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

MAILING ONLINE EXPERIMENT	)	Docket No. MC2000-2

INITIAL BRIEF OF
MAIL ADVERTISING SERVICE ASSOCIATION INTERNATIONAL
AND PRINTIMAGE INTERNATIONAL

(Replacement)

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INTRODUCTION

Mail Advertising Service Association International ("MASA"), and PrintImage International ("PII") file this initial brief setting forth their opposition to the Postal Service's renewed request in this docket for a recommended decision approving the experimental offering of Mailing Online ("MOL").

As the Commission is aware, the Postal Service originally filed a combined request for a market test and a two-year experimental Mailing Online service in docket MC98-1. The Commission issued a recommended decision approving a market test of MOL and the market test commenced in the fall of 1998. After seven months of discovery and hearings, the Postal Service withdrew the request for the experimental service shortly before initial briefs were due. The Postal Service was facing massive delays due to an overall structural redesign that was transferring MOL from the Post Office Online platform to the USPS.com platform. Eventually, the Market Test was terminated on October 29, 1999, after a long period when the Postal Service was not seeking to promote usage of MOL, but was instead focused on the system redesign.

The request for recommended decision approving a three-year experimental offering of MOL was filed in this docket on November 16, 1999, amidst predictions that system development was on course to an April start and promises that many of the technical problems faced during the Market Test had been solved. As discussed below, while the Postal Service request has attempted to duck some of the issues it faced in MC98-1, the new filing has not resolved the fundamental problems with the MOL request. Foremost among these is the anticompetitive impact of MOL on businesses that will be forced to compete with the Postal Service (i) upon which they depend upon to provide the ultimate delivery services to their customers, (ii) which is improperly extending its statutory mail delivery monopoly to compete for the provision of non-monopoly mail preparation and printing services, and (iii) which proposes to charge MOL customers automation rates while exempting itself from the qualification criteria for those rates.

In addition to the fundamental issue of competitive injury, the Postal Service filing raises other costing and pricing issues. While reliance on the experimental rules and waivers from the Commission has relieved the Postal Service from meeting the normal requirements for a classification filing, the Postal Service has taken advantage of the information dearth to underestimate costs, argue for special exceptions from the Commission's well-established principles of cost attribution, and propose a cost coverage that is anticompetitively low.

MASA and PII urge the Commission to heed the competition concerns they have raised. The competition debate during the proceedings, as posed by the Postal Service and certain of the other parties, has focused on the question whether "functionally equivalent" services would be permitted to obtain similar waivers of the automation requirements. While the functional equivalence stipulation agreed to by certain of the parties to these proceedings may or may not help private businesses that seek to offer an online service similar to MOL, it is of no help to the letter shops and mail preparation houses that are MASA members and which compete for the same SOHO customers that MOL is targeting. Likewise, it is of no help to all the printers who will not get one of the 25 exclusive contracts to provide printing services for the billions of pieces of mail projected to be entered through MOL.

The competition concerns should guide the Commission in several respects in deciding on the Postal Service request. First, the Commission should ensure that all costs caused by MOL are properly captured and attributed to MOL. This means taking account of the Postal Service's refusal to provide complete information about so-called "shared costs" like advertising, rejecting efforts to avoid attribution of historical, start-up or "product specific" costs, and ensuring that the Postal Service's gross underestimation of Help Desk costs and advertising costs during the experiment are not uncritically accepted. Second, it means that a proper markup in the 50% range should be applied to all attributable costs. Only in this way can the Commission minimize the risk that competitive harm will be done during the MOL experiment to many private businesses that depend on the Postal Service for their livelihood.

I. THE ANTICOMPETITIVE EFFECT OF THE POSTAL SERVICE'S PROPOSED MAILING ONLINE EXPERIMENT REQUIRES SPECIAL SCRUTINY OF ITS COSTS AND PRICING

A. MASA's Prima Facie Showing Requires the Commission to Consider the Anticompetitive Effect of Mailing Online

As the Commission observed in its opinion concerning the Market Test, its pro-competitive mandate is embodied in § 3623(c)(1) of the Postal Reorganization Act, 39 U.S.C. § 101 et seq., which requires that classifications be fair and equitable, and § 403(b)(1) of the Act, which requires that the Postal Service provide "an efficient system of collection, sorting, and delivery of the mail." Market Test Op. at 21. Consequently, in evaluating the Postal Service's proposed Mailing Online service, the Commission is required to promote competition so far as consistent with regulatory requirements. PRC Op. MC-78-3 ("E-COM I") at 51.[1]

The Commission's obligation to consider the impact of rates and classification proposals on competition is typical of regulatory agencies required to pursue the public interest. E-COM I at 57. Two fundamental considerations support such a requirement. First, the pervasiveness of antitrust principles suggests that an action that violates them is contrary to accepted notions of the public interest. *Id.* at 55. Second, antitrust enforcement and regulatory decision-making share the common objective of increasing the efficiency of the national economy through optimal allocation of resources and stimulation of innovation and cost efficiency. *Id.*

Of course, the Commission, like other regulatory agencies, does not enforce the antitrust laws and is not strictly bound by their dictates. *Id.* at 55-56. Rather, antitrust considerations are among a number of relevant policies to be weighed in the Commission's evaluation of classification and rate proposals. A "rule of reason" governs the Commission's consideration of antitrust policy. *Id.* at 212.

A party objecting to the anti-competitive impact of a Postal Service proposal must make a two-part *prima facie* showing. First, it must show that it participates in the same properly-defined market as the Postal Service offering. Second, it must establish that there is "an economically reasonable apprehension of material competitive injury from the challenged proposal." PRC Op. R83-1 ("E-COM II") at 22. The Commission applies a more flexible standard than would a court in determining whether the requisite showing has been made; the

[1] E-COM I was the first of two proceedings regarding E-COM, a Postal Service proposal for a program similar to Mailing Online involving the electronic submission of messages subsequently converted into hard copy and delivered through the mailstream. The first E-COM proceeding addressed the initial request for classification, and the second concerned proposed rate and classification changes.

Commission must render a recommended decision whether or not competitive harm is alleged, and that decision would be incomplete if it did not give sufficient regard to the potential for future competitive injury. *Id.* at 23. Thus, a "reasonably apprehended material harm to a protected competitive interest" within the relevant period of time, along with a suitable definition of the competitive market, will constitute a *prima facie* case. *Id.* at 24. Applying this standard in E-COM II, the Commission found that testimony of the president of a direct mail firm that belonged to MASA was sufficient to establish a *prima facie* case of competitive injury with respect to the Postal Service's first attempt to marry electronic technology with mail delivery.

Here, MASA has presented abundant evidence of both factors required to establish a *prima facie* case. First, it has shown beyond question that its members participate in the same market as that targeted by Mailing Online. The Postal Service itself has defined that market as short-run direct mail advertising and solicitations, generally under 5,000 pieces, generated for the most part by small businesses, home offices and individuals – so-called "SOHO" (small office/home office) users. Tr. 1275. Witnesses Schuh and Jurgena, both presidents of direct mail production companies that belong to MASA, each testified that mailings under 5,000 pieces represent a very substantial part of their businesses – 65% in the case of Jurgena and 60% in the case of Schuh. Tr. 825-26; 850-851. Moreover, witness Schuh gathered information from 14 other MASA members concerning the percentage of their mailings that were under 5,000 pieces, and for the group as a whole an average of 58% of their jobs accounting for 35% of their total revenues were mailings under 5,000 pieces. Tr. 826.

Second, the evidence abundantly establishes that Witnesses Schuh, Jurgena and other MASA members reasonably apprehend material harm to their competitive interests. Of course, Mailing Online has not yet been launched and there has not yet been an opportunity for it to cause competitive harm, aside from the Market Test. But the evidence that it will cause future competitive harm is substantial.

Witness Schuh observed that if 62% of Mailing Online's business comes from existing users of direct mail, as the Postal Service projects, he and other MASA members servicing this market will lose a substantial part of their current and potential business. Tr. 825-826. In addition, the Postal Service has accrued substantial funds from its monopoly over mail delivery, and those funds are available to promote Mailing Online on a scale far beyond the small-scale advertising Schuh's company can support. Tr. 826-827. Schuh described the valuable competitive information to which the USPS has access, which it has denied to him. In particular, even as an active participant in his local Postal Customer Council chapter he has been unable to obtain from the Postal Service the chapter's mailing list. The Postal Service, on the other hand, not only has access to these lists but maintains a proprietary database of the end users serviced by direct mail companies, as well as detailed information concerning every mailing. Tr. 827-828.[2] Schuh compared the Mailing Online pricing of a sample job to the pricing he would be able to provide and found that his own *cost* for the job was 65% greater than the Postal Service's *price* for a 5,000 piece mailing, and 2½ times the Postal Service's price for a 1,000 piece mailing. Tr. 829-30; 835. And Schuh described other unfair competitive advantages of Mailing Online, including its proposed exemption from minimum quantity requirements for automation discounts and its exemption from state sales tax. Tr. 828, 830; 889-90.

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[2] Indeed, the Postal Service has conceded that in its own direct mail advertising of Mailing Online, which it found to be its most effective means of advertising, it compiled mailing lists using internal Postal Service data containing information about existing Postal customers – information that is unavailable to private parties. Tr. 1248-49.

Similarly, Witness Jurgena testified that Mailing Online's postage rate advantage alone would cause his company to lose a significant portion of its business. Tr. 851. He described his own company's limited funds for advertising as compared with the Postal Services far greater resources. Tr. 852. He testified to the importance of business referrals from the Postal Service, which would be curtailed by the advent of competition between Mailing Online and direct mail production companies. Tr. 854-855. And he explained that even if Mailing Online were unable to provide a minimally acceptable level of service and therefore failed, it would cause the very potential users of direct mail that the Postal Service claims it will bring into the marketplace to turn to other forms of advertising as a result of their bad experiences with Mailing Online. Tr. 855-586.

These two MASA members, along with many others that similarly rely on the small mailings targeted by Mailing Online, are well within the zone of competitive injury from Mailing Online – indeed, the heart of their business is the very target of Mailing Online. Even Postal Service Witness Garvey testified that he could not dispute the testimony that a substantial portion of their business was comprised of the small mailings targeted by Mailing Online. Tr. 1246. The record leaves no doubt that MASA has established a *prima facie* case, and consequently the Commission must evaluate the competitive impact of the proposed Mailing Online experiment.

B. The Postal Service's Proposed Vertical Integration of the Production and Delivery of Mail Runs Afoul of Settled Antitrust Principles

The vertical foreclosure doctrine in antitrust law provides the most directly applicable framework for analyzing Mailing Online. The proposed Mailing Online experiment, if approved, would join the Postal Service's monopoly in mail delivery service with the previously separate activity of mail production. This extension of the Postal Service's activities to a second stage of the mail production and delivery process is a classic example of vertical integration. Tr. 884-86.

Vertical arrangements have been challenged, under both § 7 of the Clayton Act and § 1 of the Sherman Act, on the basis of the vertical foreclosure doctrine. In the seminal case on vertical foreclosure, Brown Shoe Co. v. United States, 370 U.S. 294 (1962), the Supreme Court held that a merger of two companies, each involved in manufacturing and retailing shoes, was proscribed by the Clayton Act. The Court recognized that "the primary vice of a vertical merger or other arrangement tying a customer to a supplier is that, by foreclosing the competitors of either party from a segment of the market otherwise open to them, the arrangement may act as a clog on competition, which deprives rivals of a fair opportunity to compete." *Id.* at 323-24.

Vertical foreclosure analysis requires a determination whether the effect of the arrangement "may be substantially to lessen competition, or to tend to create a monopoly, in this market." Brown Shoe, 370 U.S. at 328. The threshold inquiry is the share of the market foreclosed by the arrangement. If the share of the market foreclosed is so large as to approach monopoly proportions, the antitrust laws have been violated; on the other hand, foreclosure of a *de minimis* share of the market does not tend to substantially lessen competition. Where the foreclosure falls between monopoly and *de minimis* proportions, the percentage of the market foreclosed is not by itself decisive. Rather, it then "becomes necessary to undertake an examination of various economic and historical factors to determine whether the arrangement under review is of the type Congress sought to proscribe." *Id.* at 329.

The courts have considered a number of factors in examining such vertical arrangements. These factors include (1) whether the vertical integration forecloses the competitors of either party from a segment of the market otherwise open to them; (2) the nature and purpose of the vertical arrangement; (3) the actual and reasonably likely adverse effects upon local industries and small businesses; and (4) the ease with which potential entrants may readily overcome barriers to full entry and compete effectively with existing companies. See United States Steel Corp. v. Federal Trade Commission, 426 F.2d 592, 599 (6^{th} Cir. 1970). See also, e.g., Ford Motor Co. v. U.S., 405 U.S. 562, 568 (1972) (finding antitrust violation based on factors including barriers to entry); Gulf & Western Industries, Inc. v. Great Atlantic & Pacific Tea Co., 476 F.2d 687, 695 (2d Cir. 1973) (finding likelihood of success on antitrust claim based on factors including nature and purpose of the arrangement).

Vertical arrangements involving an entity which, like the Postal Service, is a statutorily authorized monopolist require no less scrutiny. In finding unlawful one such arrangement, the court in International Telephone and Telegraph Corp. v. General Telephone & Electronics Corp., 449 F. Supp. 1158, 1183 (D. Hawaii 1978), observed:

> Perhaps the single most alarming aspect of GTE's vertical integration . . . is the use of its monopoly leverage in the telephone operating market to foreclose competition in the telecommunications equipment industry, an area that has not been entrusted to it by franchise and that is not regulated. In short, GTE (and not alone) has betrayed its public trust in operating a public utility by misusing its power to destroy competition in another economic area and violate the national economic freedoms embodied in the antitrust laws. Such practice must be

> condemned, even more than the use of leverage from an earned, rather than government-granted, monopoly.

Id. at 1183.

As a threshold matter, Mailing Online causes precisely the sort of market impact that the vertical foreclosure doctrine is designed to forestall. The integration of the Postal Service's mail delivery service with the mail production services of a small number of printers – four printers at the outset, gradually increasing to twenty-five as the program grows – will by definition foreclose competing mail production firms from the portion of the SOHO market that Mailing Online captures. Nor is this a *de minimis* share of the SOHO market for short run mailings. By the Postal Service's own projections, assuming it offers only basic Mailing Online service at prices consistent with its proposed pricing structure, Mailing Online volume will be almost 300 million pieces during the first year of the experiment and over 800 million pieces by the third year. Tr. 213. While there is no clear evidence of the size of the SOHO market, by any measure the impact of Mailing Online is more than *de minimus*.

Borrowing from conventional antitrust analysis, the Commission should therefore analyze the factors enumerated by the court in United States Steel Corp. A review of four key factors establishes that there is in fact vertical foreclosure here, and that it is accomplished by anticompetitive means.

1. Foreclosure of competitors from an otherwise available market segment

The projected success of Mailing Online, if achieved, would foreclose MASA and PII members, and other competitors, from a portion of the SOHO market representing millions of mailpieces each year. This entire market segment would otherwise be available to Mailing Online's competitors – some SOHO mailers are currently using private lettershops, others are using direct mail that they produce themselves or have produced by small print shops, and still others are not using direct mail at all. USPS-T1 at 13. All would be accessible to private lettershops and printing businesses but for Mailing Online; those who are not already customers are potential customers.

Moreover, the Postal Service's separate projections of Mailing Online's volume if it offers only basic service as compared with the volume if it offers enhanced service establish that service enhancements are directly correlated to volume; the greater the range of options available to customers, the greater Mailing Online's volume is likely to be. MOL-1 USPS-LR-2 at Tables 15, 17. The Postal Service is already offering significant new options that were not part of its prior proposal and intends to continue expanding its offerings as technical advances permit the development of additional capabilities. MOL-2 Request at 3; USPS-T1 at pp. 12-15. Specifically, the Postal Service will increase the number of printing and preparation options available as the experiment progresses, possibly to include full color printing; it will expand the range of postage options to include First-Class Mail single piece (for pieces with non-standardized addresses), Nonprofit Standard Mail (A), Priority Mail and Express Mail; and it will use its FastForward address change system from the outset of the experiment. *Id.* As Mailing Online offers greater use of color, economical digital printing for higher volume runs, and other increased functionality and efficiency, its volume will likely grow, and with it the extent of the market foreclosed from competitors.

2. <u>Nature of vertical arrangement</u>

The foreclosure of private competitors from a large segment of the SOHO market is a result not of healthy competition, but of precisely the opposite: unfair competition driven by the Postal Service's advantages as a monopolist. Whether deliberately or by happenstance, the nature of the Postal Service's vertical integration, or, put differently, the manner in which it has chosen to design Mailing Online, confers on it benefits that are not available to its competitors, and that result directly from its statutory monopoly over mail delivery. Those competitive benefits are discussed in turn below.[3]

a. Exemption from Minimum Quantity Requirements

The Postal Service proposes to exempt its own service from the minimum quantity requirements for automation discounts it imposes on all other mailers. The exemption is no small matter. At present, Mailing Online software requires unique batching for each combination of paper size, individual spot colors (red, green, blue and magenta), and finishing options (staple and tape binding), and limits batching to mailings with certain envelope sizes. Tr. 657. Absent batching, the Postal Service cannot commingle separate mailings in order to increase volumes. Thus, under the proposed Mailing Online system, for the potentially substantial volume of mailings that cannot be batched or can be batched only to a limited extent, if a mailing is less than 500 pieces (First Class) or 200 pieces (Standard A), it will qualify for automation rates only because of the exemption from minimum quantity requirements.

As a result of the exemption, postage for a one ounce piece is reduced from 33 cents, the single piece rate, to 27 cents for First Class mailings and 18.3 cents for Standard A mailings. This reduction in postage costs for small mailings would afford the Postal Service a substantial competitive advantage, one which would be especially important while the Postal Service is launching Mailing Online and attempting to build its volume. Moreover, in light of

[3] The courts have considered the intent of the monopolist in entering into the vertical arrangement as well as the nature of the arrangement. Such an analysis is neither appropriate nor necessary in the regulatory context. The Commission does not enforce the antitrust laws, but considers the effect of Postal Service proposals on competition in order to ensure that it acts in the public interest. The foundation of the Commission's analysis in public interest considerations counsels against an enforcement-oriented attempt to determine circumstantially the Postal Service's intent.

the repeated delays in rolling out new Mailing Online software – on February 24, 2000, counsel for the Postal Service stated at a Commission hearing that the Postal Service might have to postpone the beginning of the experiment yet another two months -- the continued limitations on the Postal Service's batching capability and the corresponding heightened importance of the minimum volume exemptions may well continue throughout much or all of the experimental period – now increased to a full three years. It is impossible to know when, if at all, this competitive benefit will come to an end.

b. Postal Service Control of Competing Services

Even more insidious is the manner in which the Postal Service would leverage its minimum volume exemption into control over the services offered by its competitors. The Postal Service proposes to offer the exemption only to competing services that achieve "full functional equivalence" with Mailing Online -- as determined by the Postal Service itself. Tr. 657. The Postal Service has now acquiesced in a definition of "functional equivalence" tailored to satisfy Pitney Bowes, but the definition will nevertheless stifle the efforts of other competitors to develop competitive systems.

For example, in order to be "functionally equivalent" a system must generate volumes "that exceed on average any otherwise applicable volume minimums." *Id.* at § 981.62(d). Yet Mailing Online will receive the benefit of volume discounts irrespective of its ability to exceed volume minimums on average, ensuring it preferred pricing even if, as a result of problems ramping up, due to limited batching capability or for any other reason, it does not generate anticipated volumes. In effect, the Postal Service allows itself preferred pricing during its entire three year experiment, while its competitors can only qualify for such pricing after they have reached a volume sufficient to meet this arbitrary requirement.

Moreover, competing systems must have "100 percent standardized addresses on all pieces claiming discounted rates." *Id.* at § 981.62(b). Again, the Postal Service gives itself greater flexibility; it acknowledges its intention to expand the range of postage options to include First-Class Mail single piece for pieces with non-standardized addresses. See p. 12 *supra*.

Worst of all, the Postal Service has included in its definition of "functional equivalence" requirements that have no bearing on the costs it will incur in connection with the mailings of a competing service. It requires that a "functionally equivalent" service commingle and batch mailpieces from all sources and batch them "*prior to printing* and mailing." *Id.* at § 981.62(c) (emphasis added). The commingling and batching of mailpieces before rather than after printing has no conceivable effect on the Postal Service's costs to handle and deliver the mail; as long as the mailpieces are batched and commingled before their delivery to the Postal Service, the way that has been accomplished is utterly irrelevant. If, for example, a competitor were to develop a system that achieves efficiencies by printing all mailpieces at a single facility and then commingling and batching them prior to mailing, it would not, under the Postal Service's proposal, qualify for Mailing Online postage rates. By including meaningless requirements under the guise of "functional equivalence," the Postal Service defines the ground rules for its competitors, depriving them of a free hand in developing competing services that might achieve greater efficiencies through differences in design.

In short, the Postal Service's approach would allow it to control the types of competitive offerings that are favored with the same postage rates as Mailing Online. Competing services that do not mimic Mailing Online would be subject to less favorable postage rates. No better way exists to control competition than to provide incentives that stifle innovation, and that is exactly what the Postal Service is doing.

c. Free Address List Cleansing and Fast Forward

The Postal Service proposes to obtain further competitive advantage by conferring on Mailing Online customers valuable services at no charge. The Postal Service will not charge Mailing Online customers for cleansing address lists – i.e., identifying addresses that do not match its Address Management System database, purging them from the customer's mailing list and providing a list of these unverifiable addresses to the customer. Tr. 564. MASA members must perform this service themselves, using approved software they must purchase for this purpose.

Similarly, the Postal Service would provide its Fast Forward service, which automatically substitutes forwarding addresses, as part of Mailing Online at no cost to customers. Fast Forward is available to private parties only upon payment of a $10,000 annual fee. Tr. 721.

These benefits can be provided without charge to Mailing Online customers precisely because of the Postal Service's monopoly on mail delivery. It is because of that monopoly that address lists are cleansed against a *Postal Service* database, and because Fast Forward is part of the actual delivery of mail it is within the scope of the Postal Service's statutory monopoly. Here again, the Postal Service takes advantage of its monopoly to confer special benefits on its own Mailing Online customers.

d. Postal Service Cost and Resource Advantages

As a result of its statutory monopoly, the Postal Service enjoys significant advantages both in available resources to design and implement Mailing Online and in the costs it incurs in providing the service. First, the Postal Service has a customer base of 270 million customers. Tr. 1299. This customer base and the corresponding revenues have allowed it to invest tens of millions of dollars in Mailing Online even before the service has generated revenue – an investment that even the Postal Service grudgingly acknowledges exceeds the resources of most mail services. *Id.* By the time the first Mailing Online proceeding came to an end, the Postal Service investment for information systems already exceeded $22 million. Since that time, substantial additional costs have been incurred to continue developing software, yet the Postal Service's virtually unlimited resources have still been insufficient to cure many of the technical problems that have plagued the system. The Postal Service spent more than $4 million for advertising and promotion activity at a time when Mailing Online was only conducting a limited Market Test. Only the Postal Service alone has the wherewithal – and the inclination -- to spend $4 million in advertising that generates only $7 million in revenue. Tr. 1254.

The Postal Service likewise has cost advantages as a result of the size of its customer base. By virtue of its 270 million customers, it is able to project large volumes and thereby to obtain favorable pricing from printers, whose charges constitute a large portion of Mailing Online prices. MOL-2 USPS T2, Exhibit A, Table 1. Similarly, the Postal Service can negotiate more favorable advertising rates. PRC Op. MC-97-5 at 18. As a result of these advantages, the Postal Service will have no difficulty undercutting private competitors' prices, and may well price Mailing Online below the costs incurred by competitors. *See* Tr. 829-830; 835.

e. Postal Service Institutional Advantages

By virtue of its government affiliation, the Postal Service enjoys a host of institutional advantages that permit it to compete on unfair terms with private competitors. The Postal Service is exempt from sales tax, a benefit that is passed through directly to its customers. Tr. 888. Its freedom from the necessity of making a profit, PRC Op. MC-97-5 at 18, permits it to pursue actions that would be impossible for a private business, such as the expenditure of $30 million before generating meaningful revenue. Tr. 1299.

Finally, and perhaps most importantly here, because the Postal Service is a monopoly, it alone has access to customer information concerning the use of the mails. Such information has great competitive value and would never be turned over to private competitors. Tr. 827-828. For Mailing Online, the Postal Service tried a number of different advertising methods and found most effective the use of direct mail. Tr. 1242. It used mailing lists derived from information the Postal Service collects from users of the mails – information available only to it. Tr. 1243; 1248-49. Witness Schuh has requested and been denied access to such information. Tr. 827-828. The Postal Service thus not only has sole access to information about users of the mails by virtue of its statutory monopoly, it has made actual competitive use of that information. And the proof is in the pudding: "The direct mail drop that [the Postal Service] did in January and February is what filled up [its] rolls." Tr. 1242.

3. Actual and Reasonably Likely Adverse Effects on Small Businesses

Since Mailing Online has not yet been made available, except in the Market Test, there is as yet no actual adverse effect on small businesses. But the many competitive advantages of Mailing Online assure that, if the experiment proceeds, it will take a heavy toll on the small businesses that dominate the SOHO market against which it competes. The postage rates paid by these small businesses are greater than those available to Mailing Online customers. The Postal Service's non-postage costs, at least as currently formulated, are far below the costs of its competitors. The Postal Service has a budget that is by comparison to its small business competitors unlimited, and it can support advertising and development costs that cannot even be contemplated by small businesses. Its ability to compete is bolstered by its use of information concerning users of the mails to which no one else has access.

The Postal Service, while acknowledging that lettershops may lose some small volume mailings to Mailing Online, has consistently minimized the importance to these small businesses of short-run jobs under 5,000 pieces. *See, e.g.*, Tr. 723. But the significance of this market segment to mail production businesses is far greater than the Postal Service suggests. For the 14 MASA members who provided data to Witness Schuh, an average of more than half of their jobs accounting for more than one-third of their total revenues comes from jobs under 5,000 pieces. The Postal Service's own projections reflect Mailing Online's appeal to current users of mail production firms. And over time, as the Postal Service continues to refine the Mailing Online software and enhance its functionality, it will develop the ability to service a fuller range of printing options and run sizes, increasing the potential loss to small mail production businesses. A loss of even a third of the short-run segment of these companies' business would reduce their revenues by an average of 10 percent. That loss might be fatal in some instances, and would be keenly felt in all.

The Postal Service's claim that Mailing Online would actually benefit mail production businesses rings hollow at best. The hypothesis that Mailing Online will increase the satisfaction of postal customers and cause an increase in business for the entire direct mail services industry, Tr. 890-891; 724; USPS-T1 at 16-17, reflects a grandiose view of Mailing Online unsupported by any evidence. Even assuming broad user satisfaction with Mailing Online, there is no reason to believe that satisfaction with the Postal Service will lead to greater demand for its competitors' products.

The effect of Mailing Online on small businesses will be overwhelmingly adverse and significant. A few printers, most likely large companies, will receive contracts with the Postal Service. The balance of mail production companies will lose substantial existing business and opportunities as a result of the Postal Service's unfair competition. This is precisely the harm against which the antitrust laws protect.

4. The Ease of Overcoming Barriers to Entry and Effective Competition

The Postal Service has designed Mailing Online in a way that erects substantial barriers to effective competition barriers. First, the waiver of minimum volume requirements is an essential feature of Mailing Online. The Postal Service has repeatedly emphasized that a central goal, driven by its research concerning the desires of potential users, is simplicity, and to that end it insists upon the use of a single postage rate, capable of determination at the time an order is placed. Exemption from minimum volume requirements permits the use of automation basic rates as the single postage rate the Postal Service desires. Notwithstanding the Commission's specific inquiries concerning the feasibility of a rebate system, the Postal

Service has been unable to come up with its an alternative, and has continued to press for exemption from minimum volume requirements.

But the effect of the exemption, discussed at greater length above is twofold. First, the exemption would confer on Mailing Online postage savings as great as 45 percent for a one ounce mailpiece (based on the Standard A automation basic rate of 18.3 cents as compared with the single piece rate of 33 cents) – savings that are too substantial for mail production companies to overcome. Second, the exemption would allow the Postal Service to stifle innovation in system design and execution by making the same exemption available to competitors only if their systems mimic Mailing Online.

The Postal Service's other competitive advantages further interfere with effective competition. Because the Postal Service delivers the mail, it is able to offer free address list cleansing and Fast Forward service; others must pay $10,000 annually for Fast Forward service and must incur the cost of acquiring and maintaining certified software to cleanse address lists. The Postal Service has lower printing and advertising costs, resulting in total non-postage costs that are a fraction of those of lettershops. Direct mail advertising of Mailing Online is far more effective than advertising of any competing service because the Postal Service alone has access to information provided by users of the mail. And the Postal Service's substantial resources and freedom from the constraints of the profit motive allow it to invest millions of dollars to develop and promote its new system.

Mailing Online's effect on competition is even more daunting in light of the newly enlarged duration proposed for the experiment. The Postal Service now suggests that the experiment must be three years rather than two because it needs two years of data to "consider whether a request for permanent service would be appropriate," MOL-2-USPS-T1 at 12, and another full year to prepare a request for permanent Mailing Online. *Id.* This glacial schedule would allow the Postal Service to take advantage of its pricing and other competitive advantages during the experiment for a full three years – and any additional period required for the Commission to consider the Postal Service's request for a permanent designation. By the end of the experiment Mailing Online will be so entrenched that it will be impossible for competitors to catch up, even if the assumptions on which the Postal Service relies to justify favorable treatment of Mailing Online prove invalid.

The Postal Service's competitive advantages are thus pervasive and substantial. They can only be offset through the more complete inclusion of costs in determining prices, the elimination of the proposed exemption from minimum volume requirements, and the other adjustments discussed in the cost analysis below. *See infra.* pp. 28-40.

C. Mailing Online Creates an Unlawful Bottleneck

Entirely apart from the vertical foreclosure of competition caused by Mailing Online, the program raises other antitrust concerns. The discriminatory pricing features of Mailing Online give rise to an unlawful bottleneck in the provision of an essential facility -- the delivery of mail.

The possession of a monopoly facility by a competitor of those who must use it calls for the application of what antitrust law has labeled the "essential facilities" or "bottleneck" doctrine. E-COM II at 35-36. In the seminal case concerning the doctrine, United States v. Terminal Railroad Ass'n, 224 U.S. 383 (1912), the Supreme Court held that a group of competitors who controlled the only western access railroad terminal in St. Louis violated § 2 of the Sherman Act when they denied competitors the right to use the terminal.[4]

In MCI Communications Corp. v. American Telephone and Telegraph Corp., the Seventh Circuit adopted a four-part formulation of the doctrine that has since frequently been cited by other courts. An unlawful bottleneck requires (1) control of an essential facility, without which effective competition is impossible; (2) a competitor's inability practically or reasonably to duplicate the essential facility; (3) the denial of the use of the facility by the competitor; and (4) the feasibility of providing the facility to the competitor. *Id.* at 1132-33. The court explained why a refusal to deal coupled with the other required elements may be unlawful:

> [A] monopolist's control of an essential facility (sometimes called a "bottleneck") can extend monopoly power from one stage of production to another, and from one market to another. Thus, the antitrust laws have imposed on firms controlling an essential facility the obligation to make the facility available on non-discriminatory terms.

Id. at 1132.

"[T]here need not be an outright refusal to deal in order to find that denial of an essential facility occurred. It is sufficient if the terms of the offer to deal are unreasonable." Delaware & Hudson Railway Corp. v. Consolidated Rail Corp., 902 F.2d 174, 180 (2d Cir. 1990), cert. denied, 500 U.S. 928 (1991) (finding a genuine issue of material fact as to whether defendant's policy concerning the use of its railroad tracks was unreasonable and thus constituted denial of an essential facility); Fishman v. Estate of Wirtz, 807 F.2d at 540-541 (finding that defendant denied plaintiff access to an essential facility even though defendant

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[4] The doctrine only later received the "bottleneck" moniker. See MCI Communications Corp. v. American Telephone and Telegraph Corp., 708 F.2d 1081, 1132 (7th Cir. 1982), cert. denied, 464 U.S. 891 (1983).

had offered to lease Chicago Stadium to plaintiff; the offer was on unreasonable terms and thus did not show that defendant was willing to deal on non-discriminatory terms.). Put differently, access to an essential facility must be "upon such just and reasonable terms and regulations as will, in respect of use, character and cost of service, place every such company upon as nearly an equal plain as may be with respect to expenses and charges as that occupied by the proprietary companies." See Delaware & Hudson Railway Corp., 902 F.2d at 180, quoting Terminal Railroad Ass'n, 224 U.S. 383 (1912).

The Commission considered the application of the bottleneck doctrine in E-COM II. There the Commission determined that the Postal Service's monopoly over the mail delivery system created a bottleneck, to the detriment of competitors of the Postal Service's proposed mail messaging system. The Commission observed:

> [A]mong the foremost characteristics of the present fact situation, for purposes of competitive analysis, is the existence of a facility, controlled by the Postal Service, which must be used not only by it but also by its competitors. That facility is the letter delivery system, which is statutorily established as a Postal Service monopoly by the Private Express Statutes [18 U.S.C. §§ 1694 ff.; 39 U.S.C. ch. 6].

E-COM II at 35. The Commission found that the terms on which access to the letter delivery system was offered to competitors of the Postal Service were unreasonable, and cured this problem by unbundling the provision of mail delivery services from the reception and preparation of the mail for the purpose of determining rates.

Here too, the terms on which the Postal Service offers its competitors access to the mail delivery system are unreasonable and discriminatory, denying competitors reasonable access to an essential facility. The most obvious discrimination is the Postal Service's proposed exemption of itself from the minimum quantity requirements for automation basic rates, while it makes the exemption available to competitors only if they satisfy a rigorous set of "functional equivalence" requirements. In addition, the Postal Service discriminates against private mail production firms by providing Mailing Online customers free Fast Forward and address list cleansing services. *See supra* pp. 16.

The bottleneck created by the Postal Service's discriminatory pricing is an anticompetitive effect separate and distinct from the vertical foreclosure discussed above. The bottleneck can be eliminated only by requiring the Postal Service to do away with minimum quantity requirements for competitors, as it has for itself; to eliminate charges for FastForward service; to provide to other Postal customers free of charge the same address list cleansing services it provides for Mailing Online; and to adjust its pricing to reflect the deficiencies in its analysis of costs.

D. Mailing Online Creates a Price Squeeze for its Competitors

The Commission also recognized in E-COM II the competitive harm caused by a price squeeze. Here, as in E-COM II, the existence of a bottleneck facility and the accompanying price discrimination, combined with the Postal Service's institutional cost advantages, gives rise to a price squeeze.

A price squeeze may arise where a firm has a wholesale monopoly and wishes to extend the monopoly to the retail level, where competition exists. If the monopolist raises its wholesale prices sufficiently to make it impossible for others to compete with it at the retail level, the result is a price squeeze. See City of Anaheim v. Southern California Edison Co., 955 F.2d 1373, 1376-77 (9th Cir. 1992). Similarly, a manufacturer can create a price squeeze by favoring company-owned distributors over independents in establishing transfer prices. Such practices are often challenged as violating §§ 1 and 2 of the Sherman Act. See, e.g., Eastman Kodak Co. v. Southern Photo Materials, 273 U.S. 359 (1927); United States v.

Aluminum Co. of America, 148 F.2d 416 (2d Cir. 1945); Bonjorno v. Kaiser Aluminum & Chemical Corp., 752 F.2d 802 (3rd Cir. 1984), cert. denied, 477 U.S. 908 (1986).

Where a price squeeze exists in the specialized context of a regulated utility service, the regulatory agency is typically required to remedy the price discrimination. E-COM 2 at ¶ 2051. In the leading case, Conway Corp. v. FPC, 510 F.2d 1264 (D.C. Cir. 1975), aff'd, 426 U.S. 271 (1976), the wholesale customers of a vertically integrated power company objected to proposed wholesale rates as anticompetitive, in violation of the Power Act. The wholesale customers claimed that, by charging them more than its own large retail customers, the integrated power company prevented them from competing for these large customers. The court treated the matter as one of undue discrimination remediable under the terms of the Power Act, and instructed the FPC that it must at least consider lowering the wholesale rate within the "zone of reasonableness":

> When costs are fully allocated, both the retail rate and the proposed wholesale rate may fall within a zone of reasonableness, yet create a price squeeze between themselves. There would, at the very least, be latitude in the FPC to put wholesale rates in the lower range of the zone of reasonableness, without concern that overall results would be impaired, in view of the utility's own decision to depress certain retail revenues in order to curb the retail competition of its wholesale customers. Id. at 1274.

In E-COM II, the Commission stressed that it, like the FPC in Conway, is governed by a statutory framework prohibiting undue discrimination. Specifically, 39 U.S.C. § 403(c) provides:

> In providing services and in establishing classifications, rates and fees under this title, the Postal Service shall not, except as specifically authorized in this title, make any undue or unreasonable discrimination among users of the mails, nor shall it grant any undue or unreasonable preferences to any such user.

The Commission proceeded to consider whether E-COM users enjoyed an effective price reduction on the carriage of completed E-COM letters for no other reason than that the letter entered the mailstream from a Postal Service SPO rather than the facilities of a letter preparation firm, observing that such circumstances would establish *prima facie* discrimination and might indeed amount to "undue or unreasonable" discrimination in violation of § 403(c). *Id.* at 37. The Commission determined that customers of the Postal Service's integrated mail messaging service were indeed receiving the benefit of an implicit rate discriminatorily lower than the explicit rate occupying the corresponding stage in the nonintegrated system, thus creating a price squeeze. *Id.* at 39-40. The PRC remedied the discrimination by implementing an unbundled pricing system. [5]

As in E-COM II, a price squeeze exists here and must be remedied.[6] Indeed, the analysis is simpler here; rates are already unbundled, and the evidence of rate discrimination and the resulting price squeeze is clear. Again, the Postal Service's exemption of Mailing Online, but not other services, from minimum quantity requirements for automation rates, as well as its different treatment of Mailing Online customers and private mail production companies with respect to FastForward and address list cleansing services, result in substantially lower charges to Mailing Online customers than to others. Again, each of these features must be eliminated, and costs more completely captured, in order to remedy the problem.

[5] The Commission noted that, in addition to considering the "undue discrimination" prohibited by § 403(c) (which focuses on the discrimination itself rather than the effects thereof), it was also required to consider competitive effects pursuant to 39 U.S.C. § 3622(b)(1) and (5). ECOM II at ¶ 2054. While concerns stemming from competition must be balanced with other aspects of ratemaking, nondiscrimination is itself a "basic principle of ratemaking which can be directly applied to cure a competition problem without the risk of distorting its basic nature. The application and result of this principle are the same whether it is applied for its own sake, as a matter of insuring fairness and equity in rates, or, additionally, to mitigate a demonstrated, concrete problem of anticompetitive pricing." *Id.* At 39.

[6] While E-COM II considered the effect of a price squeeze in the ratemaking context, the analysis is the same in classification proceedings. Section 403(c) mandates the prevention of undue discrimination in both classification and ratemaking proceedings. Likewise, the statute governing classifications, 39 U.S.C. § 3623, implicates concerns with respect to anticompetitive conduct similar to those reflected in the ratemaking statute, 39 U.S.C. § 3622. See ECOM II at 13-14.

II. THE POSTAL SERVICE HAS IMPROPERLY CALCULATED ATTRIBUTABLE COSTS OF MAILING ONLINE.

The non-postage costs of MOL consist of two basic components: the contract printing price and the costs incurred internally by the Postal Service as a result of offering MOL. The former are purely a function of the contract price negotiated with private printing contractors and are not controversial for purposes of the costing analysis.[7] The Postal Service internal costs, on the contrary, have generated considerable controversy.

In testimony supporting its request for an experimental classification, the Postal Service estimated its internal costs based on Rothschild's volume estimates at approximately .065¢ per impression. Tr. 761. These costs were comprised principally of so-called "information systems" costs, and the Postal Service proposed to charge .1¢ per piece for its internal costs as part of the cost base to which it proposed to apply a 25% markup. MC98-1 Request, Attachment B1.

As the market test proceeded, and problems with the system materialized, the Postal Service embarked on a process to alter in significant measure the system architecture of MOL. In February 1999, the Postal Service filed the supplemental testimony of witness Lim. This testimony gave revised estimates of Postal Service internal costs caused by MOL, which

[7] The printer prices are, of course, controversial for the competitive analysis set forth in the first section of the brief. Because the Postal Service contracts with an extremely small number of printers, which get favorable access to the postal system, the printing prices are lower than private competitors for SOHO business can match. *Supra pp.* 7 - 8. This unfairly disadvantages other printers such as the PII members who do not get one of the 36 contracts, and the many MASA members who cannot supply printing services at the low rate made possible because the Postal Service supplies its favored contractors a steady stream of mail obtained from its monopoly over mail delivery.

increased these costs by over fourfold. Although these costs were now estimated to be .41¢ per impression, or over $22 million for the experimental period, the Postal Service proposed to increase the internal cost component of MOL prices from .1¢ to only .2¢. Tr. 760-761. Further, as discovery proceeded, it became apparent that the Postal Service had made some questionable assumptions in determining what costs to include in its assessment of costs caused by MOL, and in how it would allocate costs caused jointly by MOL and by other products offered on POL. The result is that the Postal Service estimates of costs attributable to MOL are significantly understated.

Then, in the spring of 1999, on the eve of filing briefs in MC98-1, the Postal Service withdrew its Request, acknowledging that MOL was not yet ready for prime time, and that it would be some time before the revisions to the system would be complete. The Market Test approved by the Commission in connection with the original filing limped along for another six months with the Postal Service not pushing to generate volume, until it was terminated on October 29, 1999.

On November 16, 1999, the Postal Service finally filed in this docket MC2000-2, its renewed request for approval of an experimental MOL service to be offered for a three year period. This filing as far as costing is concerned attempts to sweep many of the problems from MC98-1 under the rug. Arguing that only costs incurred in developing and preparing the new version 3 of MOL are properly attributable to the experimental service, the Postal Service attempts to avoid consideration of costing issues that arose in MC98-1 with the claim that "start-up costs" incurred during the Market Test are only relevant to the determination whether MOL revenues during the experiment – including revenues that come from the mark-up -- will cover all costs including the pre-experiment costs that it does not consider attributable. This strategy is inconsistent with accepted costing principles established by Commission decisions, and should not be approved in this docket.

Further, even aside from its effort to avoid the costing issues of MC98-1, the Postal Service has failed fully to attribute all internal costs that are likely to be caused by MOL. Lim's estimates of Help Desk costs and the allocation of those costs to MOL significantly underestimate the amount of this cost category attributable to MOL. The Postal Service's refusal to allocate to MOL any of the over $4 million in advertising expenses during the market test, or properly to estimate advertising expenses that will be incurred during the experiment, is without any justification. Finally, the Postal Service has failed to account for a variety of other costs of MOL, including (i) revenue leakage, (ii) credit card fees; and (iii) contract printer minimum revenue guarantees.

A. The Postal Service Ignores Accepted Principles Of Cost Attribution.

It is an elementary principal of postal ratemaking that the price of any given postal product or service is based on its share of attributable costs plus a markup to reflect a reasonable contribution to the overhead or institutional costs of operating the Postal Service. Accordingly, the starting place for determining the rate for a postal product is the determination of the attributable costs of that product. The costing exercise in this case has raised a number of questions concerning the proper application of Commission cost attribution principals.

First, and most fundamentally, all parties agree that the touchstone of cost attribution is causality. Only those costs that are caused by a postal product are attributable to that product for ratemaking purposes. The parties are also in agreement that the Commission has long held that volume variable costs and specific fixed costs are attributable to the postal products that have caused them to be incurred. The application of these principles has produced profound disagreement.

The Commission has been clear that start-up costs of a new product or service offering are attributable, and must be recovered over the proposed life of the product. In the packaging service case, the Commission stated the position clearly and clearly rejected the Postal Service's arguments to the contrary:

> The Commission has adjusted packaging service costs to recover start-up costs during the two-year life of the provisional service . . . . Reliance on the packaging service's contribution to institutional costs for recovery of these direct costs is also an unacceptable approach, for two reasons. First, it would be inappropriate in principle to recover an attributable cost from revenues that have been earmarked for contribution to the Postal Service's institutional costs. Second, doing so in this instance would reduce the institutional cost contribution of packaging service to an unacceptably low level.

PRC Op. MC97-5 at 47. It follows that the start-up costs of MOL are attributable costs, which must be recovered over the proposed three-year term of the experimental service. As discussed below, no Postal Service witness has articulated any persuasive reason to depart from this fundamental and well-established principle of cost attribution.

B. All Start-Up Expenses Incurred On Behalf Of MOL Are Attributable And Should Be Recovered As Part Of The Internal Cost Component Of MOL Pricing

Witness Plunkett proposes that MOL prices should be based on a 30% markup over printer costs plus variable IT costs. USPS-T5 at 8. Excluded from this equation is over $30.3 million of so-called "product specific IT costs." Tr. 448-49. Witness Plunkett has discussed why, in his view, it would be inappropriate to attribute these "start-up costs" to MOL and to include them in the information system cost component of MOL pricing. Tr. 455-57. While acknowledging that these start-up costs are in the category of "fixed costs" (Tr. 752), which are generally considered attributable by the Commission, Plunkett offers a variety of reasons why they should not be so considered here. First, he claims that the product specific costs in this case are not the same as similar costs for a more "established service." Tr. 456. This is so, he argues, because such costs for established services tend to be incurred on an ongoing basis, where as the MOL product specific costs are more in the "nature of start-up costs." *Id.* In MC98-1, Plunkett suggested that once start-up expenses are recovered, a price based on the inclusion of such costs as attributable would be higher than statutory criteria would otherwise warrant.

There are two obvious responses to these points. First, at least some of these so-called start-up expenses are what might be called long-term variable; that is, if MOL continues as a product some of the system development expenses will be incurred in the future, among other things in connection with future system enhancements and improvements. In other words, these expenses may have a non-trivial component that is not truly fixed, but instead is variable. While Plunkett claims that it is more difficult to estimate these expenses than more traditionally volume variable expenses, the likelihood is in today's fast changing high tech world that system revisions and upgrades will be a regular occurrence (think of Windows 95, Windows 98 and Windows 2000, plus all the interim fixes and modifications). Second, if at the end of the experiment, it becomes clear that a component of the start-up expenses are truly non-recurring, then that fact will be taken into account in setting the rate for the permanent service.

In addition to the exclusion of product specific costs, Witness Lim has excluded so-called "pre-experiment" costs from his calculation of costs caused by MOL. In his view, most pre-experiment costs – to the tune of over $9.6 million -- were incurred in connection with the "completely different" MOL service offered during the Market Test. USPS-T2 Exh. A Table 6. Tr. 429–34. Witness Plunkett further claims that "historical costs" are not properly attributable, although he acknowledges that the costs of MOL were not recovered by revenues generated during the market test. Tr. 481-82.

The Postal Service treatment of product specific costs and historical costs is unprecedented and without basis. As the authority cited in the previous section makes clear, these are precisely the kinds of costs that meet the causation test and are classically attributable. Witness Lim's extraordinary explanation that he ignored pre-experiment costs because MOL during the Market Test is "completely different" from the MOL the Postal Service proposes to offer during the experiment is really quite ludicrous. It is plain that the Market Test was a trial run of the MOL system. As Witness Garvey testified in support of the Market Test proposal:

> The plan for this test is to allow a substantial increase in the number of participants from the current two hundred to several thousand. During this phase, we will conduct further tests of the technology and refine the relationships we need to establish and maintain with contract printers for the nationwide experimental service.
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> * * *
>
> Following the market test, the Postal Service proposes that Mailing Online be offered as an experimental service for an initial period of up to two years. The primary distinction between the market test and experimental versions of Mailing Online is the availability in the latter of service to customers nationwide.

USPS-T1 at 6-7 (MC98-1).

The basic intent expressed by Garvey has been borne out. Whatever technical changes have been made to improve MOL, it performs essentially the same mail entry function that it was originally intended to perform. Tr. 432. Likewise, Lim acknowledges that the system developers working on Version 3 of the software, learned from their work with Version 2. Tr. 433. Indeed, the very fact that the new software is called Version 3 suggests that it is related to and not "completely different" from Version 2.

There is, likewise, no justification for witness Plunkett's contention that historical costs will be covered by the mark-up and therefore need not be attributed. Tr. 483-84. The point is that the pricing of a Postal product depends on a proper attribution of costs to which a mark-up is applied. A price that does not mark up all a product's properly attributed costs is not properly priced under accepted Commission principles discussed above. This is especially important in a context like the present one, where the Postal Service offering is in direct competition with private businesses for the same customers to provides services that are not within its postal monopoly.

There is another reason for the Commission to be thorough in its identification of attributable costs in this case. The record reveals tremendous imprecision and uncertainty in the costing, volume and other data proffered by the Postal Service in support of its proposal. The Postal Service in many instances has either refused to supply data (e.g., Lim's refusal even to estimate Market Test costs, Tr. 429), or estimated costs in ways that clearly understated them (e.g., Help Desk costs, see *infra*). It is, therefore, entirely appropriate for the Commission to do the only thing it really can do – deal with the specific proposal before it on its own terms. Those terms involve a three-year experiment, with no evidentiary support for amortizing attributable start-up expenses over a longer period or trusting that institutional cost coverage will take care of costs that should properly be attributed.

The Postal Service also suggests that if demand for MOL is inelastic, then setting the price too high because of the inclusion of start-up expenses will "dampen demand such that the service appeals only to the least price sensitive users." Tr. 753. Whatever theoretical plausibility this proposition may have, it is unpersuasive in the circumstances presented by the Postal Service request. Here, the danger of setting the price artificially low is that the many private competitors of the Postal Service, who are already severely disadvantaged by having to compete with a service offered by a much larger entity backed by its monopoly products, will be at the further competitive disadvantage that their well-endowed competitor will offer its product at a predatory price. This is not an idle risk, as the pricing example offered by MASA witness Schuh illustrates. Tr. 835. Moreover, the predicate for even considering this concern – that MOL would be priced above competing products if the start-up costs were to be recovered over the period of the experiment – is not established by the evidence. Witness Schuh's testimony suggests the contrary – the Postal Service's pricing as proposed is significantly under what its private competitors can offer for similar mail pieces. *Supra.* pp. 7-8. Even if start-up costs are included, the Postal Service will be able to offer a very favorable pricing structure.

In any event, as the Commission has made clear, the elimination of attributable start-up costs from the price base of MOL is "inappropriate in principle." MC97-5 at 47. To exclude such costs would violate the fundamental mandate of postal rate-making – that all direct costs incurred by a product must be recovered by the rates paid for that product.

C. The Postal Service Has Underestimated And Misallocated Help Desk Costs.

In MC98-1, Postal Service witness Lim estimated total Help Desk costs of $2,054,000 during what was to be a two-year experiment. USPS-ST-9 at 2. In order to reach this number, he estimated total Help Desk costs for all of POL, and then allocated those costs to MOL based on the proportion of MOL Help Desk related calls to all POL calls. *Id.* at 4, lines 25-26 – 5, lines 1-3. In this docket, witness Lim estimates total Help Desk costs of $3,515,000 during what is to be a three-year experiment. USPS T-3 WP-3. In order to reach this number, he estimated total Help Desk costs on USPS.com, and then allocated 25% of certain of these estimated costs to MOL. The 25% cost driver was derived as the percentage of MOL Help Desk calls to total POL

Help Desk calls during the Market Test. The evidence suggests that Lim's estimate of MOL-related Help Desk costs is unreliable and that he has significantly understated the likely Help Desk costs of MOL.

First, the rate of Help Desk inquiries as a function of transactions during the Market Test suggests that Help Desk usage for MOL will be far greater than estimated. Witness Lim's current Help Desk cost estimates are not significantly greater than the cost estimates in MC98-1, adjusted for the additional year of the experiment.[8] Lim's MC98-1 Help Desk costs estimates were based on Stirewalt's projection of one POL Help Desk call for every ten MOL transactions.[9] The weekly reports through AP 2 of this year indicate that Help Desk phone calls and e-mail messages have been running at a rate of about 4.5 inquiries for every transaction.[10] This is a huge frequency. Even if the ratio can be expected to flatten out as the system becomes more mature, it suggests several factors that the Commission should take into account in assessing attributable Help Desk costs. In the first place, the system is reaching maturity at a much slower pace than the Postal Service expected; therefore, it is highly likely that the Help Desk burden will extend well into the experimental period before general familiarity with the system will begin to diminish Help Desk inquiries. Moreover, the ratios suggest a degree of difficulty in usage of MOL that calls into question whether the *de minimus* level of Help Desk usage that forms the implicit predicate for estimating Help Desk costs will ever be realized, or at

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[8] Two-thirds of $3.5 million is $2.35 million or $300,000 more than Lim's MC98-1 estimates. When the increase in volume for year three is factored in, there is little, if any increase in Help Desk costs estimated in this docket.

[9] One can calculate the number of calls implicit in Stirewalt's estimates of total Help Desk call hours contained in LR 1, Attachment 1. This is done by dividing the number of call hours by the estimated length of the calls (.5 hour for the first call hours, and .1 hour for the ongoing call hours).

[10] The MOL Bi-Weekly Report for AP 2 Week 3 - Week 4 Table 2 shows 334 total MOL transactions in the Market Test to that date. The sum of all Help Desk inquiries related to MOL reflected on the Bi-weekly Data

least will be realized during the experiment. The consequence is that absolute Help Desk costs are likely very substantially understated.

Second, this same analysis calls into question Lim's basis for estimating the *relative* MOL usage of the Help Desk compared to other products available on USPS.com. While Lim estimates that inquiries for non-MOL products on POL constituted 75% of total inquiries, and therefore allocates only 25 % of shared costs, that comparison is fundamentally flawed. During a substantial part of the Market Test, MOL was not actively marketed and its already meager volume fell off to almost nothing. And yet, even with low volume, the inquiry level was 25 % of the total. With healthy volume projected for the experiment, relative usage can be expected to skyrocket.

Accordingly, the Commission should attribute more Help Desk costs to MOL than suggested by witness Lim. Instead of looking merely at the percentage of total calls during the Market Test that relate to MOL, the Commission should consider what the per inquiry Help Desk cost for MOL is over the entire experiment and calculate the imputed Help Desk cost in light of the projected transaction flow. An appropriate adjustment could be made to account for some decrease in Help Desk demand over the life of the experiment as the product matures. But only with some approach like this can the Commission be sure that the Postal Service has not seriously underestimated Help Desk costs.

D. Advertising And Marketing Costs Are Attributable To MOL.

The Postal Service estimated in MC98-1 that it expended almost $4.4 million in marketing and advertising expenses on POL. It argued that none of these expenses are attributable to MOL and it estimated no future advertising and marketing expenses attributable to

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Reports through AP 2 Weeks 3 and 4 shows 1544 phone or e-mail contacts with the Help Desk. Dividing 1544 by 334 produces 4.62 calls per transaction.

MOL. The basis for its position was its assertion that all advertising expenses were POL related and would be incurred even in the absence of MOL. As a consequence, it argued, advertising and marketing expenses are not caused by MOL and are not, therefore, attributable to MOL under the standard causation tests used by the Commission.

In this docket, the Postal Service has acknowledged that $725,000 annually is "budgeted" for MOL-specific advertising. Tr. 242; USPS - T2 Table 7. It has claimed further that there are no current advertising and marketing plans. And it concedes that some advertising and marketing expense would be incurred in connection with USPS.com, but provides no information about what those expenditures may be, leaving the Commission and the parties to grapple without information with its position that no portion of such expenses are properly attributable to MOL.

Witness Prescott testified that in his opinion, some portion of the marketing and advertising expenses should be attributed to MOL. According to witness Prescott, the purpose of marketing and advertising is to produce volume, and that there is a sufficient relationship between the provision of MOL and the expenditure of advertising dollars to satisfy the Commission's causation analysis for cost attribution. Tr. 904-06. This is clearly the correct result. This is not a situation where the Postal Service is advertising to build brand awareness, or to attract new employees. On the contrary, advertising during the market test was explicitly intended to produce new users of MOL, SOL and POL. The marketing plan set forth in Library Reference 16 in MC98-1 demonstrates this fact – it provides for an evaluation of the effectiveness of the different advertising media that were used during the market test. Indeed, the Postal Service acknowledged that the marketing plan demonstrated that direct mail was the most effective in producing new registrants. It is moreover, absolutely apparent that some of the expenditures for marketing materials were caused by MOL in the traditional sense argued for by the Postal Service witnesses. Those parts of the marketing brochure discussed by witness Takis and Garvey that specifically mention MOL would, obviously enough, not be included if MOL did not exist. Tr. 1180-83, 2784-86. Further, witness Plunkett testified about marketing materials that focused on MOL. Tr. 131-37, 211-20.

Attribution of advertising expenses should not, moreover, be rejected on the ground urged by witness Takis – that it reverses the causality test. Most cost attribution issues are settled by the Commission based on whether the volume caused the cost. Here it is the expense that is incurred in order to cause the volume. There is no rigid Commission rule that would preclude the Commission from taking into account the causal connection here, however. Indeed, the Special Delivery case is a specific instance in which the Commission has taken into account shared expenses in the past.

E. The Postal Service Has Failed To Attribute Other Costs To MOL.

As described in the testimony of Roger Prescott, the Postal Service has failed to attribute other costs that are caused by MOL. These include the cost of revenue leakage, the cost of credit card fees and the cost of the minimum fee payable to the contract printer.

The Postal Service has acknowledged that it will pay not more than 3% for bank card service charges associated with the use of credit cards to pay for MOL services. Tr. 140. Based on the revenue projections for the experimental phase, the Postal Service will pay at least $13.8 million in such fees during the experiment. These should be included in the attributable cost base for MOL.[11]

[11] Witness Plunkett projects $458.9 million in fee revenues over the three year life of the experiment. USPS T5 at 8. Three percent of this amount equals $13.77 million.

Likewise, the Commission should take into account the revenue that will be lost by the Postal Service from "leakage" caused by MOL. Witness Prescott testified in MC98-1 that there would be revenue leakage associated with current mail receiving the automation discount for First Class mail and with the migration of First Class mail to Standard A. He estimated the total revenue leakage to be $43.1 million.[12] Although his calculations have not been updated to include the third year of the experiment, it is clear that at least this much leakage would occur under the current proposal. The entire amount of this leakage should be attributed to MOL.

Finally, the Postal Service has not accounted for the minimum guaranteed contract price to the contract printer. The printer contract, which was entered into in August 1998, is a one year contract with a guaranteed minimum of $325,000. The Postal Service has acknowledged that $250,000 of this contract was paid for no services because the volume of the Market Test was so low. Tr. 264-65. This amount is properly attributable to MOL for the experimental period.

III. THE COMMISSION SHOULD SET A COST COVERAGE THAT RECOGNIZES THE POTENTIAL FOR COMPETITVE HARM TO PRIVATE BUSINESSES.

In MC98-1, the Postal Service proposed a mark-up of 25% over printer and attributable internal costs as the appropriate level of contribution to institutional costs by MOL during the experimental period. In this docket, the Postal Service has proposed a mark-up of 30%. USPS-T5 at 8. As witness Plunkett recognized, however, if the improperly excluded attributable product specific and historical costs are considered, the true implicit mark-up is about 19%. Tr. 457.

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[12] The total leakage is comprised of $34.5 million associated with the revenue decrease from the shift to the automation rate and $8.6 million associated with the migration of First Class mail to Standard A. Tr. 899-902.

Commission precedent supports a significantly increased mark-up applied to the true attributable costs. The Commission has set mark-ups of 55% for the Postal Service packaging service, and 47% for money orders. Tr. 2126. The Postal Service itself has proposed a "154% cost coverage [to] guard against improper competition" with respect to insurance against the loss or damage to articles of mail, and requested a 60% mark-up in the first Pack and Send case. *Id.*

Moreover, as MASA witness Prescott observes, a cost coverage in the 50% range is necessary for several reasons. First, it would help protect against an unfairly low rate that might drive away current or potential competition during the experimental period. Tr. 2126. Second, in order to cover the IT costs projected by the Postal Service in MC98-1, the Postal Service would have needed volume of 1.4 billion pages. Tr. 2127. Because the costs are even greater in this docket, the volume needed is greater. And, as Prescott noted, nothing in the Market Test (or, in anything the Postal Service has done since – note that the commencement of the service is to be postponed yet again) suggests that the Postal Service can realistically achieve these volumes. Tr. 2127-28. Finally, as Prescott showed, raising the markup to 50% increases the absolute contribution by MOL to institutional costs. Tr. 2128-29.

The bottom line is that, in order to protect against unfair competition with private industry in products and services outside the postal monopoly, and consistent with Commission precedent, the markup should be set in the range of 50%.

CONCLUSION

For the reasons set forth above, MASA and PII request that the Commission issue a recommended decision that addresses the very real concerns raised by the associations of small businesses that depend on the Postal Service to service their own customers and who correctly perceive their biggest supplier as entering the market to compete against them. The only way to prevent the Postal Service from improperly taking advantage of its postal monopoly is to make sure that all costs are fully attributed and that the markup reflects the dangers of anticompetitive impact.

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CERTIFICATE OF SERVICE

The undersigned hereby certifies that the foregoing Replacement of the Initial Brief was served in accordance with Rule 12 of the Rules of Practice and POR No. MC98-1/4 this 16th day of March, 2000.

Graeme W. Bush