U.S. POSTAL REGULATORY COMMISSION

ANNUAL REPORT TO THE PRESIDENT AND CONGRESS

Fiscal Year 2011

CHAIRMAN'S MESSAGE, DECEMBER 2011

In the past year, the Postal Service's financial difficulties have become a matter of national debate and urgent concern in Congress, at the White House, for national mailers and among the ordinary citizens in cities and towns across the nation.

I am proud that the Postal Regulatory Commission has played a vital role in clarifying the complex issues and examining the costs and benefits central to this debate. The Commission has held a wide range of hearings, testified before Congress, and issued a full complement of reports and decisions – all while opening our doors and dockets to ever wider participation from the mailing public.

Commission rulings and Advisory Opinions are helping to shape the Postal Service's responses to the evolving market. The Commission's comprehensive review of the Postal Accountability and Enhancement Act (PAEA), as called for by statute, has contributed to the legislative reform proposals introduced in Congress.

The Postal Regulatory Commission faces changes in our role as well. We are responding with improved productivity and greater flexibility in our own operations. The following are just a few of the highlights of the Commission's accomplishments during this past year.

Enhancing PAEA

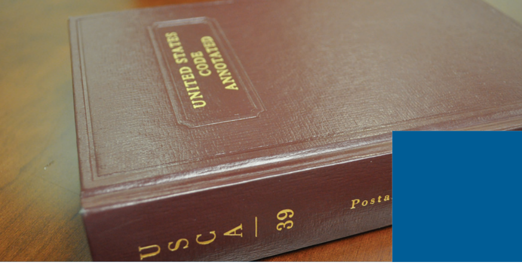
As mandated by the PAEA, in September, the Commission issued its Section 701 Report, recommending to the President and Congress legislation and other ways to improve the effectiveness and efficiency of the United States postal laws.

Focusing on the Postal Service's finances, the Commission began by reiterating its position that the Health Care Retiree Benefit Fund payment requirements were overly ambitious and onerous and suggested methods to alleviate the problem. The Commission also made other recommendations.

The Commission recommended that the Postal Service be allowed to add new market-dominant classes of mail to provide it with more flexibility.

Should Congress permit the Postal Service to offer new non-postal services, those services should have appropriate regulatory oversight and review to avoid disrupting the competitive marketplace.

To encourage innovation, the Commission recommended that Congress amend the law to raise the maximum revenue limitation on market tests of experimental products.



Another recommendation was that the scope of the Commission's appellate review of Postal Service decisions to close retail facilities be clarified and that the plain meaning of the term "post office" be interpreted to include all retail offices operated by Postal Service employees.

Guidance on the Nature of Postal Services

Post Office Closing Appeals

The Commission received over 100 post office closing appeals in FY 2011 and 100 have been filed in the first quarter of FY 2012. In 2010, there were only six appeals. This is a major increase in the work load of the Commission. More importantly, the number of appeals is a clear indication of how much citizens value the regulatory platform we provide to consider Postal Service decisions. In these matters, the Commission's role is limited to assuring that the Service has followed the closing review process and, if not, to remand for further consideration by the Postal Service. As with Advisory Opinions (below), we believe the public debate and our recommendations help the Postal Service to make better decisions that balance mailers' needs with the Service's own interests.

Advisory Opinions

Six – to – Five Day Delivery

In March, the Commission issued its Advisory Opinion on the Postal Service's proposal to eliminate Saturday delivery nationally, except for delivery of Express Mail and delivery to those Post Office Boxes currently receiving Saturday delivery (Docket No. N2010-1). The Commission found that the Postal Service's estimated savings were overstated by $1.4 billion. The Advisory Opinion also found that the Postal Service did not evaluate the impact of the proposal on customers who conduct business in rural, remote, or non-contiguous areas.

Retail Access Optimization Initiative

In July, the Commission opened Docket N2011-1 to develop an Advisory Opinion on the Postal Service's Retail Access Optimization Initiative (RAOI). This initiative examines whether to continue to provide retail and other services and products at approximately 3,650 of the more than 32,000 Post Offices, stations and branches nationwide. Given the precarious financial condition of the Postal Service, the Commission is considering the request on an expedited procedural schedule. Separately, in August, the Commission initiated a rulemaking to revise its rules governing appeals of post office closings and consolidations, and received public comments. The intent of the rulemaking is to both simplify the appeals process and better reflect current practices.

Customer Inquiries

The Commission compiles a public record that offers a snapshot of customer concerns and a fast track for the Postal Service to address minor operating issues. We also receive and respond to thousands of letters commenting on the Postal Service's proposed service reductions. These contacts remind the Commission of the continuing importance of the mail in the average citizen's daily life.

Strengthened Regulation and Oversight

Annual Compliance Determination

In March, the Commission issued its fourth Annual Compliance Determination (ACD), fulfilling the Commission's responsibilities to produce an annual assessment of Postal Service rates and services. For the first time in an Annual Compliance Determination, the Commission found rates for a market-dominant product not in compliance with the statute and directed the Service to take remedial action.

Complaint Authority

The Commission issued its first decision under its authority to act upon complaints. The Commission found that the Postal Service had discriminated in rates regarding the mailing of DVDs and directed it to offer mailing customers a more level playing field.

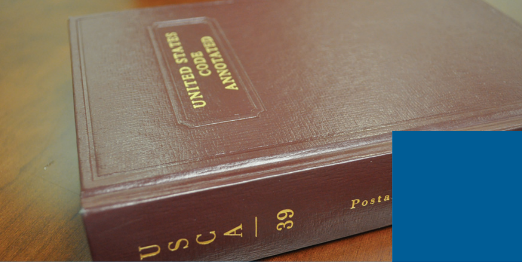
Encouraging Growth and Innovation

The Commission strongly supports efforts by the Postal Service to develop and evaluate new products and to make use of the competitive flexibilities provided by the PAEA.

For example, the Commission approved a Postal Service request for a temporary incentive program designed to promote the use of a mail piece barcode readable by a smart phone.

The Commission authorized Postal Service requests to conduct the following market tests: a new competitive product, Gift Cards, launched at over 2,000 retail locations that currently sell greeting cards; an experimental market-dominant product identified as "Every Door Direct Mail", designed to make advertising through the mail more accessible and attractive for small and medium sized businesses; and the experimental market test "Mail Works Guarantee".

The Commission approved all 64 competitive Negotiated Service Agreements (NSAs) proposed by the Postal Service in FY 2011. The Commission also approved the single market-dominant NSA proposed by the Postal Service. This agreement with Discover Financial Services involved both First-Class and Standard Mail.



Efficient Management and Accountability of the Commission

Our staff successfully managed an unprecedented increase in workload – not only with post office closing appeals as mentioned earlier, but with rate cases, rulemakings and litigation. Commission staff rose to the challenge, while instituting more transparent and accurate procedures. I thank them for their outstanding effort.

As part of our continuing effort to increase the public's awareness of our work and the transparency of our decisions and activities, the Commission made itself more accessible through social media including a Twitter feed and Flickr page.

The Commission continued holding monthly open public meetings to report on our activities with live streaming of all our open proceedings. We also modernized our website at www.prc.gov and upgraded the availability of the Commission's archive.

Conclusion

In the past year, the Commission has provided regulatory oversight for the service upon which so many U.S. citizens greatly rely. I expect the year ahead to be even more challenging. Together, the Commission and the Postal Service share an obligation to preserve an equitable, affordable universal mail system for the people, businesses and institutions across this country that depend upon it.

We look forward to being part of the solution as Congressional postal legislation moves forward and the Postal Service continues to increase efficiencies and, we hope, enhance the postal customer experience. Universal service, which has been a cornerstone throughout the history of the nation, will continue as a fundamental principle guiding Commission decisions and our collaborations with all sectors of the postal community.

Ruth Y. Goldway

Chairman

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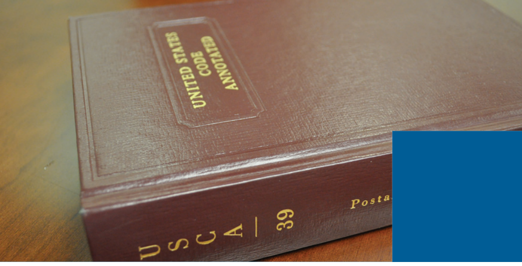
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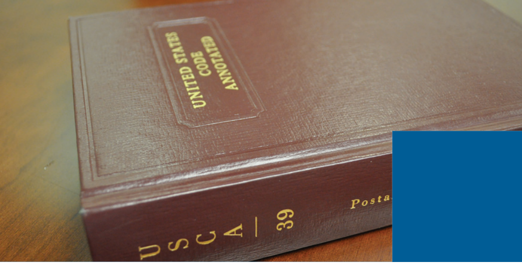
Chapter I

About the Commission

The Postal Regulatory Commission[1] is an independent agency that has exercised regulatory oversight over the U.S. Postal Service since its creation by the Postal Reorganization Act of 1970 (PRA) with expanded responsibilities under the Postal Accountability and Enhancement Act of 2006 (PAEA). The Commission is composed of five Commissioners, appointed by the President, with the advice and consent of the Senate, for a term of six years. The Chairman is designated by the President and serves as the head of the agency. A Commissioner may continue to serve after expiration of his or her term for up to one year. No more than three members of the Commission may be from the same political party.

In FY 2011, on June 30, Commissioner Dan G. Blair concluded his service. In early FY 2012, Commissioner Tony Hammond's term expired, effective October 7, 2011 and on October 8, 2011, Robert G. Taub was sworn in for his first term as Commissioner and Vice-Chairman Mark Acton was sworn in for a second term. The Commission currently has one vacancy.

[1] Formerly known as the Postal Rate Commission



Ruth Y. Goldway, Chairman

First appointed as a Commissioner on April 7, 1998. Designated Chairman by President Barack Obama on August 6, 2009. Term expires November 22, 2014. Former Manager of Public Affairs for the Getty Trust. Former Director of Public Affairs, California State University, Los Angeles. Former Council Member and Mayor, City of Santa Monica. Founder and Former Chairperson, Santa Monica Pier Restoration Corporation. Former Assistant Director of California's Department of Consumer Affairs. Co-founder of Women in Logistics and Delivery Services.

Mark Acton

Appointed as a Commissioner on August 3, 2006. Sworn in for second term on October 8, 2011. Term expires October 14, 2016. Served as Vice-Chairman from 2007 -2008 and from 2010-2011. Served as Special Assistant to former Postal Rate Commission Chairman George Omas. Former Staff Director, Republican National Committee (RNC) Counsel's Office. Former Deputy to the Chairman of the 2004 Republican National Convention. Served as Special Assistant to the RNC Chief Counsel as well as RNC Counsel's Office Government Relations Officer and Redistricting Coordinator. Formerly served as both Executive Director, Republican National Convention, Committee on Permanent Organization and as Deputy Executive Director, Committee on Rules. Former Executive Director of the RNC Redistricting Task Force.

Nanci E. Langley

Appointed as a Commissioner on June 6, 2008. Served as Vice-Chairman from October 2008 - 2009. Term expires November 22, 2012. Served for 24 years as a senior legislative and policy advisor to Senator Daniel K. Akaka and Senator Spark M. Matsunaga. Service included nine years as Deputy Staff Director on the Subcommittee on Oversight of Government Management, the Federal Workforce, and the District of Columbia for the Committee on Homeland Security and Governmental Affairs Committee. First Director of Public Affairs and Government Relations, Postal Regulatory Commission (2007-2008).

Robert G. Taub

Appointed as a Commissioner in October 2011. Term expires October 14, 2016. Former Special Assistant to Secretary of the Army, John McHugh. Former Chief of Staff to U.S. Representative John McHugh. Served for twelve years on the House of Representative's Oversight & Government Reform Committee in a series of senior positions, including service as Staff Director of its former Postal Service Subcommittee. Former Senior Policy Analyst with the U.S. Government Accountability Office (GAO). Staff member for three different Members of Congress, a Member of the British Parliament, and state and county officials in upstate New York.

Postal Regulatory Commission Organization

- **Robert Taub** Commissioner
- **Nanci Langley** Commissioner
- **Ruth Goldway** Chairman
- **Mark Acton** Vice Chairman
- **Vacant**

§ 505 Officer of the Commission representing the general public

The PRC shall designate an Officer of the Commission in all public proceedings who shall represent the interests of the public

- Office of Accountability & Compliance
- Office of General Counsel
- Office of Secretary & Administration
- Office of Public Affairs & Government Relations
- Office of Inspector General

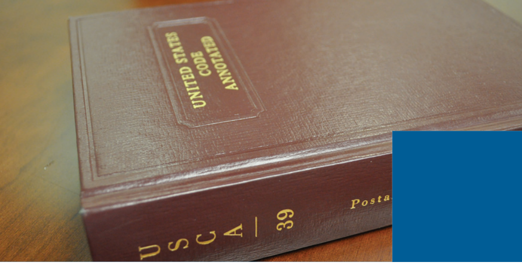
FORMER COMMISSIONERS WHO SERVED IN FY 2011

Dan G. Blair

Appointed as a Commissioner and designated Chairman on December 15, 2006. Served as Chairman until August 6, 2009. Served as a Commissioner until June 30, 2011. Formerly served as both Acting Director and Deputy Director, U.S. Office of Personnel Management. Former Senior Counsel to Senator Fred Thompson (R-TN) on the Senate Committee on Governmental Affairs. Former Staff Director, U.S. House of Representatives Subcommittee on the Postal Service. Former Minority General Counsel, U.S. House of Representatives Committee on Post Office and Civil Service. Elected as a Fellow to the National Academy of Public Administration in 2008.

Tony Hammond

Appointed as a Commissioner on August 15, 2002. Served as Vice-Chairman from 2003 to 2005 and then again from 2009-2010. Served as a Commissioner until October 7, 2011. Former owner and managing member, T. Hammond Company,



LLC. Former Senior Consultant to Forbes 2000, Incorporated. Former Senior Vice President of the direct marketing firm, FL&S. Served as Director of Campaign Operations for the Republican National Committee for the 1998 election cycle. Former Executive Director and Finance Director, Missouri Republican Party. Staff to former U.S. Representative Gene Taylor (R-MO).

Staff

Assisting the Commission is a staff with expertise in law, economics, finance, statistics, and cost accounting. The Commission is organized into four operational offices:

- Accountability and Compliance;
- General Counsel;
- Public Affairs and Government Relations; and
- Secretary and Administration.

The Commission maintains an independent office for its Inspector General.

Mission Statement

Ensure transparency and accountability of the United States Postal Service and foster a vital and efficient universal mail system.

Guiding Principles

The Commission is committed to and operates by the principles of:

- Openness;
- Stakeholder (public) participation;
- Collegiality and multi-disciplinary approaches;
- Timely and rigorous analysis;
- Fairness and impartiality;
- Integrity;
- Commitment to excellence; and
- Merit.

Commission's Strategic Plan

The Commission recently issued its Strategic and Operational Plan for Fiscal Years 2012 through 2016. At this point, the Commission has substantially met the goals established by the 2008 – 2012 plan, and now is facing the task of leading in a rapidly changing and complex environment. Given the increasing use of electronic communication alternatives, the Commission has added "adaptability" to our Guiding Principles.

The Commission plays a vital role in the Postal Service's implementation of new efficiencies and cost controls to meet the challenges it faces. Transparency in this process is essential and the Commission's Strategic Plan seeks to ensure that our efforts are clear. A significant component of the Commission's mission is to hold the Postal Service accountable. The Commission will hold itself accountable for the successful and timely performance of the strategies outlined in its Strategic Plan. Additionally, it will make appropriate modifications to the implementation strategies over the course of the Plan.

The Strategic Plan can be viewed in its entirety on the Commission's website at www.prc.gov.

Increased Workload

During FY 2011, the Commission's workload increased dramatically. This increase was largely driven by an increase in Post Office Closing Appeals, but also included two major Advisory Opinions, numerous competitive NSA cases, and several Periodic Reporting rulemakings. Also, in addition to the Annual Compliance Determination and notices of price change, the Commission initiated a Strategic rulemaking and handled several complaints. The following chapters discuss this workload in detail.

Chapter II

Effectiveness of the Commission's Rules in Achieving the Objectives of the PAEA

39 U.S.C. 3651 requires the Commission to "submit an annual report to the President and the Congress concerning the operations of the Commission under this title, including the extent to which regulations are achieving the objectives under sections 3622 and 3633, respectively." The objectives of section 3622 are to:

1. Maximize incentives to reduce costs and increase efficiency;
2. Create predictability and stability in rates;
3. Maintain high quality service standards;
4. Allow the Postal Service pricing flexibility;
5. Assure adequate revenues, including retained earnings, to maintain financial stability;
6. Reduce administrative burden and enhance transparency of the ratemaking process;
7. Enhance mail security and deter terrorism;
8. Establish and maintain a just and reasonable schedule for rates and classifications, without restricting the Postal Service's ability to make changes of unequal magnitude within, between or among classes of mail; and
9. Allocate the total institutional costs of the Postal Service appropriately between market-dominant and competitive products.

For competitive products, the objectives of section 3633 are to:

1. Prohibit the subsidization of competitive products by market-dominant products;
2. Ensure that each competitive product covers its attributable costs; and
3. Ensure that all competitive products collectively cover what the Commission determines to be an appropriate share of the institutional costs of the Postal Service.

Much of the Commission's work addresses more than one of these objectives. The following chapter discusses how well the Commission's rules have worked.

Section 1 discusses the extent to which objectives 2, 4, 5, 6, and 8 were achieved. Section 2 addresses objective 1, and Section 3 addresses objective 3. Finally, Section 4 discusses objective 9 and the three objectives related to competitive products.

The rules can be viewed at www.prc.gov

During FY 2011, the Commission also filed its Section 701 Report, *Analysis of the Postal Accountability and Enhancement Act of 2006*.[2] This report, discussed in detail in Chapter VII, made recommendations aimed at improving the effectiveness and efficiency of postal laws.

SECTION 1: EFFECTIVENESS OF RULES RELATED TO PRICING OBJECTIVES

The objectives in the area of pricing for market-dominant products are to: provide predictability and stability in rates; allow pricing flexibility; assure adequate revenues to maintain financial stability; reduce administrative burden and enhance transparency of ratemaking process; and, establish and maintain a just and reasonable schedule for rates and classifications.[3] The extent to which the Commission's rules met each objective is discussed in separate sections below.

In general, the Commission's rules were effective in furthering these objectives. However, in FY 2011, the Postal Service continued to generate insufficient revenues, due primarily to the overambitious payment schedule required by PAEA to fund retiree health

[2] Section 701 of Title 7 of the PAEA states:
(a) IN GENERAL.—The Postal Regulatory Commission shall, at least every 5 years, submit a report to the President and Congress concerning—
(1) the operation of the amendments made by this Act; and
(2) recommendations for any legislation or other measures necessary to improve the effectiveness or efficiency of the postal laws of the United States.
(b) POSTAL SERVICE VIEWS.—A report under this section shall be submitted only after reasonable opportunity has been afforded to the Postal Service to review the report and to submit written comments on the report. Any comments timely received from the Postal Service under the preceding sentence shall be attached to the report submitted under subsection (a).

[3] Objective 9 is also a pricing objective. However, because it is closely related to the objectives for competitive products it is discussed in that section.

PRC Commissioner Acton and Ann Fisher, Director of Office of Public Affairs and Government Relations with attendees of the Public Form on PAEA.

benefits, as well as continued declines in volume, particularly in First-Class Mail. Therefore, Objective 5 will be discussed first. The other pricing objectives will be discussed in numerical order.

Objective 5: Effectiveness of Rules in Assuring Adequate Revenues

Although the Commission's rules are intended to assure adequate revenues to maintain financial stability, Postal Service revenues have declined in each fiscal year since FY 2007. The Postal Service has continued to report significant losses through FY 2011.[4] Since the passage of PAEA in FY 2007, total losses have been $25.3 billion. However, $20.9 billion has been spent to pre-fund retiree health benefits as required by PAEA and $6.1 billion has been for non-cash adjustments to the workers compensation liability. Without those charges to the income statements, the Postal Service would have recorded a net income of approximately $1.6 billion since FY 2006.

The continuing losses are straining the Postal Service's ability to maintain sufficient cash balances to finance basic operations, and compromising the Postal Service's ability to make payments due for the retiree health benefits fund and workers compensation.[5] During FY 2011, in an effort to sustain cash reserves, the Postal Service suspended payment of the employer's portion of the Federal Employees Retirement System (FERS) defined benefit annuity, saving over $900 million in cash.[6] In the most recent continuing resolution funding the federal government for the beginning of FY 2012, Congress deferred the retiree health benefit fund payment until August 1, 2012. Table 1 shows the Postal Service's cash flow balance at the end of the last five fiscal years.

Table 1—Postal Service Cash Flows FY 2007 – 2011 ($ in Millions)

	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011
Net Income/(Loss)	(5,142)	(2,806)	(3,794)	(8,505)	(5,067)
Non-Cash Items and Other Cash Flows	2,539	2,367	5,367	5,213	5,561
Cash Flows from Investing Activities	500	(1,938)	(1,806)	(1,323)	(1,053)
Cash Flows from Financing Activities	2,005	2,910	2,890	1,687	886
Net Increase/(Decrease) in Cash	(98)	533	2,567	(2,928)	327
Cash Balance BOY	997	899	1,432	4,089	1,161
Cash Balance EOY	**899**	**1,432**	**4,089**	**1,161**	**1,488**
Debt Outstanding	4,200	7,200	10,200	12,000	13,000

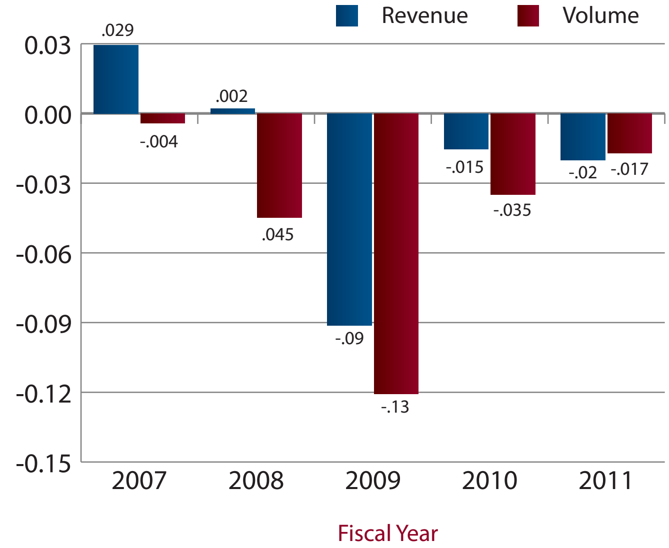
4 The Postal Service reported a net loss of $5.1 billion in FY 2011. The loss would have been much higher, $10.6 billion, without the Congress deferring the $5.5 billion payment for the pre-funding of retiree health benefits from the original due date of September 30th to November 18th in Public Law 112-36, *The Continuing Appropriations Act of 2012*.

5 In the Postal Service's recent Form 10-K filing for FY 2011 it notes that current financial projections indicate that the payments due for retiree health benefits on November 18, 2011 and September 30, 2012 will not be made due to insufficient cash resources. USPS 10-K at 6.

6 Subsequent to the end of FY 2011 the Postal Service will resume the employer's contribution to the FERS defined benefit annuity and the reimbursement of the suspended payments from FY 2011 by the first pay period in December, 2011. USPS 10-K at 6.

During FY 2011, the operating loss before taking into account the non-cash workers compensation adjustments was $2.8 billion, an amount primarily driven by continued declines in mail volumes. Total mail volume declined almost three billion pieces, or 1.7 percent from last year, with First-Class mail declining 6.4 percent. The drop in First-Class Mail volume was partially offset by a 2.6 percent increase in Standard Mail and a 2.8 percent increase in market-dominant Package Services. Volumes for competitive products also increased over six percent compared to last year. However, the net decline in overall volumes led to a decrease in revenues from last year of almost two percent, or $1.3 billion despite an average 1.7 percent increase in market-dominant prices implemented in April, 2011 and a 5 percent increase in prices for competitive products implemented in January, 2011.

Figure 1– Volume and Revenue Growth Rates FY 2007–2011



Objective 2: Effectiveness of Rules in Assuring Stability and Predictability in Pricing

The Postal Service's current financial condition raises the issue of how well the price cap method outlined in the Commission's rules is working. Consequently, a review of the two methods considered in Docket No. RM2007-1, Regulations Establishing a System of Ratemaking, is instructive.

The Commission rules for changing rates for market-dominant products under the Consumer Price Index (CPI) cap were designed to promote predictability and stability in rates. In Docket No. RM2007-1, two approaches to applying the cap were considered. One, referred to as the "point-to-point" method, calculates the cap based on a year over year comparison of the CPI index. The other method, referred to as the "moving average" method, is a "weighted average" method that calculates the cap as the percentage change between two years' annual average CPIs. The Commission uses the moving average method of calculating the CPI-U limitation because this method provides mailers with more stable and predictable rates, does not impose any undue administrative burden on the Postal Service and does not inhibit transparency. Figure 2 provides a comparison (between the two methods) of the allowable percentage rate change.

The graph seems to indicate that, generally, when CPI decreases, the moving average approach produces a higher price cap and when CPI increases, the point-to-point method produces a higher price cap. However, it is not the absolute level of inflation that determines which method produces a higher cap, it is the change in the rate of inflation. When there is

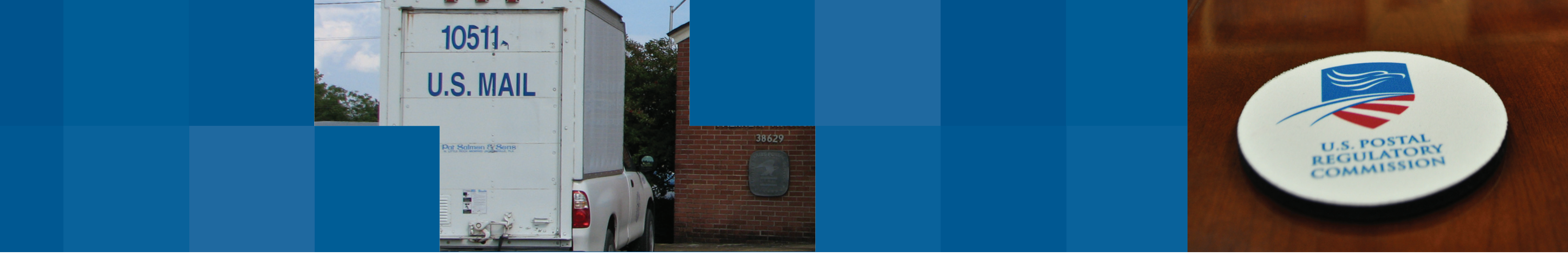
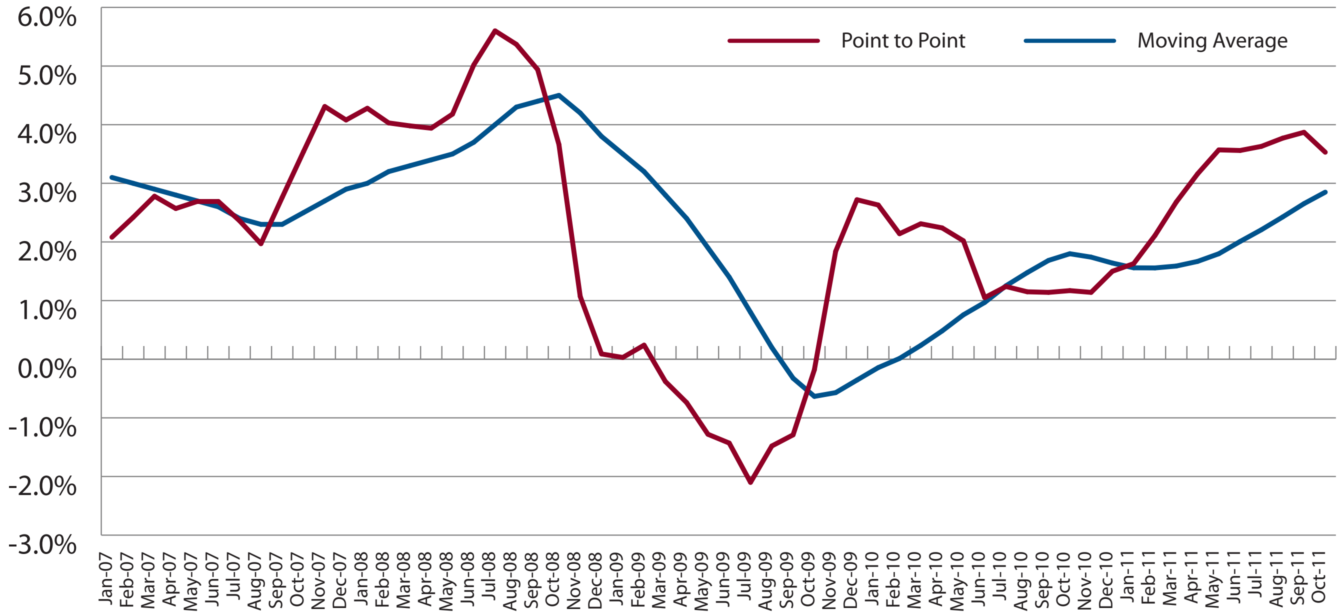


Figure 2—Comparison of CPI Cap Between Moving Average and Point-to-Point Method



a rapid change in the rate of inflation, the weighted average method responds more slowly than the point-to-point method, but shortly after the inflection point when the change in inflation switches direction, the moving average method quickly catches up, and eventually crosses the point-to-point line.

The moving average method moderates the swings in the rate of inflation so that at any given point in time, this method tends to be closer to the recent inflation trend (average), than the point-to-point, which tends towards more extreme highs and lows. Thus, the moving average method is more stable and predictable.

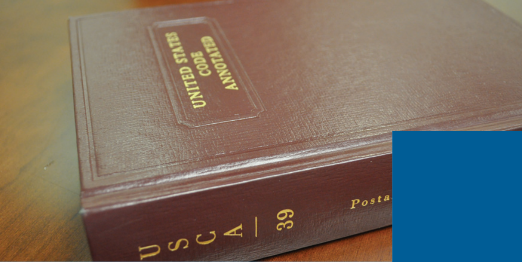
A comparison of the two methods using data from 2007 through 2011 shows that the point-to-point method would have resulted in a higher cap 56 percent of the time while the moving average method would have resulted in a higher cap 44 percent of the time. A comparison over a longer period of time, 1970 through 2011, reveals a nearly 50/50 split between the two methods as to which one results in a higher cap.

A technical description of application of the CPI cap is found in Appendix A.

Docket No. R2011-2: Price Adjustment for Market-Dominant Products and Related Mail Classification Changes

The Postal Service filed a notice of market-dominant price adjustment on January 13, 2011, twenty-three months after it had filed the previous notice of a market-dominant price adjustment (Docket No. R2009-2).[7] The applicable CPI-U price cap was 1.741 percent. Because of a sustained deflationary period during the 23-month interval, the price adjustments produced negative unused price authority, and the Postal Service added -0.577 percentage

[7] In FY 2010, the CPI cap was negative so the Postal Service could not increase rates under the cap.



points to its bank of unused rate adjustment authority. The addition of this unused rate adjustment authority caused the cumulative total of unused rate adjustment authority for every class to become negative. The Commission's rule, 39 CFR 3010.28, limits the use of unused rate adjustment authority in subsequent price adjustments to the lesser of: (a) two percent; or (b) the sum of any unused rate adjustment authority for that class. Since the sum of any unused rate adjustment authority is negative for every class, and therefore less than two percent, the Commission's rule unintentionally prevents the Postal Service from using positive unused rate adjustment authority previously generated in Docket Nos. R2008-1 and R2009-2. The Commission rules were not intended to limit the Postal Service's ability to use unused rate adjustment authority from previous price adjustments. The Commission intends to modify 39 CFR 3010.28 in FY 2012 to better reflect 39 U.S.C. 3622(d)(2)(C)(iii), and allow the Postal Service to use unused rate adjustment authority from previous price adjustments even if the sum of the unused rate adjustment authority is negative.

Table 2 shows the percentage price increase by class and the total unused price authority.

Table 2—R2011-2 Percentage Price Increase by Class

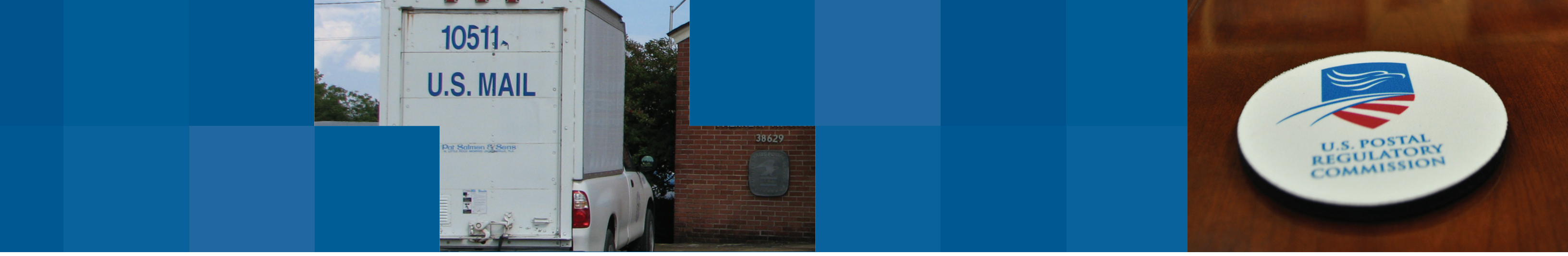
Percentage Increase by Class and Unused Price Authority

Class	Price Changes %	Unused Price Authority %
First-Class Mail	1.741	-0.533
Standard Mail	1.739	-0.472
Periodicals	1.741	-0.562
Package Services	1.740	-0.551
Special Services	1.740	-0.439

On February 16, 2011, the Commission issued an order finding that the Postal Service's planned rate adjustments established prices consistent with 39 U.S.C. 3622, as they did not exceed the statutory CPI price cap in 39 U.S.C. 3622(d), and they were consistent with the workshare requirements in 39 U.S.C. 3622(e)(2).

Section 3622(e)(2) directs the Commission to ensure that workshare discounts do not exceed the costs avoided by the Postal Service, unless certain conditions are met. The Commission's rules require the Postal Service to justify any proposed workshare discounts that exceed 100 percent of avoided costs by explaining how they qualify for one of four exceptions permitted under the PAEA. Worksharing discounts are permitted to exceed 100 percent if the discount is:

1. Associated with a new postal service, a change to an existing postal service or with a new workshare initiative related to an existing postal service and necessary to induce mailer behavior that furthers the economically efficient operation of the Postal Service and the portion of the discount in excess of the cost that the Postal Service avoids as a result of the workshare activity will be phased out over a limited period of time;
2. The amount of the discount above costs avoided is necessary to avoid rate shock and will be phased out over time;
3. The discount is provided in connection with subclasses of mail consisting exclusively of mail matter of educational, cultural, scientific or informational value; or
4. Reduction or elimination of the discount would impede the efficient operation of the Postal Service.



These workshare limitations help further the goal of predictable and stable rates by mitigating large swings in discounts.

In its FY 2010 Annual Compliance Determination issued in March 2011 and discussed further on page 26, the Commission identified 39 workshare discounts that exceeded avoided costs. Twenty-three of those discounts were justified by the exceptions in the statute. Seven discounts were adjusted to reflect 100 percent of avoided cost in Docket No. R2011-2. Because of problems with the reliability of underlying costs, the Commission could not determine if six discounts were consistent with section 3622(e).

The Commission found that two discounts in R2011-2 satisfied the statute assuming approval of the methodological changes proposed by the Postal Service in Proposal Nine of Docket No. RM2011-5. Subsequently, Proposal Nine was approved with some slight modifications in Order No. 741.

The evaluation of one discount was temporarily suspended pending the outcome of Docket No. RM2010-13. This docket was initiated to determine whether the reference group, or "benchmark," currently used to measure presort First-Class Mail avoided costs should be discarded in favor of a number of alternatives.

Docket No. RM2010-13: First-Class Workshared Benchmark

Currently, Bulk Metered Mail (BMM) is used as the benchmark for setting discounts for presorted First-Class letters. However, the use of the BMM benchmark is in dispute, and in Docket No. RM2009-3, the Commission concluded that the BMM may no longer represent the type of First-Class letters that are likely to convert to presort and that the issue needed to be further examined.[8]

Courtesy of USPS.

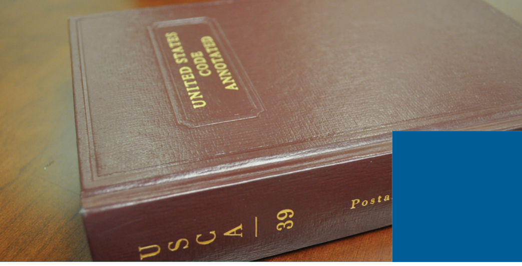
Acklen Post Office in Nashville, Tennessee.

To investigate the benchmark issue further, the Commission initiated Docket No. RM2010-13 to seek comments on an appropriate benchmark for measuring First-Class Mail workshare discounts.[9] Based on the comments in the docket, the proposed benchmarks can be grouped into four categories: BMM, Metered Mail, First-Class Single-Piece Mail, and Information Based Indicia (IBI) mail.

In addition to determining the appropriate benchmark, Order No. 537 solicited comments on the specific cost activities that should be included in the benchmark. The stakeholders suggested the following three activities: mail processing, delivery, and collection costs.

In previous dockets, some parties expressed the need to develop new methods to improve the way avoided costs are modeled, as well as to introduce new workshare discounts. Order No. 537 stated that such proposals are eligible for consideration in

8 Commission Order No. 536 at 63.
9 Commission Order No. 537 at 2.



Docket No. RM2010-13. The Commission received five technical proposals to modify the cost models and two proposals for new workshare discounts. The Commission will issue a final determination in FY 2012.

In response to Order No. 537, the Postal Service filed an Appeal with the United States Court of Appeals for the District of Columbia Circuit regarding the Commission's adoption of an analytical framework for calculating workshare discounts under a statutory cap. The Postal Service asked the Court to set aside the Commission determination for three reasons. First, it alleged that the order exceeded the Commission's statutory authority and acted unreasonably in treating different products as workshare variants of each other. Second, it claims that even if the authority was not exceeded the determinations were "arbitrary and capricious." Finally, the determination that these discounts should include prerequisite work necessary to qualify for the discount exceeded the Commission's statutory authority. The Court determined, on October 21, 2011, that the Postal Service's appeal was premature because the Commission had not yet adopted a single subset of Single-Piece First-Class Mail to serve as a benchmark for determining the workshare discount.

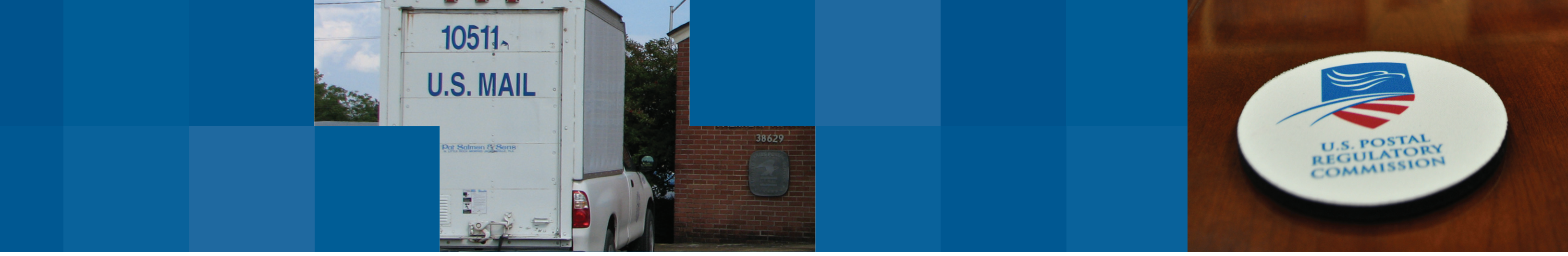
Appeal of Exigent Rate Case

The Postal Service also appealed the Commission's decision in Docket No. R2010-4, Exigent Request of the U.S. Postal Service.

39 U.S.C. 3622(d)(1)(E) of the PAEA directs the Commission to implement procedures whereby rates may be adjusted beyond the inflation-based cap due to exceptional or extraordinary circumstances. First, the Commission must determine, after notice and opportunity for a public hearing and comment, whether such adjustment is "reasonable and equitable and necessary" to enable the Postal Service to maintain and continue the development of postal services of the kind and quality adapted to the needs of the United States. Commission rules in 39 CFR 3010.2 refer to rate filings of this type as "exigent." 39 CFR 3010.6 outlines streamlined proceedings for exigent adjustments, consistent with the 90-day review period and due process considerations. These rules further the objective of predictability and stability in rates by limiting the Postal Service's ability to raise rates beyond the CPI Cap.

On July 6, 2010, the Postal Service filed an "exigent" rate request pursuant to the authority in 39 U.S.C. 3622(d)(1)(E) and 39 CFR Section 3010.60 *et seq.*, seeking to increase rates for market-dominant products, on average, by 5.6 percent. On September 30, 2010, the Commission denied the Postal Service's request for the average 5.6 percent exigent rate increase. In its decision the Commission found that the Postal Service's request failed to demonstrate that the proposed rate adjustments were "due to" extraordinary or exceptional circumstances.

On October 22, 2010, the Postal Service appealed the Commission's decision to the United States Court of Appeals for the District of Columbia Circuit. The Court remanded the case to the Commission, on July 11, 2011, and directed it to determine "how closely the amount of the adjustments must match the revenue lost as a result of the exigent circumstances." On September 20, 2011, the Commission issued Order No. 864, clarifying how close the causal connection must be between an exigent rate adjustment and the circumstances identified as the reason for the revenue lost as a result of the exigent event. On November



7, 2011, the Postal Service filed a statement that it intends to proceed with the rate case, and on November 21, 2011, the Postal Service filed related material.

Objective 4: Effectiveness of Rules in Encouraging Pricing Flexibility

Applying the CPI cap at the class level rather than the product level gives the Postal Service flexibility to apply non-uniform price adjustments within a class. Further flexibility is provided by the Postal Service's ability to offer incentive programs that adjust rates for products, or sets of products, for a limited time period. The Postal Service can also assess fees on certain products. The Postal Service has additional pricing flexibility through its ability to offer Negotiated Service Agreements (NSA) and to offer market tests of experimental products.

Docket No. R2011-1: Classification and Price Adjustments for First-Class and Standard Mail Incentive Programs

In Docket No. R2011-1, Order No. 606, issued December 10, 2010, the Commission approved three price adjustments and related classification changes for First-Class Mail and Standard Mail products. The Commission determined that two of the price adjustments, Reply Rides Free and Saturation and High Density incentives constitute rate reductions, while the third price adjustment—the Move Update Assessment Charge alteration—is a rate increase.

In its order, the Commission noted that implementing the Reply Rides Free and Saturation and High Density incentives would not have price cap implications. The Move Update price increase for First-Class Mail and Standard Mail would impact current and prospective rate adjustment authority. The Commission indicated

Courtesy of USPS.

Postal employee scans package.

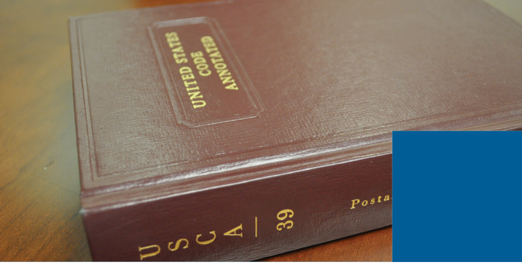
that implementing the Move Update change would reduce the maximum allowable size of the next price increase by more than 0.6 percentage points.

On December 22, 2010, the Postal Service withdrew its notice of the Move Update change. The Reply Rides Free and Saturation and High Density incentives became effective on January 2, 2011.

Docket No. R2011-5: Quick Response Barcode Incentive Program

On April 12, 2011, the Postal Service filed a Notice of Price Adjustment for First-Class Mail and Standard Mail requesting approval of a temporary incentive program to reduce prices by three percent for qualifying mailpieces that contained a barcode readable by a smartphone. The 2011 Incentive Program is an example of the Postal Service exercising its pricing authority under the PAEA.

Although the Postal Service estimated that the 2011 Incentive Program would reduce contribution by between $1.5 million and $4.6 million, the program was designed to "increase awareness of how integrating technology increases the value of the



mail." The Commission determined that the temporary reduction in prices would not materially affect the degree to which the prices of First-Class and Standard Mail would comply with the objectives and factors of 39 U.S.C. 3622 and approved the program to begin on July 1, 2011, and to expire on August 30, 2011.

On November 25, 2011, the Postal Service provided a data collection report in accordance with the Commission's approval of the initiative in Order No. 731. The Postal Service reported that "customer participation in the promotion greatly exceeded the initial expectation of the Postal Service, meeting the primary goal of increasing awareness." The Postal Service provided mailers with $31.4 million in discounts for 5 billion qualifying pieces including $4.4 million in discounts for 406 million qualifying Standard Mail Flats.

Docket No. RM2010-9: Estimating Volume Changes from Pricing Incentive Programs

The purpose of Docket No. RM2010-9 was to consider new methods to estimate volume changes resulting from pricing incentive programs like those discussed above. To evaluate these programs, the Postal Service developed a new methodology based on trend analysis. The Commission's method uses price elasticity to estimate the new volume generated by pricing incentive programs.

On June 8, 2010, the Commission sought suggestions from interested persons. Several parties including the Postal Service and the Commission's Public Representative submitted comments. The Commission was not persuaded that the alternatives proposed offer a demonstrable improvement over the current method. It determined that the Commission's methodology should be retained.

Negotiated Service Agreements

The Commission's rules regarding Negotiated Service Agreements (NSA) combine pricing flexibility and accountability. The rules direct the Postal Service to provide details demonstrating compliance with the statutory requirements of 39 U.S.C. 3622(c)(10), requiring that NSAs result in either financial or operational benefit to the Postal Service and do not cause undue harm to the market. The Postal Service is also required to provide annual data intended to enable evaluation of the success of each negotiated service agreement. The rules allow 45 days for review by the Commission. The rules seek to minimize the administrative and economic burden of implementing agreements, while still requiring submission of comprehensive relevant data. The rules are intended to strike a reasonable balance to foster pricing flexibility, transparency, and accountability.

The Commission's regulations were intended to create a new, streamlined regulatory process for market-dominant NSAs, however, the Postal Service has only proposed one domestic market-dominant NSA since the passage of the PAEA.

Docket No. R2011-3: Discover NSA

On January 14, 2011 the Postal Service filed R2011-3, its first domestic market-dominant NSA. The Commission approved the Postal Service's agreement with Discover Financial Services (Discover) on March 15, 2011. The agreement offers a pricing incentive designed to maintain the total contribution from First-Class Mail and Standard Mail sent by Discover, and to provide an incentive for it to generate additional net contribution. In order to qualify for discounts,

Discover is required to maintain contribution by mailing enough additional Standard Mail pieces to offset the loss of contribution that is expected to result from the continuation of the downward trend in its First-Class Mail volume. The Postal Service will begin filing data on the results of the agreement in the FY 2011 Annual Compliance Report.

For competitive NSAs, the rules allow for not less than a 15-day review of all agreements. Competitive NSAs are evaluated for compliance with the statutory requirements for competitive products. In FY 2011, the Commission approved 64 notices of competitive negotiated service agreements (NSA). As seen in Table 3, in FY 2011 there were approximately half as many NSAs as there were in FY 2010. This decrease is due to the approval of two Non-published Rates (NPR) products, which allow the pre-approval of certain contracts that meet Commission approved price and cost coverage requirements, thus, streamlining the approval procedure and eliminating the review of individual contracts.

In FY 2011, the Postal Service filed three Priority Mail-NPR contracts and 168 Global Expedited Package Services – Non-published Rates (GEPS-NPR) contracts[10] with the Commission.

Table 3—Negotiated Service Agreements Approved by Commission

Type of NSA	FY 2011	FY 2010	FY 2009	FY 2008
Competitive Domestic	14	13	31	2
Competitive International	50	111	32	19
Total Competitive	64	124	63	21

[10] The GEPS—NPR 1 product offers discounted rates to small and medium-size business mailers that use Express Mail International (EMI) and Priority Mail International (PMI) and are capable of paying at least $50,000 per year in international postage.

Review of Experimental Products

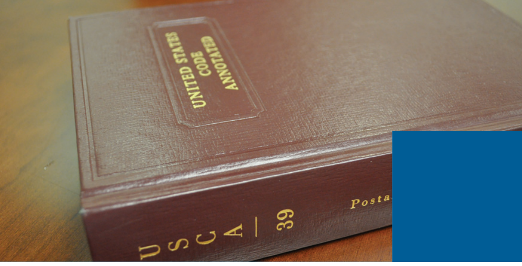
The Postal Service has broad flexibility in providing experimental products. If a product is deemed to be experimental it is excluded from the requirements of the ratemaking rules. Specific limitations on experimental products are outlined in 39 U.S.C. 3641. A product may not be tested under this provision unless it satisfies each of the following conditions: (1) the product is significantly different from all products offered by the Postal Service within the two-year period preceding the start of the test (section 3641(b)(1); (2) the product will not result in undue market disruption, especially for small business concerns (section 3641(b)(2)), and; (3) the product is correctly characterized as either market-dominant or competitive (section 3641(b)(3)). The Commission's rules embody these requirements.

Experimental products reviewed in FY 2011 are described below.

Docket No. MT2011-2: Gift Cards Market Test

In Docket No. MT2011-2, the Commission authorized the Postal Service's request to conduct a 24-month market test for a new competitive product, Gift Cards.[11] Customers may purchase two types of gift cards: fixed and variable. Fixed gift cards are available for $25 or $50. Variable gift cards are available in amounts ranging between $25 and $100. The market test was launched in June 2011 at 2,000 retail locations that currently sell greeting cards. In its request, the Postal Service stated its intention to expand the market test to up to a total of 3,000 locations, including locations that do not sell greeting cards. In October 2011 the Postal Service

[11] Docket No. MT2011-2, Order Authorizing Gift Card Market Test, April 28, 2011 (Order No. 721).



carried out its intention to expand its gift cards market test. Gift cards are now available at approximately 5,000 locations.[12]

Docket No. MT2011-3: Every Door Direct Mail Market Test

The Postal Service proposed to conduct a test of an experimental market-dominant product identified as "Every Door Direct Mail" (EDDM). EDDM — a Standard Mail Flat Product — is restricted to locally-entered and locally-paid mail, delivered to every household on delivery routes and limited to 5,000 pieces entered per office per day. The Postal Service designed EDDM to make advertising through the mail more accessible and attractive for small and medium sized businesses. To that end, it waived all permit and mailing fees, simplified qualification and preparation requirements, and priced EDDM using the price schedules for existing Standard Mail saturation products.

The Commission approved the proposed experimental product in March 2011. In its order, the Commission included a data collection plan as a necessary condition of the Postal Service's implementation of the EDDM market test. The Postal Service's collection report for Quarter 3 of FY 2011 indicates that 1,665 customers used the EDDM product.

Docket No. MT2011-4: Mail Works Guarantee

On April 15, 2011, the Postal Service proposed "Mail Works Guarantee." The Commission approved the experimental market test on May 16, 2011. There are 16 participants in the experimental market test that spend at least $250 million annually on advertising, but allocate less than 0.36 percent of their total advertising budget to direct mail.

Commissioner Langley with attendees of the Public Forum on PAEA.

Participants are required to pay "list price" at the time of mailing, but the experimental market test offers participants a postage back guarantee (in the form of a credit to their account with the Postal Service) if a campaign fails to achieve the pre-established metric. The credit is limited to $250,000 per participant. The Postal Service expects the program to generate additional volume and revenue.

Objective 6: Effectiveness of Rules in Reducing Administrative Burden and Enhancing Transparency of Ratemaking Process

There is a natural conflict between reducing administrative burden and enhancing transparency. As the Commission noted in Order No. 26, there is a tension in the PAEA between its goals of facilitating rapid and flexible adjustments to rates and classifications, and increasing the transparency and accountability of those processes. This tension is readily apparent from 39 U.S.C. 3622(b)(6), which simultaneously calls for reducing the administrative burden and increasing transparency relative to the system that prevailed under the Postal Reorganization

[12] Postal Bulletin 22323, November 17, 2011 at 7.

Act. The Commission's rules are intended to strike a balance between these two goals.

Reducing Administrative Burden

In designing the ratemaking rules, the Commission took a number of steps intended to reduce the administrative burden.

Rate Requests

Previously, under the Postal Reorganization Act, the most burdensome filing requirements for the Postal Service were those associated with specific rate requests. These requirements have been replaced by far less burdensome criteria. The 90-day time limit for rate cases necessarily reduces the administrative burden and the Commission rules further reduce the burden by allowing only 20 days for parties to comment. Parties no longer submit discovery requests or testimony. As discussed above, in FY 2011, the Commission completed review of the Postal Service's proposed changes to rates of general applicability in 34 days. The review focused on the CPI cap and worksharing requirements.

Negotiated Service Agreements

The Commission rules for negotiated service agreements attempt to strike a balance between reducing administrative burden and enhancing transparency. These rules require the Postal Service to provide sufficient information to allow the Commission to review NSAs for consistency with applicable statutory requirements while reducing the need for the Postal Service's NSA partners' active participation in the Commission's review process. Accordingly, the Commission review process does not require mailers to allocate additional time or financial resources beyond their negotiations with the Postal Service.

The GEPS—NPR product classification represents an innovative approach to streamlining the regulatory process for approving GEPS agreements, which are categorized as competitive NSAs. Mailers enter into a standardized agreement with the Postal Service and are offered discounted rates commensurate with the size of their revenue commitment and the entry location of their mailpieces. The standardized agreement minimizes Postal Service administrative expenses compared to negotiating separate GEPS agreements with each mailer. Moreover, the use of a standardized agreement and discounted rates based upon each mailer's revenue commitment and entry location permits the Commission to forego a prior review of each agreement. The Commission reviews the financial performance of GEPS—NPR products in its Annual Compliance Determination (ACD) report.

Periodic Reporting Rules

The Commission's rules for periodic reporting are also intended to reduce the administrative burden of the ratemaking process. Under 39 U.S.C. 3652(e)(1) of the PAEA, the Commission has responsibility for selecting appropriate input data and analytical methods to be used by the Postal Service to demonstrate compliance with the requirements of the PAEA.[13] The Commission's rules for changing methods for collecting and analyzing these data are based on informal rulemakings under section 553 of the APA.

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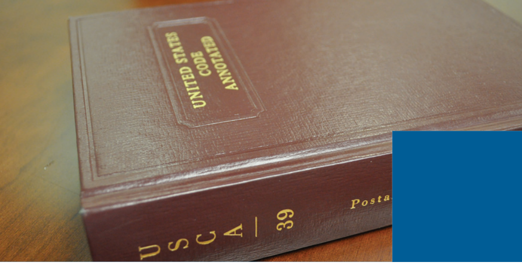
[13] 39 U.S.C. 3652(a) states:
(a) COSTS, REVENUES, RATES, AND SERVICE.—Except as provided in subsection (c), the Postal Service shall, no later than 90 days after the end of each year, prepare and submit to the Postal Regulatory Commission a report (together with such nonpublic annex to the report as the Commission may require under subsection (e))—
(1) which shall analyze costs, revenues, rates, and quality of service, using such methodologies as the Commission shall by regulation prescribe, and in sufficient detail to demonstrate that all products during such year complied with all applicable requirements of this title; and



One of the important benefits of the PAEA is the freedom that it gives the postal community to decide analytical issues in a non-adversarial context, rather than the cumbersome litigation model used under the PRA. The Commission's rules approach analytical issues through a process that is intended to promote cooperation and facilitate consensus. The procedures are intended to be highly flexible, and vary according to the complexity of the proposed change and the level of documentation supporting it. The rules identify separate procedures for strategic rulemakings, discrete issue rulemakings and expedited rulemakings. In FY 2011 the Commission initiated a Strategic rulemaking and the Postal Service initiated several discrete issue rulemakings.

In anticipation of filing its 2010 Annual Compliance Report, the Postal Service filed 14 proposals with the Commission seeking consideration of a number of proposed changes in costing methodologies and data collection methods. These proposals led to a series of rulemakings. The Commission accepted all of the proposed methodology changes, although it modified one.

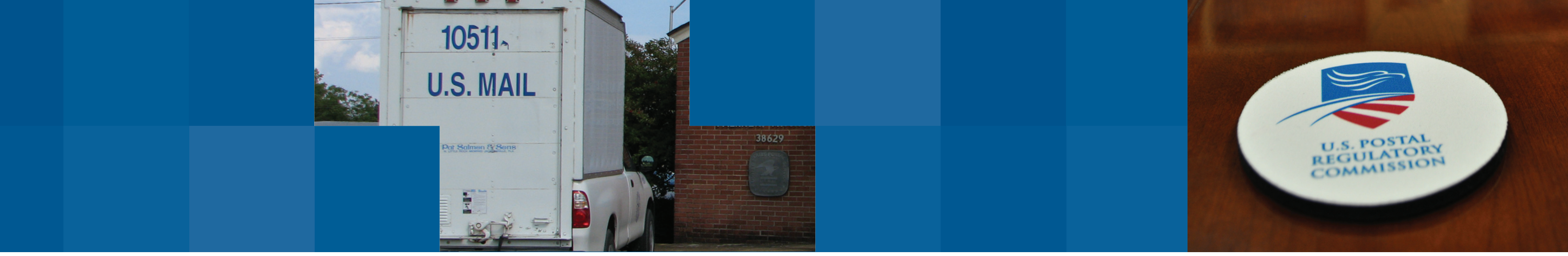
The Postal Service has filed 15 additional proposed changes to its costing methodologies in anticipation of filing its 2011 ACR, 8 of which have been accepted by the Commission. The other proposals are currently under evaluation by the Commission's staff.

The Commission initiated Docket No. RM2011-3 to systematically evaluate the Postal Service's need to update and improve upon the data and analytical methods that it uses to report on the costs, volumes, revenues, and service quality of its products under 39 U.S.C. 3652(a) of the PAEA. This docket is designed to involve the Postal Service, its stakeholders, and the public in the evaluation process. The objective is to arrive at a consensus as to the priorities that should be assigned to various areas of future research and the nature of the data and analytical methods that future research should employ.

Comments have been received from seven participants, identifying a range of issues including methods of estimating the volume variability of mail processing and other costs, "bottom-up" vs. "top-down" evaluation of worksharing costs, the costs of flat shaped mail, the effects of excess capacity on Postal Service costs, developing a single measure of service performance, and aligning demand elasticity estimates with the new product structure. The Commission has scheduled a technical conference on January 12, 2012, which will be largely focused on the Postal Service's comments about city carrier street time. This conference will be followed by a public forum to address the question of what future research is most urgent and would be most beneficial, given the limited time and money available to the Postal Service for such research.

Enhancing Transparency

A key tool for achieving transparency in Postal Service operations is the annual review of information provided by the Postal Service to the Commission, in accordance with regulations adopted by the Commission. The Postal Service has 90 days after the close of the fiscal year to collect, audit, and submit data which the Commission determines necessary. The Commission has an additional 90 days to solicit comments from the public, evaluate the data, and provide a written determination of Postal Service compliance with applicable statutory policies.




Courtesy of USPS.

Postal carrier on her route.

On March 30, 2011, the Commission issued its ACD report. This report, the fourth since enactment of the PAEA, assessed the financial and service performance of the Postal Service during FY 2010.

The Commission concluded that, despite exercising the pricing flexibility afforded by the PAEA and achieving substantial cost reductions, the Postal Service's financial condition continued to deteriorate. Moreover, the Commission found that the Postal Service faces severe financial problems, placing the Postal Service's ability to fulfill its universal service obligation at risk.

The Commission also identified ten market-dominant products and services for which revenue did not cover attributable costs. In the case of the Standard Mail Flats product, the Commission concluded that the Postal Service had repeatedly failed to use existing pricing options to address the growing cross-subsidy from other products within the Standard Mail class. The Commission found the rates for Standard Mail Flats not in compliance with the PAEA, and directed the Postal Service to take appropriate action to end this cross-subsidy. This was the first time the Commission found the Postal Service not in compliance. The Postal Service subsequently petitioned for review in the United States Court of Appeals for the District of Columbia Circuit and the matter is pending.

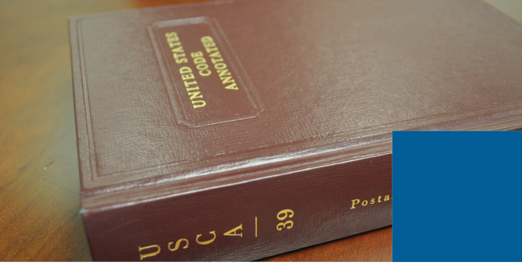
Objective 8: Effectiveness of Rules in Maintaining Just and Reasonable Rate Schedule

The Commission rules related to providing predictability and stability in rates, enhancing transparency and allowing pricing flexibility help maintain just and reasonable rates. In addition, the Commission rules for complaints are designed, in part, to facilitate maintenance of a just and reasonable rate schedule and adequate service by enabling the Commission to hear and resolve complaints in a streamlined and efficient manner while providing appropriate due process for all participants. There were no new rate related complaints filed in FY 2011. However, the Commission rendered its decision in the GameFly Complaint on April 20, 2011.

Docket No. C2009-1: Complaint of GameFly

The Complainant in this proceeding was a mailer of DVDs who alleged that the Postal Service was discriminating in favor of certain other DVD mailers by providing the other mailers with preferential service.

DVDs sent through the mail are vulnerable to breakage when processed by automated letter



processing equipment. The Complainant alleged that the Postal Service unlawfully implemented a national policy that affords select DVD mailers preferential processing, such as hand culling and sorting that prevents damage to DVDs, at no additional charge. Complainant claimed that it and other DVD mailers have been unlawfully denied such preferential service with the result that they must pay significantly higher mailing costs in order to achieve comparable reductions in DVD breakage rates. The Postal Service argued that there are valid operational and other reasons for limiting the availability of the allegedly preferential services to certain specific mailers.

Upon consideration of the evidentiary record and the arguments made in the initial and reply briefs of the parties, the Commission concluded that the Postal Service has unduly discriminated against GameFly in violation of 39 U.S.C. 403(c). The Commission found that GameFly is similarly situated to Netflix and Blockbuster; concludes that Netflix and Blockbuster have been given a number of preferences, including various forms of manual processing coupled with the avoidance of the non-machinable surcharge; and determined that the Postal Service failed to present adequate and legitimate justifications for these preferences.

To remedy this unreasonable preference, the Commission ordered the Postal Service to establish two parallel rate categories within First-Class Mail for round-trip DVD mail. One category establishes that DVDs sent as presorted First-Class Mail letters to subscribers will not be subject to the non-machinable surcharge when returned. The other rate category provides that DVDs mailed as First-Class Mail flats to and from subscribers will not be subject to an additional ounce charge. The Commission allowed the Postal Service 60 days to implement this remedy.

GameFly appealed the decision in May 2011 to the United States Court of Appeals for the District of Columbia Circuit and the matter is pending.

SECTION 2: EFFECTIVENESS OF RULES IN MAXIMIZING INCENTIVES TO REDUCE COSTS AND INCREASE EFFICIENCY

The CPI Cap provides incentive for the Postal Service to increase efficiency and reduce costs.

In FY 2011, the Postal Service was able to reduce compensation and benefits expenses primarily through reductions in workhour usage. Total workhour usage declined over 34 million workhours, saving the Postal Service approximately $1.4 billion in compensation costs. However, increases in FERS retirement costs, health benefits, and unit compensation rates offset over half of these savings. Additionally, higher fuel prices pushed transportation and vehicle maintenance costs up by $511 million and $154 million, respectively. Total operating costs increased almost $1 billion in FY 2011, a one percent increase.

Role of Commission Advisory Opinions

In addition to the workhour reductions, the Postal Service has pursued initiatives intended to reduce costs or increase efficiency. In FY 2011, the Commission reviewed two of these initiatives proposed by the Postal Service in requests for Advisory Opinions under 39 U.S.C. 3661 which states:

(a) The Postal Service shall develop and promote adequate and efficient postal services.

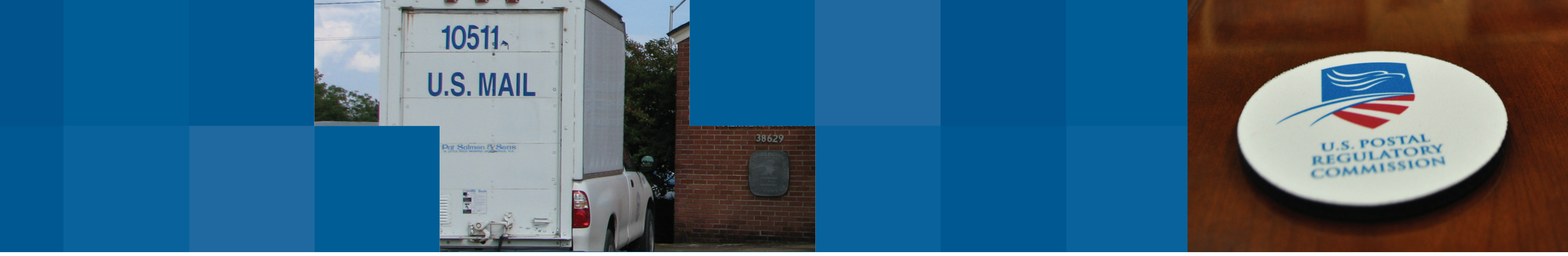
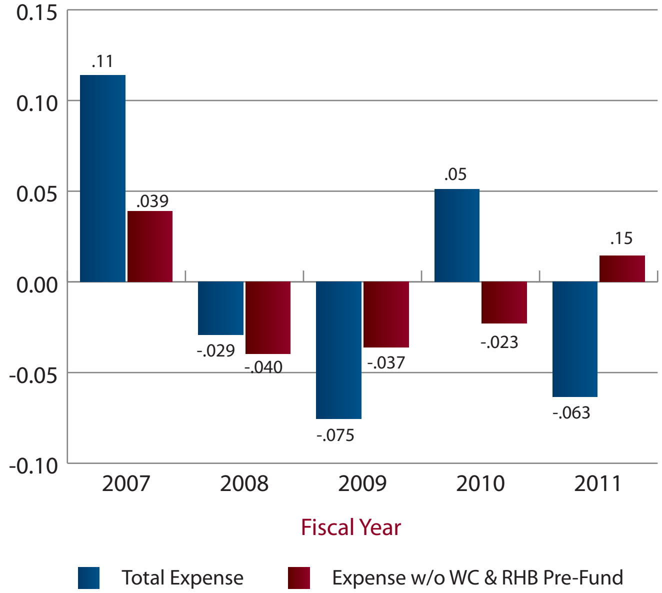


Figure 3—Expense Growth Rates
FY 2007 – 2011



(b) When the Postal Service determines that there should be a change in the nature of postal services which will generally affect service on a nationwide or substantially nationwide basis, it shall submit a proposal, within a reasonable time prior to the effective date of such proposal, to the Postal Regulatory Commission requesting an advisory opinion on the change.

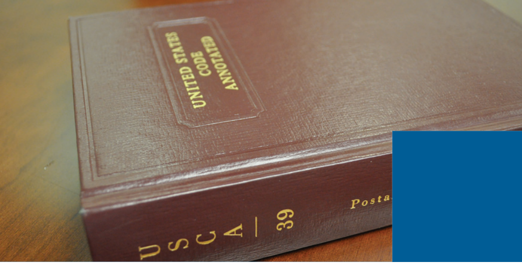
(c) The Commission shall not issue its opinion on any proposal until an opportunity for hearing on the record under sections 556 and 557 of title 5 has been accorded to the Postal service, users of the mail, and an Officer of the Commission who shall be required to represent the interests of the general public. The opinion shall be in writing and shall include a certification by each Commissioner agreeing with the opinion that in his judgment the opinion conforms to the policies established under this title.

Docket No. N2010-1: Six-Day to Five-day Street Delivery and Related Service Changes

The Postal Service, on March 30, 2010, filed a request with the Commission for an Advisory Opinion for the elimination of Saturday delivery. The Postal Service proposed to eliminate Saturday delivery nationally, except for delivery of Express Mail and delivery to those Post Office Boxes currently receiving Saturday delivery. The Postal Service also proposed to eliminate Saturday outgoing mail processing, except for Express Mail and qualifying destination entry bulk mail. The collection of mail from street collection boxes would also be eliminated on Saturday, except to collect overflow on an as-needed basis.

A reduction in delivery frequency would impact city carrier, rural carrier, mail processing, transportation, and post office operations. The Commission also considered how a reduction in service quality due to reduced delivery frequency would impact the public. Commission Docket No. N2010-1 involved 34 witnesses, 59 technical analyses, and over 10,000 pages of information.

The Postal Service estimated the annualized cost savings expressed in 2009 dollars at $3.1 billion. The Postal Service noted that the estimate could be affected by future increases in hourly labor costs, input unit costs, number of delivery points, and reduced mail volumes. The Postal Service stated that extensive market research has revealed that the elimination of Saturday delivery would have little impact on its consumer and commercial customers. It estimated the potential volume loss at 0.7 percent, which results in an annual revenue loss of $201 million.



In its Advisory Opinion, issued March 24, 2011, the Commission did not recommend for or against elimination of Saturday delivery. Rather, in keeping with 39 U.S.C. 3661(a) which calls for promotion of adequate and efficient postal services, the Commission focused on the balance between the cost savings achievable and the impact on service from eliminating a day of delivery. The Commission found that the Postal Service's estimated net savings were overstated by $1,410 million, and full savings may not be achieved until year three after implementation. The Postal Service's estimate of net revenue reduction likely understated the net revenue reduction by $386 million. The Advisory Opinion also found that the Postal Service did not evaluate the impact of the proposal on customers who conduct business in rural, remote, or non-contiguous areas. Table 4 shows the differences in the Commission and Postal Service estimates of cost savings.

The Commission estimated that the Postal Service could reduce its expenditure on city carriers by $1,503 million, $750 million less than the savings estimated by the Postal Service. The Commission found that the Postal Service's approach—using the Tuesday after a Monday holiday to determine workhour absorption—was a new and important area of research, but an oversimplification that leads to a substantial over-estimation of potential savings. The estimate provided to the Commission was developed using 11 data points and did not consider: the productivity changes previous to 2008; how the cost of different Postal Service products impacts productivity; how weekly productivity is impacted by reducing a day of delivery; or if the Postal Service has been able to achieve the projected productivity. The Postal Service implementation plan and associated cost savings did not account for ongoing operational changes in the number of routes and overtime costs needed to adjust to additional volume spread across fewer days of delivery. The Commission's estimate for delivery savings was based on established methodology from the Commission's Report on Universal Postal Service and the Postal Monopoly, issued December 19, 2008.

Regarding the net revenue loss, the Commission found that the Postal Service's estimate of $201 million in

Table 4—Comparison of Cost Savings Estimates from Elimination of Saturday Delivery ($ in Millions)

	Postal Service Estimate	Commission Estimate	Difference
Delivery	$2,747	$1,987	$760
Transportation	$377	$169	$208
Mail Processing	$123	$67	$56
Post Office Operations	$53	$53	—
Total Savings	$3,300	$2,276	$1,024
Lost Revenue	$(201)	$(587)	$386
Net Savings	$3,099	$1,689	$1,410

forgone contribution was underestimated primarily due to flaws in the market research conducted by the Postal Service. This research relied upon a "likelihood factor" that adjusted the estimated impact, as measured by the Postal Service survey, downward. The Commission heard testimony that this "likelihood factor" was not appropriate for measuring response to the elimination of a service, and the Postal Service witnesses were unable to provide an example of such use previous to this case.

The Advisory Opinion identified improvements the Postal Service could make to its proposal to eliminate Saturday delivery that would ameliorate some of the disparate impact on the following constituencies: rural, remote and non-contiguous areas, vote by mail programs, mail order pharmacies, and general customer access. The Advisory Opinion also contained the separate views of four Commissioners that highlight areas where the Postal Service can improve its proposal and implementation plans. The Opinion can be viewed at www.prc.gov. On June 14, 2011, the Postal Service provided Congress with a Report regarding the Commission's Advisory Opinion. That report is discussed in detail in Appendix B.

Docket No. N2011-1: Retail Access Optimization and Consolidation Initiative

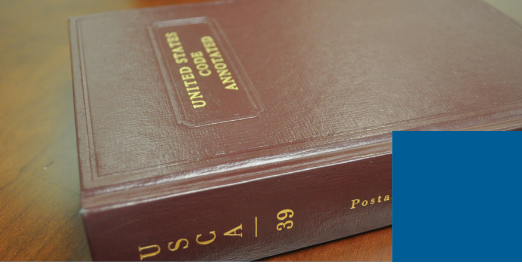
On July 27, 2011, the Postal Service filed a request for an advisory opinion from the Postal Regulatory Commission on its Retail Access Optimization Initiative (RAO Initiative). This Initiative examines whether to continue providing retail and other services and products at approximately 3,650 of the more than 32,000 Post Offices, stations and branches in the Postal Service's retail network.

Courtesy of Evan Kalish.

Postal store in Fort Lauderdale, Florida.

The Postal Service noted that at the time of this request, the specific facilities to be discontinued, and thus the actual scope of the potential service changes, could not be estimated. No facility closure or service change resulting from the Initiative would be implemented before December 2011. However, until definitive information to the contrary were to emerge, the Postal Service conceded the possibility that the scope of the changes in service resulting from the Initiative could be at least "substantially nationwide," within the meaning of 39 U.S.C. Section 3661(b). As such, the Postal Service has requested that the Commission consider whether it has jurisdiction to review the matter under Section 3661(c).

In its Notice and Order, the Commission noted that the RAO Initiative applied to postal retail facilities across the country, without limit to geography or population, and is driven by Postal Headquarters. It issued a finding that because the Postal Service's RAO Initiative appears to encompass a Headquarters-mandated system-wide review of postal retail facilities, similar to the review of station and branch discontinuation in Docket No. N2009-1, a



Commission Advisory Opinion pursuant to 39 U.S.C. Section 3661 would be appropriate.

The following categories of Postal retail facilities were identified for discontinuance review pursuant to the RAO Initiative:

- 2,825 Post Offices with low earned workload and no greater than $27,500 in total annual revenue ($10,000 in Alaska).
- 384 stations and branches that earned fiscal year 2010 revenue of less than $600,000, that had FY 2010 revenue less than the average for FY 2008 and 2009, and that are located within two miles of at least five postal retail and and/or alternative access sites.
- 178 retail annexes that had FY 2010 revenue of less than $1 million and are located within a half-mile of at least five postal retail and/or alternate access sites.
- 265 Post Offices, stations and branches that were already undergoing locally initiated discontinuance reviews independent of the RAOI at the time of the Postal Service's amendment to its retail facility closing regulations, but had not advanced to the community meeting stage of the review process. The Postal Service planned to apply its recently revised public notice and comment procedures in its internal handbook USPS Handbook PO-101 (effective July 14, 2011) to these locally-initiated non-RAOI discontinuance proposals as if they had been identified as candidates for review as part of the RAO Initiative.

Given the Postal Service's precarious financial position, the Commission found it appropriate to expedite the proceeding. Although expedited, the procedural schedule adopted in the case allowed for hearings on the Postal Service's direct case and rebuttal testimony of interveners, as well as the filing of briefs by each party.

At the time of this printing, the docket was still pending.

Other Commission Activity Related to Maximizing Incentives to Reduce Costs and Increase Efficiency – Periodicals Study

On October 13, 2011, after a review extending over three years, the Commission and Postal Service released the Joint Study on Periodicals Costs. This report responds to Section 708 of the PAEA, which directs the U.S. Postal Service and Postal Regulatory Commission to jointly address matters of special importance to periodicals. The study found that after review of Postal Service responses to data quality recommendations from prior reviews, the Postal Service and the Commission agree that the cost data are reasonably accurate for ratemaking purposes.

The study also found that a reduction in manual processing of Periodicals mail where feasible would reduce costs. Both the Postal Service and the Commission agreed on the goal of increasing automation to achieve cost savings. However, the two agencies disagreed on the level of achievable savings. The Commission found that absent operational data on manual handling of Periodicals, Standard Mail flats processing costs provide a useful comparison for potential savings opportunities. This comparison shows that if mail processing costs were the same for Periodicals flats as they are for Standard Mail flats, the Postal Service would save $349 million. The Postal Service believes this amount of savings is unrealistic and unattainable, as substantial differences exist between the characteristics of

Periodicals and Standard Mail flats. According to the Postal Service, these differences reflect mailer and reader preferences that need to be respected.

The Postal Service estimated cost savings for major operational efficiency improvement opportunities with an upper bound of $146 million. While the Commission's approach results in a conclusion that most, but not all, of the Periodicals deficit may be resolved through operational efficiencies, the Postal Service's method leads to the conclusion that cost reduction initiatives alone will not be sufficient to resolve the Periodicals deficit. Furthermore, the Postal Service believes that, while additional data could help illuminate problems and their potential solutions, benefits that may be derived from costly new data collection efforts are limited. The Commission believes that the Postal Service may be able to better utilize data already available to it to further this analysis.

The report can be viewed in its entirety at the following link: http://www.prc.gov/prc-docs/home/whatsnew/PMS_final_2131.pdf.

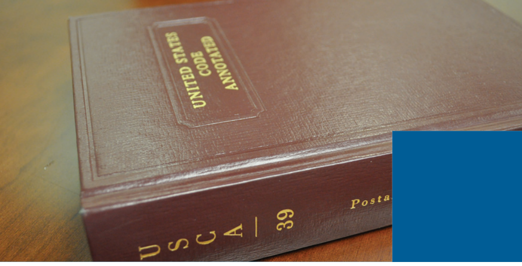
SECTION 3: EFFECTIVENESS OF RULES IN MAINTAINING HIGH QUALITY SERVICE STANDARDS

The Commission's service performance reporting rules employ a two-tiered approach. The first requirement focuses on whether service standards are met over the course of a year. Annual reporting of service performance enables the Commission to make these determinations. The second requirement is broader, focusing on such standards as the obligation to provide services to bind the nation together and to provide prompt and reliable service to all areas. To evaluate these standards, the Commission requires more detailed, quarterly information. The reporting rules are applied at the product level.

In its FY 2010 Annual Compliance Determination, the Commission concluded that reported service measurement results for bulk First-Class Mail and Standard Mail, as well as Package Services and Periodicals, remain deficient. Only the Postal Service's external measurement system for the Single-Piece First-Class Mail product was sufficient to meet the service performance measurement objectives of the PAEA.

For bulk First-Class Mail and Standard Mail, the Commission agreed in 2007 to a Postal Service request to mitigate the costs of service performance measurement by permitting use of an internal measurement system based upon the Intelligent Mail barcode (IMb) in lieu of an external measurement system. However, persistent data errors, insufficient IMb usage by customers, and a lack of product specific documentation have impeded Postal Service efforts to meet the service performance measurement objectives of the PAEA. Accordingly, the Commission stressed that the Postal Service must vigorously address these problems to achieve full compliance with all service performance measurement objectives.

Recognizing the challenges the Postal Service was facing in measurement of its service performance, the Commission allowed the Postal Service to request short-term waivers from reporting in areas where measurement and reporting systems require additional time for development or, in limited instances,



request semi-permanent exceptions from reporting altogether. Commission rules permit the Postal Service to request a semi-permanent exception provided it can demonstrate that the cost of implementing the measurement system would be prohibitive relative to product revenue, the product defies meaningful measurement, or the product is a negotiated service agreement.[14] As described below, the Postal Service requested both short-term and semi-permanent waivers in FY 2011.

Summary of Order No. 745

The Commission addressed three separately docketed Postal Service requests for temporary waivers, semi-permanent exceptions, and/or other alternative forms of relief from the periodic reporting of service performance measurements.[15] On June 16, 2011, the Commission issued Order No. 745 ruling on all three requests.

Docket No. RM2011-1: On October 1, 2010, the Postal Service filed a request for temporary waivers from several service performance reporting requirements.[16] This request sought temporary waivers for First-Class Mail Flats at the District level; non-retail First-Class Mail Parcels; all categories of Standard Mail; Outside County Periodicals; non-retail Media Mail, Library Mail, and Bound Printed Matter Parcels; and Stamp Fulfillment Services.

Docket No. RM2011-4: On November 23, 2010, the Postal Service filed a request for a semi-permanent exception, or alternative relief, for quarterly reporting of First-Class Mail Flats at the District level.[17] On November 24, 2010, the Postal Service filed a conditional notice of withdrawal concerning the temporary waiver request for District level reporting of First-Class Mail Flats previously filed in Docket No. RM2011-1.[18]

Docket No. RM2011-7: On February 3, 2011, the Postal Service filed an additional request for temporary waivers from several quarterly service performance reporting requirements.[19] This request seeks temporary waivers for Standard Mail, Bound Printed Matter Flats, and certain Area and District level data for presort First-Class Mail and End-to-End Periodicals.

The Commission denied the Postal Service's requests for a waiver, semi-permanent exception, or alternative forms of relief concerning First-Class Mail Flats. The Commission directed the Postal Service to begin quarterly reporting including District level service performance based upon available data from the existing External First-Class (EXFC) system with the next

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[14] § 3055.3 Reporting exceptions.
(a) The Postal Service may petition the Commission to request that a product, or component of a product, be excluded from reporting, provided the Postal Service demonstrates that:
(1) The cost of implementing a measurement system would be prohibitive in relation to the revenue generated by the product, or component of a product;
(2) The product, or component of a product, defies meaningful measurement; or
(3) The product, or component of a product, is in the form of a negotiated service agreement with substantially all components of the agreement included in the measurement of other products.
(b) The Postal Service shall identify each product or component of a product granted an exception in each report required under subparts A or B of this part, and certify that the rationale for originally granting the exception remains valid.

[15] *See* Docket Nos. RM2011-1, -4 and -7.

[16] Docket No. RM2011-1, United States Postal Service Request for Temporary Waivers from Periodic Reporting of Service Performance Measurement, October 1, 2010 (RM2011-1, Request).

[17] Docket No. RM2011-4, United States Postal Service Request for Semi-Permanent Exception from Periodic Reporting of Service Performance Measurement or, in the Alternative, Petition for Rulemaking Concerning 39 CFR 3055.45(a), November 23, 2010 (RM2011-4, Request).

[18] Docket No. RM2011-1, United States Postal Service Notice of Provisional Partial Withdrawal of Request for Temporary Waiver, November 24, 2010.

[19] Docket No. RM2011-7, United States Postal Service Request for Temporary Waivers from Periodic Reporting of Service Performance Measurement, February 3, 2011 (RM2011-7, Request).

due quarterly report. Standard statistical calculations describing the validity of data are to be included where appropriate.

The Postal Service's request for a temporary waiver for presorted First-Class Mail Parcels appeared moot because this component of First-Class Mail Parcels has been reclassified within competitive products. *See* Docket No. MC2011-22.

The Commission granted the Postal Service's request for a temporary waiver concerning presorted First-Class Mail. Beginning with the FY 2011 Quarter 4 report, the Postal Service was directed to report all data regardless of whether the data met the Postal Service's self-imposed data sufficiency thresholds, and where appropriate, include standard statistical calculations describing the validity of the data.

The Commission denied the Postal Service's request for a waiver concerning Standard Mail. The Commission then directed the Postal Service to inform the Commission of its plan concerning the implementation of a measurement system capable of reporting service performance for individual Standard Mail products by August 1, 2011. While this issue is being resolved, the Postal Service was directed to report Standard Mail service performance as outlined in its waiver requests.

The Commission denied the Postal Service's request for a waiver concerning Periodicals. Beginning with the FY 2011 Quarter 4 report, the Postal Service was directed to report all Periodicals data regardless of whether the data met the Postal Service's self-imposed data sufficiency thresholds, and where appropriate, include standard statistical calculations describing the validity of the data. The Commission accepted the use of proxy measurements and the use of Red Tag and Del-Trak data while a transition is being made to an Intelligent Mail Barcode (IMb)-based system in the near term.

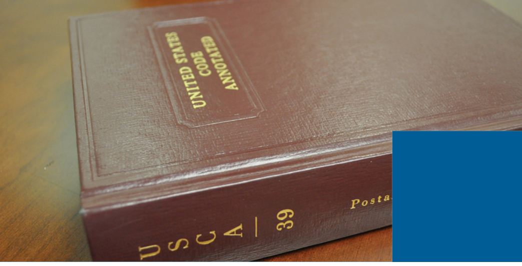
Concerning the commercial Package Services start-the-clock issue, the Commission did not find acceptable the Postal Service's proposal to move start-the-clock downstream to the first en route scan without a further accounting for the period beginning when the Postal Service receives the mail up until the first en route scan. The Postal Service was directed to present a plan to the Commission detailing how it intends to account for the period prior to the first en route scan by August 1, 2011. Furthermore, beginning with the FY 2011 Quarter 4 report, the Postal Service is directed to report all Package Services data regardless of whether the data met the Postal Service's self-imposed data sufficiency thresholds, and where appropriate, include standard statistical calculations describing the validity of the data.

The Commission granted the Postal Service's request for a temporary waiver from reporting service performance for Stamp Fulfillment Services until the filing date for the 2011 Annual Compliance Report (ACR).

Docket No. RM2010-14: Semi-Permanent Exception from Periodic Reporting of Service Performance Measurement for Applications and Mailing Permits

On September 30, 2010, the Postal Service requested Commission approval of a semi-permanent exception from the periodic reporting of service performance measurements for Applications and Mailing Permits pursuant to 39 CFR 3055.3.

The Postal Service explained that establishing or renewing Applications and Mailing Permits, which grant mailers permission to enter bulk mailings that



meet applicable requirements, are nothing more than a transaction. Furthermore, the Postal Service stated that such transactions were not susceptible to meaningful service performance measurement.

The Commission granted the request for a semi-permanent exception, agreeing with the Postal Service that the transactions for Applications and Mailing Permits defy meaningful measurement.

Special Study on Non-Contiguous Delivery Performance

39 CFR 3055.7 requires the Postal Service to submit as part of the Annual Compliance Report a special study on delivery performance, by class of mail, to non-contiguous areas of the United States. The first such report is due as part of the FY 2011 ACR.

Access to Postal Services

The Commission requires, under 39 CFR 3055.91, annual submission of data on access to postal services, including numbers of retail postal facilities, emergency suspensions, business and residential delivery points, collection boxes, and average wait time in line. The Postal Service provided this data in FY 2011.

Customer Satisfaction

The Commission requires, under 39 CFR 3055.92, annual reporting of customer satisfaction as measured by Customer Experience Measurement survey data. The Postal Service provided this data in FY 2011.

Reporting of Retail Service Performance and Nonpostal Products

The Commission has not yet established rules for the annual and periodic reporting of either retail service performance, or the service performance for nonpostal products.

The Commission may issue draft rules on retail service performance reporting in FY 2012.

Congress is currently examining potential changes to the level of nonpostal services that may be offered by the United States Postal Service.

SECTION 4 - EFFECTIVENESS OF RULES IN ACHIEVING THE OBJECTIVES OF SECTION 3633 OF THE PAEA

The Commission's review of rate adjustments and mail classifications for competitive products is governed by 39 U.S.C. 3633(a), which establishes three statutory standards, incorporated into the Commission's rules, applicable to competitive products. First, competitive products may not be cross subsidized by market-dominant products. The Commission uses an incremental cost test to validate compliance with the cross-subsidy requirement that revenue generated from competitive products equals or exceeds the incremental costs of such products

Second, each competitive product must cover its attributable cost. The Commission reviews each product in the Annual Compliance Determination and when notices of competitive price changes are filed to ensure this requirement is being met.

Third, competitive products must collectively cover their appropriate share of the Postal Service's institutional costs. The Commission has determined the minimum contribution must be 5.5 percent of the Postal Service's total institutional costs. As seen in Figure 4, since the first Annual Compliance

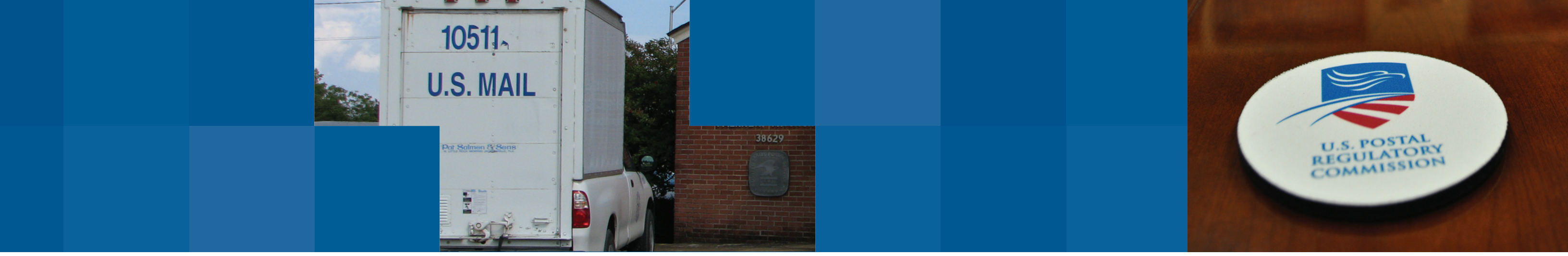
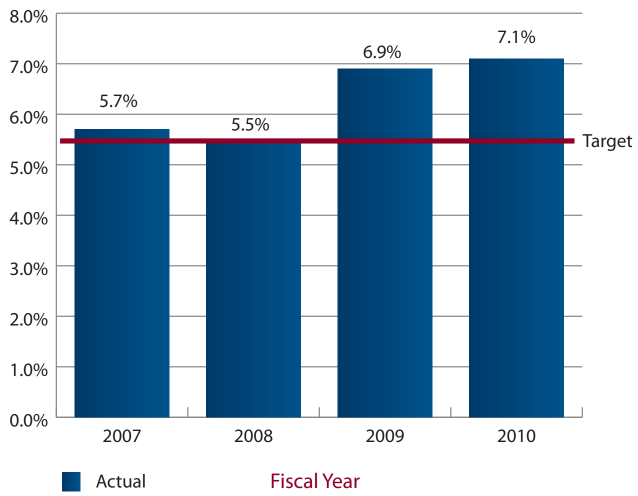


Figure 4—Competitive Products Share of Institutional Costs FY 2007 – FY 2010



Determination in FY 2007 the Postal Service has met or exceeded the contribution minimum.

Objective 9, allocating the total institutional costs of the Postal Service appropriately between market-dominant and competitive products is closely related to these three objectives.

Within the constraints of these objectives, the Commission's rules provide flexibility to price competitive products. The rules allow the Commission 30 days to determine whether the Postal Service's proposed rates for competitive products are meeting the objectives of section 3633.

Docket No. CP2011-26: Changes in Rates of General Applicability for Competitive Products

On November 2, 2010, the Postal Service filed notice with the Commission concerning changes in rates of general applicability for competitive products. In Order No. 603, the Commission determined the rate adjustments met the requirements of 39 U.S.C. 3633(a) and approved the rates proposed to go into effect on January 2, 2011.

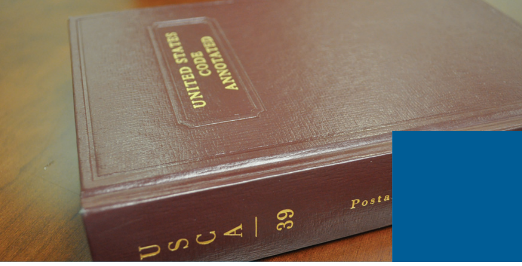
The Commission also approved the addition of Priority Mail Regional Rate Boxes and Critical Mail within the Priority Mail product. Regional Rate Boxes allow Commercial Base and Commercial Plus Priority Mail customers to use specific boxes within Zones 1 through 5 to receive discounted rates. Critical Mail allows Priority Mail Commercial Plus customers to send automation compatible letters and flats at a discounted rate.

The prices for competitive products increased, on average, as follows: Express Mail, 4.6 percent; Priority Mail, 3.5 percent; Parcel Select, 4.4 percent; Parcel Return Service, 3.1 percent; Competitive Post Office Boxes, 21 percent to 291 percent; and Premium Forwarding Service, 5.0 percent.

The prices for International Competitive Products increased, on average, as follows: Express Mail International, 3.1 percent; Global Express Mail Guaranteed, 3.7 percent; Priority Mail International, 3.8 percent; International Priority Airmail, 3.3 percent; International Surface Air Lift, 6.4 percent; Airmail M-Bags, 5.8 percent; International Ancillary Services, 3.7 percent to 10 percent; International Money Transfer Service, 10.4 percent.

Docket No. CP2011-45: Global Expedited Package Services—Non-published Rates

In Docket Nos. MC2010-29 and CP2010-72, the Commission approved the Postal Service's request to add Global Expedited Package Services—Non-published Rates 1 (GEPS—NPR 1) to the competitive product list within the Mail Classification Schedule (MCS). The Commission also approved a schedule of discounted rates for the GEPS—NPR 1 product.



The GEPS—NPR 1 product offers discounted rates to small and medium-size business mailers that use Express Mail International (EMI) and Priority Mail International (PMI) and are capable of paying at least $50,000 per year in international postage. These features make it similar to the preexisting GEPS products, nearly all of which would fit within the GEPS—NPR 1 product classification.

The Postal Service subsequently filed a notice of a change in rates for the GEPS—NPR 1 product in Docket No. CP2011-45. This rate change was implemented by Commission approval of new rates for EMI and PMI, which are used to develop discounted rates for the GEPS—NPR 1 product. The Postal Service's notice also identified four changes to the GEPS—NPR 1 product related to expanding the definition of "qualifying" mail, requiring use of approved forms, expanding the number of EMI and PMI country groups, and the schedule of new discounted rates. As a result of these changes, the Postal Service requested that a new product, GEPS—NPR 2, be added to the competitive product list.

Based upon its review of materials filed in Docket No. CP2011-45, and the supporting justification filed in Docket Nos. MC2010-29 and CP2010-72, the Commission approved the addition of GEPS—NPR 2 to the competitive product list. The Commission also concluded that the rates for the GEPS—NPR 2 product should cover their attributable costs, should not lead to the subsidization of competitive products by market-dominant products, and should have a positive effect on competitive products' contribution to institutional costs.

Docket No. CP2011-51: Priority Mail Non-Published Rates

On December 17, 2010, the Postal Service requested the addition of Priority Mail - Non-Published Rates (Priority Mail—NPR) to the competitive product list as a competitive product not of general applicability. The Commission approved the Postal Service's request in Order No. 661 issued on February 3, 2011. Priority Mail—NPR is intended to reduce the time associated with implementing customized Priority Mail contracts, while still meeting the requirements of 39 U.S.C. 3633(a). The Priority Mail—NPR product allows the Postal Service to enter into contracts with customers as long as the prices fall within a pre-approved range. The minimum prices of the range are expected to meet the requirements of Section 3633(a)(2). Since the approval of Priority Mail—NPR, the Postal Service has entered into three such agreements.

Mail Classification Changes

To increase pricing flexibility for products that are of a competitive nature but were determined to be market-dominant at the time of passage of the PAEA, the Postal Service is also allowed to transfer products between market-dominant and competitive. However, when a product is transferred to the competitive product list it must meet the objective of covering its attributable costs.

Docket No. MC2010-36: Transferring Commercial Standard Mail Parcels to the Competitive Product List

On August 16, 2010, the Postal Service filed a request to transfer commercial Standard Mail Fulfillment Parcels from the market-dominant product list to the competitive product list. At that time, Standard Mail Fulfillment Parcels were part of the

Standard Mail NFMs/Parcel product. The Postal Service filed this request assuming the Commission would approve the Postal Service's proposal in its previously filed exigent rate proceeding. In that filing, the Postal Service proposed to change the name of the Standard Mail Not Flat-Machinable/Parcels product to Standard Parcels, and to divide it into two categories: Marketing parcels and Fulfillment parcels. On September 30, 2010, the Commission denied the exigent rate request. The predicate approval of the Standard Mail Fulfillment Parcels product underlying the Request was not authorized. The Commission advised the Postal Service that if it wanted to pursue its request, it could refile its Docket No. MC2010-36 proposal and identify the applicable testimony and designate documents from the exigent case to support the Request.

On November 1, 2010, the Postal Service filed a Supplement that revised its original Request. As modified by the Supplement, the Postal Service requested to transfer its market-dominant commercial Standard Mail Parcels to the competitive product list in the Mail Classification Schedule (MCS). Upon the transfer, commercial Standard Mail Fulfillment Parcels would become a "Lightweight" subcategory of Parcel Select.

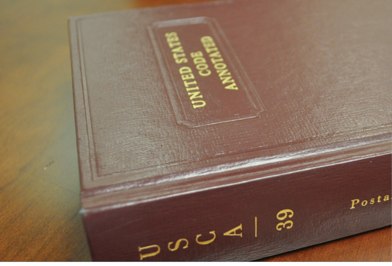
An important issue arose during the proceeding. Rates for the Standard Mail Parcels being transferred did not cover their attributable costs. Section 3633(a)(2) of Title 39 of the United States Code requires each competitive product to cover its attributable costs. In consideration of this, the Commission authorized the transfer subject to the following conditions: (1) the Postal Service files a notice of competitive price adjustment for Parcel Select rates, including Lightweight Parcel Select parcels, that demonstrates such rates satisfy 39 U.S.C. 3633(a) and 39 CFR part 3015; (2) the Commission issues an Order finding that the Parcel Select rates in (1) above satisfy 39 U.S.C. 3633(a) and 39 CFR part 3015; and (3) the Standard Mail Parcels transfer authorized by this Order is not effective until the effective date of prices authorized in (b) above. The Postal Service has not yet met the conditions necessary for the transfer to occur.

Docket No. MC2011-22: Restructuring First-Class Mail Parcel Product Offerings

In Docket No. MC2011-22, the Postal Service proposed to transfer two price categories within the First-Class Parcels product to the competitive products list. At the time of the filing, the First-Class Parcels product included price categories for single-piece parcels, commercial parcels, commercial plus parcels, and keys and devices. The Postal Service sought to transfer the commercial and commercial plus categories to the competitive product list. It also proposed to create a new competitive product named Lightweight Commercial Parcels which would contain the newly transferred price categories.

In Order No. 710, the Commission granted the Postal Service's proposal. The Commission found that Lightweight Commercial Parcels would cover attributable costs, would not be cross-subsidized by market-dominant products, and would assist competitive products as a whole in meeting the 5.5 percent contribution to institutional costs requirements. Additionally, the Commission found that Lightweight Commercial Parcels pass the market power tests for classifying products as competitive.

The Commission also noted that the redefined First-Class Mail Parcels product is estimated to have a



cost coverage below 100 percent. Section 3622(c)(2) of Title 39 provides, "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." While the cost coverage for First-Class Mail in total is sufficiently above 100 percent, each product within a class should cover its attributable costs to assure adequate revenues. The Commission recommended that the Postal Service bring the cost coverage above 100 percent during the next general price adjustment.

Docket No. MC2011-25: PO Box Transfer Case

In Docket No. MC2011-25, the Commission approved the Postal Service's request to transfer Post Office Box (P.O. Box) service at approximately 6,800 locations from the market-dominant product list to the competitive product list. The Commission previously approved the Postal Service's request to add P.O. Box service to the competitive product list in Docket No. MC2010-20 and the initial transfer of 49 locations from the market-dominant product list to the competitive product list. The additional 6,800 locations comprised approximately one-fifth of all market-dominant P.O. Box service locations and almost 44 percent of the market-dominant post office boxes used by customers.


Courtesy of Evan Kalish.

Post Office boxes at Grady Hospital in Atlanta, Georgia

Chapter III

Costs of the Universal Service Obligation and Value of Mail Monopoly

ESTIMATED COST OF THE UNIVERSAL SERVICE OBLIGATION

The PAEA requires the Commission to provide annual updates on the estimated cost to the Postal Service for providing universal service. The law requests three separate estimates: (1) the cost of providing service to areas of the Nation that would not receive service but for the universal service obligation; (2) the revenue foregone by providing free or reduced rates for postal services as required by 39 U.S.C. 2401(c); and (3) other public services or activities related to the universal service obligation. Table 5 provides the estimate for the first and third components. Table 6 provides the estimate for the second component.

The data necessary to compute the costs of the USO for a given year are not available until after the Commission's Annual Report for that year is published. Therefore, the cost estimates use data from the previous fiscal year. For fiscal years 2007-2009, the USO cost of six-day delivery is based on the George Mason University method used in previous annual reports. For fiscal year 2010, it has been updated to reflect the Commission's finding in N2010-1, Advisory Opinion on the Elimination of Saturday Delivery. These updates include additional components, such as mail processing and transportation related USO costs of six-day delivery and other refinements such as improvements in calculating average wage rates and overhead costs. The changes account for the majority of the increase over FY 2009. Without these refinements the FY 2010 cost of six-day delivery would have been $2.1 billion.

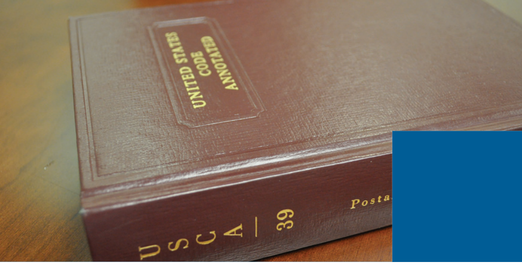


Table 5—Estimated Cost of Universal Service ($ in Billions)

Mandate	FY 2010	FY 2009	FY 2008	FY 2007
Six Day Delivery Instead of Five Day Delivery	2.427	2.080	2.160	1.930
Impact of Nonprofit Mail Discounts Net of Costs	1.284	1.322	1.223	1.150
Unzoned Media/Library Rates	0.098	0.096	0.094	0.063
Losses on Market Dominant Products	0.799	0.696	0.437	0.448
Maintaining Small Post Offices	0.566	0.536	0.549	0.586
Alaska Air Subsidy	0.118	0.121	0.124	0.107
Uniform Rates for First-Class Mail	0.078	0.081	0.212	0.130
Total Cost of Universal Service Obligation	**5.370**	**4.932**	**4.799**	**4.414**

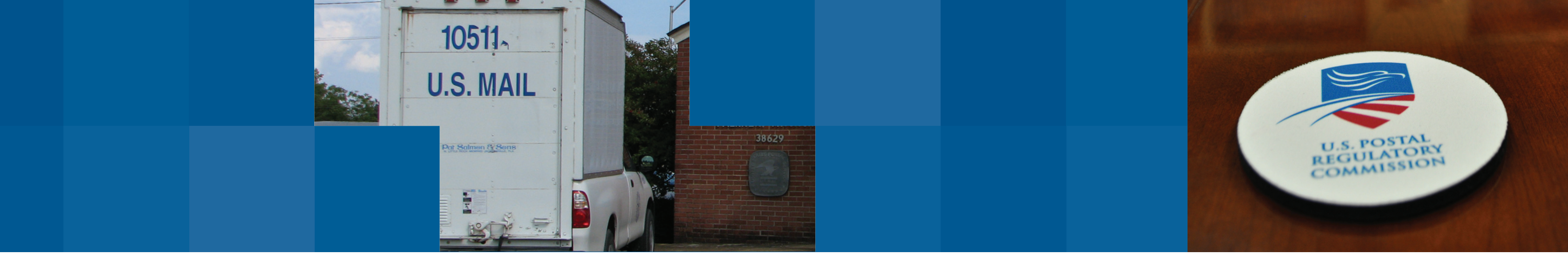
The Postal Service provides statutorily discounted rates for the nonprofit rate categories in Periodicals, Standard Regular, and Standard Enhanced Carrier Route. Additionally, statutory discounts are given to Periodicals, Classroom and Science of Agriculture and to Library Rate. The Postal Service also provides free postage for blind and disabled persons, and balloting materials under the Uniform and Overseas Citizens Absentee Voting Act. Table 6 presents the Commission's estimates of revenue not received by the Postal Service in providing discounted rates to preferred categories of mail in FY 2007, FY 2008, FY 2009, and FY 2010. As seen in Table 5, estimate for nonprofit Standard Mail decreased in FY 2010. This is due primarily to the decline in volume and the 23 month lag between rate increases.

Courtesy of Evan Kalish.

Post Office in Ninole, Hawaii

Table 6—Estimated Revenue Not Received ($ in Billions)

Mail Class	Estimated Revenue Not Received			
	FY 2010	FY 2009	FY 2008	FY 2007
Standard Mail				
Nonprofit	0.989	1.001	0.969	0.757
Nonprofit – ECR	0.085	0.097	0.072	0.150
Total Standard Mail	**1.074**	**1.098**	**1.041**	**0.908**
Periodicals				
Nonprofit	0.012	0.013	0.011	0.013
Classroom	0.001	0.001	0.001	0.001
Total Periodicals	**0.013**	**0.014**	**0.012**	**0.014**
Library Rate	0.001	0.001	-0.001	(0.000)
Free-for-the-Blind Mail	0.066	0.054	0.052	0.001
Total	**1.154**	**1.167**	**1.104**	**0.982**



Courtesy of USPS.

Sunderland Post Office in Sunderland, Maryland.

ESTIMATED VALUE OF THE MONOPOLY

The Commission updated its combined and mailbox monopoly values for the present year using the base assumptions and methodology outlined in its 2008 Report on Universal Postal Service and the Postal Monopoly. The value of the monopoly estimates the profit lost by the Postal Service if potential competitors were allowed to enter and compete in the Postal Service's letter monopoly (stemming from the Private Express Statutes) and the mailbox monopoly. In other words, if the Postal Service's combined monopolies (letter monopoly and mailbox monopoly) and, separately, the mailbox monopoly, were eliminated the value of the monopoly estimates the reduction in the Postal Service's profit. The updated "base case" monopoly values reported below are substantially lower than last year's values, partly due to the reduction in mail volume this year and increased delivery costs. These factors would make it less profitable and attractive for potential competitors to enter into previously monopolized areas. In addition, the increase in loss-making products that overlap with contestable products, such as Periodicals and Standard Flats, make entry less desirable and as entrants remove the Postal Service's burden of delivering these loss-making products.

The base case assumptions applying to competitors in the present analysis include: (1) full diversion of local contestable mail when discounting existing Postal Service rates by at least ten percent; (2) competitors incur only delivery costs, and deliver three times a week under the combined monopoly, and once a week under the mail box monopoly; and (3) competitors are ten percent more cost efficient than the Postal Service. Other than differences in delivery frequency, mail subject to diversion under the mail box monopoly is much more restricted in scope compared to the combined monopoly, as explained in the Commission's USO report.

The method employed to estimate each monopoly value is much the same as last year's approach. The Commission's model estimates competitor profits for all routes based on contestable volumes, discounted rates and adjusted delivery costs. Entry occurs only on routes with positive profits.[20] The monopoly value is estimated as the sum of the contribution lost to the Postal Service from routes where competitors capture volume. The updated and previous year values are shown in Table 7 below.

Table 7—Estimated Value of the Monopoly ($ in Billions)

Mandate	FY 2010	FY 2009	FY 2008	FY 2007
Mailbox Monopoly	0.69	0.79	1.07	1.33
Combined Monopolies	1.55	2.11	2.96	3.48

[20] This year the monopoly valuation model incorporates separate unit variable and non-delivery costs for city and rural routes.

The Commission's estimates are incomplete in several respects. As described in the 2008 USO report, it is possible that entry would only occur on profitable co-located routes that benefit from economies of density. The Commission's model evaluates entry for each route regardless of the extent of route clustering. The Commission's model also does not capture the cost of any carrier route sorting required by potential entrants for five-digit sorted letter mail entering the system at the plant or delivery unit level. Including these costs would lower the extent of entry. In addition, the model does not include switching costs or brand loyalty, both of which could also reduce the extent of entry.

Courtesy of USPS.

Postal carrier on her route.

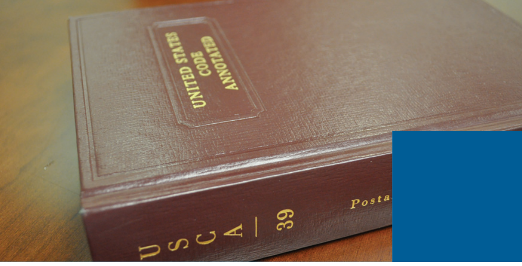
Chapter IV

Other Legal Proceedings

The Office of the General Counsel supports the Commission in the timely and efficient adjudication of matters filed under the provisions of the PAEA. In order to comply with PAEA requirements to increase the transparency of the Postal Service's pricing, classification and service policies, the Office of the General Counsel initiated rulemakings to support relevant statutory objectives. Additionally, its legal review of the Postal Service's products and services for compliance with statutory requirements in documents available for public review on the Commission's website enhances transparency in Postal Service pricing and classification policies. A significant development during FY 2011 has been the markedly increased activity in Post Office closing appeals filed before the Commission in accordance with 39 U.S.C. 404(d)(5).

DOCKET NO. RM 2011-8: RULEMAKING CONCERNING MAIL CLASSIFICATION SCHEDULE

On February 7, 2011, the Commission established a rulemaking to consider modifications to its rules governing the Mail Classification Schedule (MCS). Modifications are proposed to add material describing some Postal Service products and make conforming changes. The rulemaking does not add products to, remove products from, or transfer products between the existing market-dominant or competitive product lists for products currently being offered by the Postal Service. However, the rulemaking does reorganize how products appear within each individual list. This reorganization is most significant within the competitive product list where, at the suggestion of the Postal Service, the vestiges of "class" groupings have been replaced with functional product groupings.



On August 15, 2007, the Commission began the process of developing a MCS by requesting that the Postal Service develop language describing individual products. The Commission requested that the Postal Service draw from existing material provided in the Domestic Mail Classification Schedule (DMCS) and the International Mail Manual to develop a model MCS at a comparable level of detail as provided in the DMCS. The Postal Service complied with this request and provided a MCS proposal on September 24, 2007.

An initial MCS was published for public comment on October 29, 2007. Included for the first time were international products and a division of products into market-dominant and competitive categories. This publication met the requirements of publishing market-dominant and competitive product lists necessary for operation of the regulatory system. However, the initial MCS did not have individual product descriptions.

Subsequently, in order to address the need for more descriptive material to accurately describe current product lists the Commission again requested that the Postal Service provide additional proposals for MCS language. This time the additional material focused on treatment of negotiated service agreements, certain international products, and the final categorization of products as either market-dominant or competitive. The Postal Service complied with this request and provided additional proposals on November 20, 2007.

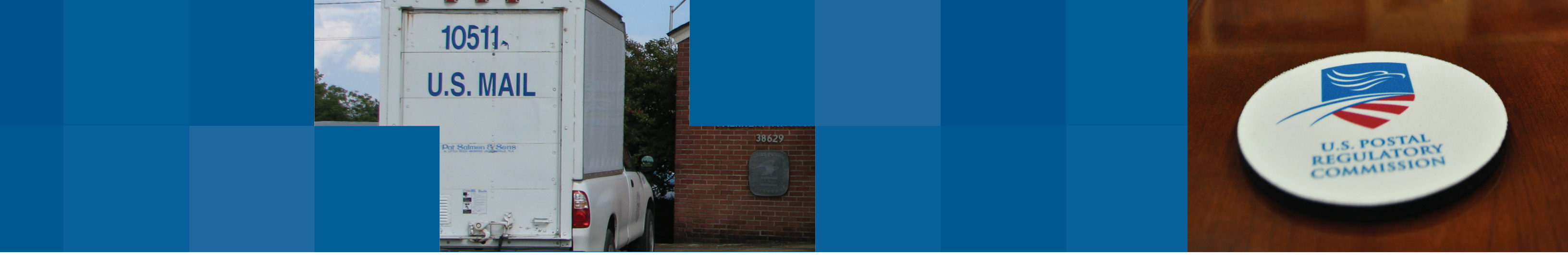
In the interim, the Commission developed a "draft" MCS, which included material describing each product. As the Commission has reviewed and approved various market-dominant price adjustments, competitive price adjustments and classification changes, the draft version of the MCS has been kept up to date. Price and classification changes have been incorporated into the proposed MCS as of December 31, 2010.

The currently published product lists require updating to remove products no longer offered (certain negotiated service agreements) and otherwise to correct for inaccuracies as a better understanding of the Postal Service's product structure has developed under the PAEA. This task is incorporated into the rulemaking.

The Commission has consulted with the Postal Service as the proposed MCS was developed and has found the Postal Service's input invaluable in concisely and accurately describing all product offerings.

The Commission intends to incorporate any subsequently approved rate or classification changes that occur prior to issuing the final rule in this docket. This rule will consider formal incorporation of all draft material describing each market-dominant and competitive product into the official MCS, and conforming language to the Commission's rules governing the MCS.

The intent of the rule changes is to incorporate the market-dominant product list and the competitive product list into the Commission's rules so that the lists are prominently available for examination, and to publish the material describing individual products into four appendices. This matter is still pending.



Commission Hearing.

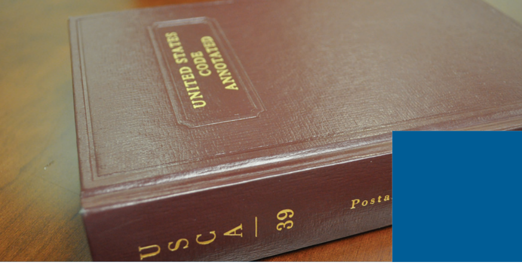
DOCKET NO. RM2011-13: RULEMAKING APPLICABLE TO APPEALS OF POST OFFICE CLOSINGS

The Commission has proposed revising its rules governing appeals of post office closings and consolidations in order to simplify them and better reflect current practices. The Commission proposed for comment the rulemaking on August 18, 2011. The Commission's current rules were adopted more than 30 years ago in 1977 and are complex. The Postal Service has recently revised its rules on procedures for the closing or consolidation of post offices. The new rules are intended to provide more streamlined procedures and simplify the appeals process particularly for the majority of petitioners who are not represented by legal counsel. The proposed rules address administrative requirements for options for filers without access to the Internet, elimination of delays in the filing of the administrative record, conformity with Postal Service rule changes and acceleration of the procedural schedule for these proceedings. These proposed rules are still pending.

The proposed rules also reference the Postal Service's new rules regarding post offices closings and consolidations. The Commission notes that many recommendations from its Advisory Opinion on the N2010-1 case, Concerning the Process for Evaluating Closing Stations and Branches, have been addressed by the Postal Service. These include applying the same rules for the closing of stations and branches as apply to the closing or consolidation of post offices and improvement and consistency in the notice provided to customers of post offices, stations, and branches even if a facility is suspended. This matter is still pending.

DOCKET NO. RM2011-14: STAMP FULFILLMENT SERVICES RULES

On September 21, 2011, the Commission initiated rules to establish reporting requirements for the measurement of level of service afforded by the Postal Service in connection with Stamp Fulfillment Services (SFS). SFS, a market-dominant product, provides the fulfillment of stamp and product orders received by mail, phone, fax, or Internet at the Postal Service's SFS center in Kansas City, Missouri. Orders can



include stamps, stamped cards, envelopes, stationery, and other philatelic items. A fee is charged for order processing and handling. The review of the level of service is part of the Commission's implementation of a modern system of rate regulation for market-dominant products that ensures service is not impaired as a result of the greater flexibility provided to the Postal Service under the PAEA in light of the price cap requirements. The Postal Service is required by 39 U.S.C. 3652(a)(2)(B)(i) to reporting level of service along with supporting documentation in its annual compliance report to the Commission. The Commission has received input and proposals from the Postal Service on SFS measurement systems for processing time and service standards including goals or targets for Internet, business level and philatelic custom orders. The Postal Service proposes to meet its target at least 90 percent of the time.

The Commission proposes that its rule requirements for periodic reporting (quarterly) will be consistent with the Postal Service's reporting proposals.

COMPLAINTS DURING FY 2011

There were five Complaints before the Commission during FY 2011.

Docket No. C2011-1: Complaint of William Smith

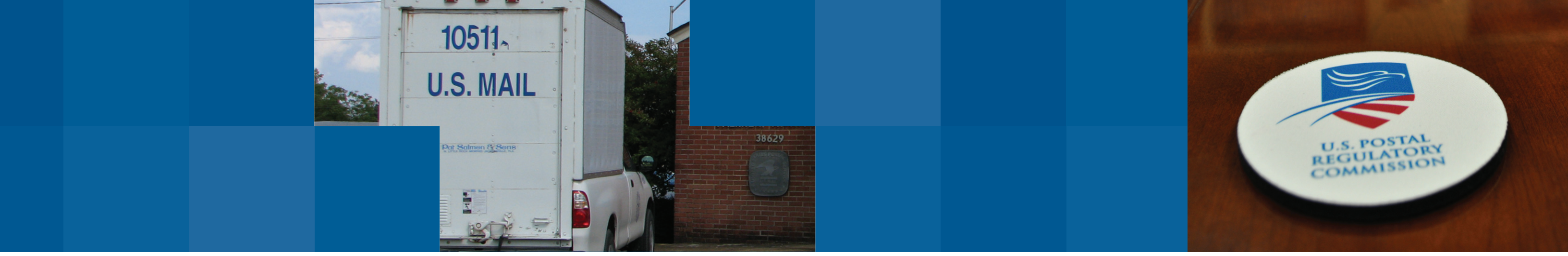
On January 11, 2011, William Smith filed a complaint alleging that the Postal Service discriminated against William Smith by refusing to exchange lawful postage and provide stamped paper in accordance with the Postal Service's Domestic Mail Manual Section 604.9.1.6. On February 1, 2011, the Commission granted Mr. Smith's Motion to withdraw his complaint, which was filed in an attempt to resolve this matter amicably.

Docket No. C2011-2: Complaint of the City and County of San Francisco

On May 18, 2011, the City and County of San Francisco filed a complaint that claimed that the Postal Service refused to deliver mail to individual locked mailboxes in most of San Francisco's Single Room Occupancy (SROs) buildings. Instead, the Postal Service's stated policy is to deliver mail only to a single-point at SROs in San Francisco.

In July 2006, San Francisco enacted an ordinance requiring owners of SROs to install, by 2007, mail receptacles for each resident that comply with Postal Service requirements. City of San Francisco Postmaster Noemi Luna, addressed the new ordinance issue by letter to the City officials and announced the Postal Service's position on SRO delivery in San Francisco going forward. The "Luna Letter", in pertinent part, acknowledged that after the ordinance was enacted the Postal Service switched from single point delivery to centralized delivery at some compliant SROs, which was discovered subsequent to a fiscal review related to services. The Postal Service determined that the change to centralized delivery to SROs was inconsistent with Postal Service policies.

The Commission found that the Postal Service has responded in good faith to address the issues that initially motivated this controversy by providing a new delivery option for residents of most SROs in San Francisco: delivery of the mail to a locked receptacle, with management continuing to be responsible from



that point. The Commission views the Postal Service's offer as an attempt to appropriately balance the concerns of the Complainant (for more security and reliability in mail delivery) and the Postal Service (for efficiency and effectiveness, including the cost implications of adding numerous delivery points at an especially critical financial time).

The Commission directed the parties to participate in settlement negotiations based on the Postal Service's offer. The Commission appointed a Public Representative to represent the interests of the public and also serve as settlement coordinator. The Public Representative has filed reports on the progress of the settlement discussions. At this time there are motions pending from both parties relative to the adjudication of specific issues before the Commission because of a separate federal District Court case involving both parties related to SROs.

Docket No. C2011-3: Complaint of the National Association of Postmasters, *et al.*

On May 23, 2011, the National Association of Postmasters, the National League of Postmasters of the United States, and several individuals, jointly filed a complaint with the Commission concerning the Postal Service's proposed rules regarding post office discontinuance and its alleged actions concerning a plan to close thousands of post offices. The Complainants allege that the Postal Service has proposed rules that violate title 39, United States Code by arbitrarily changing the definition of "consolidation" in 39 U.S.C. 404(d) (claim 1) and ignoring the provision that a "postmaster" is the manager of a "post office" in 39 U.S.C. 1004(i)

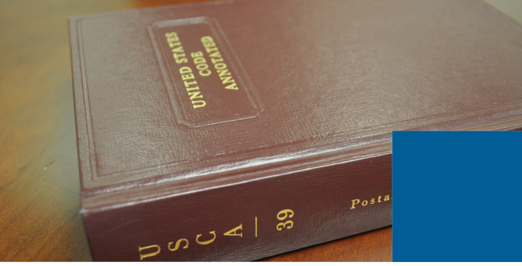
USPS witness James Boldt.

(3) (claim 2). The final claim is that the Postal Service has undertaken a change in the nature of postal services by starting a process to close thousands of post offices without following the advisory opinion procedure required by 39 U.S.C. 3661(b) (claim 3).

The Complainants argued the Commission has jurisdiction to hear the Complaint and allege that they have standing because they are interested persons and have legal status as postmasters.

On July 27, 2011, the Postal Service filed a request for the Commission to consider its proposal to review the possible discontinuance of over 3,500 retail postal facilities. The Commission found that the request was consistent with the relief sought by Complainants and dismissed Claim 3 of the complaint as moot.

The Commission determined that Claims 1 and 2 both focus on the Postal Service's alleged misinterpretation of provisions of title 39. Because both claims were based on Postal Service rules that were proposed but not finalized or implemented



the Commission dismissed the claims without prejudice because they were not ripe for review. The Commission provided that if the proposed rules became final and the Complainants' interests were implicated the Complaint could be renewed. On November 7, 2011, as a result of the Postal Service's adoption of final rules on October 26, 2011, the Complainants filed a motion to renew claims from its original complaint regarding the rules provisions regarding the term "consolidation" and "postmaster." On November 14, 2011, the Postal Service filed a motion opposing the renewal of the complaint. On November 30, the motion to renew the complaint was denied.

Docket No. C2011-4: Complaint of Armando M. Pons

On July 12, 2011, Armando Mirarchi Pons of Montvale, NY, filed a complaint alleging that the Postal Service failed to properly deliver a Department of Treasury check to his post office box in Los Angeles, CA, which the Postal Service had in its possession. Mr. Pons alleged that failing to deliver the check violates federal law prohibiting the obstruction of mail delivery or passage and California laws prohibiting mail theft. He also alleged related due process, search and seizure, employee supervision, and privacy issues. He sought the recovery and delivery of the Department of Treasury check, employee disciplinary action, and damages.

The Commission forwarded the Complaint to the Postal Service as a rate or service inquiry for resolution. The Commission received notice from the Postal Service that it had investigated and resolved all issues pertaining to the nondelivery of the Department of Treasury check to Mr. Pons. The Postal Service also informed Mr. Pons of the outcome of the investigation.

As a result, the Commission dismissed the complaint on July 14, 2011.

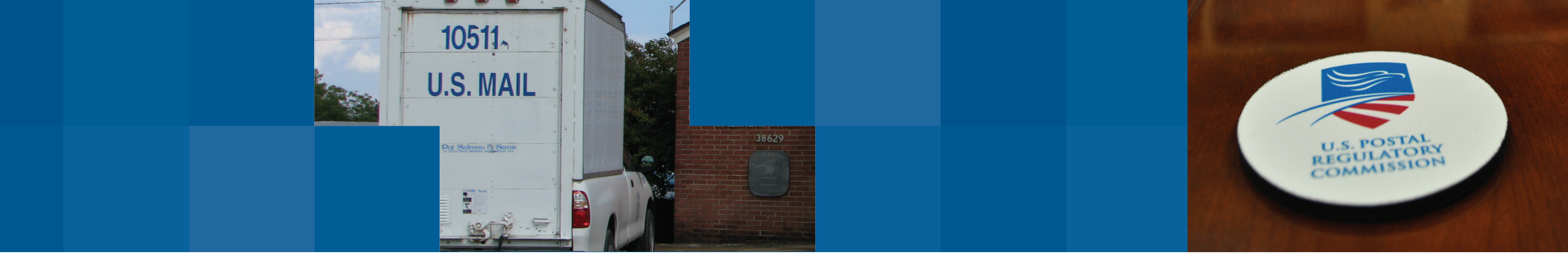
Docket No. C2011-5: Complaint of Raymond Lopez

On July 12, 2011 a second complaint was filed. In this proceeding the Complainant alleged that the Postal Service discontinued mail delivery to his residence located in Homestead, Florida. The Complainant alleged that the Postal Service refuses to deliver mail to his residence causing him to incur unnecessary expenses of approximately $2,500. He indicated that previous attempts to resolve the matter with the Postal Service had been unsuccessful. The Complainant sought restoration of his mail service and compensatory damages of no less than $2,500.

The Commission forwarded the complaint to the Postal Service as a rate or service inquiry for resolution. The Postal Service advised the Complainant by letter of the reasons deliveries ceased to his residence, the actions it took and the reasons for them, and its policies on the reinstatement of deliveries. This letter, which was mailed to Mr. Lopez, resolved all issues pertaining to his Complaint. The Commission determined that no further action was necessary and the complaint was dismissed.

POST OFFICE APPEALS

The Commission's authority to determine the outcome of appeals filed under 39 U.S.C. 404(d) and review Postal Service decisions to close or consolidate post offices is limited. The law authorizes the Commission



to review the procedures used by the Postal Service to reach its decision, determine whether the record is supported by substantial evidence, and consider whether the decision was arbitrary, capricious, or otherwise contrary to law. Upon a finding that the Postal Service's decision to close or consolidate a post office does not conform to the law, the proceeding can be remanded to the Postal Service for reconsideration. The Commission may not modify a determination of the Postal Service.

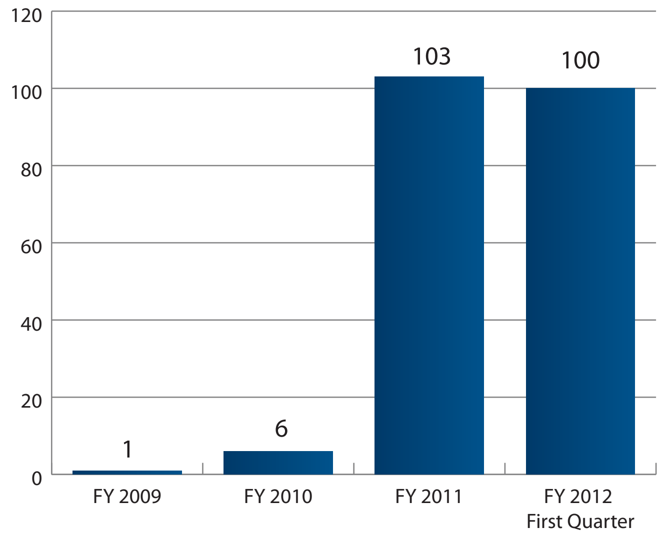
During FY 2011, the Commission has received 103 appeals of Postal Service actions to close or consolidate post office locations including branches and stations. In FY 2010 the Commission received 6 appeals. In July 2011, the Commission initiated Docket N2011-1 to review the Postal Service's Plan to consider closing approximately 3,700 post offices. As the Postal Service's closing and consolidations proceed, patrons continue to file appeals. Public officials and other interested parties also continue to voice concerns about the effect of closing or consolidation of post offices and access to postal services.

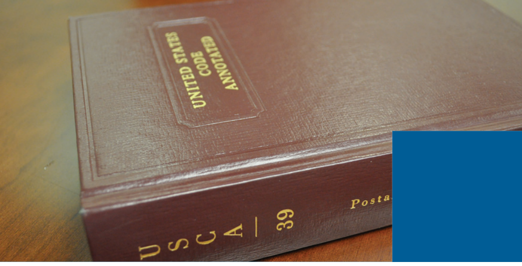
The dramatic increase in appeals has significantly impacted the Commission's workload. Virtually all staff members are currently involved in post office appeals in some capacity.

APPEAL OF NONPOSTAL SERVICES DETERMINATION

On March 26, 2010, the United States Postal Service and LePage's Products, Inc. (collectively the Petitioners) filed an action in the United States Court of Appeals for the District of Columbia Circuit for review of a Commission order classifying the Postal Service's licensing of its intellectual property for use on third-party mailing and shipping supplies as "nonpostal" under the PAEA and requiring the Postal Service to discontinue that activity. The case concerns the Commission's determination that the Bubblewrap program is a nonpostal service and is to be discontinued. The Petitioners claim that the Commission departed from a previous order without explanation and failed to support its findings with sufficient evidence. On June 7, 2011, the Court found that the criteria the Commission used for determining that the Bubblewrap products were nonpostal varied from its previous orders without a supporting rationale to explain the change. Therefore, the Court rescinded the decision finding the program nonpostal and remanded the classification issue for

Figure 5—Number of Post Office Closing Appeals FY 2009 through Quarter 1, FY 2012





the Bubblewrap program to the Commission with instructions to initiate further proceedings consistent with the Court's opinion.

The Postal Service also appealed the Commission's decision in Docket No. R2010-4, Exigent Request of the U.S. Postal Service, and Docket No. RM2010-13, Consideration of Technical Methods to Be Applied in Workshare Discount Design. These appeals are discussed in Chapter II.

Chapter V

International Activities

As the Postal Service advances its international products and services, so too has the PRC been engaged in efforts to promote a strong universal service network for mail exchanged with other countries. We have provided greater transparency into the Postal Service's initiatives to strengthen affordable, quality communication and commercial channels between the United States and the rest of the world. As some domestic mail products continue to decline in revenue, some international products and services, particularly International Expedited Services and Priority Mail International (PMI), were sources of revenue growth for the Postal Service. International Expedited Services and PMI revenues grew by 9.1 percent and 15.0 percent, respectively, between FY 2009 and FY 2010. Figure 6, shows the revenue for International Mail for the past 3 years. In an effort to lead as a globally competitive entity, in FY 2011 the Postal Service filed 68 Negotiated Service Agreements (NSAs) with the Commission for analysis and review. Fifty-three of these were for international products and services.

Section 407(a) of the PAEA provides that the Secretary of State has primary authority for the conduct of foreign policy with respect to international postal and delivery services. It further requires the Secretary of State to coordinate with other agencies, including the Postal Regulatory Commission. As part of an interagency process, the PRC continues to play an active role in the work of the Universal Postal Union (UPU), particularly with respect to delivery payments among postal operators, quality of service, reform of the UPU, universal service, and strategic planning. The Commission provided constructive input into U.S. positions on the UPU Strategic Plan to be adopted at the 2012 Doha Congress and initiatives to separate governmental and operational functions more clearly in the UPU, in line with U.S. government policy as stated in Section 407(a) of the PAEA. The Commission updated the public regularly on its international activities through its monthly public briefings.

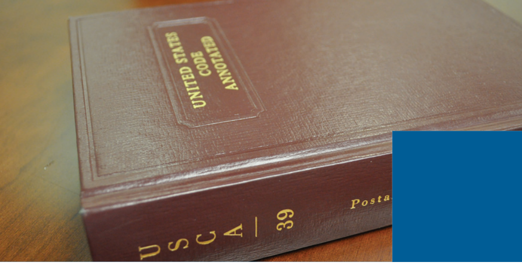
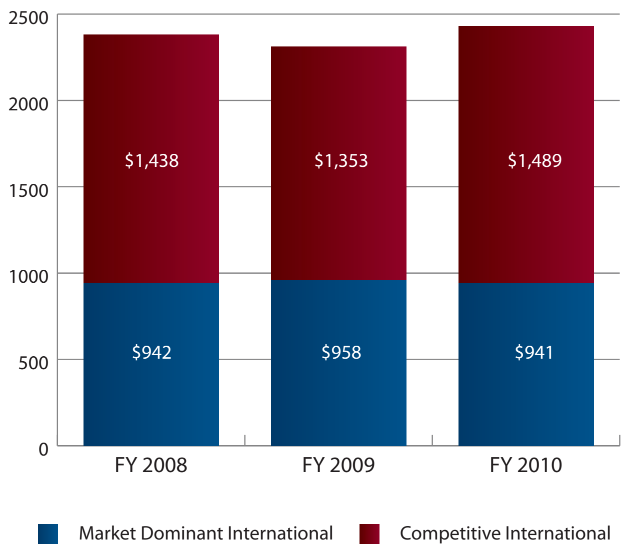


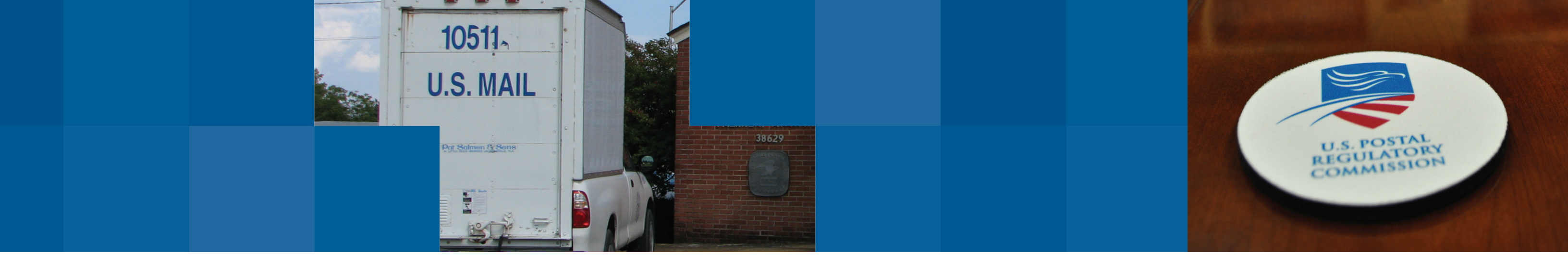
Figure 6—Revenue for International Products FY 2008 – FY 2010 ($ Millions)



The Commission has a statutory obligation under 39 U.S.C. 407 to provide its views to the Department of State on any amendments to a rate or classification in an international treaty. The Commission has therefore become increasingly engaged in the UPU's work on payments among postal operators for letter mail delivery, also known as terminal dues, particularly in light of the Postal Service's loss of $53.2 million on inbound international mail in FY 2010. This loss decreased by 49.4 percent from FY 2009, due in part to higher terminal dues rates and better service quality, but in large part to sharp declines in inbound mail volumes. The Commission worked actively with the Department of State, Postal Service and other UPU members to develop alternative payment methodologies that would improve the Postal Service's cost coverage for inbound international mail while preserving the affordability of international mail for U.S. citizens. These methodologies will form the basis of proposals to go forward to the UPU Congress in the fall of 2012. These proposals will ultimately amend the UPU Acts, which constitute an international treaty.

In FY 2011, the PRC strengthened its efforts to engage with other postal regulators. In order to carry out our regulatory function most effectively, we find great value in keeping abreast of postal reform and regulatory activities in other countries to ensure that we are providing informed regulatory oversight. The Commission has continued in-depth bilateral discussions with postal regulators from across the

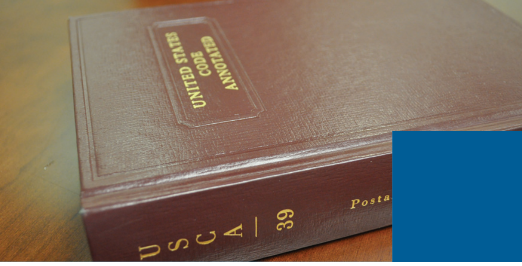
State Post Bureau China visiting the offices of the Commission.



Postal Regulatory Dialogue, Brussels, Belgium.

globe, including counterparts from Belgium, China, France and Russia. Technical meetings were also held with postal operators who look to the Commission for its technical expertise in postal law, economics, finance and accounting. In June 2011, the Commission participated in the third Postal Regulatory Dialogue, hosted by the European Commission in Brussels. Regulators from Australia, Brazil, France and China also attended. The Postal Regulatory Dialogue was an initiative launched by the Postal Regulatory Commission in 2008 to bring together postal regulators to share best practices and exchange views on regulatory models and challenges in their respective countries. This initiative has now become an annual event with solid international support, and will be hosted by Brazil in 2012.

The importance of the Postal Service's agility in international markets is critical to its ability to offer quality, affordable delivery services to overseas markets. The Commission plays an important role in supporting the United States position in global delivery services.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Chapter VI

Public Affairs and Outreach Efforts

OVERVIEW

The Commission's Office of Public Affairs and Government Relations (PAGR) is a significant resource both in support of public outreach and education, media relations and liaison with Congress, the Administration, the Postal Service and other government agencies. This office informs and advises Commissioners and Commission staff on legislative issues and policies related to the Commission and the Postal Service in addition to coordinating the preparation of both congressional testimony and and reponse to congressional inquiries concerning Commission policies and activities. PAGR coordinates media requests and provides assistance to general public and inquiries.

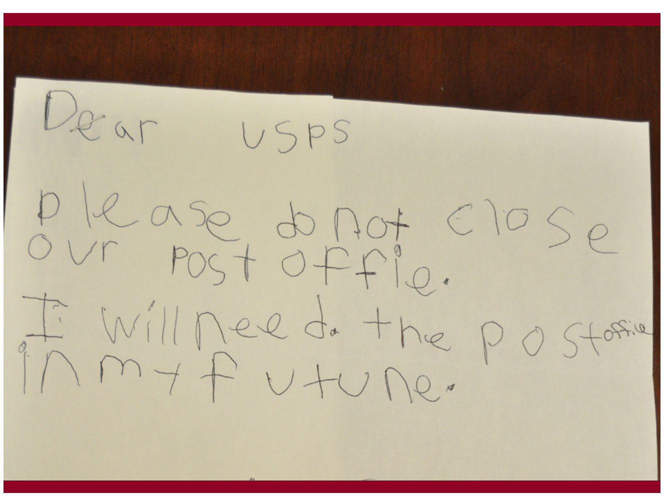
CONGRESSIONAL TESTIMONY

Chairman Goldway and the Director of the Office of Accountability and Compliance (OAC) appeared before congressional committees to report on the program plans and actions of the Commission and respond to questions from Members. Congressional testimony of Commissioners and staff is available online at the Commission website.

12/2/2010 —Testimony of Chairman Ruth Goldway before the Senate Homeland Security and Governmental Affairs Committee Subcommittee on Federal Financial Management, Government Information, Federal Services and International Security. The purpose of the hearing was to discuss Subcommittee Chairman Carper's recently introduced legislation, the "Postal Operations Sustainment and Transformation Act" (POST Act). Goldway stated the Commission's support for the general principle embodied in the bill that the Postal Service cannot sustain its mandated scheduled payments for the Retiree Health Benefit Fund (RHBF). Commission concerns

were expressed related to the unregulated use of the Postal Service processing, transportation, delivery, retail network or technology to provide new nonpostal services. Goldway also discussed recommendations the Commission had submitted to the Postal Service regarding its plan to consider 3,200 station and branch retail facilities for closure.

3/2/2011—Testimony of Chairman Goldway before the House of Representatives Committee on Oversight and Government Reform, Subcommittee on Federal Workforce, U.S. Postal Service and Labor Policy. The intent of the hearing was to discuss the future of the Postal Service and ways to promote its long-term viability and health. Chairman Goldway described the positive influence passage of the 2006 postal law had on Postal Service operations and agency transparency. Also discussed were two separate studies overseen by the Commission regarding calculation of the Postal Service's pension obligation and the Office of Personnel Management (OPM) computation of the RHBF liability. Goldway also updated Committee Members on the Postal Service Advisory Opinion request for elimination of Saturday mail delivery, and noted that the Commission had begun its first five-year review of the PAEA.


Dear USPS
please do not close our post offie.
I will need the postoffice in my futune.

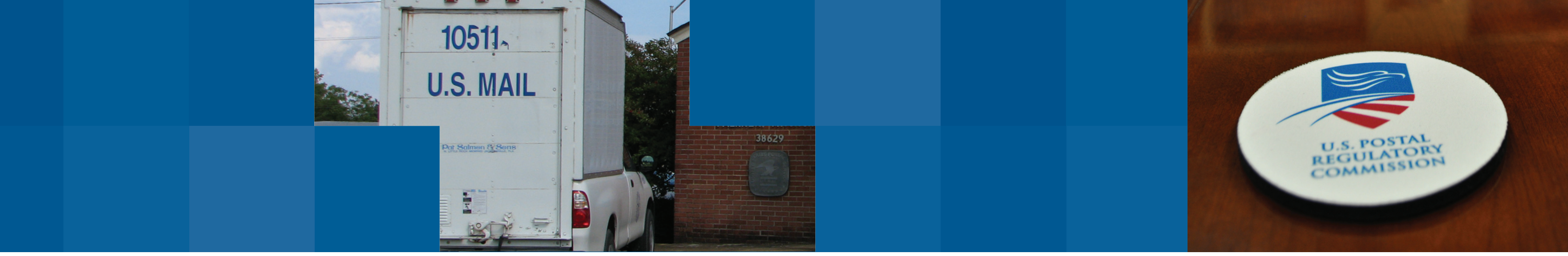
Letter received from a child regarding a post office closing.

5/17/2011—Testimony of Margaret Cigno, Director, Office of Accountability and Compliance before the Senate Homeland Security and Government Affairs Committee, Subcommittee on Federal Financial Management, Government Information, Federal Services, and International Security. The hearing was convened to address the U.S. Postal Service's ongoing financial crisis. Cigno testified that Commission analysis during its review of the Postal Service's request for an exigent rate increase found that the Postal Service's cash flow problem, and the primary cause of its liquidity crisis, was related to an overly ambitious requirement for the Postal Service to prefund its future retiree health benefit premiums. Cigno also discussed the need for continually improving service measurement, and shared Commission recommendations from the Advisory Opinion on five-day mail delivery.

OUTREACH ACTIVITY

In its normal course of activities, the Commission routinely hears from members of the public involved in or representing the mailing industry as well as members of Congress. The Commission performed public outreach activities to engage citizens and other stakeholders as a key part of its statutory responsibilities.

The Commission affords public comment on rulemakings, complaints, mail classification cases, public inquiries, rate cases and other matters. There is an opportunity for both formal and informal comment and both initial and reply comments.



Ann Fisher, Director of Office of Public Affairs and Government Relations and Steve Sharfman, General Counsel reporting at a Commission public meeting.

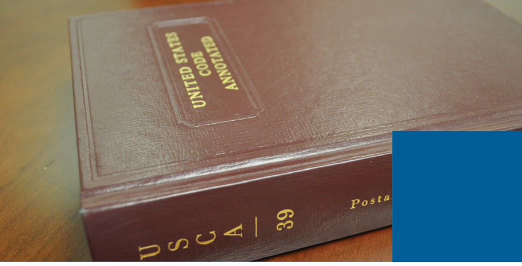
The Commission convened a public forum at Commission Headquarters to provide interested parties with the opportunity to comment on the effectiveness of current U.S. postal laws and to recommend improvements. The Commission conducted the public forum as part of its statutory responsibility to issue a report to the President and Congress evaluating the amendments made by the PAEA and offering recommendations for any legislation or other measures to improve the effectiveness or efficiency of the postal laws of the United States. For those unable to attend in person, the public forum was broadcast live. Written comments submitted by mail or e-mail were also invited.

As noted previously, the Postal Service filed with the Commission a request for an advisory opinion related to the systemic review of whether to continue service at over 3,650 post offices nationwide (N2011-1). This filing resulted in over one thousand public and congressional inquiries being submitted to the Commission's Office of Public Affairs and Government Relations (PAGR). To help educate Members of Congress, and thereby their constituents, on the Commission's role in this process, the Commission's Director of PAGR sent a letter to each Member of Congress. The letter described avenues available for constituents interested in participating in the Commission's review of the overall process. The letter also noted that the Commission does not have authority to decide whether any post office should remain open.

CONSUMER RELATIONS

The Commission's Consumer Relations Specialist responds to public comments and customer inquiries, handles complaints which do not rise to the level of formal complaints, and serves as liaison with the Office of Consumer Advocate of the Postal Service for service issues. The Consumer Relations staff manages and tracks public inquiries, informal complaints of a rate or service nature, and correspondence utilizing a Public Inquiry Log database developed in-house. Inquiries are tracked based on source and nature of the inquiry.

Further in-depth breakdown of categories are used to determine issues of significance to consumers and the mailing industry. Other factors the Commission deems of interest to the public are also tracked. This process provides a tool for the Commission to perform general analyses related to quality of service and helps to identify concerns, trends, and potential systemic problems as part of the PAEA's requirement to monitor service. The Public Inquiry Log is posted on the Commission's website on a quarterly basis under the "What's New" column. A new web page was developed to archive quarterly and yearly logs for interested consumers.



During FY 2011, the Commission received over 10,000 inquiries, suggestions and comments. As opposed to last year, consumer queries were received largely through the mail rather than the Commission's website link, "Contact PRC," found on the top banner of the home page.

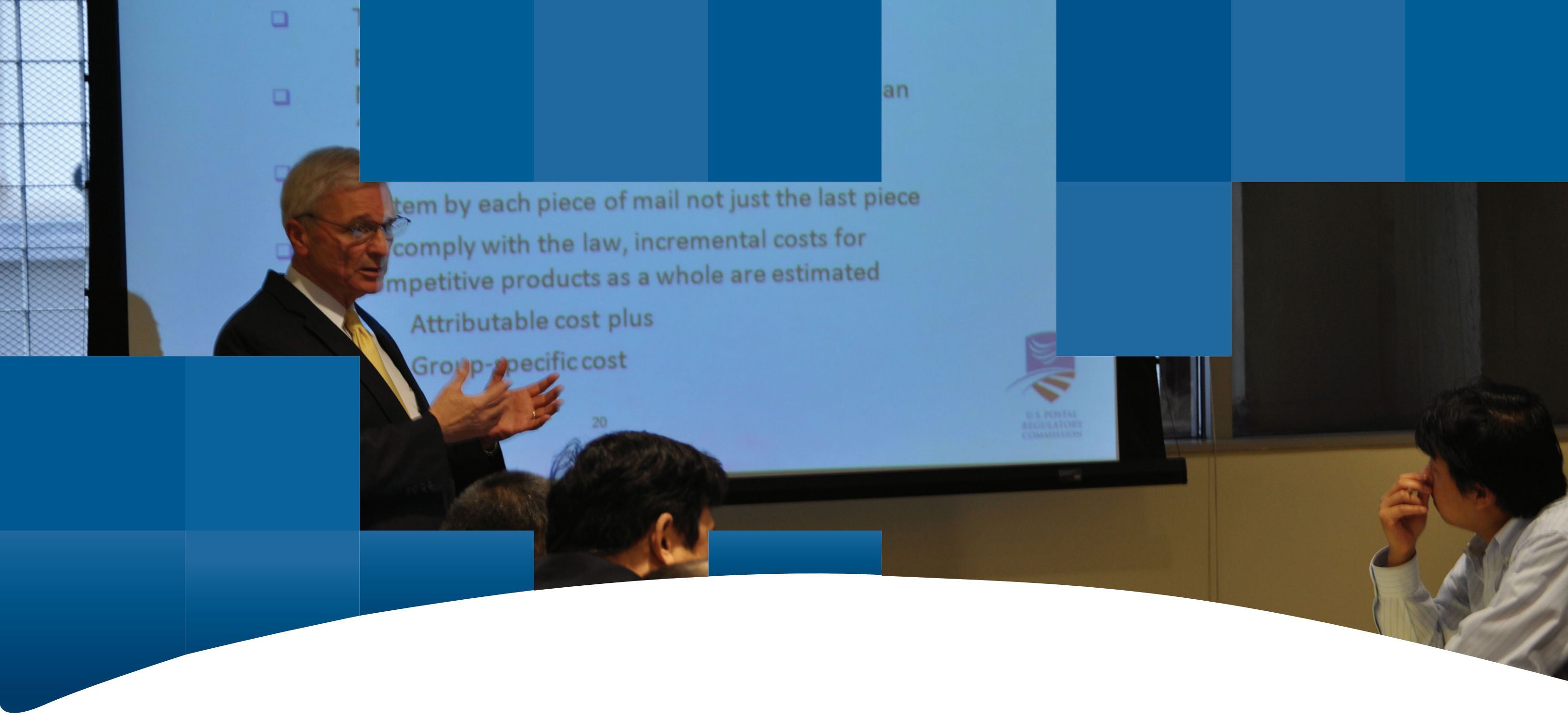
Table 8—Method of Contact

Mail	6618
Contact PRC	2777
Phone	771
Email	204
FAX	48

4,663 comments were from Consumers, 4851 from Business Owners whose comments were solicited by the National Association of Letter Carriers for Docket N2010-1, 496 from postal employees and organizations, 223 from Federal, State and local governments, 132 from the media, and 53 from mailers. While approximately half of the comments were for Docket N2010-1 on the Postal Service's proposal for a change from 6-day to 5-day delivery, inquiries and comments on post office closings increased to 3,039. This almost ten-fold increase from 360 post office closing inquiries in FY 2010 was due to an increase in post offices undergoing formal studies for closing, appeal activity and media publicity and public concern regarding Docket N2011-1, nature of service inquiry on the Postal Service's Retail Access Optimization Initiative to consider closing almost 3,700 post offices.

In addition to this outpouring of opinions, other top consumer issues included 220 comments and suggestions on the Postal Service's financial situation, concerns about Missing Mail (159), Undelivered Mail (107), Delayed Mail (89), and 80 comments about the Postal Service's Area Mail Processing reviews.

Commission Order No. 195 established that rate and service inquiries forwarded to the Postal Service's Office of the Consumer Advocate require a response by the Postal Service within 45 days. In 2011, the Commission forwarded 718 rate and service inquiries to the Postal Service. The Order also requires the Postal Service to file a monthly report summarizing the general nature of these inquiries. The reports are filed on the Commission's website under "What's New" and with Postal Service Periodic Reports.



CHAPTER VII

OTHER COMMISSION ACTIVITIES

SECTION 701 REPORT: ANALYSIS OF THE POSTAL ACCOUNTABILITY AND ENHANCEMENT ACT OF 2006

The Section 701 Report, *Analysis of the Postal Accountability and Enhancement Act of 2006*[21], was initiated on December 3, 2010, when the Commission solicited public comment on the Postal Accountability and Enhancement Act (PAEA) of 2006. The report was provided to the President and Congress on September 22, 2011, over three months before the statutory deadline. The report makes recommendations on various issues facing the Postal Service, including its financial circumstances, rates and services. In addition, it addresses the advisory opinion process. The recommendations made by the Commission seek to improve the effectiveness and efficiency of postal laws as well as remediating the short and near term financial problems of the Postal Service. The Commission finds that the PAEA is generally functioning as Congress intended. The Commission's first 701 Report has identified areas where key adjustments to postal laws could help address the liquidity crisis facing the Postal Service and improve the Commission's processes, including the Advisory Opinion and post of closing procedures.

The 701 Report explains that the current Postal Service Retiree Health Benefit Fund (PSRHBF) payment schedule is the principal cause of the Postal Service's liquidity problems. The Commission recommends that Congress

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[21] Section 701 of Title 7 of the PAEA states:
(a) IN GENERAL.—The Postal Regulatory Commission shall, at least every 5 years, submit a report to the President and Congress concerning—
(1) the operation of the amendments made by this Act; and
(2) recommendations for any legislation or other measures necessary to improve the effectiveness or efficiency of the postal laws of the United States.
(b) POSTAL SERVICE VIEWS.—A report under this section shall be submitted only after reasonable opportunity has been afforded to the Postal Service to review the report and to submit written comments on the report. Any comments timely received from the Postal Service under the preceding sentence shall be attached to the report submitted under subsection (a).

Commission monthly meeting.

adjust the current PSRHBF payment schedule. Most of these alternative funding levels proposed are actuarially sound, provide funding levels significantly higher than the Postal Service's public and private sector counterparts and also relieve the financial burden imposed by the current payment schedule. The Commission also recommends that Congress consider the PAEA section 802(c) report on the Postal Service's Civil Service Retirement System (CSRS) liability as a potential remedy for the PSRHBF issues. The Section 802(c) report, conducted by the Segal Group on behalf of the Commission, found that the Postal Service's CSRS liability was overstated by approximately $50-$55 billion. The PSRHBF would be almost fully funded by transferring excess funds from the CSRS liability.

The Report outlines five issues and the appropriate recommendation for matters concerning rates and services. First, the Commission recommends that the PAEA be enhanced to allow the Postal Service to add new market-dominant classes of mail. This flexibility should enable the Postal Service to the changing needs of most users and the postal system. Second, if Congress allows the Postal Service to offer new nonpostal services, it should include adequate safeguards including the same regulatory review that the Commission applied to prior nonpostal services under section 404(e)(3). Third, to encourage innovation the Commission recommends that Congress raise the maximum revenue limitation on experimental market test products. If market tests are allowed to generate higher revenue, the Postal Service will be able to advance more ideas that could increase revenue streams. Fourth, Congress should consider clarifying the current statutory law, 39 U.S.C. 3691(a), requiring the Postal Service to consult with the Commission in establishing service standards for market-dominant products. The Commission recommends that proposed changes in service standards require consultation between the Postal Service and the Commission, similar to the consultation required when the service standards were established. Finally, the Commission suggests Congress consider allowing the Postal Service to obtain increased pricing flexibility for quality of service enhancements. Such a mechanism provides an incentive to the Postal Service to increase revenues by increasing the service performance of its products.

The 701 Report makes recommendations aimed at improving the Commission's processes. The Commission recommends that the scope of the Commission's appellate review of determinations to close postal operated retail facilities be clarified to adopt the plain meaning of the term post office which would include stations and branches. Specifically, the definition of post office should include all retail offices operated by the Postal Service. This definition would eliminate any uncertainty or confusion among stakeholders. The Commission also recommends that Congress consider adding statutory language that would allow the Postal Service to obtain expedited processing of Postal Service Requests for Commission advisory opinions on proposals to change service on a substantially nationwide basis. In particular, the Commission recommends the following legislative language be considered as an addition to 39 U.S.C. 3661: "If the Postal Service seeks expedited processing for time-sensitive advisory opinions, it shall state such request in its proposal filed under subsection (b)." Congress should consider adding language to 39 U.S.C 3661 that requires, upon receipt of the Commission's advisory opinion, the Postal Service provide a written response to Congress. The proposed change would require both the Commission's advisory opinion and the Postal Service's written response to be submitted to Congress for appropriate review and oversight.

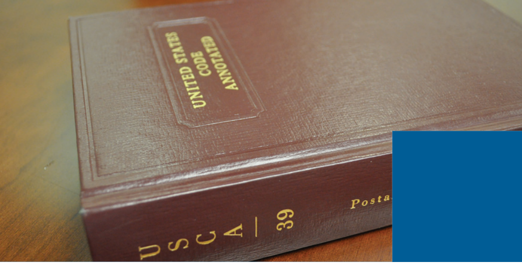
Margaret Cigno, Director of Accountability and Compliance

In the interest of furthering the PAEA goals of transparency and accountability, Congress should consider requiring the Postal Service to provide regular reports to the Commission on the Postal Service's plans and activities regarding its retail network, including identifying all post offices that have been suspended and those where closure actions have been taken. The reports should also contain information on how particular closings conform with previously filed plans and alternative access.

The 701 report can be viewed in its entirety at http://www.prc.gov

URBAN INSTITUTE STUDY ON THE SOCIAL VALUE OF THE MAIL

In February 2010, the Urban Institute completed its study, "A Framework for Considering the Social Value of Postal Services" commissioned by the Postal Regulatory Commission. The study identified dozens of ancillary benefits from postal services that result in improvement in the lives of individuals and society. The Urban Institute recommended additional research to quantify the social and economic value of these benefits. In May 2010, the Commission issued a Request for Proposal (RFP) seeking research proposals to quantify the value of social benefits of postal services including those identified by the Urban Institute study. In November 2010, the Commission selected three contractors to perform a total of six studies of various aspects of the social value of postal



services to the nation. Activities in support of those studies were completed in late August 2011.

These studies fall into two broad categories. Three of the studies evaluate the value of social benefits that derive from the provision of postal services in ways that complement services provided by the private sector. SJ Consulting Group, Inc. quantified the benefits of the Postal Service's parcel service to and from rural areas, including a separate analysis of service to Alaska and Hawaii. The Urban Institute researched the role and benefits of the price leadership role of the Postal Service for parcels, expedited services, money orders, and post office boxes. And Joy Leong Consulting, LLC quantified the value of essential services for the unbanked and underbanked populations by the Postal Service.

Three other studies address security and economic benefits that are an indirect result of the Postal Service's performance of its traditional core mail services. Joy Leong Consulting, LLC quantified the benefits of the Postal Service's role in disaster response and emergency preparedness. The Urban Institute quantified the economic benefits of post offices by measuring the effect on local employment when a post office is closed in a community. The Urban Institute was also selected to quantify community security and public safety benefits from the presence of letter carriers and post offices. Some work in study design and data collection was done, but for budgetary reasons this last study was not completed.

The reports describing the research methods and findings are available on the Commission's website. Additional supporting documentation provided by the contractors is posted with the reports.

CONSULTATION WITH THE POSTAL SERVICE

39 U.S.C. 3652(a)(2)(B) requires the Postal Service, in consultation with the Commission, to establish modern service standards for market-dominant products. Through a series of monthly consultations, the Commission has monitored Postal Service progress toward compliance with PAEA provisions, in particular those related to service performance measurements. The Commission has continued these monthly consultations to monitor Postal Service progress in implementing systems for measuring Postal Service performance in meeting the agreed upon service standards.

Chapter VIII

Administration

ADMINISTRATION OVERVIEW

The Postal Regulatory Commission continues to provide a safe work environment for the 69 employees on the rolls at the end of Fiscal Year 2011 (FY 2011). The Commission ended FY 2011 accident free with no on-the-job injuries or lost workdays. In line with the President's guidance, The Commission enhanced its Flexible Work Program to include alternative work schedules and telework opportunities during inclement weather. 71 percent of employees reported that they participate in the Flexible Work Program, with 30 percent teleworking.

In response to employee feedback in the FY 2010 Federal Human Capital Survey (FEVS), the Commission instituted several key initiatives for employees, including quarterly updates and increased training opportunities. The Commission is extremely proud that our 80 percent response rate to the FY 2011 FEVS is an improvement over our response rate of 75 percent for 2010 and the 2011 government-wide response rate of 49 percent. The FY 2011 FEVS highlighted new opportunities for improvement, and the Commission is committed to developing actionable plans to ensure that the concerns of employees are addressed.

During this fiscal year, the Commission also completed its 5-year Strategic Plan Plan, and is committed to operationalizing the strategies for the new fiscal year.

Commission staff on CFC Jeans Day.

EQUAL EMPLOYMENT OPPORTUNITY (EEO)

During FY 2011, the Commission had no formal EEO complaint filings and provided the required EEO and Notification and Federal Employee Anti-discrimination and Retaliation Act of 2002 (No FEAR) training to our employees.

DIVERSITY

In FY 2011, the Commission continued its agency commitment to support initiatives to recruit, develop and retain a skilled, high-achieving, and diverse workforce. The Commission made measurable progress in this area, ending the year with 57 percent of its executive positions filled by women and minorities. Progress was also made in the overall workforce, with women and minorities representing 61 percent of the overall workforce. The veteran representation in our workforce grew by 300 percent in FY 2011. The Commission provided expanded internship opportunities to aid in the recruitment and development of minority employees. The Commission also instituted a Student Loan Repayment Program to increase the retention of our employees.

TRANSPARENCY AND OPEN GOVERNMENT

As part of our mission of ensuring transparency, accountability and openness, the Commission continued to provide live audiocasts of hearings, technical conferences and public meetings. In 2011, we increased the capability of the system to allow for more people to access the live audiocasts. We also posted these audiocasts to the www.prc.gov website.

In FY 2011, the Commission improved its Freedom of Information Act (FOIA) process. At the end of FY 2011, the Commission responded to all requests received and did not have a backlog of FOIA requests.

CONTRACTS

In response to the Presidential Memoranda regarding government contracting,[22] and in line with the President's subsequent Campaign to Cut Waste,[23] the Commission undertook a comprehensive review of contracts and contract process and policy. Improvements and standardization of the process resulted in increased accountability and cost savings to the Commission.

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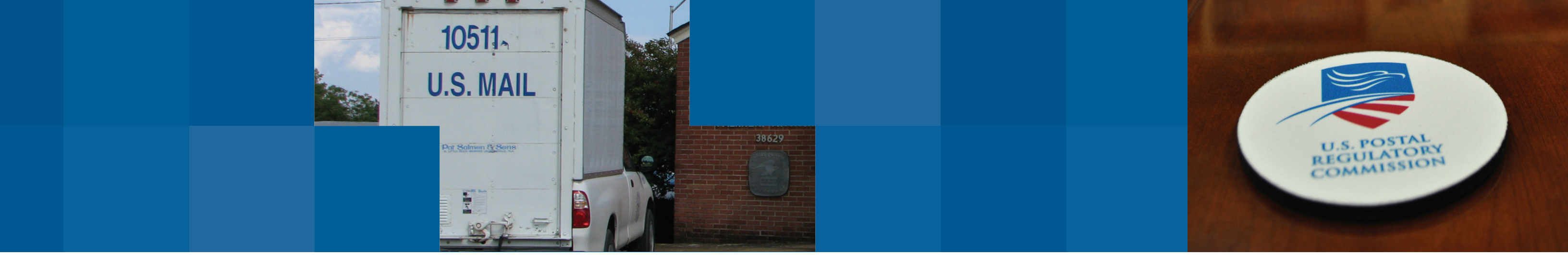
[22] Presidential memoranda re: Government Contracting, dated March 4, 2009.

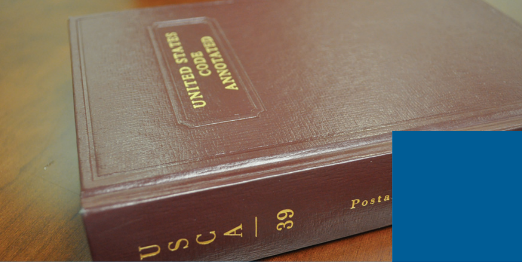
[23] The Campaign to Cut Waste Executive Order, dated June 13, 2011 – the Administration committed to delivering an efficient, effective and accountable government.



INFORMATION TECHNOLOGY

Improvements to the Commission infrastructure in the area of Information Technology in 2011 include: implementation of electronic personnel records; implementation of a dockets platform upgrade; improvements in the online archive of Commission documents; and consolidation of telecommunications capabilities.

Shoshana Grove, Secretary and Chief Administrative Officer at a public meeting.



Appendix A

Technical Description of Price Cap

Pursuant to 39 U.S.C. 3622(d) and 39 CFR 3010.20 et seq. the annual limitation (price cap) is equal to the percentage change in the CPI-U between the most recent average 12-month period and the average of the preceding 12-month period.

The Commission publishes the 12-month average change in CPI on its website at http://www.prc.gov/PRC-DOCS/home/CPI.pdf.

Generally, the difference between the annual price cap and the percentage change in rates is the unused rate adjustment authority. Unused rate adjustment authority (also known as banked authority) is also accrued when notices of price adjustment are greater than 12-months apart, as was the case in Docket No. R2011-2. Docket No. R2011-2 was initiated 23 months after Docket No. R2009-2 was initiated. Therefore, 11- months of CPI-U were not included in the price cap in either docket (See Docket No. R2009-2 and Docket No. R2011-2.) The CPI-U changes occurring during these 11-months are referred to as interim unused rate adjustment authority (or interim banked authority). Pursuant to 39 CFR 3010.26(c) the percentage change in CPI-U that occurred over these 11-months was calculated and added to the unused rate adjustment authority for each class. Because that 11-month period reflected a sustained period of deflation, the interim unused rate adjustment authority shown in Table 10 is negative.

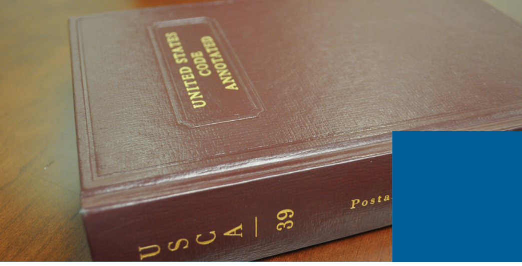
Typically, unused rate adjustment authority provides the Postal Service with greater pricing flexibility because it enables the Postal Service to increase rates beyond the annual price cap by as much as 2 percent. However, deflation caused the Docket No. R2011-2 interim authority to be negative. Under the law, the Postal Service may choose to let the negative interim authority expire after five years. *See* 39 U.S.C. 3622(a)(2)(C)(ii).

Table 9— Illustration of Docket No. R2011-2 Price Cap

Description	Rule	Result
Recent Average: Calculate the simple average of the 12 most recent CPI-U values (December 2009-November 2010)	§3010.21(a)	217.8
Base Average: Calculate the simple average for the 12 CPI-U values immediately preceding the Recent Average (December 2008-November 2009)	§3010.21(a)	214.1
The Price Cap equals the Recent Average divided by the Base Average minus one (expressed as a percentage)	§3010.21(a)-(b)	1.74%

Table 10—Illustration of Docket No. R2011-2 Interim Unused Rate Adjustment Authority

Description	Rule	Result
Base Average applicable in Docket No. R2011-2	§3010.26(c)(2)	214.1
Recent Average utilized in Docket No. R2009-2	§3010.26(c)(2)	215.3
The interim unused rate adjustment authority equals the R2011-2 Base Average divided by the R2009-2 Recent Average minus one (expressed as a percentage)	§3010.26(c)(2)	-0.577%



Appendix B

Postal Regulatory Commission's Comments in Response to the Postal Service's Comments Regarding the Commission's Advisory Opinion in Docket No. N2010-1

The Postal Service provided Congress with the *Report of the United States Postal Service Regarding Advisory Opinion in Postal Regulatory Commission Docket No. N2010-1* (Report on Advisory Opinion), which evaluated the Commission's decision in that docket. The report claims that the Commission's Opinion does not address the financial need for reducing delivery frequency and that the Commission's key findings are flawed. The Commission takes this opportunity to address the Postal Service's comments.

Postal Service's Financial Needs

In its Advisory Opinion the Commission recognized the Postal Service's financial condition and reviewed the Postal Service's proposal to determine the balance between rates and service that exists under the PAEA. It is important to note that under a rate cap regime, the rate cap only has meaning to the extent that reliable, efficient, and economical service is maintained. The Commission concluded that a reduction in service must be warranted by declining demand for the service, rather than to ease the obligation of adhering to the price cap. The Commission's financial analysis demonstrated that the Postal Service would likely realize two-thirds of its projected cost savings, while delivery of a quarter of First-Class Mail and Priority Mail would be delayed. The Commission's Advisory Opinion was written to assist Congress in evaluating the change in the balance between the PAEA rate and service requirements resulting from the Postal Service's proposal. In its Advisory Opinion, the Commission stated:

> The Commission supports the Postal Service in its attempt to regain financial stability…The question, in terms of the USO, that Congress and the Postal Service will examine, is whether the long-term cost savings from eliminating Saturday delivery justify the service reductions resulting from this plan.

Commission's Key Findings

The Postal Service makes essentially three arguments to the Commission's Advisory Opinion: 1) the Commission contradicts its own USO report, 2) it ignores expert testimony, and 3) it presents cost savings estimates that have not been scrutinized by the Postal Service or parties. The Commission refutes these arguments below.

Commission's USO Report

In the Commission's USO Report, the Commission did suggest that a different approach to analyzing cost savings from eliminating Saturday delivery might be more appropriate. The Commission found that assuming, as the Postal Service did in its USO report, that volume variable costs decline quickly at the margin rather than change at a constant rate, implies that the efficiency with which mail is sorted and delivered by carriers accelerates as volume

increases. Rather than dismiss this claim out of hand, the Commission stated:

> In order to be comfortable with the conclusion that "economies of density" in the delivery function accelerate as volume increases, the Commission would need to see whether this conclusion can be verified by an appropriate econometric model that is corroborated by either operational experience or intuition. Apart from economies of density, the Commission is not aware of any engineering, operational, or other consideration that would lead one to expect such a large change in the direction of marginal costs under the reduced frequency-of-delivery scenario. USO Report at 128-130.

The Commission further stated that, "there is no obvious reason that handling mail a piece at a time or a bundle at a time would become easier and faster as volume increases," and concluded that, "there is no intuitive reason to suspect that any of these functions would be performed more quickly or efficiently as rising volume increases the number of times they must be repeated."

The Commission did not contradict this conclusion in the Advisory Opinion. The Commission found that:

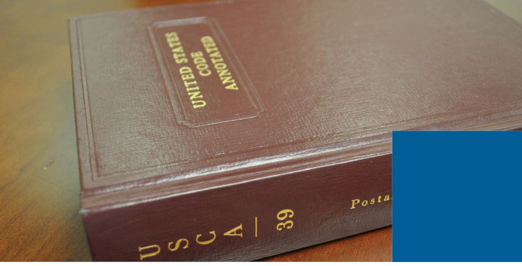
> the Postal Service's efforts to explore methods other than traditional volume variability analysis to estimate savings from large day-to-day shifts in delivered volume… is a new and important area of research. The operational judgments as to what broad categories of activities would be fixed with respect to day-of-the-week fluctuations in volume are welcome as well. The Postal Service has made a positive contribution to this aspect of the task of estimating the cost impacts of changing the frequency of delivery. This analysis goes partway toward bridging the gap between the established method of estimating volume-variable street time costs and the "different model"…that the Commission suggested in its USO Report.

The Postal Service did not present an "appropriate econometric model" that was "corroborated by operational experience" in its Request for an Advisory Opinion. Rather, the Postal Service's cost savings estimates were based, in large part, on the expert opinion of operational witnesses. While the Commission welcomed the Postal Service's discussion regarding operational changes that may occur when Saturday delivery is eliminated, it was not able to corroborate the cost estimates provided by the Postal Service.

Procedural Issues

Throughout the Report on the Advisory Opinion, the Postal Service claims that the Commission ignored expert testimony. It makes this claim regarding city carrier, transportation and mail processing cost savings estimates, as well as the estimated loss in revenue that may result from eliminating Saturday delivery. During the course of the N2010-1 docket the Commission asked over 80 Chairman Information Requests to clarify the record and obtain data that would corroborate the Postal Service's savings estimates.

Regarding city carrier cost savings estimates, the Postal Service states, "the cost reduction estimates were based upon extensive experience in day-to-day management and analysis of fluctuating delivery volumes and carrier operations." The Postal Service asserts that the commission ignored this evidence and made an "extreme and illogical assumption" by relying on the established methodology for estimating the city carrier savings from eliminating Saturday delivery. In fact, the Postal Service's cost reduction



estimates were based on 11 data points (Tuesdays after a holiday) spread over two years.

To determine the relevance of these data points when not viewed in isolation, the Commission compared weekly productivity for weeks that included a holiday with weeks that did not. This comparison showed no apparent differences in total weekly productivities. This implies that volume is distributed over an entire holiday week to smooth the workload. When asked to comment on this finding, Postal Service witness Bradley stated, "I think it is an issue of how the Saturday mail volume will be distributed across the other days that would affect the productivity...." Tr. 4/967.

Thus, the Commission could not corroborate the Postal Service's analysis regarding city carrier cost savings.

In the area of transportation, the Postal Service states, "in place of careful and conservative estimates by experienced managers who oversee day-to-day operation of the postal transportation network…the Commission substituted its own operational theory…" The Commission cost estimates for transportation savings differed from the Postal Service's estimate in surface transportation only. The Postal Service witnesses claimed that all of Saturday's mail volume could be transported on other days without adding any more capacity. The analysis ignored the impact of critical entry times (CET) related to service standards.

The Commission tested this assumption by reviewing unused capacity by day of the week over a period of four years. This analysis included time periods when volume was increasing as well as when volume was decreasing. The analysis showed that average unused capacities per truck trip are relatively consistent, however, the number of trips is sensitive to changes in volume levels. The Commission concluded that this type of sensitivity might be indicative of the acute service-related constraints that could be expected on intra-SCF transportation runs. Consequently, the Commission applied the transportation variabilities previously estimated by the Postal Service to estimate cost savings from eliminating Saturday delivery.

Similarly, in the area of mail processing, the Postal Service states, "the PRC rejected postal mail processing operations expert testimony regarding allied and support workhours not being needed on Saturday and declared that most of the workhours… would instead be used on Monday." The Commission asked the Postal Service's expert witnesses to explain what operational changes would occur that would imply that no additional workhours would be necessary to process the additional workload on other days of the week. Absent a satisfactory answer, the Commission relied on the Postal Service's volume variability estimates submitted in its Annual Compliance Report.

In its Report on the Advisory Opinion, the Postal Service also claims that the Commission, "summarily dismisses un-refuted expert testimony on market research" related to volume and revenue loss from eliminating Saturday delivery. The testimony the Postal Service is referring to involves its use of a "likelihood factor" to reduce the volume loss that would be expected if the survey results were not adjusted. Contrary to the Postal Service's claim that this methodology was un-refuted, several parties took issue with the Postal Service's use of the "likelihood factor."

To corroborate the Postal Service's use of the "likelihood factor," the Commission conducted an extensive search and while finding support in the

academic literature for use of a likelihood scale in attempting to forecast profitability for new product development, the published academic literature does not refer to such a likelihood scale being used in a product or service reduction or elimination scenario. The Commission, therefore, was unable to verify such use of the likelihood factor and instead used the unadjusted survey results from the Postal Service witness to estimate the likely volume loss.

Commission's Approved Methodology

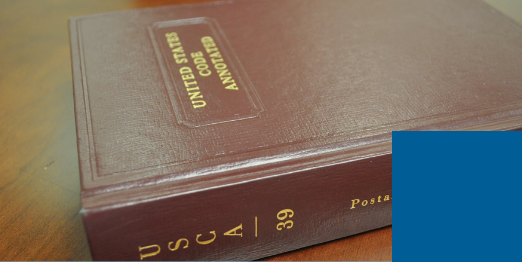
As for the methodology used to estimate the cost savings, the Commission based its cost savings estimates on established methodology that has already been vetted. In addition, the Commission only applied this methodology where the Postal Service's estimates could not be corroborated.

The Commission analyzed the Postal Service's cost savings estimate in the context of previous analysis done by both the Commission and the Postal Service in their respective USO reports. The Commission reviewed each component of the Postal Service's costing methodology, to determine whether each new proposed method could be corroborated and would represent an improvement over the previous methods used by the Commission and the Postal Service. In instances where the costing methodology, or a portion of that methodology represented an improvement, the Commission adopted and incorporated it into the cost savings calculations. In instances where there was not enough evidence in the record to show that the new methodology was an improvement, the Commission utilized the previous methodology used by the Postal Service or the Commission.

Recognizing the limitations of using ratemaking cost analysis in this manner, the Commission also provided a lengthy discussion on the importance of analyzing peak load cost issues in delivery, transportation and mail processing when estimating cost savings and recommended that further analysis be conducted.

Impact on Service

As for the Commission's finding that delivery of approximately 25 percent of First-Class Mail and Priority Mail would be delayed by two days, which the Postal Service states " [t]he Commission ignores the extensive market research results indicating that many customers would adjust when they mail," the 25 percent figure is the Postal Service's figure provided in response to CHIR 5. In that response, the Postal Service did not quantify the impact a change in mailer behavior would have on delays. The Commission would be interested in seeing such a quantification.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