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MAURA ROBINSON
VICE PRESIDENT, PRICING

MARIE T. DOMINGUEZ
VICE PRESIDENT, GOVERNMENT RELATIONS AND PUBLIC POLICY

SUBJECT: Audit Report – Impact of Postal Accountability and Enhancement Act Price Caps (Report Number CRR-AR-10-005)

This report presents the results of our audit of the impact of the Postal Accountability and Enhancement Act's (Postal Act of 2006 or "the Act") price caps on U.S. Postal Service rates (Project 10RG006CRR000). Our objective was to evaluate the impact of the Postal Act of 2006's mandated price caps on Postal Service rates. The Act requires the U.S. Postal Service Office of Inspector General (OIG) to audit the data collection systems and procedures the Postal Service uses in their rate-making process. This audit was self-initiated and addresses both financial and operational risks. Please refer to Appendix A for additional information about this audit.

The Postal Act of 2006 fundamentally changed the Postal Service's rate-setting process and divided Postal Service products into two categories: market-dominant and competitive. The market-dominant category includes classes of mail such as First-Class™ and Standard, for which the Postal Service holds a monopoly. Priority Mail® and Express Mail® are examples of classes of mail in the competitive products category, which compete with products competitors in the private sector offer.

The Act established a price cap on postage rates for market-dominant products. The price cap is limited to the increase in inflation for the most recent 12-month period.[1] The price cap applies to classes of mail rather than to the market-dominant category as a whole. Additionally, the Act allows the Postal Service to bank any unused portions of rate increases for up to 5 years.[2]

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[1] The Postal Act of 2006 requires the Postal Service to use the Consumer Price Index for Urban (CPI-U) Consumers as a measure of inflation.
[2] For example, if the CPI-U is 2.5 percent for 1 year and the Postal Service raises rates for that class of mail by 1.5 percent, the unused 1 percent could be used to raise rates within the next 5 years. However, the rate increases, including prior years' unused rates increases, may not exceed the CPI-U by more than 2 percent.

The Act also requires the Postal Service to cover the costs for each class of mail or type of mail service and for market-dominant and competitive products to contribute towards covering the general overhead costs of the Postal Service. The Act requires the Postal Service to assure it collects adequate revenue to maintain long-term financial stability.

Mail volume peaked at 213 billion pieces in fiscal year (FY) 2006. Since then, mail volume has declined each year[3] and much of the current Postal Service network is underutilized. The network has about 36,000 post offices, 600 processing facilities, and 600,000 career employees. Even with aggressive cost-containment efforts, mail volume declines spread the Postal Service's costs over a smaller mail volume base, resulting in more products that are unable to cover their costs.

The Act allows the Postal Service to request an exigent rate increase for extraordinary and exceptional circumstances. However, neither the Act nor Postal Regulatory Commission (PRC) rules contain detailed criteria or guidelines that qualify as exigent circumstances. On July 6, 2010, the Postal Service filed for an exigent rate increase for market-dominant products. The proposed adjustment includes the available CPI-U cap, the unused rate authority for each mail class or type of service and an exigent adjustment. The PRC has 90 days to determine whether the adjustment is reasonable, equitable, and necessary.

Conclusion

The Postal Act of 2006 expedited the rate-making process and introduced price predictability; however, it impacts the Postal Service's ability to appropriately cover costs within certain mail classes and provide sufficient profit margins to cover overhead costs.[4] For example, while the Act provided the Postal Service additional flexibility in managing its product line, certain objectives, factors, and requirements of the Act are contradictory and present a compliance challenge for the Postal Service. One mandate requires each class of mail to cover its cost, while another mandate limits rate increases to the change in inflation, which was negative in FY 2009. Therefore, when inflation is low and mail volumes are declining, the price cap does not allow the Postal Service to raise prices to a level that appropriately covers costs.

Specifically, seven domestic market-dominant products and services[5] did not cover their costs or contribute to covering overhead costs in FY 2009. Revenue loss resulting from these seven products could total approximately $1.5 billion in FY 2010. Had management used all its available banked rate authority in FY 2009, the Postal Service could have captured approximately $1.75 million of the $1.5 billion revenue shortfall. See Appendix C for additional details.

[3] Mail volume totaled 177 billion pieces in FY 2009 and is forecast to drop an additional 15 percent by 2020, to a level of 150 billion pieces.
[4] In FY 2009, the total general overhead costs for the Postal Service was $28,906.8 million.
[5] There were 14 products and services that failed to cover costs. This report did not include special services or international products, and therefore, focused on the remaining seven products and services.

Allowing the Postal Service to apply the price cap to a larger base, such as the market-dominant level instead of each mail class, would give additional flexibility for the Postal Service to cover the cost of its products and services. If the increase in inflation in FY 2008 was applied to the market-dominant category as a whole for the FY 2009 price increase, the Postal Service could have generated additional revenue of approximately $424 million. The $1.5 billion revenue loss for the seven products and the $424 million from the application of the inflation rate at the market-dominant level represents approximately $2 billion in unrecoverable revenue loss[6] for the Postal Service. See Appendix B and Appendix D for additional details.

In summary, the effects of the price cap under the Act have been exacerbated by unprecedented declines in mail volume, and excess network capacity. Legislative reform allowing more flexibility in applying the price cap to a larger base, such as at the market-dominant level versus the mail class level, would assist the Postal Service in developing a long-range plan to comply with legislative mandates.

Cost Coverage and Pricing Flexibility

Cost Coverage Compliance

The price cap has negatively impacted the Postal Service's ability to price its market-dominant products and services to generate sufficient revenue to cover product costs and contribute to the coverage of overhead costs. Despite aggressive cost-cutting measures, the Postal Service did not cover product costs in FY 2009 for seven domestic products and services within the Standard, Periodicals, and Packages mail classes.[7] Accordingly, these seven domestic products did not contribute to the coverage of overhead costs. See Table 1.

[6] Unrecoverable revenue loss is revenue that should have been collected or recognized for goods delivered or services rendered, but was not collected or not recognized due to the passage of time or other circumstances.
[7] Package Services and Periodicals did not cover their costs at the mail class level while Standard Mail did cover its costs at the class level. However, as shown in table 1 there were 7 significant sub-classes that did not attain the required cost coverage.

Table 1. Cost Coverage for Selected Mail Products

	Percentage of Cost Coverage			
Market-dominant Mail Classes	FY 2006	FY 2007	FY 2008	FY 2009
Standard Mail®:				
Flats	Not Available[8]	Not Available	94.16	82.15
Non Flat-Machinables and Parcels	Not Available	Not Available	79.59	75.23
Periodicals:				
In County	90.9	83.91	94.47	86.26
Outside County	89.2	82.21	82.94	75.03
Package Services				
Single-Piece Parcel Post	106.33	103.22	91.60	91.85
Bound Printed Matter Parcels	Not Available	Not Available	107.71	97.70
Media and Library Mail	90.54	91.24	87.49	84.13

The price cap model can function as intended only if mail volume is steady or increasing and costs increase by no more than the rate of inflation. When mail volume decreases, the lost revenue must be offset by cost reductions; however, the Postal Service has not been able to reduce costs fast enough to offset the effects of the unprecedented declines in mail volume and revenue. The decline in mail volume from FY 2008 levels prevented Bound Printed Matter Parcels, which covered its costs in 2008, from covering its costs in FY 2009. Specifically, in FY 2008 Bound Printed Matter Parcels was able to cover its costs when it had a volume of 308 million pieces. The volume decrease contributed to the decline in cost coverage from FYs 2008 to 2009 for five of the other six products. Only Single-Piece Parcel Post mail showed a slight increase in cost coverage, but still it did not cover its overall costs.

In 2009, the average hourly labor costs increased by 6.2 percent. In FY 2009, the Postal Service reduced compensation costs by $1.4 billion by eliminating 115 million workhours. However, this was offset by a $1.1 billion increase due to the increase in average hourly labor costs. Since inflation was negative in FY 2009, it was not possible to increase rates within the price cap provision without using the banked portion of unused prior rate increases. Further, due to the economic downturn the Postal Service elected not to proceed with a rate increase for market-dominant products because they believed this would drive volume down even more. If rates are not increased to cover costs for these seven products alone, the Postal Service will lose approximately $1.5 billion in revenue for FY 2010.

Postal Service revenue must cover both product costs and overhead costs to break even. However, market-dominant products have a greater burden for contributing to the Postal Service's overhead expenses because 88 percent of the Postal Service's revenue is derived from those products. Therefore, it becomes even more critical for

[8] The sub-classes for Standard Mail Flats, Non-Flat Machinables and Parcels, and Package Services Bound Printed Matter Parcels did not exist in 2006 and 2007.

these products to not only cover product costs, but also to generate sufficient revenue to contribute to overhead costs.

The exigent rate increase filed by the Postal Service on July 6, 2010, for implementation on January 2, 2011, provides for an aggregate increase of approximately 5.6 percent for all market-dominant products. The Postal Service expects that four of the seven domestic products[9] would remain below 100 percent cost coverage after implementation of the proposed adjustments.

Unused Rate Authority

Management used most, but not all of its available unused rate authority in FY 2009 to raise rates in FY 2010, stating the long-term effect of increasing rates could drive additional mail volume out of the system. The Act allows the Postal Service to use its unused rate authority to assist in maintaining financial stability. If the Postal Service had applied all of its available unused rate authority in FY 2009 to the applicable classes of mail, it would have generated approximately $1.75 million in additional revenue.

The total price adjustments for each mail class or type of service in the exigent rate increase proposal include the available CPI-U cap of 0.578 percent,[10] plus all of the unused rate authority for each mail class or type of service, and an exigent adjustment.

Price Cap Flexibility

The Act requires the price cap to be applied to narrow bases of individual mail classes within the market-dominant category, rather than to market-dominant products as a whole. This limits the Postal Service's flexibility to rebalance rate increases across all market-dominant products and adjust for the price elasticity[11] of the various classes of mail.

Management must decide how best to apply a rate change for each mail product without exceeding the price cap average for the mail class. For example, in FY 2009, management decreased the rates for Bound Printed Matter Flats by 2 percent to compensate for above average increases for other within class products. Applying the price cap across a larger baseline, such as at the market-dominant level, would have provided more options and may have mitigated the need for a decrease in pricing for this product.

The Postal Service has developed a long-range strategic plan[12] which recognized the need to ensure that prices of market-dominant products are based on the demand for

[9] Standard Mail Flats, In County Periodicals, Outside County Periodicals, and Media and Library Mail.
[10] As of May 2010.
[11] Price elasticity refers to the impact on demand of a product given price increases or decreases. In general as the price of mail increases the volume will decrease.
[12] *Ensuring a Viable Postal Service for America: An Action Plan for the Future, March 2010.*

each individual product and its costs, rather than capping prices for each class at the rate of inflation. However, implementation of the plan would require legislative changes and it does not address or provide milestones for covering costs for those mail classes which currently do not cover their costs. The Postal Service also issued a Flats Strategy on July 6, 2010, that describes strategies and general timeframes for improvements in transportation, mail processing, and Post Office operations and delivery.

Allowing the Postal Service to apply the price cap to a larger base, such as the market-dominant level instead of each mail class, would give additional flexibility for the Postal Service to cover the cost of its products and services. If the increase in inflation in FY 2008 was applied to the market-dominant category as a whole for the FY 2009 price increase, the Postal Service could have generated additional revenue of approximately $424 million.

Obtaining legislative relief on additional pricing options and developing a detailed plan to comply with the legislative mandate to cover costs for all market-dominant products would assist mailers in their strategic planning and improve the financial stability of the Postal Service.

We recommend the vice president, Pricing, coordinate with the vice president, Government Relations and Public Policy, to:

1. Seek legislative reform to aid with rebalancing when capping prices at the inflation rate conflicts with the requirement to cover costs.

2. Develop a detailed transparent plan, with established milestones, for each individual product to move towards coverage of their costs and a contribution to overhead costs.

Management's Comments

Management did not address concurrence with the finding but agreed with recommendation 1 and partially disagreed with recommendation 2. Management agreed that, as a matter of good business practice, all products should cover their attributable costs. Management suggested that the exigent price change request, if approved, could result in all but four domestic market-dominant products covering their attributable costs and that significant progress could be made in cost coverage for those remaining four products.

With regard to recommendation 1, management stated they submitted proposed legislative language in May 2010 to congressional oversight committees that would move the price cap from the individual product level to the market-dominant basket as a whole. Management stated this would provide the Postal Service with additional flexibility to address situations where the price cap does not permit the Postal Service to increase prices sufficiently to allow products to cover their costs. Management also stated they would continue to educate members of Congress on the value of this proposal.

With regard to recommendation 2, management disagreed with the recommendation to the extent that establishment of a detailed, transparent plan with established milestones would prevent the Board of Governors from fulfilling their statutory duty to balance all relevant considerations in establishing prices. Management also stated that compliance with the recommendation could potentially eliminate pricing flexibility, which is a hallmark of the Postal Act of 2006.

Management stated that pricing decisions are the purview of the Board of Governors, who balance statutory and regulatory requirements with market conditions and business strategies when establishing prices. Management stated that the recommendation elevates the cost coverage requirement above all other factors and objectives in a way the statute did not contemplate. Management added that the Board of Governors must consider all elements of the statute and balance them when reaching a pricing decision and cannot focus solely on one factor to the exclusion of all other statutory considerations.

Management also stated the conclusion that a $1.6 billion "revenue shortfall" could have been captured is incorrect. Management stated that increasing the prices for all non-compensatory prices to fully cover product costs would require reduction of other product prices. Management stated this would reduce revenue by an offsetting amount.

Finally, management stated that the OIG analysis evaluates the effect of a price change for a single fiscal year and does not incorporate the longer term effects of targeted pricing. Management stated that the OIG analysis does not correct for changes in weight per piece between FYs 2008 and 2009 and, therefore, overstates the potential additional revenue resulting from applying the price cap to the market-dominant products as a whole rather than each individual mail class in any price change. See Appendix E for management's comments in their entirety.

Evaluation of Management's Comments

The OIG considers management's comments to recommendation 1 to be responsive. Management took corrective action to convey a legislative change request to the oversight committees to raise the threshold for application of the price cap from individual mail classes to the market-dominant basket as a whole.

Management's comments to recommendation 2 are not responsive. The recommendation to provide a detailed transparent plan with established milestones for each product to cover costs does not interfere with the Board of Governors ability to fulfill their statutory duty to balance all relevant considerations in establishing prices, nor does it eliminate pricing flexibility. Best practices, along with the dire financial position of the Postal Service, require the agency to provide the Board of Governors with strategies and options for each product that is not covering costs so they can carry out their decision-making responsibilities. The plan can be adjusted as necessary as market conditions and circumstances evolve. Further, when products do not cover their costs, other products must provide a greater contribution toward the costs of the Postal Service, which may cause inequities among customers. Accordingly, we plan to elevate this issue via the audit resolution process.

The need for a detailed transparent plan is further supported by similar requests the PRC made in the FY 2009 *Annual Compliance Determination* wherein they directed the Postal Service to develop a plan explaining how it intends to increase Periodicals cost coverage to a reasonable level in its next notice of general price adjustments for market-dominant products and devise a plan to improve the cost coverage of the Standard Mail Flats product. The plan, to be filed at the time of the next *Annual Compliance Report* or the next general market-dominant price adjustment, will outline how the Postal Service anticipates addressing the revenue shortfalls of the Package Services class and each of the products that did not produce sufficient revenue to exceed attributable costs.

We agree that the Postal Service would be unable to capture the $1.5 billion revenue shortfall in the short term while complying with the price cap provision of the Act and we specifically classify this as “unrecoverable” revenue loss. This figure represents the amount of revenue the Postal Service lost as a result of the domestic market dominant products which did not cover their costs, due in part to the Postal Service’s compliance with the price cap provision of the Act. This also underscores the complexities the Postal Service faces in complying with the various, sometimes conflicting, provisions of the Act.

Further, on September 14, 2010, The PRC issued Order 536, *Order Adopting Analytical Principles Regarding Workshare Discount Methodology*. While this order focuses on workshare discount methodology, it also states that the PAEA requires that market dominant rates observe three pricing standards, one of which is that prices for each class are capped at the Consumer Price Index. Therefore, we believe, that based on prior actions of the PRC, as well as statements in Order 536, that it is implied that the price cap is the dominant requirement for pricing decisions.

We agree with management’s assertion that the changes in weight between FY 2008 and FY 2009 can be a factor in pricing, and they were not included in our methodology. However, we believe our methodology, which utilized the Postal Service’s elasticity factors and was coordinated with management several times during the audit, is adequate to provide an estimate of the revenue impact of applying the price cap at the market dominant level versus the mail class level.

The OIG considers all the recommendations significant and, therefore, requires OIG concurrence before closure. Consequently, the OIG requests written confirmation when corrective actions are completed. The management response to recommendation 1 is sufficient to close that recommendation; recommendation 2 should not be closed in the Postal Service's follow-up tracking system until the OIG provides written confirmation that the recommendation can be closed.

We appreciate the cooperation and courtesies provided by your staff. If you have any questions or need additional information, please contact Paul Kuennen, director, Cost, Revenue, and Rates, or me at 703-248-2100.

E-Signed by Darrell E. Benjamin, Jr
VERIFY authenticity with ApproveIt

Darrell E. Benjamin, Jr.
Deputy Assistant Inspector General
for Revenue and Systems

Attachments

cc: Stephen M.Kearney
Joseph D. Moeller
Scott J. Davis
Corporate Audit and Response Management

APPENDIX A: ADDITIONAL INFORMATION

BACKGROUND

The Postal Act of 2006 provides the regulatory framework for reducing costs and increasing efficiency, creating rate predictability and stability, maintaining high quality service standards, and allowing for pricing flexibility. The key objectives were to assure the Postal Service is collecting adequate revenue and reduce administrative burden in the rate-making process.

The Act revised the rate-setting procedure and relieved much of the administrative burden for setting rates. The time currently required to set rates is approximately 3 months. Previously, the process required 18 months: 5 months for preparation, 10 months for litigation, and 3 months for consideration and implementation.

The maximum rate adjustment the Postal Service is authorized to make in any year is subject to the annual limitation of the rate of inflation. This price cap, which is applied to each class of mail, is set to equal the change in the CPI-U over the most recent available 12-month period. The Postal Service is allowed to bank any unused portions of rate increases for up to 5 years and use it for future rate increases as long as the unused authority does not exceed the CPI-U by 2 percent.

The Act also allows the Postal Service to request an exigent rate increase for extraordinary and exceptional circumstances. PRC rules outline the process for filing an exigent rate increase. The exigency-based rate adjustment is not subject to the inflation-based limitation or the restrictions on the use of unused rate adjustment authority.

A key requirement of the Act is for each class of mail or type of mail service to cover its costs. Other key factors require the Postal Service to increase its efficiency and reduce its costs, help maintain high quality and affordable services, and consider the value of the kinds of mail matter entered into the postal system and the desirability and justification for special classifications and services of mail. This includes the value of educational, cultural, scientific, and informational mail matter for the recipient.

OBJECTIVE, SCOPE, AND METHODOLOGY

Our objective was to evaluate the impact of the Postal Act of 2006's mandated price caps on Postal Service rates. To accomplish our objective, we reviewed available policies, procedures, and documentation. We interviewed key officials and subject matter experts in Pricing, Forecasting, and Regulatory Reporting and Cost Analysis at the Postal Service. We also interviewed key officials at the PRC.

We analyzed Cost and Revenue Analysis reports from 2000 to 2009. We determined there were two international and 12 domestic market-dominant products and services that did not cover costs in 2009. However, we focused our review on the seven domestic products for Standard, Periodicals, and Package Services. We analyzed Annual Compliance Reports for 2008 and 2009 and recent models and studies. We monitored a blog we posted on pricing and price caps under the Postal Act of 2006.

We conducted this audit from November 2009 through September 2010, in accordance with generally accepted government auditing standards, and included such tests of internal controls as we considered necessary under the circumstances. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We used publically available data and data we received from the Postal Service for our analysis. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. We discussed our observations and conclusions with management officials on June 30, 2010, and included their comments where appropriate.

PRIOR AUDIT COVERAGE

As mandated under the Act, the Comptroller General of the U.S. prepared and submitted a report evaluating various options and strategies for the long-term operational and structural reform of the Postal Service. In July 2009, the Government Accountability Office (GAO) added the Postal Service's financial condition to the list of high-risk areas needing attention by Congress and the executive branch to achieve broad transformation. The following GAO reports are part of a series that update the Postal Service's financial condition and outlook.

Table 2. GAO Reports

Report Title	Report Number	Report Date	Report Results
USPS: Progress Made to Implement GAO's Recommendations to strengthen Network Realignment Planning and Accountability and Improve Communication	GAO-08-1134R	9/25/2008	Major changes affecting the Postal Service include declining mail volumes and increasing operating expense which reinforce need to increase efficiency in network.
USPS: Escalating Financial Problems Require Major Cost Reductions to Limit Losses	GAO-09-475T	3/25/2009	The Postal Service's financial condition continues to deteriorate, accelerating declines in mail volume and accelerating financial losses.
USPS: Restructuring Urgently Needed to Achieve Financial Viability	GAO-09-958T	8/6/2009	The Postal Service's financial condition and outlook continue to deteriorate. The Postal Service expects to generate insufficient cash to make mandated payments for retiree health benefits.
USPS: Financial Challenges Continue, with Relatively Limited Results from Recent Revenue-Generation Efforts	GAO-10-191T	11/5/2009	The Postal Service's financial condition and outlook continue to be challenging. The Postal Service will reach statutory debt limit by 2011 and projects large cash shortfalls.

APPENDIX B: MONETARY IMPACT CALCULATIONS TO COVER COSTS

Increasing Rates for Products Failing to Cover Costs

The potential revenue resulting from rate increases to cover costs for the seven domestic market-dominant products is calculated as follows:

Table 3 illustrates how we calculated additional unit revenue required for the seven products to break even and projected the mail volume for those products, taking into account price elasticities and the impact a price increase would have on volume. On the resulting volume we applied the revenue increase required to break even to arrive at the monetary impact. For example, for Standard Mail Flats, the piece count (column B) was multiplied by the elasticity based on percentage increase[13] (column C) and the result was subtracted from the piece count (column B) to get the projected volume estimate (column D). The revised volume estimate was multiplied by the difference in revenue needed to cover cost (column A) to get the possible unrecoverable revenue loss (column E). The unrecoverable revenue loss in 2010 due to not raising rates to cover costs is approximately $1.5 billion.

Table 3. Revenue Calculations to Cover Costs

Mail Classes and Products	Difference in Revenue Needed to Cover Cost	Pieces (thousands)	Elasticity Based on Percentage Increase	Projected Volume (thousands)	Possible Unrecoverable Revenue Loss[14] (millions)
	A	B	C	D	E
Standard Mail:					
Flats	$0.080	7,793,511	**0.0964**	**7,042,371**	$ 563.39
Not Flat-Machinables and Parcels	0.306	679,041	**0.0673**	**633,357**	193.81
Periodicals:					
In County	0.017	859,268	**0.0334**	**830,595**	14.12
Outside County	0.091	7,094,447	**0.0274**	**6,900,060**	627.91
Package Services:					
Single-Piece Parcel Post	0.769	80,716	0.0174	79,312	60.99
Bound Printed Matter Parcels	0.032	270,623	0.0155	266,416	8.53
Media and Library Mail	0.535	140,139	0.1704	116,264	62.20
Totals				**15,868,374**	**$1,530.94**

[13] Elasticity based on percentage increase was calculated by multiplying the elasticities by the percentage increase in rates. The elasticities were obtained from the Postal Service Volume Forecasting group.
[14] Calculated values in tables may include rounding differences.

APPENDIX C: CALCULATIONS FOR UNUSED RATE AUTHORITY

Increasing Rates to Unused Banked Authority

Potential revenue resulting from using unused banked rate authority to increase rates for the seven domestic market-dominant products not covering costs is calculated as follows:

Table 4 illustrates how we calculated the revenue possible for the seven products if unused rate authority is applied and projected the mail volume for those products taking into account the price elasticities and the impact the price increase would have on volume. On the resulting volume we applied the revenue increase from unused rate authority to arrive at the monetary impact. For example, for Standard Mail Flats, the piece count (column B) was multiplied by the elasticity based on percentage increase (column C) and the result was subtracted from the piece count (column B) to get the projected volume estimate (column D). The revised volume estimate was multiplied by the revenue increase based on the banked CPI-U (column A) to get the possible unrecoverable revenue loss (column E). The 2010 unrecoverable revenue loss for not raising rates by applying unused rate authority is approximately $1.75 million.

Table 4. Revenue Calculations for Unused Rate Authority

Mail Classes and Products	Revenue Increase Based on Banked CPI-U	Pieces (thousands)	Elasticity Based on Percentage Increase	Projected Volume (thousands)	Possible Unrecoverable Revenue Loss (thousands)
	A	B	C	D	E
Standard Mail:					
Standard Mail Flats	$ 0.00015	7,793,511	0.0001	7,792,997	$1,160
Not Flat-Machinables and Parcels	0.00038	679,041	0.0001	678,989	256
Periodicals:					
In County	0.00001	859,268	0.0000	859,267	7
Outside County	0.00002	7,094,447	0.0000	7,094,435	145
Package Services:					
Single-Piece Parcel Post	0.00108	80,716	0.0002	80,699	87
Bound Printed Matter Parcels	0.00017	270,623	0.0001	270,593	45
Media and Library Mail	0.00035	140,139	0.0003	140,094	50
Totals				16,917,074	**$1,750**

APPENDIX D: MONETARY IMPACT CALCULATIONS APPLYING PRICE CAP TO MARKET-DOMINANT PRODUCTS AS A WHOLE

The Postal Service could gain additional flexibility in covering costs and generating revenue if price caps are applied to a larger base rather than at the class level. Table 5 illustrates the results if the increase in inflation of 3.8 percent in FY 2008 was applied to the market-dominant category as a whole in FY 2009 price increase. While multiple options are available to apply price increases to product prices, the table shows an across the board increase of 3.1 percent for all market-dominant products.[15] The 3.1 percent reflects a weighted average rate taking into account the rate change dates within the fiscal year.

We calculated the new revenue per piece for all market-dominant products by applying a 3.1 percent rate increase to the FY 2008 revenue per piece. The revenue derived from the increase from the price cap was multiplied by FY 2009 volumes for all market-dominant products. This provided the projected revenue had the 3.1 percent rate increase been applied to all market-dominant products, which was then subtracted from the actual FY 2009 product revenue. The FY 2009 unrecoverable revenue loss for not applying the cap at the market-dominant level is approximately $424 million.

[15] The list of products and services do not include international products and services whose rates are negotiated with the Foreign Postal Administrations; and Negotiated Service Agreements mail which was not listed as separate products in the FY 2008 CRA; and Special Services that offered subscriptions or rentals, as unit and per piece data is neither applicable nor available.

Table 5. Revenue Calculations All Market-dominant Products with FY 2009 Cap

Mail Classes and Products	Difference in Actual Rate increase	Elasticity Based on Percentage Increase	Projected Volume (thousands)	Projected Revenue (millions)	Actual FY 2009 Revenue (Millions)	Difference Revenue Loss (millions)
First Class						
Single-Piece Letters	-0.01481	-0.003	30,101,817	$13,305.00	13,298.98	$ 6.03
Single-Piece Cards	-0.0148	-0.006	1,626,261	455.35	454.53	0.82
Presort Letters	0.0006	0.000	44,796,956	15,589.34	15,615.86	(26.52)
Presort Cards	0.0006	0.001	3,123,562	662.20	666.22	(4.03)
Flats	-0.0075	-0.001	2,868,593	3,551.32	3,539.89	11.43
Parcels	0.0057	0.001	580,192	1,107.59	1,113.76	(6.17)
Standard Mail						
High Density and Saturation Letters	0.0189	0.013	5,020,022	677.70	681.95	(4.24)
High Density and Saturation Flats and Parcels	0.0090	0.006	12,280,902	2,014.07	1,971.82	42.25
Carrier Route	-0.0118	-0.008	9,935,635	2,315.00	2,271.91	43.09
Letters	-0.0069	-0.003	46,340,451	8,851.03	8,709.49	141.54
Flats	0.0083	0.004	7,764,896	2,927.37	2,865.99	61.38
Not Flat-Machinables and Parcels	-0.1329	-0.027	697,506	634.73	631.90	2.83
Periodicals						
In County	-0.0060	-0.001	860,327	95.50	90.62	4.88
Outside County	-0.0084	-0.001	7,099,310	2,058.80	1,932.09	126.71
Package Services						
Single-Piece Parcel Post	-0.0132	-0.003	80,924	669.41	699.27	(29.86)
Bound Printed Matter Flats	0.0514	0.033	230,816	215.35	206.45	8.91
Bound Printed Matter Parcels	0.0063	0.004	269,511	387.29	362.61	24.68
Media and Library Mail	-0.0433	-0.039	145,622	396.82	397.40	(0.58)
Ancillary Service						
Certified Mail	-0.0057	-0.001	266,811	734.53	729.81	4.72
Collect on Delivery	-0.0263	-0.044	1,059	7.70	7.56	0.13
Insurance	-0.0068	-0.008	44,105	127.46	129.07	(1.60)
Registered Mail	-0.0556	-0.012	3,220	48.92	49.91	(0.99)
Special Services Money Orders	-0.0080	-0.005	135,651	$ 209.58	191.10	18.48
Total						**$ 423.88**

APPENDIX E: MANAGEMENT COMMENTS

UNITED STATES POSTAL SERVICE

September 9, 2010

Lucine Willis
Director, Audit Operations
1735 North Lynn St.
Arlington, VA 22209-2020

SUBJECT: Draft Audit Report – Impact of Postal Accountability and Enhancement Act Price Caps (Report Number CRR-AR-10-DRAFT)

Thank you for the opportunity to review and comment on the subject draft audit report. This provides management's response to the subject audit report.

The Postal Service agrees with the audit team's first recommendation; however, it does not agree with the team's second recommendation. It also has concerns about one of the methodologies used in the team's analysis. Our response to the recommendations is provided below.

The audit team recommended the Vice President, Pricing, and the Vice President, Government Relations and Public Policy, to:

Recommendation [1]:
1. Seek legislative reform to aid with rebalancing when capping prices at the inflation rate conflicts with the requirement to cover cost.

Response
Management agrees with this recommendation and, in fact, has submitted the attached legislative language that would move the price cap from the individual product level to the market-dominant basket as a whole. This will provide the Postal Service with some additional flexibility to address situations where the price cap does not permit the Postal Service to increase prices sufficiently to allow products to cover their costs. In May, 2010, Government Relations provided language (see Attachment 1) to the House and Senate oversight Committees, among others, and has urged that this language be adopted. Whether Congress

475 L'Enfant Plaza SW
Washington DC 20260

enacts this or similar language is out of the Postal Service's control, however, Government Relations will continue to educate Members on Congress on the value of this proposal.

Recommendation [2]:
2. Develop a detailed transparent plan, with established milestones, for each individual product to move towards coverage of their costs and a contribution to cover costs

Response
Management disagrees with this recommendation, to the extent that a "detailed transparent plan, with established milestones" implies that, once such a plan is established, the Governors cannot fulfill their statutory duty to balance all relevant considerations in establishing prices. This recommendation potentially eliminates the pricing flexibility that is a hallmark of the Postal Accountability and Enhancement Act of 2006 (PAEA).

In addition, the conclusion that a $1.6 billion "revenue shortfall" from noncompensatory domestic market dominant products could have been captured is incorrect. To increase the prices for all noncompensatory prices sufficiently to result in these products fully covering costs, some other price would have needed to be reduced. This would have, in general, reduced revenue from those prices by an offsetting amount. Redefining the statutory price cap application to the market dominant products as a whole provides additional **long term** flexibility to ensure that the Postal Service as a whole can price its products as effectively as possible. It does not increase short term revenues assuming that (consistent with recent price changes) all price cap authority is used in each price change.

The Postal Service agrees, that as a matter of good business, all products should cover their attributable costs. In fact, the prices proposed in the exigent price change request are projected to result in all but four domestic market dominant products covering their FY2011 costs on an annualized basis. For the remaining four products, significant progress is made towards achieving 100 percent cost coverage.[1]

Pricing decisions are the purview of the Postal Service's Governors. In exercising this statutory responsibility, the Governors balance statutory and regulatory requirements with market conditions and business strategies to establish prices.

This recommendation elevates the cost coverage requirement above all other factors and objectives in a way not contemplated by the statute. In establishing the market dominant pricing system, the Commission was required to consider 9 objectives and 14 factors including

[1] Docket No. R2010-4. Statement of Stephen J. Masse on Behalf of the United States Postal Service (Attachment 12).

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> [Factor] (2) the requirement that each class of mail or type of mail service bear the direct and indirect postal costs attributable to each class or type of mail service through reliably identified causal relationships plus that portion of all other costs of the Postal Service reasonably assignable to such class or type.[2]

In many instances, consideration of one factor, in isolation, suggests a different conclusion than consideration of another factor or objective. For example, consideration of the effect of rate increases on customers[3] (Factor 3) typically suggests that price increases be mitigated (lower) while consideration of the cost coverage factor (Factor 2) might suggest that price increases be higher.

In establishing prices, the Governors must consider all elements of the statute and balance them in reaching a pricing decision. They cannot focus solely on one factor to the exclusion of all other statutory considerations.

Additional Comments

Applying the price cap to the larger market dominant category as a whole, allows the Postal Service to adjust prices (consistent with all other statutory criteria) where it would provide the largest potential value **assuming that volumes change**. This provides additional flexibility to ensure that the Postal Service as a whole can use its pricing authority over the long run as effectively as possible. This analysis, while incorporating some volume changes, evaluates the effect of a price change for a single fiscal year and, therefore, (by definition) does not incorporate the longer term effects of targeted pricing.

In addition, the supporting OIG analysis does not correct for changes in weight per piece between FY2008 and FY2009 and consequently, overstates the potential additional revenue resulting from applying the price cap to the market dominant products as a whole rather than to each individual class of mail in any price change. Under the Commission's rules compliance with the price cap is calculated using fixed (historical) volume weights. This is done to avoid confounding the calculated change in prices with the resulting effect of volume changes. Consequently, for any single price change, applying the price cap to the market dominant products as a whole will generate little, if any additional revenue, as compared to applying the price cap to each individual class of mail.

This report uses FY2009 volumes to estimate potential additional revenue which allows the analysis to consider part of the effect of the FY2009 volume decline, as well as the volume effect resulting from the application of the price cap to the market dominant products as a whole. However, the effect of the change in weight per piece between FY2008 and FY2009 was not included.

For many products, a significant part of the revenue per piece comes from prices for pounds, not pieces. For example, for Outside County Periodicals, FY2009 advertising pounds per piece were 16 percent below FY2008, and editorial pounds per piece were down 7 percent. The FY2008 weight per piece is

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[2] 39 USC 3622 (c)(2)

[3] 39 USC 3622 (c)(3)

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embedded in the FY2008 revenue per piece ($0.281) used as the starting point of the OIG analysis. If the analysis had been conducted at the level of individual prices cells, and used actual FY2009 pounds, bundles, sack, and pallets as well as actual pieces, the projected FY2009 revenue per piece would be essentially identical to that generated by actual Postal Service prices.

The report contains no FOIA exempt information.

Maura Robinson
Vice President
Pricing

Marie Therese Dominguez
Vice President
Government Relations & Public Policy

cc: Stephen M. Kearney
Joseph D. Moeller
Scott J. Davis
Jamie Gallagher

Attachment 1

USPS Legislative Proposal

§ 3622. Modern rate regulation

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(d) Requirements—

(1) In general.—The system for regulating rates and classes for market-dominant products shall—

(A) include an annual limitation on the percentage changes in rates to be set by the Postal Regulatory Commission that will be equal to the change in the Consumer Price Index for All Urban Consumers unadjusted for seasonal variation over the most recent available 12-month period preceding the date the Postal Service files notice of its intention to increase rates;

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(2) Limitations—

~~(A) Classes of mail—Except as provided under subparagraph (C), the annual limitations under paragraph (1)(A) shall apply to a class of mail, as defined in the Domestic Mail Classification Schedule as in effect on the date of enactment of the Postal Accountability and Enhancement Act.~~

(A) <u>Scope of limitation—Except as provided under subparagraph (C), the annual limitations under paragraph (1)(A) shall apply to the group of market-dominant products as a whole.</u>

(B) Rounding of rates and fees—Nothing in this subsection shall preclude the Postal Service from rounding rates and fees to the nearest whole integer, if the effect of such rounding does not cause the overall rate increase for ~~any class~~ <u>market dominant products as a whole</u> to exceed the Consumer Price Index for All Urban Consumers.

(C) Use of unused authority—

(i) Definition.—In this subparagraph, the term "unused rate adjustment authority" means the difference between—

(I) the maximum amount of a rate adjustment that the Postal Service is authorized to make in any year subject to the annual limitation under paragraph (1); and

(II) the amount of the rate adjustment the Postal Service actually makes in that year.

(ii) Authority.— Subject to clause (iii), the Postal Service may use any unused rate adjustment authority for any of the 5 years following the year such authority occurred.

(iii) Limitations.— In exercising the authority under clause (ii) in any year, the Postal Service—