caps based on cost savings.

[56] In response to CIR No. 1, question 16, the Postal Service provided an estimate of $160 thousand net increase in contribution using a more recent elasticity (-0.368).

incentives. Just as in the Bookspan NSA, this static approach generates an unrealistic result, in this case a $330 thousand net loss in contribution from the discounts. If the same own-price elasticity as was used for Bookspan (-0.296) is applied to determine the increase in volume resulting from the discounts, the estimated net benefit for the Discover NSA is $878 thousand in additional contribution.[57] Adding the net savings from electronic returns, the total estimated net benefit is $946 thousand in increased contribution.

Analysis of the Bank One/Chase NSA presents additional complications. As with most of the other NSAs, this one included a stop loss cap set at the amount of savings expected to result from the substitution of electronic notices for physical returns of undeliverable solicitations. Shortly after the NSA was filed with the Commission, the merger of Bank One and Chase was announced. Because the terms of the agreement and the financial analysis supporting it were developed for a pre-merger with Bank One, an added level of uncertainty existed that made the stop loss cap critical to the Commission's approval of the agreement.

The Postal Service reports that the stop loss cap was reached in the second year of the agreement. As a result, it is not possible to estimate any effect the discounts may have had on volume using the elasticity-based approach. The change in volume is estimated by applying the elasticity to the change in price at the margin (*i.e.,* the discount on the last piece). Since the cap was reached well

[57] The elasticity is used for illustrative purposes. This should not be construed as endorsing this as the best proxy for Discover's eligible mail, but the Commission finds that it provides a more reasonable basis for estimating the effects of the NSA than the analysis presented in the data collection report. In response to CIR No. 1, question 16, the Postal Service provided an estimate of $2.3 million net increase in contribution using a more recent elasticity (-0.368). However, the estimate assumed that all of the volume increase was new First-Class Mail, and none was converted from Standard Mail. Previous analysis conservatively assumed that any increase in volume would come in the form of converted Standard Mail solicitations. It should also be noted that all of these estimates apply the discount response (elasticity) to all of Discover's First-Class Mail volume, two-thirds of which was statement mail. It is widely believed that statement mail is less price elastic than solicitation mail.

before the end of the year, the marginal price was not discounted, and no change in volume can be attributed to the discounts.

It could be argued that marginal purchasing decisions for mailings were being made at discounted rates, and therefore some increase in volume occurred at the time of those purchases. However, the cap was reached roughly halfway through the three-year agreement,[58] and about six months after implementation, Bank One/Chase indicated that it believed it was possible to reach the cap less than one year into the agreement.[59] This seems to suggest that from a very early date in the agreement, Bank One/ Chase anticipated that it would receive the full amount of discounts allowable under the cap well before the agreement expired. If this were the case, the discounts would not be perceived as dependent on any mailing decisions, but rather as an inevitable fixed refund, unaffected by any change in behavior.[60]

The following table summarizes the impact of NSAs on the contribution of the Postal Service. It shows that the NSAs collectively improved the net financial position of the Postal Service by about $2.5 million, virtually all of which was a result of the cost savings from substituting electronic notices for physical return of undeliverable solicitations. The net loss in contribution from the Bank One/Chase NSA occurred despite the stop loss cap, which was designed to protect the Postal Service from harm even if no benefit was realized as a result of the discounts. The cap was developed using the estimated savings from eliminating the physical return of undeliverable solicitations, and the bulk of the savings (about $2 million per year) were projected to come from avoiding the return of flats. However, sometime before the implementation of the agreement, Bank One/Chase ceased mailing flat-shaped First-Class Mail solicitations and the anticipated savings were not realized.

[58] Since Bank One/Chase is not the one NSA for which discounts were awarded in FY 2007, it can be inferred that the cap was reached before October 2006, which was roughly one-and-a-half years after implementation.

[59] *See* Docket No. MC2004-3, Petition of J.P. Morgan Chase & Co. to Reopen Record, September 14, 2005, at 6.

[60] The only way the mailer's behavior would affect the discounts would be in the timing of payment, not the amount.

TABLE X-2
Summary of NSAs Net Effect on Postal Service Contribution
($ thousands)

	Discount Incentives	ACS Net Savings	Total Net Benefit
Capital One	–	2,243	2,243
HSBC	–	–	–
Discover	878	68	946
Bank One/Chase	(957)	174	(783)
Bookspan	92	–	92
Total	**13**	**2,484**	**2,497**

Note: The time period covered varies for each NSA, but each reflects one year.

Appendix A—International Mail

This Appendix describes outbound and inbound international mail categories offered by the Postal Service. The Appendix also organizes the international mail categories into market dominant and competitive products as listed in the Mail Classification Schedule. Finally, the Appendix briefly discusses the origin and development of international mail volumes, revenues and costs.

Description of International Mail. For purposes of analysis, the Postal Service categorizes international mail by its place of origin, either U.S. or foreign. U.S. origin, or “outbound” mail, begins as collection mail or other domestically entered mail dispatched from U.S. processing facilities to foreign postal administrations for delivery. Foreign origin, or “inbound” mail, is entered in foreign countries and is transported to the Postal Service for delivery in the U.S.

Postal Service International Mail Categories. Based upon existing data systems, the Postal Service’s annual compliance report (and supporting documentation) presents international mail data organized into outbound and inbound categories rather than market dominant and competitive products. Table A-1 displays both outbound and inbound international mail categories offered by the Postal Service.

Table A-1
International Mail Categories and Services by Origin as Presented by the Postal Service, FY 2007

Outbound Mail	Inbound Mail
First-Class Mail International	**Surface**
Letter, Flats, IPPs and Parcels	LC/AO
International Cards	Parcel Post
International Expedited Services	**Air**
Global Express Guaranteed (GXG)	LC/AO
Exprses Mail International	Express
International Packages	Parcel Post
PMI Flat-Rate Envelopes	**Inbound Extra Services**
PMI Flat Rate Boxs	**Global Direct**
PMI Parcels	
International Priority Airmail (IPA)	
International Surface Airlift (ISAL)	
International Direct Sacks–M-Bags	
Outbound Extra Services	

The primary categories of outbound international mail, shown in the upper half of Table A-1, are: First-Class Mail International, International Expedited Services, International Packages, and Outbound Extra Services. In addition, there are three categories of outbound international mail for bulk business (*i.e.,* large-volume) mailers.

First-Class Mail International consists of single-piece letters, cards, flats, irregular pieces and packages (IPPs), and parcels weighing up to 4 pounds. International Expedited Services consists of two separate but related services. The first, Global Express Guaranteed (GXG), is a high-speed delivery service for documents and non-documents (including merchandise), featuring a date certain, money-back delivery guarantee to over 190 countries. 71 Fed. Reg. 76232 (December 20, 2006). The other, Express Mail International, is also a high-speed delivery service for documents and non-documents to over 190 countries with a money-back delivery guarantee to select destinations. *Id.*

International Packages consists of three separate services similar to domestic Priority Mail: Priority Mail International (PMI) Flat-Rate Envelope, PMI Flat-Rate Boxes, featuring two flat-rate box-size options,[1] and PMI Parcels.[2] Outbound Extra Services is the name given to several special services that are similar to those available to domestic mailers. The Outbound Extra Services offered by the Postal Service during FY 2007 were Insurance, Money Orders, Registered Mail, Restricted Delivery and Return Receipt.

The three bulk business categories of outbound mail are International Priority Airmail (IPA), International Surface Airlift (ISAL), and International Direct Sacks-M Bags. IPA is a bulk service for mailpieces that can be entered as First-Class Mail International. ISAL is also a bulk service for First-Class Mail International mailpieces that meet a 50-pound minimum per mailing. M-Bags provide outbound service for printed matter, such as magazines, catalogs, and other publications, entered in “direct” sacks for delivery to one addressee.

The lower half of Table A-1 shows the primary categories of inbound international mail, which includes LC/AO (*i.e.,* letter post), Express, Parcel Post, and Special Services. As described previously, LC/AO includes mail similar to domestic First-Class Mail, Periodicals, Standard Mail, Bound Printed Matter, and Media/Library Mail. LC/AO is presented separately for surface or air transportation. Surface and Air LC/AO and Express are equivalent services that correspond to outbound First-Class Mail International and Express Mail International, respectively. Parcel Post is also presented separately by mode of transportation (*i.e.,* surface or air). Surface and Air Parcel Post offer service for virtually any

[1] In FY 2007, the Postal Service proposed (and subsequently approved) combining three preexisting service offerings—Economy Parcel Post, Air Parcel Post, and Global Priority Mail—into a new service, Priority Mail International (PMI). 71 *Fed. Reg.* 76232 (December 20, 2006).

[2] In the Postal Service’s presentation, PMI Flat-Rate Boxes and PMI Parcels were combined into one line item for analysis. They are listed here as separate services within Priority Mail International for informational reasons only.

mailable matter other than correspondence with weight limits that vary by destination country, which range from 44 pounds to 70 pounds. Inbound Special Services are called Extra Services. Inbound Extra Services consist of Money Orders and Registered Mail.

Global Direct, available for outbound and inbound international mail, is displayed separately in the last line of Table A-1. As an outbound service, mailers tender to the Postal Service items meeting the applicable makeup and preparation requirements for domestic mail in the destination country. However, Global Direct is available only pursuant to an International Customized Mail (ICM) agreement—an individually negotiated agreement between the Postal Service and a qualifying mailer. Such agreements often require minimum volume and revenue commitments by the mailer in exchange for volume discounts from the Postal Service. In addition to Global Direct, ICMs are (predominantly) utilized for IPA and ISAL qualifying mail, as well as Express Mail International and PMI items, with volumes typically dispatched to Western Europe and other industrialized countries. As an inbound service, Global Direct often involves agreements with foreign postal administrations.

Market Dominant and Competitive Products. As required by the PAEA, and pursuant to Order No. 43, the Commission approved the list of postal products to be included in Mail Classification Schedule (MCS). The MCS classifies mail services, including international mail categories, into market dominant and competitive products. Table A-2 displays market dominant and competitive products, including Global Direct and International Ancillary (Special) Services, by origin according to the classifications in the MCS.

Table A-2
International Mail Categories and Services by Origin as Presented by the Postal Service, FY 2007

MCS

Market Dominant Products	**Competitive Products**
Outbound Mail	**Outbound Mail**
1125 **First-Class Mail International**	2110 **International Expedited Services**
Letters, Flats, IPPs, Parcels	Global Express Guaranteed (GXG)
Cards	Express Mail International
1510 **Internationl Ancillary (Special) Services**	2210 Priority Mail International
Inbound Mail	PMI Flat Rate Envelopes
1130 **First-Class Mail International**	PMI Flat Rate Boxes
Surface LC/AO	PMI Parcels
Air LC/AO	2505 **International Priority Airmail (IPA)**
1410 **Surface Parcel Post**	2510 **International Surface Airlift (ISAL)**
Surface Parcel Post (at UPS rates)	2515 **International Direct Sacks–M-Bags**
1510 **International Ancillary (Special) Services**	2520 **Global Direct Outbound**

Table A-2 (Continued)
International Mail Categories and Services by Origin as Presented by the Postal Service, FY 2007

MCS

2535 **International Ancilliary (Special Services)**[1]	2215 **Air Parcel Post**
Inbound Mail	Air Parcel Post
2115 **International Expedited Services**	2520 **Global Direct Inbound**
Express	2525 **Surface Parcel Post (at non-UPU rates)**
	2530 **International Ancillary (Special) Services**[1]

1 Competitive outbound and inbound Money Orders are classified as a service within the separate “stand alone” product, International Money Transfer Service (MCS § 2530). For analysis, Money Orders will be discussed with all other competitive Special Services.

For market dominant products, outbound First-Class Mail International is comprised of single-piece letters, flats, aerogrammes, packages and cards, consistent with the Postal Service’s initial presentation. Inbound First-Class Mail International consists of Surface and Air LC/AO. Unlike the Postal Service’s initial presentation, however, both Outbound and Inbound Extra Services were subsequently separated into market dominant and competitive products by the Postal Service at the request of the Commission. *See* Response of the United States Postal Service to Quesetion 4 of Commission Information Request No. 1, February 4, 2008. Market dominant outbound special services are Registered Mail, Return Receipt, and Restricted Delivery. Registered Mail is the only inbound special service. Based upon data provided by the Postal Service, the Commission also separated inbound Surface Parcel Post into market dominant and competitive products; that is, Surface Parcel Post (at UPU rates) and Surface Parcel Post (at non-UPU rates), respectively.

With respect to competitive products, seven are classified as outbound—International Expedited Services, Priority Mail International, International Priority Airmail (IPA) Service, International Surface Airlift (ISAL), International Direct Sacks-M-Bags, Global Direct Outbound, and International Ancillary (Special) Services. International Expedited Services consists of GXG and Express Mail International. Priority Mail International consists of PMI Flat-rate Envelopes, PMI Flat-Rate Boxes, and PMI Parcels. International Priority Airmail (IPA), International Surface Airlift (ISAL), International Direct Sacks-M Bags, and Global Direct Outbound are unchanged from the Postal Service’s presentation. Competitive outbound special services are Insurance, Money Orders,[3] and Registered Mail.

[3] Competitive outbound and inbound Money Orders are classified as a service within the separate "stand alone" product, International Money Transfer Service (MCS § 2530). *See* Order No. 43, Appendix A, at 3. However, Money Orders will be discussed with all other competitive special services.

Separate from, but included within, competitive outbound International Expedited Services, PMI, as well as IPA, ISAL, International Direct Sacks-M-Bags, and Global Direct, are numerous International Customized Mail (ICM) agreements, each of which is classified as a separate product pursuant to the Mail Classification Schedule (MCS).

Competitive inbound products include International Expedited Services, Air Parcel Post, Global Direct Inbound, Surface Parcel Post (at non-UPU rates), and International Ancillary (Special) Services. International Expedited Services consists of Express. Money Orders are the only competitive inbound special service.

Postal Service Volumes, Revenues and Costs. The Postal Service reports volume, revenue and cost data separately for each outbound and inbound international mail category. Depending upon the mail category, volumes represent pieces dispatched or received for delivery or, in the case of Extra Services, transactions.

The Postal Service reports revenues from several sources. For outbound mail categories, revenues are obtained from postage paid, or fees for Outbound Extra Services.[4]

The Postal Service also receives revenues in the form of settlement charges—payments from foreign postal administrations for handling, transporting, and delivering inbound mail in the U.S.[5] There are three types of settlement charges:

- *Terminal dues* are charges imposed on all inbound letter post. The Postal Service assesses terminal dues at rates set by the Universal Postal Union (UPU) on all developing countries (DCs) and industrialized countries (ICs), except Canada, which pays terminal dues based upon rates established in a negotiated bilateral agreement, *i.e.,* non-UPU rates.
- *Imbalance charges*, established by the Postal Service, are payments received for handling inbound Express.
- *Inward land charges* consist of payments received for handling inbound Surface and Air Parcel Post. For the Postal Service, country payments for inward land charges parallel payments of terminal dues. All countries pay inward land charges at UPU rates, except Canada, which pays such charges at non-UPU rates based on a bilateral agreement.

[4] In addition to fees, revenues for outbound Money Orders include interest earned on the balance of outstanding money orders, and funds taken into revenue from unredeemed money orders more than one year old. The Postal Service also receives revenues from a money wire transfer service. For inbound Money Orders, revenues are derived from a commission for redeeming international foreign issue money orders, and the gain (or loss) on foreign exchange transactions.

[5] For purposes of analysis, the Commission will use the term settlement "charges" when referring to payments (revenues) received from foreign postal administrations, and the term settlement "costs" when referring to Postal Service payments to foreign postal administrations.

With respect to costs, outbound and inbound mail utilize similar and different resources. For outbound mail, the Postal Service incurs costs for collection, processing, domestic transportation, international transportation and associated overhead costs, as well as payments to foreign postal administrations to deliver the mail. These latter expenses are referred to as settlement costs. Inbound mail requires processing, domestic transportation, delivery and the overhead costs associated with performing these activities. Note that outbound mail incurs virtually no delivery costs while inbound mail incurs no international transportation costs on the part of the Postal Service. [6]

The Postal Service develops and reports these international mail costs according to the Commission's volume variable costing methodology. Volume variable costs are those costs that change in response to a small change in mail volume. The Postal Service organizes volume variable costs into six cost functions: (1) Processing, (2) Delivery, (3) Domestic Transportation, (4) International Transportation, (5) Settlement Costs, and (6) All Other (primarily administrative costs associated with the other five cost functions). Total and unit volume variable costs, as well as total and unit volume variable costs by cost function, are reported for each outbound and inbound mail category.

In addition, the Postal Service reports international service incremental costs, representing costs that can not be reliably assigned to any specific international mail and therefore are treated as incremental to international mail as a whole. Such costs include expenses for salaries and benefits for personnel, supplies and services, rents, utilities and other related expenses of providing international mail services.

[6] Postal Service reports a small amount of delivery costs incurred for outbound international mail resulting from carrier pick-up of such mail from postal customers or collection boxes.

Appendix B—Cost Attribution and Distribution Issues

In its ACR FY 2007 filing, the Postal Service adopted the cost attribution and distribution methodology used by the Commission in Docket No. R2006-1 in general but made a number of relatively minor changes. Some of these changes were a result of better data collection methods and were non-controversial. These include: new allocation and distribution of LDC 15 and LDC 48 cost pools; distribution of rural delivery costs by shape; a new source for detached address label volumes; the estimation of the percentage of saturation letters that are sequenced; and the disaggregation of delivery confirmation costs by shape. The Commission finds these changes to be appropriate in this instance.

In cost segment 14, purchased transportation, the Postal Service used an improved distribution key to allocate the costs of the Christmas network. No parties commented on this change and the Commission finds it acceptable.

The largest change in attributable costs in the FY 2007 CRA was the determination of the variability and the distribution of costs for the Retiree Health Benefits and CSRS retirement obligations. The Postal Service explains its treatment of these costs in the Supplement to USPS-FY07-02. The Postal Service says that the costs of $7.1 billion, which is the sum of the $5.4 billion payment into the Retiree Health Benefits Fund and the $1.7 billion payment for the health benefit premiums for current retirees is included in Cost Segment 18, and is treated as it treats the costs for Workers Compensation. The costs for Retiree Health Benefits is divided into “current year” and “prior year” amounts, with the current year amount of $4.5 billion having the same variability as all labor, which adds $2.7 billion to attributable costs. The prior year amount of $2.6 billion was determined to be institutional.

In this Annual Compliance Report, USPS-FY-07-7 documents:

- The formation of Cost Segment 3 cost pools;
- Development of mail processing accrued costs and volume-variable subclass costs by cost pool; and
- Other related calculations that are inputs to the B Workpapers, CRA model, and Special Cost Studies.

In light of the difficulty in quickly converting the main-frame SAS programs to PC SAS and then successfully running the programs in a timely manner, the submission of “linked” output summary tables within the Cost Segment 3 costs materials are helpful. The Commission finds the linked tables submitted in response to Commission Information Request No. 2 (CIR

No. 2), question 10 helpful in its review and anticipates linked tables will be submitted with future annual compliance reports at the time of the filing.

A hard copy review of the Cost Segment 3 SAS programs and documentation provides the following insights into and suggestions regarding the SAS programs and the Cost Segment 3 costs.

Express Mail. Prior to FY 2007, the Postal Service grouped the out-of-office clerk Express Mail delivery costs with the non-handling costs and then distributed them to the subclasses on the basis of the in-office subclass handling costs. In FY 2007, the out-of-office Express Mail delivery costs are now separately identified using In Office Cost System (IOCS) tally information that is now available in the IOCS redesign of FY 2005. Also in FY 2007, the Postal Service now uses a 0.43 percent volume-variability (VV) factor to calculate the volume-variable portion of out-of-office Express mail delivery costs. The volume-variability is calculated using Base Year 2000 data for the now obsolete cost segment 3.4 for Special Delivery Messengers. There is no justification given for why this Base Year 2000 data on Special Delivery Messengers appropriately represents the current activities of clerks sent off the premises as needed to collect and deliver Express mail pieces. The Commission recommends that the Postal Service review its method for calculating out-of-office Express Mail Delivery/Collection costs volume-variability factors to ensure that this method reflects the current Express Mail collection/delivery environment. The results of the review should be submitted to the Commission before the end of FY 2008 and subjected to public comments.

Once calculated, the volume-variable costs are then allocated to domestic and international Express Mail based on in-office Express Mail IOCS tallies in the MODS LDC 18 Express Mail cost pool and all LDC 48 cost pools as well as the NON-MODS Express Mail cost pool. In FY 2007, total Express Mail volume was 69.9 million pieces (domestic 54.8 million + 14.4 million (in-bound and out-bound international)). Of the 69.2 million pieces, 79 percent (54.8 / 69.2 = 79 percent) was domestic Express Mail. However, the Postal Service allocated 96 percent of the out-of-office Express mail delivery costs to domestic Express mail on the basis of IOCS tallies.

Given the large disparity in the FY 2007 volume split between domestic and international Express Mail and the split based on IOCS tallies[1], the Commission recommends that the Postal Service review its IOCS allocation methodology to ensure that the actual cost allocation of the out-of-office Express Mail costs, is appropriate.

[1] 96 percent domestic and 4 percent international; Docket No. ACR2007, Responses of the United States Postal Service to Questions 9, 10, 12, 13, and 17 of the Commission Information Request No. 7, February 14, 2008.

In FY 2007, the Express Mail volume-variability factor, under the Mail Processing-NON-MODS Group of the Cost Segment 3 Clerk and Mailhandler cost pools Table 1, is a calculated as 0.7723. This volume-variability (VV) factor is significantly lower than the VV factor of 1.00 used in past rate cases including the VV factor used in Docket No. R2006-1. A review of this change suggests that this calculated VV factor is a weighted average of in-office Express Mail (1.00 volume-variability) and out-of-office Express Mail (0.4305 volume-variability). Response to CIR No. 3, question 2 (d). The Commission recommends that for useful reviews, any weighting factors used in calculations, as well as the calculations themselves are adequately described and their justifications are adequately explained in future compliance reports.

Bulk Mail Centers. Prior to FY 2007, the Postal Service used IOCS tallies to distribute the cost of bulk mail centers (BMC) to classes of mail because the MODS system was not used at BMCs. Since FY 2006, the MODS system was expanded to include BMCs, and these costs are now distributed based on MODS instead. In library reference USPS-FY07-7, the Postal Service provided information on the changes it made to mail processing accrued costs and volume-variable subclass costs in the segment 3 cost pools.[2] The PRC-version methodology used for MODS 1&2 facilities was extended to BMCs to align “function 1” cost pools. In FY 2007, MODS hours were used to allocate BMC data into the same cost pools as those used in Docket No. R2006-1. In addition, MODS hours were used to identify two additional cost pools and segregate those costs from the “OTHER” cost pool. The two new pools are the LDC 13 Tray Sorter/Robotics and the LDC 14 manual parcel sorting.

The Commission believes it is logical to align all “function 1” cost pools to ensure consistency in the appropriate application of distribution keys. Rather than combining costs into an “OTHER” category, the establishment of unique LDC 13 and 14 cost pools allows costs to be properly disaggregated and facilitates the alignment of costs to those activities that generated them.

Non-MODS Offices. Prior to FY 2007, the nonMODs mail processing break-time was included as an input to the B workpapers. The clocking in/out time was subsequently allocated to subclass costs in the B workpapers. In FY 2007, both break-time and clocking in/out costs are included as mail processing NonMODs input subclass costs for the B workpapers. While the methodology used for allocating clocking in/out costs remains the same, the location of where and how the costs are included has changed. The Postal Service has indicated that the inclusion of clocking in/out time in the MODS hours of the cost pools facilitates downstream data processing.

In FY 2007, the Postal Service added code to the file “ADMWIN.sas” to allocate clocking in/out time for the NonMODS subclass costs to be consistent with its handling of the clocking

[2] Docket No. ACR2007, USPS-FY07-7, files “Preface.Part.1.USPS-FY07-7.doc.”

in/out time for the BMCs and the MODS 1&2 facilities. No change in methodology appears to have taken place – rather, the change is in the location of where the allocation occurs – internal to the SAS program versus external to the program. The change appears reasonable.

Delivery/Collection Costs.

Postal Service Changes.

1. Methodology Changes—In the FY 2007 Annual Compliance Report (ACR), the Postal Service made three methodological changes to the Commission's approved methodology that affected the attribution of city carrier in-office and street time costs in Segments 6 and 7. First, the Postal Service treated approximately $60 million in non-volume variable collection box costs as product-specific costs attributable to First-Class single-piece letters, rather than treating these costs as institutional costs, according to the Commission's established method. Second, it allocated approximately $5 million non-volume variable collection costs from Express Mail collection boxes, previously considered institutional, to Express Mail. Third, the Postal Service assigned approximately $25 million associated with delivery confirmation scans performed by carriers directly to Special Services – Other.

2. Data Collection Changes—The Postal Service made three data collection changes that could affect the development of unit delivery costs. First, it estimated the volume of detached address labels (DALs) from samples taken from the City Carrier Cost System (CCCS) and Rural Carrier Cost System (RCCS), rather than using mailer-provided data to obtain estimates of DAL volumes. This allowed the breakout of DALs by shape of the mailpiece with which they were associated.

Second, the Postal Service estimated the proportion of city saturation letters and flats taken directly to the street (sequenced mail) using the difference between saturation and cased volumes of ECR saturation letters and flats taken from the CCCS. This is in contrast to the method used prior to FY 2007 which used data from the In-Office Cost System (IOCS) combined with an old productivity casing study.

Finally, the Postal Service used the RCCS to estimate the relative volumes of boxholder ECR saturation flats and parcels rather than relative flat and parcel volumes from the Revenue, Pieces, and Weights (RPW) sample. In all other substantive respects, the Postal Service followed the methodology utilized by the Commission in Docket No. R2006-1.[3]

[3] Opinion and Recommended Decision, PRC Op. R2006-1, ¶5155. Specifically, the Postal Service incorporated the Commission's model of disaggregating automation and non-automation delivery costs by using the delivery point sequenced (DPS'd) percentage associated with each rate category. The Commission also changed the percentages of mail that was DPS'd based on the updated accept rates it requested.

Comments of Parties. Valpak raises general concerns about the small unit cost difference between the unit delivery costs for saturation letters and flats. Valpak Comments at 38. It reiterates concerns it raised in both R2005-1 and R2006-1, namely that saturation letter unit costs should be lower. *See*, Valpak Initial Brief, Docket No. R2006-1.

Valpak also questions the validity of delivery data in general, pointing to various discrepancies involving the measurement of DALs. It first points out a possible discrepancy between the approximately 529 million DALs identified in the Billing Determinants, and the number of DALs used to distribute FY 2007 delivery costs. *Id.* at 42. Similarly, Valpak questions whether and how mixed Basic ECR letters will be used for ratemaking purposes, since this category was eliminated May 15, 2007. *Id.* at 44. Finally, Valpak identifies a possible DAL discrepancy involving parcels, by pointing out that there are approximately 1.6 billion DALs associated with parcels, but approximately 900 million saturation parcels that would need DALs. *Id.,* at 43.

Valassis responds to Valpak's key delivery arguments in its Reply Comments. It first argues that the new method of using the RCCS, coupled with the shift away from DALs associated with flats due to the DAL surcharge, has increased the volume of non-DAL rural saturation letters by 60 percent. Valassis argues that the large increase in non-DAL saturation letters is primarily due to correcting the misidentification of rural DALs and their proper identification as rural saturation letters. Since the costs associated with DALs had been attributed to saturation flats, a reduction in DAL volumes would tend to reduce rural saturation flat with DALs costs. Valassis Reply Comments at 3 and 4, n. 4.

Valassis rebuts Valpak's implication that saturation letters should be substantially less costly to deliver than saturation flats delivered as sequenced mail. It contests Valpak's contention that nearly all saturation letters are DPS'd. Rather, Valassis asserts that the new estimates of DALs, proportions of saturation letters and flats taken to the street, and rural boxholder volumes by shape, show that only 49.4 percent of city saturation letters are DPS'd and approximately 15.5 percent of city saturation letters were taken directly to the street. These two low-cost delivery options constituted approximately 65 percent of city saturation letters, a lower percent than the low cost delivery options available to city saturation flats, 74 percent of which were delivered as sequenced mail. *Id.* at 6. Valassis makes a similar argument with regard to rural saturation letters. It states that 56 percent of rural saturation letters were delivered as either DPS'd mail or boxholder mail, while 50 percent of rural saturation flats were delivered as boxholder mail. Valassis concludes that both saturation letters and flats take advantage of lower cost delivery options to similar degrees. *Id.,* at 6.

Valassis argues that the Postal Service's measurement of DAL volumes is correct. It states that only 529 million DALs appear in the Billing Determinants, because those DALs were connected with the revenue collected once the DAL surcharge was implemented. In contrast, the 3.1 billion DALs delivered by city and rural carriers used for unit delivery cost development, represented all DALs measured by the CCCS and RCCS in FY 2007. *Id.,* at

7. Valassis also notes that the use of DALs with parcels includes basic and high density parcels in addition to saturation parcels. This accounts for the discrepancy between DALs associated with parcels and the volume of saturation parcels. *Id.,* at 7.

Major Mailers Association (MMA) disagrees with the method the Commission used in Docket No. R2006-1 to separate casing from non-casing costs of disaggregated rate categories. In that docket the Commission used modeled mail processing DPS'd percentages associated with individual rate categories to perform this task. MMA does not question the desirability of using DPS'd percentages to separate casing from non-casing costs for individual rate categories. Rather, it contends that the Commission should have tied DPS'd percentages for individual automation and non-automation rate categories to the more aggregated DPS'd percentages for automation and non-automation mail taken from the CCCS, instead of using model-derived DPS'd percentages to perform the rate disaggregation. MMA-FY07-_FCM_Delivery_Cost_Savings.xls, worksheet "Corrected DPS%s," and Initial Comments of Major Mailers Association (MMA Comments), Docket No. ACR2007, at 15.

MMA proposes this method for two reasons. First, it contends that actual DPS'd percentage data is superior to model-derived DPS'd percentage data. MMA Comments at 16. In addition, MMA's method increases the difference between non-automation machinable presort and automation DPS'd percentages, thereby increasing avoided unit delivery casing costs for automated mail categories. MMA Comments at 17. Specifically, it solves what might be considered an anomaly, namely that Non-Auto Machinable mail for all presort levels had higher delivery workshared savings than Auto-Mixed AADC.

Finally, MMA identifies an error in the DPS'd percentage for Auto 5-Digit Letters CSBCS/ Manual Sites entered into the delivery spreadsheets from the First-Class mail flow spreadsheet. *Id.,* at 16, n. 13.

The Postal Service rebuts MMA's argument in favor of tying the percent of modeled DPS'd mail to the percent of mail estimated to be DPS'd by the CCCS. It first argues that the Commission should generally treat criticisms of its pre-existing methodologies as being prospective in effect; that is, as suggestions on how to improve the cost models for future compliance reports, and it then notes that the Commission has used modeled percentages of DPS'd mail to develop unit delivery costs by rate category for the last four omnibus rate cases. Reply Comments Of The United States Postal Service, Docket No. ACR2007, at 9 and 13.

Commission Analysis.

1. Methodology Changes—The Postal Service associated approximately $60 million non-volume variable collection box costs with First-Class Single-Piece Letters as product-specific costs, rather than treating these costs as institutional costs according to the

Commission's established method. The Commission asked the Postal Service to justify this change in light of the fact that First-Class Single-Piece Cards, Priority Mail, Express Mail, Zone Rated Parcels, U.S. Postal Service Mail, Free Mail, and International Mail were collected from general collection boxes. CIR No. 2, question 1, February 1, 2008. The Postal Service confirmed the mail products were collected in general collection boxes, but justified assigning all non-volume variable collection costs to First-Class single-piece letters since the collection boxes "…are put into service for collecting First-Class Single Piece letters…." Responses of the United States Postal Service to Questions 1 – 5, 7, 8, 14, and 19 of Commission Information Request No. 2, February 11, 2008.

The Commission does not find this explanation a sufficient basis for a methodology change. Not only are numerous mail products other than First-Class single-piece letters collected in general collection boxes, the boxes themselves do not state that their use is solely for the collection of First-Class single-piece letters. Consequently, the Commission will retain the costs as institutional costs.

The Postal Service also associated approximately $5 million non-volume variable collection costs from Express Mail collection boxes as costs specific to the delivery of Express Mail. The Commission accepts this change because Express Mail collection boxes are identified to the general public as being for the collection of Express Mail.

Third, the Postal Service assigned approximately $25 million associated with Delivery Confirmation Scans directly to Special Services – Other. The Commission asked the Postal Service whether delivery confirmation scans were used for competitive services (*e.g.*, Priority Mail). CIR No. 2, question 2, February 1, 2008. The Postal Service response agreed that delivery confirmation scans were associated with both competitive and market dominant products, but it stated that delivery confirmation scans have been classified as market dominant, and so their costs should be assigned to a market dominant product.

The Commission accepts the Postal Service treatment for purposes of this filing in the absence of information on how to accurately adjust this allocation. However, the Commission finds it would be more appropriate to distribute the cost of these scans in proportion to the volume of the specific products for which the scans are made, keeping in mind that Priority Electronic and Parcel Select Electronic include the recovery of costs associated with delivery confirmation scans in their rates. The Postal Service should correct this cost distribution in future filings. The proper allocation of the costs of delivery scans is particularly important given the distinction between Market Dominant and Competitive products outlined in the PAEA.

2. Data Collection Changes—The Commission agrees with Valassis that the percentage of saturation letters delivered by low cost delivery letter mechanisms (DPS'd, sequenced mail and rural boxholder) are approximately the same as the percentage of saturation flats delivered by the low cost flat delivery mechanisms of sequenced mail and

rural boxholder. The Commission reproduced Valassis' calculation for city routes that 65 percent of saturation letters are delivered either as DPS'd or sequenced mail, while 74 percent of saturation flats are delivered as sequenced mail.[4] The Commission also reproduced Valassis' calculation for rural routes that 50 percent of saturation flats are delivered as boxholder mail[5]. The Commission was not able to exactly reproduce Valassis' calculation for rural routes 56 percent of saturation letters are delivered as either DPS or boxholder mail. Rather, the Commission calculated a lower percent, 45 percent for these rural letter delivery methods.[6]

The Commission also agrees that the data anomalies identified by VALPAK are readily explained. The discrepancy between the volume of DALs with the DAL surcharge in the Billing Determinants, and the total volume of DALs in the CCCS and RCCS is explained by the fact that the DAL surcharge only applied to DAL volumes subsequent to May 15, 2007 when the DAL surcharge was implemented, while the DALs recorded in the CCCS and RCCS are recorded for the entire FY 2007. The Postal Service also confirmed that the volume of DALs associated with ECR parcels would be greater than the volume of DALs associated only with ECR saturation parcels, since basic and high density ECR parcels must also be sent with DALs. Response of the United States Postal Service to Commission Information Request No. 2, Question 14.

The Commission finds additional reasons to support the new data collection methods. First, In R2006-1, the Postal Service estimated the FY 2005 volume of DALs by taking a mailer-provided annual 2004 DAL volume, and increasing it by the ratio of FY 2005 saturation flats to FY 2004 saturation flats.[7] This method is no longer valid because a DAL surcharge was implemented in FY 2007. PRC Op. R2006-1, ¶5422. The prior method of estimating DALs does not account for the volume effect of this price change. For this reason, the Commission accepts the new method of collecting data on DAL volumes. Second, the Commission finds the use of data sampled from a current and established dataset to estimate the volume of sequenced mail an improvement over relying on an outdated casing productivity study. Finally, the new data on rural boxholder saturation flats shows that, since the test year 2008 estimates made in R2006-1, saturation flats have increased by 13 percent compared to 5 percent for saturation letters, thereby offering an additional reason for the narrowing of unit cost difference between saturation letters and flats.[8]

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[4] *See*VolAdj071211.xls,"SaturationVols." Cells: D15/D11; F20/(D20+D15+D11); and F20/(D20+D15+D11).

[5] *See* UDCInputs.xls, "RCSECRVOls: BoxholderbyShape!D13/(BoxholderbyShape!D13+RCSECRVols!C27).

[6] *See* UDCInputs.xls, "RCSECRVOls": BoxholderbyShape!D13/(BoxholderbyShape!D13+RCSECRVols!C27).

[7] *See* Docket No. R2006-1, PRC-LR-11, UDCInputs.PRC.xls, "DALS."

[8] *See* UDCModel07211.xls, "7.Boxdrs.ByShape," UDCmodel.PRC.xls, "7.Boxdrs.ByShape."

While the Commission finds the new data collection methods to be an improvement, it is concerned about the growth of in-office direct labor costs attributed to certain mail categories. *See* CIR No. 1, question 12. The Postal Service responded to a question from the Commission regarding these increases. It stated that because modeled DPS'd percentages increased from the previous rate case, in-office unit direct labor costs increased due to a decline in cased mail volumes. Response of the United States Postal Service to Commission Information Request No. 1, Question 12b. While the answer is technically satisfactory, it raises a theoretical concern, at least for certain non-automation rate categories identified in the table above. If the volume of cased mail has declined, and the variability of casing is approximately 100 percent (which should certainly be true for non-automation, non-machinable mail), the percentage decline in volume should be matched by a similar percentage decline in cost. That is not the case for the identified mail categories, and is an area that warrants further examination.

Regarding MMAs comments, the Commission agrees with the Postal Service that using modeled DPS'd percentages to develop unit delivery costs for individual rate categories is an established Commission practice. The Commission concludes that it would be imprudent to make such a substantial change in methodology in this proceeding. However, the use of sampled DPS'd delivery percentages rather than DPS'd percentages developed in mail processing models may be appropriate for the development of unit delivery costs. The Postal Service should review this issue prior to its next annual report. This is an issue the Commission also may examine after it establishes rules to alter cost or pricing methodologies outside of annual compliance reviews and/or annual price cap filings.

Abbreviations and Acronyms

Long Version	Abbreviation/Acronym
FY 2007 Annual Compliance Report	ACR
area distribution center	ADC
automated area distribution center	AADC
Automated Flat Sorting Machine	AFSM
Automated Package Processing System	APPS
Automated Tray Handling System	ATHS
bulk mail centers	BMCs
Bulk Metered Mail	BMM
City Carrier Cost System	CCCS
Civil Service Retirement System	CSRS
Collect on Delivery	COD
Consumer Price Index	CPI
Consumer Price Index for all urban consumers	CPI-U
cost and revenue analysis	CRA
Cost of Living Adjustments	COLA
Customer Satisfaction Measurement	CSM
delivery point sequence	DPS
delivery point sequenced	DPS'd
Destinating Sectional Center Facilities	DSCF
detached address label	DAL
educational, cultural, scientific or informational [value]	ECSI
enhanced carrier route	ECR
Equal Employment Opportunity	EEO
External First-Class Measurement System	EXFC
Global Express Guaranteed	GXG
Integrated Financial Plan	IFP
Intelligent Mail Barcode	IMB
International Cost and Revenue Analysis	ICRA
International Customized Mail	ICRA
International Mail Measurement System	IMMS
International Priority Airmail	IPA

Abbreviations and Acronyms

Long Version	Abbreviation/Acronym
International Surface Airlift	ISAL
irregular pieces and packages	IPPs
letter post	LC/AO
Labor Distribution Code	LDC
Mail Classification Schedule	MCS
Mailers Technology Advisory Council	MTAC
Management Operating Data System	MODS
mixed area distribution center	MADC
multiline optical character reader information system service	MLOCR-ISS
Negotiated Service Agreement	NSA
Office of Personnel Management	OPM
Occupational Safety and Health Administration	OSHA
personal computer software and solution	PC SAS
Postal Accountability and Enhancement Act	PAEA
Postal Reorganization Act	PRA
qualified business reply mail	QBRM
Remote Encoding Center	REC
Postal Service Retirement Health Benefits Fund	PSRHBF
Premium Forwarding Service	PFS
Priority Mail International	PMI
Revenue, Pieces, and Weights	RPW
Rural Carrier Cost System	RCCS
Small Parcel Bundle Sorter	SPBS
software and solution	SAS
Strategic Transformation Plan 2007 Update	Strategic Transformation Plan
Total Factor Productivity	TFP
unit delivery costs	UDC
United States Postal Service FY 2007 Annual Compliance Report	ACR
Universal Postal Union	UPU
Voice of the Employee	VOE