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

Postal Rate and Fee Changes, 1997	DOCKET NO: R97-1

DIRECT TESTIMONY
OF
DAVID R. FRONK
ON BEHALF OF
UNITED STATES POSTAL SERVICE

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AUTOBIOGRAPHICAL SKETCH

My name is David Fronk. I am a Senior Economist in Pricing in Marketing Systems. My primary duties are to develop Postal Service domestic rate and fee proposals. Specific areas of responsibility include First-Class Mail.

I joined the Postal Service in 1996. Prior to joining the Postal Service, I worked for 15 years as an economic and management consultant. For 10 of those years, I was employed as an Associate, Senior Consultant, and Principal by the consulting firm of Putnam, Hayes & Bartlett, Inc. (and a San Francisco firm which merged into it). For approximately five years, I maintained my own independent consulting practice. My consulting work included ratemaking and forecasting analysis in the electric utility and telecommunications industries. I also worked on a large number of commercial disputes (antitrust, licensing, etc.), primarily in high technology industries. This work frequently involved preparing pricing and demand analyses under alternative assumptions about costs, business conditions, future growth, and competitive response.

Earlier in my career, I also worked as an Economist at the Federal Trade Commission and the Internal Revenue Service, and as a Financial Management Analyst at NASA.

I received a BA in economics and history from the University of Minnesota in 1973. I also hold an MA in economics from the George Washington University (1979) and an MBA from Stanford University (1980).

This is the second piece of testimony I have filed with the Commission. I also filed direct testimony with the Commission in Docket No. MC97-1.

I. PURPOSE OF TESTIMONY

The purpose of this testimony is to describe the Postal Service's proposed rate design for First-Class Mail and to present the specific First-Class Mail rates that the Postal Service is requesting that the Commission recommend for approval. Rate levels will be described in terms of percentage changes, cost coverages, and total contribution. The testimony also includes a description of First-Class Mail volume trends, mail characteristics, and a recent rate history. The testimony concludes with a summary of the financial results of the proposed rates in Test Year 1998.

II. PROPOSAL

A. General Description of Proposed Rates and Proposal Highlights

The proposed average changes from current rates for First-Class Mail, including fee revenue, are as follows:

Letters	3.3%
Cards	5.9%
Total Class	3.4%

These changes result in revenues that are 199.5 percent of volume variable cost for letters and 183.7 percent of volume variable cost for cards. For the class as a whole, the resulting cost coverage is 199.0 percent.[1]

First-Class Mail letters are the vanguard service and the principal source of revenue and costs for the Postal Service. The most visible postal rate is the first-ounce rate for single-piece letters. The Postal Service proposes a one-cent, or 3.1 percent increase, in this flagship rate. The proposed increase from 32 cents to 33 cents is the smallest increase since postal reorganization. The Postal Service is also proposing to hold the additional-ounce rate at 23 cents per ounce; this rate has not changed since February 1991.

With three exceptions, the Postal Service's proposals keep all elements of the existing First-Class Mail rate structure in place. The first rate structure change is the introduction of new Prepaid Reply Mail and Qualified Business Reply Mail postage rates for both letters and cards. These new rate categories are introduced in Sections B and C below. The second proposed rate structure change is the elimination of the heavy-piece discount, which currently applies to presort mail weighing more than two ounces. The third rate structure change is a new Hazardous Medical Materials Surcharge.

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[1] While these cost coverages may appear high by historical standards, the change in costing methodology has worked to increase cost coverages across mail classes (see testimony of Dr. Bradley, USPS-T-13 and USPS-T-14, for a discussion of changes in costing methodology) The Test Year cost coverage for First-Class Mail before any rate changes is 194 percent. The First-Class Mail cost coverage resulting from this rate proposal continues to bear the same relationship to the system-wide average cost coverage as it did following Docket No. R94-1.

The Postal Service's proposed rates for First-Class Mail letters are presented below in Table 1. The proposed rate structure retains all existing presort and automation discounts, though the magnitudes of some discounts have changed to reflect the continued impact of postal automation and the results of new cost studies. The largest percentage increase in the letter rates is for the nonstandard surcharge, where a new cost study indicates higher rates are needed to recover costs.

The rates proposed for cards are presented in Table 2. It is proposed that the basic card rate increase by one-cent from 20 cents to 21 cents. This represents a 5 percent increase. As with letters, the card proposal retains all existing presort and automation discounts, though the magnitudes of some discounts have changed to reflect the continued impact of postal automation and the results of new cost studies.

Table 1 – Rates for First-Class Letters

	Current Rate (cents)	Proposed Rate (cents)
Single-Piece & Nonautomated Presort:		
Single Piece (all shapes):		
First Ounce	32	33
Nonstandard Surcharge	11	16
Hazardous Medical Materials Surcharge	N/A	50
Prebarcoded Parcels (experimental)*	28	29
Prepaid Reply Mail	N/A	30
Qualified Business Reply Mail	N/A	30
Presorted (all shapes):	29.5	31
First-Ounce	5	11
Nonstandard Surcharge	-4.6	0
Heavy Piece Deduction		
Additional Ounce	23	23
Automated:		
Letters (First Ounce):		
Basic Automation	26.1	27.5
3-Digit	25.4	26.5
5-Digit	23.8	24.9
Carrier Route	23	24.6
Flats (First Ounce)		
Basic Automation	29	30
3/5 Digit Flats	27	28
Nonstandard Surcharge	5	11
Heavy Piece Deduction	-4.6	0
Additional Ounce	23	23

* This experimental rate is in effect until April 28, 1998.

Table 2 -- Rates for First-Class Cards

	Current Rate (cents)	Proposed Rate (cents)
Single-Piece	20	21
Prepaid Reply Mail	N/A	18
Qualified Business Reply Mail	N/A	18
Nonautomated Presort	18	19
Basic Automation	16.6	17.6
3-Digit	15.9	17.0
5-Digit	14.3	15.9
Carrier Route	14	15.6

B. Prepaid Reply Mail

This proposed classification offers an opportunity for the general public to benefit from a discounted rate of 30 cents on prebarcoded, automation-compatible letters. Under this rate proposal, businesses or other organizations can provide their correspondents with Postal Service-approved, postage-paid courtesy envelopes that will enable the correspondents to return mail such as bill payments without affixing postage. The discounted rate is intended to benefit the public served by large-volume business mailers, such as utility companies or credit card companies.

The postage for this mail will need to be prepaid by the envelope provider. For example, a utility offering this service to its customers would prepay the postage for the courtesy envelopes it supplies for remittances. This prepayment of postage would be based on the number of courtesy envelopes returned, not on the full number of envelopes distributed with the bills.

This proposed classification also offers an opportunity for the public to benefit from a discounted rate of 18 cents on prepaid, Postal Service-approved cards. These cards will also need to be prebarcoded and automation compatible.

Under this proposal, businesses and other organizations offering Prepaid Reply Mail (PRM) to their customers will also need to pay a monthly fee to cover Postal Service auditing and administrative activities, as described in section VI.D below. Auditing activities are needed because the PRM postage accounting function would not be performed at Postal Service postage-due units, but instead would be performed by the PRM recipient.

This proposal offers consumers the convenience of prepaid envelopes and cards, and it avoids burdening and confusing the public with differently-rated postage stamps for both letters and cards. In addition, a key factor in developing this proposal is operational feasibility, that is, developing a processing and accounting approach that is workable for both mailers and Postal Service. In comparison to other alternatives, Prepaid Reply Mail has the advantage of avoiding administrative and enforcement problems associated with what would happen if the general public were expected to use differently-rated stamps for its First-Class Mail correspondence and transactions.[2]

[2] For a discussion of the infeasibility of alternatives using differently-rated postage stamps, see Decision of the Governors of the United States Postal Service on the Recommended Decisions of the Postal Rate Commission on Courtesy Envelope Mail and Bulk Parcel Post, Docket No. MC95-1 at 4 (March 4, 1996).

C. Qualified Business Reply Mail

This proposed classification offers a discounted rate of 30 cents postage for Qualified Business Reply Mail (QBRM) letters. A discounted rate of 18 cents would also be available for QBRM cards. Qualified means that the mail pieces will need to be Postal-Service approved and meet automation requirements such as prebarcoding.

While these proposed rates are the same as PRM, this classification would differ from PRM in the method of postage accounting and auditing. For QBRM, postage would be collected on a postage-due basis through an advance deposit account, as is currently the case with Business Reply Mail. As with PRM, the provider of the envelope pays the postage. To cover the costs of postage-due accounting, a per-piece Business Reply Mail fee would still apply; see discussion in section VI.E below.

The Postal Service expects that a number of organizations currently using Business Reply Mail may be interested in and qualify for either this classification or the PRM classification. The proposed rates for QBRM and PRM are identical because both types of mail have the same cost-avoidance characteristics (see the testimony of cost witness Miller, USPS-T-23). Whether an organization is interested in QBRM or PRM will depend on a number of factors, including its willingness to prepay postage and whether it finds a monthly fee or a per-piece fee more advantageous financially.

III. CHARACTERISTICS OF FIRST-CLASS MAIL

First-Class Mail consists of mailable matter weighing 11 ounces or less. It includes business and personal correspondence, cards, sealed parcels, bills, invoices, remittances, financial statements, and advertising. All mailable matter weighing 11 ounces or less may be sent as First-Class Mail. In practice, a large share of many types of mail eligible for First-Class Mail, such as publications and advertising, is mailed at lower Periodical and Standard (A) rates.

First-Class Mail is varied in content, but has fairly homogeneous physical characteristics. The average letter weighs only 0.6 ounces. Cards are five percent of total First-Class Mail volume. Within First-Class Mail letters, close to 94 percent of the pieces are letter-sized, six percent are flats, and less than one percent are other shapes.

By most measures, First-Class Mail is the predominant type of mail within the postal system. For example, in Fiscal Year 1996, First-Class Mail accounted for 54 percent of total mail volume and 59 percent of total mail revenue (domestic and international combined). Single-piece, nonpresorted First-Class Mail alone accounted for 30 percent of total mail volume and 38 percent of total mail revenue.

For purposes of market analysis, the First-Class Mail flow can be divided into four sectors: (1) household to household, (2) household to nonhousehold, (3) nonhousehold to household, and (4) nonhousehold to nonhousehold.

According to the "Household Diary Study: Fiscal Year 1995,"[3] about 20 percent of First-Class Mail originates from households, transmitted either to other households (7 percent of total First-Class Mail) or to nonhouseholds (13 percent). About 45 percent of First-Class Mail goes from nonhouseholds to households, and the remainder, 35 percent, is nonhousehold to nonhousehold mail.

As might be expected, household-generated First-Class Mail consists primarily of bill payments, greeting cards, and personal correspondence. The importance of payments needs to be emphasized. More than 79 percent of the mail sent by households to nonhouseholds in FY 1995 contained some type of payment (utility remittance, credit card payment, insurance premium, etc.).

The nonhousehold to household sector is the largest component of the First-Class Mail stream. The largest volume of First-Class Mail, in terms of content, continues to be bills. On average, households receive 2.9 bills per week. The majority of bills come from the service sector, including utility and medical bills. The insurance and credit card industries account for a substantial percentage of bills as well. After bills, the largest volume of First-Class Mail received by households from nonhouseholds consists of advertisements (7 percent), primarily from credit card companies, publishers, specialty stores, mail order companies, and banks.

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[3] USPS Library Reference H-162 The other numbers in this section were also taken from this source.

The major industry users of First-Class Mail are concentrated in the financial sector. The three largest senders of First-Class industry mail are banks, credit card companies, and insurance companies, which combine for 16 percent of total First-Class Mail volume. This high volume by industry corresponds with the large percentage of the mail stream associated with bills and remittances described earlier. Social/charitable/political/nonprofit organizations account for four percent of the total First-Class Mail volume, medical and non-Federal government organizations account for three percent each, and non-telephone utilities account for approximately two percent.

Since 1987, there has been an increase in the percentage of nonhousehold to household mail sent presorted or prebarcoded, up from 54 percent to 65 percent. Use of presorted First-Class Mail increased dramatically in the securities industry (from 38 percent in 1987 to 60 percent in 1995) and the mortgage industry (from 19 percent to 42 percent over the same period). In the early 1990s, these two industries had substantially lagged utility and credit card companies in the use of presort.

The volume of First-Class Mail received by a household varies according to demographic characteristics. As income and education increase, so does the volume of mail received. According to the 1995 Household Diary Study, households with incomes less than $7,000 per year receive less than one-half the mail received by households with incomes greater than $65,000 per year. Households receiving the largest volume of mail are those headed by an individual aged 45-54 years. Volume then falls off as the age of the head of the household increases. Volume of First-Class Mail received also depends on the occupation of the head of household and whether the household is urban or rural. As an occupational group, white collar professionals receive the most mail, and suburbanites receive more mail than both city-dwellers and rural households.

IV. VOLUME AND REVENUE HISTORY

Tables 1 and 2 provide historical information on First-Class Mail volumes, revenues, and percentage shares. Since 1970, First-Class Mail volume has decreased somewhat as a percentage of total mail volume, dropping from 59 percent of total volume in 1970 to 54 percent in 1990. Since 1990, however, First-Class Mail volume as a percentage of total mail volume has remained fairly steady at approximately 54 percent.

This decline in volume share occurred despite the fact that First-Class Mail volume has increased every year since 1976. From 1976 to 1996, First Class Mail volume nearly doubled, from 52.5 billion pieces annually to 98.2 billion pieces. The average annual growth rate in First-Class Mail volume has been declining in recent years, however. During the 1980s, First-Class Mail volume increased about 3.6 percent per year on average. During the 1990s, the average annual growth rate has been only 1.6 percent.

The growth in First-Class Mail since 1976 has been concentrated almost entirely in presorted (both automated and nonautomated) mail. Nonpresort letter volume has grown slowly and has fluctuated in the 54 billion to 57 billion piece range during the last 10 years, while actually declining throughout most of the 1990s. On the other hand, presort letter volume has grown since its inception in 1976 to 39 billion pieces in 1996. Card growth has similarly been dominated by the presort category, though cards represent only about 5 percent of First-Class Mail volume.

While both total letter and card volume have grown similarly over the long run, their patterns of growth do show recent differences. Letter volume has grown every year since 1976. Card volume has also grown virtually every year, but declined in 1992 and 1993 following the large rate increase implemented in February 1991.

In terms of revenue, First-Class Mail accounts for approximately 60 percent of domestic mail revenue. Of the $33.1 billion in First-Class Mail revenue in 1996, approximately $21.2 billion came from nonpresorted letters, emphasizing the continuing importance of single-piece letters in the mail stream. Cards generated less than $1 billion, or 3 percent, of First-Class Mail revenue.

Table 3
First-Class Mail
Volume Trends
(In millions)

Fiscal Year	Non-presort Letters	Presort Letters	Total Letters	Postal Cards	Post Cards	Presort Cards	Total Cards	Total First-Class
1970	47,769	0	**47,769**	803	1,601	0	**2,404**	**50,173**
1971	49,037	0	**49,037**	717	1,738	0	**2,455**	**51,492**
1972	48,046	0	**48,046**	574	1,673	0	**2,247**	**50,293**
1973	50,008	0	**50,008**	609	1,675	0	**2,284**	**52,292**
1974	50,605	0	**50,605**	568	1,755	0	**2,323**	**52,928**
1975	50,349	0	**50,349**	490	1,643	0	**2,133**	**52,482**
1976	50,310	0	**50,310**	496	1,652	0	**2,148**	**52,458**
1977	49,486	1,832	**51,318**	392	1,595	362	**2,349**	**53,667**
1978	50,826	2,779	**55,605**	343	1,526	508	**2,377**	**55,982**
1979	50,759	4,846	**55,606**	333	1,590	397	**2,320**	**57,926**
1980	51,056	6,838	**57,894**	334	1,489	559	**2,382**	**60,276**
1981	50,133	8,821	**58,955**	297	1,564	595	**2,456**	**61,410**
1982	48,586	11,096	**59,682**	349	1,601	569	**2,519**	**62,200**
1983	48,055	13,355	**61,410**	484	1,656	697	**2,837**	**64,247**
1984	50,267	15,310	**65,578**	340	1,800	711	**2,851**	**68,429**
1985	51,931	17,546	**69,477**	348	2,008	607	**2,963**	**72,440**
1986	53,189	19,808	**72,997**	354	2,024	812	**3,190**	**76,187**
1987	54,160	21,379	**75,539**	373	2,119	838	**3,330**	**78,869**
1988	55,785	24,793	**80,578**	506	2,579	1,086	**4,172**	**84,749**
1989	55,858	25,792	**81,650**	539	2,435	1,231	**4,206**	**85,855**
1990	56,788	27,585	**84,373**	483	2,824	1,590	**4,897**	**89,270**
1991	56,351	28,805	**85,156**	497	2,561	2,070	**5,128**	**90,285**
1992	54,963	31,232	**86,195**	610	2,507	1,470	**4,586**	**90,781**
1993	55,204	32,650	**87,854**	535	2,378	1,401	**4,315**	**92,169**
1994	55,057	35,507	**90,564**	438	2,562	1,768	**4,768**	**95,333**
1995	54,931	36,413	**91,344**	441	2,577	1,935	**4,951**	**96,296**
1996	54,151	39,058	**93,208**	454	2,598	1,956	**5,008**	**98,216**

Source: USPS Library Reference H-187 (Volume History)

Table 4
First-Class Mail
Summary Volume and Revenue Data
(in millions)

Fiscal Year	First-Class Mail Volume (in millions)	**% of Total Piece Volume**	First-Class Mail Revenue	**% of Total Domestic Mail Revenue** (Except Spcl. Srvcs.)
1970	50,173	**59%**	$3,492	**63%**
1975	52,482	**59%**	$6,021	**69%**
1980	60,276	**57%**	$10,146	**68%**
1985	72,440	**52%**	$16,740	**65%**
1990	89,270	**54%**	$24,023	**65%**
1995	96,296	**53%**	$31,955	**63%**
1996	98,216	**54%**	$33,117	**63%**

Source: USPS Library Reference H-187 (Volume and Revenue Histories)

V. RATE HISTORY

The most recent changes in First-Class Mail rates occurred on July 1, 1996 as a result of Docket No. MC95-1 reclassification reform. While Docket No. MC95-1 was essentially revenue neutral and left the basic First-Class Mail stamp price unchanged, it did adjust discounts for various presort and automation rate categories and significantly changed mail preparation requirements in some instances. As a result, direct comparison to previous rates is not always possible and will be noted in the discussion which follows. More detail on the First-Class Mail rate history can be found in USPS Library Reference H-187.

A. Letters

1. Single-Piece and Additional-Ounce Rate

The basic, first-ounce First-Class Mail letter rate has been changed 9 times since postal reorganization, increasing from 8 cents to 32 cents. The past two increases, occurring in 1991 and 1995, saw the rate go from 25 cents to 29 cents and then to 32 cents.

An additional-ounce rate is charged for ounces above the first ounce. Until 1975, this additional-ounce rate was the same as the first-ounce rate. Since then, a structure has been maintained where the additional-ounce rate is less than the first-ounce rate. Over the last 22 years, the additional-ounce rate has grown from 9 cents to 23 cents. In each set of rate adjustments, except for the nine months when the Commission's Docket No. R80-1 recommended rates were implemented under protest, the additional-ounce rate has increased by the same or a lesser amount than the first-ounce rate, thus gradually increasing the gap between these two rates. The additional-ounce rate has been unchanged at 23 cents since February 1991. During this time, the differential between the first-ounce rate and the additional-ounce rate has increased from 6 cents to 9 cents.

2. Presorted and Automation Rates for Letters and Flats

Rates for 3/5 digit presorted, nonautomated First-Class Mail letters were introduced in 1976 with an initial discount of 1 cent off the basic letter rate. Subsequently, that discount was increased to 2 cents in 1978, 3 cents in 1981, 4 cents in 1985, 4.2 cents in 1991, and 4.6 cents in 1995. As a result of Docket

No. MC95-1, the size of this discount was reduced to 2.5 cents, consistent with the evolving impact of automated mail processing. Carrier route presort incentives began with a 1-cent discount off the 3/5 digit presort rate in 1981. The discount was increased to 1.5 cents in 1988, 1.8 cents in 1991, and 2 cents in 1995. As a result of Docket No. MC95-1, the carrier route rate was only made available for delivery-point barcoded letters destinating in zones specified by the Postal Service. The difference between this rate and the nonautomated presort rate was increased to 6.5 cents.

Discounts for ZIP + 4 coded letters were introduced in 1983 at 0.9 cents for nonpresorted letters and 0.5 cents for presorted letters. In 1991, these discounts were increased to 1.4 cents and 0.6 cents, respectively. In 1995, these discounts were increased again to 1.5 cents and 0.7 cents, respectively. As a result of Docket No. MC95-1 classification reform, ZIP + 4 discounts were eliminated.

A prebarcoded letter discount was first offered in 1988. The current incremental prebarcoded discounts are 0.7 cents for 3-digit presorted pieces (compared to the Basic Automation rate) and 1.6 cents for 5-digit presorted pieces (compared to the 3-digit rate). The Basic Automation rate of 26.1 cents was also introduced in 1996 for automation pieces that do not meet the minimum volume requirements for 3-digit or 5-digit areas.

Prebarcoded flat rates were implemented in 1992, at 2.3 cents less than the basic nonpresorted rate for nonpresorted pieces and 1.5 cents less than the basic presorted rate for presorted pieces. In 1996, the discount for nonpresorted flats was eliminated. Now, prebarcoded flats meeting minimum volume requirements by 3/5-digit area receive a 2.5 cent discount from the nonautomated presort rate, and residual automation pieces pay a Basic Automation rate.

3. Other Letter Rates

First-Class Mail weighing one ounce or less and exceeding standard letter-size dimensions, or not conforming to a specified range of aspect (length to width) ratios, is assessed a nonstandard surcharge. The nonstandard surcharge for nonpresorted mail was set at 7 cents in 1979, and has increased three times since, to 11 cents today. The nonstandard surcharge for presorted mail was also set at 7 cents in 1979, but has since been reduced to 5 cents.

There is also a heavy piece deduction for presorted mail weighing more than 2 ounces. The discount, introduced at 4.0 cents per piece in 1988, is currently 4.6 cents.

B. Cards

The basic card rate has gone from 6 cents to 20 cents since postal reorganization. A 1-cent presort discount was introduced in 1976. The discount was increased to 2 cents in 1985, increased again to 2.1 cents in 1995, and then returned to the 2-cent level in 1996. As with letters, an incremental 1-cent carrier route discount from the 3/5 digit presort rate was introduced in 1981. It increased to 1.5 cents in 1988, 1.8 cents in 1991, and 1.9 cents in 1995. As a result of Docket No. MC95-1, the carrier route rate was only made available for delivery-point barcoded cards destinating in zones specified by the Postal Service. The difference between this rate and the nonautomated presort rate was increased to 4 cents.

As with letters, ZIP + 4 discounts were first offered in 1983 at 0.9 cents per piece for nonpresorted cards, and 0.5 cents for presorted cards. By 1995, these discounts had increased to 1.1 cents and 0.6 cents, respectively. Docket No. MC95-1 classification reform eliminated the ZIP + 4 discount.

A prebarcode discount for cards was offered beginning in 1988. In 1995, the prebarcode discounts for cards were 1.3 cents for nonpresort, 0.9 cents for 3-digit presort, and 1.5 cents for 5-digit presort. In 1996, the nonpresort prebarcoded rate was eliminated. Instead, prebarcoded cards meeting minimum volume requirements by 3-digit and 5-digit areas received a 2.1 cent and 3.7 cent discount from the nonautomated presort rate, respectively. Cards not meeting the minimum volume requirements by 3/5-digit area pay the Basic Automation rate.

VI. RATE DESIGN

A. Rate Design Issues

The testimony of witness O'Hara (USPS-T-30) discusses how the First-Class Mail rate proposal is consistent with the pricing criteria set forth in section

3622(b) of title 39, United States Code. In designing First-Class Mail rates, I also considered the following broad rate design issues.

1. Benchmarks and Avoided Costs

One of the critical issues affecting First-Class Mail rate design is establishing an appropriate point of comparison for determining automation related cost savings. That point of comparison is frequently termed the "benchmark" because it is the mail type used as the standard for computing cost savings. Simply stated, cost avoidances and the resulting discounts are measured by subtracting the cost of the rate category under consideration from the benchmark cost. Consequently, the benchmark is just as critical as the measured cost of the rate category in determining the discount.

A key aspect of choosing the benchmark for determining the bulk presort/automation discounts is the broad spectrum of nonpresorted mail. Nonpresorted mail includes everything from "clean" mail (uniform pieces featuring typewritten or pre-printed addresses and often mailed in bulk) to "dirty" mail (pieces featuring handwritten and incorrect or incomplete addresses) and all the mail in between. Using all nonpresort letters as a benchmark results in a larger discount than using a benchmark which tends to have all the attributes of presort/automated mail, except for the actual presortation or application of the barcode.

In its Docket MC95-1 Opinion and Recommended Decision, the Commission included an extensive discussion of the benchmark issue. In its analysis, the Commission generally concluded that discounts should be based on the costs that the worksharing activity (presortation, prebarcoded) avoids, rather than full cost differences. Discounts for bulk automation categories based in part on "dirty" rather than the "clean" mail most likely to be candidates for automation overstate the benefits of worksharing and can create the wrong incentive for mailers.

Setting discounts to compensate mailers only for the costs avoided by the Postal Service provides the bulk mailer an incentive to presort or apply a barcode only if it can do so at lower cost than the Postal Service.

In developing the bulk presort/automation discounts for letters and cards, I have focused on the costs avoided by successive degrees of presorting or automation compatibility. I have not blindly followed this approach in setting rates, however, because the statutory pricing criteria call for a balanced consideration of a number of factors, including fairness and equity, the effect of the rate increase on mailers, and simplicity in the rate structure.

The specific benchmark I used in setting the discounts for bulk automation letters is the sum of mail processing and delivery costs for bulk metered mail. As the Commission stated in Docket No. MC95-1 (paragraph 4302 at page IV-136), " ...the single-piece mail most likely to convert to the automation categories is limited to the bulk metered mail component." I focused on the mail processing and delivery cost aspects of this benchmark because these are the costs that will be affected by presorting and prebarcoding. Transportation and "other costs" are not likely to be avoided by these worksharing activities. The Commission reached the same conclusion about transportation and "other" costs in MC95-1 (paragraph 4273 at page IV-123).

2. Postal Service Automation Goals

For a number of years, the Postal Service has been relying on automation to control the costs of several mail processing and delivery functions. The goal has been to work toward a mailstream that is as barcoded as practicable. In developing my rate proposals, I have taken account of the importance of the automation program by developing discounts that not only recognize the need for continued bulk mailer participation in the automation program, but also create opportunities for single-piece mailers to benefit from automation-based rate reductions.

B. Rate Proposal for Letters

1. Single-Piece and Nonautomated Presort

The rate structure for single-piece and nonautomated presort letters currently consists of five components: (1) the single-piece, first-ounce rate, (2) the additional-ounce rate, (3) the nonautomated presort rate, (4) the nonstandard surcharge, and (5) the heavy piece discount. The Postal Service proposes retaining all elements of this rate structure except the heavy piece rate, which it proposes to eliminate. The Postal Service also proposes a new Hazardous Medical Materials Surcharge. In addition, as discussed above, the Postal Service is proposing new rates for two new categories: Prepaid Reply Mail and

Qualified Business Reply Mail. Prepaid Reply Mail and Qualified Business Reply Mail are discussed separately below in Sections D and E, respectively.

a. Single-Piece Letter Rate

The basic letter rate is the most visible and important rate in the eyes of the general public. In 1996, the basic letter rate (first-ounce only), accounted for about 30 percent of domestic mail revenue, far more than any other rate category in any other class of mail.

The Postal Service is proposing an increase of one cent, or 3.1 percent, in the basic letter rate. This is the smallest proposed increase since postal reorganization.

This increase is consistent with the Postal Service's revenue requirement and the statutory pricing criteria of the Act. In view of that revenue requirement, a proposal not to change this rate would impose unreasonably large rate increases in other classes of mail; conversely, a two-cent increase would unfairly relieve other classes of mail from sharing in the burden of the increase in the revenue requirement.

For administrative ease and to avoid burdening the public, the Postal Service is continuing the practice of proposing this rate in whole cents. Conceivably, some fractional rate could be developed which would satisfy the revenue requirement, but this would be cumbersome at best.

b. Additional-Ounce Rate

The Postal Service proposes maintaining the additional-ounce rate at 23 cents for both single-piece and presorted mail. Because this rate was last changed in Docket No. R90-1, this proposal continues to increase the difference between the first-ounce rate and the additional-ounce rate. The "degression" in the additional-ounce rate increased from 6 cents as a result of Docket No.R90-1 (29 cents minus 23 cents) to 9 cents as a result of Docket No. R94-1 (32 cents minus 23 cents). I now propose that it be increased to 10 cents (33 cents minus 23 cents).

The additional-ounce rate continues to be an important source of revenue for the Postal Service. In 1996, additional ounces generated about $4.3 billion in revenue, or 13 percent of First-Class Mail revenue for the year.

The proposal to maintain this rate at its current level is consistent with the revenue requirement. A uniform rate of 23 cents for both nonautomated and automated mail is also consistent with the need for simplicity in rate design.

c. Presorted, Nonautomated Rate

The Postal Service proposes a nonautomated presort rate of 31 cents, or 2 cents below the single-piece rate. This proposal retains 80 percent of the current discount of 2.5 cents. The 2-cent discount represents a passthrough of close to 90 percent of the measured cost avoidance as compared to the bulk metered benchmark cost (see Exhibit USPS-T-29C).[4] I reduced the discount somewhat in order to increase the incentive for mailers to prebarcode their mail and thus to further the automation goals of the Postal Service.

d. Nonstandard Surcharge

The Postal Service proposes increasing the nonstandard surcharge for nonpresort mail weighing one ounce or less from 11 cents to 16 cents. In addition, the Postal Service proposes increasing the nonstandard surcharge for presort mail weighing one ounce or less from 5 cents to 11 cents.

These increases reflect the results of new nonstandard surcharge cost data (see USPS Library Reference H-112). The proposed surcharges are the minimums needed to recover the additional mail processing costs associated with handling nonstandard mail.

e. Heavy Piece Discount

The Postal Service proposes eliminating the heavy-piece discount of 4.6 cents which currently applies to presort mail weighing more than 2 ounces. This change affects a relatively small number of mail pieces. In 1996, about 300 million pieces, or 1 percent, of First-Class Mail received this discount.

There are two related reasons for this proposal. First, by keeping the additional-ounce rate the same since 1990 and progressively increasing the difference with the first-ounce rate, the Postal Service has already reduced the

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[4] Shortly before the filing of the Request in this proceeding, the mail processing cost associated with the bulk metered benchmark estimate was revised, as indicated in USPS-T-29C. This revised cost was not available at the time this rate proposal for nonautomated presort mail was developed and approved by the Board of Governors

relative price for heavy pieces, making a special discount less necessary. Second, elimination of this discount simplifies the rate structure.

f. Hazardous Medical Materials Surcharge

The Postal Service proposes a rate of 50 cents per piece for this surcharge (see testimony of witness Currie, USPS-T-42, at Appendix A).

2. Automated

The rate structure for automated presort and carrier route letters and flats currently consists of several components. First, the rate structure for bulk automated letters consists of four tiers: basic, 3-digit, 5-digit, and carrier route. To be eligible for the 3-digit and 5-digit rates, a mailing must consist of 500 or more prebarcoded pieces. Further, to be eligible for the 3-digit (or 5-digit) rate, the mailing must have at least 150 pieces to the same 3-digit (or 5-digit) ZIP Code. Pieces that do not meet the 150-piece minimum pay the Basic Automation rate. Thus, the basic rate can be viewed as a rate for bulk residual barcoded pieces. The carrier route letter rate is only available for delivery-point barcoded letters destinating in zones specified by the Postal Service. Further, the mailing must have at least 10 pieces per carrier route. Pieces destined for routes with less than 10 pieces do not qualify for this rate category.

Second, the rate structure for bulk automated flats currently consists of two components: basic and 3/5-digit. To be eligible for the 3/5-digit rate, the mailing must consist of 500 or more pieces. Further, to be eligible for the 3/5-digit rate, the mailing must have at least 10 pieces per ZIP Code; remaining pieces pay the Basic Automation rate for flats. As in the case of letters, the Basic Automation rate can be viewed as a rate for bulk residual barcoded pieces.

The Postal Service is not proposing any changes in the piece minimums associated with this rate structure. In addition, all existing automation tiers will be retained.

Unit cost data for the bulk automation letter tiers are shown in Table 5. Differences for basic automation and 3-digit automation are in terms of the bulk metered benchmark, while the 5-digit and carrier route differences shown are in terms of the previous automation tier (for example, 5-digit difference in terms of 3-digit automation). As noted above, the single-piece mail most likely to convert to the automation categories is bulk metered mail, making it the appropriate benchmark.

Table 5
Unit Cost Data for Automation Letters

	Unit Costs* (Cents)	**Difference** (Cents)	**Notes**
Bulk Metered Benchmark	**13.6851**[5]	-	
Basic Automation	9.0298	4.6553	difference with benchmark
3-Digit	8.1997	5.4854	difference with benchmark
5-Digit	6.5995	1.6002	difference with 3-digit
Carrier Route	6.4170	0.1825	difference with 5-digit

* Unit costs include mail processing and delivery costs. Source USPS-T-29C.

[5] As indicated in the preceding footnote, very recently the mail processing cost associated with this benchmark was revised. This revision affects the differences for Basic Automation and 3-Digit mail shown in the table. This revised cost was not available at the time the rate proposals for these two rate categories were developed and approved by the Board of Governors.

a. Basic Automation and 3-Digit Automation

I have treated the 3-digit letter rate as the "key" from which the other letter automation rates are determined because this rate applies to the largest volume of barcoded letters. In the test year, 60 percent of the automation letters are in this rate category. The Postal Service proposes a modest, 0.1-cent reduction in the 3-digit automation discount. Currently this rate is 6.6 cents below the single-piece rate. The proposed rate of 26.5 cents is 6.5 cents below the proposed single-piece rate of 33 cents.

The Postal Service also proposes a 0.4-cent reduction in the Basic Automation discount. Currently this basic rate is 5.9 cents below the single-piece rate. The proposed rate of 27.5 cents is 5.5 cents below the proposed single-piece rate of 33 cents.

These somewhat smaller discounts reflect the use in this docket of a benchmark that better isolates the cost savings from automation. As shown in Table 5, the difference in unit costs (mail processing plus delivery) between a 3-digit letter and the bulk metered benchmark is 5.5 cents. To avoid rate shock and to maintain incentives to automate, I did not shrink the discount by the full 1.1 cents suggested by this difference. Instead my proposal retains over 98 percent of the current discount by passing through approximately 118 percent of the cost differential.

The Table 5 difference in unit costs between a basic automation letter and the bulk metered benchmark is 4.7 cents. To avoid rate shock, to maintain incentives to automate, and to help maintain the general rate relationship with 3-digit mail, I also passed through 118 percent of the cost difference in this instance. The proposed Basic Automation rate retains over 93 percent of the current discount for these pieces. I note that this rate proposal increases the gap between the Basic Automation and 3-digit rates from its current 0.7 cents to 1.0 cents. By increasing this gap, the Postal Service can reduce the risk that large 3-digit mailings will be fragmented into numerous smaller mailings, unnecessarily raising acceptance and mail processing costs.

b. 5-Digit

The Postal Service proposes maintaining the current 1.6 cent discount from the 3-digit rate. Use of this rate category, which contains the second largest volume among automated rate categories, is optional. Mailers can be expected to use this rate only when their cost of making the 5-digit separation is less than the rate difference between the 3-digit and 5-digit rates and when their mailings have sufficient geographic density. Accordingly, this proposed rate represents a 100 percent passthrough of the cost difference between 3-digit and 5-digit mail, as shown in Table 5.

c. Carrier Route

The Postal Service proposes a carrier route rate that is 0.3 cents below the proposed 5-digit rate. This proposed discount represents a 150 percent passthrough of the cost differential of 0.2 cents between 5-digit and carrier route mail.

At present, this incremental discount is 0.8 cents more than the 5-digit discount. I increased the discount over and above what a purely cost-based approach would suggest to help moderate the reduction in the carrier route discount. The proposed rate difference does recognize the extra mailer preparation required to make carrier route trays and packages.

d. Flats

The rate structure for bulk barcoded flats has two tiers: a basic barcoded rate and 3/5-digit presort rate. The Postal Service proposes a one-cent increase in each of these rates to 30 cents for the Basic Automation rate and to 28 cents for 3/5-digit flats. These rates are for the first-ounce, but one-ounce flats will also pay the nonstandard surcharge of 11 cents, so total postage for one-ounce basic automation and 3/5-digit flats will be 41 cents and 39 cents, respectively. Two-ounce flats will not pay the nonstandard surcharge, but will pay 23 cents for the second ounce, or a total postage of 53 cents and 51 cents, respectively, for basic automation and 3/5-digit flats.

Bulk automation flat rates are selected primarily to preserve the appropriate rate relationships between letters and flats in the automated arena, and between automation flats and the nonautomated presort rate that applies to both letters and flats. These considerations are most easily seen in the proposed rates for two-ounce pieces:

	----Automation-----		Nonautomated
	Letters	Flats	Presort
Basic	50.5	53.0	54.0
3-Digit Letters; 3/5 Flats	49.5	51.0	54.0

With the proposed rate relationships, barcoded flats pay less postage than nonautomated presort flats, and more postage than barcoded letters. This is consistent with the pricing criterion which calls for simple, identifiable relationships among rates (section 3622(b)(7) of title 39, U.S.C).

C. Rate Proposal for Cards

As discussed below, the proposed percentage increases for cards are somewhat higher than those proposed for letters. In large part, this is the result of applying whole cent increases to smaller current prices. (For administrative ease and to avoid burdening the public, the Postal Service is continuing the practice of proposing the most broadly used rates in whole cents.) This is also the result of working to narrow the gap between the cost coverages for letter and cards. The rates implemented in Docket No. R94-1 resulted in a letter cost coverage 38 percentage points higher than that for cards. The proposed rates in this proceeding would narrow this gap to about 16 percentage points.

1. NonAutomated

a. Single-Piece

Single-piece cards account for 60 percent of card revenues, more than any other card rate category. As was the case with single-piece letters, the Postal Service is also proposing an increase of one cent in the basic card rate. This represents an increase of 5 percent, and retains the 12-cent gap with the single-piece letter rate.

As in the past, this rate is proposed in whole cents to avoid the administrative difficulties and the public confusion and inconvenience that would result from a fractional rate. Also, a one-penny increase is the amount consistent with the Test Year revenue requirement.

b. Presorted

The Postal Service also proposes a one-cent increase in the nonautomated presort card rate. This maintains the two-cent discount from the single-piece card. It is also consistent with the proposed 2-cent difference between the single-piece letter rate and the rate for nonautomated presort letters.

2. Automated

The rate structure for automated presort and carrier route cards consists of four tiers: basic, 3-digit, 5-digit, and carrier route. As was the case with letters, a mailing must consist of 500 or more prebarcoded pieces to be eligible for the 3-digit and 5-digit rates. Further, to be eligible for the 3-digit (or 5-digit) rate, the mailing must have at least 150 pieces to the same 3-digit (or 5-digit) ZIP Code. Pieces that do not meet the 150-piece minimum pay the Basic Automation rate. Thus, the basic rate can be viewed as a rate for bulk residual prebarcoded pieces.

The carrier route letter rate is only available for delivery-point barcoded letters destinating in zones specified by the USPS. Further, the mailing must have at least 10 pieces per route. Pieces destined for routes with less than 10 pieces do not qualify for this category.

The Postal Service does not propose any changes in the piece minimums associated with this rate structure. In addition, the Postal Service proposal retains all existing automation tiers.[6]

a. 3-Digit Automation and Basic Automation

As is the case with bulk letters, I have treated the 3-digit card rate as the "key" from which the other card bulk automation rates are developed because this rate applies to the largest volume of barcoded cards. In the test year, close to 50 percent of the bulk automation cards are in this rate category.

The Postal Service proposes a 3-digit rate that is 2 cents below the nonautomated presort rate. This represents a 100 percent passthrough of the cost difference with nonautomated presort cards. This discount represents a slight reduction, 0.1 cents, in the current difference between nonautomated

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[6] Cost data referenced in this section on automated rates are taken from Exhibit USPS-T-29C.

presort and 3-digit cards.

The basic automation rate proposal maintains the current 1.4 cent discount from the nonautomated presort rate.

b. 5-Digit

The 5-digit rate represents a 100 percent passthrough of the cost difference between 3-digit and 5-digit cards. The resulting discount of 1.1 cents is less than the current 1.6 cent discount. Use of this rate category is optional. Mailers can be expected to use this rate only when their cost of making the 5-digit separation is less than the rate difference.

c. Carrier Route

The Postal Service is proposing to maintain the carrier route rate at 0.3 cents below the proposed 5-digit rate. While the card cost data suggest that a larger carrier route discount would be possible, the cost estimates are based on a very small amount of data due to the small volume in this rate category. An incremental discount of 0.3 cents would match the incremental discount for letters, where there are considerably more data available. The proposed rate difference does recognize the extra mailer preparation required to make carrier route trays and packages.

D. Rate Proposal for Prepaid Reply Mail

1. Introduction to the Proposal

The proposed Prepaid Reply Mail (PRM) classification offers an opportunity for the general public to benefit from a discounted rate of 30 cents.

The proposed new rate is 3 cents less than the proposed basic letter rate of 33 cents.

This discounted letter rate is intended to benefit the customers of large-volume business mailers, such as utility companies or credit card companies. Households and others would be provided with PRM envelopes[7] by the PRM account holder for which no postage would need to be affixed for mailing. The envelopes would be used to return bill payments or other correspondence to the envelope provider, a PRM account holder who would pay the postage (and applicable fees).

The Postal Service also proposes a new discounted card rate of 18 cents for PRM. This proposed rate offers the general public an opportunity to benefit from the same discount of 3 cents on certain automation-compatible cards.[8] The cards would be used to return orders or other information to the card provider, a PRM account holder who would pay the postage (and applicable fees).

For both letters and cards, the postage would need to be prepaid by the envelope provider. For example, if a utility offers this service to its customers, it would prepay the postage for the courtesy envelopes it supplies for remittances at the time it mails out the bills. This prepayment of postage would be based on

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[7] The envelopes would be pre-approved by the Postal Service. They would need to meet Postal Service automation standards and bear a Facing Identification Mark, a proper barcode, and indicia signifying the piece is eligible for the discount

[8] The cards would be pre-approved by the Postal Service and required to meet the automation standards discussed in the preceding footnote. Thickness requirements would also have to be met. Cards that are too thin can jam automation equipment and erode mail processing cost savings.

the average percentage of envelopes returned, not on the full number of envelopes distributed with the bills.

The new rates offer consumers the advantages of convenience and potential savings in mailing costs. Advantages to businesses include potentially faster return of remittances and goodwill from their customers.

The Postal Service further proposes a monthly fee of $1000 for mailers who choose to offer PRM envelopes or cards to their correspondents. As discussed below, this fee will cover certain Postal Service administrative and accounting expenses. A special PRM permit will also be required at $100 annually (see the testimony of witness Needham, USPS-T-39).[9]

2. Context of the Proposal

a. Electronic Diversion

Invoices and bill payments are the largest component of the First-Class Mail stream. As noted earlier, households receive on average about 3 bills per week. More than 79 percent of the mail sent by households to nonhouseholds contains some type of payment (utility remittance, credit card payment, insurance premium, etc.).

Historically, consumers have paid their bills through the mail or in person. In recent years, however, technological advancements have created many new options for consumers, including payment by telephone, by automatic debit

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[9] This monthly fee of $1,000 would typically be proposed in the testimony of the Special Services pricing witness. I have included this proposed new fee here because it is an integral part of the proposed PRM classification

payment from a bank account, by automatic deduction from a debit or credit card, by automated teller machine, and by personal computer. It is now possible to set up electronic bill payment accounts with several large banks. For example, for a monthly fee of approximately $4 or $5, a bank will pay bills electronically (for payees who accept electronic funds transfer) or produce and mail checks (when electronic funds transfer is not possible). In the Chicago area, 6 percent of households use on-line banking services.[10]

Electronic alternatives to the mail are discussed at some length in the testimony of witness Tolley (USPS-T-2, Chapter II). In a section on Electronic Funds Transfer, Dr. Tolley references a "Bank Network News" estimate that electronic funds transfer volume has nearly tripled from 3,579 million in 1985 to 10,464 million in 1995. These transactions can be used to send electronic remittances instead of checks through-the-mail. Dr. Tolley further indicates that check printing industry data support the expectation that electronic remittances are growing. While check printing volume grew at an average annual rate of 3 percent during the 1980s and early 1990s, the American Bankers Association anticipates that U.S. check printing volume will grow no faster than 1 percent per year over the next decade.

While some may quarrel over how quickly various forms of electronic payment will become widespread, it appears clear that electronic diversion is a real threat to through-the-mail bill payment. The proposed PRM rate can help

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[10] Metropolitan Chicago Information Center (MCIC) Update, Spring 1997.

address the threat of electronic diversion and, at the same time, provide added convenience for the general public.

b. Sharing the Benefits of Automation and Improving the Convenience of the Mail

PRM is clean, pre-barcoded mail and incurs less mail processing costs than non-barcoded mail. Automation-compatible First-Class Mail is used daily by millions of individuals and small businesses. By recognizing some of the cost savings associated with this mail, the Postal Service is able to permit the general public to more directly share in the benefits of automation and to enjoy the convenience of not having to affix postage to a portion of their core correspondence.

The concept of a discounted rate in the form of Courtesy Envelope Mail (CEM) rate or a Public's Automation Rate (PAR) has been around for some time. The Commission recommended the adoption of either shell classifications or rates and classifications of this type in Docket Nos. R87-1, R90-1, and MC95-1.

In comparison to other alternatives, Prepaid Reply Mail has the advantage of not burdening and confusing the public with two different stamps for both letters and cards. The proposal also has the advantage of avoiding the serious Postal Service administrative and enforcement problems associated with what would happen if the general public were expected to use differently-rated postage stamps for its First-Class Mail correspondence and transactions.[11]

[11] For a detailed discussion of the problems with two stamps, see the testimony of witness Alexandrovich (USPS-RT-7) and witness Potter (USPS-RT-6) in Docket No. MC95-1.

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c. Market Research

Quantitative consumer market research was conducted via the CARAVAN® Survey of "Prepaid Reply Mail: Household Weighting Study."[12] Approximately 68 percent of the households indicated that PRM was very or somewhat attractive. About 62 percent of the households indicated that the potential added convenience of the service was either extremely important or somewhat important.

The great majority of households (81 percent) indicated that the inclusion of a PRM envelope with the billing statement would have either a strong positive influence or somewhat of a strong positive influence on the level of customer satisfaction with the company, indicating that businesses could generate significant goodwill by offering this service. In addition, 14 percent of households indicated they would definitely mail the payment back sooner with PRM, and 29 percent of households indicated they would send the payment back maybe a little sooner.

The survey demonstrated that PRM could potentially generate some new volume by converting some in-person payments to the mail. About 26 percent of households currently paying some bills in-person indicated that it is very likely that they would switch some or all bill payments from in-person payment to PRM if it were available. An additional 28 percent said it was somewhat likely that they would switch from in-person payments to PRM.

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[12] USPS Library Reference H-200.

On the other hand, almost three-quarters of households currently using electronic methods to pay some of their bills would not be likely to switch bill payments from electronic methods to PRM if it were available. This suggests that the convenience of PRM is more likely to forestall electronic diversion than reverse it.

3. Operating Concept

The PRM postage accounting function would not be performed at postage due units, but instead would be performed by the PRM recipient. Each participating business would need to maintain a certified, high-quality, easily-audited system for determining the amount of mail received. Typically, the PRM recipient would count the PRM pieces anyway as part of a bill processing or order processing system.

The Postal Service will establish auditing procedures for each PRM recipient which are designed to protect postal revenue in a manner which minimizes disruption of mail processing and permits expeditious transfer of processed mail from the delivery unit to the PRM recipient. The latter objective is a key consideration in the processing of remittances. Auditing approaches will be modeled after those currently in use for outbound manifests of bulk mailings. A monthly fee of $1,000 will be charged to cover Postal Service costs associated with these activities.

An overriding factor in developing this proposal is operational feasibility, that is, developing a processing and accounting approach that is workable for both mailers and the Postal Service.

Reply mail recipients offering this prepaid service to their customers will be required to maintain a Centralized Accounting Payment System (CAPS) debit account. On approximately a weekly basis, the account will be debited for the amount of postage the mailer is expected to owe for the week. On a monthly basis, the monthly fee will be debited. Postage must be paid by the recipient on all PRM envelopes received; the Postal Service will not provide refunds or offsets for PRM envelopes on which the mailer has affixed postage.

4. Costs

The cost study prepared by witness Miller (USPS-T-23) shows a cost avoidance of 4.0 cents, applicable to both letters and cards. Given the uncertainty in the estimate of the volume of mail likely to qualify for this rate (discussed below), I have passed through 3 cents, or approximately 75 percent of the estimated cost savings in developing both the letter rate and the card rate.

Not passing through the full amount of the estimated cost savings is consistent with past ratemaking practice involving new discounts. A conservative passthrough provides a hedge against the product attracting more volume from full-rated First-Class Mail than anticipated and consequently having a larger revenue impact than anticipated. At the same time, however, the new rate better aligns rates with costs.

The proposed monthly fee of $1,000 is set at a level which recovers the administrative and auditing costs associated with making sure that the mailer-supplied piece counts are correct. The auditing approach will be modeled after those currently in use for outbound manifests. Audits of these types involve professional postal personnel; EAS grades 18 and 21 are representative of the type of personnel involved in these activities.

The hourly cost (fully loaded) of an EAS 18 employee is $49.11 per hour. The hourly cost of an EAS 21 employee is $54.34 per hour.[13] Assuming both levels are used in approximately equal amounts, I averaged the two rates together for an average hourly cost of $51.73.

The Postal Service estimates that to establish a PRM "system" would involve 14 person days during the first year at a labor cost of about $5,800.[14] Needed travel costs would be extra. Once established, the Postal Service anticipates that 10 person days would be involved annually at a labor cost of about $4,100.[15] Again, needed travel would be additional.

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[13] See USPS Library Reference H-194.

[14] Cost comprised of: 14 person days * 8 hours per day * $51.73 per hour. Four person days (2 site visits, 2 individuals per one-day visit) to set the system up. Monthly site visits would then be necessary for approximately 6 months, involving 6 person days (1 person per one-day visit). At the end of one year, the system would be audited again, involving 4 person days (2 persons for a two-day visit).

[15] Cost comprised of: 10 person days * 8 hours per day * $51.73 per hour. Eight person days for semiannual audits (2 site visits, 2 individuals per two-day visit) plus two person days over the course of the year for ongoing administrative activities.

Thus, a $1,000 fee is sufficient to cover estimated costs. In the future, the Postal Service may be able to lower this fee should these estimates prove accurate. A somewhat higher fee initially serves two purposes. First, it is a hedge against the uncertainty surrounding the administration of any new postal service and the resulting cost estimates. Second, it allows the Postal Service an opportunity to adjust operationally to this new service and to develop expertise and administrative controls while setting up and overseeing a manageable number of PRM accounts. With a lower fee, the Postal Service could potentially be affected by a higher than anticipated response.

5. Volume Estimate

PRM will come from two sources. First, certain courtesy reply mail recipients will qualify. There will be an estimated 6,800 million pieces of courtesy reply envelope mail in Test Year 1998.[16] Second, certain high-volume Business Reply Mail users who prebarcode their pieces and currently qualify for the 2-cent per- piece BRM fee may qualify for PRM. There are an estimated 527.7 million such BRM letter and card pieces in Test Year 1998.[17]

I develop my estimate of how many of these pieces will switch to PRM in two steps. First, I estimate that up to 286.6 million BRM letters and 61.2 million BRM cards will convert to PRM, for a total of 347.8 million pieces. I develop this

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[16] In FY 1996, 12.51 percent of the single-piece First-Class Mail in ODIS (excluding BRM) was identified as Stamped and Metered FIM (see Response to OCA/USPS-T3-10 in Docket No. MC97-1). Applying this percentage to TY 1998 single-piece volume of 54.5 billion yields 6.8 billion pieces.
[17] See testimony of witness Needham, USPS-T-39.

estimate by computing the break-even BRM volume needed to make the monthly fee of PRM less expensive than the per-piece fees of BRM. I then aggregate the volumes associated with the BRM permits above this break-even volume. These calculations are contained in my Workpaper III.

Second, the Postal Service has limited information about how much courtesy reply mail might switch to PRM. As described below, I have developed a "round-number" estimate of 500 million pieces of courtesy reply envelope mail that might shift to PRM.

Household Diary Study data indicate about 41 percent of courtesy reply envelopes are associated with two industries likely to be attracted to this rate – credit card companies and utilities. Taking 41 percent of 6,800 million pieces of courtesy reply envelope mail yields 2,800 million pieces. In the Test Year, I estimate up to 10 percent of this mail would switch to PRM, yielding 280 million pieces.

I further estimate that a smaller fraction, 2 percent, of the remaining 4,000 million pieces of courtesy reply envelope mail could switch to PRM. The result is 80 million pieces. I based this percentage on the experience of the Postal Service in introducing a barcode discount in the late 1980s. In the first full year following the introduction of barcodes (1989), 2.0 percent of presorted mail was barcoded. (This percentage increased to 6.5 percent in 1990.) While not a perfect parallel by any means, experience with this postal product provides some estimate by computing the break-even BRM volume needed to make the monthly fee of PRM less expensive than the per-piece fees of BRM. I then aggregate the volumes associated with the PRM permits above this break-even volume. These calculations are contained in my Workpaper III.

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I further estimate that a smaller fraction, 2 percent, of the remaining 4,000 million pieces of courtesy reply envelope mail could switch to PRM. The result is 80 million pieces. I based this percentage on the experience of the Postal Service in introducing a barcode discount in the late 1980s. In the first full year following the introduction of barcodes (1989), 2.0 percent of presorted mail was barcoded. (This percentage increased to 6.5 percent in 1991.) While not a perfect parallel by any means, experience with this postal product provides some insight into the potential for PRM and how initial business resistance can be overcome.

Because of the uncertainty in this 360 million piece estimate of mail switching from courtesy reply envelope mail to PRM (280 + 80 million), and, therefore, the uncertainty in the range around a point estimate, I increased the estimate to 500 million pieces. In one sense, this is conservative as it is a hedge against the revenue loss associated with a higher than anticipated acceptance of PRM. At the same time, I believe the Postal Service would aggressively promote the classification as it is now formulated.

The total estimate of PRM volume in the Test Year is 847.8 million pieces (the sum of 347.8 million BRM pieces and 500 million courtesy reply pieces). In the next section, I discuss the rate proposal for Qualified Business Reply Mail and develop a volume estimate for it in the Test Year. I estimate that PRM and QBRM together will account for approximately 1 billion pieces in the Test Year.

E. Rate Proposal for Qualified Business Reply Mail

1. Introduction to the Proposal

The Postal Service proposes a new discounted letter rate of 30 cents for pre-approved, prebarcoded, automation-compatible Business Reply Mail letters, and a new discounted rate of 18 cents for pre-approved, prebarcoded, automation-compatible Business Reply Mail cards.

While these proposed rates for Qualified Business Reply Mail (QBRM) are the same as PRM, this classification would differ from PRM in that the postage-due calculation would be performed by the Postal Service and an advance deposit account would be debited, as is currently the case with Business Reply Mail. To cover the costs of postage-due accounting, a per-piece Business Reply Mail fee of 6 cents would apply (see the testimony of witness Needham, USPS-T-39, for a discussion of this fee).

The Postal Service estimates that a number of organizations currently using Business Reply Mail may be interested in and qualify for either this classification or the PRM classification discussed above. The proposed rates for Qualified Business Reply Mail (QBRM) and PRM are identical because both types of mail have the same cost-avoidance characteristics. Whether an organization is interested in QBRM or PRM will depend on a number of factors, including the willingness to prepay postage and whether it finds the PRM monthly fee of $1,000 or a per-piece fee of 6 cents more advantageous financially.

As was the case with PRM, QBRM is clean, prebarcoded mail and incurs less cost than non-barcoded mail. Automation-compatible First-Class reply mail is used daily by millions of individuals and small businesses. By recognizing some of the cost savings associated with this mail, the Postal Service is able to permit a broader base of customers to more directly share in the benefits of automation.

2. Costs

The cost study prepared by witness Miller (USPS-T-23) applies to PRM and to Qualified Business Reply Mail. That study shows a cost avoidance of 4.0 cents, applicable to both letters and cards. As with PRM, I have passed through 3 cents, or approximately 75 percent of the cost savings in developing both the letter rate and the card rate for QBRM.

Not passing through the full amount of the estimated cost savings is consistent with past ratemaking practice involving new discounts. A conservative passthrough provides a hedge against the product attracting more volume from full-rated First-Class Mail than anticipated. At the same time, however, the new rate better aligns rates with costs.

3. Volume Estimate

QBRM in the Test Year will come from current Business Reply Mail. I estimate that up to 132.8 million BRM letters and 47.1 million cards that are prebarcoded and meet the requirements for the current 2-cent per-piece BRM fee will qualify for this new rate. I develop this estimate by computing a break-even BRM volume needed to make the monthly fee of PRM more expensive than the per-piece fee of BRM. In essence, all automation-compatible, prebarcoded letters and cards currently paying the 2-cent per-piece fee are allocated to either the PRM classification or the QBRM classification on the basis of the break-even calculation. These calculations are presented in my Workpaper III.

It is possible that the new QBRM rate will attract new volume in the future, but this volume is uncertain and I have not attempted to quantify it in this analysis.

F. Classification Criteria Applied to Prepaid Reply Mail and Qualified Business Reply Mail

Section 3623(c) of title 39 requires that changes to classification schedules be made in accordance with the following factors:

1. The establishment and maintenance of a fair and equitable classification schedule for all mail;

2. the relative value to the people of the kinds of mail matter entered into the postal system and the desirability and justification for special classifications and services of mail;

3. the importance of providing classifications with extremely high degrees of reliability and speed of delivery;

4. the importance of providing classifications which do not require an extremely high degree of reliability and speed of delivery;

5. the desirability of special classifications from the point of view of both the user and the Postal Service; and

6. such factors as the Commission may deem appropriate.

Achieving fairness and equity is an important goal for the Postal Service in preparing rate proposals. The proposed new categories for Prepaid Reply Mail and Qualified Business Reply Mail promote fairness and equity by establishing rates that are more closely aligned with costs. Also, by recognizing some of the cost savings associated with this mail, the Postal Service is able to permit a broader base of customers to more directly share in the benefits of automation (Criterion 1).

PRM and QBRM have considerable value. By facilitating the invoice/remittance mail cycle and making bill payments more convenient, the Postal Service is able to enhance the value of an important component of the mail stream. In addition, these services can enhance commerce by facilitating access to services offered by firms (Criterion 2).

Speed of delivery is important for both PRM and QBRM. Prompt turn-around of bill payments or customer orders is of obvious business importance. Both rate categories have been developed to allow the PRM or QBRM recipient to receive its mail in as expeditious a manner as possible (Criterion 3). Criterion 4 is not applicable in this instance.

This proposal enhances the desirability of the mail by better meeting the needs of PRM and QBRM mail recipients and their correspondents (Criterion 5).

VII. SUMMARY OF THE FINANCIAL IMPACT OF THE RATE DESIGN

The overall rate proposal, including percentage changes in the rates for each rate category, is presented in Exhibit USPS-32A. The financial impact of the rate design is detailed in Exhibit USPS-32B. The calculations supporting these financial results are contained in my Workpapers I and II.

The key financial results are summarized below in Table 6. Revenues include fees. In developing these estimates, I made three adjustments related to

First-Class single-piece letter mail: (1) the elimination of the Standard (A) Mail single-piece rate category resulted in the migration of volume to single-piece First-Class Mail; (2) Priority Mail delivery confirmation resulted in volume migration away from First-Class Mail to Priority Mail; and (3) the imposition of the proposed Hazardous Medical Materials surcharge resulted in single-piece First-Class Mail volume loss. Associated costs and revenues were also adjusted accordingly. These adjustments are detailed in my Workpaper I. I also moved full-rated, single-piece letter and card volume to the proposed new PRM and QBRM rate classifications as discussed in Sections VI.D and VI.E above.

Table 6
Estimated Total Revenues and Cost
Test Year After Rates 1998 ($ thousands)

	Revenues	Costs	Contribution	Percentage Rate Increase
Letters	$33,614,768	$16,846,154	$16,768,614	3.3%
Cards	$1,088,978	$592,934	$496,044	5.9%
Total Class	$34,703,746	$17,439,088	$17,264,658	3.4%

FIRST-CLASS MAIL
CURRENT AND PROPOSED RATES FOR LETTERS AND CARDS

	Current Rate (Cents) (1)	**Proposed Rate (Cents) (2)**	% Change (3)
REGULAR			
Letters, Flats & IPPs:			
Non-presorted:			
First Ounce	32	**33**	3.13%
Nonstandard Surcharge	11	**16**	45.45%
Hazardous Medical Materials Surcharge	N/A	**50**	N/A
Prebarcoded Parcels (experimental)*	28	**29**	3.57%
Prepaid Reply Mail	N/A	**30**	N/A
Qualified Business Reply Mail	N/A	**30**	N/A
Presorted:			
First Ounce	29.5	**31**	5.08%
Nonstandard Surcharge	5	**11**	120.00%
Heavy Piece Deduction	-4.6	**0**	N/A
Additional Ounce	23	**23**	0.00%
Cards:			
Single Piece	20	**21**	5.00%
Prepaid Reply Mail	N/A	**18**	N/A
Qualified Business Reply Mail	N/A	**18**	N/A
Presorted	18	**19**	5.56%
AUTOMATED:			
Letters & Flats:			
Letters (First Ounce):			
Basic Automation	26.1	**27.5**	5.36%
3-Digit Letters	25.4	**26.5**	4.33%
5-Digit Letters	23.8	**24.9**	4.62%
Carrier Route Letters	23	**24.6**	6.96%
Flats (First Ounce):			
Basic Automation	29	**30**	3.45%
3/5 Digit Flats	27	**28**	3 70%
Nonstandard Surcharge	5	**11**	120.00%
Additional Ounce	23	**23**	0 00%
Heavy Piece Deduction	-4.6	**0**	N/A
Cards:			
Basic Automation	16.6	**17.6**	6.02%
3-Digit Cards	15.9	**17**	6.92%
5-Digit Cards	14 3	**15.9**	11.19%
Carrier Route Cards	14	**15.6**	11.43%

NOTES: Proposed discounts are rounded to the nearest tenth of a cent.

* This experimental discount is in effect until April 28, 1998.

FIRST-CLASS SUMMARY: TOTAL CLASS AND SUBCLASS
FY 1998 BEFORE AND AFTER RATES

	BEFORE RATES	AFTER RATES	% CHANGE
LETTERS:			
VOLUMES	95,901,302	95,550,984	-0.37%
REVENUES:			
POSTAGE REVENUE	$32,521,960	$33,454,602	2.87%
FEE REVENUE	$146,300	$160,166	9.48%
TOTAL REVENUE	$32,668,260	$33,614,768	2.90%
REVENUE PER PIECE	$0.340645	$0.351799	3.27%
COSTS ·			
TOTAL COSTS (incl. 1.0% contg.)	$16,753,648	$16,846,154	0 55%
COST COVERAGE	194.99%	199.54%	2.33%
CONTRIBUTION	$15,914,612	$16,768,614	5.37%
CARDS:			
VOLUMES	5,693,118	5,523,047	-2.99%
REVENUES:			
TOTAL POSTAGE REVENUE	$1,051,784	$1,079,473	2.63%
FEE REVENUE	$8,059	$9,505	17.94%
TOTAL REVENUE	$1,059,843	$1,088,978	2.75%
REVENUE PER PIECE	$0.186162	$0.197170	5.91%
COSTS :			
TOTAL COSTS (incl. 1.0% contg.)	$610,907	$592,934	-2.94%
COST COVERAGE	173 49%	183.66%	5.86%
CONTRIBUTION	$448,936	$496,044	10.49%
LETTERS AND CARDS:			
VOLUMES	101,594,420	101,074,031	-0.51%
REVENUES:			
TOTAL POSTAGE REVENUE	$33,573,744	$34,534,075	2.86%
FEE REVENUE	$154,359	$169,671	9.92%
TOTAL REVENUE	$33,728,103	$34,703,746	2.89%
REVENUE PER PIECE	$0	$0	3.42%
COSTS :			
TOTAL COSTS (incl. 1.0% contg.)	$17,364,554	$17,439,088	0.43%
COST COVERAGE	194.24%	199.00%	2 45%
CONTRIBUTION	$16,363,549	$17,264,658	5.51%

Source: USPS-T-32, Workpaper I.