



May 9, 2008

STEPHEN M. KEARNEY
VICE PRESIDENT, PRICING AND CLASSIFICATION

WILLIAM (ASHLEY) LYONS
MANAGER, CORPORATE FINANCIAL PLANNING

SUBJECT: Audit Report – Bound Printed Matter Workshare Discounts
(Report Number CRR-AR-08-005)

This report presents the results of our audit of workshare discounts (Project Number 07YG014MS000). Our objective was to review the development and implementation of workshare discounts. Our review focused on Bound Printed Matter (BPM). This audit was self-initiated and addresses both strategic and financial risks. Click [here](#) to go to Appendix A for additional information about this audit.

Conclusion

The U.S. Postal Service properly established BPM workshare discounts in accordance with postal legislation and internal policies and procedures. Management also properly implemented the BPM workshare discounts established in Omnibus Rate Case R2006-1. At six large BPM acceptance facilities, controls were in place to ensure mailers prepared BPM to workshare standards. However, some of the supporting documentation that management used to develop the BPM discounts was old, which could affect the reliability of the BPM workshare discount rates. Updating this data would help establish more accurate management information the Postal Service can use to develop and implement rate changes and prepare annual reports for the Postal Regulatory Commission¹ on the impact of workshare discounts. We will report this non-monetary impact, reliability of information,² in our next *Semiannual Report to Congress*.

Development and Implementation of Bound Printed Matter Workshare Discounts

Controls over development and implementation of BPM workshare discounts were adequate. Omnibus Rate Case R2006-1 established the current BPM workshare discount rates and the Postal Service implemented them in May 2007. Click [here](#) to go to Appendix B for our detailed analysis on this topic.

¹ Formerly known as the Postal Rate Commission.

² Data used to support management decisions that is not fully supported or completely accurate.

Old Data Used to Develop Bound Printed Matter Workshare Discounts

Some of the supporting data the Postal Service used to develop BPM workshare discounts was old. The agency did not always update the supporting data used in prior omnibus rate cases to reflect the current operational environment. This occurred because the time and resources to update certain studies were inadequate, and because the 2005 and 2006 rate cases were filed in rapid succession. Old supporting data may not be reliable and may lead to inaccurate BPM workshare discount rates. Click [here](#) to go to Appendix B for our detailed analysis of this issue.

We recommend the Manager, Corporate Financial Planning, direct the Manager, Special Studies, to coordinate with Postal Service Operations to:

1. Determine whether the old supporting data is accurate in the current operational environment.
2. Develop updated cost avoidance models based on current data.

Management's Comments

Management generally agreed with the overall findings and recommendations. In response to recommendation 1, management for Special Studies agreed to communicate with Postal Service Operations to incorporate technological and policy-driven changes to field operations into the cost models. Special Studies also agreed to conduct field observations in Quarter 4, fiscal year (FY) 2008 to determine whether further field study and data collection are needed.

In response to recommendation 2, management stated that each year, as part of the Annual Compliance Report, new information from Postal Service data systems is incorporated into the cost avoidance models. Management for Special Studies agreed to conduct research to locate alternative sources for more recent data. Management noted the Postal Regulatory Commission plans to consider how best to categorize costing issues to establish priorities in a manner that reflects the importance of the data, its age, and obsolescence, along with the cost of updating to ensure the appropriate use of resources. Management stated that by the end of 2008, they could complete a draft of a cost study of short-term and longer-term data needs. However, management indicated that updating the BPM inputs cited in the report may not be a top priority once a comprehensive approach to costing needs is developed.

Management did not agree with the representation that the information did not reflect the current operation environment. They indicated that the report did not provide information on the types of operational changes that could have impacted the productivities, which productivities would have been impacted, and which direction those productivities would have been driven. They also questioned whether increases

in productivities would have occurred over the years in the areas cited, as these are manual versus automated operations. Lastly, management questioned the information provided regarding a possible increase in Bound Printed Matter revenue of \$1 million to \$3.5 million.

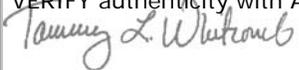
Management's comments, in their entirety, are included in [Appendix C](#).

Evaluation of Management's Comments

The U.S. Postal Service Office of Inspector General (OIG) considers management's comments responsive to the recommendations in the report. OIG did not presume that old data used to develop cost avoidances and workshare discounts is inaccurate, and agrees with management that updating this information may require expensive field studies. OIG stated that the inputs and productivities *might* not reflect the current operational environment; however, determining whether or not the inputs and productivities are still valid within the current operational environment was beyond the scope of this audit. Regarding management's concern over the possible increase in revenue, the OIG used test year volume estimates, not actual volume. Calculations were based on information that the Postal Service submitted to the Postal Regulatory Commission in the R2006-1 rate case. As management stated, the Postal Accountability and Enhancement Act (Postal Act of 2006) allows the Postal Service flexibility to choose which prices it will increase or decrease within the same mail class as long as the provisions of the statutory cap are met.

The OIG considers all recommendations significant, and therefore requires OIG concurrence before closure. Consequently, the OIG requests written confirmation when corrective actions are completed. These recommendations should not be closed in the follow-up tracking system until the OIG provides written confirmation that the recommendations 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 Tammy Whitcomb 
VERIFY authenticity with ApproveIt


Tammy L. Whitcomb
Deputy Assistant Inspector General
for Revenue and Systems

Attachments

cc: H. Glen Walker
Michael K. Plunkett
Joseph D. Moeller
Virginia J. Mayes
Katherine S. Banks

APPENDIX A: ADDITIONAL INFORMATION

BACKGROUND

Workshare discounts are rate discounts the Postal Service provides to mailers for presorting, pre-barcoding, handling, or transporting mail — duties the agency would otherwise assume. The Postal Service first established workshare discounts in 1976 with a 1-cent discount for presorted First-Class Mail[®]. Today there are over 450 workshare discount rates that encompass all classes of mail (except Priority and Express Mail) and apply to over 80 percent of mail the Postal Service processes. Table 1 shows the growth of workshare discounts over the past nine rate cases dating back to 1984.

Table 1. Workshare Volume by Rate Case
(in millions)

Mail Volume	R84-1	R87-1	R90-1	R94-1	R97-1	R2000-1	R2001-1	R2005-1	R2006-1
Non-Workshared	54,071	61,909	61,869	59,923	56,883	57,011	50,743	45,824	40,756
Workshared	71,404	84,822	94,686	116,959	133,327	149,743	159,993	165,146	169,166
Total Mail Volume	125,475	146,731	156,556	176,883	190,210	206,754	210,736	210,970	209,923
Percentage of Volume Workshared	56.9	57.8	60.5	66.1	70.1	72.4	75.9	78.3	80.6

BPM is a subclass of the Package Services class of mail that consists of advertising, promotional, directory, and editorial material in permanently bound printed volumes. This includes catalogs, books, directories, and manuals that can be packaged as flats or parcels. There are currently six BPM workshare discounts. The first discount, established in the 1970s, provided a bulk BPM discount for mail presorted with a 3- or 5-digit ZIP Code. The Postal Service established a 5-cent carrier route discount³ for bulk BPM in 1984, introduced a pre-barcoding⁴ workshare discount in 1997, and established additional dropshipping workshare discounts in 2000.⁵

Since introducing BPM dropship discounts, dropship BPM volume has increased. In Omnibus Rate Case R2000-1, the test year volume estimates for dropshipped BPM was 329.1 million pieces. By the R2006-1 rate case, the test year volume estimates for dropshipped BPM rose to 520 million pieces. At the same time, volume estimates for non-dropshipped BPM pieces decreased. Table 2 shows the increase in BPM dropship volume.

³ This discount applies when the mailer arranges mail by carrier route to qualify for a discounted postage rate and requires no primary or secondary distribution.

⁴ Pre-barcoding occurs when the mailer applies a barcode to the mailpiece that bears the correct destination ZIP Code to qualify for a discounted postage rate.

⁵ Discounts include dropshipping BPM at destination bulk mail centers (DBMC), destination sectional center facilities (DSCF), and destination delivery units (DDU). Dropshipping is entering mail deeper into the Postal Service mail processing system to qualify for discounted postage rates.

Table 2. BPM Dropship Volumes⁶
(in pieces)

Rate Case	R2000-1	R2001-1	R2005-1	R2006-1
Dropshipped				
DBMC	259,980,784	179,345,886	243,688,434	242,162,883
DSCF	48,732,533	118,705,364	183,438,887	205,809,377
DDU	20,396,561	19,037,653	55,588,745	71,994,983
Total Dropshipped	329,109,878	317,088,903	482,716,066	519,967,243
Non-Dropshipped	201,841,122	242,842,057	111,593,579	103,677,231

Along with the increase in BPM dropship volume, there was an increase in BPM workshare discount rates. Table 3 shows this trend.

Table 3. BPM Dropship Discounts
(in cents)

Rate Case	R2000-1	R2001-1	R2005-1	R2006-1
DBMC	13	26.0	27.4	31.7
DSCF	15	21.5	22.6	38.3
DDU	21	28.6	30.1	8.4
<p>In R2006-1, a different calculation method was used to determine the DDU discount. In prior rate cases, the DDU discount was determined by the difference of DDU cost savings – DBMC cost savings; in R2006-1, the discount was determined by the difference of DDU cost savings – DSCF cost savings.</p>				

The current BPM workshare discount rates were established in R2006-1, the last omnibus rate case filed before postal reform legislation was enacted in December 2006.⁷ Under the Postal Reorganization Act of 1970, there are nine factors the Postal Regulatory Commission must use when considering mail categories and rates:

- Establishment and maintenance of a fair and equitable schedule.
- The value of mail service each class of mail or type of mail service actually provides to both the sender and the recipient — including but not limited to — the collection, mode of transportation, and priority of delivery.
- The requirement that each class of mail or type of mail service bear the direct and indirect costs attributable to that class or type plus that portion of all other costs to the Postal Service that are reasonably assignable to such class or type.

⁶ Volumes based on test year estimates in rate cases R2000-1, R2001-1, R2005-1, and R2006-1.

⁷ Public Law 109-435, Postal Accountability and Enhancement Act, December 20, 2006.

- The effect of rate increases upon the general public, business mail users, and enterprises in the private sector of the economy engaged in the delivery of mail matter other than letters.
- Available alternative means of sending and receiving letters and other mail matter at reasonable costs.
- Degree of mailer's preparation of mail for delivery into the Postal Service system and its effect on reducing costs to the Postal Service.
- Simplicity of structure for the entire schedule and simple, identifiable relationships between the rates or fees charged the various classes of mail for postal services.
- Educational, cultural, scientific, and informational value to the recipient of mail matter.
- Other factors the Postal Regulatory Commission deems appropriate.

The Postal Act of 2006 classifies BPM as a market-dominant (mailing services) product, and limits the change in rates for market-dominant products to no more than the annual change in the *Consumer Price Index for All Urban Consumers*. Under the statute, the Postal Regulatory Commission must consider six additional factors when considering mail categories and rates.

- The importance of pricing flexibility to encourage increased mail volume and operational efficiency.
- The relative value to the people of the kinds of mail matter in the Postal Service's system and the desirability and justification for special classifications and services of mail.
- The importance of providing both those classifications with extremely high degrees of reliability and speed of delivery and those that do not require high degrees of reliability and speed of delivery.
- The desirability for both the Postal Service and its users of having special classifications that are in accordance with the policies of this title, which requires agreements between the Postal Service and its users (when available) with terms applicable to similarly situated mailers that:

- Either improve the net financial position of the Postal Service through reducing Postal Service costs or increasing the overall contribution to the institutional costs of the Postal Service; or enhance the performance of mail preparation, processing, transportation, or other functions.
- Do not cause unreasonable harm to the marketplace.
- The need for the Postal Service to increase its efficiency and reduce its costs, including infrastructure costs, to help maintain high quality and affordable postal services.
- The value of promoting intelligent mail and secure, sender-identified mail to the Postal Service and its users.

The requirement for establishing and maintaining a fair and equitable schedule was eliminated by the Postal Act of 2006, leaving a total of 14 factors the Postal Regulatory Commission must weigh when considering mail categories and rates.

On February 11, 2008, the Postal Service notified the Postal Regulatory Commission they planned to adjust prices for their market dominant products (including BPM) on May 12, 2008. The notice included a .42 percent increase for BPM flats and a 2.10 percent increase for BPM parcels. The BPM cost avoidance passthroughs ranged from 96.8 percent (pre-barcoded parcels) to 146.3 percent (carrier route destination bulk mail center parcels). The Postal Service indicated they intend to gradually reduce some BPM discounts where the passthrough significantly exceeds 100 percent of avoided costs, in order to maintain a more stable and predictable price structure. The Postal Regulatory Commission concluded the Postal Service adequately justified BPM passthroughs in excess of 100 percent.

OBJECTIVES, SCOPE, AND METHODOLOGY

Our overall objective was to review the development and implementation of workshare discounts. Specifically, we focused on determining whether:

- The Postal Service developed BPM workshare discounts in accordance with postal law and applicable Postal Service policies and procedures;
- The supporting data used to develop BPM workshare discounts was reliable;
- The Postal Service properly implemented new BPM workshare discount rates; and
- Controls were in place to ensure that BPM mailings met workshare discounts standards.

We reviewed the BPM subclass of mail because it has a relatively small number of workshare discounts (six), and because a small number of large mailers perform the vast majority of BPM mailings. The six large mailers we reviewed accounted for 40 percent of Quarter 1, FY 2007 BPM mail volume.

To determine whether the Postal Service developed BPM workshare discounts in accordance with postal law and applicable Postal Service policies and procedures, we reviewed the development of BPM workshare discounts in prior omnibus rate cases up through Omnibus Rate Case R2006-1.

To determine whether the Postal Service properly implemented new BPM workshare discount rates, we reviewed Postal Service programs designed to implement the new BPM rates established in R2006-1. Additionally, we visited six business mail entry units and their associated detached mail units⁸ at six large BPM mailers and interviewed Postal Service and mailer personnel. To determine whether management properly implemented the R2006-1 rate change on May 14, 2007, we compared before and after postage statements.

To determine whether the supporting data used to develop BPM workshare discounts was current and reliable, we examined the source data used to develop them in R2006-1 and traced the supporting data back to its original source. We also interviewed Postal Service employees who developed the BPM workshare discount rates.

To determine whether controls were in place to ensure that BPM mailings met workshare discounts standards, we analyzed BPM mail preparation errors reported in the Electronic Mail Improvement Reporting system from April 25, 2006, through April 24, 2007. To determine what corrective actions management took, we interviewed Postal Service personnel at the six facilities we visited and identified the actions taken when mailers did not properly prepare BPM.

We conducted this performance audit from January 2007 through May 2008 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 objectives. We believe the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. We discussed our observations and conclusions with management on March 14, 2008, and included their comments where appropriate.

⁸ Hanover, Pennsylvania; Martinsburg, West Virginia; Gordonsville, Virginia; Pewaukee, Wisconsin; Warsaw, Indiana; and Fernley, Nevada.

PRIOR AUDIT COVERAGE

Report Title	Report Number	Final Report Date	Monetary Impact	Results
<i>Enhanced Carrier Route Standard Mail Worksharing Discounts</i>	AC-AR-03-006	September 29, 2003	None	The review found the benefits of Enhanced Carrier Route letters had been reduced as the volume of letters processed to delivery point sequence increased. Also, the delivery point sequencing of Enhanced Carrier Route letter mail with destination delivery unit discounts resulted in transportation and handling inefficiencies. We recommended management develop a rate case proposal to eliminate destination entry discounts for letters destinating at delivery units that receive delivery point sequenced mail processed on delivery barcode sorters. Management disagreed with the recommendation and indicated they would address the issues in subsequent rate cases.

APPENDIX B: DETAILED ANALYSIS

The Postal Service developed and implemented workshare discounts for BPM in accordance with postal law and internal policies and procedures. However, postal operations are continuously changing and the old conversion and productivity factors (arrival and dispatch profiles) and other inputs used to develop the existing BPM workshare discounts might not reflect the current operational environment. The Postal Act of 2006 limits the change in rates for market-dominant products and requires the Postal Service to annually report to the Postal Regulatory Commission. The report should describe the per-item costs the Postal Service avoids through workshare discounts for each market-dominant (mailing services) product and the per-item contributions the discounts make to the Postal Service's institutional costs. Updating the old data would help establish more accurate cost models and annual reports that can assist the Postal Service and the Postal Regulatory Commission in developing and reviewing future postal rate changes.

Development and Implementation of Bound Printed Matter Workshare Discounts

Our examination indicates that management developed and implemented BPM workshare discounts in accordance with postal law and Postal Service policies and procedures. The Postal Service developed the current BPM workshare discounts under the ratemaking process established in the Postal Reorganization Act of 1970. Under that process, the Postal Service submitted a request to establish new BPM rates to the Postal Regulatory Commission. Postal Service testimony and documentation⁹ supported this request. The Postal Regulatory Commission and other interested parties examined the BPM testimony and supporting documentation and the Commission issued an Opinion and Recommended Decision recommending the new rates. The Postal Service Board of Governors agreed with the Commission's recommendations for new BPM rates and the Postal Service implemented an average 12 percent across the board increase in BPM rates on May 14, 2007.

The changes in BPM rates established in R2006-1 were communicated to Postal Service employees through a variety of means, including:

- Area and district briefings and training.
- Publication in the *Postal Bulletin*.
- Field implementation kits detailing the rate changes and how to implement them.

At the six Postal Service facilities we visited, management effectively communicated the changes in BPM workshare discount rates. We also examined relevant postage statements and verified that management implemented the correct rates.

⁹ The supporting documentation included cost models, special studies, and volume variability factors.

Bound Printed Matter Prepared to Workshare Standards

At the six facilities we visited, mailers generally prepared BPM mailings in accordance with preparation standards outlined in the DMM.¹⁰ When mailers did not prepare BPM to workshare standards, management resolved the issues through collaboration with the mailer and the business mail entry unit.

For major mailers who have national accounts, issues are resolved through the Area Business Service Network. According to Electronic Mail Improvement Reporting system data, only 444 of 31,000 (1.4 percent) errors that occurred for all classes of mail for the 12-month period ending April 24, 2007, involved BPM. Effective monitoring of mailer submissions ensures the workshare discount rates claimed are appropriate.

Old Data Used to Develop Bound Printed Matter Workshare Discounts

To propose new discount rates, the Postal Service filed testimony and associated library references that contain the detailed data used to develop the discount rates; however, some of the data that goes into the primary inputs are old. The primary library reference used to develop BPM discount rates was the Parcels Cost Models.¹¹ The Parcels Cost Models are used to develop cost avoidance data. The primary inputs into the Parcels Cost Models for BPM include mail processing productivity factors, arrival and dispatch profiles at facilities, conversion factors, and miscellaneous other inputs. The inputs contain aged data because recent rate cases were filed in rapid succession and management did not have the time and resources to update certain studies. Changes in productivity factors, mail profiles, and the number and the types of mail in each container could have an impact on BPM workshare discount rates.

Productivity Factors

Mail processing productivity factors include loading, unloading, dumping, and sorting mail. The BPM section of the Parcels Cost Models uses 19 productivity factors to estimate BPM mail processing activities. Fourteen of these are based on old data from prior rate cases dating back to 1984, as shown in Table 4.

¹⁰ *Domestic Mail Manual*, Sections 365 and 465.

¹¹ R2006-1, Library References USPS-LR-L-46 (Postal Service version) and USPS-LR-L-103 (Postal Regulatory Commission version).

Table 4. Age of Data in Productivity Factors

Productivity Factor	Age of Data (Rate Case)
Unloading	
Unload sacked parcels to extended conveyor	R97-1
Unload non-machinable parcels	R97-1
Unload wheeled containers	R97-1
Unload pallet/pallet box	R97-1
Dumping and sack handling	
Dump containers	R97-1
Manually dump sacks	R2000-1
Loading	
Bedload sacked machinables	R97-1
Load wheeled containers	R97-1
Load pallet/pallet boxes	R97-1
For carrier route	
Sorting BPM flats to carrier route	R97-1
Sorting BPM parcels to carrier route	R84-1
Sorting at carrier station	R2000-1
Other operations	
Tend container loader/sweep runouts	R97-1
Crossdock	R97-1

Changes in productivity factors can impact BPM workshare discount rates. For example, the 11.1 cent carrier route discount rate established in R2006-1 uses two productivity factors: sorting BPM parcels to the carrier route and sorting at the carrier station. The sorting BPM parcels to the carrier route productivity factor dates back to the R84-1 rate case.¹² If sorting BPM parcels to carrier route productivity factors increased by 5, 10, or 20 percent, the corresponding workshare discount rates could potentially decrease from 11.1 cents to 10.5, 10, and 9 cents, respectively. Based on BPM test year FY 2007 mail volume estimates from rate case R2006-1, the decreases in the workshare discount rates could increase BPM revenue by \$1 million to \$3.5 million.¹³

Arrival and Dispatch Profiles

Arrival and dispatch profiles detail the percentage of mail arriving to and dispatched from bulk mail centers, sectional center facilities, and destination delivery units.

¹² Initiated November 10, 1983.

¹³ This simplified example illustrates how changes in data can impact workshare discount rates and mail revenue. The example assumes mail volume would not change in response to price changes, which is unlikely.

Thirteen of the 15 arrival and dispatch profiles use old percentages from the R97-1¹⁴ and R2000-1 rate cases. Table 5 lists the arrival and dispatch profiles.

Table 5. List of Old Arrival and Dispatch Profiles

Arrival and Dispatch Profile	Age of Data (rate case)
Mail Flow Arrival at Destinating BMCs for BPM	
Machinable parcels arriving on pallets/pallet boxes at DBMC	R2000-1
Machinable parcels arriving in sacks at DBMC	R2000-1
Mail Flow Dispatch Profiles from BMCs to Service Area	
Machinable parcels dispatched in bedloaded sacks to service area	R97-1
Machinable parcels dispatched loose in over-the-road containers (OTRs) to service area	R97-1
Machinable parcels dispatched sacked in OTRs to service area	R97-1
Machinable parcels dispatched in hampers, containers, etc., to service area	R97-1
Mail Flow Dispatch Profiles to Delivery Unit	
Machinable parcels dispatched in bedloaded sacks to delivery unit	R97-1
Machinable parcels dispatched loose in OTRs to service area to delivery unit	R97-1
Machinable parcels dispatched in containers to delivery unit	R97-1
DSCF	
Machinable parcels	R2000-1
Flats	R2000-1
Proportion of DSCF using requirements	
Sacks	R2000-1
Pallet and pallet boxes	R2000-1

Updating mail flow arrival and dispatch percentages would assist management in ensuring that changes to BPM workshare discounts are properly justified.

Conversion Factors and Other Inputs

Conversion factors provide BPM pieces-per-container estimates. Containers include OTR containers, hampers, and sacks. Conversion factors include inside and outside container dimensions, cubic feet per container, cubic feet per piece, and parcel capacity. The data used to calculate the pieces-per-container conversion factors was from FY 1982. However, the shape and weight of BPM packages has changed over time. For example, in FY 1991, the average cubic-feet-per-piece for BPM was .182. By FY 2007, the average cubic-feet-per-piece increased over 28 percent to .234. This increase in cubic-feet-per-piece would affect the pieces-per-container conversion factor estimates and could also change certain productivity factors. We also noted that

¹⁴ Initiated July 10, 1997.

management updated other inputs, including wage rate and operation-specific piggyback factors, using base year FY 2005 data.

APPENDIX C. MANAGEMENT COMMENTS

FINANCE



April 30, 2008

JOHNSON JOHN
ACTING DIRECTOR
AUDIT OPERATIONS

SUBJECT: Bound Printed Matter Workshare Discounts (Report Number CRR-AR-08-DRAFT)

Management generally agrees with the overall findings of the Office of the Inspector General self-initiated audit reviewing the development and implementation of the Bound Printed Matter (BPM) workshare discounts and supporting cost avoidances. Management agrees that the Postal Service properly established the BPM workshare discounts in accordance with postal legislation and internal policies and procedures. Management agrees that the prices were developed, and cost analyses were conducted, in accordance with the requirements of the Postal Reorganization Act (PRA), and that subsequent work has been consistent with the requirements of the Postal Accountability and Enhancement Act (PAEA), and the rules associated therewith as established by the Postal Regulatory Commission (PRC). Management acknowledges the observation that the BPM workshare discounts established by Docket No. R2006-1, were properly implemented. Management also acknowledges the observation that controls were in place at six BPM acceptance facilities to ensure that mailers prepared the mail in accordance with workshare standards.

Management agrees that some of the data inputs, but not the "supporting documentation" as the audit states¹, used to develop the cost avoidances had not been updated in recent years. Management will also agree that it is possible that continued use of the data could lead to inaccuracies in the estimation of the costs avoided by certain workshare activities.

Management does take exception, however, with the representation that the information presumptively did not "reflect the current operational environment". Although the audit report states, for example, "postal operations are continuously changing and ... inputs used to develop the existing BPM workshare discounts might not reflect the current operational environment" [p.9], the report offers no insight as to the types of operational changes that it believes could have affected the productivities in question. Nor does the report offer specifics regarding which productivities the changing operations would have affected and in which direction

¹ The workpapers were fully documented, with the dates of the data collection and estimation of the data elements clearly stated in the accompanying footnotes.

the productivities would have been driven. Cost models are routinely reviewed by members of postal Operations to ensure that there are no glaring inconsistencies with current operations. The audit team was informed of this internal review process during interviews with the postal costing analysts.

A review of Table 5 shows that the "old" productivities to which the report refers are all productivities associated with manual activities. Although the Postal Service has made great strides in automating letters and flats and increasing the use of mechanization for other mail processing, the very nature of the activities in question (bedload sacked machinables, unload wheeled containers, for example) does not suggest that the technological improvements which have occurred in the past two decades and have greatly improved productivities in other operations would be expected to show similar impact on the activities in question. Because the productivities in question are associated with manual activities, there is no data source that readily provides the information in the detail required to populate the workpapers, and field studies would be the only way to obtain such information.²

Finally, it is worth noting that the financial loss of \$1 to \$3.5 million as asserted in the report appears unlikely, as described in the attachment.

Recommendation 1:

Determine whether the old supporting data is accurate in the current operational environment.

Response:

Management for Special Studies commits to continuing dialog with postal Operations to incorporate technological and/or policy-driven changes to field operations into the cost models. Special Studies also commits to conducting field observations in Quarter 4 of FY2008 pursuant to determining the need for further field study and data collection. However, Management also notes that the only way to truly address the first recommendation of this audit report would be to actually conduct extensive and expensive data collection. Please refer to the response to Recommendation 2 below.

Recommendation 2:

Develop updated cost avoidance models based on current data.

Response:

Management notes that each year, as part of the Annual Compliance Report, new information from postal data systems (e.g., new wage rates, piggyback factors, cost pool data, volume variabilities, etc.) is incorporated into the cost

² As postal analysts explained to members of the audit team, many of the conversion factors and densities used in the model for BPM are not unique to BPM because BPM does not have its own unique mail processing stream, which is to say that BPM parcels are not isolated from other parcels, nor are BPM flats isolated from other flats. Hence, other than mailer-prepared containers handled intact throughout the postal operating system, the information would likely be for all parcels (or flats) handled in the same operation or in the same container.

avoidance models. Management for Special Services commits to researching alternative sources for more recent data for the elements cited by the audit report as being "old".

The desire to have the most recent data is understood. However, management notes that the audit report did not address the potential cost that would be required to adequately address the data perceived by the audit team to be deficient. Management questions the appropriateness of undertaking a cost study that could cost more than \$1 million, if performed in accordance with PRC and postal quality standards, at this particular time when discussions are already underway to establish a regulatory mechanism to provide a means for stakeholders such as the USPS, the PRC and other interested parties to develop priorities for future work on cost analyses.³ Our understanding is that the PRC has begun to consider how best to categorize costing issues to establish priorities in a manner that reflects the importance of the data, its age, obsolescence along with the cost of updating to ensure the appropriate use of resources. Our understanding is that the intended outcome of the process is to establish work lists of short-term and longer-term data needs, while taking into consideration the cost of collecting such information and the need to accommodate the production schedule for the ACR. The expectation is that initial drafts of the cost study work lists could be completed by the end of 2008. However, Management is not able to state that updating the BPM inputs that were the focus of the audit report would necessarily be a top priority once a comprehensive approach to costing needs is developed.

This report and management's response do not contain information that may be exempt from disclosure under the FOIA.



W. Ashley Lyons
Manager, Corporate Financial Planning

cc: Kathy Banks
Stephen Kearney

³ As noted in the audit report, the existing studies were deemed sufficient for the PRC to recommend and postal Board of Governors to implement rates under the PRA. Moreover, this judgment of their sufficiency took place in a regulatory environment where other interested parties, including those who might have wanted different BPM prices, had an opportunity to question the Postal Service analysts.

Attachment A

The productivities in question are associated with manual operations. As such, management finds the report's discussion of the possibility that the productivities in question might increase by 5, 10, or 20 percent, together with the anticipated impact on rates and revenue associated with such increases in productivity to be hypothetical as opposed to a statement of fact. I would note that the report's assertion that if the productivity associated with sortation of BPM parcels to carrier route increased by 5, 10, or 20 percent, and the workshare discount rates decreased from 11.1 to 10.5, 10 and 9 cents, the decreases in the discount rates would have increased "BPM revenue by \$1 million to \$3.5 million" are again hypothetical. [p.11]

The speculative \$1 million to \$3.5 million revenue increase is not the result of any legal requirement under either the old or new law. Under the PRA, applicable during the litigation of Docket R2006-1, the goal of the rate case was to establish rates sufficient to permit the Postal Service to break even financially. Had more revenue been allocated to BPM, as posited by the audit report, the revenue requirement for some other subclass or rate category would, *ceteris paribus*, have been decreased. The ultimate impact, taking into account volume responses to rate changes, would have been no change to net revenue. As the audit report notes, there are sets of pricing criteria applicable to ratemaking, and not all of the criteria refer to costs. It is speculative to assert that any changes of the magnitude provided in the examples would necessarily have been incorporated into the rate design wholesale.

Under PAEA, BPM is part of the Package Services class, along with Media Mail, Library Mail, and Parcel Post as defined by the Commission. The audit report itself notes on page 6 that the notice provided to the PRC by the Postal Service on February 11, 2008, "included a .42 percent increase for BPM flats and a 2.10 percent increase for BPM parcels." Application of the statutory price cap requires balancing price increases for specific products, such as BPM flats and BPM parcels, relative to the price increases of the other products in the class (e.g., Media/Library Mail) and overall Postal Service business goals. While the overall price cap for Package Services was 2.9 percent, the Postal Service has the statutory discretion to choose which prices increase or decrease as long as the provisions of the cap are met. There is no requirement that all prices increase by exactly the amount of the cap. The price cap regulation does not focus on revenue, but rather on a weighting of prices using a historical set of volumes. Therefore, the suggestion that revenue would have increased if a particular passthrough was chosen neglects consideration of the probability that another price within the Package Service's class would have changed if a workshare BPM price were increased.

Furthermore, as the same page of the report notes, the passthrough for the carrier route destination bulk mail center parcel cost avoidance was 146.3 percent, a passthrough that the Postal Service justified and the Commission accepted based on the requirements of the new law. Hence it is speculative at best to suggest that changing productivity estimates, even if they were to cause changes in the estimated cost avoidance, would in fact have led to any changes in the rates, much less to the total revenue associated with BPM. This remains true even if the productivity changes were to have the magnitudes posited in the report.