

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

POSTAL RATES AND FEE CHANGES, 2005)

Docket No. R2005-1

Direct Testimony of

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Concerning

STANDARD ENHANCED CARRIER ROUTE MAIL

On Behalf of

VALPAK DIRECT MARKETING SYSTEMS, INC. AND
VALPAK DEALERS' ASSOCIATION, INC.

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AUTOBIOGRAPHICAL SKETCH

My name is John Haldi. I am President of Haldi Associates, Inc., an economic and management consulting firm with offices at 488 Madison Avenue, New York, New York 10022. My consulting experience has covered a wide variety of subjects for government, business and private organizations, including testimony before Congress and state legislatures.

In 1952, I received a Bachelor of Arts degree from Emory University, with a major in mathematics and a minor in economics. In 1959, I received a Ph.D. in economics from Stanford University.

From 1958 to 1965, I was an assistant professor at the Stanford University Graduate School of Business. In 1966 and 1967, I was Chief of the Program Evaluation Staff, U.S. Bureau of the Budget. While there, I was responsible for overseeing implementation of the Planning-Programming-Budgeting (“PPB”) system in all non-defense agencies of the federal government. During 1966, I also served as Acting Director, Office of Planning, United States Post Office Department. I was responsible for establishing the Office of Planning under Postmaster General Lawrence O'Brien, where I established an initial research program, and hired the initial staff.

1 I have written numerous publications. Among those publications
2 dealing with postal and delivery economics are an article, "The Value of
3 Output of the Post Office Department," in *The Analysis of Public Output*
4 (1970); a book, *Postal Monopoly: An Assessment of the Private Express*
5 *Statutes*, published by the American Enterprise Institute for Public Policy
6 Research (1974); an article, "Measuring Performance in Mail Delivery," in
7 *Regulation and the Nature of Postal Delivery Services* (1992); an article
8 (with Leonard Merewitz), "Costs and Returns from Delivery to Sparsely
9 Settled Rural Areas," in *Managing Change in the Postal and Delivery*
10 *Industries* (1997); an article (with John Schmidt), "Transaction Costs of
11 Alternative Postage Payment and Evidencing Systems," in *Emerging*
12 *Competition in Postal and Delivery Services* (1999); an article (with John
13 Schmidt), "Controlling Postal Retail Transaction Costs and Improving
14 Customer Access to Postal Products," in *Current Directions in Postal*
15 *Reform* (2000); an article (with John Schmidt), "Saturday Delivery: Who
16 Provides? Who Needs It?" in *Postal and Delivery Services: Pricing,*
17 *Productivity, Regulation and Strategy* (2002); and an article (with William
18 J. Olson), "An Evaluation of USPS Worksharing: Postal Revenues and
19 Costs from Workshared Activities," in *Competitive Transformation of the*
20 *Postal and Delivery Sector* (2004).

1 I have testified as a witness before the Postal Rate Commission in
2 Docket Nos. R2000-1, R97-1, MC96-3, MC95-1, R94-1, SS91-1, R90-1,
3 R87-1, SS86-1, R84-1, R80-1, MC78-2, and R77-1. I also have
4 submitted comments in Docket No. RM91-1.

1 **I. PURPOSE OF TESTIMONY**

2 This testimony has three purposes. The first is to explain why the
3 Commission’s methodology for developing attributable costs for ECR
4 Saturation letters and flats should correct the costing of detached
5 address labels (“DALs”) by (i) giving explicit recognition to the costs
6 caused by processing and delivering DALs, (ii) removing all costs of DALs
7 from the costs attributed to letters, and (iii) attributing all costs of DALs
8 to the nonletter mailpieces that they accompany.

9 The second purpose is to explain why the Postal Service’s current
10 cost systems fail to develop correct estimates of marginal costs in
11 situations where it has low-cost capacity that is constrained, and to
12 propose a better method for estimating marginal costs under such a
13 condition.

14 The third purpose is (i) to propose an alternative method for
15 estimating the volume of DALs currently in the system, and (ii) to develop
16 an alternative estimate of the volume of DALs to use when attributing
17 their costs to the mailings that they accompany.

1 **II. INTRODUCTION**

2 This testimony is presented on behalf of intervenors Valpak Direct
3 Marketing Systems, Inc. ("VPDMS") and Valpak Dealers' Association,
4 Inc., hereinafter collectively referred to as "Valpak." As described more
5 fully below, Valpak's mail primarily consists of letter mail sent at the
6 Standard Mail Saturation rate.

7 VPDMS is the nation's largest firm in a subset of the hard-copy,
8 direct mail cooperative advertising industry which is sometimes referred
9 to as "coupons in an envelope." Headquarters offices are located in
10 Largo, Florida. VPDMS is a wholly-owned subsidiary of Cox Enterprises,
11 Inc. of Atlanta, Georgia.

12 **VPDMS Mailing Practices**

13 VPDMS entered 505 million pieces of its own mail in the United
14 States in 2004, and is estimated to mail 517 million pieces during the
15 year 2005. In addition, it entered more than 42 million pieces under
16 contract for various clients in 2004.

17 More than 95 percent of VPDMS' mailings use letter-shaped
18 number 10 envelopes, while less than 5 percent use letter-shaped 6" x 9"
19 envelopes. The average weight of a VPDMS piece is about 2.5 ounces.

1 All are trayed by VPDMS for individual carrier routes and entered at the
2 Standard A Mail ECR Saturation Rate.

3 In business for more than 37 years, VPDMS operates throughout
4 the United States through approximately 179 U.S. franchisees, which are
5 members of the Valpak Dealers' Association, Inc. The work of these
6 franchisees is supplemented by efforts of approximately 1,200 sales
7 representatives. VPDMS' mailings reach 43.9 million households in the
8 United States each year. Its mailings can be highly targeted to meet the
9 marketing needs of even the smallest retail businesses. This is
10 accomplished by Valpak's geographic advertising plan, which divides the
11 country into thousands of "Neighborhood Trading Areas" ("NTAs"), most
12 consisting of approximately 10,000 residences. These NTAs are built
13 around neighborhood purchasing patterns, taking into account factors
14 such as traffic zones and natural barriers, such as rivers. Through this
15 NTA construct, businesses can precisely target for advertising purposes
16 those geographic market segments that are most economically attractive.
17 Advertisers may purchase coverage for the entire nation, or any number
18 of NTAs, from several thousand down to only one.

19 Most franchisees mail at least 10 times per year, with many offices
20 mailing on a monthly schedule.

1 Each year, more than 80,000 individual advertisers purchase ECR
2 Saturation advertising with VPDMS. Some of these advertisers are
3 national or regional businesses, but the vast majority are small, local
4 businesses.

5 Once an advertiser places an order with a VPDMS franchisee for
6 distribution of a particular coupon to a particular geographic area with a
7 particular frequency, the order is directed to Valpak's corporate
8 headquarters in Largo, Florida. There, the graphics for the coupon are
9 created. VPDMS fashioned as many as 295,000 advertising layouts in
10 2004 and projects to layout more than 320,000 in 2005.

11 After review and approval by the advertiser, the coupons are
12 printed in either Largo, Florida or Elm City, North Carolina. Printing
13 may be simple, involving only one color, or may involve sophisticated,
14 four-color printing.

15 VPDMS has been encouraged by the Postal Service to put delivery
16 point barcodes on all of its mail. At present, 100 percent of VPDMS' mail
17 is walk sequenced Delivery Point Barcoded. VPDMS incurs additional
18 computer charges as a result of adding the delivery point barcode to
19 mailing lists that have only ZIP + 4 information. VPDMS works closely
20 with firms supplying mailing lists to ensure that it buys the cleanest and
21 most up-to-date lists available anywhere. For example, when the Postal

1 Service changes boundary lines, these lists are updated by list
2 companies supplying VPDMS within the next bimonthly update from the
3 Postal Service.

4 Also, for more than 10 years, VPDMS has participated voluntarily
5 in Postal Service tests, such as those involving traying letter-shaped
6 carrier route mail and palletizing trays, despite the fact that these
7 procedures have caused VPDMS to incur additional costs. VPDMS has
8 been a national test site for such tests. Since such traying became
9 mandatory, VPDMS has been in full compliance.

10 Virtually all of VPDMS' mail is transported by truck at VPDMS'
11 expense, of which 99 percent is entered at the destinating SCF. The
12 remainder is entered at BMCs, or locally, in either St. Petersburg, Florida
13 or Elm City, North Carolina.

14 VPDMS advertisers require that the Valpak mail be delivered in a
15 timely fashion. For example, if a pizza carry-out firm issues \$1-off
16 coupons to be delivered during a particular week, it must anticipate the
17 additional business generated by purchasing additional ingredients and
18 hiring additional staff. If the mail is delivered too early, the client may
19 not be prepared, or if late, the extra ingredients can be wasted and the
20 staff can stand idle.

1 Several other national and regional firms around the country are
2 known to operate in a manner similar to that of Valpak. Money Mailer of
3 Manhattan Beach, California, is believed to be the second largest such
4 firm, followed by many others, such as SuperCoups in Taunton,
5 Massachusetts, United Marketing Solutions in Springfield, Virginia, and
6 Trimark in Wilmington, Delaware. Many competitors operate only in
7 limited geographic markets.

1 **III. ADJUSTMENTS TO ECR COSTS NEEDED ON ACCOUNT OF**
2 **DETACHED ADDRESS LABELS**

3 Saturation non-letter mail may contain (i) addressed pieces, such
4 as ordinary catalogs, or (ii) unaddressed pieces, provided that such
5 pieces are accompanied by a letter-shaped detached address label that
6 complies with specifications contained in the Domestic Mail Manual
7 (“DMM”). As explained herein, unaddressed mailings with DALs can
8 receive handling that differs from that received by addressed flats, which
9 in turn gives rise to certain problems and issues in cost development.

10 **A. Detached Address Label Mailings**

11 Within ECR, a DAL can accompany non-letter-shaped pieces,
12 which can be either flats or parcels.¹ Flat-shaped pieces most commonly
13 mailed with DALs are a collection of loose (unbound) pieces enclosed
14 inside a folded host piece, which the DMM refers to as a “cover,” “short
15 cover,” or “protective cover.”² The only limit on the number of enclosures
16 within the host piece is that the entire piece may not exceed the

¹ Institutional response to VP/USPS-T30-18 (Tr. 8/____). DALs are not permitted with letter-shaped pieces.

² See Docket No. R2001-1, response to VP/USPS-T31-2 (Tr. 8/1684), which also states that “[c]onversationally, these pieces may be referred to by mailers as ‘wraps,’ ‘half covers,’ or other terms.” The term “cover” will be used herein. Overall size of the cover may not exceed the size limits for flats, as specified in DMM 602.4.0.

1 maximum thickness for an ECR flat.³ All Standard ECR Saturation
2 parcels are required to be merchandise samples and must be mailed with
3 DALs.⁴

4 **B. Recording of Detached Address Label Mail Upon Entry**

5 When saturation non-letter mailings with DALs are entered with
6 the Postal Service, the Revenue, Pieces and Weight (“RPW”) system
7 credits non-letters with all revenue. Consistent with this treatment, the
8 RPW system records the volume of all such mailings as the number of
9 non-letter items only; *i.e.*, the DAL and accompanying piece are counted
10 **as only one item** in the RPW database and RPW reports. Accordingly, if
11 a mailing consists of 1 million DALs and 1 million accompanying covers,
12 the RPW system records the volume of the mailing as 1 million non-
13 letters.⁵

14 The RPW system does **not distinguish** between (i) mailings of
15 unaddressed ECR flats accompanied by DALs, and (ii) mailings that

³ See Docket No. R2001-1, response to VP/USPS-T31-3 (Tr. 8/1685).

⁴ The vast majority of all DAL mailings consist of saturation flats, but certain other items in Periodicals, Standard Mail, and Bulk Printed Matter also may be entered with DALs. See responses to VP/USPS-T30-18b-c, and VP/USPS-T30-28b (Tr. 8/___ and Tr. 8/___, respectively).

⁵ See Docket No. R2001-1, response to VP/USPS-T4-6 (Tr. 3/337).

1 consist of addressed ECR flats, such as catalogs. Thus, the RPW system
2 neither counts nor records the volume of DALs, and it would be correct
3 to say that the volume of DALs is disregarded by the RPW system.
4 Moreover, none of the Postal Service's other data systems contain any
5 information about the volume of saturation flats accompanied by DALs.
6 Consequently, none of the Postal Service's data systems contain any data
7 that identify the total annual volume of DALs handled each year. As
8 discussed below, this is an important void in the data system. Because
9 of this void, the Postal Service in this case has undertaken an initial ad
10 hoc effort to estimate the annual volume of DALs. That estimate, and the
11 procedure used to derive it, are discussed in the Appendix.

12 **C. Need for Consistency in Recording Revenues and Attributing**
13 **Costs**

14 In order to estimate accurately the unit cost of individual rate
15 categories, such as saturation letters and flats, costs must be attributed
16 to each respective rate category consistent with the way revenues and
17 volumes for each rate category are recorded. When costs are not
18 attributed consistently with respect to the way revenues and volumes are
19 recorded, the result is a mismatch, or inconsistency, in the data.⁶ When

⁶ See responses to VP/USPS-T16-7(a) and 19 (Tr. 7/2860-62 and
(continued...))

1 a rate category is affected by such a mismatch, the resulting unit cost
2 will not provide an accurate estimate of marginal cost, which is what the
3 Postal Service aspires to use when setting rates.⁷

4 The first docket to establish ECR rates, Docket No. MC95-1, used
5 modeled costs to develop bottom up costs for each rate category. That
6 procedure had an internal consistency that avoided any mismatch
7 between the costs of letters and flats. However, in each successive
8 docket (Docket Nos. R97-1, R2000-1, and R2001-1), this mismatch
9 occurred when, for ECR DAL mailings, (i) the RPW system recorded all
10 revenue and volume as being derived from flats, and (ii) both the city and
11 rural carrier cost systems distributed to letters certain costs attributable
12 to handling DALs.⁸

13 It makes no sense to distribute to letters any of the costs
14 attributable to DALs, when the RPW system always classifies the revenue
15 and volume of every DAL mailing solely as non-letters. The effect of this
16 mismatch has been to (i) **overstate** the unit costs of letters,

⁶ (...continued)
7/2882-87, respectively.)

⁷ See library reference USPS-LR-K-1, App. H.

⁸ The unit cost data developed by the Postal Service in Docket No. MC95-1 were not similarly biased because their unit cost development was based on modeled cost, not sample data. This mismatch was first identified by Valpak in Docket No. R2001-1, and resulted in a small adjustment to saturation letter rates in the settlement agreement.

1 (ii) **understate** the unit cost of nonletters, and (iii) thereby bias
2 downward the letter/flat cost difference used for ratemaking within the
3 saturation rate category. The letter/flat cost difference is a key
4 determinant, through the presort tree, of relative rate levels within ECR.
5 The systematic bias from the mismatch in the underlying data identified
6 here explains some of what has appeared to be a decline in the shape-
7 based cost differences since Docket No. MC95-1.⁹

8

9 **D. Costs of DALs in Cost Segment 7 (City Carrier Street Time)**
10 **and Cost Segment 10 (Rural Carriers)**

11

12 The mismatch described in the preceding section arises from the
13 way certain data used for cost attribution are systematically recorded.
14 As noted above, DALs are **not** counted or recorded in the RPW system,
15 which credits to non-letters the revenue and volume from all ECR pieces
16 mailed with DALs. At the same time, in both the city and rural carrier
17 cost systems DALs **are** counted — as letters.¹⁰ The city carrier mail
18 count includes both the number of DALs and the accompanying covers,
19 because carriers must handle each DAL when on the street. Likewise, in
20 the national rural mail count used to attribute rural carrier costs, the

⁹ For commercial ECR, using PRC costs, at the Basic level the difference was 2.5299 cents in Docket No. R97-1, 0.849 cents in Docket No. R2000-1, and 0.251 cents in Docket No. R2001-1.

¹⁰ Response to VP/USPS-T30-20(c) (Tr. 6/2377-78).

1 DAL and the accompanying non-letter piece each incurs time credits that
2 translate directly into costs, and costs associated with handling DALs are
3 attributed to letters. The resulting mismatch, with all revenues and
4 volumes being credited to non-letters, but some of the costs being
5 attributed to letters, is an inconsistency which long has been in need of
6 correction.

7 Those who record the mail count data are not instructed to
8 distinguish between DALs and ordinary letters. Consequently, the
9 problem has been recurring and continues to this day. Furthermore,
10 since the problem arises from the way the data are recorded, the end
11 result would not be improved by expanding the size of either the city or
12 rural carrier sample. And because the sampling systems consistently
13 develop erroneous unit costs for saturation letters and flats, an after-the-
14 fact adjustment needs to be made to correct the costs improperly
15 attributed to those letters and flats.

16 In this docket, the Postal Service has undertaken to calculate a
17 correction. Library reference USPS-LR-K-67, sponsored by witness
18 Kelley (USPS-T-16), estimates that the total volume of DALs in FY 2004
19 was 3.375 billion. Interestingly, the Postal Service's estimated volume of
20 DALs amounts to 98 percent of the FY 2004 volume of saturation letters,
21 or 3.444 billion, in the Billing Determinants, USPS-LR-K-77. The

1 estimated volume of DALs is used to adjust the cost of letters and flats.
2 Because the estimated volume of DALs is so large in comparison to
3 saturation letters, the resulting correction makes a meaningful
4 difference. It reduces the Test Year USPS delivery cost of saturation
5 letters from 6.665 to 4.137 cents, while increasing the cost of saturation
6 flats from 3.191 to 4.163 cents.¹¹ Of course, since the Postal Service's
7 proposed rates are not designed to reflect Test Year costs, proposed rates
8 have not been adjusted to reflect the extent of the mismatch.

9 The Commission likewise should adopt a procedure to correct for
10 the mismatched data. It either should adopt the procedure used by the
11 Postal Service for the first time in this docket, or it should develop its
12 own procedure for removing all DAL costs that are incorrectly attributed
13 to letters and instead attribute them to flats.

14 The volume of 3.375 billion DALs estimated by the Postal Service is
15 not inconsequential; it amounts to 35.5 percent of the total volume of
16 saturation non-letters (*i.e.*, 9.515 billion). At the same time, based on
17 other data sources considered to be more authoritative, as explained in
18 the Appendix, the Postal Service estimate appears to understate by

¹¹ See Notice of Unites States Postal Service of Filing of Revisions to the Testimony of Witness Kelley (USPS-T-16) - Errata (June 9, 2005), p. 6.

1 approximately 2.0 billion the total volume of DALs actually handled.¹²
2 Therefore, when adjusting for the cost of handling DALs, I recommend
3 that the Commission use the figure of 5.4 billion as developed in the
4 Appendix, and shown there in Table A-8. This would be the conservative
5 approach to correct the current over-attribution of costs to saturation
6 letters. Finally, the Commission should assume that only 1 percent of all
7 DALs are delivered to P.O. Boxes, and that the remaining 99 percent of
8 DALs are delivered by city or rural carriers.

9 **E. Costs of DALs in Cost Segment 6 (City Carrier In-Office Time)**

10 The In-Office Cost System (“IOCS”) is used to allocate city carrier
11 in-office costs to rate categories of ECR mail. When a DAL is being
12 handled at the time a tally is taken (*e.g.*, being cased manually by the
13 carrier), the tally taker is instructed to record the characteristics of the
14 accompanying piece (*e.g.*, weight, shape, etc.), not the characteristics of
15 the DAL. As a result, with respect to tallies taken when DALs are being
16 cased manually, the IOCS should attribute in-office carrier costs to flat-
17 shaped pieces in a manner consistent with the way revenues and
18 volumes are recorded, so long as IOCS instructions are followed. The

¹² See the Appendix for more discussion on estimating the volume of DALs.

1 type of consistency problem that arises with respect to attributing
2 delivery costs for rural carriers and street time costs of city carriers
3 should occur only on those occasions when an error is made when
4 recording an IOCS tally. Two Postal Service witnesses have mentioned
5 recording error as a distinct possibility for anomalous cost results (*see*
6 *fn. 23, infra*).

7 Although recording cased DALs as flats does not create a
8 mismatch, it does create another problem. Namely, because cased DALs
9 are recorded as flats, the Postal Service has no data on how many DALs
10 are cased each year.¹³ To estimate the number of flats that are cased,
11 the Postal Service uses costs developed from the IOCS to estimate the
12 number of hours spent casing flats, and then divides those hours by the
13 rate for casing ordinary flats (casing rates are from witness Shipe in
14 Docket No. R90-1).¹⁴ The obvious assumption underlying this procedure
15 is that all carrier time recorded as casing flats was in fact spent casing
16 catalogs or other flats, not DALs. However, if some of the time was spent
17 casing DALs, as it would be reasonable to expect, and if the letter shape
18 of DALs enables them to be cased at the much faster rate for letters, as it

¹³ Response to VP/USPS-T30-16 (Tr. 6/2373).

¹⁴ The procedure is described by witness Bradley, USPS-T-14, p. 59, ll. 5-17, and implemented by witness Kelley, USPS-T-16, in library reference USPS-LR-K-67, which he sponsors.

1 also would be reasonable to expect, then the estimated number of flats
2 that are cased and taken to the street would be erroneous for several
3 reasons.

4 First, since DALs are recorded as flats by the IOCS, the procedure
5 used actually is estimating the number of **pieces** cased — addressed
6 flats and DALs combined — not just flats. Second, since DALs are
7 probably cased at a faster rate than ordinary flats, using the casing rate
8 for flats alone underestimates the actual volume of pieces cased. Third,
9 many of the cased pieces are DALs, and the uncased covers that
10 accompany those DALs would bypass casing and be taken directly to the
11 street. After all, the very reason DALs are cased is to enable the covers
12 to be taken to the street, and any implicit assumption that the volume of
13 cased DALs represents flats **not** taken directly to the street is about as
14 wrong as can be. Underestimating the volume of flats taken directly to
15 the street will underestimate the share of city carrier street costs of
16 sequenced mail that should be attributed to flats.

17 **F. Costs of DALs in Cost Segment 3 (Mail Processing)**

18 Prior to development of equipment that could delivery point
19 sequence (“DPS”) letters, all DALs either were cased manually by carriers
20 or taken directly to the street (uncased) along with the accompanying

1 covers, as “third bundles.” Now, however, it seems that some unknown
2 volume of DALs are sorted on automation equipment. One prerequisite
3 is that DALs have barcodes, which can be applied by the Postal Service
4 using automation equipment with optical character reader (“OCR”)
5 capability, or sometimes are pre-applied by the mailer.¹⁵ According to
6 witness Lewis (USPS-T-30), “there is field interest in DPSing the letter-
7 shaped component of a DAL mailing and ... in some places delivery and
8 plant managers have implemented local procedures to do this.”¹⁶
9 Sometimes, when ECR flats with DALs are entered at Destination
10 Delivery Units (“DDUs”), the DALs may even be transported back to the
11 Processing and Distribution Center (“P&DC”) to be processed on
12 automation equipment.¹⁷ At the same time, despite knowledge that
13 interest in DPSing of DALs is increasing, and the practice is growing,
14 “[t]he Postal Service has no estimate of the volume or percentage of the
15 amount of letter-shaped DAL pieces processed on automated
16 equipment.”¹⁸

¹⁵ Response to VP/USPS-T30-13(a) (Tr. 6/2369).

¹⁶ Response to VP/USPS-T30-14 (Tr. 6/2370-71).

¹⁷ Response to VP/USPS-T30-15 (Tr. 6/2372). Such transportation costs, although small, are likely attributed incorrectly to saturation letters, given the tendency to record DALs as letters unless explicitly instructed to do otherwise.

¹⁸ Response to VP/USPS-T30-13 (Tr. 6/2369); also response to
(continued...)

1 To the extent that DALs are processed on automated equipment,
2 the cost of such processing occurs within MODS cost pools for which
3 most or all of the cost is distributed to letters. For instance, costs are
4 attributed to saturation letters from the BCS and OCR cost pools (in
5 addition to the BCS/DBCS MODS costs pool). All saturation letters are
6 required to be barcoded by mailers, whereas no such requirement exists
7 for DALs, which may or may not be barcoded. It therefore is easy to
8 comprehend why DALs with no barcodes would be processed on BCS or
9 OCR equipment, but impossible to comprehend why any pre-barcoded
10 saturation letters would be processed on such equipment.¹⁹ If any costs
11 incurred to process DALs on automated equipment are being attributed
12 to letters, that would create yet another mismatch situation. That is, all
13 revenues and volumes arising from DAL mailings are credited to
14 saturation flats, while certain costs incurred to process some unknown,
15 but possibly large and growing, volume of DALs are being attributed to
16 letters.²⁰

¹⁸ (...continued)
VP/USPS-T30-16(a-d) (Tr. 6/2373).

¹⁹ When the handling of a DAL is tallied, IOCS procedures call for the information about the accompanying cover to be entered. The IOCS handbook presumes that covers and DALs are physically proximate. But it seems unlikely that pallets of covers would be stored in automated processing areas while DALs are being run on automated equipment.

²⁰ The additional mismatch problem within Cost Segment 3 did not
(continued...)

1 **G. Other Mismatch Data Problems**

2 **1. Letter-shaped pieces over 3.5 ounces.** A mismatch between
3 revenues and volumes on the one hand, and costs, on the other hand,
4 also can arise from simple identification errors when recording
5 information. The result is similar: unit cost is erroneous, and fails to be
6 a correct measure of marginal cost. One example of such a possible
7 recording error in ECR mail would occur if costs of **letter-shaped pieces**
8 **in excess of 3.5 ounces** were attributed to letters. This clearly would be
9 erroneous, because all pieces in excess of 3.5 ounces pay non-letter
10 rates, and the revenues and volumes of such pieces are credited
11 appropriately to non-letters in the RPW system.²¹ It is unclear whether
12 these pieces are always counted as letters. Possible recording errors,
13 such as that just described, pose an issue of what I would describe as
14 asymmetrical bias. Namely, it is not difficult to envision a letter-shaped

²⁰ (...continued)

occur to Valpak until drafting of interrogatories to the Postal Service. Having been unaware of the problem before, Valpak did not alert the Postal Service to the problem. Consequently, in this docket, the Postal Service does not address this potential mismatch problem, since it offers no correction for any mail processing costs of DALs that may have been mis-attributed to saturation letters, which would require attribution to saturation flats in order to correct any such error.

²¹ In TY 2003 of Docket No. R2001-1, approximately 3.7 percent of the total mail processing cost (segment 3.1) and 1.8 percent of in-office carrier cost (segment 6.1) were estimated to arise from such letter-shaped pieces weighing in excess of 3.5 ounces; see Docket No. R2001-1, response of witness Schenk to ADVO/USPS-T43-1.

1 piece that weight more than 3.5 ounces, and which therefore paid non-
2 letter rates (and was included appropriately in non-letter revenues and
3 volumes in the RPW system), being recorded in the carrier cost systems
4 as a letter, which would result in the cost of that piece being attributed
5 incorrectly to letters. It seems far less likely that a compensating error
6 would be made by misidentifying a letter-shaped piece under 3.3 ounces
7 as a flat.

8 **2. Letter-shaped pieces between 3.3 and 3.5 ounces.** A more
9 ambiguous, and possibly more difficult, case concerns letter-shaped
10 pieces (both Regular and ECR) that **weigh between 3.3 and 3.5 ounces.**
11 Since Docket No. 2001-1, such pieces pay (i) a pound rate, plus (ii) the
12 non-letter piece rate, less the differential between the piece-rated letters
13 and flats. In essence, such pieces pay the piece rate for letters plus the
14 pound rate for all excess weight between 3.3 and 3.5 ounces. In the
15 Billing Determinants, USPS-LR-K-77, for saturation mail the revenues
16 and volumes of such pieces are recorded as non-letters. In USPS-LR-K-
17 87, such pieces are recorded as letters, based solely on their shape.²² It
18 is not known how such pieces are recorded when they are the subject of
19 an IOCS tally, nor how such pieces are counted in the city and rural

²² See response to VP/USPS-T16-2 (Tr. 7/2841-47), Alternative Attachment B.

1 carrier cost systems. The IOCS may use the recorded weight of these
2 pieces to count them as **non-letters**, while the two respective carrier
3 systems record them as **letters** on account of their shape. Again,
4 revenues and volumes, on the one hand, and costs, on the other, may be
5 recorded inconsistently.

6 That recording errors, with similar erroneous results, may have
7 occurred in First-Class Mail with respect to the costs of automation
8 presort and non-automation presort is acknowledged by witness
9 Abdirahman (USPS-T-21), who candidly admits that “[b]ased solely on
10 the physical examination of mail piece characteristics (e.g., barcodes), it
11 is not always possible for data collectors to determine whether the
12 revenue of a given mail piece, and the piece itself, was recorded at the
13 nonautomation or automation rates.”²³

14 **H. Summary**

15 To sum up the discussion in this part of my testimony, I conclude
16 the following. First, the Commission should agree with the Postal Service
17 that costs of DALs have been mis-attributed to saturation letters.
18 Second, it should change its cost model so as to remove the costs that

²³ See response to POIR No. 1a. See responses to VP/USPS-T16-16 (Tr. 7/2875-77, and VP/USPS-T16-17 (Tr. 7/2878-79) for additional examples of possible data entry error.

1 are mis-attributed to saturation letters, and attribute those costs to
2 saturation flats. Third, when making such a correction, it should adopt
3 a volume of 5.4 billion DALs, as developed in the Appendix to this
4 testimony. Fourth, the Commission should assume that 99 percent of all
5 DALs are delivered by city and rural carriers. Fifth, the Commission
6 should be aware that even after correcting for the inconsistency created
7 by the way DALs are counted in the city and rural carrier cost systems,
8 other possible inconsistencies and recording errors exist that may have
9 mis-attributed costs systematically to saturation letters instead of flats.

10 As a further suggestion, the ad hoc nature of the procedure used
11 by the Postal Service to estimate the volume of DALs, combined with the
12 total lack of any reliable data on the volume of DALs that are DPS'd,
13 cased, or taken to the street, demonstrates the need to obtain more
14 accurate data both as regards the annual volume of DALs and the way
15 DALs are handled. By any reckoning, the volume of DALs is quite
16 substantial. The Postal Service should be urged to improve its data
17 systems in this regard.

1 **IV. CITY CARRIER COST OF HANDLING SEQUENCED MAIL**

2 Some of the problems associated with costing of DALs, as
3 discussed in the preceding section of this testimony, were raised via a
4 number of interrogatories in Docket No. R2001-1, prior to that case being
5 settled. This section of my testimony discusses other costing issues, not
6 heretofore raised, pertaining to saturation mail and city carrier costs.

7 **A. Sequenced Mail: The Extra Bundle Option**

8 The Postal Service has a low-cost option used by city carriers to
9 handle a limited amount of saturation mail. Such mailings, which
10 mailers presort by carriers’ walk sequence or line of travel, can be
11 handled as separate, “extra” bundles on the street.²⁴ Advantages of the
12 extra-bundle system are explained by witness Lewis (USPS-T-30), who
13 says “[t]he additional bundles carriers take to the street save a
14 considerable amount of in-office time.”²⁵ However, this savings of in-
15 office time also results “in carriers retrieving mail from more sources
16 when delivering mail on the street”²⁶ — ergo, higher street costs. In view

²⁴ Testimony of witness Lewis, USPS-T-30, at: p. 2, l. 21 to p. 3, l. 16; p. 8, ll. 8-13; p. 9, ll. 10-15; p. 16, ll. 8-9; p. 16, l. 19 to p. 17, l. 12; and p. 18, ll. 12-17.

²⁵ USPS-T-30, p. 3, ll. 12-13.

²⁶ USPS-T-30, p. 3, ll. 12-14.

1 of the fact that the option of taking sequenced mail directly to the street
2 is the preferred handling method that the Postal Service wants city
3 carriers to use to the maximum extent feasible, savings of in-office time
4 presumably more than offsets any extra street time. According to
5 witness Lewis, city carriers are paid by the hour, so,
6 with city carriers we prefer to have work rates
7 that minimize costs, so we'll take bundles
8 directly to the street because overall that
9 reduces the amount of time it takes to finish an
10 assignment. [Tr. 6/2424.]

11 **1. Cost consequences of the extra bundle option are limited**
12 **to city carriers.** The savings in city carrier cost from the extra-bundle
13 option raises important issues, discussed below, with regard to
14 determining the cost of saturation letters and flats. These costing issues
15 pertain only to city carriers; they do not pertain to rural carriers. For
16 rural carriers, the volume variable portion of their compensation is based
17 on a formula which has fixed per-piece rates for various types of pieces.
18 Consequently, the cost to the Postal Service does not vary with handling
19 procedures or work method. For any given volume and mix of mail, rural
20 carriers receive the same pay, regardless of whether they elect to sort any
21 or all of their sequenced mail in the office, or take such mail directly to

1 their vehicle and handle it as one or more extra bundles on their
2 routes.²⁷

3 **2. Capacity limitations.** According to witness Lewis, “[w]ork
4 rules stipulate that the Postal Service not require carriers serving foot
5 routes and park and loop deliveries to work from more than three
6 bundles on the street.... When delivering to curblines, centralized, cluster
7 box unit (“CBU”), and dismount stops, carriers on motorized routes have
8 no restriction on the number of bundles they can take directly to the
9 street.”²⁸ It is possible to quantify the number of (i) foot routes and
10 (ii) park and loop routes.²⁹ However, according to witness Lewis,

11 the Postal Service does not maintain statistics
12 identifying the routes where on-street work rules
13 strictly limit to three the number of bundles
14 carriers take directly to the street. Whether or
15 not carriers can work from more than three
16 bundles when making deliveries on the street is
17 a function of the type of deliveries that they are

²⁷ Response to VP/USPS-T16-22 (Tr. 7/2893-94).

²⁸ USPS-T-30, p. 3, ll. 1-10. *See also* Docket No. R2001-1, responses to VP/USPS-T39-4 (Tr. 10-C/3734) and 65 (Tr. 10-C/3784). Since carriers on mounted routes can take more than one additional bundle directly to the route, the term “extra bundle,” rather than “third bundle,” is used here to describe this low-cost option. The vehicles typically used on city carrier routes can accommodate three letter trays; Tr. 6/2422; *see also* Docket No. R2001-1, response to VP/USPS-T39-43 (Tr. 10-C/ 3769).

²⁹ Foot routes and park and loop routes constituted about 60 percent of all city carrier routes. Responses to VP/USPS-T30-1, 2, and 3 (Tr. 6/2353-55).

1 serving rather than the classification of the route
2 or whether it has an assigned vehicle.³⁰

3 Although some city carriers have no restrictions on the number of
4 extra bundles that they can take to the street, and some segments of
5 other routes are not restricted to three bundles, just how many extra
6 bundles a carrier can handle efficiently on a single day is somewhat
7 ambiguous. When city carriers have two sequenced mailings for delivery
8 on a given day, witness Lewis states that,

9 [t]he supervisor of the operation is responsible
10 for ensuring carriers take the appropriate
11 number of bundles of mail directly to the street
12 ... where carriers are delivering to centralized,
13 cluster box, curblin and dismount deliveries,
14 they would take both sequenced mailings
15 directly to the street uncased.³¹
16

17 Where carriers have routes that preclude them from taking two
18 extra bundles, “the supervisor would ensure the carriers collated the
19 mailings together into a third bundle.”³² Since each year a significant
20 number of saturation mailings are in fact DPS’d, or cased (or collated) by
21 city carriers, there would seem to be some practical limit to the number
22 of such mailings that, on any given day, can be handled more efficiently

³⁰ Response to VP/USPS-T30-1 (Tr. 6/2353).

³¹ Response to VP/USPS-T30-5 (Tr. 6/2357).

³² Response to VP/USPS-T30-6 (Tr. 6/2358).

1 by taking them directly to the street.³³ At the same time, witness Lewis
2 “know[s] of no guidance or analysis limiting the number of bundles that
3 City carriers can work from while on the street.”³⁴ Even though the limit
4 may not be well defined, when saturation mailings exceed that limit it
5 probably is more practical for carriers to sort any additional saturation
6 mailings at the DDU.

7 The layout of a carrier’s vehicle is an important constraint limiting
8 the number of bundles from which a carrier can work effectively. Postal
9 Service vehicles have the most flexibility, because they have space for
10 three trays near the seat. (Tr. 6/2422, l. 23 to 6/2423, l. 1.) Private
11 vehicles are more constrained, and the interior layout typically gives the
12 carrier less flexibility.

13 Further evidence that capacity of the extra-bundle option is
14 constrained (*i.e.*, does not offer incremental savings when the number of
15 such bundles is too large) is provided by rural and highway contract
16 carriers, who “have significant discretion regarding the work methods
17 they employ.” According to witness Lewis, “[m]any rural and HCR
18 carriers case both the detached address label and the unaddressed

³³ The Postal Service estimates that 25.7 percent of all saturation flats are cased, and 63.8 percent of all saturation letters are DPS’d or cased; response to VP/USPS-T16-22 (Tr. 7/2893-94).

³⁴ Response to VP/USPS-T30-9 (Tr. 6/2362).

1 component of detached address label mailings as a way to minimize the
2 number of bundles they must work from on the street.”³⁵

3 **3. Data Limitations.** The option of taking saturation mail
4 directly to the street is considered to be sufficiently important to warrant
5 inclusion as an explicit variable in the regression models for city carrier
6 costs of witness Bradley (USPS-T-14). Despite rising above this
7 threshold of significance, however, witness Lewis states that “[t]he Postal
8 Service does not maintain statistics showing the volume of either letter or
9 non-letter shaped saturation mail carriers take directly to the street
10 without casing.”³⁶ As discussed in more detail elsewhere in this
11 testimony, the RPW system does not record the volume of DAL mailings,
12 yet the Piece Count Recording System (“PCRS”) does count DALs
13 separately,³⁷ and it includes them in the count of letters. However, when
14 DALs are cased by carriers, they are recorded as flats. This adds a
15 further complication to the data problems concerning sequenced mail
16 (see Section III-G, *supra*), and indicates a need for the Postal Service to
17 gather more and better data on DALs.

³⁵ Response to VP/USPS-T30-26 (Tr. 6/2385-86).

³⁶ Response to VP/USPS-T30-25 (Tr. 6/2384).

³⁷ Response to VP/USPS-T30-20 (Tr. 6/2377-78).

1 **B. City Carrier Priorities for Handling Extra Bundles Strongly**
2 **Favor DAL and Addressed Flat Mailings**

3
4 Within saturation mail, a hierarchy clearly exists as to which
5 mailings receive extra bundle treatment. DALs with unaddressed flats
6 (referred to in the DMM as “covers”) virtually always preempt addressed
7 flats or letters for extra-bundle status. As the Postal Service itself
8 acknowledges, “[t]he Postal Service considers the casing of unaddressed
9 flats as wasteful and unnecessary.³⁸ Consequently, “[u]naddressed flats
10 are very rarely cased. On those rare occasions when it does happen, it
11 usually involves park and loop and foot routes, and managing the third
12 bundle issue.”³⁹

13 In the absence of covers with DALs, addressed saturation flats
14 always will preempt letters for extra bundle treatment, because it costs
15 more to case flats manually than it does to case letters manually.⁴⁰ In

³⁸ Docket No. R2001-1, responses to VP/USPS-T39-16 (Tr. 10-C/3478) and 42 (Tr. 10-C/3768). If the type of flat that typically accompanies a DAL had to be cased, data providing a reliable indication of what the unit cost would be do not exist; see Docket No. R2001-1, responses to VP/USPS-T39-17 (Tr. 10-C/3749) and 41 (Tr. 10-C/3767).

³⁹ Docket No. R2001-1, response to VP/USPS-T39-12 (Tr. 10-C/3745). This statement can be interpreted as an implicit acknowledgment that, whenever the volume of covers exceeds the extra-bundle limit, the marginal cost of such mail increases sharply, as discussed in Section C, *infra*.

⁴⁰ The minimum rate for carriers to case letters and flats is 18 and 8 pieces per minute, respectively. In Docket No. R90-1, Postal Service witness Shipe, USPS-T-10, introduced evidence that walk-sequenced letters and flats can be cased at rates of 41.2 and 27.4 pieces per minute, respectively. Docket (continued...)

1 general, a saturation letter mailing will become a candidate for the extra-
2 bundle option only when the DDU has no DAL mailings and no
3 saturation addressed flat mailings. And even when the DDU has no
4 saturation flats that could go directly to the street, the supervisor may
5 deny the lowest-cost treatment to saturation letters just because of the
6 **contingency** that a mailing of saturation flats may arrive. Tr. 6/2436,
7 ll. 9-16. Postal Service data confirm the handling hierarchy described
8 here. It estimates that 74.3 percent of all saturation **flats** are taken
9 directly to the street (*i.e.*, as “sequenced” mailings described in the
10 testimony of witness Bradley, USPS-T-14), but only 36.2 percent of all
11 saturation **letters** are taken directly to the street as extra bundles.⁴¹

12 Within the universe of saturation flats, when carriers have to select
13 from two or more mailings one that is to be handled as an extra bundle,
14 it would be reasonable to expect carriers to take the bundle that contains
15 noticeably thicker, or heavier pieces, and case the others, so long as both
16 mailings were addressed or both were covers with DALs.⁴²

⁴⁰ (...continued)

No. R2001-1, response to VP/USPS-T39-5 (Tr. 10-C/3735-36). In this docket, witness Shipe’s data are used by witnesses Bradley (USPS-T-14), and Kelley (USPS-T-16), to estimate the volume of sequenced mail that is cased manually.

⁴¹ Response to VP/USPS-T16-22 (Tr. 6/2893-94).

⁴² Docket No. R2001-1, response to VP/USPS-T39-60 (Tr. 10-C/3780).

1 The hierarchy described above has important consequences for the
2 way the costs of affected categories are determined, as discussed below.
3 When the Postal Service systematically gives high priority to certain
4 subsets of mail in one rate category, so that those subsets benefit from
5 an option with low recorded costs, while giving low priority to other
6 **equally eligible** subsets in other rate categories (and diverting those
7 subsets to other alternatives with higher recorded costs), the subset(s)
8 selected for preferred treatment then will appear to have a lower unit cost
9 than the other subsets, whose access to the extra-bundle option has
10 been systematically restricted. If all eligible subsets of mail capable of
11 benefitting from the extra-bundle option were selected on a random
12 basis, then the cost benefits would be spread randomly amongst all
13 eligible subsets, but that clearly is not the case.

14 **C. In-Office Cost Issues Posed by the Extra Bundle Option**

15 Stated in somewhat general terms, when the Postal Service has
16 available a strictly limited, low-cost handling option that, once
17 exhausted, requires resort to higher-cost alternatives, an important issue
18 arises with respect to measuring costs for subsets (*i.e.*, rate categories) of
19 mail that are eligible to use the low-cost option. The importance of
20 recognizing this capacity limitation cannot be overstated. When a critical

1 limitation on low-cost capacity exists, **the Postal Service cost systems**
2 **fail to produce estimates of marginal cost.** Importantly, the Postal
3 Service itself acknowledges that “**Postal Service costing methods do**
4 **not presuppose persistent processing capacity constraints.**”⁴³

5 When capacity is constrained by space or equipment, given
6 sufficient time the Postal Service can overcome the constraint and
7 expand capacity. With respect to automated equipment for sorting flats,
8 it took the Postal Service many years, far longer than the average three-
9 year interval between rate cases, to overcome the capacity constraint.
10 Ultimately, however, it did so.

11 With respect to the number of extra bundles that can be handled
12 more efficiently when taken directly to the street, the constraints are (i)
13 the average length of a carrier’s arm, (ii) the configuration of the vehicle,
14 and (iii) contractual constraints. Obviously, the first of these
15 constraints— arm length— will not change. As to the second constraint,
16 the interior configuration of Postal Service delivery vehicles appears to be
17 optimized and no testimony in this case indicates that new vehicle
18 designs with expanded tray capacity within arm’s reach of the carrier are

⁴³ Response to VP/USPS-T2-15 (Tr.8/____). USPS-LR-K-1, Appendix H, discusses the relationship between (i) costs generated by Postal Service costing methods and (ii) economic concepts of volume variable and marginal cost, but it does not point out this important limitation.

1 on the horizon. In theory, the constraint on extra bundles for certain
2 routes (or route segments) could be changed in any negotiation with the
3 union. The contract has contained such a constraint for many years,
4 however, and it would seem imprudent to forecast any such change.
5 Consequently, the capacity constraint on extra bundles is far more
6 permanent than any constraint that the Postal Service has ever faced
7 with respect to automation equipment or space. For saturation mail,
8 Postal Service costing methods need to change and presuppose
9 persistent processing capacity constraints.

10 The capacity constraint just described necessarily restricts all
11 benefits from the low-cost option to a limited portion of eligible mail. All
12 other eligible mail that might benefit from the low-cost option instead
13 must be diverted to higher-cost alternatives. Further, since the low-cost
14 option is limited, it must be rationed.⁴⁴ Every mailer that prepares
15 eligible mail would naturally prefer that its mail be processed using the
16 low-cost option. It is the Postal Service, of course, that does the
17 rationing; *i.e.*, it determines which subset(s) of mail will be selected and
18 subsequently appear to have the lowest cost. Under the circumstances

⁴⁴ In a competitive market system, the low-cost option would be rationed by assigning it an appropriate scarcity rent, which would then raise the cost of the low-cost option to that of the higher-cost options. In the context of a linear programming model, this scarcity rent would be reflected as a high shadow price on the limited low-cost option. The IOCS is not designed to produce such costs, or take into account such considerations.

1 of a capacity constraint and hierarchical operating procedures described
2 here, a number of important issues arise, such as:

- 3 ● Do the costs for each rate category, as measured
4 by the IOCS, reflect the “true” marginal cost
5 which that subset imposes on the Postal
6 Service?
 - 7 ○ Are IOCS costs the most appropriate
8 basis for establishing cost-based
9 rates within affected rate categories?
 - 10 ○ Do IOCS costs provide a reliable
11 basis to guide pricing, marketing
12 and internal operating decisions?⁴⁵
- 13 ● Do costs allocated to rate categories of mail on
14 the basis of IOCS tallies constitute a fair and
15 equitable distribution?

16 The issues posed here raise an important question — namely,
17 whether the IOCS is the most appropriate vehicle for “slicing and dicing”
18 costs within subsets (*i.e.*, at the rate category level) whenever capacity is
19 constrained, and most especially when capacity is permanently
20 constrained.

21 **1. The estimate of city carrier in-office costs may be distorted**
22 **for individual rate categories of sequenced mail.** Every saturation
23 mailing is presorted by line of travel or walk sequence, and therefore

⁴⁵ The advent of negotiated service agreements (“NSAs”) increases the importance of accurate marginal costs for each rate category, since major mailers who are most likely to become recipients of an NSA often enter much of their mail in a single rate category.

1 qualifies for extra bundle delivery, regardless of whether the mailing
2 consists of letters, addressed flats, flats/covers with DALs, or parcels
3 with DALs.

4 When carriers take saturation mailings directly to their vehicles as
5 an extra bundle, the likelihood that carriers will be sampled by the IOCS
6 while handling such mailings is greatly reduced, to the point of being
7 minimal. Further, if carriers use any kind of rolling equipment (*e.g.*, a
8 cart or hamper) to take mail from inside the office to their parked
9 vehicles, any IOCS tally taken during this operation likely would be
10 recorded as a “mixed mail” tally, not as handling sequenced mail. Thus,
11 for those mailings that carriers handle as extra bundles, the Postal
12 Service will attribute little or no in-office cost, because the mailing is
13 handled only briefly, and in bulk, not as individual pieces. The
14 distribution of city carrier direct costs is shown in Table 1, columns 4-6.
15 Any costs attributed to mail taken directly to the street would be part of
16 “Other” (column 5), which also includes tallies for clocking in and out,
17 obtaining mail or keys, loading and unloading vehicle, attending a safety
18 meeting, training, break and personal needs and moving empty
19 equipment.⁴⁶ The fact that the percentage of “Other” costs for flats
20 (10.6%) is greater than for letters (7.0%) is consistent with the fact that

⁴⁶ Response to VP/USPS-T16-23(d) (Tr. 7/2895-96)

1 74 percent of all saturation flats are taken directly to the street, whereas
 2 only 36 percent of all letters are taken directly to the street.⁴⁷

3

4

Table 1

5

**In-Office Direct Costs for Saturation Letters and Flats
 6 BY 2004**

6

7

-----Cost (\$,000) ----- -----Distribution (%) -----

8

9

	Casing	Other	Total	Casing	Other	Total
	(1)	(2)	(3)	(4)	(5)	(6)

10

11

Letters	25,600	1,925	27,525	93.0	7.0	100.0
Flats	28,573	3,399	31,972	89.4	10.6	100.0

12

13

14

Source: Responses to VP/USPS-T16-21 and 24 (Tr. 7/2889-92 and Tr. 7/2897, respectively).

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Among qualified candidates for the extra-bundle option, the hierarchical procedure described above clearly gives lowest priority to saturation letters, which means that this option frequently is denied to saturation letters.⁴⁸ At the same time, saturation covers accompanied by DALs, which generally would be among the most expensive saturation mail to process if cased, instead will appear to have the lowest in-office unit cost when estimated solely on the basis of IOCS tallies. In other words, the extra bundle option helps not only to reduce costs for the

⁴⁷ A resulting trade-off for lower in-office costs may, of course, be higher street costs.

⁴⁸ See Docket No. R2001-1, responses to VP/USPS-T39-8(b-c) (Tr. 10-C/3739-41) and 55 (Tr. 10-C/3773-74).

1 subclass as a whole, it also **results in an appearance of the lowest**
2 **average mail processing cost** for the particular subset (*i.e.*, rate
3 category) of mail that is selected to receive such handling. One obvious
4 result of this handling hierarchy is to reduce the letter-flat difference
5 below what it otherwise would have been.⁴⁹

6 The cost to process letter-shaped mail is generally thought to be
7 less than the cost to process flat-shaped mail. For example, the
8 traditional sorting standard was 18 and 8 pieces per minute for letters
9 and flats, respectively. And when both letters and flats are sorted to
10 carriers' line of travel, witness Shipe, in Docket No. R90-1, found that
11 they could be sorted, respectively, at a rate of 41.2 and 27.4 pieces per
12 minute.⁵⁰ For saturation mail that is actually cased, the unit cost for
13 flats, \$0.0209, is about \$0.0069, or 50 percent greater than the unit
14 costs for letters, \$0.0140, as shown in Table 2, column 3.⁵¹

⁴⁹ The letter-flat difference is an issue of particular concern in this testimony, especially the differential for saturation letters and flats. It also is worth noting that when the combination of a capacity constraint and the costing system reduces the apparent cost of flats while increasing the apparent cost of Saturation letters, other differences in the presort tree also are distorted. For instance, the difference between Basic Automation letters and saturation letters will be reduced, while the difference between Basic flats and saturation flats will be increased.

⁵⁰ This is the most recent study of casing rates and costs; response to VP/USPS-T30-27 (Tr. 6/2387).

⁵¹ These are direct costs only. The absolute difference will increase when indirect costs are included.

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Table 2

**Direct Casing Costs for Saturation Letters and Flats
BY 2004**

	(1) Casing Costs (000)	(2) Volume Cased (000)	(3) Unit Cost
Letters	25,600	1,833,667	0.0140
Flats	28,573	1,366,096	0.0209

Sources: Column 1, response to VP/USPS-T16-21 and 24 (Tr. 7/2889-92 and Tr. 7/2897, respectively).
Column 2, response to VP/USPS-T16-25 (Tr. 7/2898-99).

15 Despite the fact that letters can be cased at a lower costs than
16 flats, witness Kelley finds that the **average** city carrier in-office cost for
17 **all** saturation flats and letters is, respectively, \$0.0053 and \$0.0121.⁵²
18 He thus finds that the **average** in-office cost for saturation letters is more
19 than twice the cost of flats. This average reflects the much greater
20 proportion of flats that bypass casing altogether. On the surface, this
21 result appears anomalous, but with understanding from the preceding
22 discussion, it is perhaps an understandable result from the combination
23 of circumstances described here.

24 **2. Estimates of in-office cost for individual rate categories of**
25 **saturation mail are not marginal.** As discussed above, prioritizing use
26 of the limited low-cost option to those non-letter mailings that are the

⁵² Response to VP/USPS-T16-38(a) (Tr. 7/2915-18).

1 most expensive for carriers to sort can result in a low **average cost**.
2 Interpreting the average cost as equal to **marginal** cost then gives the
3 false impression that an incremental volume of those mailings will cause
4 the Postal Service to incur little or no in-office costs.⁵³ Any such
5 impression, however, is likely to be erroneous, because capacity of the
6 low-cost option is strictly limited.⁵⁴

7 What must be recognized is that giving higher-cost non-letter mail
8 priority access to low-cost handling often preempts such handling by
9 saturation letter mail, which otherwise also could have benefitted from
10 the low-cost option. On those occasions when non-letter mailings have
11 used up the capacity of the low-cost option, any additional non-letter

⁵³ A similar result obtains when using costs developed from the IOCS to study the weight-cost relationship of ECR mail. When carriers have more than one saturation mailing of flats, they virtually always will prefer to take heavier weight pieces to the street before other eligible lighter weight pieces, at least if there exists a noticeable difference in weight. Consequently, the hierarchical handling procedure also is tilted strongly toward using the low-cost option for heavier-weight pieces, while denying the lowest-cost option to lighter-weight pieces, and forcing them to use higher-cost options. The resulting lack of tallies for heavier weight pieces can make it appear that lighter weight pieces cost more than heavier weight pieces. Such a result can be described aptly as anomalous, counter-intuitive, or downright nonsensical. The result is caused by the combination of a capacity constraint coupled with a cost system that is inappropriate for such circumstances. See cross-examination of witness Shaw (USPS-T-2) at Tr. 5/1259-1267.

⁵⁴ The Postal Service seemingly has no way to measure or estimate whether, on average, it has any unutilized capacity to carry extra bundles. Not only is the capacity undefined and unmeasured, but also “[t]he Postal Service does not maintain statistics showing the volume of either letter or non-letter shaped saturation mail carriers take directly to the street without casing.” Response to VP/USPS-T30-25 (Tr. 7/2898-99).

1 saturation mailings will then have to incur the cost of manual in-office
2 sortation or collation; *i.e.*, the unit cost shown in Table 2. Thus, at the
3 point where the constrained capacity is fully utilized, the marginal cost
4 curve rises sharply and the marginal in-office cost of additional
5 saturation non-letter mailings would exceed by a considerable amount
6 the average cost as estimated by the IOCS sampling system.

7 In any situation where saturation letter mailings would have been
8 handled by the low-cost option but for priority having been given to an
9 additional saturation non-letter mailings — *i.e.*, where non-letter mailings
10 “bump” or pre-empt letter mailings — the cost of sorting letters will
11 appear to have increased and be higher than it would be had the Postal
12 Service given the letter mailing the low-cost extra-bundle option (which
13 bypasses DPSing and manual sortation). The non-letter mailing will
14 appear to have a cost lower than the letters which it pre-empted. In
15 other words, the average cost for **letters** (as measured by the IOCS) is
16 **higher** than it otherwise would have been, while the average cost for
17 **non-letters** (as measured by the IOCS) is **lower** than it otherwise would
18 have been. Significantly, the resulting **average costs cannot be relied**
19 **upon to represent the marginal cost** of either saturation letters or non-
20 letters. The marginal cost from additional saturation mailings is the

1 change in the Postal Service’s total cost caused by the additional
2 volume.⁵⁵

3 Under the circumstance where capacity of the low-cost option has
4 been reached (as described here), and saturation non-letters bump
5 letters, the change in total mail processing cost from additional
6 saturation non-letter mailings would be (i) the additional in-office cost of
7 handling the non-letter mailing using the low-cost extra-bundle option,
8 **plus** (ii) the additional in-office cost of sorting the “bumped” saturation
9 letters using the lowest-cost option available (*e.g.*, either by DPSing or
10 manual sortation) in lieu of the low-cost option. In other words, the
11 **marginal cost includes the full amount of the high-cost option** that
12 must be used.⁵⁶ Witness Bozzo (USPS-T-12) concurs. Tr. 5/1561, ll. 14-
13 22. In general terms, when a “joint” capacity for handling either X or Y is
14 constrained, the marginal cost of handling any given volume of X (*e.g.*,
15 saturation letters) depends not only on the volume of X, but also on the
16 volume of Y (*e.g.*, saturation non-letters).

17 To sum up this discussion about the marginal costs of city carrier
18 in-office activity, the net result of the capacity constraint, coupled with

⁵⁵ Response to VP/USPS-T12-1 (Tr. 5/1492).

⁵⁶ Here the additional cost includes the cost of sorting letters. If a saturation mailing with DALs were to bump a mailing of addressed flats, the additional cost of the DAL mailing would include the cost of sorting the addressed flats.

1 the handling hierarchy described above, is that the existing cost
2 measurement system can (i) result in the most expensive-to-handle non-
3 letters appearing to have the least cost, (ii) introduce an upward bias to
4 estimated marginal cost of the least expensive-to-handle pieces, and (iii)
5 distort the cost difference between the two.

6 **D. Hypothetical Illustrations Showing the Effect of Capacity-**
7 **constrained Low-Cost Options on Cost Estimation**

8 A hypothetical example can help illustrate the issue. First,
9 suppose that within saturation mail the Postal Service developed
10 separate in-office cost estimates for casing (i) letters, (ii) addressed flats,
11 (iii) unaddressed covers with DALs, and (iv) parcels.

12 Second, assume that whenever carriers sort letters, addressed
13 flats, and covers with DALs, the in-office cost is, respectively, 1.0, 2.0
14 and 3.0 cents per piece.⁵⁷ Any of these, when entered as a sequenced
15 saturation mailing, can be taken on the route as an extra bundle, and
16 little or no in-office cost will be incurred or attributed by the IOCS,
17 because the brief in-office handling of the extra bundle will be tallied
18 rarely, if ever.

⁵⁷ Parcels are mentioned here because the Postal Service does develop separate costs for parcels. In the remainder of the discussion, however, they are ignored because the total volume of ECR parcels is so low as to indicate that saturation mailings of parcels have become somewhat rare and inconsequential.

1 Third, assume that whenever covers are taken directly to the route,
2 the pre-sequenced DALs also are taken directly to the route, with no in-
3 office sortation (note that this sometimes occurs, but not always).

4 Fourth, to keep this hypothetical simple, assume that only one
5 sequenced mailing can be taken as an extra bundle.

6 Fifth, to handle one extra-bundle piece on the street costs an
7 additional 0.25 cents over the cost of pieces cased or DPS'd. This means
8 that (i) the in-office savings from extra-bundle treatment more than
9 offsets the additional street time cost, regardless of which type of mail is
10 taken to the street, and (ii) the procedure that minimizes mail processing
11 cost also will minimize total cost.

12 On a particular day, assume that a carrier has three saturation
13 mailings for delivery, one of each type. From an operations perspective,
14 it would be mismanagement, to the point of being downright frivolous,
15 not to obtain a gross savings of 3.0 cents by taking the covers with DALs
16 as the third bundle. This would minimize total costs for the Postal
17 Service, and it also would minimize costs for the subclass as a whole. At
18 the same time, it would be foolish to the point of wilful self-deception to
19 pretend that the covers and DALs, which are the most expensive to sort
20 under this hypothetical, instead are the least expensive to process,
21 simply because of the way the IOCS tallies and records costs.

1 When estimating costs for individual subsets within the subclass,
2 the capacity limitation on the low-cost option requires that other
3 considerations be into account. For example, it is assumed here that the
4 carrier also had a saturation mailing of addressed flats which could have
5 been the extra bundle. Hence, in order for the Postal Service to realize
6 the 3.0 cents per-piece savings from not sorting the DAL mailing, it must
7 forgo a potential 2.0 cents per-piece savings from not sorting the mailing
8 of addressed flats. (Such foregone savings are referred to by economists
9 as opportunity costs.)

10 As a variation within this hypothetical, suppose that on some
11 particular day a carrier had only two saturation mailings, one of letters
12 and one of addressed flats. In this case, it would be wrong not to save
13 2.0 cents per piece by taking the addressed flat mailing as the extra
14 bundle. As before, however, it would be equally wrong to pretend that
15 the addressed flats cost less to process than letters simply because they
16 are not tallied. Whenever carriers have more saturation mailings to
17 deliver on one day than can be accommodated with the “extra bundle”
18 method, an opportunity cost is involved. Namely, those mailings not
19 taken as an extra bundle will have to be sorted (or collated) before leaving
20 the DDU. These mailings are far more likely to be the subject of an IOCS

1 sample, and the cost of sorting those mailings will show up explicitly in
2 estimated costs.

3 Or consider yet another variant of this hypothetical. Assume that,
4 on a particular day, a carrier has three saturation mailings for delivery:
5 two are addressed flats, and one is letters. If one of the addressed flat
6 mailings is carried as an extra bundle, it will not be the subject of an
7 IOCS tally, hence, for all practical purposes, its in-office mail processing
8 cost will appear to be zero. At the same time, the second flat mailing,
9 which must be sorted manually, would show up under the IOCS as
10 having an in-office cost of 2.0 cents per piece. Under the circumstances
11 here, the **average** in-office cost of the two flat mailings is, of course,
12 equal to 1.0 cent, which is equal to the cost of sorting the letter mailing.
13 This “outcome” from the IOCS does **not** mean that the **marginal cost** of
14 sorting **flats** is equal to the **marginal cost** of sorting **letters**. Any such
15 inference would be wrong and misleading. Thus, great care must be
16 taken with regard to inferences drawn from IOCS data when capacity
17 constraints impose different operating procedures and result in certain
18 subsets not having the same probability of being sampled.

19 The purpose of a hypothetical is to simplify things in a way that
20 helps illustrate essential points. The real world, of course, is more
21 complex than the hypothetical. When saturation letters are not taken as

1 the extra bundle, they can be cased manually by carriers or, at many
2 facilities, they can be sorted into delivery point sequence using
3 automation equipment. When the covers accompanied by DALs are
4 taken as a third bundle on foot routes or park and loop routes, the DALs
5 may need to be cased manually, whereas, when carriers on mounted
6 routes use the extra bundle option, they also may load the DALs directly
7 into an extra letter tray in their vehicles without any in-office casing.
8 Such added complexities should not obscure the fact that marginal cost
9 estimates can be badly skewed when one rate category of mail
10 systematically receives preferential access to a capacity-constrained low-
11 cost option.

12 **E. Estimating City Carrier Street Costs (Cost Segment 7) of**
13 **Handling Sequenced Mail**

14 Prior to this docket, the only study specifically concerned with the
15 cost of handling and delivering any sequenced mail was that of witness
16 Acheson, USPS-RT-1, in Docket No. C87-1. That study was limited to
17 comparing the cost of (i) unaddressed flats with DALs to (ii) addressed
18 flats.⁵⁸ The cost of handling sequenced letter-shaped mailings was not

⁵⁸ Witness Acheson also compared the cost of handling DALs and addressed flats when neither was sequenced. Mailer sequencing is now required for both, hence that portion of his study is not applicable to today's saturation mail.

1 examined by witness Acheson, hence that study has no relevance to the
2 cost of handling sequenced letters, or to the letter-flat cost difference.

3 In his study, witness Acheson found significant in-office benefits,
4 in the form of time savings, from either (i) casing DALs in lieu of the
5 accompanying flat-shaped mail pieces, or (ii) not casing the DALs at all,
6 and instead taking sequenced DALs to the street as a third bundle. On
7 routes with curblines or centralized delivery, the in-office benefits were
8 offset by higher street costs on account of having to combine the
9 unaddressed flat with regular flats after reaching the delivery point. On
10 foot routes and park and loop routes, carriers were able to select mail
11 from the extra bundle while traveling between delivery points and
12 without incurring any additional street time, hence on these routes the
13 Postal Service realized a net savings.

14 In this docket, witness Bradley (USPS-T-14) presents a new study
15 of city carrier street time. In that study, he includes specific variables in
16 his regression equations for sequenced mail delivered by carriers. This
17 enables an estimate of the total street cost of handling sequenced mail,
18 which includes letters, addressed and unaddressed flats, and DALs.
19 That cost, then, needs to be allocated between letters and flats, with the
20 costs attributable to DALs included in flats. Once the costs have been so
21 allocated, the unit cost of delivering sequenced letters and flats can be

1 determined by dividing costs by the respective volumes of letters and
 2 flats (including DALs) that bypass casing and are taken directly to the
 3 street.⁵⁹ The resulting unit costs are shown in Table 3, Column 3.

4
 5 **Table 3**

6 **City Carrier Street Costs of Saturation ECR Mail Taken Directly to the Street**
 7 **BY 2004**

	(1) Volume Taken to Street (000)	(2) Direct Costs for "Sequenced" Mail (\$, 000)	(3) Unit Cost
13 Letters	1,863,243	11,400	0.0061
14 Flats 3,949,453	75,900	0.0192	

15 Sources: Column 1, response to VP/USPS-T 16-25 (Tr. 7/2898-99).
 16 Column 2, response to VP/USPS-T 16-21 (Tr. 7/2889-92).
 17

18 **F. Using Marginal Costs to Determine the Cost of Sequenced Mail**

19 **1. A form of standard costs is used for rural carriers.** The
 20 procedure for determining volume variable rural carrier costs, discussed
 21 previously, is based on standardized payments specified in the union
 22 contract with rural carriers. The unit cost neither depends on, nor
 23 reflects, the priority that rural carriers give to one rate category versus
 24 another, or work methods of rural carriers. Whether rural carriers sort

⁵⁹ Response to VP/USPS-T16-21 (Tr. 7/2889-92).

1 sequenced mail in the office, or take it out as extra bundles, affects
2 neither attributable cost, nor average unit cost, nor marginal cost. Nor
3 do the standardized payments to rural carriers contain or reflect any
4 capacity constraints.

5 Development of rural carrier volume variable costs requires neither
6 regression analysis nor any other form of econometric analysis. In
7 comparison to the city carrier cost system, the procedure is relatively
8 simple and straightforward. The only “sample” involved is the mail
9 count. The basic requirement to achieve consistency, and avoid a
10 mismatch problem, is that mail be counted and recorded accurately vis-
11 a-vis the way revenues and volumes are recorded. That is, cost data
12 need to be attributed in a manner that is consistent with revenue and
13 volume data. When standardized payments are used, as they are in the
14 rural carrier cost system, cost relationships, including the letter-flat
15 difference, reasonably can be expected to remain fairly constant over
16 time.

17 **2. The Commission has confronted the special treatment of**
18 **extra bundles on at least one prior occasion.** This case is not the first
19 time the Commission has been confronted with the letter/flat cost issue
20 raised by saturation mail that has been presorted in a manner that
21 enables it to be taken directly to the street as an extra bundle. In Docket

1 No. R90-1, several years before the saturation subclass was created, the
2 Commission dealt with the issue as follows.

3 However, for the saturation letter/flat
4 differential, we recommend applying the 50
5 percent passthrough to only the portion of the
6 differential representing the street time cost. Of
7 the factors Crowder identified, we believe only
8 the third bundle problem and the centralized
9 delivery problem bear directly on the letter/flat
10 differential for saturation mail. Based on the
11 record, we cannot estimate what proportion of
12 saturation mail volume is carried in third
13 bundles nor can we estimate the effects of
14 saturation mail on centralized delivery.
15 Adhering to our traditional approach, we
16 conservatively assume for this case that all
17 saturation mail is handled in third bundles and
18 thus avoids in-office casing. For this reason, we
19 exclude the in-office cost from the letter/flat
20 differential.⁶⁰

21 **3. The Commission used modeled costs in Docket No. MC95-1**
22 **to deal with cost issues raised by the extra bundle handling**
23 **procedure.** Instead of using costs based on IOCS samples to estimate
24 city carrier costs of rate categories within a subclass, an alternative
25 method is to use modeled costs, as was done in Docket No. MC95-1. Use
26 of modeled costs is more complex, and requires more data than the
27 standard costs used for rural carriers. Significantly, under the modeling
28 approach used in Docket No. MC95-1, **no eligible subset of mail was**

⁶⁰ Docket No. R90-1, *Op. & Rec. Dec.*, p. V-244, para. 5965.

1 **assumed to receive preferential access to capacity-constrained, low-**
2 **cost options.** This put eligible rate categories (*i.e.*, ECR saturation
3 letters and flats) on an equal footing with regard to extra bundle
4 treatment.

5 Rate differentials, such as the letter-flat differential, were
6 maintained and did not vary with the particular subset given preferential
7 access to the limited capacity, low-cost option. To the extent that use of
8 the low-cost option resulted in lower subclass costs, the adjustment to
9 Cost and Revenue Analysis (“CRA”) costs was reduced, and all eligible
10 subsets and rate categories participated ratably in the reduced
11 adjustment. That resulted in non-discriminatory, fair and equitable
12 costs for each rate category. It also reflected relative costs of individual
13 rate categories better than costs developed via the IOCS. The use of
14 modeled costs also resulted in a substantial letter-flat cost difference
15 (1.36 cents at the Basic level; 0.63 cents at the saturation level).⁶¹

16 As discussed previously, handling priority for the low-cost extra-
17 bundle option favors pieces that generally are the most difficult and
18 expensive to handle, with the result that the mail handled under the low-
19 cost option essentially escapes being sampled by the IOCS.

⁶¹ Docket No. MC95-1, *Op. & Rec. Dec.*, p. V-265. Subsequently, after reclassification, the Postal Service reverted to using the IOCS to determine costs of rate categories, and the letter-flat difference has not only diminished, but has also shown substantial volatility.

1 Consequently, increasing the sample size would not solve the issue of
2 how to estimate properly the marginal costs of (i) the subset of mail that
3 systematically is exempted from in-office handling, and (ii) other eligible
4 mail with more limited access to the low-cost option. Nor is it clear that
5 any sampling system could be designed that would result in a reliable,
6 fair and equitable allocation of costs when costs are interdependent by
7 virtue of being eligible candidates for a capacity-constrained, low-cost
8 option. Use of modeled costs at the rate category level, adjusted to reflect
9 aggregate subclass costs as determined by the IOCS, and within the
10 context of the CRA, would appear to be one way out of the impasse.

11 **4. In this docket, the Commission should use marginal costs**
12 **to establish the letter-flat cost difference.** In the absence of an
13 entirely new and better way to estimate marginal costs and the letter/flat
14 cost difference, for in-office city carrier costs, it is recommended to treat
15 the unit costs in Table 2 as marginal in-office costs in BY 2004. The unit
16 costs shown in Table 3 are city carrier street time costs for the limited
17 low-cost option, hence it would not be appropriate to use these as
18 marginal costs. For city carrier street time, the marginal cost would be
19 the unit cost for **regular** delivery of letters and flats, \$0.0181 and

1 \$0.0193 respectively.⁶² These costs are summarized in Table 4. The
 2 difference in direct cost between letters and flats is \$0.0081. Adjusting
 3 direct costs to include indirect piggybacked costs will increase the
 4 difference slightly. Total delivery costs will of course be a weighted
 5 average of city and rural carrier costs.

7 **Table 4**
 8 **Marginal City Carrier Direct Costs for Saturation ECR Mail**
 9 **BY 2004**

	(1)	(2)	(3)
	In-Office	Street	Total
	Costs	Costs	
13 Letters	0.0140	0.0181	0,0321
14 Flats	0.0209	0.0193	0.0402
15 Difference	0.0069	0.0012	0.0081
16 Sources:	Column 1, see Table 2, <i>supra</i> .		
17	Column 2, USPS-LR-K-67, file LR-K-67_2nd.revised.xls,		
18	worksheet 21. ECR Unit Costs FY04		
19			
20			

21 **G. Summary**

22 All saturation mailers would like to have the Postal Service always
 23 deliver their mail using the lowest cost option of taking the mail directly
 24 to the street, since their mail is prepared in carriers' walk sequence. If
 25 the Postal Service were able to oblige, the low **average** cost of saturation

⁶² USPS-LR-K-67, file LR-K-67, worksheet 21. ECR Unit Costs FY04.

1 mail would be even lower, and the marginal cost would be equal to the
2 average cost.

3 Postal Service costing methods for saturation mail are premised on
4 the incorrect presupposition that persistent capacity constraints do not
5 exist for the extra bundle option used by city carriers. Clearly, such
6 constraints do exist, because no saturation mail would be cased or DPS'd
7 if extra-bundle capacity were not constrained. In consequence thereof,
8 Postal Service costing methods distort the estimated marginal cost of
9 saturation letters and flats. In turn, the letter-flat cost difference is
10 distorted, as are the differences between (i) Basic Automation and
11 saturation letters, and (ii) Basic and saturation flats.

12 To correct for the distortion caused by the capacity constraint, the
13 Commission should rely on marginal costs for individual rate
14 subcategories.

1 **Appendix A**

2 **Estimating the Number of DALs**

3 **Introduction**

4 In Docket No. R2005-1, the Postal Service has given explicit
5 recognition to the following set of facts: (i) DALs are handled separately
6 at various points in the postal network; (ii) each such handling incurs a
7 cost; (iii) the Postal Service’s aggregate costs obviously reflect all such
8 handling costs; (iv) the Postal Service’s systems used to develop the cost
9 of individual rate categories capture this cost; (v) at each point where the
10 costs of handling DALs are captured, they routinely are attributed to
11 letters, even though all revenues and volumes of DAL mailings are
12 credited to flats, and the result is a mismatch, or inconsistency, of data
13 between costs, revenues and volumes; (vi) a correction for the mismatch
14 needs to be made — namely, **deduct** all the costs of DALs mis-attributed
15 to saturation **letters**, and **add** those costs to saturation **flats**; and (vii) in
16 order to make such a correction, the Postal Service requires an estimate
17 of the annual volume of DALs, because none of its data systems identify,
18 much less record, the volume of DAL mailings separately.

19 In consequence of the foregoing, in this docket, for the first time,
20 the Postal Service has developed a procedure to estimate of the annual
21 volume of DALs. As explained elsewhere in this testimony, explicit

1 recognition of the cost of DALs is long overdue. This Appendix has two
2 purposes: (i) to assess the Postal Service's procedure and its resulting
3 estimate of the total volume of DALs, and (ii) to develop an alternative
4 estimate using publicly available data considered to be more
5 authoritative and reliable than the source used by the Postal Service. By
6 way of overview, the Postal Service's estimate is, at best, conservatively
7 low, and other evidence offered here indicates that it substantially
8 underestimates the total volume.

9 **Postal Service Methodology**

10 The Postal Service's estimate of the number of DALs is developed in
11 library reference USPS-LR-K-67, sponsored by witness Kelley (USPS-T-
12 16). The procedure is as follows. First, the number of possible
13 residential and business delivery points (including P. O. Boxes) as of
14 September 30, 2004 is obtained. Second, the number of DALs received
15 per week per delivery point is estimated on the basis of data from the
16 2004 Household Diary Survey (discussed below). Third, to estimate the
17 annual volume delivered to residences, the estimate of DALs received per
18 week is multiplied by (i) the number of residential delivery points, and
19 (ii) 52 weeks.

1 For business deliveries, a procedure generally similar to that
2 described above is followed, but only for business delivery points on rural
3 and contract highway routes. The reason for including these business
4 delivery points is because saturation rural mailings that use a simplified
5 address format are required to send a piece to every delivery point,
6 including all businesses. Neither the 7,185,300 businesses on city
7 routes, nor any of the 4,321,862 post office boxes are assumed to be
8 recipients of any DALs because, according to witness Kelley:⁶³

9 My understanding is that DAL mailings going to 100% of all
10 possible rural-route residential and business delivery points
11 are the only mailings among all city and rural Saturation
12 DAL mailings that include business delivery points.⁶⁴

13 When computing the annual volume of DALs for rural and highway
14 contract business points, witness Kelley uses the same basic procedure
15 described above, but with one significant change. He reduces the
16 frequency of DAL mailings to businesses on these routes. The figure of
17 6,248(000) shown in Table A-1 represents an 80 percent reduction in the
18 number of DALs delivered to businesses on rural routes, and a 90

⁶³ Response to VP/USPS-T16-10 (Tr. 7/2866-68).

⁶⁴ The Form 10-K of a major mailer of DALs, Harte-Hanks, states that it delivers to **every business** and residence in the parts of California that it covers. As Harte-Hanks is a major mailer covering much of California, this statement alone indicates that some businesses on city routes probably receive DALs, contrary to witness Kelley's assumption. Since The Household Diary Survey does not cover businesses, no recipient data are available that would either refute or support the statement by witness Kelley.

1 percent reduction in the number of DALs delivered to businesses on
2 highway contract routes. Although witness Kelley offers no explanation
3 for this reduction, it presumably reflects the small and shrinking number
4 of delivery points to which simplified addresses are applicable, on
5 account of the switch to numbered street addresses to facilitate
6 responses to 911 emergency telephone calls.

7 The Postal Service's estimating procedure is summarized below in
8 Table A-1. As shown there, the Postal Service estimates the total annual
9 volume of DALs at 3.375 billion.

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Table A-1

Postal Service Estimate of Annual Volume of DALs

	Sept 30, 2004	Estimated	Estimated
	Number of	FY04 DAL	FY04 DAL
	Possible	Mailings/week	Mailings/Year
	Deliveries	Per Delivery Point	(000)
	(000)		
	—	—	—
Residential Delivery Points:			
1. City	77,967.046	0.50	2,027,143
2. Rural	33,817.615	0.50	879,258
3. P. O. Box	15,634.610	0.50	406,500
4. Highway Contract	<u>2,162.772</u>	0.50	<u>56,232</u>
5. Total Residential	129,582.043		3,369,133
Business Delivery Points:			
6. City	7,165.300		
7. Rural	1,172.499		6,097
8. P. O. Box	4,321.862		
9. Highway Contract	<u>58.084</u>		<u>151</u>
10. Total Business	12,737.745		<u>6,248</u>
TOTAL ANNUAL VOLUME OF DALs			3,375,381

Source: USPS-LR-K-67, file FY2004.DAL.MAILING.VOLUME.ESTIMATED.WithFootnotes.xls, Attachment B, Annual Delivery Points.

1 Having estimated the total volume of DALs shown in Table A-1,
2 witness Kelley then extrapolates from his estimating procedure to
3 assume that only 2,912.5 million of the total 3,375.4 million DALs — or
4 86.3 percent — are delivered by city and rural carriers.⁶⁵ The remaining
5 462.9 million — or 13.7 percent — are assumed to be delivered to P.O.
6 Boxes (which are serviced by clerks) or by highway contract carriers.
7 Apparently relying on this assumption, witness Kelley deducts the costs
8 of 2,912.5 million DALs attributed to letters, and he attributes those
9 costs to flats.⁶⁶

10 In order to assess witness Kelley's assumption with regard to the
11 volume of DALs delivered to P.O. Boxes, Valpak was asked to determine
12 how many DALs it mailed to P.O. Boxes. As described in Section II of
13 this testimony, Valpak is a major user of saturation mail. Although
14 Valpak uses only letter-shaped mail, its mailing lists and its mailing
15 practices are thought to be representative of saturation mailers generally.
16 For a recent month, May, 2005, Valpak determined that less than 1.0
17 percent of its mail (0.77 percent) was sent to P.O. Boxes. Valpak

⁶⁵ USPS-LR-K-87, file
FY2004.DAL.MAILING.VOLUME.ESTIMATES.xls.

⁶⁶ Neither witness Kelley's testimony nor his library reference provides any rationale for reducing the volume of DALs used to correct the costs mis-attributed to letters.

- 1 considers its mailings in May, including the percent to P.O. Boxes, to be
- 2 typical of the entire year.

1 **The Household Diary Survey**

2 **Detached labels.** One item that respondents to the Household
3 Diary Survey are asked to report is “detached label.” Quarterly results of
4 the surveys for FY 1987 and FY 1999-2003 are shown in Table A-2. As
5 shown there, the yearly average for FY 2003 was 0.50 detached labels
6 per week.

7 Table A-2

8 **Detached Labels in Household Diary Survey**
9 (Pieces per Household Per Week)

	FY 1987	FY 1999	FY 2000	FY 2001(a)	FY 2001(b)	FY 2002	FY 2003
10 Quarter 1	0.6	0.6	0.2	0.1	0.3	0.6	0.5
11 Quarter 2	0.5	0.5	0.2	0.1	0.3	0.5	0.5
12 Quarter 3	0.7	0.7	0.5	0.1	0.3	0.5	0.5
13 Quarter 4	0.6	0.6	0.4	0.1	0.3	0.6	0.5
14 Total	2.4	2.4	1.3	0.4	1.2	2.2	2.0
15 Yearly 16 Average	0.6	0.6	0.33	0.1	0.3	0.55	0.5

17 Source: Data from The Household Diary Study, Mail Use & Attitudes in PFYs 2000-2003,
18 Table A3-2, Standard Mail by Major Industry by Quarter.

19 In FY 2002, the yearly average was 0.55 DALs per week, 10
20 percent higher than in FY 2003, and in FY 1987 and FY 1999, the yearly
21 average was 0.60 DALs per week, 20 percent higher. In FY 2000,
22 however, the yearly average inexplicably dropped to 0.33 DALs per week.
23 For FY 2001, two sets of data, labeled (a) and (b), are shown. The first,
24 FY 2001(a) appeared in the FY 2001 volume, and one year later, in the

1 FY 2002 volume, revised data, FY 2001(b) were published.⁶⁷ Like the FY
2 2000 yearly average, both of the FY 2001 yearly averages are inexplicably
3 low. As discussed below, major mailers that use DALs with their
4 saturation mailings, including the largest, Advo, Inc., mail in a pattern
5 that has been rather consistent from year to year. Fluctuations in the
6 yearly averages shown in Table A-2 indicate that Household Diary Survey
7 data for detached label mail are subject to a fairly wide range of
8 uncertainty, and possible unreliability.

9 Examination of Table A-2 also shows that data reported in the
10 Household Diary Survey are rounded to a single decimal point. That
11 alone introduces a range of uncertainty into the estimated annual
12 volume of DALs. Allowing for rounding, the average number of DALs was
13 anywhere between 0.45 (which would round up to 0.5) and just under
14 0.55 (which would round down to 0.5). Applying this range to the
15 estimated annual volume of 3.4 billion, using Household Diary Survey
16 data the actual number of DALs could have been anywhere from 3.06
17 billion to 3.74 billion.

⁶⁷ The yearly average for 2001(a), 0.10, is clearly an outlier. Disregarding this datum, the ratio of the high yearly averages in FY 1987 and FY 1999 (0.60) are twice the low yearly average of 0.30 in FY 2001(b).

1 category is almost 2.5 times the average number of DALs. Under witness
 2 Kelley's estimating procedure, 0.5 detached labels per week translate into
 3 3.4 billion pieces annually. Thus, using the same procedure, and
 4 focusing only on one year, 1.22 pieces per week would translate into an
 5 annual volume of around 8.3 billion pieces of N-FOO mail. This 8.3
 6 billion pieces is about two-thirds of the total FY 2004 volume of
 7 commercial saturation mail (letters and flats combined), which was 12.7
 8 billion pieces. Table A-4 is constructed on the assumption that all 8.3
 9 billion pieces of N-FOO mail were commercial saturation mail, and it
 10 distributes those pieces between letters and flats in proportion to FY
 11 2004 volume.

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Table A-4
 Mail Not From One Organization
 (Volumes in billions)

	FY04 RPW Volume ¹	Dist. (percent)	Volume of Mail Not From One Org.
Commercial Saturation Letters	3.148	24.9%	2.1
Commercial ECR Flats	<u>9.514</u>	<u>75.1</u>	<u>6.2</u>
TOTAL	12.662	100.0%	8.3

22

¹ Response to VP/USPS-T16-2, Alternative Attachment B (Tr. 7/2841-47).

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To sum up this part of the discussion about the category of N-FOO mail, the volume of 3.4 billion DALs estimated by witness Kelley is substantially less than the estimate of about 6.2 billion N-FOO flats in

1 Table A-4. Nothing in these data for FY 2003 indicate that the Postal
2 Service's estimated volume of 3.4 billion DALs is too high, and they
3 suggest that it could be too low by a substantial margin.

4 Looking at years prior to FY 2003, the yearly averages of N-FOO
5 mail are seen to vary far more widely than the corresponding averages for
6 detached labels. The low yearly average was 0.28 pieces per week in FY
7 2001(a), and the high yearly average was 2.53 pieces per week in FY
8 2000. Again, the yearly average for FY 2001(a) is something of an outlier.
9 Disregarding this datum, FY 1999 had the lowest yearly average, 0.35
10 per week. Using these data, along with witness Kelley's procedure for
11 estimating the annual volume of DALs, gives results that appear to be
12 both unrealistic and unreliable; see Table A-5, column 2.⁶⁸ Such wide
13 variations in yearly volumes are inexplicable, and call into question the
14 amount of weight that should be given to Household Diary Survey data,
15 especially data for a single year.

⁶⁸ The volumes shown in Column 2 are in proportion to witness Kelley's estimate of 3.375 billion DALs.

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Table A-5

Annual Mail Volume Not From One Organization

Fiscal Year	Pieces per Household per Week (1)	Pieces per Household per Year (billions) ¹ (2)
—	—	—
1987	0.45	3.04
1999	0.35	2.36
2000	2.53	17.08
2001(a)	0.28	1.89
2001(b)	0.78	5.27
2002	1.13	7.63
2003	1.22	8.24

¹ Not adjusted for annual changes in residential delivery points.

19 **Total number of pieces per week.** Because of the wide variations
20 in the yearly averages of mail received each week and recorded as (i)
21 Detached Label, and (ii) Not From One Organization, data for the total
22 number of pieces per week also were examined. These data are shown in
23 Table A-6.

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Table A-6

Total Pieces in Household Diary Survey
(Pieces per Household per Week)

	FY	FY	FY	FY	FY	FY	FY
	1987	1999	2000	2001(a)	2001(b)	2002	2003
Quarter 1	8.2	9.5	11.1	9.6	13.0	11.6	12.1
Quarter 2	7.3	7.2	8.9	8.8	11.7	10.3	10.1
Quarter 3	8.4	9.0	17.9	7.9	10.6	11.2	10.7
Quarter 4	7.4	7.6	16.4	7.9	10.3	11.2	10.0
Total	31.3	33.3	54.3	34.2	45.6	44.3	42.9
Yearly							
Average	7.83	8.33	13.58	8.55	11.4	11.08	10.73

Source: Data from The Household Diary Study, Mail Use & Attitudes in PFYs 2000-2003, Table A3-2, Standard Mail by Major Industry by Quarter.

13 The low yearly average of 7.83 pieces per week was recorded in FY
14 1987, and the high yearly average of 13.58 pieces per week occurred in
15 FY 2000. These averages show less variation than for N-FOO mail.
16 Nevertheless, the year-to-year change is much greater than the change
17 in total mail volume. Using the data in the bottom row of Table A-6,
18 along with witness Kelley’s procedure for estimating the annual volume
19 of DALs, gives interesting results for the total volume of mail received by
20 all Households; see Table A-7, column 2.⁶⁹ For comparison, total mail
21 volume for the years FY 1999-2003 is shown in column 4. The year-to-

⁶⁹ The volumes shown in column 2 are in proportion to witness Kelley’s estimate of 3.375 billion DALs.

1 year percentage change for recent years is shown in columns 3 and 5,
 2 and the lack of correlation between the percentages in those two
 3 columns is rather marked. Clearly, changes in the estimated total
 4 volume of mail received by households has been a rather poor predictor
 5 of total mail volume.

7 Table A-7

8 Annual Mail Volume Received by Households

9	10	11	12	13	14	15	16
	Fiscal	Pieces per	Pieces per	Year-to-	Total	Year-to-	
	Year	Household	Household	Year	Volume	Year	
		per Week	per Year	Change	(billions)	Change	
		(1)	(billions) ¹	(percent)	(4)	(percent)	(5)
	—	—	(2)	(3)	—	—	—
15	1987	7.83	52.85				
16	1999	8.33	56.23		201,644		
17	2000	13.58	91.67	+16.0%	207,882	+3.1%	
18	2001(a)	8.55	57.71	-37.0	207,643	-0.1	
19	2001(b)	11.40	76.95	-16.1	207,643	-0.1	
20	2002(a)	11.08	74.79	+29.6	202,843	-2.3	
21	2002(b)			-2.8			
22	2003	10.73	72.43	-3.2	202,185	-0.3	

23 ¹ Not adjusted for annual changes in residential delivery points.
 24

25 To sum up this discussion, whether Household Diary Survey data
 26 constitute a sample of households that is reliable, consistent, and
 27 representative of total mail volume sent to all households therefore
 28 appears highly questionable. Although better than no data at all,
 29 reliability of the Household Diary Survey data pertaining to detached
 30 labels deserves to be weighed against other publicly available sources of
 31 information discussed in the next section.

1 **Other Information**

2 The universe of saturation mailers using DALs consists of one
3 major, national firm, a few large regional firms, and a number of
4 relatively small firms that are more local than regional. A limited
5 amount of information on the larger firms is publicly available, and is
6 reviewed here.

7 **Advo.** Advo is a publicly traded company, operating nationwide.
8 Its Form 10-K for the fiscal year ended December 31, 2004, filed with
9 the Securities and Exchange Commission (“SEC”), states (at p. 1) that
10 “[t]he Company currently is the largest commercial user of standard
11 mail in the United States.” Advo’s core product, a shared advertising
12 program called Shopwise(TM) “reaches approximately 78 million
13 households, primarily on a weekly basis.” That program alone would
14 distribute approximately 4.06 billion pieces a year.⁷⁰

15 In addition, the Form 10-K states (at p. 2) that Advo has a wholly-
16 owned subsidiary, Mail Marketing Systems, Inc. (“MMSI”), which
17 “complements Advo’s core distribution network by providing additional
18 shared mail coverage to approximately 4.5 million households in 109
19 smaller market areas not served by ADVO.” Assuming this coverage in

⁷⁰ Advo’s website states that the “missing child piece” (a DAL)
reaches up to 85 million homes per week. On this basis, the annual volume of
DALs from Advo alone is as much as 4.4 billion pieces.

1 smaller market areas is only monthly, that would represent an
2 additional 54 million DALs annually.

3 Further, the Form 10-K states (at p. 3) that “ADVO [has] expanded
4 advertising programs in the Southern California and Pittsburgh
5 metropolitan areas at the end of the fiscal year 2004 approximately
6 doubling ADVO’s advertising program frequency” to twice a week.
7 Although the extra volume generated by these semi-weekly mailings is
8 not stated, the existence of such volume reinforces credibility of at least
9 4 billion DALs from Advo alone.

10 Finally, Advo “is part of a network, described as A.N.N.E.,
11 comprising of [sic] regional shared mail companies, which provides its
12 clients with extended coverage outside the markets already served by
13 the Company ... [and reaching] approximately 34 million additional
14 households.” See the sub-section “other mailers,” below, for further
15 discussion of annual volume generated by other mail marketing firms
16 that use DALs, some in conjunction with Advo, and some independent
17 of Advo.

18 **Harte-Hanks.** Harte-Hanks, Inc. is a publicly traded company.
19 Its core business is Shoppers, which “are weekly advertising
20 publications delivered free by Standard Mail to households and
21 businesses in a particular geographic area.” These publications have

1 “virtually 100% penetration in their area of distribution.”⁷¹ Harte-Hanks
2 is a regional company; its “California publications account for 87% of
3 Shoppers’ weekly circulation.” The balance of its business is in Florida.
4 Harte-Hanks’ Form 10-K for the fiscal year ended December 31, 2004,
5 filed with the SEC, states (at p. 7) that “[a]s of December 31, 2004,
6 [Harte-Hanks] Shoppers delivered more than 11 million shopper
7 packages in four major markets each week.” All of Harte-Hanks
8 Shoppers are DAL mailings. Harte-Hanks thus claims to have entered
9 more than 572 million DALs with the Postal Service in 2004.

10 **MailSouth.** MailSouth, Inc. is a regional mailer that, according to
11 a press release dated May 25, 2005, “specialize[s] in shared mail
12 advertising services in which advertising circulars and flyers of multiple
13 retailers and service businesses are collated into a single package and
14 then direct mailed to every household in a given market area with
15 targeting selectivity by postal zip code, neighborhood or specific
16 demographic variable.” According to the press release, which concerned
17 acquisition of another firm, MailSouth “will now serve over 11.5 million
18 unduplicated households in 285 different rural market areas on a

⁷¹ All quotations are from the Harte-Hanks Form 10-K for the year ended December 31, 2004, pp. 7-8.

1 monthly basis.” On this basis, MailSouth can be expected to enter each
2 year approximately 138 million DALs with the Postal Service.

3 **Other regional mailers.** A number of other regional and local
4 mailers are said to exist.⁷² As discussed above, for example, Advo
5 claims to have an alliance with a network of such regional dealers that
6 reaches 34 million households. Assuming that these others allied with
7 Advo collectively mail once a month would result in an additional
8 annual volume of 408 million DALs. Finally, allowing for a small volume
9 from other saturation mailers independent of Advo indicates a total
10 annual volume of DALs of 5.4 billion, as shown in Table A-8.

11 Table A-8
12 Annual Volume of DALs by Mailing Organization
13 FY 2004

14 Mailer	15 Volume (billions)
16 —	17 —
18 Advo	
19 • Shopwise	4.060
20 • MMSI	0.054
21 Harte-Hanks	0.572
22 MailSouth	0.138
23 Others, allied with Advo	0.408
Others, Independent <u>0.168</u>	
24 TOTAL	5.400

⁷² See, for example, testimony of Harry J. Buckle (SMC-T-1) in Docket Nos. R97-1 and R2000-1, on behalf of Saturation Mail Coalition.

1 **Conclusions and Recommendations**

2 The Postal Service’s procedure for estimating the annual volume
3 of DALs relies solely on survey data provided by recipients. The data
4 series for detached labels shows considerable year-to-year variation.
5 That variation greatly exceeds the variation in the annual volume of
6 saturation flats, and it likely exceeds the variation in the actual number
7 of DALs mailed. In addition, the annual variation in the total volume of
8 mail recorded by recipients greatly exceeds variations in the total
9 volume of mail. Reliability of these data appears highly questionable,
10 especially when used to extrapolate total volumes of mail for the entire
11 country.

12 Over 90 percent of the total volume shown in Table A-8 is derived
13 from data and information submitted to the SEC by major mailers
14 known to use DALs. They constitute much of the universe of saturation
15 mailers that use DALs. Unlike the Household Diary Survey data,
16 virtually no extrapolation is required. These data would thus appear to
17 be a considerably more reliable source for estimating the universe of
18 DALs.

19 In sum, the Postal Service’s estimated volume of DALs appears to
20 be substantially understated on the basis of other readily available
21 evidence. The annual volume of DALs in the saturation mailstream is

1 obviously quite large, and an adjustment clearly needs to be made to
2 recognize the cost of handling such a large volume of DALs. When
3 adjusting for the cost of handling DALs, I recommend that the
4 Commission use the figure of 5.4 billion shown in Table A-8. I further
5 recommend that the Commission assume that 99 percent of all DALs
6 are delivered by city and rural carriers. This recommendation reflects
7 the only data on record with regard to saturation mail sent to P.O.
8 Boxes; *i.e.* Valpak's percentage.

9 By any reckoning, the annual volume of DALs is quite substantial.
10 Using the Postal Service's ultra-conservative low estimate of 3.4 billion
11 derived entirely from indirect sources, the volume of DALs is seen to
12 exceed the entire volume of Nonprofit Enhanced Carrier Route mail in
13 FY 2004. An annual volume of 5.4 billion DALs would be almost as
14 much as the entire volume of First-Class cards. For a category this
15 large, the Postal Service clearly needs to establish better procedures for
16 gathering volume data and other pertinent information.