USPS-T-36

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

| POSTAL RATE AND FEE CHANGES, 1997 | Docket No. R97–1 |
|---|---|

# DIRECT TESTIMONY
# OF
# JOSEPH D. MOELLER
# ON BEHALF OF
# UNITED STATES POSTAL SERVICE

TABLE OF CONTENTS

## Autobiographical Sketch

My name is Joseph D. Moeller. I am an Economist in Pricing in Marketing Systems at Postal Service Headquarters. My responsibilities include rate design for Standard Mail (A). Prior to my assignment in Pricing, I was a Marketing Specialist for Advertising Mail in Product Management. I joined the Postal Service in 1987 as a Staff Economist in the Rate Studies Division of the Office of Rates.

I have testified on behalf of the Postal Service on several previous occasions. In Docket No. R90-1, I presented direct testimony regarding second- and third-class presort-related and shape-related cost differentials. I also presented rebuttal testimony in that proceeding regarding the third-class minimum-per-piece rate structure. In Docket No. MC93-1, I presented cost estimates and proposed rates for the Bulk Small Parcel Service. I offered testimony in support of the Postal Service's proposals for Standard Mail (A) in Docket No. MC95-1, and in Docket No. MC96-2, Nonprofit Classification Reform.

My previous experience includes work as an Industrial Engineer for the Batesville Casket Company of Hillenbrand Industries. My responsibilities included time study analysis of indirect labor.

I received a Master of Science Degree in Management in 1986 and a Bachelor of Science Degree in Industrial Management in 1983 from Purdue University.

## I. PURPOSE OF TESTIMONY

The purpose of my testimony is to present the proposed classification changes and rates for Standard Mail (A). Rates for the commercial subclasses, Regular and Enhanced Carrier Route, are developed using cost data from various cost witnesses and the rate level requirements developed by witness O'Hara. Rates for the preferred subclasses, Nonprofit and Nonprofit Enhanced Carrier Route, are also developed from cost data provided by cost witnesses, and the rate levels prescribed by the Revenue Forgone Reform Act.

I begin with an overview of the proposals, and then address each subclass individually.

## II. PROPOSAL OVERVIEW

### A. Classification Changes

#### 1. Standard Mail (A) Single-Piece

The current rates for Single-Piece Standard Mail are equal to the rates for the Letters and Sealed Parcels subclass of First-Class Mail up to 11 ounces, which is the weight limit for the latter subclass. Pieces weighing eleven ounces or more, up to the maximum weight for Single-Piece of less than sixteen ounces, are priced only 5 to 10 cents lower than the corresponding rate increment for Priority Mail. As described in section III, if Single-Piece Standard Mail were not eliminated, its rates would have to exceed First-Class Mail rates in order to cover costs. These rates would be anomalous

in that the service offered by First-Class Mail is superior to the service provided by Single-Piece Standard Mail. For this reason, the Postal Service is proposing the elimination of Single-Piece Standard Mail.

2. Residual Shape Surcharge

The Postal Service proposes a new shape-based rate determinant, a Residual Shape Surcharge, that would apply to pieces that are not letter or flat shaped. This proposal responds to concerns that pieces typically identified as parcels are more costly for the Postal Service to process and should be priced to reflect this higher cost.

B. Average Rate Changes

The following table displays the percentage change in revenue per piece for the four bulk subclasses in Standard Mail (A):

| Subclass | Percent Change[1] |
|---|---|
| Regular | 4.1 |
| Enhanced Carrier Route | 3.2 |
| Nonprofit | 15.1 |
| Nonprofit Enhanced Carrier Route | -4.8 |

These figures measure change in rates using a constant volume mix. The calculation applies the proposed rates to the before-rates volume. If the after-rates volume were used, the percentages would be affected by the migration of pieces from the Basic tiers of the carrier route subclasses to the lower-priced automation categories in the Regular and Nonprofit subclasses. This migration adds low revenue-per-piece

[1] WP 1, pages 27, 28. WP 2, pages 37, 38. The figures for the nonprofit subclasses reflect the rates expected to be in place during the test year.

volume to the Regular and Nonprofit subclasses. This influx of low revenue pieces causes a downward effect on the after-rates revenue per piece, and gives the appearance of an even lower increase for the Regular subclass. By using a constant volume mix, the effect of the rate change can be isolated.

## III. STANDARD MAIL (A) SINGLE-PIECE

### A. Characteristics

Though Standard Mail (A) is predominantly a bulk service, it does include a single-piece service. Unlike the other subclasses in Standard (A), Single-Piece rates do not include a minimum volume requirement. The service can be used by individuals or organizations for residual pieces not eligible for bulk rates, as well as printed matter and merchandise. Single-Piece rates are also used to assess postage for returned pieces. Separate rates are charged to recipients for the return of lost or mistakenly retained items, such as hotel keys and identification devices.

### B. Rate History

Since 1968, Single-Piece rates have been equal to, or lower than, First-Class Mail rates, except for the period from July 18, 1976 to March 22, 1981, when the rates for pieces weighing less than one ounce exceeded the first-ounce First-Class single piece rate. In 1981, the gradual move to parity with First-Class rates began when rates for Single-Piece were aligned with First-Class for the first four ounces in order to cover costs. In 1991, this parity was extended to the fifth ounce; and in 1995, the entire weight range of the Letters and Sealed Parcels subclass of First-Class Mail had rates

equal to the Single-Piece rates. Using the Commission's figures, the move to parity resulted in a 43.7 percent rate increase for Single-Piece pursuant to Docket No. R94-1. This increase was necessary in order for the subclass to cover its projected costs.[2] Although parity did not appear to be an objective in and of itself, it was a necessary outcome given the need to cover costs.

C. Volume History

Since 1970, Single-Piece volume has fallen about 85 percent. The remaining portion of Standard (A) has grown about 275 percent over the same period. These rates of change have reduced Single-Piece's share of Standard (A) sharply, from 5 percent to one-fifth of one percent.[3]

D. Proposed Elimination of the Subclass

As described above, the volume of Single-Piece has fallen precipitously over the past few decades. The decline was fueled at least in part by the gradual move to parity with First-Class Mail rates. Most customers with an option would presumably elect to use the higher level of service for the same price. The before-rates test year estimated cost coverage is 67 percent, which implies that a significant increase in rates would be required to satisfy the criterion in 3622(b)(3) that the subclass cover its costs.[4] In fact, the increase would have to be much greater than the modest increase proposed for First-Class. Such a disproportionate increase for Single-Piece would result in rates for Single-Piece which exceed First-Class Mail rates – a situation which would almost

---

[2] The rate increase resulted in a coverage of 104 percent. PRC Op., R94-1, para. 5242.
[3] USPS LR-H-187.
[4] WP 3, page 3. In order for unit revenue to equal unit cost, a 50 percent increase in unit revenue would be required.

surely result in further reduction in volume, and, moreover, illogical rate relationships. Although rates for Single-Piece have at times exceeded First-Class, the disparity was limited to the first ounce. Rather than propose rates for Single-Piece that would substantially exceed First-Class rates at every weight increment, the Postal Service proposes the elimination of the Single-Piece subclass. The proposed elimination recognizes the long-term decline in volume for the subclass, as well as avoids anomalous rate relationships. Furthermore, it responds to the Commission's recommendation in Docket No. R94-1 that the Postal Service consider merging Single-Piece with First-Class.[5]

Much of the volume which is entered at Single-Piece rates will simply migrate to Letters and Sealed Parcels. Pieces weighing more than 11 ounces will likely migrate to Priority Mail. Some returned items, which today are charged rates based on the Single-Piece schedule, will instead be charged First-Class Mail rates, or fees for the proposed Bulk Parcel Return Service, if applicable. Keys and identification devices will be subject to the applicable First-Class rate based on the weight of the piece, plus the applicable fee for Business Reply Mail items without an active advance deposit account.

The proposed elimination of Single-Piece meets the classification criteria of the Postal Reorganization Act. The proposed elimination of Single Piece promotes fairness and equity by preserving a logical relationship between Standard Mail and First Class. As explained above, were the Postal Service not proposing to eliminate Single Piece, proposed rates for this subclass would be higher than First-Class Mail. It makes little sense to charge customers higher rates for Standard Mail service, especially when

[5] PRC Op., R94-1, para. 5254.

First-Class serves as an all-encompassing substitute that offers many features that Standard Mail lacks, such as free forwarding and return, air transportation, better service standards, and fewer content restrictions.

The proposal is desirable from the Postal Service's perspective because it reduces the administrative burden of maintaining a subclass and preserves credibility in rate and service level relationships. It is desirable from the customer's perspective because it eliminates the possibility of paying higher rates for an inferior service when a superior alternative is readily available.

The proposal is also consistent with the 3623(c) criteria regarding speed and reliability. Again, there is no reason to provide a service with inferior features when a substitute offers superior service in all respects.

## IV. STANDARD MAIL (A) REGULAR SUBCLASS

### A. Characteristics

In Docket No. MC95-1, the Commission recommended, and the Governors approved, a series of changes to First Class, Periodicals, and Standard Mail schedules. Implemented on July 1, 1996, the changes split the former third-class bulk regular rate subclass into two new subclasses: Regular and Enhanced Carrier Route (ECR). The two new subclasses consist primarily of advertising mail; however, the ECR subclass is geared toward more geographically-dense advertising, whereas Regular caters to advertising that is targeted to recipients based on factors other than, or in addition to,

geographic location. Examples of Regular subclass users include mail-order firms targeting specific markets, such as professional uniform buyers or coin collectors.

Detailed rate and volume histories are available in Library Reference H-187.

B. Recent History of Rate Design

In Docket No. R90-1, the Postal Service employed, and the Commission adopted, a rate design methodology for bulk third-class mail which uses an equation to calculate rates.[6] The equation requires a number of inputs, primarily: selection of a benchmark category from which discounts will be applied; selection of a break point;[7] a target cost coverage for the subclass; and a piece rate for pound-rated mail. This last input, the piece rate for pound rated mail, is theoretically set at the rate which, if it were to take advantage of all applicable discounts, would equal zero.[8] Other variables which feed into the equation are the passthroughs for the various discounts. The primary output of the formula is the basic undiscounted piece rate for nonletters and an undiscounted pound rate.[9]

In Docket No. R94-1, the Commission recommended an across-the-board increase of 14 percent for third-class bulk regular rate mail, so the formula was not used. In Docket No. MC95-1, the Postal Service proposed two new subclasses to replace bulk third-class regular rate and developed an alternative rate design methodology. The Commission, however, in its Recommended Decision, relied on the Docket No. R90-1 methodology by using two separate formulae for the two new

---

[6] PRC Op., MC95-1, para. 5639.
[7] The breakpoint is the maximum weight for a piece subject to the minimum-per-piece rate. Pieces above this weight are subject to the piece/pound rates.
[8] PRC Op., MC95-1, para. 5643.

subclasses.[10] The Postal Service used these two formulae in its Nonprofit Classification Reform proposal, Docket No. MC96-2.[11]

C. Proposed Rate Design

1. Rate Design Formula

The proposed rate design uses the Commission's methodology and rate design formula from Docket No. MC95-1, with a few modifications.

The first modification is to the revenue requirement element of the formula. Since one output of the formula is the basic undiscounted piece rate for nonletters, the revenue requirement element accounts for revenue reductions due to discounts. In this filing, the Postal Service is proposing a residual shape surcharge.[12] For purposes of rate design, the revenue from this surcharge is treated as an offset to the reductions from the discounts.[13]

The second modification is a change in the formula's solution. Currently, the formula solves for the pound rate, whereas the piece rate element for pound-rated pieces serves as an input. Theoretically, the piece rate is the sum of all the available per-piece discounts available to pound-rated pieces in the subclass.[14] In practice, however, the piece rate is often adjusted so as to not cause a large increase in the

---

[9] WP 1, page 16.
[10] PRC Op., MC95-1, para. 5642.
[11] Docket No. MC96-2, USPS-T-9, p. 6.
[12] See Section IV.C.2.b. of this testimony.
[13] Fee revenue receives similar treatment in the formula.
[14] For example, the Summary Worktables on pages 7 and 13 of the Commission's Standard Mail Workpapers from Docket No. MC95-1 include an "intercept," which is the sum of the presort, or walk-sequencing discounts for nonletters. In the case of Enhanced Carrier Route, this intercept is the per piece rate element which is the input for the formula.

pound rate.[15] Also, the theoretical piece rate results in a situation where the rate for a pound-rated piece eligible for all discounts doubles as weight doubles – a relationship that may not be consistent with the cost relationship. By modifying the formula to solve for the piece rate for pound-rated pieces, the pound rate can be considered directly and chosen. This avoids the situation encountered by the Commission in developing rates for the Regular subclass in Docket No. MC95-1, where the piece rate was increased above the theoretical rate so that the pound rate would not increase.[16] It also allows for direct consideration of weight-related costs in the Enhanced Carrier Route subclass.[17]

It is important to note that the same rates can be achieved with or without the modification. It is simply an algebraic modification to the formula which changes an input to an output, and vice-versa. The modification allows direct consideration of the pound rate, which is a major rate element, rather than having the pound rate determined algebraically based on the per-piece element.[18]

2. Shape Recognition

a. Letter/Nonletter Differential

The proposed rates for the Regular subclass continue the rate differential based on shape, which was first introduced in 1991. The differentials incorporated in the current rates reflect 37 percent of the cost difference between letters and flats at the Basic presort tier, and 18 percent of the difference at the 3/5-digit presort tier. In this proceeding, the Postal Service proposes an increase in the shape-based passthroughs

[15] See PRC Op., MC95-1, para. 5643; Docket No. MC96-2, USPS-T-9 at 6.
[16] PRC. Op., MC95-1, para. 5643.
[17] See Section V.C.2 of this testimony

to 40 percent for the Basic tier, and 40 percent for the 3/5-digit tier. Widening the passthrough allows for greater recognition of the cost difference between shapes. Although raising these passthroughs even further has some logical appeal, two factors weigh against the expansion of the passthrough percentages at this time: the introduction of a residual shape surcharge, and the Postal Service's desire to moderate rate increases for individual categories.

The residual shape surcharge is a separate mechanism for capturing cost differences, and the source of revenue from the surcharge is solely from nonletter-rated pieces. In the rate design formula, the additional revenue from the surcharge serves to reduce the total pool of revenue required from the subclass as a whole. This implies that the surcharge serves to lower the rates for all other pieces in the subclass. Although some observers may argue that the surcharge should be used to deaverage only the nonletter category, the proposed rate design achieves the same objective through alternative means. Specifically, by limiting the letter/nonletter passthrough, more of the "revenue benefit" from the surcharge can be directed to flats. In other words, the lower letter/nonletter passthrough helps flats recoup some of the benefit of the surcharge which accrues to letters. Conversely, while letters share the benefits from the surcharge, this benefit is offset by virtue of the lower shape differential than would otherwise be proposed between letters and flats.

The second limiting factor on the letter/nonletter passthrough is the need to temper the increase on any one rate category. If the passthrough were greater, the

[18] If indeed the intercept is not used, other piece rates are presumably tried in the formula until the desired pound rate is achieved. Inputting the pound rate directly avoids this trial and error process.

percentage increase for the category receiving the highest increase in the proposed rates, minimum-per-piece 3/5-digit presorted automation flats, would be even higher.[19]

b. Residual Shape Surcharge

The Postal Service is proposing another means of reflecting cost differences due to shape in the rates for Standard Mail (A). The proposed rate design for Standard (A) includes the "residual shape" surcharge. The residual shape surcharge would apply to Standard Mail (A) pieces that are not letter or flat shaped. It is expected that most pieces subject to the surcharge would be parcel-shaped.

In Classification Reform I, United Parcel Service witness Blaydon offered testimony in favor of a proposal that the Commission recommend separate rate categories for parcels within Standard Regular and Enhanced Carrier Route.[20] In response, the Commission issued Notice of Inquiry No. 2 Concerning Shape Based Rates Within Standard Class Mail. UPS witness Luciani responded with testimony describing several alternatives regarding a separate rate category for parcels.[21] The Commission declined to recommend a change in the rate structure for parcels due to the "many unanswered questions" remaining on the record.[22] The Commission, however, "urge[d] the Postal Service to develop expeditiously a comprehensive parcels proposal with supporting information."[23] The Commission expressed its view that, "[t]he below cost-rate problem [for parcels] cannot be allowed to stand for an unreasonable

---

[19] Minimum-per-piece 3/5-digit presort automation flats is the existing category which has the highest proposed increase. Pieces subject to the residual piece surcharge, in either subclass, may receive a greater increase

[20] Docket No. MC95-1, UPS-T-1, at 15-16.

[21] Docket No. MC95-1, Testimony of Ralph L. Luciani on Behalf of UPS in Response to Notice of Inquiry No. 2, UPS-ST-1, at 11.

[22] PRC Op., MC95-1, at V-230.

and unwarranted period of time."[24] Two commissioners, Vice Chairman LeBlanc and Commissioner Haley, issued opinions dissenting from the Commission's decision not to recommend a separate rate category for parcels. They expressed their view that the Commission should have taken the opportunity to pursue a more cost-based rate design for third-class. Vice Chairman LeBlanc went so far as to recommend that a specific surcharge of five cents per piece be instituted for parcels.[25]

The residual shape surcharge responds to the Commission's and the dissenting Commissioners' concerns by increasing revenue from these pieces, thereby helping to alleviate the "below cost rate problem."

Witness Crum's testimony (USPS-T-28) conclusively demonstrates that there is a measurable difference between the costs for flat-shaped pieces and the costs for the remaining pieces in the non-letter categories of Regular and Enhanced Carrier Route Mail. Currently, the same rates apply to non-letters, regardless of shape. In order to continue the development of a price structure which better reflects significant cost differences, the Postal Service proposes a surcharge of 10 cents per piece for Standard Mail (A) that is neither letter- nor flat-shaped.

The Postal Service proposes a simple per-piece surcharge within the existing non-letter rate structure, as opposed to completely replacing the rate designs for Standard Regular and Enhanced Carrier Route Mail with separate rate structures (*i.e.*, different per-piece and per-pound elements) for flats and the remaining pieces in non-letters that are not flat-shaped. Two factors influence this decision. First, the Postal

---

[23] *Id.*
[24] *Id.*

Service agrees with the Commission that the time has come to recognize that differences in shapes and costs exist within the non-letter categories, but submits that another schedule of piece and pound rates complete with presort tiers and automation discounts is unwarranted. Such an addition to the rate schedule would introduce added complexity and complicate rate relationships. Secondly, the relative share of the pieces within nonletters that do not qualify as flats is small,[26] which reduces the need for added complexity.

The surcharge has been designed with sensitivity to residual shape mailers. The proposed surcharge of ten cents per piece represents only a fraction of the shape-based cost difference between flats and non-flats within nonletters. Witness Crum demonstrates a cost difference of over 35 cents between these shapes for Standard Mail (A).[27] This equates to a passthrough of less than one-third of the measured cost difference.

There are at least two reasons for holding the surcharge to 10 cents per piece. The first is to mitigate the impact of the potential increase in rates on customers. Some nonletters categories are already receiving significantly greater than average rate increases. Second, in Classification Reform I and in other forums, mailers have argued that there are different types of parcels, some of which are claimed to be similar in cost to flats, and some of which are claimed to be more costly than flats. Some may contend that it is inappropriate or unfair to apply the surcharge evenly to all

---

[25] Dissenting Op. of Vice Chairman W.H. "Trey" LeBlanc, Docket No MC95-1, at 3.
[26] See WP 1, page 13. Less than 8 percent of Regular nonletters are parcel-shaped; less than one percent of ECR nonletters are parcel-shaped
[27] USPS-T-28, page 12.

residual-shaped pieces, particularly those that may be less costly to handle. The low passthrough associated with the proposed surcharge may help to respond to the concerns of mailers of potentially less-costly parcels by mitigating the impact that would have resulted had the Postal Service assessed a surcharge closer in magnitude to the measured cost difference.

One issue that surfaced during Classification Reform I was difficulty in defining what is and is not a "parcel." This proposal avoids this problem by subjecting all pieces that do not qualify as letters or flat shaped pieces to the surcharge. This is consistent with Commissioner LeBlanc's dissenting opinion, where he noted that "[t]he Commission does know, however, that parcels are not letters or flats, and thus, by definition, they are a residual element of third class."[28] This avoids the unnecessary complexity of attempting to differentiate among the wide variety of shapes and sizes associated with pieces that are neither letter- nor flat-shaped. Thus, regardless of whether they are called parcels, IPPs, or residual shapes, such pieces that do not qualify under current definitions of letters (including postcards) or flats will be subject to the surcharge.

Creation of the surcharge is consistent with the classification criteria of the Postal Reorganization Act. It would enhance fairness and equity in that the higher cost of residual shape pieces would be at least partially de-averaged from letters and flats. This de-averaging is advantageous from the point of view of the great majority of Standard Mail (A) users in that they will bear less of the additional costs associated with residual shape pieces. It is advantageous from the viewpoint of the Postal Service in

that it allows for rates for letter- and flat-shaped advertising mail to be priced more appropriately, without being saddled with the additional costs of the residual, predominantly non-advertising, pieces.[29] The proposal is also desirable from the point of view of both the mail user and the Postal Service in that it is simple, and it achieves a reasonable measure of de-averaging without adding significant complexity to the rate structure for Standard Mail (A).

3. Pound Rate

The Postal Service proposes a modest reduction in the pound rate for the Regular subclass. The reduction, from 67.7 cents to 65 cents, is supported by several factors. First, the Postal Service has previously contended that the changing shape mix between flats and parcels as weight increases supports a higher pound rate than would be necessary otherwise.[30] In other words, if parcels are more prevalent at the higher weight increments, the pound rate results in a higher revenue-per-piece for parcels than for flats. In this filing, however, the Postal Service is proposing a surcharge on pieces that are neither letter nor flat shaped. As such, the surcharge reduces the need for the pound rate to act as a proxy for the changing shape mix as weight increases. As discussed in the previous section, however, the surcharge does not reflect the entire cost difference between flats and residual pieces; consequently, the pound rate still has a role, albeit diminished, as a proxy for shape.

---

[28] Dissenting Opinion of Vice Chairman LeBlanc, Docket No. MC95-1, at 1-2.
[29] This holds true for the Regular subclass. In ECR, residual pieces are likely to be merchandise samples, which are a form of advertising.
[30] Docket No R84-1, USPS-RT-8 at 21.

Another factor warranting the reduction is a new cost study that attempts to determine the role of weight as a cost driver. The new study suggests that weight is not as significant a cost driver as the pound rate implies.[31] However, the reduction in the pound rate is modest, in part due to the push-up on piece rates that is required to fund such a reduction, and the Postal Service's intent to temper the percentage increase for individual categories.

The proposed breakpoint weight which is incorporated into the rate design formula is 3.3 ounces. This breakpoint is very near the current breakpoint.

4. Presort Tiers

Presorting continues to result in reduced costs for the Postal Service and warrants recognition in the rate schedule. The rate design methodology includes the "presort tree" first described in Postal Service witness Mitchell's Docket No. R90-1 testimony.[32] In the Regular subclass, selection of the shape passthrough at each presort tier and a presort passthrough for letters dictates the effective passthrough for nonletters. The shape passthroughs were selected as described above in section IV.C.2. Therefore, the letter presort passthrough completes the presort tree.

Due to significant changes in costing methodology, the cost differentials supporting many of the discounts have changed significantly. These changes, coupled with the desire to limit the maximum increase by rate category, leads to some rather unconventional passthroughs. The passthroughs that help determine the proposed rates were chosen to balance several goals, including (1) recognizing the value of the

[31] USPS LR-H-182. The study is discussed further in the Enhanced Carrier Route rate design section of this testimony

worksharing activity, (2) avoiding major changes in the level of discounts, and (3) limiting the percentage increases for individual rate categories. As a general guideline, an attempt was made to keep individual proposed rate increases below 10 percent in the Regular and Enhanced Carrier Route subclasses in order to mitigate the impact of increases. Also, significant changes in worksharing incentives were implemented with Classification Reform on July 1, 1996. These incentives presumably caused many mailers to change their processes significantly. It would be unfair to undo these incentives extensively so early after their recent implementation. It is, however, also necessary to be sensitive to the implications of the cost studies. As an additional general guideline, the proposed rates maintain discounts at or above 80 percent of their current level. This limit also aids in achieving the percentage rate change guideline of 10 percent.

The guidelines described above lead to the proposed letter presort passthrough of 165 percent. This passthrough results in a discount which is 80 percent of the current discount. The resulting passthrough for nonletters is 75.6 percent. If the passthrough for letter presort were reduced, this would lead, by virtue of the presort tree, to a reduction in the passthrough for nonletters. The proposed presort passthrough for nonletters results in a discount which is only 74 percent of today's discount, below the guideline, but a necessary outcome given the other passthrough selections in the presort tree. So, although the passthrough for letters is relatively high, any reduction in it would also lead to a lower passthrough for nonletters and cause the presort discount to fall even further below the guideline. Given the shape-based

[32] Docket No. R90-1, USPS-T-20 at 108-09.

passthroughs described above, the high passthrough for letter presort allows for a higher presort passthrough for nonletters.

5. Automation

a. Letters

The new costing methodology and other changes to the cost models for automation letters lead to significant reductions in the calculated value of automation compatibility.[33] As discussed above, in order to avoid drastic changes in the price signals for automation, yet move in a direction which reflects the decline in the measured value of worksharing, the Postal Service proposes passthroughs which limit the reduction of the discounts. The passthrough for Basic, 140 percent, was selected to keep the discount at 80 percent of its current value. The 3-digit automation discount was kept at 90 percent of its current value by selecting a passthrough of 130 percent. The 5-digit automation discount also maintains 90 percent of its value, with a passthrough of 130 percent.

b. Flats

As described by witness Moden (USPS-T-4), the processing environment for flats continues to evolve with a movement toward greater use of mechanization and automation. This changing environment, coupled with differences in mail characteristics between automation and non-automation flats makes more difficult the estimation of the savings associated with mailer-applied barcodes. Witness Seckar (USPS-T-26) presents studies which measure the costs of automation and non-automation flats. These studies reflect a number of factors driving the costs of these

two types of flats, only one of which is the mailer-applied barcode. Witness Seckar has also presented mail processing cost studies which isolate the effect of mailer-applied barcodes.[34] Given the changing environment for flat processing, and the rate disruption that would be caused by using the studies which incorporate all mail characteristics, the discounts are derived by holding all variables constant except those associated with the presence or absence of a mailer-applied barcode. Although flat-shaped mail preparation and rate application may need to be reviewed as the flat processing environment evolves, the Postal Service, in this proceeding, is not proposing a significant change in the rate relationships between automation and non-automation flats. The passthrough selected for both Basic and 3/5-digit automation is 100 percent, which allows the proposed rate increase for piece-rated automation 3/5 flats to be less than 10 percent. The passthrough, in combination with the new costs, results in a significant rate reduction for the Basic automation tier, without a corresponding push-up on other rates, since the volume is this category is very low. The passthrough also results in a more reasonable presort differential for automation flats. Currently, the presort differential for automation flats is greater than the presort differential for nonautomation flats. Intuitively, it seems that the relationship should be reversed, since presorting bypasses more costly piece-distribution operations for non-automation mail.

[33] Exhibit USPS-T-29C.

[34] The results of the studies are in USPS-T-26, Table III-4 for Regular; Table III-5 for Nonprofit

6. Destination Entry

Destination entry discounts for Standard (A) were first offered in 1991. The studies presented in USPS LR-H-111 show that the savings due to destination entry, unlike most other worksharing discounts, have increased. A passthrough of 80 percent generally maintains the discounts at current levels and continues to encourage mailer dropshipment. A greater passthrough would result in a larger increase in the basic rates, which conflicts with the general guideline of tempering individual rate increases.

D. Summary of Proposed Regular Rates

Below is a summary of proposed Regular Rates:

**Regular Subclass**

| | | Destination-entry: | |
|---|---|---|---|
| **Automation** | | BMC | SCF |
| **Letters** | (in $) | | |
| Basic | 0.189 | 0.174 | 0.171 |
| 3-digit | 0.178 | 0.163 | 0.160 |
| 5-digit | 0.160 | 0.145 | 0.142 |
| **Flats (pc-rated)** | | | |
| Basic | 0.243 | 0.228 | 0.225 |
| 3/5-digit | 0.207 | 0.192 | 0.189 |
| **Flats (lb-rated)** | | | |
| per piece: | | | |
| Basic | 0.109 | | |
| 3/5 digit | 0.073 | | |
| per pound: | | | |
| Basic | 0.650 | 0.578 | 0.562 |
| 3/5 digit | 0.650 | 0.578 | 0.562 |

**Presort**

| | | Destination entry: | |
|---|---|---|---|
| **Letters** | (in $) | BMC | SCF |
| Basic | 0.247 | 0.232 | 0.229 |
| 3/5-digit | 0.209 | 0.194 | 0.191 |
| **Non-letters (pc-rated)** | | | |
| Basic | 0.300 | 0.285 | 0.282 |
| 3/5-digit | 0.240 | 0.225 | 0.222 |
| **Non-letters (lb-rated)** | | | |
| per piece: | | | |
| Basic | 0.166 | | |
| 3/5 digit | 0.106 | | |
| per pound: | | | |
| Basic | 0.650 | 0.578 | 0.562 |
| 3/5 digit | 0.650 | 0.578 | 0.562 |

## V. STANDARD MAIL (A) ENHANCED CARRIER ROUTE SUBCLASS

### A. Characteristics

In Docket No. MC95-1, the Postal Service proposed the creation of the Enhanced Carrier Route subclass so that the distinct cost and market characteristics of mail within this subclass could be more fully recognized. Enhanced Carrier Route consists primarily of geographically targeted advertisements, although it does include mailings with as few as 10 pieces per carrier route in the Basic tier. The advertisements are generally for widely used products or services. Examples of ECR users include large department stores and other local service establishments. Parcel-shaped pieces include merchandise samples and are less prevalent in the ECR subclass relative to the Regular subclass.

Detailed rate and volume histories are available in a Library Reference.[35]

### B. Recent History of Rate Design

As described in the Regular subclass section, a rate design formula was used in Docket No. R90-1 to develop rates for bulk third-class mail. In Docket No. MC95-1, the Commission recommended the establishment of two subclasses to replace bulk regular rate, and used two separate formulae to develop the rates for the two subclasses. In that same docket, the Postal Service proposed elimination of separate rates for letters in the new subclass, but the Commission recommended retention of the existing letter

rates, introduced a letter rate for the High Density tier, and placed the carrier route automation rate in the Enhanced Carrier Route subclass.

C. Proposed Rate Design

1. Rate Design Formula

The proposed rate design uses the Commission's methodology and rate design formula from Docket No. MC95-1, with a few modifications.

As described in the Regular subclass section, the formula includes recognition of the residual shape surcharge as a reduction in the revenue requirement element of the formula. As such, revenue from the surcharge reduces the revenue required from the base rate, which is an output of the formula, and from which the other minimum-per-piece rates are calculated.

The other modification is a change the formula's solution. The formula, as used by the Commission in Docket No. MC95-1, has as its output the pound rate and the basic minimum-per-piece rate prior to application of any discounts. The modified formula also solves for the minimum-per-piece rate. Instead of producing the pound rate, however, it produces the per-piece rate element for pound-rated mail. As described in the section IV.C.3 above, this allows for direct consideration of the appropriate pound rate, rather than perfunctorily accepting the pound rate as an output of the formula.

[35] See USPS LR-H-187.

2. Pound Rate

The modification of the rate design formula allows for the direct input of the pound rate. The Postal Service is proposing a pound rate of 53 cents for Enhanced Carrier Route. This is a significant reduction from today's pound rate of 66.3 cents, and is similar to the pound rate proposed by the Postal Service in Docket No. MC95-1. The reduction is warranted for several reasons.

First, under the current rate design formula, the per-piece rate for pound-rated mail is an input which is theoretically set at a level that produces a piece rate of $0.000 for pound-rated Saturation nonletters. The implication of this rate structure is a rate for this pound-rated mail which doubles as weight doubles. Thus, the total revenue from two 4-ounce pieces is identical to one 8-ounce piece. Yet it seems illogical that the Postal Service would be indifferent between processing and delivering two 4-ounce pieces, and one 8-ounce piece. For example, a mailing consisting of a package of advertisements totaling 8 ounces pays the saturation destination delivery unit rate of 27.6 cents. If the package were split into two packages of 4 ounces each, and perhaps even entered on separate days, the revenue per piece would be 13.8 cents, but the total revenue would be the same. Costs, on the other hand, would presumably be higher under the two mailing scenario. Only by establishing a piece rate at a level above $0.000 can this package splitting result in added revenue for the Postal Service. The modification of the formula avoids the implied selection of the $0.000 per-piece rate element for pound-rated saturation mail. If a pound rate is input into the formula that comports with weight-related costs, the formula should produce a saturation piece rate which is greater than $0.000.

Second, the high pound rate has previously been supported by acknowledgment of a changing shape mix between flats and parcels as weight increases. To the extent parcels are more costly to handle, and are more prevalent at the higher weight increments, the steep pound rate generates a higher revenue per piece from parcels. This rationale is no longer applicable in Enhanced Carrier Route for two reasons. First, it was offered as rationale when carrier route was a part of the bulk regular rate subclass. There was one pound rate for the entire subclass, and parcels were heavier than flats on average for the subclass.[36] Now we have two subclasses, each with its own pound rate. In Enhanced Carrier Route subclass, the weight-per-piece for flats and parcels is about the same.[37] No longer can the high pound rate be justified as a proxy for shape change.

Third, even if the weight of a carrier route parcel were higher than a carrier route flat, the proposed residual shape surcharge reduces the need for the pound rate to act as a proxy for shape, since the surcharge serves as a means of receiving additional revenue from residual shape pieces.

Fourth, the new cost study in USPS LR-H-182 graphically displays the very small role that weight plays in Enhanced Carrier Route costs. The Christensen Associates' study distributes all cost components to weight increment using a variety of distribution keys. The most significant cost driver is In-Office Cost System tallies. The shape of the cost curve for ECR in the study shows very little increase in costs as weight increases. Even if some of the costs that are distributed on a per-piece basis were instead

[36] Docket No. R84-1, USPS-RT-8 at 21
[37] Docket No. MC97-2, USPS LR-PCR-38, Table 1.

distributed on a weight basis, it is difficult to envision a curve that would support a steep pound rate.

Finally, the Enhanced Carrier Route subclass is in a competitive market and is susceptible to diversion to alternative media.[38] As such, the rate structure should be sensitive to, and priced competitively with, the alternatives. A lower pound rate is more consistent with the rates for other advertising media that are not as sensitive to weight.[39]

In its Recommended Decision in Docket No. MC95-1, the Commission explained that "using the Docket No. R90-1 methodology reduces the pound rate to dependency on a host of other ratemaking decisions, all of which are cost based."[40] The Postal Service has proposed a modification to the formula that no longer makes the pound rate dependent upon the other ratemaking decisions, and is more cost based in that it results in a pound rate which better reflects the weight-cost relationship for saturation mail. It retains the other cost-based aspects of the previous formula in that the rate differentials between the various density tiers are based on cost differentials. The Commission concluded that by "retaining the Docket No. R90-1 methodology, there is not much latitude in the pound rate."[41] The Postal Service's minor modification to the formula maintains the essence of the Docket No. R90-1 methodology, while appropriately giving the Postal Service and the Commission more latitude to consider other factors in a comprehensive fashion when determining the appropriate pound rate.

---

[38] Docket No. MC95-1, USPS-T-18 at 5. See also Docket No. R94-1, USPS-T-2 at 169.
[39] Docket No. MC95-1, USPS-T-21 at 8
[40] PRC Op., MC95-1, para. 5649.
[41] Id.

The proposed breakpoint weight which is incorporated into the rate design formula is 3.3 ounces. This breakpoint is very near the current breakpoint.

3. Shape Recognition

a. Residual Shape Surcharge

As discussed in Section IV.C.2.b, the Postal Service is proposing a surcharge for pieces which are neither letter nor flat shaped in the Regular subclass. This surcharge of 10 cents is proposed for the Enhanced Carrier Route subclass as well.

b. Letter/Nonletter Differential

In Docket No. MC95-1, the Postal Service proposed elimination of separate rates for letters at all density tiers in the proposed Enhanced Carrier Route subclass. The Commission, citing data showing a cost difference by shape, recommended the continuation of the existing rate categories for letters, and extended letter rates to High-Density (formerly 125-piece walk sequence). In this filing, the Postal Service does not propose elimination of ECR letter categories. The Postal Service does, however, propose a modification to the rate design for letters. In the Basic tier, the passthrough for the letter/nonletter differential is zero percent, which results in the same rate for letters and nonletters.[42] At the other density tiers, the Postal Service is proposing a passthrough of 35 percent of the shape differential. This is similar to the passthroughs for shape in the Regular subclass, and results in differentials similar to today's differentials. This modification, the zero percent shape passthrough at the Basic tier while retaining shape differentials at the other tiers, balances the Commission's concern

[42] The proposal does not include the elimination of the rate category; however, since the rate is equal to the nonletter rate, letters and nonletters will be subject to a single rate.

for recognition of cost differences while giving special consideration to the Postal Service's concern regarding its letter automation program.[43] It does not result in a cross-subsidy of nonletters by letters;[44] and aids the Postal Service's automation program.

As described by witness Moden (USPS-T-4), the value of basic carrier route presortation has diminished for letters, and will continue to diminish in the future. Witness Moden explains that Basic ECR letter mail is frequently barcoded by the Postal Service and subsequently sorted to delivery sequence on automation. Therefore, the Postal Service is proposing rates that, by virtue of the zero percent passthrough described above, would encourage letter mailings with this density to be entered instead as Automation Enhanced Carrier Route or 5-digit Automation letters. The result of this rate relationship is an expected migration of 3.3 billion letters from the Basic ECR letter rate to 5-digit automation.[45]

4. Automation

In Docket No. MC95-1, the Commission recommended an automation rate for Basic letters in the Enhanced Carrier Route subclass. The Postal Service proposes retention of that rate category and a passthrough of 110 percent of the cost differential. The passthrough is set above 100 percent to mitigate the increase for this category.[46]

---

[43] In Docket No. MC95-1, the Commission acknowledged the Postal Service's concern that lower rates for carrier route letter mail would be counterproductive to the Service's letter mail automation program, but *on balance* determined that it could not ignore cost differences of the magnitude presented by Postal Service witnesses. PRC Op., MC95-1, para. 5593.

[44] The cost coverage for the ECR subclass is so high that elimination of letter/nonletter differentials would be unlikely to result in nonletters being priced below cost. Also, letter-shaped pieces can avoid being averaged with nonletters by taking advantage of the lower proposed automation rates.

[45] USPS LR-H-172.

[46] At 7.5 percent, the increase in the Automation ECR rate is well above the average for the subclass.

Eligibility for this rate category will remain unchanged. That is, it will be available for letters destined to delivery offices equipped with CSBCSs or where letters are sequenced manually. As described above, those letters which are not destined for these facilities should find the 5-digit automation rate attractive.

5. Density Tiers

The Postal Service proposes the continuation of the High-Density and Saturation tiers in Enhanced Carrier Route. An updated study used by witness Daniel (USPS-T-29) uses In-Office Cost System data to help ascertain the relevant mail processing cost differences. In previous proceedings, the differential was based solely on delivery cost differences. This new methodology allows for a more comprehensive analysis of the cost differentials. The study groups High-Density and Saturation together for cost measurement purposes, so the reported mail processing difference between High-Density and Saturation is zero. However, this is an improvement over previous studies which assumed that the mail processing differential was zero between all three tiers.[47] The proposed passthroughs of 100 percent of mail processing and delivery cost differences for letter tiers results, by virtue of the "presort tree," in passthroughs of 39 percent between Basic and High-Density nonletters, and 72 percent between High-Density and Saturation nonletters. These lower than full passthroughs are warranted because a greater passthrough would result in more significant increases in the Basic tier.

[47] See Docket No. MC95-1, Exhibit USPS-T-12C, page 2.

6. Destination Entry

Destination entry discounts were first offered in 1991. The studies presented in USPS LR-H-111 show that the savings due to destination entry, unlike most other worksharing discounts, have increased. A passthrough of 80 percent was used in the development of the proposed rates to maintain the discounts at current levels and to continue to encourage mailer dropshipment. A greater passthrough would require a larger increase in the basic rates, which conflicts with efforts to mitigate substantial increases for individual rate categories.

D. Summary of Proposed Enhanced Carrier Route Rates

Below is a summary of the proposed ECR rates:

| | | Destination-entry: | | |
|---|---|---|---|---|
| | | BMC | SCF | DDU |
| **Letters** | (in $) | | | |
| Basic | 0.164 | 0.149 | 0.146 | 0.141 |
| Automation | 0.157 | 0.142 | 0.139 | 0.134 |
| High-Density | 0.143 | 0.128 | 0.125 | 0.120 |
| Saturation | 0.134 | 0.119 | 0.116 | 0.111 |
| **Non-letters (pc-rated)** | | | | |
| Basic | 0.164 | 0.149 | 0.146 | 0.141 |
| High Density | 0.153 | 0.138 | 0.135 | 0.130 |
| Saturation | 0.141 | 0.126 | 0.123 | 0.118 |
| **Non-letters (lb-rated)** | | | | |
| per piece: | | | | |
| Basic | 0.055 | | | |
| High Density | 0.044 | | | |
| Saturation | 0.032 | | | |
| per pound: | | BMC | SCF | DDU |
| Basic | 0.530 | 0.458 | 0.442 | 0.420 |
| High Density | 0.530 | 0.458 | 0.442 | 0.420 |
| Saturation | 0.530 | 0.458 | 0.442 | 0.420 |

## VI. STANDARD MAIL (A) NONPROFIT

### A. Characteristics

On October 6, 1996, Nonprofit Classification Reform was implemented. The new structure for nonprofit mail mirrored the structure implemented on July 1, 1996 for commercial Standard Mail (A). The Nonprofit subclass mirrors the Regular subclass. Nonprofit Mail consists primarily of charitable solicitations and informational and promotional materials. Examples of users of Nonprofit mail include philanthropic organizations and universities.

Detailed rate and volume histories are available in USPS LR-H-187.

### B. Brief History of Rate Design

One of the most significant recent developments in the rate design for nonprofit mail was the implementation of the Revenue Forgone Reform Act (RFRA). This law establishes a six-year phasing schedule that ultimately results in rate levels for nonprofit that are one-half the comparable commercial markup. The first "step" of the phasing schedule was a markup which was one-twelfth of the commercial markup. Each additional step adds another one-twelfth. In the sixth year, the final step results in a markup which is six-twelfths, or one-half, the commercial markup. In this proceeding, Test Year 1998 is Step 5.

In connection with Docket No. MC96-2, two subclasses, Nonprofit and Nonprofit Enhanced Carrier Route, were established to replace the third-class bulk nonprofit subclass. As a result, separate markups were set for the two subclasses, whereas only

one markup was necessary previously. Regular and ECR serve as the commercial counterparts for Nonprofit and Nonprofit Enhanced Carrier Route (NECR), respectively. The effect of the adoption of these two separate markups, and the generally low costs for nonprofit mail in the test year, led to significant rate declines for almost all rate categories of nonprofit mail.[48]

In Docket No. MC96-2, the Postal Service not only proposed a nonprofit structure to mirror the commercial structure, but also proposed passthroughs for the discounts which were as similar as possible to those for the commercial discounts. In this proceeding, the structure is again mirrored; however, in order to limit rate increases for certain individual rate categories, it is necessary to select some passthroughs independently of the commercial subclasses.

C. Proposed Rate Design

1. Rate Design Formula

In keeping with the effort to mirror the commercial subclasses, the proposed rate design uses the same formula, along with the modifications described in section IV.C.1 of this testimony, to develop the rates for the Nonprofit subclass. The markup selected for the formula is an attempt to produce rates that, when applied to the after-rates volume forecast, result in a cost coverage that meets the RFRA-prescribed relationship with the commercial coverage. This resulting Nonprofit coverage, coupled with relatively high costs for the Nonprofit subclass, results in a large overall increase for the

[48] Only the rates for Basic presort non-automation pieces, and Basic presort automation flats increased from what they otherwise would have been on October 6, 1996.

subclass. The following sections detail aspects of the proposal and how the Postal Service is attempting to temper the increase for individual rate categories.

2. Pound Rate

The current pound rate for "full" nonprofit rates[49] is 48.4 cents. In order to temper the increase on the per-piece rates that would otherwise occur, the Postal Service is proposing a pound rate of 55 cents. Unlike the commercial subclass, where the pound rate is being lowered, this proposed pound rate represents a 14 percent increase in the pound rate element. This increase is consistent with the overall increase that is necessary for the subclass as a whole in order to meet the RFRA requirements. Because the proposed pound rate increase is similar to the overall increase, the upward pressure on piece rates that would accompany a lower pound rate increase is avoided.

The proposed breakpoint weight which is incorporated into the rate design formula is 3.3 ounces. This breakpoint is very near the current breakpoint.

3. Shape Recognition

a. Letter/Nonletter Differential

As in the Regular subclass, the rate structure recognizes a cost differential between letters and nonletters. The proposed shape-based passthrough is 55 percent at both presort tiers, which is similar to the passthrough of 62 percent for both tiers underlying the current Nonprofit rates. By choosing this passthrough, the percentage

[49] Full rates are the Step 6 rates, or the rates that are in place at the end of the phasing process, after FY98.

change in full rates for all nonautomation letters and flats can be held within a few percentage points of each other, and all under 20 percent.

b. Residual Shape Surcharge

Consistent with the proposals for the commercial subclasses, the Postal Service proposes a residual shape surcharge of 10 cents for non-letter and non-flat shaped pieces. There are relatively few parcels in Nonprofit,[50] so the revenue received through the surcharge does not significantly push down the letter and flat rates.

4. Presort Tiers

The proposed presort passthrough for letters is 100 percent, the same passthrough underlying today's rates. Given the shape passthroughs described above, the letter presort passthrough implies a 65.6 percent passthrough for nonletters, which is similar to the existing passthrough of 71.6 percent. This combination of passthroughs results in similar percentage changes for the presort tiers within each shape, which tempers the increase on any one category.

5. Automation Discounts

a. Letters

For letters, the proposed passthrough for the basic automation discount is 100 percent. This passthrough, aside from being desirable in that it fully reflects the cost differential, maintains the increase in line with most of the other increases within the subclass, and is equal to or less than the increases for the nonautomation categories.

The proposed passthroughs for 3-digit and 5-digit automation are 130 and 160 percent, respectively. These passthroughs result in discounts which are similar to

those in the commercial subclass, and also help achieve the rate relationship between 5-digit automation and Nonprofit Enhanced Carrier Route Basic letters. This proposal strives to mirror the structure of the commercial subclasses, including rate relationships that foster automation compatibility.

b. Flats

For flats, the passthroughs are applied to the costs as described in section IV.C.5.b. The proposed passthrough for the 3/5-digit automation is 100 percent, which is equivalent to the passthrough in the commercial subclass. Despite this passthrough, the rate increase for this category is significant. Counter to this large increase for 3/5-digit presort is the relatively low increase for Basic automation flats that is achieved through a 95 percent passthrough of the cost difference. This passthrough is only slightly lower than the desired passthrough of 100 percent.[51]

6. Destination Entry

Destination entry discounts are determined for this subclass in the same manner as the other subclasses. Since the cost study used is a measure of all subclasses combined, and since the passthroughs selected are the same for each subclass, the discounts do not vary by subclass. The resulting DBMC discounts are slightly higher than the existing nonprofit destination entry discounts, which places some additional upward pressure on the base rates.

---

[50] Less than 3 percent of nonletters are parcels. See WP 2, page 13.

[51] Due to rounding in the rate design formula, if 100 percent were used as the passthrough, all rates would be pushed up $0.001 in one of the phasing steps, which might push the cost coverage beyond the RFRA-prescribed coverage.

D. Proposed "Full" Nonprofit Rates

Below is a summary of the proposed "full" rates for Nonprofit:

**Nonprofit Subclass**

| | | Destination-entry: | |
|---|---|---|---|
| **Automation** | | BMC | SCF |
| **Letters** | (in $) | | |
| Basic | 0.124 | 0.109 | 0.106 |
| 3-digit | 0.112 | 0.097 | 0.094 |
| 5-digit | 0.095 | 0.080 | 0.077 |
| **Flats (pc-rated)** | | | |
| Basic | 0.190 | 0.175 | 0.172 |
| 3/5-digit | 0.155 | 0.140 | 0.137 |
| **Flats (lb-rated)** | | | |
| per piece: | | | |
| Basic | 0.077 | | |
| 3/5 digit | 0.042 | | |
| per pound: | | | |
| Basic | 0.550 | 0.478 | 0.462 |
| 3/5 digit | 0.550 | 0.478 | 0.462 |

**Presort**

| | | Destination entry: | |
|---|---|---|---|
| **Letters** | (in $) | BMC | SCF |
| Basic | 0.165 | 0.150 | 0.147 |
| 3/5-digit | 0.143 | 0.128 | 0.125 |
| **Non-letters (pc-rated)** | | | |
| Basic | 0.239 | 0.224 | 0.221 |
| 3/5-digit | 0.176 | 0.161 | 0.158 |
| **Non-letters (lb-rated)** | | | |
| per piece: | | | |
| Basic | 0.126 | | |
| 3/5 digit | 0.063 | | |
| per pound: | | | |
| Basic | 0.550 | 0.478 | 0.462 |
| 3/5 digit | 0.550 | 0.478 | 0.462 |

## VII. STANDARD MAIL (A) NONPROFIT ENHANCED CARRIER ROUTE

### A. Characteristics

On October 6, 1996, Nonprofit Classification Reform was implemented. The new structure for nonprofit mail mirrored the structure implemented on July 1, 1996 for Commercial Standard Mail (A). The Nonprofit Enhanced Carrier Route (NECR) subclass was created as the mirror for the Enhanced Carrier Route subclass. Nonprofit Enhanced Carrier Route consists primarily of requests for funds or information regarding nonprofit organizations. Examples of NECR users include churches or local philanthropic organizations.

Detailed rate and volume histories are available in USPS LR-H-187.

### B. Brief History of Rate Design

As described in section VI.B, the Revenue Forgone Reform Act (RFRA) significantly affected the rate design for nonprofit mail. In Docket No. MC96-2, the creation of a separate Nonprofit Enhanced Carrier Route subclass, and the relatively low costs for nonprofit carrier route mail, led to significant reductions in rates for carrier route mail. The rate decreases were so great that the implied Step 4 and Step 5 rates for NECR nonletters fell below a floor established in the RFRA for the phased rates. In order to comply with this provision of the law, the Postal Service implemented "full" rates for a few categories that would otherwise fall below the statutorily-prescribed floor for nonletters.

C. Proposed Rate Design

1. Rate Design Formula

In keeping with the effort to mirror the commercial subclasses, the proposed rate design uses the same formula, along with the modifications described in sections IV.C.1 and V.C.1 of this testimony, to develop the rates for the NECR subclass. The markup selected for the formula is an attempt to produce rates that, when applied to the after-rates volume forecast, results in a cost coverage that meets the RFRA-prescribed relationship with the commercial ECR coverage. Unlike the Nonprofit subclass, where the prescribed markup and volume-variable costs combine to cause large rate increases, proposed NECR rates decrease. This allows for passthroughs which generally compare to the commercial passthroughs, since tempering rate increases is not an issue.

2. Pound Rate

The Postal Service proposes a reduction in the pound rate of similar magnitude to the reduction in commercial ECR.[52] The proposed pound rate is 35 cents. A higher pound rate would lead to even larger reductions in the minimum-per-piece rates than those proposed.

The proposed breakpoint weight which is incorporated into the rate design formula is 3.3 ounces. This breakpoint is very near the current breakpoint.

[52] The decrease is 13.3 cents for ECR; 10.1 cents for NECR.

3. Shape Recognition

a. Letter/Nonletter Differential

The proposed passthroughs for shape are similar to the commercial passthroughs: zero percent for the Basic tier and 40 percent for the High-Density and Saturation tiers. The Basic tier rate design helps establish a rate relationship between Basic NECR and 5-digit automation which would mirror the corresponding relationship proposed for the commercial subclasses. The High-Density and Saturation shape passthroughs lead to similar percentage decreases for letters and nonletters.

b. Residual Shape Surcharge

In order to mirror the commercial subclasses, the Postal Service proposes a residual shape surcharge of 10 cents for non-letter and non-flat shaped pieces. There are relatively few parcels in NECR,[53] so the revenue received through application of the surcharge does not significantly push down the letter and flat rates.

4. Density Tiers

The proposed passthroughs of 100 percent between the density tiers for letters are equivalent to the commercial passthroughs. Given the shape passthroughs described above, the resulting passthroughs for density for nonletters are 50.5 percent between Basic and High-Density, and 75.9 percent between High-Density and Saturation. These passthroughs are similar to those for ECR, and, in combination with the other NECR passthroughs, create the relationship between the basic carrier route

[53] Less than 1 percent of nonletters are parcels. See WP 2, page 13.

tier and 5-digit automation, which mirrors the proposed relationship in the corresponding commercial subclasses.

5. Automation

The proposed passthrough for the Automation discount, 150 percent, is higher than its commercial counterpart, so that there is a meaningful rate differential between 5-digit automation and NECR Automation at Step 6.[54] Also, this category, unlike all other NECR rate categories, is proposed to receive a rate increase.[55] The higher passthrough tempers that increase.

6. Destination Entry

Destination entry discounts are determined for this subclass in the same manner as the other subclasses. Since the cost study used to determine destination entry discounts measures savings for all subclasses combined, and since the passthroughs selected are the same for each subclass, the discounts do not vary by subclass.

[54] Automation ECR should be priced lower than 5-digit automation. The passthrough results in a $0 003 differential, which is the differential under the current rates.

[55] This increase is due to the fact that the current rate is suppressed in order to avoid a rate anomaly. See Docket No. MC96-2, USPS-T-9 at 12.

D. Proposed "Full" Nonprofit Enhanced Carrier Route Rates

Below is a summary of proposed "full" rates for Nonprofit Enhanced Carrier Route:

| | | Destination-entry: | | |
|---|---|---|---|---|
| | | BMC | SCF | DDU |
| **Letters** | (in $) | | | |
| Basic | 0.096 | 0.081 | 0.078 | 0.073 |
| Automation | 0.092 | 0.077 | 0.074 | 0.069 |
| High-Density | 0.078 | 0.063 | 0.060 | 0.055 |
| Saturation | 0.072 | 0.057 | 0.054 | 0.049 |
| **Non-letters (pc-rated)** | | | | |
| Basic | 0.096 | 0.081 | 0.078 | 0.073 |
| High Density | 0.086 | 0.071 | 0.068 | 0.063 |
| Saturation | 0.080 | 0.065 | 0.062 | 0.057 |
| **Non-letters (lb-rated)** | | | | |
| per piece: | | | | |
| Basic | 0.024 | | | |
| High Density | 0.014 | | | |
| Saturation | 0.008 | | | |
| per pound: | | BMC | SCF | DDU |
| Basic | 0.350 | 0.278 | 0.262 | 0.240 |
| High Density | 0.350 | 0.278 | 0.262 | 0.240 |
| Saturation | 0.350 | 0.278 | 0.262 | 0.240 |

## VIII. STEP 5 NONPROFIT & NONPROFIT ENHANCED CARRIER ROUTE RATES

In this proceeding, the proposed rates are based on an FY98 test year. In order to complete the financial analysis of the Postal Service's proposal, the Step 5 rates, which would be in effect in FY98, must be projected. Although the Commission recommends "full" rates, the formula can be used to anticipate the Step 5 rates. The following rate tables are derived from the formula by entering a markup that would be expected to lead to the RFRA-prescribed coverage in FY98. For those rate cells that would fall below the floor provision of the Act, the "full" rates are entered. Only NECR rates are affected by this provision. The analysis of test year finances reflects the rates presented in the tables.

## NONPROFIT SUBCLASS
## Step 5 Rates - FY98

| Automation | | Destination-entry: BMC | SCF |
|---|---|---|---|
| **Letters** | (in $) | | |
| Basic | 0.119 | 0.104 | 0.101 |
| 3-digit | 0.107 | 0.092 | 0.089 |
| 5-digit | 0.090 | 0.075 | 0.072 |
| **Flats (pc-rated)** | | | |
| Basic | 0.185 | 0.170 | 0.167 |
| 3/5-digit | 0.150 | 0.135 | 0.132 |
| **Flats (lb-rated)** | | | |
| per piece: | | | |
| Basic | 0.072 | | |
| 3/5 digit | 0.037 | | |
| per pound: | | | |
| Basic | 0.550 | 0.478 | 0.462 |
| 3/5 digit | 0.550 | 0.478 | 0.462 |

**Presort**

| Letters | (in $) | Destination entry: BMC | SCF |
|---|---|---|---|
| Basic | 0.160 | 0.145 | 0.142 |
| 3/5-digit | 0.138 | 0.123 | 0.120 |
| **Non-letters (pc-rated)** | | | |
| Basic | 0.234 | 0.219 | 0.216 |
| 3/5-digit | 0.171 | 0.156 | 0.153 |
| **Non-letters (lb-rated)** | | | |
| per piece: | | | |
| Basic | 0.121 | | |
| 3/5 digit | 0.058 | | |
| per pound: | | | |
| Basic | 0.550 | 0.478 | 0.462 |
| 3/5 digit | 0.550 | 0.478 | 0.462 |

## NONPROFIT ENHANCED CARRIER ROUTE SUBCLASS
## Step 5 Rates (FY98)

| | | Destination-entry: | | |
|---|---|---|---|---|
| | | BMC | SCF | DDU |
| **Letters** | (in $) | | | |
| Basic | 0.096 | 0.081 | 0.078 | 0.073 |
| Automation | 0.087 | 0.072 | 0.069 | 0.064 |
| High-Density | 0.073 | 0.058 | 0.055 | 0.050 |
| Saturation | 0.067 | 0.052 | 0.049 | 0.044 |
| **Non-letters (pc-rated)** | | | | |
| Basic | 0.096 | 0.081 | 0.078 | 0.073 |
| High Density | 0.086 | 0.071 | 0.068 | 0.063 |
| Saturation | 0.080 | 0.065 | 0.062 | 0.057 |
| **Non-letters (lb-rated)** | | | | |
| per piece: | | | | |
| Basic | 0.024 | | | |
| High Density | 0.014 | | | |
| Saturation | 0.008 | | | |
| per pound: | | BMC | SCF | DDU |
| Basic | 0.350 | 0.278 | 0.262 | 0.240 |
| High Density | 0.350 | 0.278 | 0.262 | 0.240 |
| Saturation | 0.350 | 0.278 | 0.262 | 0.240 |

## IX. TEST YEAR 1998 FINANCIAL SUMMARY

The following table depicts the financial implications of Standard Mail (A) proposal.[56] The revenue, cost, and contribution figures are in millions of dollars:

**Test Year After Rates Financial Summary**

| | Revenue | Cost | Contribution | Coverage |
|---|---|---|---|---|
| Regular | $8022.045 | $5192.943 | $2829.102 | 154.5% |
| ECR | 4304.004 | 1885.383 | 2418.622 | 228.3% |
| Nonprofit | 1351.433 | 1107.575 | 243.858 | 122.0% |
| Nonprofit ECR | 201.408 | 125.122 | 76.286 | 161.0% |

The coverages for Regular and ECR meet those proposed by witness O'Hara (USPS-T-30). The coverage for Nonprofit meets the RFRA requirement that the markup for the subclass be 5/12$^{ths}$ of the commercial markup. The markup for NECR is slightly higher than 5/12$^{ths}$ of the commercial markup due to the expected early implementation of "full" rates for nonletters in order to comply with the floor provision of the RFRA.[57] The rates for Step 5 without consideration of the floor are derived in workpapers, and result in a coverage of 154.3 percent for Nonprofit Enhanced Carrier Route,[58] which approximates a markup which is 5/12$^{ths}$ of the commercial ECR markup.

[56] WP 1, page 25, and WP 2, page 35. The revenues do not include any projected revenue from the Hazardous Medical or Material surcharges since few, if any, pieces containing these materials are expected to be entered via Standard Mail (A). To the extent pieces containing this matter are entered at Standard (A) rates, the effect of the surcharge on revenues is expected to be *de minimis*.

[57] "Full" rates begin in FY 99, so the "early implementation" will likely only be a few months early, given that the rates proposed in this docket would likely not be implemented until this proceeding is completed, which may not occur until well into the next fiscal year.

[58] WP 2, page 35.

All of the cost figures reflect a final adjustment. The adjustment is necessary because the unadjusted costs assume that the cost of a migrating letter from ECR to Regular is similar to the average unit cost of a Regular piece, when, in fact, it will be significantly lower. Also, the unit cost applied to those pieces remaining in ECR reflects a pre-migration unit cost, when, in actuality, the unit cost of the remaining pieces will be slightly lower since the pieces leaving the subclass are higher in cost than the average ECR piece. The adjustments are detailed in workpapers for this testimony,[59] and are incorporated in witness Patelunas' workpapers.[60]

[59] WP 1, page 24; WP 2, page 34.
[60] USPS-T-15, WP G.