

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

COMPLAINT OF TIME WARNER INC. ET AL.
CONCERNING PERIODICALS RATES

Docket No. C2004-1

DIRECT TESTIMONY OF
ROBERT W. MITCHELL
ON BEHALF OF
TIME WARNER INC.,
CONDÉ NAST PUBLICATIONS, A DIVISION
OF ADVANCE MAGAZINE PUBLISHERS INC.,
NEWSWEEK, INC.,
THE READER'S DIGEST ASSOCIATION, INC.
AND
TV GUIDE MAGAZINE GROUP, INC.
CONCERNING PERIODICALS
RATE DESIGN

April 26, 2004

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1 **Direct Testimony**

2
3 **Of**

4
5 **Robert W. Mitchell**

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7
8 **AUTOBIOGRAPHICAL SKETCH**

9
10
11 My name is Robert W. Mitchell. I am a consultant on issues relating to postal
12 rates. From 1992 until my retirement in 2002, I worked as Special Assistant to the Postal
13 Rate Commission and, before that, as Special Assistant to the Chairman. From 1975 to
14 1992, I was a Cost Systems Analyst, a Planning Officer, an Assistant to the Assistant
15 Postmaster General of Rates and Classifications, Manager of the Primary Rates Branch in
16 the Office of Rates, and a Principal Economist at the United States Postal Service. I have
17 worked on a wide range of rate issues, from costing to rate administration to rate design
18 to regulatory policy. I have represented the Rate Commission and the Postal Service to
19 mailers and postal groups. I was the Postal Service's witness on Periodicals and Standard
20 Mail rates (then second and third class) in Dockets No. R87-1 and R90-1, and testified
21 for the Postal Service in four other dockets. I have also been a consultant on rates to the
22 nations of Dominica and The Gambia.

23 Prior to joining the Postal Service, I was an Assistant Professor of Business at the
24 University of Wisconsin-Milwaukee, teaching Economic Theory and Managerial
25 Economics. I have a Bachelor of Science in Mechanical Engineering from the University

1 of Cincinnati and an M. A. in Economics from Case Western Reserve University. While
2 at Case, I passed my written and oral comprehensive examinations for the Ph.D. in
3 Economics, with major areas in Economic Theory, Econometrics, and Industrial
4 Economics.

5 I have written a number of articles and published papers, primarily on economic
6 issues relating to postal rates, including: “Postal Worksharing: Welfare, Technical
7 Efficiency, and Pareto Optimality,” in *Emerging Competition In Postal and Delivery*
8 *Services* (1999), and “Preparing the Postal Service’s Rate Structures for Competition: A
9 Study of How the United States Postal Service Might Adjust to Increased Competitive
10 Pressure,” in *Future Directions in Postal Reform* (2001).

1 **Adjustments to this Testimony and its Workpapers**

2 Certain adjustments to this testimony and its workpapers have been made since they were
3 filed as proffered testimony and workpapers on January 12, 2004 and January 16, 2004,
4 respectively. All adjustments made are listed below.

- 5 1. The headers originally on all pages have been removed.
- 6 2. The word “PROFFERED” has been removed from the title page.
- 7 3. The date on the title page has been changed.
- 8 4. This adjustment page has been added here, and so noted in the Table of Contents.
- 9 4. The page number of the second page of the Autobiographical Sketch is iii instead of ii.
- 10 5. Page 13, line 4, the word “is” has been added.
- 11 6. Page 20, line 18, an open single quote was added at the beginning of the line.
- 12 7. Page 36, line 20, “piece rate” was changed to “piece’s postage.”
- 13 8. Page 39 fn. 34, line 3, an extraneous “or” no longer appears.
- 14 9. Page 41, line 6, the period after the close parenthesis was added.
- 15 10. Page 41, line 10, the open parenthesis before “2” was added.
- 16 11. Page 43, a revised Rate Schedule has been inserted.
- 17 12. Page 45 fn. 39, line 2, an “s” was added to a word that is now “mailings.”
- 18 13. Page 51, line 12, the comma after the word “above” was added.
- 19 14. Page 55, line 12, an unneeded space no longer appears after the word “Service.”
- 20 15. Page 58, line 32, the period after the close parenthesis was added.
- 21 16. Page 66, line 6, the period after the close parenthesis was added.
- 22 17. Cost adjustments, supplied by witness Stralberg, were made to workpaper WP-
23 Mitchell-3.xls, sheet ‘BT inputs’ cells Y67-AG84, now renamed WP-Mitchell-3F.xls.
24 This change caused other changes in numbers calculated in the sheet.
- 25 18. Workpapers WP-Mitchell-1.xls and WP-Mitchell-2.xls have been renamed WP-
26 Mitchell-1F.xls and WP-Mitchell-2F.xls, respectively. No adjustments in contents
27 have been made.
- 28 19. Revised workpaper file names have been placed in appropriate places on pages 1, 2,
29 33 fn. 29, and 42.

1 **I. PURPOSE OF TESTIMONY**

2 The purpose of my testimony is to describe the deficiencies in Periodicals rates
3 and to propose alternative rates, more consistent with the guidance in the Postal
4 Reorganization Act, that recognize costs efficiently and give appropriate signals to
5 mailers.

6 I contend that our current understanding of postal costs and mailer capabilities
7 makes it clear that Periodicals rates are at variance with the Act's guiding background
8 presumption in favor of efficient rates. I also contend that when a full record is
9 developed, it will show that the unzoned editorial pound rate is not serving its intended
10 purpose and is adverse to accepted principles of efficient rate setting.

11 My testimony has three main sections: (1) an analysis of the deficiencies of the
12 current Periodicals rates (Section III); (2) a proposed alternative rate design for
13 Periodicals that would take a long stride toward remedying those deficiencies, including a
14 specific rate schedule and a detailed account of the development of the rates therein
15 (Section IV); and (3) an explanation of the desirability of the proposed alternative rates,
16 and their superiority to the current rates, in relation to the statutory ratemaking factors
17 and other policy provisions of the Act (Section V).

18 In Appendix A, I develop a model of publisher decisions on whether a zoned
19 editorial pound rate would provide reason to reduce or eliminate subscribers in the higher
20 zones.

21 My workpapers consist of three spreadsheets and are contained in library
22 reference TW et al. 2. WP-Mitchell-1F.xls is equivalent to the Commission's Library
23 Reference No. 9 in Docket No. R2001-1, except that the billing determinants are for full-

- 1 weight zoning and three errors are corrected. WP-Mitchell-2F.xls contains the formulas
- 2 to separate the letter-size pieces from the non-letter-size pieces; see sheet 'Ltr BD' in it.
- 3 WP-Mitchell-3F.xls shows the development of the proposed rates.

1 **II. SUMMARY OF TESTIMONY**

2 Following is a summary of the three principal sections of this testimony.

3

4 Section III

5 Section III poses what seems, in the context of a complaint proceeding, the
6 obvious threshold question: what is so wrong with current Periodicals rates as to
7 justify a complaint proceeding seeking to effect their reform?

8

9 My answer to that question is essentially as follows:

- 10 1. Over a period that extends back into the 1980s, the increases in Periodicals
11 rates have been greater than the increases in the Consumer Price Index,
12 even after the reduced markups recommended by the Commission. The
13 fact that this has been occurring makes it all the more important to search
14 for other avenues of progress, on which this Complaint focuses.
- 15
- 16 2. Improvement in our understanding of costs in recent years has brought the
17 existing deficiencies into clearer focus and has suggested new paths that
18 cost recognition should follow. For example, the makeup of bundles,
19 sacks, and pallets, including their entry points and associated interactions,
20 are now understood to be important cost drivers, but these factors are all
21 but neglected in rates. As a consequence, mailers often have no way of
22 knowing or reason for caring that their decisions about mail preparation

1 and transportation are needlessly wasteful. If the factors that drive costs
2 were reflected in rates, mailers would respond accordingly.

3
4 3. Despite statutory language and legislative history that emphasize costs and
5 require recognition of the preparation of the mail, the Periodicals rate
6 structure still includes the highly inefficient unzoned editorial pound rate,
7 an outdated policy preference that thwarts adequate recognition of cost
8 incurrence. Maintaining this structure has interfered with the natural
9 forces that promote more efficient rates in every part of the Periodicals
10 rate design. For example, a variety of pound-oriented savings have been
11 converted into per-piece discounts in order to avoid undermining the
12 insensitivity of the editorial pound charge to actual cost incurrence.

13
14 4. If the pound rates for editorial matter were to vary with distance, the
15 marginal costs of printing and distributing would remain low relative to
16 revenues from advertising and subscriptions, even for the higher zones.
17 Therefore, publishers faced with zoned editorial pound rates would
18 continue to find it profitable to add higher-zone subscribers and would not
19 find reason to drop such subscribers or otherwise to limit the availability
20 of their publications based on the geographical proximity of the recipients.
21 An unzoned editorial pound rate is not required to make periodical
22 publications equally accessible in all areas or to promote the widespread
23 dissemination of editorial matter.

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5. Because of the unzoned editorial pound rate, many local and regional publications that choose to print near their home base are unfairly charged elevated rates in order to support reduced rates for publications going greater distances.

Section IV

1. Section IV develops a schedule of rates designed to recognize costs efficiently and to give appropriate signals to mailers. The proposed rates are tied to the rates recommended by the Commission in Docket No. R2001-1; they preserve all discounts and rate structures to the maximum extent possible; they are revenue neutral; and they are based on the same volumes and billing determinants.

Section V

1. The proposed rates achieve improved consistency with the ratemaking factors set out in §§ 3622(b) and 3623(c) of the Act. They are more fair and equitable. Implicit cost coverages are more in line with principles of worksharing, efficient component pricing, and lowest combined cost.

2. Costs are recognized in the proposed rates in ways that are consistent with widely accepted rate-setting principles. The rates present mailers with the cost implications of their decisions and give them tools for dealing with

1 those implications in the form of incentives for more economical mailing
2 practices.

3
4 3. The proposed rates substantially improve the recognition of the effects of
5 the preparation of the mail on the Postal Service's costs. Specific
6 attention is paid to the handling and the makeup of bundles, sacks, and
7 pallets, and their associated entry points. Weight-related costs, however,
8 continue to be recovered in the pound charges, even when they are
9 incurred handling bundles.

10
11 4. The effects on mailers of any rate increases have been carefully
12 considered. The proposed rates move closer to rates that would be
13 generated by a competitive market at a measured pace that leaves room for
14 further improvement in the future. They would reduce cost averaging
15 across the subclass and increase the alignment of the rates of individual
16 mailers with the underlying Postal Service costs, but these steps are
17 tempered by consideration of potential impacts on individual mailers and
18 the desire to avoid undue burdens or extreme dislocations in intra-subclass
19 rate relationships. For example, no markups are proposed for the new rate
20 elements and higher-zone mailers would be faced with only the *additional*
21 costs associated with their mail. Also, many small publications will be
22 helped by the ADC presort level, the DBMC dropship rate, the recognition

1 of machinability, improvements in the pallet/sack differential, and
2 improved dropship discounts for sacks.

3

4 5. The proposed rates are not unduly complex. They align with the
5 operations that mailers perform in preparing mail and should be easy to
6 understand. They avoid certain complexities in the current rates and
7 diminish or eliminate a number of anomalies caused by the divergence of
8 current rates from costs.

9

10 6. The proposed rates do not diminish the current recognition of the
11 educational, cultural, scientific, and informational value of matter in
12 Periodicals. The implicit cost coverages on editorial and advertising
13 matter are not altered.

1 **III. WHAT IS WRONG WITH PERIODICALS RATES?**

2 Essentially, Periodicals (then denominated “second class”) came into existence in
3 1879. In 1885, the rate was set at 1 cent per pound, independent of the distance
4 transported or the proportion of advertising. If a publisher failed to qualify for this rate,
5 he paid the third-class rate of 1 cent for each 2 ounces, fully 8 times higher. Clearly,
6 Congress intended not only to separate Periodicals for rate purposes but also to make the
7 rates extremely attractive.

8 Many adjustments in rates have occurred since that time, but Periodicals has
9 remained a separate class of mail throughout. Since the Postal Reorganization Act of
10 1970 (hereinafter Act), the rate level for Periodicals has been determined, except for
11 phasing provisions, by the application of a Commission-determined markup to
12 Periodicals costs. In a 1976 Amendment to the Act, Congress required that in selecting
13 markups, consideration is to be given to the “educational, cultural, scientific, and
14 informational [ECSI] value” of the mail matter conveyed. This consideration is
15 understood to apply in its strongest form to Periodicals.¹

16 With this kind of history, one might expect Periodicals rates to be low and
17 attractive. But Periodicals rates are not low. They have been rising inordinately, and
18 their attractiveness is dwindling. One would be hard pressed to argue that this outcome is
19 consistent with what Congress expected. Something went wrong.

20 I do not contend that a few adjustments in the rates for Periodicals will solve all of
21 the problems. I do contend, however, that the current rates are inefficient to such a

¹ “Eligibility for the Periodicals class is conditioned, among other things, on a minimum amount of nonadvertising—or editorial—content. The presence of this type of content entitles all Periodicals mail to special consideration, given explicit statutory recognition of educational, cultural, scientific and informational value as a ratemaking criterion.” PRC Op. R2000-1, p. 406, ¶ 5573 (footnote omitted).

1 degree that they do not conform to the policies of the Act and that improved rates that
2 enhance efficiency will improve the lot of publishers. The purpose of this section is to
3 explain some of the problems and to point to improvements. Then the next section
4 discusses more specifically the improvements being proposed.

5
6 **A. Periodicals Rates Have Been Increasing Too Rapidly**

7 Particularly since the late 1980s, there has been concern that, due to rising costs,
8 the rates for Periodicals have been rising inordinately rapidly. After years of efforts by
9 mailers and the Postal Service to stem the rising costs, or even to agree about the reasons
10 for the rise, the Commission said in Docket No. R2000-1:

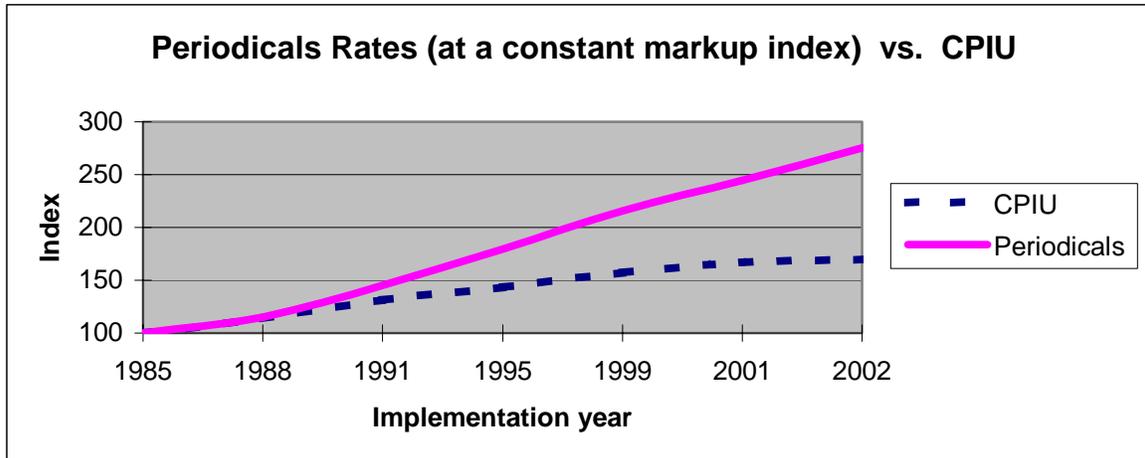
11 The only conclusion is not comfortable: there are many
12 reasons for believing that costs should have decreased; only a few
13 factors that could be associated with increases; and a persistent net
14 upward trend. It is clear that mailers and the Service must
15 aggressively pursue the cost reduction opportunities identified on
16 this record, and explore other aspects of the “operational realities”
17 they face.

18
19 PRC Op. R2000-1, p. 412, ¶ 5593.

20 The extent of the problem is easy to illustrate. Graph 1 shows an index of
21 Periodicals rates, at a constant markup index,² along with the Consumer Price Index,
22 Urban (CPIU). The picture is disturbing. If no technological changes occurred and no
23 scale economies were realized, and if factor prices increased in accord with inflation,
24 then the index would be expected to increase with the CPIU.³ As shown, however, the
25

² The notion of a markup index was introduced by the Commission in Docket No. R90-1 to help compare markups over time for specific subclasses when the average markup for all subclasses varies. The index is equal to the markup for a subclass divided by the average markup, both in percentage terms. If a rate were 6 cents and the cost were 4 cents, the markup would be 50 percent. If the average markup were 75 percent, the markup index would be 0.667 (50/75).

³ Strictly speaking, this expectation requires an assumption that there have been no qualitative changes of significance in the product supplied by the Postal Service. If mailers switched to the use of pallets, for



1
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Graph 1

3 Periodicals index has outstripped the CPIU, by a wide margin. Using the outcome of the
4 1984 rate case as a base, meaning that the indexes have a value of 100 in 1985, the
5 Periodicals index increased to 275 while the CPIU increased to 170. The difference is
6 substantial.

7 But the actual situation is worse than the picture. The Postal Service claims that
8 important technological advances *did* occur during the period and that its total factor
9 productivity (TFP) index increased 9.8 percent. It claims as well that it is realizing
10 increasing returns to scale. In addition, some shifting to the use of pallets occurred, but a
11 separate pallet rate did not exist.⁴ This means that the most supportable expectation
12 would actually be for the price index to be *below* the CPIU. Alternatively, if increases in
13 real wages absorbed the gains from mechanization, palletization, scale, and other
14 improvements, the rate index still should not exceed the CPIU. It is clear no such
15 expectations have been borne out.

example, but no separate cost-based pallet rate were reflected in the index (as was in fact the case during the period shown), one would expect the price index to *decrease*. Excepting pallets, it is not apparent that meaningful changes in the product have occurred. But if they have, possibly through the efforts of MTAC workgroups, the effect on the index would probably be to reduce rates, not to increase them.

1 This outcome is consistent with a phenomenon I have elsewhere referred to as
2 *negative technological change*. That is, mailers make cost-reducing adjustments (such as
3 the use of pallets), the Postal Service invests in advanced technology (such as flat sorting
4 machines and barcode readers), economies of scale are realized (consistent with the
5 Service’s analysis of mail processing costs), and costs, corrected for inflation, do not
6 decline but *increase*.

7 By any measure, the situation is troubling. More effective measures to restrain
8 cost growth and to improve subclass efficiency are plainly needed. The most promising
9 measure—one that requires approval by the Commission—is to provide improved signals
10 in the rates for efficient conduct by aligning them more closely with Postal Service costs.

11

12 **B. Periodicals Rates Are Not Cost Based**

13 Under the Postal Reorganization Act of 1970, which supports recognition of costs
14 and of the preparation of the mail, a number of improvements have been made to the
15 Periodicals rate structure, all based on a record developed before the Postal Rate
16 Commission. In the first rate case, Docket No. R71-1, piece rates were introduced to
17 recognize that not all costs are pound related. The piece rates grew on a case-by-case
18 basis and now account for approximately 60 percent of Periodicals revenue; beyond this,
19 some evidence has been presented that the proportion should be even higher. It is clear,
20 then, that pound rates play a substantially lesser role than they did prior to reorganization;
21 indeed, the revenues obtained from the pound rates have gone from 100 percent down to
22 40 percent.

⁴ Note that since the Periodicals rate index is a constant-mix index, it is unaffected by volume shifts over the period among established worksharing categories. Changes in worksharing would, however, affect

1 In 1978, presort discounts were introduced, providing three separate presort tiers.
2 In 1985, dropship discounts (on a per-piece basis) were introduced for destination-SCF
3 entry. These discounts were subsequently expanded and refined to include both per-piece
4 and per-pound elements and to apply to destination area distribution centers and
5 destination delivery units. Saturation and high-density discounts were introduced in
6 1991, as were barcode discounts. In 2001 the number of presort tiers was expanded to
7 four. A pallet discount was introduced in 2002.

8 All of these changes improved the signals given to mailers, and they were all cost
9 based. As explained here and in other sections of my testimony, however, both the
10 quality of the signals and the extent to which costs are recognized are at this point
11 deficient. Our understanding of cost incurrence has improved substantially, especially in
12 recent years, as has the ability of mailers to respond to such incurrence. It is therefore
13 time to improve the signals and to take further steps in the direction of recognizing costs
14 in rates. Periodicals appears to be lagging other subclasses in this respect. There is little
15 question, for example, that some of the recent growth in the volume of parcel post has
16 been due to cost-based rate innovations, and Standard mail rates have been moving in the
17 direction of closer alignment with costs.

18 In times past, particularly when mailings were smaller and computers were rarer,
19 rate differences on the order of a cent per piece might not have been large enough to
20 evoke meaningful responses. But one of the realities of today's mailing environment is
21 that most mailers are reasonably sophisticated and have both the capability and the
22 willingness to analyze their operations and to respond to signals in rates. Today,
23 fractions of a cent can bring about meaningful alterations in the way mail is prepared,

revenue-per-piece figures.

1 entered, and delivered. Even small changes in the parameters and constraints in mailing
2 software can change the output in important ways, just by pressing the calculate button
3 on a computer. When such capabilities on the part of mailers are neglected, and cost-
4 based signals are not provided, the entire subclass suffers. It is important that we not let
5 this continue to occur.

6 Disparities between costs and rates are in need of attention, despite the progress to
7 date in the recognition of worksharing: (1) the *differences* among zones in the advertising
8 pound rates are based on transportation costs only, and do not recognize that non-
9 transportation costs also vary with distance; (2) the non-transportation portion of the
10 dropship discounts (relative to zones 1&2), which is largely pound oriented, is given 50
11 percent on a per-piece basis; (3) many of the costs depend on the quantities and sizes of
12 the bundles, sacks, and pallets in a mailing, but this fact goes largely unrecognized in
13 rates; (4) the costs of handling bundles depend on the makeup (*e.g.*, ADC, SCF, 3-digit,
14 or 5-digit) of their containers and where they are entered, but neither are these factors
15 recognized in rates; (5) the one-half-cent per-piece pallet discount is based on a pound-
16 oriented savings; and (6) the one-cent per-piece pallet discount is also based on pound-
17 oriented savings and applies only to dropshipped pallets, although the savings exist for *all*
18 pallets.

19 Many of these factors can be recognized in rates, and doing so would be in line
20 with Commission emphasis in recent years on cost recognition, efficient component
21 pricing, worksharing, and notions of lowest combined cost. Recognizing them would
22 help the Postal Service to be a more effective delivery organization, and would improve
23 the lot of mailers.

1 C. Periodicals Rates Provide Poor Signals to Mailers

2 Signals in prices are important throughout the economy. In fact, buyers (whether
3 firms or individuals) respond more strongly to price signals than to any other force I can
4 think of. Both firms and individuals watch out for their bottom line. The following story
5 may seem mundane and far removed from the economics of big business, but it is quite
6 relevant. I have a niece who lived in an apartment in Indianapolis for some years, and
7 had a cat. She told me that she left her kitchen faucet running slowly night and day, so
8 that her cat could get a drink. I asked her about her water bill. She said: “What
9 difference does it make? My water is included in my rent.” Without appropriate signals,
10 people make inefficient decisions.

11 The current rates send underdeveloped signals to mailers, thus failing to provide
12 them with a reasonable and valuable avenue for responding to the high costs. It is
13 difficult to accept that putting mailers in this position is consistent with the ratesetting
14 guidance contained in the Act.

15 The following observations indicate the importance of signals generally and the
16 inadequacy of the signals given by the current rates.

17 Our understanding of cost incurrence and how it should be reflected in rates
18 progresses as we make advances in cost analysis. For many years, attention centered on
19 whether costs were piece-oriented or pound-oriented, with some recognition of cubic
20 measures in parcel post.⁵ If only reality were so simple. More recently, attention has

⁵ The reasoning has been that a marginal cost can be partitioned into a piece-related cost and a pound-related cost. If the number of pieces increases, say, 10 percent and the number of pounds remains the same (which requires a decrease in the per-piece weight), the piece-cost will increase 10 percent and the pound-cost will remain unchanged. Alternatively, if the number of pounds increases 10 percent and the number of pieces remains the same (which requires an increase in the per-piece weight), the pound-cost will increase 10 percent and the piece-cost will remain unchanged. It is not necessarily the case, however, that such a

1 focused increasingly on cost drivers and on linkages among cost drivers and volume.⁶
2 Part of the interest in cost drivers derives from the increased use of mechanization and
3 automation by the Postal Service. For example, with bundles now being sorted on small
4 parcel and bundle sorters (SPBSs), the cost of sorting bundles is virtually independent of
5 the weight of the bundles and the number of pieces in them. Similarly, with the use of
6 sack sorters and lift trucks, the costs of sorting sacks and pallets are virtually independent
7 of the nature of their contents.⁷ Moreover, the processing these receive depends on their
8 makeup and their entry point. When these factors are not recognized in rates, mailers
9 cannot be expected to understand or respond to the costs of handling their mail. The rates
10 being proposed, by taking significant steps toward recognizing these factors, would
11 increase the efficiency with which mail is prepared and handled.

12 The current relationship between rates and actual processing is disjointed and
13 sometimes perverse, as James O'Brien explained in his testimony in Docket No. R2000-
14 1. (Tr. 24/11166). For example, the same carrier-route bundles receive different
15 processing and incur different costs depending on whether they are on 5-digit pallets or 3-
16 digit pallets. Yet, these pieces pay the same rates. Faced with such signals, mailers

partitioning is always possible. That is, it is not always the case that the cost function, even for marginal cost in a relevant range, can be described well by an equation of the form $MC = a * \text{pieces} + b * \text{pounds}$.
⁶ For example, see Michael D. Bradley, Jeff Colvin, and John C. Panzar, "Issues in Measuring Incremental Cost in a Multi-function Enterprise," pp. 3-21, in *Managing Change in the Postal and Delivery Industries*, ed. Michael A. Crew and Paul R. Kleindorfer, 1997, Kluwer, Boston. Also see "Technical Report #1: Economic Analysis of Data Quality Issues," especially Chapter 2, *Data Quality Study*, prepared for the United States Postal Service, Contract No. 102590-97-B-1972, April 16, 1999. The Commission has emphasized reliance on cost drivers as well. In a discussion of transportation costs, for example, it said: "This step is viewed as relating to the behavior of pricing in the transportation markets in the sense that the cost at which transportation can be procured is related to the cubic-foot-miles of capacity involved; in the parlance used in recent years in such analyses, cubic-foot-miles of capacity is called a 'cost driver' of transportation costs." PRC Op. R2000-1, p. 169, para. 3250.

⁷ One dimension of scale economies is that a larger-scale operation might have heavier bundles, sacks, and pallets. These economies cannot be realized if inappropriate signals are given to mailers.

1 cannot be expected to consider the cost implications of the preparation decisions they
2 make.

3 As another example, consider the tradeoff between bundles and sacks. In some
4 cases, mailers have a choice between preparing one 24-piece bundle and 24 sacks
5 containing one piece each, which would be sorted individually and taken intact to the
6 carrier. Processing the sacks is vastly more expensive than processing the bundle, but the
7 rates are the same. If the mailer, given appropriate signals, values the sacks and is
8 willing to pay for their handling, the outcome is not inconsistent with efficiency.
9 Alternatively, the mailer could decide that the return from using the sacks is not worth the
10 cost. But neither of these is happening, as the result of improper pricing signals.

11 Before Docket No. R90-1, the rates for Standard mail were uniform nationwide.
12 In that case, consistent with principles of efficient component pricing, lower rates were
13 allowed for mail entered at destination BMCs, SCFs, and delivery units. Going into the
14 case, the Postal Service estimated that 14.6 percent of Standard mail was dropshipped.
15 Today, 73.3 percent of it is dropshipped, and the efficiency of the class has increased
16 dramatically. Changes of this magnitude point to the efficacy of signals in rates in
17 promoting more efficient mailer behavior.

18 The difference between 14.6 percent and 73.3 percent represents an enormous
19 waste of resources, at the expense not of the Postal Service, since it is entitled by law to
20 charge rates that achieve breakeven, but of Standard mailers themselves. Until the advent
21 of correct price signals, however, they were helpless to do anything about it. Periodicals
22 mailers are currently in much the same situation.

1 It is not reasonable to expect publishers, or printers, or anyone else to consider
2 costs that do not affect their bank accounts. So, if the Postal Service charges no more to
3 deliver to more distant locations, it is unreasonable to expect printing bids to reflect the
4 additional transportation costs that the Postal Service incurs, or to expect the publisher to
5 recognize those costs.⁸ In the extreme, if service were not an issue and rates were not
6 dependent on distance, all printing could be done in Guam and the publisher could not be
7 faulted for making a bad decision. But publishers collectively would nonetheless suffer
8 from such decisions, because *all* of the handling and transportation costs for Periodicals
9 *are* attributed to Periodicals, even if they are not transcribed into rates that recognize
10 actual handling and distance. If all publications were printed in Guam, handling and
11 transportation costs for Periodicals, and, accordingly, all Periodicals rates, would be
12 exceedingly high, although no publisher or printer would be right to regard his own
13 choices as the reason for those high rates.

14 The implications are clear. In order for publishers and/or printers to make
15 efficient decisions about distribution methods and/or printing locations, and thereby to
16 bring about efficient, low-cost postal services, postal rates must reflect the Postal
17 Service's costs. The extent to which they do so currently is limited. Insofar as
18 unnecessary or inefficient transportation over long distances is concerned, the problem is
19 two-fold. First, due to the unzoned editorial pound rate, the postage paid does not reflect
20 the higher *transportation* costs associated with the higher zones. Second, as Periodicals

⁸ I am assuming that postage costs are included in printer's bids. Another possibility is for the printer to bid without postage and then somehow pass the postage through to the publisher. Either way, the publisher should be considering the postage.

1 rates have been developed thus far, neither does the postage paid reflect the higher *non-*
2 transportation costs associated with the higher zones.

3 Recognition of the importance of rates as signals for efficient behavior is not new.
4 In Docket No. MC95-1, where automation and bulk bypass were issues, the Commission
5 said that “[r]ates send economic signals to mailers,” that it “remains committed to
6 adapting mail classifications and . . . rates to the demonstrated cost savings resulting from
7 automated processing,” and that its decision would “encourage mailers to provide mail
8 that is compatible with automated processing and the bulk bypass of processing.” PRC
9 Op. MC95-1, pp. I-9-10, ¶¶ 1023-24. Rates that are better aligned with preparation
10 options and their associated costs, as proposed in this Complaint, would undoubtedly
11 have an effect on mailer decisions, whether it be on the sizes of the bundles, the
12 containers selected, the makeup and contents of the containers, or the entry points.
13 Mailer responses to these signals would make Periodicals more efficient as a subclass.
14 One of the purposes of this case is to help make that happen.

15

16 **D. Zoning the Editorial Pound Rate Will Not Reduce the Widespread Availability**
17 **of Periodicals and Will Treat Local and Regional Publications More Fairly**

18

19 1. History and purpose of the unzoned editorial rate

20 In the decades before the 1917 legislation on rates (40 Stat. 327, 328), several
21 postmasters general expressed concern that the extraordinarily low rate at which second-
22 class material was being carried (one cent per pound irrespective of distance) was a
23 serious drain on public revenues.⁹ “In 1901, Postmaster General Smith reported that the

⁹ In 1901 President Roosevelt noted that second class “composed three-fifths of the weight but paid only about \$4 million of the more than \$111 million it cost to operate the postal service.” *A Study of the Intent of Legislation on Second-Class Mail*, Rita L. Moroney, Research Administrator/Historian, United States

1 Government paid not less than 5 cents a pound for transportation of second-class matter
2 and at least 2 cents a pound for handling.”¹⁰ Transportation costs at that time, at least
3 relative to other postal costs, were obviously very large.

4 Following a detailed and exacting study of all 1908 postal costs, the Hughes
5 Commission found that 42.4 percent of second-class costs were for transportation (a
6 proportion that increased to 66.5 percent if costs characterized as “other transportation”
7 were added).¹¹ In contrast, transportation costs are now approximately 14.3 percent of
8 Periodicals costs, and only about two-thirds of these are distance-related.¹² If these
9 proportions are indicative, the importance of transportation costs then was at least three
10 times what it is now, and maybe higher than that.¹³

11 Despite the desire of the Post Office Department and two successive presidents
12 (Roosevelt and Taft) to do something about the situation, opposition from the
13 beneficiaries of the existing rate prevented anything from being accomplished until 1917,
14 when a Congress in urgent need of revenues to fund America's participation in World
15 War One acted to improve the alignment of second-class rates with costs.¹⁴ After

Postal Service, July 1977, p. 39. The magnitude of the sums involved can be inferred from the fact that total federal outlays in that year were \$525 million. *Political Facts of the United States: 1789*, ed. Erik W. Austin (Columbia U. Press, 1986), p. 450.

¹⁰ Quoted in The Report of the Commission on Second-Class Matter, Appointed Pursuant to the Joint Resolution of Congress, Approved March 4, 1911), contained in Message of the President transmitting The Annual Report of the Postmaster General for the Fiscal Year ending June 30, 1911 and The Hughes Commission Report, February 22, 1912, p. 65 (hereinafter Hughes Commission Report).

¹¹ Hughes Commission Report, at 127.

¹² Calculated from PRC Library Reference 9, Docket No. R2001-1. Only the distance-related transportation costs affect the relative levels of the zoned pound charges.

¹³ Operations then and now may be comparable in terms of average haul. The Hughes Commission Report shows an average haul for subscriber second class of 602 miles, *id.* at 84, and the Postal Service's CRA for Fiscal Year 1989, the last year average haul figures were developed, shows an average haul for Regular second class of 724 miles. Similar figures can be developed, however, from the Periodicals billing determinants and the average hauls by zone. Doing this for the test year in Docket No. R2001-1 yields 464.8 miles for all of Outside County.

¹⁴ The magnitude of the unexpected financial burden imposed on the federal government by World War One is indicated by the growth in total federal outlays from \$713 million in 1916, to \$1.95 billion in 1917,

1 extensive negotiation and compromise, a zoned rate structure was adopted for advertising
2 matter carried in second-class publications, with a lower, unzoned rate for editorial
3 matter.

4 The decision not to apply the zone rates but to arrange a low, clearly subsidized
5 rate for editorial matter was a compromise reached after publishers argued that applying
6 the zone rates uniformly would have deleterious effects on the distribution of
7 publications. The extremely low, unzoned rates for publications that had existed since
8 1885 had generated a powerful political constituency fiercely devoted to their
9 preservation, particularly the many highly successful nationally circulated publications
10 that tended to be edited and produced in the nation's great cities and to be transported
11 throughout the country virtually free of charge, courtesy of the Post Office. *The Saturday*
12 *Evening Post* and *The Ladies Home Journal* are familiar examples. It is therefore not
13 surprising that the arguments against zoning focused on the high costs of transportation
14 and raised the specter of a nation divided into separate regional publishing zones because
15 of cost prohibitive rates for mailing to subscribers in remote parts of the country.

16 When it last reviewed the question of zoning the full weight of publications, the
17 Postal Rate Commission emphasized similar concerns: "Witness Kielbowicz concludes:
18 'Public information found on the pages of periodicals should be just as accessible to the
19 residents of Washington State as to the residents of Washington, D.C.'" PRC Op. R90-1,
20 p. V-120, ¶ 5277. The *MOAA* court recognized that a concern of this kind, rooted in the
21 "rather broad anti-Balkanization principle" (2 F.3d 408, 436 (D.C. Cir. 1993)) expressed

\$12.7 billion in 1818, and \$18.4 billion in 1919. After 1919, federal outlays would not top the \$10 billion mark again until 1941. *Political Facts of the United States: 1789*, p. 451.

1 in the Act's definition of the Postal Service's purpose as "bind[ing] the Nation," prompted
2 the Commission's decision to maintain the unzoned editorial pound rate.

3 I do not see that a risk of publishing zones exists today. For one thing,
4 transportation costs are much lower than they were in 1917, making it highly unlikely
5 that publishers would find it profitable to drop subscribers in the higher zones.¹⁵ And
6 even in the unlikely event that zoning of the editorial pound rates were to cause some
7 zones to be disfavored or dropped by some publications,¹⁶ it is hard to see how, given all
8 of the other sources of information and avenues of communication now available, the
9 effect on the unity or cohesion of the nation could be significant.

10 Another factor that needs to be considered is the *funding* of the unzoned editorial
11 rate. Since the advertising rate appears to have been set at a level approximate to its
12 costs, any remaining shortfall in revenue had to be covered as part of the federal budget.
13 For all practical purposes, this continued until Reorganization in 1970. The situation
14 now, however, is that any relief in rates provided to one group of mailers is made up by
15 higher rates for other groups. Therefore, any evaluation of the effects of the unzoned
16 editorial rate on "bind[ing] the Nation" must include its effects on publications that are
17 disadvantaged by it, which would include all lower-zone publications. One well defined
18 group having this characteristic, as discussed further below, is local and regional
19 publications. The expectation would certainly be for them to print near their areas of

¹⁵ For a detailed analysis of why zoning the editorial rate would be unlikely, in current circumstances, to alter the overall geographical pattern of publication distribution, or to diminish the "widespread dissemination of information," see Appendix A.

¹⁶ It should not go unnoted that providing a subsidy to a wide group of publications in order to achieve certain behavior on the part of a small portion of that group is an extremely inefficient way to bring about a desired end, and should be avoided.

1 delivery, which leads currently to rates elevated by the benefit given to higher-zone
2 publications.

3

4 2. Impact of the unzoned editorial rate on local and regional publications

5 According to *The Magazine Handbook*, published by the Magazine Publishers of
6 America,¹⁷ there were 17,321 different magazine titles published in the year 2002.
7 *Handbook*, p. 4. In Docket No. R2000-1, the Postal Service indicated that there were
8 9,679 Nonprofit permits and 22,798 Regular permits, with an overlap of 1,218.¹⁸ These
9 numbers are large enough to contain subgroups of considerable size, an important one
10 being local and regional publications. Some of these publications are represented on the
11 Mailers Technical Advisory Committee by the City and Regional Magazine Association,
12 which has existed for 25 years and whose 87 member magazines have circulations
13 averaging in the range of 25,000 to 50,000. Most of the copies are delivered within a
14 given metropolitan area, and very few use In-County rates.¹⁹

15 The local and regional category includes publications devoted to particular
16 industries or professions, such as the eleven different construction magazines published
17 by McGraw-Hill, including *California Construction News*, *Colorado Construction*,
18 *Louisiana Contractor*, and *New York Construction News*,²⁰ publications centered on
19 individual cities, such as *Chicago*, *Cincinnati*, *Indianapolis Monthly*, and *Kansas City*
20 *Home Design*, state travel magazines, such as *Ohio* and *Wisconsin Trails*,²¹ college

¹⁷ *The Magazine Handbook* is available on MPA's website:

http://www.magazine.org/Government_Action/2408.cfm

¹⁸ See Docket No. R2000-1, interrogatory response CRPA/USPS-T38-3, Tr. 17/6959.

¹⁹ See <http://www.citymag.org>.

²⁰ See the McGraw-Hill web site <http://regionalpublications.construction.com/>.

²¹ See <http://www.magazinetime.com/categories-regional---local-mid-west.html>.

1 alumni magazines,²² regionally and locally oriented religious publications, and various
2 publications that cater to geographically concentrated ethnic communities or interest
3 groups, such as *The Baltimore Afro-American*.

4 Around the subclass average, a publication's implicit cost coverage is a function
5 of its proportion of advertising content, among other things. This reflects the recognition
6 of ECSI value. In order to abstract from this effect, and to allow balanced comparisons, I
7 assume that all local and regional publications have an average proportion of advertising
8 content. It follows that if they were average in other respects as well, their cost coverages
9 would all be equal to the average for the subclass. But these publications are not average
10 in other respects. Importantly, their final delivery occurs primarily in limited
11 geographical areas, regardless of where they are printed. I know of one city magazine
12 that is entered in zones 1 and 2. Ninety-four percent of its copies stay within those two
13 zones.

14 Another factor affecting publications' implicit cost coverages is their postal zone,
15 with respect to which local and regional publications may be viewed as falling into one of
16 two camps. Camp 1 is composed of publications printed in close proximity to their final
17 delivery area. These publications have short hauls and relatively high cost coverages.
18 They represent what would seem the natural and expected model for publications with
19 geographically concentrated subscriberships. Camp 2 is composed of publications
20 printed some distance from their delivery area and then carried to the delivery area by the
21 Postal Service. These publications have a substantial haul and relatively low cost
22 coverages.

²² The graduates of larger, more prominent schools that draw students from across the nation may be distributed widely, but there are thousands of smaller schools that draw largely from their own states and

1 Camp-2 publishers have made decisions to print some distance from their home
2 base. There is no reason to believe that these decisions were not rational, given the rates
3 they see. But these rates do not show them the full costs of their decisions and thus they
4 cannot be expected to make efficient decisions. Because the increase in postal rates
5 attendant to a decision to print at a distant location is less than the associated increase in
6 postal costs, Camp 2 publishers have unknowingly made decisions that imposed extra
7 costs on someone else. Camp-1 publishers, who are printing in close proximity to their
8 delivery area, are paying these extra costs, and thus are helping to finance longer-distance
9 mail.

10 Camp 1 publishers should not be discriminated against, and Camp 2 publishers
11 should not be blinded to the resource implications of their decisions. Both should be
12 given cost-based signals and then allowed to choose where to print. Those who decide to
13 print locally should not be required to pay elevated postal rates to help support publishers
14 who make different decisions or who mail more broadly.

15 The discussion thus far has assumed that local and regional publications have an
16 average degree of advertising content. This assumption is important to thinking clearly
17 about implicit coverages, cost-based rates, and the signals sent to mailers. But when one
18 begins to look at real situations and actual decisions, it is evident that the proportion of
19 advertising content is actually quite important. Consider, for example, a local publication
20 with little or no advertising, whose increase in postage with distance is therefore
21 negligible. The current rate structure puts the Postal Service in the position of saying:
22 “You can print your publications 3,000 miles from where your subscribers live if you
23 wish. We will carry it back at no additional charge. All of your freight will be paid by

communities, and whose graduates tend to remain much closer to home.

1 other mailers.” This is an extreme example of inappropriate signals in rates. In the case
2 of a *nationwide* publication distributed from one location, *some* of the copies will be
3 carried a considerable distance at no additional charge; in the case of a *local* publication
4 printed far from home, *all* of the copies will be carried a considerable distance at no
5 additional charge.

6 Publications whose subscribers are concentrated in limited geographic areas exist
7 naturally, because of who they are, and are not the result of plucking unusual
8 observations from the tail of a distribution. There is nothing random about them, and
9 they are not part of some kind of continuum that warrants averaging for rate purposes.
10 The local and regional grouping represents a legitimate focus and warrants attention. I do
11 not contend that this group should be singled out for any kind of preferred treatment, but
12 it certainly deserves to be treated fairly.

1 **IV. RATE DESIGN**

2 The rates developed in this section are for the Outside County subclass and are
3 aimed specifically at the weaknesses discussed in earlier parts of my testimony. In a
4 general sense, the costs of the mail are recognized in the rates, consistent with accepted
5 rate-design principles, in such a way that mailers are able to decide whether the value
6 they receive from higher-cost services is greater than the value they receive from lower-
7 cost services, after considering any costs they might incur to prepare their mail in one
8 way or another. Unless mailers are presented with the cost consequences of the decisions
9 they make, and unless they are given choices concerning preparation alternatives, it is not
10 possible for them to make decisions that result in the efficient use of the nation's
11 resources.²³ It is certainly the case that neither the Postal Service nor the Rate
12 Commission knows either the value that individual mailers receive from their use of the
13 mail or these mailers' costs of various preparation alternatives. But even if these values
14 and costs were known and understood, it would still not be possible to use them
15 effectively, on a mailer-by-mailer basis. Mailers, however, can do just that, given cost-
16 based rates.

17 More specifically, the rates developed here zone publications' full weight,
18 recognizing transportation costs according to the way they are incurred, and at the same
19 time recognizing alternatives associated with the preparation and usage of bundles, sacks,
20 and pallets. Mailers have alternatives in all of these areas, and it is accordingly important
21 that the cost-consequences of these alternatives be reflected in the rates. The non-

²³ Note that the postal costs associated with mailer decisions are costs not to the Postal Service only, but to the nation as well. It is not possible for the Postal Service to use resources to process and deliver the mail without the remainder of the nation giving up the use of those resources and the output associated with that

1 transportation portion of distance-related costs is reflected by allowing the charges for
2 containers to vary with the point of entry. As explained further below, for example, a 5-
3 digit sack entered at an origin facility receives more handling than the same sack entered
4 at a destination facility, such as an SCF.²⁴ Similarly, a 5-digit bundle in an ADC sack
5 receives more handling than the same bundle in a 5-digit sack.

6 In line with precedent, but with one modification, the degree of presortation is
7 recognized. The flow models developed by the Postal Service, which underlie the current
8 rates, give separate recognition to, among others, pieces sorted into mixed ADC bundles,
9 ADC bundles, and 3-digit/SCF bundles. Therefore, in order to follow costs, these three
10 presort levels are proposed. There is no change in recognition of sortation to the 5-digit
11 and the carrier-route levels, the latter including high density and saturation. For all
12 sortation levels except the carrier-route level, machinability is recognized, in addition to
13 the current recognition of prebarcoding. Note that the inclusion of SCF bundles in the
14 existing 3-digit category is consistent with the cost analysis on which the current rates are
15 based. For this reason, the costs behind the current rates are not well aligned with the
16 definition of the categories.²⁵

17 While recognizing the distinctions necessary to allow mailers to make efficient
18 decisions, the rates developed preserve to the maximum extent possible the
19 recommendations of the Commission in Docket No. R2001-1. Specifically, the rates
20 preserve all applicable discounts, are based on the same costs and the same cost studies,

use. When viewed in terms of other output forgone, the cost of inefficiently using resources for postal output becomes real indeed.

²⁴ Throughout my testimony, and in the proposed rate schedules, “origin” entry refers to entry at an office or other facility that is upstream of the destination BMC.

²⁵ There was no record evidence concerning this issue in R2001-1 and no indication that anyone focused on the problem. Now that it is clear, however, there is no reason not to recognize the issue in the rates. Indeed, costs are not available to properly support the former presort structure.

1 are revenue neutral, are based on the same volumes and billing determinants, and result in
2 the same cost coverage. Neither the In-County nor the Ride-Along rates are affected.
3 Existing palletization discounts are eliminated as separate rate categories, but the costs
4 avoided due to palletization are recognized more thoroughly and more uniformly via the
5 per-sack and per-pallet charges that vary by container type and entry point. As explained
6 below, three rate-design errors are corrected, one of which the Settlement Agreement
7 could have recognized.

8 An overview of the rates developed here should note that no argument is being
9 made, and no position taken, that any mailers *should* change the way they are preparing
10 their mail or that *all* mailers find themselves in situations where changes are feasible or
11 costless. Similarly, no position is taken that any mailers, given the rate signals and the
12 alternatives they currently face, are making poor preparation decisions. However, a
13 position *is* taken that mailers should be given cost-based signals in rates, and it *is*
14 believed that many mailers will then find it in their best interests to make changes.
15 Furthermore, the position *is* taken that these changes will improve the general situation of
16 Periodicals mailers as a class and the efficiency of Periodicals mail as a subclass.

17 The remainder of this section deals with specific topics important to the design of
18 the rates being proposed.

19 **Per-Piece Charges.** The per-piece costs, along with the associated volumes, are
20 provided by witness Stralberg, TW et al.-T-2. The volumes reconcile with those of the
21 Commission, as contained in PRC LR-9, Docket No. R2001-1. The top presort tier is for
22 pieces sorted into mixed ADC (MxADC or MADC) bundles. Within this tier, barcoding
23 is recognized, as in the current rates. Also, recognition is given to the machinability of

1 the pieces. Machinable pieces can be processed on the AFSM-100 and non-machinable
2 pieces (usually processed on the FSM-1000) cannot. The breakout, then, is non-
3 machinable (Non), machinable (Mach), barcoded non-machinable (Bar-Non), and
4 barcoded machinable (Bar-Mach).

5 Beyond this first tier, the tiers are ADC, 3-d/SCF, 5-d, and carrier route. Within
6 carrier route, high density and saturation are recognized, with discounts equal to those in
7 the current rates. The 3-d/SCF tier is slightly different from the current 3-digit tier, in
8 that it includes pieces sorted into SCF bundles.²⁶ This is done because the flow models
9 on which the current 3-digit discount is based include the costs for SCF pieces in the
10 costs for the 3-digit tier. One could argue, then, that the existing tiers are not defined
11 according to the costs behind them.

12 In Docket No. R2001-1, the rates recommended for barcoded pieces and carrier-
13 route presorted pieces recognized the associated *carrier* savings. Those savings were
14 derived from the carrier costing system and are not included in the costs developed by
15 witness Stralberg. In order to be consistent with the Commission's recommendations,
16 those savings are added to the differences derived from witness Stralberg's figures. The
17 savings for barcoded pieces are found in PRC LR-9, Discounts! cells D32-D53 (0.633
18 cents) and for carrier route in Discounts! cells D32-D59 (2.983 cents). Because the high
19 density and saturation rates are found by applying Commission discounts to the carrier-
20 route rate, no adjustments in them are required.

21 **Per-Bundle Charges.** The handling received by bundles depends on the makeup
22 of the bundles (whether they are mixed ADC bundles, ADC bundles, 3-d/SCF bundles, 5-

1 digit bundles, or carrier-route bundles) and the level of the container on (or in) which the
2 bundles reside. For example, a 5-digit bundle on an ADC pallet receives bundle sorts
3 before it is broken, while a 5-digit bundle on a 5-digit pallet does not. Within limits
4 allowed by Postal Service regulations, mailers have options concerning the sizes and the
5 makeup of bundles. Since the cost of bundle handling is relatively independent of both
6 the weight of the bundles and the number of pieces in the bundles, it is clear that makeup
7 can affect Postal Service costs. The charges shown are per bundle, depending on the
8 level of the bundle and its container.

9 **Per-Sack and Per-Pallet Charges.** Sacks are the traditional container for mail
10 and are handled in various ways. Pallets are more recent and are handled with lift trucks,
11 although pallet jacks are sometimes used. Intuitively, a cost is incurred each time a sack
12 or a pallet is handled, and this cost is relatively independent of both the weight of the
13 container and the number of pieces on (or in) it. Since mailers have options concerning
14 not only what kind of container to use but also container makeup, these costs should be
15 recognized in rates.

16 Sacks and pallets incur costs up to the point where their contents are removed and
17 processed further. Clearly, a container entered far from its destination receives more
18 handling than a container entered at its destination. Also, a container should not be
19 entered further downstream than its makeup. For example, an ADC container should not
20 be entered at a destination SCF, as it would then have to be hauled upstream to the ADC
21 for processing. The costs developed by witness Stralberg recognize the containers' levels
22 and entry points.

²⁶The Postal Service is expected to clarify preparation guidelines concerning 3-digit and SCF bundles. At the present time, there are relatively few SCF bundles. It may be that mailers will be required to exhaust

1 Because of their role in dropshipping activities, specific recognition in the
2 proposed rates is given to the destination BMC, the destination ADC, the destination
3 SCF, and the destination delivery unit (commonly DBMC, DADC, DSCF, and DDU,
4 respectively). Facilities not qualifying as one of these are categorized as “origin”
5 facilities. These include stations, branches, post offices, annexes, SCFs, P&DCs, ADCs,
6 and OBMCs.²⁷ Costs do vary according to which of these facilities are used, but they are
7 averaged, as in the current rates. Most mail is entered at larger facilities, and mailers
8 often respect Postal Service preferences on entry arrangements. The respective entry
9 points are recognized in the proposed rates for mixed ADC, ADC, 3-d/SCF, and 5-d/CR
10 containers.

11 **Zoned Pound Rates.** The zoned pound rates are developed according to
12 Commission procedures of long standing, with the modification that they apply to the
13 publications’ full weight. As usual, only the transportation costs are used in this
14 development, separated, as typically done, according to whether they are distance-related,
15 with the result that the *differences* in the zone rates reflect 100 percent of the variable
16 transportation costs between any two zones for which the difference is calculated.
17 Importantly, the higher zones do not pay any additional institutional costs relative to the
18 lower zones. The scheme is as follows: DDU entry pays no transportation costs; DSCF
19 entry and above pay non-distance-related transportation costs; and DADC and above pay
20 distance-related transportation costs.

the preparation of 3-digit bundles before preparing SCF bundles.

²⁷ In Docket No. R97-1, DBMC and OBMC facilities for Periodicals were referred to as Transfer Hubs. See Response of USPS to ABM interrogatory No. 6, Tr. 19A/8430. For dropship and other entry purposes, it is assumed that the Postal Service will specify the appropriate facilities for Periodicals, along with any submission requirements.

1 The first step in distributing the transportation costs is to develop a set of billing
2 determinants appropriate to zoning the full weight. This provides, for each entry point,
3 the weight in pounds of both the advertising and the editorial matter. Much of the
4 development needed was done by the Postal Service in Docket No. R2001-1 and is
5 contained in PRC LR-9. The calculations were done by recognizing that, even though the
6 *pounds* of editorial for DDU and DSCF entry are not reported separately, there has been a
7 *per-piece* discount for these entry points. Therefore, the number of pounds can be
8 estimated by multiplying the number of pieces by the per-piece weight. The Postal
9 Service also estimated the number of pieces entered in the DADC, so that the weight at
10 this entry point can also be calculated. For zones 1&2 through 8, the number of pounds
11 is estimated in my workpapers by assuming that pieces entered in these zones have an
12 average proportion of editorial content. The average proportion on a pound basis is used
13 for this calculation, not the piece-weighted average.

14 Normally, 100 percent of the distance-related transportation cost is distributed to
15 the zones, according to the proportion in each zone of total pound miles.²⁸ That is, 100
16 percent of the distance-related transportation cost is distributed on 100 percent of the
17 weight. Per-pound transportation costs by zone are then obtained by dividing the cost for
18 each zone by the total pounds in each zone. The *differences* among the zones in these
19 per-pound costs are preserved for advertising matter while, in order to cover other pound-
20 related costs and the benefit given to editorial matter, the absolute levels are increased.
21 Equivalently, 44 percent (approximating the proportion of the total weight that is
22 advertising) of the distance-related transportation costs could be distributed on 44 percent

²⁸ The average haul in miles for each zone is contained in PRC LR-9, which includes an average haul for DADC entry.

1 of the weight, and the *differences* would not be affected. In Docket No. R2001-1, however,
2 the Postal Service distributed 50 percent of the distance-related transportation cost on 44
3 percent of the weight, thus obtaining inflated differences among the zones and inflated
4 pound rates for higher-zone mail. When asked about this procedure in a Presiding
5 Officer’s Information Request (POIR), witness Taufique responded that “[d]istributing
6 approximately 44 percent of the transportation cost to the calculation of advertising
7 pound rates is more appropriate than the 50 percent allocation in the context of the Postal
8 Service proposal.” Response of witness Taufique to Question 3, POIR No. 5, Tr.
9 11C/4512. Strangely, this error was not corrected in the Settlement Agreement. The
10 problem, however, goes somewhat beyond the Commission’s question and Taufique’s
11 response. According to Taufique’s workpapers, only 40.47 percent of weight entered at
12 the DADC and above is advertising. Thus, 40.47 percent of the transportation cost
13 should be distributed to the advertising weight. In order to reduce the burden on higher-
14 zone mailers, indeed to reduce their rates so that they are aligned more fairly with costs,
15 this error is corrected in the rates being proposed.²⁹

16 Two other errors of the Postal Service in Docket No. R2001-1 are corrected. As
17 shown in PRC LR-9, Pound Data_Adv!, cell E57, the Postal Service withheld a portion
18 (0.4 cents per piece) of the DSCF pound-rate discount from DSCF-entered mail.³⁰
19 Correcting this error improves the alignment of rates and costs and is consistent with past
20 Commission recommendations. Also, on the same spreadsheet (see cells D58 and D59),
21 the Postal Service divided the transportation costs by only 75 percent of the weight of

²⁹ As developed in my workpaper WP-Mitchell-1F.xls, correcting this error would have resulted in a zone-8 pound rate for advertising of 56.6 cents per pound instead of the current 63.8 cents.

³⁰ Specifically, the reference to cell E49 should be removed from cell E57.

1 Science-of-Agriculture publications. Since the transportation costs are caused by the full
2 weight carried, the 75-percent restriction should be removed.

3 **Dropship Discounts.** In the current rates, dropshipping is recognized in several
4 ways. First, the pound rates for advertising are reduced according to the zone of entry,
5 including separate pound rates for DADC, DSCF, and DDU entry. Second, per-piece
6 discounts are offered for pieces entered at DADC, DSCF, and DDU locations. Third, an
7 increased pallet discount of one cent per piece is provided to dropshipped pallets. And
8 fourth, a special discount is added for a limited class of co-palletized pieces that are
9 dropshipped. All of these are based, in one way or another, on Postal Service savings.
10 However, not all of the savings for dropshipping are recognized. Specifically, no pound-
11 rate discount is provided for editorial, and no discount is provided to account for non-
12 transportation cost differences between the zone of otherwise entry and zones 1&2, the
13 latter being different for sacks and pallets. In addition, some of the discounts that *are*
14 given are not well aligned with costs.

15 The rates being proposed recognize dropship savings in both transportation and
16 non-transportation costs, in fairer, more balanced, and more appropriate ways. First, the
17 transportation savings are recognized in the zoned pound rates, which are proposed to
18 apply to the full weight of the mailing. Second, both the per-sack and the per-pallet
19 charges vary with the makeup of the container and, more importantly, with the entry
20 point of the container. Third, the per-bundle charges vary with the makeup of both the
21 bundle and the associated container. The rate schedule recognizes that a mixed ADC
22 container would not normally be dropshipped, and that an ADC container may or may
23 not be dropshipped. When the options are offered in this way, the question of

1 dropshipping is integrated with other alternatives mailers have, all of which have cost
2 consequences.

3 **Pallet Discounts.** As reviewed partially above, the current rates contain an
4 overlay of three pallet discounts. First, a one-half-cent per-piece discount is provided to
5 all pieces on approved pallets. Second, an additional one-cent per-piece discount is
6 provided to all pieces on dropshipped pallets. Third, effective April 20, 2003, as a result
7 of Docket No. MC2002-3, an even further discount of either one cent per piece or 0.7
8 cents per piece is provided, in order, for DSCF and DADC entry of qualifying *co-*
9 *palletized* pieces.

10 Generally, these discounts reflect costs in an uneven way and do not present
11 mailers with a true reflection of the cost consequences of their decisions. For example,
12 the savings on which the one-cent-per-piece discount (No. 2 in the previous paragraph) is
13 based exist whether or not the pallet is dropshipped, yet the discount is given only if the
14 pallet is dropshipped. This presents an unnatural incentive to remove potentially
15 attractive pallets from the Service's transportation system. Similarly, the savings on
16 which the co-palletization discount (No. 3 in the previous paragraph) is based exist for
17 both sacks and pallets, whether co-palletized or not, but the discount is given only for co-
18 pallets. In addition, on a per-piece basis, the cost of handling pallets as they move across
19 the country is less than the corresponding cost of handling sacks, but these differences are
20 not recognized at all. Finally, many, perhaps most, of the pallet savings are pound-
21 oriented; yet the discounts are given on a per-piece basis.

22 The recognition of pallets in the rates being proposed is uniform and cost-based,
23 as well as much simpler. It occurs implicitly through the per-sack and the per-pallet

1 charges that vary by container makeup and entry point. Mailers can make choices based
2 on container preferences, in view of the cost consequences of those decisions. At the
3 same time, the Postal Service will receive suitable compensation for handling containers,
4 including on its transportation equipment. No perverse incentives are provided.

5 **Recognition of Editorial Content.** In the past, editorial content³¹ has been
6 recognized in rates in two ways. First, editorial matter in all zones and at all entry points
7 has paid a pound rate that has generally been set at 75 percent of the pound rate for
8 advertising going to zones 1&2. Second, since Docket No. R84-1, a per-piece editorial
9 discount has been provided, which now equals 7.4 cents times the proportion of editorial
10 content. If a piece has 70 percent editorial content, a per-piece discount of 5.18 cents (7.4
11 $* 0.70$) is allowed.

12 The funding for these lower rates has been provided by increasing *all* Periodicals
13 rates, both pound and piece rates, both advertising and editorial. In support of the
14 unzoned editorial pound rate, all of the pound rates for advertising have been increased.
15 When the editorial rate was then set at 75 percent of the increased zones 1&2 rate, the
16 editorial rate became higher as well. In support of the per-piece editorial discount, the
17 piece rates have been increased. If an average piece had 50 percent editorial, for
18 example, all piece rates would be increased by 3.7 cents ($0.5 * 7.4$), and then the piece
19 with 70 percent editorial would receive the 5.18-cent discount. The net reduction in the
20 piece's postage would be 1.48 cents ($5.18 - 3.70$). This reduction becomes an add-on for
21 pieces with a lower-than-average proportion of editorial content. Although the form of

³¹ A definition of advertising is contained in the DMCS, which refers to content that does not qualify as advertising as non-advertising. Informally, non-advertising is often referred to as editorial. My testimony refers frequently to editorial content.

1 the per-pound editorial benefit is different in the rates being proposed, the funding
2 mechanism is the same.

3 Because of the lower rates provided to editorial matter, the cost coverage on
4 editorial matter has been considerably lower than the cost coverage on advertising matter.
5 As reference points, these “implicit” coverages can be calculated easily from the current
6 rates and the billing determinants behind them. Two packages of mail can be considered,
7 each identical in every way to the nation’s total Periodicals mailings for one year, except
8 that one is all editorial and the other is all advertising. The revenue for these two
9 packages can be calculated at current rates. The two revenues can be compared to the
10 costs for the year, it being the case that the costs of handling editorial and advertising are
11 the same. When this is done, it turns out that the current cost coverage on editorial is
12 84.7 percent and the corresponding coverage on advertising is 129.5 percent.³² On
13 average, the coverage is 101.3 percent. PRC Op. R2001-1, Appendix G, Schedule 1.

14 In the rates being proposed, these coverages on advertising and editorial matter
15 are maintained. Substantial deference is therefore provided to the educational, cultural,
16 scientific, and informational value of Periodicals, as required by § 3622(b)(8) of the Act
17 and as reflected in current rates. The current per-piece editorial benefit is maintained.
18 The per-pound benefit, currently skewed by distance, is provided in the form of a new
19 discount equal to 10.1 cents per pound of editorial matter. Arranging the editorial benefit
20 in this way does not favor some (longer-distance) editorial matter over other (shorter-
21 distance) editorial matter.

³² These cost coverages are calculated before accounting for the benefit for the preferred categories, which generally lowers the coverage by about one-half percentage point.

1 It is reasonable to ask why it would not be better to arrange a per-pound editorial
2 benefit by allowing a suitable percentage reduction to the total pound charges. This
3 would provide a discount proportionate to postage and, therefore, generally,
4 proportionate to costs incurred.³³ Such a proposal, however, fails on two counts. First,
5 the higher-zone publications, which would have the higher pound charges and therefore
6 the higher discounts, have not been charged any additional institutional costs. Therefore,
7 even at subclass coverages some distance above those that currently exist, these
8 publications, after the percentage discount, would be paying below-cost rates. Second,
9 and perhaps more importantly, the zone charges are recognized in the dropship discounts,
10 and giving a percentage postage reduction would effectively reduce those discounts to
11 levels below avoided costs. The end result, then, would violate the principles of cost-
12 based rates, lowest combined cost, and efficient component pricing, which are critical to
13 bringing about efficient mailer decisions.

14 The damage that would be done to discounts by a uniform percentage reduction
15 for editorial can be illustrated easily. Assume the base rate is 20 cents and the
16 worksharing activity saves 4 cents. The rate for workshared pieces should then be set at
17 16 cents. If both workshare and non-workshare mailers were given a discount of 10
18 percent, the non-workshare mailers would be paying 18 cents (20 cents less 10 percent of
19 20 cents) and the workshare mailers would, similarly, be paying 14.4 cents. The
20 difference between 18 and 14.4 is 3.6 cents, less than the savings of 4 cents (20 cents less

³³ The argument in favor of a percentage discount would be that it is somehow unfair for highly workshared publications to be given a percentage reduction for editorial content that is larger than the percentage reduction given to less workshared publications. But, as explained in the text, this argument runs up against difficulties.

1 4 cents = 16 cents; 16 cents less 10 % of 16 cents = 14.4 cents). The signal, then, would
2 be inappropriate.

3 **Deference to Higher-Zone Material.** The unzoned editorial pound rate has
4 clearly provided considerable deference to higher-zone publications, depending, of
5 course, on their proportions of editorial content. Indeed, they are generally carried below
6 cost. It is reasonable to ask how these higher-zone publications would be treated under
7 the rates being proposed. The answer is that they would be treated quite favorably. By
8 design, the higher-zone publications would pay only the *additional* costs associated with
9 distant entry, and no additional fixed costs. Relatively speaking, then, their rates would
10 tend to exceed their marginal costs by less than the rates of other mailers, and rates equal
11 to marginal costs are generally understood to be ideal. The result is a high form of
12 consideration.

13 **Proportion of Revenue from the Pound Rates.** The proportion of Periodicals
14 revenue obtained from the pound rates has declined over time to a current level about 40
15 percent. To some extent, this proportion has been as much an input to rate design as an
16 endogenous figure based on costs and billing determinants. The procedure has been to
17 begin with a revenue requirement for the subclass (equal to total cost multiplied by the
18 cost coverage), and to obtain 40 percent of that requirement from the pound rates.
19 Conversely, 60 percent of the requirement is obtained from the piece rates.³⁴

³⁴ When the procedure is mapped out in detail, account is taken of Ride-Along revenue and fees, plus the contingency and a small adjustment factor. Note that the proportion of revenue from the pound rates should be expected to change with the average weight per piece and therefore or should have been affected by the merger into Outside County of Nonprofit and Classroom. The result should also be affected by the discount received by Nonprofit and Classroom.

1 Of the revenue obtained from the pound rates, about 36 percent is accounted for
2 currently by transportation costs.³⁵ The remainder, to the extent that the rates are cost-
3 based, is accounted for by non-transportation costs that are pound-oriented.³⁶ To build
4 these non-transportation costs into the pound rates, as well as to recover the revenue loss
5 associated with the unzoned editorial pound rate, the usual procedure has been to develop
6 first-cut pound rates based on transportation costs alone, and then to add an additional
7 amount (23.8 cents per pound in PRC LR-8, R2001-1) onto each zoned rate. Doing this
8 does not affect the zone differences of the first-cut rates.

9 In the rates being proposed, some of these non-transportation costs (currently
10 viewed as pound oriented) are covered by the per-bundle, per-sack, and per-pallet
11 charges, as the associated costs are affected in some degree by weight. Therefore, in
12 order to maintain an appropriate level for the pound rates, I adopted a reduced proportion
13 for the pound rates, consistent with witness Stralberg's conclusion that about 30 percent
14 of the costs are pound-oriented, and obtained 70 percent of the revenue from the per-
15 piece, per-sack, and per-bundle charges. In effect, this assumes that 10 percentage points
16 of the revenues formerly obtained from the per-pound rates should be obtained from the
17 per-piece, per-bundle, per-sack, and per-pallet rates. This tie to the current rates seems
18 reasonable.

19 **Letter-Size Pieces.** The Outside County subclass contains a number of letter-size
20 pieces (hereinafter letters). Most of them, if not all, are prepared in trays, and any
21 associated use of bundles, sacks, and pallets is undoubtedly quite different from the use
22 of same by flats. Because of the differences in the way letters are handled and the

³⁵ Transportation costs are 14.3 % of total costs; 14.3% divided by 40% = 35.75%.

³⁶ One could argue that about 1.3 % of the pound revenue is a contribution to institutional costs.

1 associated inapplicability of the proposed charges for bundles, sacks, and pallets, it is
2 proposed that letters continue to pay the current rates.

3 Making this provision for letters requires an estimate of the amount of revenue
4 they generate, so that the remainder of the revenue requirement can be obtained from
5 non-letters. Postal Service Library Reference J-53 (R2000-1) shows that 4.3793 percent
6 of the total volume is letters. (See cell Class! G74 in spreadsheet SHP03U_1.xls.). A
7 partial breakdown of this proportion is contained in the billing determinants, which
8 provide the number of barcoded letters at each of the non-carrier-route presort levels.
9 The following assumptions were then made: (1) that there are no high density or
10 saturation letters; (2) that no pallet discounts are given for letters; (3) that no letters have
11 Ride-Along attachments; (4) that the ratio of letters to flats in the carrier-route category is
12 the same as the corresponding ratio for *all other* letters; (5) for the per-piece editorial
13 benefit and the per-piece discounts for DDU, DSCF, and DADC, that the number of
14 letters is equal to the billing determinant figure for these categories multiplied by the
15 proportion of letters in the subclass; (6) that letters are distributed among the zones in the
16 same proportions as the flats; (7) that letters in the Regular and the Classroom categories
17 weigh 2.5 ounces each; and (8) that letters in the Nonprofit category weigh 2.0 ounces
18 each.

19 Next, in order to complete the estimate, the ratio of barcoded letters to total
20 barcoded pieces was calculated for each of the non-carrier-route presort tiers, a factor was
21 applied to each of these ratios (the same factor for each ratio), and the result was applied
22 to the number of *non-barcoded* pieces in each tier. This factor, which was selected so
23 that the total number of letters came out at the correct level, turned out to be 48.13

1 percent. Thus, if 6 percent of the barcoded pieces in the basic presort tier are letters, then
2 the estimate is that 2.88 percent ($6\% * 0.4813$) of its non-barcoded pieces are letters. It
3 makes sense that the proportion of letters in the non-barcoded categories is lower than in
4 the barcoded categories, because: a) the incentive for letters to barcode is larger than the
5 incentive for flats, and b) the equipment necessary to barcode letters is cheaper and more
6 readily available. The calculations leading to the estimate of letter revenue are shown on
7 sheet Ltr BD! of file WP-Mitchell-2F.xls, in my workpapers.

8 **Nonprofit and Classroom Publications.** In P.L. 106-384, Congress amended
9 the Revenue Forgone Reform Act (RFRA) (P.L. 103-123) to require that Nonprofit and
10 Classroom Periodicals be given a 5 percent discount on their total postage bill, excepting
11 postage due to the advertising pound rates or for commingled pieces. This provision is
12 accommodated in the rates being proposed.

13 **Science-of-Agriculture Publications.** As provided in RFRA, Science-of-
14 Agriculture (SoA) publications pay pound rates on their within-zones-1&2 advertising
15 equal to 75 percent of the corresponding rate for Outside County publications. Under the
16 proposed rates, this provision is satisfied. In general, SoA publications will benefit from
17 the proposed rates, since they have a short average haul. The proportion of SoA
18 publications going to zones 1&2 (and closer) is 73 percent, compared to only 59 percent
19 for all Outside County publications. The corresponding proportions for zone 3 and closer
20 are 90 percent and 68 percent. Also, SoA publications are highly presorted, 59.4 percent
21 to carrier route, compared to a subclass average of 42.1 percent. In effect, under the
22 unzoned editorial rate, SoA rates have been increased to help pay the costs of higher-zone
23 publications, even though SoA publications are predominately lower-zone.

1 **Schedule of Rates.** The complete schedule of rates, consistent with the
 2 development described above, is shown below.

3

4 **Proposed Rate Schedule – Outside County Periodicals – Non-Letters**

PERIODICALS RATES									
Per Piece		Per Bundle		Per Sack		Per Pallet		Per Pound	
Bundle Level Piece Description		Container Level Bundle Level		Sack Level Entry Point		Pallet Level Entry Point		Distance (Zone) From Entry Point	
Bundle/ Piece	\$/Pc	Container/ Bundle	\$/Bundle	Sack/ Entry Pt.	\$/Sack	Pallet/ Entry Pt.	\$/Pallet	Entry Zone	\$/Pound
Mx. ADC		Mx. ADC		Mx ADC		ADC			
Non	0.440	MADC	0.260	Origin	1.53	Origin	40.44	DDU	0.145
Mach	0.310	ADC	0.320			DBMC	26.90	DSCF	0.166
Bar-Non	0.386	3-D/SCF	0.340			DADC	13.67	DADC	0.174
Bar-Mach	0.264	5-D	0.370	ADC				Z 1&2	0.191
ADC				Origin	3.25			Zone 3	0.206
Non	0.321			DBMC	2.37			Zone 4	0.244
Mach	0.275	ADC		DADC	1.29	3-D/SCF		Zone 5	0.301
Bar-Non	0.290	ADC	0.100			Origin	40.02	Zone 6	0.362
Bar-Mach	0.241	3D/SCF	0.170	3-D/SCF		DBMC	26.90	Zone 7	0.436
SCF/3-D		5-D	0.200	Origin	3.22	DADC	25.72	Zone 8	0.498
Non	0.307	CR	0.210	DBMC	2.37	DSCF	13.67		
Mach	0.260			DADC	2.02				
Bar-Non	0.280			DSCF	1.29				
Bar-Mach	0.230	3-D/SCF				5-D			
5-D		3-D/SCF	0.110	5-D/CR		Origin	42.39		
Non	0.233	5-D	0.180	Origin	3.30	DBMC	30.46		
Mach	0.210	CR	0.190	DBMC	2.78	DADC	24.58		
Bar-Non	0.225			DADC	2.10	DSCF	17.05		
Bar-Mach	0.194			DSCF	1.73	DDU	1.57		
CR Basic	0.121	5-D/CR		DDU	0.93				
CR HD	0.089	5-D	0.000						
SAT	0.081	CR	0.080						
Piece Sorting Delivery		Bundle Sorting		Sack Handling/Sorting Sack Opening Sack Return		Pallet Handling Pallet Opening Pallet return		Transportation Bulk Handling Some Piece Sorting Delivery	
Per-pound Editorial Discount, cents per editorial pound					10.1				
Per piece editorial discount, cents times editorial percent					7.4				
Per-piece charge for qualified Ride-Along pieces, cents					12.4				

5

1 **V. COMPLIANCE WITH REORGANIZATION ACT**

2 In addition to certain general policies, the Act identifies two specific sets of
3 factors that should be included in considerations leading to rates. One set is found in §
4 3622(b) and the other in § 3623(c). Although there is overlap, the former set is specified
5 as applicable to changes in rates and fees, and the latter set as applicable to “changes in
6 the mail classification schedule.” § 3623(b). In practice, the former set has received its
7 greatest scrutiny in regard to selecting markups for the various subclasses and services,
8 consistent with breakeven, as is typically done in omnibus rate cases. They are
9 important, then, as much or more in a relative sense as in an absolute sense.

10 The rates being proposed are guided by an interest in giving mailers more
11 appropriate signals. The belief is that such signals will bring about more efficient
12 decisions, which will improve the efficiency of the class, the lot of the mailers, and the
13 contribution that periodicals make to the nation. Practically speaking, the rates being
14 proposed recognize more effectively the costs of bundles, sacks, and pallets, and
15 associated interdependencies, including entry points, in a way that aligns operationally
16 with decisions mailers make. To an extent, then, the changes focus on the implicit
17 markups of mail categories (some of which may be viewed as new), a process the
18 Commission has indicated is at the heart of rate design.^{37 38} No changes in subclass
19 markups are proposed.

³⁷ The phrase “implicit coverage” (or “implicit cost coverage”) is used in rate proceedings to refer to cost coverages calculated for categories or other groupings of mail that fall *within* subclasses. Such coverages are usually expressed in percentage terms. The numerical value of an implicit coverage is not necessarily *implied* by anything other than that the numerator is the revenue of the category and the denominator is the corresponding cost. In percentage terms, the implicit *markup* equals the implicit coverage minus one hundred percentage points.

³⁸ See PRC Op. R2000-1, p. 390, ¶ 5533, where the Commission said: “Rate design for a subclass can be thought of as setting the implicit percentage markups for each rate category.”

1 Periodicals has long been regarded as the class with the most complex rate
2 structure. To the extent that this is true, it has been because of: a) the way in which rates
3 differ for editorial and advertising content and b) an interest in being at the forefront of
4 recognizing costs in rates.³⁹ At any particular time, however, cost recognition is limited
5 by the data that are available, the analysis that has been done, and our understanding of
6 the mail and its markets. Especially with the improved flow models now being used, our
7 perspective is much better than it was even a few years ago. Accordingly, this case can
8 be viewed as a significant step in the appropriate recognition of costs and in bringing
9 Periodicals into suitable alignment with the criteria in the Act.

10 It is not necessary to decide which set of criteria is most applicable to the changes
11 being proposed. Both sets are important in their own right and should be included, as
12 applicable, in all rate considerations. They are considered here. My discussion of these
13 criteria should not be viewed as legal opinion, as I do not claim expertise in that area. It
14 *is* my opinion, however, that the criteria primarily employ practical language and
15 economic terms of art, and that most, if not all, refer to concepts that are susceptible to
16 being understood by economists and rate practitioners. It is from this perspective that I
17 testify.

18 Section 3622(b) identifies nine specific criteria, listed below:

- 19 1. the establishment and maintenance of a fair and equitable
20 schedule;
- 21 2. the value of the mail service actually provided each class or type of
22 mail service to both the sender and the recipient, including but not
23 limited to the collection, mode of transportation, and priority of
24 delivery;
- 25

³⁹ Another point worth noting is that since all periodicals are required to have a frequency of publication and a list of subscribers or requesters, Periodicals mailings are to a considerable extent repetitive. Thus, once mailing arrangements are made, any associated efficiencies can be realized over and over.

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3. the requirement that each class of mail or type of mail service bear the direct and indirect postal costs attributed to that class or type plus that portion of all other costs of the Postal Service reasonably assignable to such class or type;
4. the effect of rate increases upon the general public, business mail users, and enterprises in the private sector of the economy engaged in the delivery of mail matter other than letters;
5. the available alternative means of sending and receiving letters and other mail matter at reasonable costs;
6. the degree of preparation of mail for delivery into the postal system performed by the mailer and its effect upon reducing costs to the Postal Service;
7. simplicity of structure for the entire schedule and simple, identifiable relationships between the rates or fees charged the various classes of mail for postal services;
8. the educational, cultural, scientific and informational value to the recipient of mail matter; and
9. such other factors as the Commission deems appropriate.

Section 3623(c) identifies six specific criteria that are to be included in the consideration of classification changes. They are:

1. the establishment and maintenance of a fair and equitable classification system for all mail;
2. the relative value to the people of the kinds of mail matter entered into the postal system and the desirability and justification for special classifications and services of mail;
3. the importance of providing classifications with extremely high degrees of reliability and speed of delivery;
4. the importance of providing classifications which do not require an extremely high degree of reliability and speed of delivery;
5. the desirability of special classifications from the point of view of both the user and of the Postal Service; and

1
2 6. such other factors as the Commission may deem appropriate.

3
4 Sections 3623(c)(3) through (c)(4) do not apply to this proposal. Also, §
5 3622(b)(5), focusing on alternatives, does not apply. The remainder of the criteria are
6 considered.

7 **Sections 3622(b)(1) and 3623(c)(1), Fairness and Equity**

8 In both sections, criterion number one indicates that consideration should be given
9 to the fairness and equity of the rates. Although fairness and equity are sometimes
10 viewed as existing in the eye of the beholder, and therefore as matters of opinion, there
11 are several generally accepted notions that are usually thought of as being indicated.
12 First, fairness and equity require that similarly situated mailers be treated similarly. I
13 believe the rates being proposed move strongly in the direction of meeting this
14 requirement. In accordance with widely accepted rate-design principles, they recognize
15 similarities and differences in bundle preparation, sack usage, and pallet usage. They
16 also recognize similarities and differences in entry patterns, entry points, and distance
17 transported. In addition, they reduce the extent to which mailers will find their rates
18 influenced in undesirable ways by the practices of dissimilarly situated mailers whose
19 rates do not reflect cost incurrence.

20 Another reflection of fairness and equity involves the extent to which the rates
21 reflect costs. On this point, the Commission has explained:

22 The Commission begins the rate design process assuming
23 equal implicit markups. This is a neutral starting position which
24 seems to be implied by § 3622(b)(1), a fair and equitable schedule.
25 It is consistent with the Commission's general policies that the
26 rates for each rate category be above cost; that rates reflect the
27 costs developed in the record; and that rate design results in
28 identifiable relationships between rate categories. Equal implicit

1 markups, however, are only a starting place, and often may not be
2 practical or appropriate.

3
4 The Commission bases worksharing discounts on avoided
5 costs. Basing discounts on avoided costs does not result in equal
6 implicit markups, rather it results in equal per-piece markups. It
7 also results in worksharing mail having higher implicit markups
8 than mail which is not workshared and the most heavily
9 workshared pieces (*i.e.* those with the largest discount) having the
10 highest implicit markups.

11
12 This approach to worksharing discounts is called “efficient
13 component pricing” (ECP) in the economic literature. The theory
14 requires the discount to be 100 percent of the cost savings. The
15 Commission tries to achieve 100 percent passthrough of the
16 worksharing savings, but again it frequently may depart from this
17 standard for a variety of reasons. An important virtue of ECP is
18 that the mailer will perform the workshared activity (*e.g.* presort)
19 when he can do so at a lower cost than the Postal Service. This
20 leads to productive efficiency (*i.e.* the most efficient provider does
21 the work resulting in the lowest cost to society). Because ECP also
22 lowers the real cost of mailing, volume should increase in response
23 to lower effective prices.

24
25 PRC Op, R2000-1, p. 390, ¶¶ 5533-35.

26
27 The rates being proposed reflect costs fairly and lead to implicit markups that are
28 consistent with notions of efficient component pricing and the appropriate recognition of
29 worksharing activities. The costs of bundles are recognized in the rates for bundles,
30 according to their makeup and the processing they receive. And the costs of sacks and
31 pallets are recognized in their rates, according to the way incurred. In all cases, the
32 makeup of the containers is recognized, consistent with their entry point. The converse
33 of developing implicit markups in this way is that it is fair for mailers to face in rates the
34 costs of their own mail and their own preparation decisions, and that it is fair for mailers
35 to see in rates a reflection of the resources absorbed by their mail.

36 There are three more notions of fairness that warrant note. First, it is fair to give
37 mailers tools for responding to the situations they face, and for influencing the market

1 into which they are essentially locked.⁴⁰ As explained earlier in my testimony,
2 Periodicals mailers have faced substantial rate increases for nearly two decades. They
3 have sought options for cooperating with the Postal Service in ways that would help both
4 sides. They have been willing to invest of themselves and make changes, if only given
5 the options and the appropriate signals. They have found themselves *with* the motivation,
6 but *without* the tools. The proposed rates provide mailers with a broader range of signals
7 relating to costs and resource usage. The rates place a little more of the outcome in the
8 hands of the mailers themselves, so they can do more than stand and watch. I believe this
9 is an inherently fair thing to do.

10 Second, to mailers that dropship, it is fair to provide a rate reduction equal to the
11 Postal Service's associated cost reduction. The existing rates are deficient in this regard;
12 the proposed rates are not. Costs mailers incur preparing and submitting their mail may
13 be irrelevant to determining economically efficient rate levels, but they are not irrelevant
14 to fairness. They point as well to the importance of assuring that accepted rate-design
15 principles are honored, such as those associated with efficient component pricing.
16 Besides, it seems unfair on its face for the Postal Service to find itself in the position of
17 saying: "We understand that you may dropship in order to meet subscriber needs and to
18 achieve a viable product, and we are giving you that option. But when you do it, your
19 reduction in rates will be considerably smaller than our reduction in costs, so that we will
20 be extracting a higher per-piece contribution than before, and your implicit markup will
21 be elevated far more than might be expected under accepted worksharing principles.

⁴⁰ The Private Express Statutes, as I understand they are interpreted, do not prevent rivals from competing with the Postal Service for the delivery of periodicals. However, the mailbox rule places a severe constraint on potential (and actual) private operators. If it were not for that rule, I am confident that private operators would be delivering a substantial portion of periodicals today.

1 Furthermore, we are going to use that extra contribution to help provide lower rates (in
2 many cases below-cost rates) to mailers who do not dropship.”

3 Third, it is an axiom of regulatory theory that the rates that would be generated by
4 the forces of a competitive market, were such a market possible, are fair and equitable
5 rates, and that regulation should tend to replicate such rates, where feasible. It seems
6 clear that competitive rates would be based on the costs of providing the service and that
7 the rates for mail entered at the destination would be based on the costs to accomplish
8 delivery from that point. Periodicals rates at the present do not meet this test, while the
9 proposed rates do.

10 **Sections 3622(b)(2) and 3623(c)(2), Value**

11 These sections refer in one way or another to the value of the mail matter and the
12 mail service to the sender and the recipient. The rates being proposed, along with the
13 associated rate structure, are designed specifically to allow mailers to focus on the value
14 they place on various kinds of service, and at the same time, on the costs to the Postal
15 Service and to the nation of providing those services. Consider sacks, for example. The
16 cost of handling a sack is relatively independent of the amount of mail in the sack. This
17 means that a sack could have one 5-pound bundle or several bundles totaling 30 pounds.
18 Under the proposed rates, the mailer using sacks can focus on the value of using the sack,
19 with various contents. If the sack is the preferred alternative and is worth the cost, the
20 mailer will use it, and will pay for the resources required. Importantly, and fairly, no
21 other mailer will be required to help finance that decision. On the other hand, if the
22 mailer decides on a different alternative, he will be able to evaluate that alternative in
23 view of its costs and the value placed on it.

1 Considerations of value are unique to each mailer. Neither the Postal Service nor
2 the Rate Commission can presume the value that various mailers place on various
3 alternatives. But when the cost of each service is reflected in the rates, each mailer can
4 make his own assessment, given his own value determinations. Nothing is wrong with a
5 mailer using a higher-cost service, as long as he is charged for that service. The Postal
6 Service, under these conditions, incurs the costs and passes them on to the mailer.
7 Neither the Postal Service nor the mailer would be better off if the mailer chose a
8 different service and the Postal Service's costs were lower.

9 **Section 3622(b)(3), Costs**

10 This section has been interpreted, for the most part, to require that *subclasses* of
11 mail recover their costs, with appropriate cost coverages. But, as the Commission noted
12 in Docket No. R2000-1, quoted also above “[r]ate design for a subclass can be thought of
13 as setting the implicit percentage markups for each rate category.” Op. p. 390, ¶ 5533.
14 Clearly, the interest in tracing costs goes well below the subclass level as, I believe, it
15 should. Indeed the contribution that the classification approach makes to the setting of
16 appropriate rates is that it helps provide a fair path to establishing rates for particular
17 mailpieces that recognize their costs and other appropriate factors. If the cost coverages
18 on particular mailpieces were found to be substantially higher than the coverage for the
19 subclass as a whole, or even if substantially lower, including the possibility of coverages
20 below 100 percent (indicating below-cost rates), a case could be made for inquiry into
21 whether the pieces are appropriately classified and rated. Much of the history of
22 ratemaking under the Reorganization Act has involved questions of whether new rate

1 categories (within subclasses) should be established and of how these categories should
2 be priced.

3 The Commission has often shown an interest in the cost coverages on particular
4 groups of mail within subclasses. For example, after considering the coverage on
5 Standard mail above and below the break point, it concluded:

6 The Commission hopes that reliable information on
7 implicit markups may make it possible to calculate the total
8 amount of revenue that should be obtained from pieces above and
9 from pieces below the break point. This would be an important
10 contribution to ensuring that intra subclass rate relationships for
11 Standard Mail are fair and equitable. The separate issue of the best
12 way to design rates for the pieces above and below the break point
13 might also be addressed by studying implicit markups.

14
15 PRC Op. R2000-1, p. 392, ¶ 5540.

16
17 Similarly, in regard to the Residual Shape Surcharge in Standard, on the same
18 record, the Commission said:

19 Several objections raised on this record were also presented
20 and resolved in Docket No. R97-1. In essence, these include
21 arguments that there is no cost coverage requirement below the
22 subclass level; that costs should not be “blended”; and that other
23 mailers have not objected to “averaged” costs. The Commission
24 has once again considered the validity of these arguments, but
25 finds no sound reasons to depart from its previous conclusions. In
26 general, the Commission continues to believe that overall
27 considerations of fairness and equity and an interest in cost-based
28 rates overcome opponents’ objections.

29
30 PRC Op. R2000-1, p.357, ¶ 5436.

31
32 The rates being proposed are designed to track costs within the subclass, and to do
33 so in a way that aligns with decisions mailers must make about their mail. They are in
34 line with interests the Commission has expressed in cost-based rates and in implicit
35 markups.

1 In addition to a general interest in tracking costs and in giving mailers appropriate
2 signals concerning the resource requirements of *their* subclass, improvements are made in
3 three specific categories within Periodicals that now have what may be called *deviant*
4 cost coverages. First, as discussed in the Rate Design section above, Science-of-
5 Agriculture publications have a much lower average haul than the Periodicals subclass.
6 They are, therefore, paying rates that are elevated in order to help finance discounts for
7 higher-zone mail. It would seem more reasonable for them to receive their
8 congressionally provided discount from a cost-based rate than from one that is elevated.
9 This end is achieved in the proposed rates.

10 Second, a more general perspective on the extent to which the Periodicals rates
11 track (or do not track) costs is provided by a comparison with In-County rates. Under
12 RFRA, the markup on In-County is one-half the markup on Outside County. The latter
13 being 1.3 percent, it follows that the former is 0.65 percent. Therefore, for all practical
14 purposes, both sets of rates are at cost. All In-County publications are entered at what is
15 essentially their destination. Therefore, the rate for DSCF-entered In-County
16 publications is an at-cost rate. We know, then, that if Outside County rates were cost
17 based, the rate for DSCF entered Outside County pieces would be near the corresponding
18 In-County rate, for there is little reason to believe that the costs of handling the pieces
19 would be different. It turns out, however, that the Outside County rate is in the
20 neighborhood of twice the In-County rate. This suggests that the low-zone rates for
21 Outside County Periodicals are elevated above costs to a degree that cannot be called
22 anything but excessive, and therefore that higher-zone periodicals have rates that are
23 substantially below costs.

1 Third, as discussed in Section III-D, local and regional publications as a group,
2 entered in their associated areas, are paying rates that are elevated to help provide lower
3 rates for higher-zone mail. And if these publications are printed and entered at distant
4 locations, they pay rates that do not recognize the Postal Service's additional costs, and
5 they thereby impose additional costs on other mailers. Nothing in this pattern of charges
6 relates the rates to the costs incurred. In fact, these publishers are part of the group
7 discussed in the previous paragraph, which is paying excessive rates, a situation
8 addressed by the proposed rates.

9 **Section 3622(b)(4), Effects of Rate Increases**

10 It has been common in rate proceedings to set rates in such a way as to temper the
11 effects on mailers that receive substantial increases. On the other hand, it is important to
12 take meaningful steps toward improved and meritorious rate positions.

13 The proposed rates will have effects on mailers and some of them may be viewed
14 as substantial, meaning, of course, that the mail involved has been the beneficiary for
15 some time of rate preferences. But the impact is limited. For one thing, the amount of
16 revenue obtained from the bundle, sack, and pallet charges, is only about 21 percent of
17 the total revenue requirement, and no markup is proposed on these charges. For another,
18 some of the effects are due to improvements in the piece charges, in that ADC
19 preparation is no longer averaged with mixed ADC and non-machinability is recognized.
20 Many small mailers will benefit from these changes. In addition, it may be important to
21 mailers of smaller quantities that a new DBMC dropship discount is proposed, that the
22 pallet discounts are not restricted to dropshipped mailings, and that improved dropship
23 discounts are proposed for pieces in sacks.

1 More importantly, however, the proposed rates focus on a range of cost-driving
2 factors over which mailers have control and to which mailers would be expected to
3 respond. In general, Periodicals mail is prepared using computers and commercially
4 available software. In using such, inputs and constraints must be selected, like sack
5 weight, pallet weight, bundle weights, and preferences relating to sack and bundle
6 makeup. In addition, mailers will face improved signals relating to machinability and
7 barcoding. If the reality of the costs behind these signals is hidden by excessive
8 tempering, mailers will not understand the cost consequences of their decisions and
9 efficient changes will not be made.

10 **Section 3622(b)(6), Preparation**

11 This criterion requires that consideration be given to the “degree of preparation of
12 [the] mail . . . by the mailer and its effect upon reducing costs to the Postal Service.”
13 The importance of this criterion, and the role it has played, is great. It has been the basis
14 and justification for a wide and still evolving range of worksharing discounts, which have
15 set the United States apart from most countries of the world.⁴¹ In addressing, as it does,
16 the general issue of “preparation,” its importance goes beyond issues of worksharing *per*
17 *se* and to issues of the nature of the mail itself, for the preparation of mail involves
18 decisions on bundles, containers, and entry points. These issues are addressed
19 specifically by the rates being proposed.

20 One of the great failures of the current rates is the extent to which they do not
21 allow mailers to see the cost effects or the efficiency implications of the decisions they

⁴¹ See: Elcano, Mary S., German, R. Andrew, and Pickett, John T., “Hiding in Plain Sight: The Quiet Liberalization of the United States Postal System,” in Michael Crew and Paul Kleindorfer, *Current Directions in Postal Reform*, pp. 337-52, 2000, Kluwer, Boston. Also, the Commission said: “The concept

1 make. Mailers cannot be expected to do what is best when they are given financial
2 incentives to do something different. Yet these same mailers are forced to live with the
3 cost implications of their decisions, because the rates they pay are ultimately based on
4 costs.

5 One could argue that mailers are hamstrung; they want to do something to help,
6 but are given no guidance. The proposed rates break through this blindness and allow
7 them to consider the efficiency improvements that are possible by aligning preparation
8 decisions with the value of the service and its associated costs. Mailers will be expected
9 to do nothing more than watch out for their own best interests, and at the same time reap
10 the efficiency benefits of being able to balance the benefits and the costs. The overall
11 efficiency of the Periodicals subclass should increase.

12 **Section 3622(b)(7), Simplicity**

13 This section is referred to, in shorthand, as focusing on simplicity and complexity.
14 But it goes on to highlight the importance of “identifiable relationships between the rates
15 . . . charged.” It is true that one could argue for simplicity at any cost. In fact, a postal
16 official, not especially knowledgeable in rates, once asked me: “Why don’t we just
17 charge them all a quarter and get it over with?”

18 As rates become simpler, however, fairness declines, the efficiency of the
19 subclass declines, costs get ignored and become inflated, mailers are given poor signals
20 concerning what is best to do, and rates increase. To their credit, Periodicals mailers
21 have not generally argued for simplicity. They use computers to prepare their mail and
22 are able to respond to the signals in rates.

of worksharing has been widely applied and is credited with helping the Service to attract expanding volumes of mail and to improve its productivity.” PRC Op. MC95-1, p. III-26, ¶ 3068.

1 The rates being proposed may appear complex, but they are orderly and
2 identifiable. Also, they are not adorned with special discounts, restrictions, or
3 surcharges. There are per-piece charges, per-bundle charges, per-sack charges, and per-
4 pallet charges. The charges depend in clear ways on the makeup and entry point of the
5 containers. The purpose of the charges is clear. The options of the mailers are also clear.
6 And, the charges are for things that mailers know and understand: mailers understand
7 presorting, barcoding, and machinability; mailers know how many bundles they have and
8 their makeup; mailers understand their usage of sacks and pallets; and mailers are keenly
9 aware of their entry points. Indeed, one of the great advances of recent years has been
10 the development of dropship software and the integration of such programs into trucking
11 operations.

12 Part of the attractiveness of the proposed rates is their freedom from the
13 complexities caused by the split nature of the pound rates that now exist. Under the
14 unzoned editorial pound rate, the rates are skewed away from costs in a way that presents
15 an endless array of anomalies and administrative difficulties. Several examples will
16 illustrate this point. First, printers see dropship discounts that depend on the proportion
17 of editorial content. Accordingly, two publications, identical except that one has more
18 editorial than the other, might have to be scheduled and handled differently. This causes
19 disparity in printing practices, for no apparent reason.

20 Second, discounts are difficult to arrange. In connection with the non-
21 transportation savings for DSCF and DDU entry in Docket No. R2000-1, witness
22 Taufique said:

23 The allocation of these non-transportation cost savings to pounds
24 and pieces is one area where my proposal differs from the R97-1

1 Commission methodology. Instead of a 50/50 split, the Postal
2 Service is proposing a 75 percent allocation of these cost savings
3 to piece-related discounts and only 25 percent to pound-related rate
4 reduction for DDU and DSCF entry. . . . On the pound side the
5 value of this discount diminishes because less than half of all the
6 pounds actually pay the zoned advertising pound rates. The piece
7 discount provides a more efficient vehicle to provide dropship
8 incentives because the value of the discount applies to every piece
9 regardless of the proportions of editorial and advertising contents.

10
11 USPS-T-38, pp. 9-10.

12
13 In support of its decision to continue its R97-1 method, the Commission observed:

14
15 It would seem, however, that if the savings are the same for
16 a container with many light-weight pieces as for a container
17 holding fewer heavy-weight pieces, then the savings are, in fact,
18 pound oriented. If, under these conditions, the discount is given on
19 a per-piece basis, the container with many lightweight pieces will
20 receive a discount larger than the Postal Service's savings and the
21 container with fewer heavy-weight pieces will receive a discount
22 smaller than the savings. The incentive thus provided would be for
23 mailers of lightweight pieces to dropship and receive an excessive
24 discount.

25
26 PRC Op. R2000-1, p. 437, ¶ 5684.

27
28 Third, there are complexities in the current pallet discount. In its Opinion in
29 Docket No. R2001-1, the Commission observed that the "consideration of pallet
30 discounts in previous cases has raised the possibility that associated savings, in terms of
31 transportation, may have a pound orientation and may vary with distance." (p. 109, ¶
32 3177). But it proceeded to recommend the per-piece pallet discount contained in the
33 Settlement Agreement. Under that arrangement, the discount is the same for a) heavy-
34 weight and light-weight pieces and b) pieces transported a short distance and those
35 carried long distances, even though the cost savings vary with both weight and distance.
36 There is no way that mailers can rationalize discounts of this kind. The proposed rates
37 turn these anomalies into understandable relationships.

1 **Section 3622(b)(8), ECSI Value**

2 The educational, cultural, scientific, and informational value of the materials in
3 the Periodicals subclass is recognized in two ways. First, the overall subclass is given a
4 low cost coverage of 101.3 percent. Second, the implicit coverage on editorial matter is
5 84.7 percent and that on advertising matter is 129.5 percent. These are values that
6 characterize the current rates, per the Commission’s recommendation in Docket No.
7 R2001-1, and it is not proposed that they be changed.

8

9 The proposed rates, if approved, will meet the statutory criteria, send effective
10 pricing signals to mailers, help to align mail preparation with mail processing, and
11 increase the efficiency with which mailer needs are met.

1 **Appendix A – A Model of Publishers’ Decisions**

2 Paraphrasing Kielbowicz slightly, additional light can be shed on the possibility
3 that the information on the pages of periodicals might become less accessible to residents
4 of Washington State than to the residents of Washington, D.C. by considering the
5 conditions that might lead to reduced accessibility. Specifically, it seems to me that in
6 order for information to be less accessible in the further zones than in the closer zones,
7 one of two possibilities would most likely have to occur. The first possibility is that a
8 publication might zone its subscription rates. The second is that a publisher might decide
9 to offer the publication to the closer zones only, to which the postage is lower.⁴²

10 The possibility that a publisher would, given a zoned editorial pound rate, decide
11 to adopt a subscription scheme under which the higher zones are charged more than the
12 lower zones is, I think, remote. The primary reasons for this remoteness are
13 administrative difficulties and customer confusion (and, maybe, customer anger). One
14 example would be that travelers purchasing a newsstand copy could not be told as easily
15 what the subscription rate might be in their hometown. Also, both gift subscriptions and
16 subscriber relocations would be more difficult. In addition, publishers view themselves
17 as having competitors in the further zones and tend to feel that an increase there would
18 impair their competitive position. Interestingly, support for my conclusion was provided
19 at a recent postal meeting wherein one publisher explained that he once tried such a
20 scheme and found it to be a disaster.

21 The second possibility, concerning a publisher disenfranchising further-zone
22 subscribers, is at the heart of questions the Commission raised about accessibility, and the

⁴² Other possibilities might be concocted, such as a change in the publisher’s basic business model. But most of these changes would be second-order in character and would most likely affect all zones.

1 court's notice of an anti-Balkanization principle. If a publisher were to decide to cancel
2 all subscriptions from the higher zones, and to refuse to accept new subscriptions from
3 those zones, then it might be the case that potential subscribers in those zones would be
4 cut off from the information in the publication. Of course, such a cut-off, shown below
5 to be unlikely, would be total only if the publication were unavailable in libraries, or on
6 newsstands, or on the Internet.

7 In order to investigate whether it would be likely that publications would drop
8 subscribers in the further zones, the following model focuses on the determinants of their
9 profitability. Once the model is developed, the effects on profits of dropping subscribers
10 in zone 8 can be examined.

11 The profit of a publication (Π) is equal to its total revenue (TR) minus its total
12 cost (TC):

13

14 (1) $\Pi = TR - TC$

15

16 The total annual *revenue* of a publication is equal to the subscription revenue plus
17 the advertising revenue, which can be expressed as follows:

18

19 (2) $TR = V * P_{SUB} + n * V * k * P_{ADV} * Q_{ADV}$

20

21 where: V = the volume of one issue = the number of subscribers

22 P_{SUB} = the average price of a one-year subscription

23 P_{ADV} = the posted rate for a one-page advertisement in one copy

1 Q_{ADV} = the number of pages of advertising in one copy
 2 k = a reduction factor from the posted advertising rate to account for
 3 discounts, commissions, and sales fees
 4 n = the number of issues per year

6 The total annual *cost* of the publication is equal to the cost of creating the editorial
 7 material (C_{ED} , for one issue) plus the cost of printing ($C_{PRT-AVG}$, the average per piece for
 8 one issue) plus the cost of mailing ($C_{MAIL-AVG}$, the average per piece for one issue) plus
 9 the average cost of account maintenance (C_{AM} , for one subscriber for one year, includes
 10 solicitation and billing and renewal) plus the cost of administration (C_{ADM} , for the
 11 publication for one year, assumed relatively fixed with respect to volume), as follows:

12
 13 (3) $TC = n (C_{ED} + V * C_{PRT-AVG} + V * C_{MAIL-AVG}) + V * C_{AM} + C_{ADM}$

15 The average cost of printing one issue can be viewed as having a fixed component
 16 (FC_{PRT}) and a marginal component (MC_{PRT}), so that $C_{PRT-AVG} = FC_{PRT}/V + MC_{PRT}$.
 17 The total postage for one issue ($V * C_{MAIL-AVG}$) can be expressed in terms of zones as
 18 follows: $V_{SCF} * C_{SCF} + V_{1-2} * C_{1-2} + V_3 * C_3 + \dots + V_8 * C_8$. The subscripts indicate
 19 DSCF or zone of entry, assuming no DDU or DADC entry. The total volume, V , shown
 20 above, is simply the sum of the subscribed volumes. Substituting, a detailed expression
 21 for the profit is obtained:

$$\begin{aligned}
(4) \quad \Pi &= (V_{SCF} + V_{1-2} + V_3 + \dots + V_8) P_{SUB} + n (V_{SCF} + \dots + V_8) k * P_{ADV} * Q_{ADV} \\
&- n C_{ED} - n FC_{PRT} - n (V_{SCF} + \dots + V_8) MC_{PRT} \\
&- n (V_{SCF} * C_{SCF} + V_{1-2} * C_{1-2} + \dots + V_8 * C_8) \\
&- (V_{SCF} + V_{1-2} + \dots + V_8) C_{AM} - C_{ADM}
\end{aligned}$$

The partial derivative of profit with respect to zone-8 indicates the increase in profit from adding a subscriber in zone 8, or the decrease in profit from dropping such a subscriber:

$$(5) \quad \partial \Pi / \partial V_8 = P_{SUB} + n * k * P_{ADV} * Q_{ADV} - n * MC_{PRT} - n * C_8 - C_{AM}$$

This equation is perfectly general. It says that if a subscriber is added in zone 8, the revenue for the year will increase by the subscription price plus the advertising revenue. These are the first two terms. Then, with negative signs, it says the cost will increase by the marginal cost of printing another copy, the cost of mailing a copy to zone 8, and the average cost of maintaining a new account, multiplied by the number of issues where needed. It can be seen that if the last three terms, which include the postage to zone 8 as the second term, are high, possibly because of high postage to zone 8 when the full weight of the publication is zoned, there is the possibility of the addition to profit being negative.

Some idea of the orders of magnitude involved in equation (5) can be obtained by thinking about a specific publication. Since it has been discussed in previous cases, I selected *The New Republic (TNR)* magazine for this purpose. The subscription price for

1 *TNR*, according to its website (www.tnr.com) is \$39.95 per year. The lowest rate I could
2 find on the Internet was \$34.95 per year (at www.magazinecity.net). In order to be
3 conservative, I used \$34.95 as an average. *TNR* is a weekly magazine, with 44 issues per
4 year. Thus, $n = 44$.

5 Mailing information, last provided in Docket No. R90-1 by witness Dearth, shows
6 the average weight of *TNR* to be 3.3 ounces and the average proportion of advertising to
7 be 23 percent.⁴³ A set of full-weight-zoned rates to go with this information is easy to
8 develop and, for the subclass, does not result in a rate increase. It results only in a set of
9 rates that is more cost based than the existing rates, with the same revenue. This is done
10 by applying the current advertising pound rates to the full weight, instead of to just the
11 advertising weight, and then returning any excess revenue through a per-pound discount
12 on editorial pounds.⁴⁴ In this way, the average benefit to editorial matter is not changed.
13 Based on the Commission's workpapers in Docket No. R2001-1, applying the advertising
14 pound rates in this way results in additional revenue of \$243,753,950, which, after
15 rounding, is equivalent to 10.1 cents per editorial pound. Thus, after applying the
16 advertising pound rates to the full weight of publications, a new discount is applied, equal
17 to 10.1 cents per editorial pound. Under these rates, assuming the pieces are presorted to
18 the 3-digit level, barcoded, and not on pallets, the postage for sending a copy to zone 8 is
19 \$0.3416.

⁴³ See answers of Jeffrey Dearth of interrogatories of ABP, 1-18, Docket No. R90-1, Tr. 27 part 2/13661-778. The zone distribution of pieces was provided as: SCF – 3677, z1-2 – 10,110, z3 – 20,221, z4 – 22,978, z5 – 10,110, z6 – 4,595, z7 – 1,838, z8 – 18,383.

⁴⁴ Developing full-weight-zoned rates in this way, instead of developing them from scratch, adds to the conservatism of the analysis of this appendix since, as explained in Section IV, there is an error in the development of the current rates that artificially elevates the zone-8 pound rate.

1 From the web site, I also calculated a price for advertising of 0.1291 \$/page
2 (assuming the ad is in 2 colors and is run 6 times). To check this, I calculated a similar
3 figure for *Business Week* and obtained 0.1024 \$/page. In order to be conservative, I used
4 the lower of these two figures, and neglected the fact that advertising sold in less than
5 full-page increments is sold at a higher price. To account for discounts, commissions,
6 and sales charges, I used a value for k of 0.5. There is no way of knowing what the
7 correct factor is.

8 To obtain the quantity of advertising, I applied the weight of 3.3 ounces and the
9 advertising proportion of 23 percent to a weight figure of 0.00288 pounds per page,
10 which recognizes that each sheet of paper has two sides.⁴⁵ To go with these figures, the
11 marginal cost of printing is estimated to be \$0.17 per copy.

12 Putting these figures into equation (5) shows that the additional profit from a
13 subscriber in zone 8 is $\$49.55 - C_{AM}$. This means that as long as the cost of account
14 maintenance is less than \$49.55, it will be profitable to add a subscriber in zone 8 or,
15 alternatively, that it will not be profitable to drop a subscriber in zone 8. The cost of
16 account maintenance is an average annual figure that includes the cost of obtaining and
17 renewing subscribers, billing, keeping records, and maintaining address files. The
18 difference between the realized subscription price (\$34.95) and the cost of account
19 maintenance is known in the publishing industry as circ net, short for circulation net, and
20 is frequently expressed as a proportion of the subscription price. As a proportion, circ net
21 might be in the neighborhood of 50 percent. Since a negative circ net ($\$34.95 - \49.55)

⁴⁵ This figure was obtained by weighing an issue of *Business Week* magazine (8.5 ounces) with 184 pages.

1 would be very unusual, it appears that adding a subscriber in zone 8 would be
2 profitable.⁴⁶

3 This analysis does not depend on a publication having paid subscribers. To get a
4 ballpark result for a controlled circulation publication, I looked at *Pit & Quarry*, a
5 monthly magazine. According to ABP's initial brief in Docket No. R90-1, it weighs 6
6 ounces. (p. 18). Its web site (www.pitandquarry.com) shows a subscription rate of
7 \$39.00 per year for unqualified subscribers, but I assumed an average of zero. A
8 circulation of approximately 24,000 is shown. The full-page advertising rate for a color
9 ad run 6 times is \$6,740, which gives a P_{ADV} of 0.2808 \$/page. I assumed 50 percent
10 advertising, a marginal printing cost of 31 cents per copy, and 0.00288 pounds per page
11 (as above). Assuming 3-digit presort and barcoding, the postage for a piece going to
12 zone 8 is 46.63 cents. The implied increase in profit for a subscription in zone 8
13 (equation 5) is $\$100.37 - C_{AM}$. In other words, as long as the cost of account
14 maintenance for one subscriber is less than \$100.37 per year, which is almost certainly
15 the case, it is profitable to add subscribers in zone 8.

16 It may be noted that *Pit & Quarry* has been publishing since 1916. Without
17 question, as far as I know, it makes a major contribution to its industry and is an
18 important publication. On the other hand, it views itself as existing in a competitive
19 marketplace. Its website shows a "competitive analysis" with comparisons to two other
20 magazines, *Rock Products* and *Aggregates Manager*. It emphasizes that *Rock Products*
21 has lost 3,245 qualified subscribers (15 percent of its circulation) in the last year.

⁴⁶ At a subscription rate of \$19.98, exactly one-half the published rate, the cost of account maintenance would have to be \$34.57 for zone 8 subscribers to be unprofitable. The conclusion in the text is unaffected.

1 There is another way, perhaps even more revealing, of bounding these estimates.
 2 If the profit level of a publication were extremely high, one would expect healthy
 3 subscription and advertising rates relative to costs, and that subscribers in all zones would
 4 be profitable. If there were a chance that a subscriber in zone 8 would be unprofitable, it
 5 would seem most likely in a situation where the profit level of the publication is zero.
 6 Therefore, it is illuminating to constrain the estimate of equation (5) such that the profit
 7 shown in equation (4) is zero. If this is done, by substituting the required relationship
 8 from equation (4) into equation (5), it turns out that the added profit for a subscriber in
 9 zone 8 is:

$$(6) \quad \partial \Pi / \partial V_8 = n * C_{ED}/V + n * FC_{PRT}/V + C_{ADM}/V + n * C_{MAIL-AVG} - n * C_8$$

13 For *TNR*, the cost of sending a copy to zone 8 has already been calculated as
 14 \$0.3416. The average cost of sending copies in the mail ($C_{MAIL-AVG}$) can be calculated
 15 using the above assumptions and the zone distribution provided by witness Dearth. The
 16 result is \$0.2878. Thus, the last two terms in equation (6) are $44 * (0.2878 - 0.3416)$
 17 dollars, or \$-2.37. Therefore, in order for the additional profit from adding a subscriber
 18 in zone 8 to be negative, it must be the case that the sum of: a) 44 times the per-copy
 19 editorial cost, b) 44 times the average fixed cost of printing a copy, and c) the annual cost
 20 of administration per subscriber, is in total less than \$2.37. I indicated above that the
 21 marginal cost of printing a copy is estimated to be about \$0.17. The corresponding
 22 average cost is about \$0.33, which means that the average fixed cost of printing
 23 (FC_{PRT}/V) is about \$0.16. This means that the term $n * FC_{PRT}/V$ by itself is $44 * 0.16 =$

1 \$7.04. Since the second term is \$7.04, the sum of the first three terms on the right is
2 certainly more than \$2.37. The conclusion is that it is profitable to add subscribers in
3 zone 8.

4 Just as was done for equation (5), this equation can be evaluated, at least roughly,
5 for *Pit & Quarry* magazine. Some of the required figures are given above. I assumed an
6 average postage equal to that for zone 4, which is 34.52 cents per piece, and an average
7 fixed cost for printing of 30 cents. The equation shows the addition to profit for an
8 additional subscriber in zone 8 to be $12 * C_{ED}/V + C_{ADM}/V + \2.15 .

9 The explanation for these results is reasonably simple, perhaps intuitive. The first
10 term on the right of equation six ($n * C_{ED}/V$) exists because the revenues (from
11 subscriptions and advertising) must be large enough to cover, among other costs, the cost
12 of creating the editorial content, but this cost does not depend on volume, so, to be
13 profitable, additional subscriptions do not need to contribute to this cost. The second
14 term on the right ($n * FC_{PRT}/V$) exists because the revenues must also be large enough to
15 cover the fixed costs of printing, but neither does this cost vary with volume, so, to be
16 profitable, additional subscriptions do not need to contribute to it either. The third term
17 on the right (C_{ADM}/V) exists because the revenues must be large enough to cover the
18 administrative costs of publishing, but these costs too are fixed, so, to be profitable,
19 additional subscriptions do not need to contribute to them. In effect, the revenue from the
20 new subscriptions is the same as the revenue from the existing subscriptions, but it needs
21 to cover only the low marginal cost of printing, the additional postage (which is
22 somewhat higher than average, due to it being in zone 8), and the additional cost of
23 maintaining another account, which is the same as the cost of maintaining the existing

1 accounts. The new subscriptions, although they provide revenue just like the other
2 subscriptions, do not have to contribute to the cost of creating editorial, the fixed cost of
3 printing, or the administrative costs. Under these conditions, they are bound to be
4 profitable. Subscriptions will be accepted from zone 8 subscribers and there is no
5 incentive to disenfranchise persons living there. The higher postage costs in zone 8,
6 when the editorial matter is zoned, are not high enough to overcome the fact that so many
7 costs are fixed.

8 One of the factors contributing to this outcome is that transportation costs today
9 are a much smaller portion of total costs than they were in 1917. Due to piece rates, the
10 source of about 60 percent of Periodicals revenue, pound rates play a much smaller role
11 in determining postage charges than they did in 1917. The increase in postage, even for
12 zone 8, that would be occasioned by zoning publications' full weight is much smaller
13 than it would have been in 1917, and, since deferential rates are now financed by other
14 rates within the same subclass, would be partially offset by lower pound charges in the
15 lower zones.

16 This result is directly responsive to the Kielbowicz concern for the residents of
17 Washington State. The analysis shows that his standard is met just as well with zoned
18 editorial pound rates as with unzoned editorial pound rates. No subscriber will be
19 disenfranchised by zoning the full weight of publications.

CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing document upon all participants of record in this proceeding in accordance with § 12 of the rules of practice.

s/ _____
Timothy L. Keegan

April 26, 2004
Washington, D.C.