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MAILING ONLINE EXPERIMENT

Docket No. MC2000-2

REPLY BRIEF OF THE UNITED STATES POSTAL SERVICE

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INTRODUCTION

Two initial briefs were filed in this docket by participants other than the Postal Service: one on behalf of Mail Advertising Services Association International and PrintImage International and one by the Office of the Consumer Advocate.¹ As discussed in detail below, no arguments raised by these participants should deter the Commission from recommending the Mailing Online experiment as proposed by the Postal Service in its Request of November 16, 1999, as modified by the Stipulation and Agreement filed on February 24, 2000.

I. MAILING ONLINE'S DESIGN AVOIDS ENTANGLEMENT IN ANTITRUST PRINCIPLES

MASA devotes much of section I of its brief to arguing that Mailing Online violates antitrust law for which reason the Commission ought not to recommend it. MASA tries but fails to establish a factual foundation for the legal argument by claiming that the entire market of sub-5000 piece mailings is owned by MASA. Were such customers well served by MASA, the Postal Service's market research would have been unable to demonstrate market demand and Mailing Online would never have been proposed.

The Postal Service agrees that the Postal Reorganization Act, as interpreted, allows the Commission to consider the impact of Mailing Online upon competition in 39 U.S.C §§ 403(c), 3622(b)(4) and 3622(b)(5) – although not necessarily specific competitors such as the businesses of witnesses Jurgena and Schuh.² Moreover, MASA has failed to make out the *prima facie* showing of material competitive harm required by precedent; even if it had, the relief previously required by the Commission has already been incorporated into the design of Mailing Online. While the

¹ Hereinafter, MASA Brief and OCA Brief.

² *Direct Marketing Association Inc. v. United States Postal Service*, 778 F.2d 996, 1006 (2d Cir. 1985).

Commission considered antitrust principles in the E-COM case to examine competitive impact, the record shows that the impact of Mailing Online will be to foster competition. This includes not only competition among printers for printing Mailing Online pieces, but also the expansion in demand for digital printing in general, even outside of Mailing Online,³ and for third-party service providers.⁴

MASA's assertions that the Postal Service's Mailing Online proposal violates established principles of antitrust law mischaracterize Mailing Online and misapply judicial precedent. Unlike the Postal Service's previous attempt to offer a hybrid service, the Postal Service is not creating an internal network of printers; even the telecommunications network is provided by private vendors. The Postal Service, furthermore, is relying upon private entities to provide these services in a manner that fully comports with its own governmental, arms-length procurement policies and regulations. Contrary to MASA's claims, the fact that the Postal Service is entering into contracts with private businesses encourages private competition. The fact that Postal Service print contractors may offer services at prices that are lower than those of smaller MASA members simply reflects economic efficiency that benefits consumers. MASA's discussion of vertical integration and initial "unlawful bottleneck" arguments (beginning at page 8 of its Initial Brief) are based exclusively on mergers and acquisitions case law. In no sense does Mailing Online consist of a merger or an

³ Docket No. MC98-1, Direct Testimony of John Hamm, USPS-T-).

⁴ USPS-T-1 at 6-7, 12-13. In addition, the proposed "functionally equivalency" language put forth in the Stipulation and Agreement of February 24, 2000, paves the way for the development of services competitive with Mailing Online by allowing private firms to have access to the same level of discounts as Mailing Online. Further, the proposed language protects MASA members by ensuring that functionally equivalent services do not have access to deeper levels of discounts, which they can offer their clients.

acquisition; the Postal Service has no plans to merge with or acquire providers of printing or telecommunications services.

MASA's later discussion of the bottleneck or "essential facilities" doctrines (beginning at page 22 of its Initial Brief) misapplies these principles. First, the Postal Service does not have a monopoly on delivery services; if it did, competitors like UPS, FedEx, and many others would not exist. While Mailing Online is intended to encourage use of those products over which the Postal Service has a monopoly, as well as other products, it does so in a way that actually minimizes negative impacts upon competition and fosters positive ones. Mailing Online actually encourages competition among private sector printers with whom it contracts for services. The Postal Service also fosters competition by offering to extend to any functionally equivalent service entry on the same terms as Mailing Online originating mail. Mailing Online is even being developed by the private sector through contracting arrangements.

MASA's claim that Mailing Online violates the "essential facility" doctrine of antitrust law is specious.⁵ In *MCI Communications Corp. v. American Tel. & Tel. Co.*, 708 F.2d 1081 (7th Cir.), *cert. denied*, 464 U.S. 891 (1983), MCI contended that AT&T had improperly refused to let MCI connect its telephone lines with AT&T's nationwide telephone network, and that interconnection was essential if MCI was to compete against AT&T in long distance service. The Seventh Circuit held that MCI had proven that AT&T's conduct violated the antitrust laws:

A monopolist's refusal to deal under these circumstances is governed by the so-called essential facilities doctrine. As such a refusal may be unlawful because a monopolist's control of an essential facility (sometimes called a

⁵ Of course, at the present the Postal Service, as a government agency, is not subject to antitrust legislation. See, e.g., *Dept. of Water & Power v. Bonneville Power Admin.*, 759 F.2d 684, 693 n.12 (9th Cir. 1985, *cert. denied*, 488 U.S. 818 (1988)); *Tele-Communications of Key West, Inc. v. United States*, 757 F.2d 1330, 1341 (D.C. Cir. 1985).

"bottleneck") can extend monopoly power from one stage of production to another, and from one market into another.

708 F.2d at 1132.

For an essential facilities challenge to succeed, a plaintiff typically must show: (1) control of an essential facility by a monopolist; (2) a competitor's inability practically or reasonable to duplicate the essential facility; (3) the denial of the use of the facility to a competitor; and (4) the feasibility of providing access to the facility. *Id.* at 1132-33.⁶

MASA's challenge fails on both the second and third legs of the *MCI* analysis. The availability of alternative delivery networks is counter to the second element. The fact that MASA can use the delivery network (1) via Mailing Online, (2) via a functionally equivalent service, or (3) via its traditional methods are all counter to the third. Any argument that the "essential facility" is access to the automation basic rates on Mailing Online's terms would also fail because access is not being denied.

Ignoring the fact that MASA is not being denied access to any essential facility, MASA nonetheless asks the Commission to reject Mailing Online by applying a view of the essential facility doctrine that the courts have already rejected. MASA's antitrust argument could be construed as an effort to broaden the essential facilities doctrine and require a monopolist to provide its competitors access in order to enhance competition, rather than to avoid elimination from the market (as was occurring in *United States v. Terminal R.R. Ass'n*, 224 U.S. 383 (1912); *Otter Tail Power Co. v. United States*, 410

⁶ See also *Alaska Airlines v. United Airlines, Inc.*, 948 F.2d 536, 542 (9th Cir. 1991) (essential facilities doctrine "imposes liability when one firm, which controls an essential facility, denies a second firm reasonable access to a product or service that the second firm must obtain in order to compete with the first"); *Zschaler v. Claneil Enters., Inc.*, 958 F. Supp. 929 (D. Vt. 1997) (refusal to grant access to essential facility violates the antitrust laws because of danger that monopolist in one market might use its market power to extend its monopoly into another).

U.S. 366 (1973). This extension of the doctrine has been firmly rejected by the courts. *Alaska Airlines v. United Airlines, Inc.*, 948 F.2d 536 (9th Cir. 1991).

The *Alaska Airlines* court looked to two decisions in which plaintiffs, although unquestionably handicapped by a refusal on the part of a monopolist to share its facilities, could not properly be found to have the power to eliminate the potential competitor from the market. *Olympia Equipment Leasing v. Western Union Telephone Co.*, 797 F.2d 370 (7th Cir. 1986) *cert. denied*. 480 U.S. 934 (1987); *Twin Laboratories, Inc. v. Weider Health & Fitness*, 900 F.2d 566 (2^d Cir. 1990) (plaintiff must show more than inconvenience or even economic loss; it must show that alternative to facility is not feasible). Based on these more recent cases, the *Alaska Airlines* court concluded that the test as to whether a facility was "essential" was as follows:

As the word "essential" indicates, a plaintiff must show more than inconvenience, or even some economic loss; he must show that an alternative to the facility is not feasible The cases also seem to contemplate a second condition that must be satisfied for a facility to be considered essential in addition to power to eliminate competition: The power to eliminate competition must not be momentary, but must be at least relatively permanent.

Alaska Airlines at 544.

In addition to the requirement that a facility be essential in a strict sense before the U.S. antitrust laws will compel a monopolist to provide access to its competitors, a second principle, not addressed in the *Alaska Airlines* case, is also well established: no matter how essential a monopolist's resources may be, it is ordinarily not obliged to sacrifice its legitimate business objectives to provide access to a competitor. See, e.g., *City of Anaheim v. Southern California Edison Co.*, 955 F.2d 1373, 1381 (9th Cir. 1992) (essential facilities challenge rejected; defendant's desire to give the benefit of low-cost power to its entire customer base rather than having it siphoned off by a few customers was legitimate business reason for denying access to its low-cost power source).

There can be no dispute that both the terms and conditions on which the Postal Service proposes to offer Mailing Online and its willingness to extend access to rate categories on the same terms as Mailing Online to any functionally equivalent services further legitimate business objectives.

In conclusion, Mailing Online fosters many forms of competitions and creates no unlawful or inappropriate bottleneck. Moreover, because it does not deny mailing service providers access to the Postal Service's delivery network, postage discounts, or mail acceptance conditions applicable to Mailing Online (and such providers can also use Mailing Online), the Postal Service's exercise of its legitimate business objectives is entirely consistent with antitrust law and principles. The Commission should accordingly recommend Mailing Online under the terms and conditions supported by the Postal Service.

II. MASA'S OPPOSITION TO MAILING ONLINE IS NOT SUPPORTED BY THE E-COM II DECISION

In its brief, MASA cites the Commission's Decisions in E-COM II in support of its contentions that Mailing Online creates an "unlawful" bottleneck (MASA Brief at 21-22) and creates an anti-competitive "price-squeeze" for its competitors (*Id.* at 24-26). A review of the Commission's application of competitive analysis in the initial phase of this case demonstrates that MASA's reliance on the E-COM II precedent is unfounded.

In the initial phase of the Commission's review of Mailing Online, Docket No. MC98-1, in response to allegations of competitive harm raised by MASA and Pitney Bowes, the Commission directly considered the applicability of its prior decision in E-COM II to Mailing Online. The Commission's conclusion is revealing:

The conclusions that the Commission reached concerning the alleged mailstream price discriminations in E-COM II are not controlling with respect to Mailing Online. Those conclusions depend to a large degree on the Commission's findings as to the specific competitive circumstances of that

case. Though similar, the facts in E-COM II are not parallel to those in the Postal Service's proposed Mailing Online rate design. The conceptual unbundling of mailstream charges from non-mailstream charges in E-COM II involved ascribing an implicit mailstream cost to E-COM. The mailstream price that the Postal Service proposes to charge Mailing Online is an explicit price. But, as in the E-COM II result, the Commission regards the underlying economic reality, not the legal form of the pricing proposal, to be controlling when evaluating assertions that rates are unduly discriminatory in form, and unreasonably anticompetitive in effect.

E-COM II is relevant to the instant case primarily in what it required parties to demonstrate in order to make out a prima facie case that mailstream charges made to the Postal Service's offering were unduly discriminatory. As described above, the Commission based its conclusion on a factual determination with respect to the relevant market for the Postal Service's offering, the nature of the material competitive harm that a specific competitor was likely to sustain, whether the degree of cost averaging that a classification feature was likely to entail was reasonable, and whether there was sufficient operational justification for such averaging.

Docket No. MC98-1, PRC Op. at 25-26.

In Docket No. MC98-1, the Commission concluded that application of these principles to the evidence of record did not justify a finding of undue or unreasonable price discrimination, or unlawful anticompetitive pricing in regard to the proposed market test.⁷ A review of the record in this case similarly reveals that MASA has failed to carry its burden of demonstrating significant and likely harm to competition if the Postal Service's proposed experiment were to be implemented.

At the outset, it is worth noting several conclusions that the Commission reached in E-COM II with respect to such issues. First, the party alleging competitive harm, not the Postal Service, bears the burden of persuasion. In E-COM II, the Commission stated:

⁷ After having set out the elements that must be established by any party challenging Mailing Online based on competitive concerns, the Commission expressly concluded that "[t]he record in the market test phase of this docket is not adequately developed to support definitive findings of fact in any of these areas." Docket No. MC98-1, PRC Op. at 26.

While the [Postal] Service is certainly on notice, from the statute, that in designing a rate filing it ought to account for competitive concerns as well as those of cost recovery, simplicity of structure, etc., *it does not follow that it must bear the burden of persuasion on competition issues*. Rather, we think *those opposing the proposal on these grounds should have the burden of coming forward with evidence of the actual or potential harm*.

Docket No. R83-1, PRC Op. at 19 (emphasis added).

Furthermore, MASA must establish the following elements as its *prima facie* case:

In the context of this case [E-COM II], we think that a party raising competition-based objections to the rate proposal must show, first, that it participates in the same properly defined market as the Postal Service offering, and, second, that there is an economically reasonable apprehension of material competitive injury from the challenged proposal.

Id. at 22.⁸

MASA has failed to carry its burden of going forward with a *prima facie* case in this proceeding. The limited amount of evidence introduced by MASA since the Commission's market test decision was issued does not demonstrate that MASA's members participate in the same market as the Postal Service's offering, nor that there is an economically reasonable apprehension of material competitive injury from the Mailing Online proposal.

MASA relies upon the testimony of witnesses Schuh and Jurgena to establish its case. *See MASA Brief at 5-7*. On the issue of participation in the relevant market, the sole evidence cited by MASA consists of the testimony of these two witnesses that mailings under 5,000 pieces represent a substantial part of the direct mail production

⁸ Finally, even if proven, the reasonable likelihood of material competitive harm is, in itself, not sufficient to defeat the proposal. "Competitive effect is only one of several factors that [the Commission] must consider." Docket No. R83-1, PRC Op. at 23; *see id.* at 10-13. The Commission is charged with balancing competition concerns with other statutory factors and objectives. *Id.* at 15-18. The Commission need not reach the balancing stage in this case, however, because no *prima facie* case has been established.

companies they head. *Id.* at 5.⁹ Whether or not this is the case, it has limited bearing on the properly-defined market for Mailing Online. Contrary to the claim at page 5 of MASA's brief, the relevant market cannot properly be defined simply 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."¹⁰ There are, in fact, a number of other characteristics important to Mailing Online's target market that serve to distinguish Mailing Online from the services provided by Mr. Schuh and Mr. Jurgena.¹¹

First, the Postal Service is proposing a service that differs from those MASA members provide, with strictly limited color, binding, per-piece size, and postage discount options. MASA has not established that any of these limits apply to its customers, or that its current customers would choose to adopt such limitations in order to use a service such as Mailing Online.

⁹ While it is true that witness Schuh gathered information from 14 other MASA members, there is no reason to believe that these businesses, together with the businesses of witness Schuh and Jurgena, constitute a representative sampling of the much larger MASA membership. The vast majority of MASA members may be among those who expect Mailing Online to have a beneficial effect for their businesses. See USPS-T-1 at 7.

¹⁰ In fact, at the portion of the transcript cited by MASA, Tr. 1275, witness Garvey declined to describe the intended market strictly in these terms. Later, he directly contradicted the assertion that the current technical limit of 5,000 pieces is a relevant characteristic of the market ultimately intended to use the service. See Tr. 1276-78. See also Tr. 704-06.

¹¹ MASA distorts the record by implying that witness Garvey agreed that "a substantial portion of [Schuh and Jurgena's] business was comprised of the small mailings targeted by Mailing Online." MASA Brief at 7. It is apparent even from the redacted transcript portion cited by MASA that although the witness could not dispute claims regarding the character of witnesses Schuh and Jurgena's business, he did not concede the validity of defining the target market in terms of print job volume alone. See Tr. 1246.

Second, as the Postal Service demonstrated in this phase and in the initial round of Mailing Online, the target customers generally do not find that premailing service providers such as MASA members suit their needs. See USPS-T-1 at 17. See also Docket No. MC98-1, USPS-T-7 and USPS-T-8. Since the potential users of Mailing Online do not currently use services such as those provided by witnesses Schuh and Jurgena, there is little reason to believe that their businesses will be negatively affected.

Third, there has been no showing that MASA member services feature the convenience of Mailing Online, which permits a mailing to be initiated by means of a single web site visit. See Tr. 647-48. Similarly, no record evidence establishes that MASA service providers attract the increasing number of technologically savvy small mailers which Mailing Online is intended to attract. Finally, the flat rate pricing inherent in digital printing technology is used less frequently by MASA members, whose more traditional equipment better lends itself to larger jobs. See USPS-T-1 at 9, Tr. 1290, 722-28.¹²

Similarly, to simply say that a substantial portion of the business of a few MASA members consists of mailings under 5,000 pieces is insufficient to demonstrate a reasonable likelihood of harm to competition. In fact, the record contains evidence showing that the market for printing services may improve. As witness Garvey has testified, Mailing Online will provide new business to printing industry service providers. USPS-T-1 at 17. The Postal Service chose a design for Mailing Online that harmonizes its strengths in hard copy delivery with commercial firms' expertise in printing and mail preparation. *Id.* at 7. In this regard, several of the pre-qualified vendors seeking to provide print/mail services are members of MASA. In addition, some MASA members have shared with the Postal Service their expectation that Mailing Online is likely to

¹² See also Docket No. MC98-1, USPS-T-1 at 13; Tr. 2/151, 4/829-33, USPS-T-6 (Hamm).

complement their marketing strategies, stimulating increased and new business. *Id.* It should also be recognized that the proposed Mailing Online pricing forgoes deeper discounts, allowing private sector competition to provide access to those discounts via pre-mail processing. Mailing service firms, moreover, may find additional business opportunities by offering value added services to mailers wishing to use the Mailing Online mail entry channel. *Id.* at 13-16. Finally, and perhaps more importantly, by allowing for functionally equivalent services to use the Mailing Online channel, competition is directly fostered.

It is apparent that the evidentiary record from this phase of the Mailing Online case no more definitively reveals a likelihood of substantial competitive harm in the relevant market than did the record in the prior phase. Given this state of affairs, the Commission should conclude as it did in the initial phase, that no *prima facie* case of competitive harm has been established by the challenging party.

Even if there had been some showing of potential competitive harm in the properly-defined market, however, there is one last, equally compelling reason why the MASA appeal to the competitive analysis developed in E-COM II misses the mark. In the E-COM II case, the Commission found, based on a *prima facie* showing of likely and material competitive harm in the relevant market, that the potential harm could be avoided if the Commission were to recommend unbundled pricing for the proposed E-COM service. Docket No. R83-1, PRC Op. at 40ff. Such a finding could not apply in this case to Mailing Online for the simple reason that the remedy prescribed in the E-COM II case is already embodied in the Postal Service's proposal. As MASA itself acknowledges, the rates for Mailing Online "are already unbundled." MASA Brief at 26. In designing its rates so that there are no vertically integrated price components, the Postal Service has avoided the circumstance identified by the Commission in the very E-COM precedent upon which MASA relies. Despite MASA's failure to fully appreciate

the consequences of this fact, it nevertheless is compelling. If unbundled prices were found to be appropriate and lawful in the context of the E-COM II proceeding, the Commission should find a similar unbundling to be appropriate and lawful here.

III. OCA AND MASA'S CRITICISMS OF THE POSTAL SERVICE'S COSTING APPROACH AND ESTIMATES SHOULD BE REJECTED

A. Market Test and Start-up Costs for Mailing Online Should Not Be Included in the Cost Basis for Pricing Mailing Online

In their briefs, MASA and the OCA argue that start-up expenses should be included in the cost basis for pricing Mailing Online. MASA Initial Brief at 29; OCA Brief at 12. MASA and the OCA believe that these start-up costs are attributable costs, in the traditional sense of the word as used by the Commission. MASA Brief at 29-30; OCA Brief at 12. Therefore, according to MASA and the OCA, if these costs are "attributable," then they must be included in the cost basis for pricing Mailing Online. *These arguments ignore the evidentiary record and past Commission treatment of research and development costs, and therefore should be rejected.*

The Postal Service has excluded pre-experiment costs from the cost basis used for pricing Mailing Online for sound operational, economic and precedential reasons. Specifically, contrary to assertions by MASA, the technology costs incurred prior to the development of Version 3 of the Mailing Online system are completely separable from those associated with the current version of the system. MASA argues that the market test was a trial run of the Mailing Online system, referring to witness Garvey's language in Docket No. MC98-1. MASA Brief at 32. While the market test was intended to be a trial run for the experiment, in fact the Postal Service withdrew that request and designed a new system running in conjunction with USPS.com rather than PostOffice Online. Consequently, as Witness Lim states, the equipment used during the period of the experiment will entirely replace the system used in the market test. Tr. 3/429. Even

if the original experiment planned in Docket No. MC98-1 were related to the market test, the new experiment proposed in the instant docket is "fundamentally different" from that market test. Tr. 3/487-90.

The Postal Service has excluded market test costs from the cost basis for pricing the Mailing Online product for sound economic reasons, as well. Costs that are not caused by a particular product should not be allocated to that product, as has been explained in detail by Witness Takis (USPS-T-4 at 5) and nominally accepted by MASA (MASA Brief at 29). Despite the protestations of MASA, it remains an unchallenged fact in the evidentiary record of this proceeding that based on the judgment of an experienced information technology (IT) expert, the previous versions of the Mailing Online system software are not related in any meaningful way to the current Mailing Online product. As Witness Plunkett has stated, in many ways, the current version of Mailing Online represents a new product. Tr. 3/486. Therefore, these costs cannot be allocated to the current Mailing Online product, as they were not caused by the current Mailing Online product. USPS-T-4 at 5.

Moreover, witness Plunkett justified increasing the cost coverage from 125 to 130 percent in this docket in order to "facilitate recovery of the development costs incurred for earlier versions of Mailing Online" USPS-T-5, at 8. If market test costs are instead included in the cost basis for the experiment, then the cost coverage must be reduced.

Finally, the Postal Service has excluded market test costs from the cost basis for Mailing Online pricing based on Commission precedent. As Witness Plunkett states, costs associated with the market or operations test of Mailing Online are akin to research and development costs. Tr. 3/486. Therefore, the situation cited by both MASA and the OCA (*i.e.*, the Commission's findings in Docket MC97-5, the Provisional Packaging Service proceeding) does not apply here. Specifically, because the Mailing

Online product is so different in the market/operations test than in the current proposed experiment, the current Mailing Online product could not have caused these pre-experiment costs, which can be thought of as research and development costs. It has long been Commission precedent to treat research and development costs as institutional and not allocate them to any specific product because they are not caused by any particular product, and that is how the Postal Service believes pre-experiment costs associated with the market or operations test should be treated in this proceeding. Much as any contribution that might have accrued during the operations and markets tests wouldn't be subtracted from costs in this proceeding, nor are costs carried over. See Postal Service Brief at 12-13; accord Docket No. R83-1, PRC Op. at 245.

Furthermore, even for start-up costs for the experiment, the Commission's finding in Docket No. MC97-5 does not apply. That case did not involve implementation of new technology, and thus did not involve research and development costs incurred prior to offering the service. Instead, the start-up costs involved setting up post offices to offer packaging service, and would have been incurred during the provisional period. For Mailing Online, like other electronic products, the start-up costs are being incurred before the experiment can begin, and thus outside of the experimental period.

MASA also errs regarding various of its arguments for inclusion of certain additional costs in the cost basis for pricing Mailing Online by ignoring the record and making unsubstantiated assertions. MASA suggests that some pre-experiment costs are "long-term variable," in that they would be incurred in the future as system enhancements. MASA Initial Brief at 31. However, witness Lim included as experiment costs a considerable amount of costs arising from planned enhancements during the experiment. Moreover, these enhancements generally do not vary with volume. The Postal Service has decided to enhance Mailing Online regardless of volume levels

during the experiment. USPS-T-4, at 25. Thus, the Postal Service proposes that these costs be covered through an incremental cost test.¹³ See Exhibit USPS-5D; USPS-T-4, at 27-28.

MASA claims that there is "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." MASA Brief at 33. To the contrary, witness Plunkett stated in response to Presiding Officer's Information Request No. 1, Question 1, that "the product specific costs are anticipated to be incurred primarily to provide a hardware and software system that will largely survive into the post-experimental period." Tr. 3/455. There was no cross-examination of this statement, and no contrary record evidence adduced. Moreover, witness Plunkett also pointed out that the product-specific items would have been accrued to the period before the experiment began, so these would not be costs for the test period. USPS-T-5, at 6. If this were an omnibus filing with a test year, these pre-experiment costs unquestionably would not be included as experimental costs.

Moreover, witness Plunkett testified that "all costs of Mailing Online, including the product specific [pre-experiment and experiment] costs, will be recovered, and, additionally, an amount equal to 19.4 percent of total costs will be recovered as well." Tr. 3/457; Exhibit USPS-4D, as revised Tr. 3/505.

The Postal Service urges the Commission to recognize some distinction between volume variable costs and start-up costs at least in the context of the startup of an electronic service, where long terms IT marginal costs may approach zero. To take the

¹³ Most of these expenses, though during the experimental period, are start-up expenses for the mature form of the experiment. Year 3 of the experiment, when the experiment will be mature (with all print sites in place and most enhancements finished) could be treated as the test year. In that case, most product-specific costs would be outside the test period.

contrary view, and contend that it is only the sum of marginal costs and start-up costs that should be considered in pricing, or to contend that no distinction should be made in the pricing process between marginal costs and start-up costs, would be to fly in the face of the most basic fundamentals of economics. Unlike volume variable costs, start-up costs are often incurred before an experiment even begins, and thus outside of any test period. Start-up costs also are at risk, if fees are set too high to attract volume to a new product. If there is no volume, there are no volume variable costs, but there may be start-up costs. For example, any costs incurred by the Postal Service's proposed packaging service were lost because the packaging service was never implemented following the Commission's recommendation that fees be much higher than those proposed by the Postal Service. Finally, start-up costs often cannot be associated with an appropriate cost driver. The OCA proposes to charge for start-up costs on a per impression basis, but any particular impression does not cause any start-up costs.

MASA and the OCA's strict request to include in the cost base for markups all product-specific costs, including start-up costs, can lead to troubling pricing results. Applying this concept would result in all start-up costs being recovered in the experimental period, a period in which the costs were not even incurred. Fees would be dependent upon the length of the experimental period, such that shorter experiments would bear more start-up costs and have higher prices relative to longer experiments that incur identical marginal costs.

MASA and the OCA's strict requirement to include in costs all product-specific costs, including start-up costs, can lead to troubling pricing results. Consider a product that has IT costs like those for Mailing Online, but no other costs. Assume there is 1 cent in volume variable costs, and 4 cents in product-specific costs. If all costs must be recovered during an experiment, the fee for a one-year experiment would be 5 cents,

while a two-year experiment would charge 3 cents, and a three-year experiment would charge 2.33 cents, even though costs are the same. In all cases, an ensuing permanent service would see a fee reduction to 1 cent. This perverse pricing would tend to kill innovative products by having the highest fees at the beginning.

The arguments of MASA regarding inclusion of start-up costs in the cost base for pricing Mailing Online during the experiment lack evidentiary support. The Postal Service has grounded its cost basis for pricing Mailing Online in sound operational and economic concepts that are consistent with Commission precedent and are supported in the evidentiary record.

B. The Postal Service's Treatment of Advertising Costs is Justified

In its initial brief, MASA claims that the Postal Service's failure to distribute to products shared advertising costs incurred during the period of the market test, and its estimates of advertising expenses that will be incurred during the experiment, are "without any justification." MASA Brief at 29. MASA goes on to state that the reverse-causality relationship between expenses resulting in volume is a basis for allocation of costs. *Id.* at 37. These statements ignore the central theme of witness Takis' testimonies in Docket No. MC98-1 and this Docket, that costs should be allocated to products on the basis of causality.¹⁴ Despite stating that all parties agree in theory that causality should be the basis of product costing, MASA ignores these concepts when formulating its argument.

In his testimonies in both dockets, witness Takis specifically addresses advertising costs, stating that advertising costs incurred solely to promote a particular product

¹⁴ Docket No. MC98-1, Tr. 11/2638-2660, Tr. 11/2665-2666, Tr. 11/2667-2709, Tr. 11/2714-2720, Tr. 11/2732-2733, Tr. 11/2743-2748, Tr. 11/2772-2773; Docket No. MC2000-2, USPS-T-4 at 1-31.

should be allocated to that product on a causal basis.¹⁵ Furthermore, because there is no causal relationship between individual products and common advertising costs, such costs should not be allocated to individual products. Docket No. MC98-1, Tr. 11/2659. In the previous docket, the Postal Service did not incur advertising costs caused directly by Mailing Online, and therefore did not allocate any advertising costs to Mailing Online. In this docket, the Postal Service has identified Mailing Online-specific advertising costs and has allocated those costs to Mailing Online accordingly.¹⁶

Witness Takis explains that only those costs caused by specific products should be allocated to products. He dispels the notion that advertising costs are somehow volume variable. It is clear that changes in advertising costs are not caused by subsequent changes in volume, and therefore, cannot properly be treated as volume variable. Docket No. MC98-1, Tr. 11/2651, 2672. MASA itself admits that "cost attribution issues are settled by the Commission based on whether the volume caused the costs." MASA Brief at 38. There is no precedent nor any logical reason for doing the opposite. MASA ignores causality in attempting to allocated shared costs to individual products, a practice that has not only been rejected as unsound by the Commission, but is harmful to the Postal Service, its customers, and competitors. USPS-T-4, at 2, 5, 18.

C. MASA's Characterization of Mailing Online Help Desk Costs is Unsubstantiated

In its initial brief, MASA claims that witness Lim's estimates of help desk costs are "underestimated and misallocated." MASA Initial Brief at 34. MASA's attack on witness Lim's estimate of help desk costs is not based on the evidence in the record, and

¹⁵ Docket No. MC98-1, Tr. 11/2658; Docket No. MC2000-2, USPS-T-4 at 23-26.

¹⁶ See also the discussion of advertising in the context of the data collection plan in section VII, *infra*.

suggests that MASA should have filed testimony, or at least cross-examined witness Lim on this matter. The evidentiary record includes no help desk estimates or methodologies contrary to the conservative approach applied by witness Lim.

Witness Lim starts with contractual and purchase price information to develop costs for the entire USPS.com help desk. He then applies 25 percent of that total to estimate the Mailing Online portion of help desk costs. USPS-T-3, at 9-10, Workpaper C. MASA claims that the 25 percent factor witness Lim uses to allocate direct help desk costs to Mailing Online is too low. MASA Brief at 36. This assertion ignores the fact that the USPS.com help desk will be supporting a larger number of products than did the PostOffice Online help desk, including Shipping Online Client, Application Program Interfaces, Direct Mail, PosteCS, and Priority Mail. Tr. 3/363. During the market test the help desk provided assistance only to Mailing Online, Shipping Online Browser, PostOffice Online, and PosteCS. As a result, witness Lim's use of the best available cost driver is far more likely to be too high rather than too low. Tr. 3/363, 365, 370.

MASA's statements on help desk costs rely excessively on the notion that the number and nature of help desk calls relative to Mailing Online volume during the market test is indicative of those during the experiment. Witness Lim, however, reported witness Garvey's belief that the market test help desk numbers are not "especially good proxies for what should be expected during the experiment." Tr. 3/369. Moreover, help desk inquiries often arise when a customer's job does not go as expected. The market test had a number of glitches, which would be expected to generate a higher level of help desk inquiries. As MASA admitted, the weekly market test reports through AP 2 showed a "huge frequency" of help desk calls, "4.5 inquiries for every transaction." MASA Brief at 35. The Postal Service has delayed the experiment about a year in order to release a system that works well. This entirely new

system is expected to reduce help desk inquiries considerably. It is important to recognize that the first experiences of inexperienced users of a test system having significant glitches will result in many more help desk inquiries than would the ongoing use by experienced individuals of an enhanced system. Knowing this, witness Lim asserts that "the correlation between Mailing Online volume or transactions [and] Help desk cost is weak." Tr. 3/370. An experienced user with large volume or repeated transactions may have no need to contact the help desk, while a large number of small users may contact the help desk repeatedly, especially when first using the service. *Id.*

MASA questions witness Lim's estimate of Mailing Online help desk costs because they are not significantly greater, on a per year basis, than his Docket No. MC98-1 estimates. MASA Brief at 35 n.6. Contrary to MASA's claim, the Docket No. MC98-1 estimates were not based on witness Stirewalt's projections for the market test, but rather primarily on cost estimates provided by Compaq. Docket No. MC98-1, USPS-ST-9, Exhibit E. In any case, the similarity between witness Lim's estimates demonstrates the accuracy of each estimate. In addition, witness Lim's estimates reflect volume increases for the experiment, as the estimates increase as the experiment progresses. Tr. 3/367-68.

MASA urges the Commission to make an extra-record analysis to develop a different estimate of help desk costs. MASA passed up the opportunity to provide testimony with an alternate cost estimate. Witness Lim has provided the only help desk cost estimate in the record, and it provides a conservative over-projection of such costs; it is the best estimate available and should be adopted by the Commission.

D. MASA's Arguments That "Other Attributable Costs" Should be Borne by Mailing Online Are Flat Wrong and/or Lack Record Evidentiary Support

MASA argues that the Postal Service has failed to account for other attributable costs of Mailing Online, including supposed credit card fees, revenue leakage from First-Class Mail to Standard Mail, and minimum guaranteed payments to printers. MASA Initial Brief at 38-39. Each of these arguments is unsound and lacks record evidence support.

MASA claims that the Postal Service "has acknowledged" that it will pay not more than three percent for bank card service charges, citing Tr. 140 (response to MASA/USPS-T1-17). MASA Initial Brief at 38. This MASA claim is a flat mischaracterization of what appears on that transcript page:

MASA/USPS-T1-17. Confirm that the USPS plans to accept credit card payments from Mailing Online customers on which it will pay a service charge of not more than 3% of the amount charged.

RESPONSE:

Confirmed that [the] Postal Service plans to accept credit card payments. Confirmed also that all payment methods have costs. I understand that credit card payments are generally less costly than other payment methods employed by the Postal Service, but since I also understand that the costs of payments methods are not attributed to specific services, such costs have not been included in support of the Mailing Online Request.

The response quite carefully does not confirm that three percent or any other percentage is a cost borne by the Postal Service in connection with credit card charges. The response simply confirms that credit cards will be used, that some costs are associated, and the witness's understanding that such costs are not attributed to specific services. It also points out that the cost of a Mailing Online credit card transaction is less than that of a window transaction – especially one that also involves a credit card. This is another example of how Mailing Online capitalizes upon technology advances by avoiding any manual labor associated with the acceptance of a payment. Finally, even if MASA's characterization of the response were accurate, that would only suggest \$13.7 million as an upper limit, not a reasonable estimate, of credit

card costs. Accordingly, no record evidence supports MASA's argument that \$13.7 million should be attributed to Mailing Online.

MASA also argues that a revenue "leakage" from a First-Class Mail to Standard Mail migration and from use of basic automation rates¹⁷ should be attributed to Mailing Online, MASA Initial Brief at 39. The values argued by MASA rely upon speculative assumptions – for example that all pre-existing mail volume would have been entered as single piece First-Class Mail – rather than hard evidence or econometric projection of the cross-elasticities of demand. Tr. 4/920. Moreover, MASA's argument is tantamount to the nonsensical assertion that Priority Mail pieces should recover as an attributable cost the "loss" in Express Mail revenue "caused" whenever customers switch from Priority Mail so that registered mail or restricted delivery can be used.¹⁸ The revenue and cost impacts of special services upon their host or other subclasses have never been included in attributable costs.

Even assuming any "leakage" exists, it is more than offset by: (1) the unquantified mail processing cost savings achieved via automation compatibility, presortation, and destination entry characteristics of Mailing Online pieces;¹⁹ (2) the additional contribution by new Mailing Online pieces; (3) the revenue accretion from forgoing the deeper discounts for which mailings might qualify; and (4) the markup over printer costs.

Third, MASA argues that the Postal Service has not accounted for the costs associated with the market test printer, for whom the lack of sufficient volume triggered

¹⁷ Witness Plunkett provides one means of quantifying this component and concludes that it is more than offset by additional postage revenue. USPS-T-5at 9; Exhibit USPS-5F.

¹⁸ These special services are not available with Express Mail.

¹⁹ This was acknowledged by witness Prescott. Tr. 4/920.

contractual obligations to pay monthly minimums. As witness Plunkett explained, those payments were a result of the peculiar procurement policies then in effect, rather than attributable to Mailing Online. Tr. 2/273-75. Those payments, moreover, were associated with the Mailing Online market test rather than the experiment, and thus were not attributable to the experiment. See Postal Service Brief at 12-13.

IV. THE POSTAL SERVICE'S UNREBUTTED VOLUME PROJECTIONS ARE APPROPRIATE FOR ESTABLISHING EXPERIMENTAL FEES

In its initial brief, the OCA argues that "the Postal Service's volume estimates may be overly optimistic." OCA Brief at 14. The qualification expressed in the use of the word "may" is well placed, since only speculation, as opposed to record evidence, would support the use in this proceeding of any volume projections other than the sole projections on the record, those presented by witness Rothschild on behalf of the Postal Service.

On the Postal Service's motion, witness Rothschild's testimony from Docket No. MC98-1, concerning the results of the market research her firm conducted to estimate Mailing Online volumes, was incorporated into the record of the instant proceeding. The OCA did not oppose the incorporation and states, somewhat wryly in its brief, that it is "in sympathy with a decision to save time and money by 'recycling' the estimates." OCA Initial Brief at 14. The focus of the OCA's comments, however, mischaracterizes the Postal Service's motives in continuing to rely on witness Rothschild's projections. It is certainly true that there was no need to expend further time and money on expensive market research. The reason this is so in this case, however, is twofold. One reason is that the Postal Service is proposing Mailing Online as an experimental service, which is intended to gather better evidence of the volumes to be expected from a permanent service than further research could produce. In fact, the Commission has noted that its

"rules do not require an extensive market survey as a prerequisite to conducting an experiment." PRC Op., MC98-1, at 41. In this case, the Postal Service presented an extensive, scientific, market survey with its initial request for a market test and experiment. In the absence of any better evidence, the lack of opposition to its incorporation into the instant proceeding, and the participants' forbearance from presenting expert testimony suggesting revisions in the results, witness Rothschild's survey should be relied on.

The other reasons is that the Postal Service continues to believe that witness Rothschild's research was and remains reliable. Witness Garvey summed up the Postal Service's views regarding the research in his testimony:

The original market research data ... are still being relied upon as the best available guidance for our understanding of the Mailing Online market potential. Although the marketplace has changed since that research was conducted, we still believe that its estimates are essentially reliable. One purpose of the proposed experiment, moreover, is to generate real-life experience that can inform judgement regarding any request for a permanent form of Mailing Online.

USPS-T-1, at 8-10, n. 7.

In its initial brief at 15, the OCA claims to identify three assumptions underlying the research that it now questions. It argues that respondents were misled into thinking that Mailing Online would accept documents from virtually any software application, that the speed of delivery presented in the survey was faster than Mailing Online will provide, and that the level of awareness assumed in the research will not be achieved.

A. No Evidence Indicates that Volume Would Be Inhibited by the Large Range of Applications Supported by Mailing Online.

No record evidence supports the OCA's argument that volume estimates are overstated because respondents thought they could use unsupported software applications. Indeed, the record and subsequent developments contradict it. First,

since the time the survey was done, the number of applications in general use for word processing is generally acknowledged to have declined. There are virtually no alternatives today to Word and WordPerfect for word processing, PageMaker, Ventura, and Quark for desktop publishing, and Excel and Access for spreadsheets and databases. Moreover, there is no support on the record for any finding that survey respondents, or today's and tomorrow's users, were or would be counting on the use of some other obscure word processing, desktop publishing, or database programs, and, even if they were, there is no evidence that this would in any scientifically measurable way reduce the volume projections.

With respect to the OCA's concern regarding forms, invoices, and "sophisticated graphical inserts" in word processing documents,²⁰ not only is there no evidence on the record to support the OCA's concern, the record contradicts it. Witness Garvey testified, with reference to the specifically supported applications that "documents created in these *or other* applications may be submitted in the generic Portable Document Format (PDF)." USPS-T-1, at 3 (emphasis added). Even if the OCA is correct in its unsupported speculation that certain document types cannot be created in or converted to the specifically supported word processing or desktop publishing applications, they can certainly be converted to PDF and provided to Mailing Online in that facsimile format.

B. There Is No Evidence that Volume Would Be Inhibited by Changes in the Speed of Delivery

The OCA's speculation concerning changes in cut off times and how that might have affected survey respondents is interesting at best. But it is still only speculation. There is no way to get into the minds of the respondents to parse the degree to which

²⁰ OCA Brief at 16-18.

they expressed interest in Mailing Online because of its various novel features, or simply because they thought it would speed up delivery, or any combination of these and other features. It should be remembered that many respondents, and a substantial portion of the target market, are individuals and small businesses, who have not used the mail before for the purposes best served by Mailing Online. For these users, one might speculate that convenience was more of an impetus to the use of Mailing Online than their perceived speed of delivery. In the absence of any record evidence supporting the OCA's argument, there is no basis to adjust or discount witness Rothschild's projections.

C. The Levels of Awareness of Mailing Online Presumed by the Survey Were Conservative and There Is No Basis on the Record for Adjusting or Discounting Them

Witness Rothschild based her study on relatively conservative levels of awareness of the service.²¹ The OCA questions these levels of awareness because it is of the opinion that the Postal Service has not budgeted enough for advertising Mailing Online. OCA Initial Brief at 14-22. The OCA's speculation concern the link between advertising expenditures, levels of awareness and volume is nothing more than speculation, and it is refuted by record evidence. It should not be used as the basis for adjustment of cost estimates, as the OCA proposes.

The OCA engages in simplistic analyses which are premised on the assumption that each dollar spent results in a fixed number of Mailing Online pieces. The record shows that the level of awareness is not based upon advertising; nor is advertising a pre-condition to volume.

In cross-examining witness Plunkett, counsel for the OCA presented its theories regarding advertising, which were refuted by the witness. Witness Plunkett testified that

²¹ Docket No. MC98-1, USPS-T-4, at 31.

the Postal Service does not anticipate a "correlation between the amount of advertising expenditure and the amount of volume that is generated." Tr. 2/235. Regarding past expenditures, he testified that:

Drawing conclusions about how effective that advertising was in generating a given amount of Mailing Online volume, I think would be risky, at best. ... And I think what we learned during the market test was that certain very expensive types of advertising were of little utility in generating interest in and awareness of Mailing Online, specifically television and radio advertising, which, while they tend to be relatively costly, do not appear to do a very good job of reaching the expected users of the product.

Tr. 2/235-36.

Witness Plunkett also addressed his expectation regarding the generation of awareness in the future and its lack of correlation with advertising dollars.

I would expect we would develop a set of expectations revolving around producing awareness among our target customer population, and then attempting to measure how that awareness was reflected in volumes, but not necessarily to try to infer too much from the volume, the direct relationship between the expenditure and the volume.

Moreover, the Postal Service has a web site, usps.com, through which Mailing Online will be offered. That site I believe currently attracts thousands of users a day without Mailing Online being available through it. Without doing anything other than putting a link to Mailing Online on that web site, we will immediately have thousands of potential customers becoming "aware" of Mailing Online on a given day. I mean that is independent of any advertising that we undertake whatsoever.

Tr. 2/237, 238.

When counsel for the OCA insisted on a direct correlation between advertising expenditures and volume,²² witness Plunkett testified further, as follows:

²² "And I wanted to see if you could explain to me why it's reasonable to assume that 2.2 billion pieces a year will result from an expenditure of \$725,000 per year when only
(continued...)"

One of the things we did find out from the market test was that Mailing Online seems, you know, well suited, you know, to certain kinds of customers compared with others. ...[F]or example, one of the things we found out that was – Mailing Online seems to be potentially very attractive to insurance agents. Well, if you know that and what you want to do is receive or attain a very high-level awareness among that group of customers, you could do it in a number of ways, and a very inefficient way might be the way you tried to do it in the market test, which is broadcast advertising aimed at no particular group whatever, and just as a byproduct hope to reach some number of insurance agents. And that would be expensive way of doing that. On the other hand, you may through a much more targeted type of advertising be able to create awareness in a very small number of very large insurance carriers who could then, you know, promote the use of Mailing Online to their associated agents. So it is conceivable that you can create much higher levels of awareness with, you know, far lower advertising expenditures if it's done in the correct way, and consistent with what you know about who expected customers are and what they want out of your service and the right way to reach them. That kind of effort was not undertaken for the market test because the goals were different. So I think your implication, which is that, you know, if it costs you \$4 to produce one document in the market test, that you can extrapolate from that and assume that you will have to spend some level of advertising to attain Witness Rothschild's volume estimates is just wrong. Advertising does not work that way, and if we were so incompetent as to attempt to do nothing but repeat what we did in the market test for the experiment, you won't have to worry about asking me this question three years from now, because somebody else will be sitting here.

Tr. 2/243-45.

In its Initial Brief, at 20-22, the OCA faults the Postal Service for not having developed a full blown advertising plan for a product which has yet to launch. Apparently, it views advertising as perfectly appropriate even when the service is not ready. The Postal Service does not share this view. The best available projection for advertising expenses has been used. Mr. Plunkett's budget has been set, and it is unlikely he will be able to exceed it, especially in the current environment of cost cutting in the Postal Service. However, as he indicated, he has plans for maximizing the return

²² (...continued)

488,000 pieces annualized per year resulted from an expenditure of a little over \$4-1/2 million during the market test." Tr. 2/242.

on his advertising expenditures by targeting customers and for using the media to communicate with potential customers in ways that are not considered advertising. Tr. 2/237-38. In addition, given the vast increase in Internet usage since the market research was done, and the addition of Mailing Online features since that time, any speculation about inadequate volumes should be tempered by the likelihood that these changes will generate even more volume than originally projected.²³

V. THE OCA'S PRICING APPROACH SHOULD BE REJECTED

A. The OCA's Effective Elimination of Postage Discounts for Mailing Online Pieces Should Be Rejected

Through its costing and pricing approach for IT costs, OCA, in effect, proposes to eliminate, for many Mailing Online customers, the rate discount that the Postal Service proposes. The OCA "commends the Postal Service for designing a service that will extend presort discounts to individual and business mailers of relatively small quantities that normally would not qualify for discounts. OCA Brief at 6. The proposed discount provides about a 6-cent price break for such mailers, comparing the single-piece and automation basic First-Class Mail rates, or the Standard Mail presort and automation basic rates. But, at the same time, the OCA argues that the IT portion of the fee should be increased by over 0.5 cents per impression ($1.3 * (.5 - .1)$). OCA Brief at 22. Remarkably, the OCA proposal for an IT fee component of 0.65 cents would eliminate the rate discount for any piece of more than 9 impressions.

This elimination of the rate discount cannot be justified as necessary to cover costs. The Postal Service's proposal would also cover costs. Exhibit USPS-5D. Nor would customers understand why they have to pay so much extra for costs that their jobs do not directly cause. Under MASA's proposal to include market test costs, for

²³ See USPS-T-1, at 8; Tr. 2/225-28.

example, customers would need to be told that part of the cost of their job is to recover losses from a "fundamentally different product." Tr. 3/486.

B. Product Specific Costs Are Fixed and Should Not be Expressed on a Per Unit Basis

The OCA supports dividing product specific costs (plus volume variable IT costs) by total impressions to get a unit cost.²⁴ While witness Plunkett did the arithmetic for the OCA, Tr. 3/453, the Postal Service's costing witnesses never supported treating product specific costs on a unit cost basis. See Exhibit USPS-2A, at 2, lines 20, 26. Product specific costs do not vary with volume, and thus are not properly expressed on a per-unit basis.

Nonetheless, the OCA argues that the resulting unit cost must be covered by the IT component of the Mailing Online fee. First, the OCA does not explain why the IT fee component must cover these costs, rather than the Mailing Online fee as a whole. In this regard, the OCA's 0.34-cent unit cost includes advertising costs, rather than just IT-related costs.

Second, the product specific costs are fixed. While the OCA is concerned about Mailing Online volumes, these costs will not be affected by these volumes. The goal is simply to ensure that the \$32.5 million of product specific costs be covered by the contribution from Mailing Online. Witness Plunkett has shown that the Postal Service's proposal would easily do so. Exhibit USPS-5D. Contribution from Mailing Online (\$113,898,055 using total revenues) is about 3½ times the product specific costs. So even at one-third of the expected volume, product specific costs would be covered.

C. Rounding Up Generally Should Apply Only to Rates, Rather Than Costs

²⁴ The total is \$37,290,682/10,961,695,139 impressions = .34 cents/impression.

The OCA recommends rounding up the 0.34 cent per impression ratio calculated for all product specific costs, plus volume variable IT costs, to 0.5 cents "due to serious concerns of whether the Postal Service's volume projections will materialize during the experiment." OCA Brief at 13-14. Witness Plunkett rounded up volume variable IT costs to 0.1 cents, because this cost was to be included in the Mailing Online fee schedule. Therefore, witness Plunkett wanted to satisfy the one-tenth of a cent rounding constraint applicable to many rates and fees. See Docket No. MC98-1, Tr. 8/1788. Witness Plunkett's approach also would help ensure that product-specific IT costs are covered. Such an approach provides no support for the OCA's proposal to push up IT costs by nearly 50 percent, *before* the cost coverage is applied. The OCA is rounding up IT costs that already include all product specific costs, and it rounds them up beyond what is necessary to meet a one-tenth of a cent rounding constraint.

Rounding up to 0.5 cents based on volume really posits an alternative volume figure of about 7.46 billion impressions (\$37,290,682/.0005), so that dividing total product specific costs plus volume variable IT costs by this volume results in 0.5 cents. There is no record basis for such an alternative volume specification.

In any case, an alternative approach is possible. Typically, rounding applies to rates and fees, rather than costs, after the markup is applied. Thus, the 30 percent markup could be applied directly to the IT component of costs (0.0439 cents/impression). The resulting 0.057 cents could then be rounded up to 0.1 cents. Thus, the IT *fee* component would be 0.1 cents, instead of 0.13 cents.²⁵

²⁵ The appropriate language for Fee Schedule 981 would be: "Fees are calculated by multiplying the Mailing Online cost coverage times the printer contractual costs for the particular mailing, and then adding 0.1 cents per impression for other Postal Service costs."

Similarly, the OCA cost figure of 0.34 cents could be marked up by an appropriate amount, and then rounded. Since this 0.34 cost estimate would already include all product specific costs, and the Postal Service's volume estimate is reasonable, as will as the only volume estimate on the record, there is no justification for the OCA to increase the 0.34 cent estimate to 0.5 cents before markup is applied.²⁶ Moreover, the OCA's implicit proposal to markup this 0.5 cents to 0.65 cents is not justified. In any case, rounding might not be necessary at all. This is just one component of the fee, so a tenth of a cent rounding constraint need not apply.²⁷

VI. THE POSTAL SERVICE'S PROPOSED COST COVERAGE OF 130 PERCENT PROVIDES AN APPROPRIATE UPPER BOUND

A. If the Postal Service's Costing Approach and Estimates Are Accepted, the Proposed Cost Coverage Should be Adopted

In Docket No. MC98-1, the Commission concluded that there were at least two reasonable grounds supporting a 25 percent markup. First, a markup somewhat below the average for mature classes is appropriate for a price sensitive experimental service in its start up phase. Second, a low markup "will help this nascent service find its market and build volumes to the level that will support reasonable judgments about the nature of the market and the future viability of the service." PRC Op., MC98-1, at 33 (quoting witness Plunkett). While the Commission was then considering the Postal Service's market test proposal, these two grounds apply to the current proposal for an

²⁶ Since the OCA proposes that the IT "fee," rather than "cost," be increased to 0.5 cents per impression, the OCA may not intend that an additional 30 percent markup be applied.

²⁷ See Docket No. MC98-1, Tr. 8/1788. An intermediate alternative would be to exclude all pre-experiment costs only (\$10,903,417 from USPS-T-2, at 6), leaving \$26,387,265 or 0.24 cents per impression. Since this would include the bulk of product-specific costs, a lower markup should be used as discussed below.

experiment. Mailing Online is still a price sensitive, experimental service that needs reasonably low fees to attract its initial customers. Price levels are an important component of what is needed for the experiment to attract the volumes needed to test the product and obtain data necessary for a permanent filing. USPS-T-5, at 16.

Limiting the cost coverage for fees to, at most, 130 percent is critical to the success of the Mailing Online market test. The proposed cost coverage is reasonable and appropriate in light of the characteristics of Mailing Online.

B. If Costs To Be Marked Up Include More than Volume Variable Costs, a Lower Cost Coverage Should Be Adopted.

Both the OCA and MASA argue that fixed, product specific costs should be marked up along with volume variable costs. OCA Brief at 12-13, MASA Brief at 73. If this approach is adopted, a cost coverage below that proposed by the Postal Service should be adopted. Pricing criterion 9 should be used to support a lower cost coverage whenever costs consist of a significant product specific or start-up cost component.

Mailing Online permits customers to send letters and flats at First-Class Mail and Standard Mail automation rates. In this respect, Mailing Online is analogous to the annual mailing fees which enable customers to obtain discounted rates. Such fees benefit both customers and the Postal Service through reduction in the cost of mailing and increases in mailstream efficiency. These fees therefore typically have a low cost coverage; in Docket No. R97-1, the Commission recommended a 115 percent cost coverage for annual mailing fees. PRC Op., R97-1, Vol. 1, at 596. Mailing Online is expected to produce similar benefits, and thus merits a similarly modest cost coverage.

Moreover, in the last omnibus rate case, most of the major special services were recommended based on cost coverages of less than 125 percent.²⁸ Relatively lower

²⁸ The Commission in Docket No. R97-1 recommended cost coverages below 125
(continued...)

cost coverages make sense for many special services, because they not only provide a direct contribution to institutional costs, but also provide an additional, indirect contribution, by adding value to other postal products, and thus increasing their usage and contribution. Mailing Online's cost coverage likewise should be held low, because Mailing Online will generate additional contribution by adding value to, and attracting more usage of, First-Class Mail (including Priority Mail), Standard Mail, and Express Mail, all of which make substantial contribution to institutional costs in proportion to their attributable costs. USPS-T-5, at 16.

In particular, in Docket No. R97-1, the Commission recommended a 107 percent cost coverage for Delivery Confirmation, saying that the Postal Service's proposed fees "balance a number of considerations such as recovery of cost, value of service and degree of mail preparation." The Commission found that this low coverage "is not objectionable because the quality of the service is untested." Finally, the Commission affirmed that "Delivery confirmation's low markup also is justified by the expectation that delivery confirmation may provide system-wide benefits such as measuring attainment of service standards." PRC Op., R97-1, at 585, ¶ 5975.

All of these justifications for a low cost coverage apply to Mailing Online. First, as shown by witness Plunkett, a low cost coverage is all that is needed to ensure cost

(...continued)

percent for Registry, Certified, COD, Stamped Cards, Stamped Envelopes, Box/Caller Service, and Delivery Confirmation. PRC Op., R97-1, Vol. 2, App. G, at 1. All but one of the major special services (those listed with revenues of over \$100 million in the Commission's Docket No. R97-1 Appendix G) have cost coverages below 125 percent. The only exception, money orders, is unusual because it does not necessarily complement another postal product, and much of its contribution derives from float and unredeemed money orders. See Docket No. MC98-1, Tr. 10/2418-19 (OCA witness Collins). The cost coverage for another high-revenue special service, return receipts, is only slightly above 125 percent, at the Commission's Docket No. R97-1 recommended fees. See PRC Op., R97-1, Vol. 1, at 577.

recovery. Exhibit USPS-5D. Mailing Online is an untested new service for which the value of service has not been established. Mailing Online produces mail that has a high degree of mail preparation. Finally, Mailing Online provides system-wide benefits by providing more convenient access to the mails for small business and individual computer users. USPS-T-1, at 1.

Target customers for Mailing Online service appear to be price sensitive.²⁹ Thus, a lower rather than a higher markup is necessary while demand is assessed during the Mailing Online experiment. A higher markup might keep volume too low to allow the desired data to be collected during the experiment for use by the Postal Service, the Commission, and participants. USPS-T-5 at 16.

A lower cost coverage is justified, because both Mailing Online cost components (printing costs and IT costs) already include an implicit markup. As witness Plunkett stated in response to Notice of Inquiry No. 1, Issue 6, in Docket No. MC98-1:

Mailing Online is perhaps unique in that most of the direct costs of the service are borne by contractors. While this characteristic of the service does not obviate fairness considerations, it does affect the context in which such considerations should be considered. Contractors pass through, both their direct costs and some additional amount to cover overhead expenses and provide an adequate return. Thus, the Mailing Online cost coverage is not fully analogous to traditional cost coverages, since a private sector profit is already included in Mailing Online.

Moreover, the IT costs of .0439 cents per impression have been rounded up over 100 percent prior to markup. Thus, a low cost coverage is justified.

Finally, a markup of 30 percent on volume variable costs, or 20 percent on incremental costs, is sufficiently high to prevent undue competitive impact from Mailing Online. As discussed below, Mailing Online should meet customer needs that are not

²⁹ First-Class Mail customers appear most sensitive to price. Compare USPS-LR-2/MC98-1, Table 15 with Table 16; see USPS-T-5 at 16.

currently being satisfied by private sector providers. The distinctive contribution of Mailing Online is its provision of an auxiliary function that enhances the value of the mail by facilitating access, but which does not supplant services offered by private firms. Because most Mailing Online costs are incurred by private printers engaged in competitive enterprise, the need for a substantial markup to protect against unfair cost advantages that the Postal Service might enjoy is unnecessary.

MASA supports a higher cost coverage, MASA Brief at 27, but there is no record evidence to support such a finding since neither MASA nor any other participant submitted testimony supporting a higher cost coverage.³⁰ There is, as noted above, record evidence to support a cost coverage lower than the 130 percent coverage proposed by the Postal Service.

In fact, in Docket No. MC98-1, OCA witness Collins testified that a 25 percent markup should be the upper bound for the Mailing Online experiment. She testified that a 25 percent markup "should be considered the absolute upper bound for the Mailing Online service." She explained: "Because of the cost coverage security provided with the novel markup approach proposed in this case, the Commission should carefully evaluate whether the markup should be lower, and perhaps substantially lower, than the one proposed by the Postal Service [25 percent]." Docket No. MC98-1, Tr. 10/2407.

The OCA has inexplicably failed to renew this testimony in this case, despite the fact that the cost coverage security continues to apply for the large majority of Mailing

³⁰ In Docket No. C99-4, the complainant argued that the appropriate cost coverage could be argued on brief, rather than through testimony subject to cross examination. The Postal Service disagreed, asserting that the determination of an appropriate cost coverage is a matter for testimony, rather than brief. The Commission decided that testimony would be appropriate on several issues, and the complainant filed testimony explaining its basis for a specific cost coverage. See Order No. 1271 (November 18, 1999)

Online costs. Printer costs are marked up at whatever level they reach. Volume variable IT costs have a cost coverage of 296 percent (.13 cents/.0439 cents). The remaining \$32.5 million (product specific costs) are well below 10 percent of total Mailing Online incremental costs, and would only be about 15 percent of costs even if volume was half as much as projected by witness Rothschild.

C. Cost Coverage Should be Calculated Based on Actual Cost Estimates, Rather than Rounded Up Cost Estimates.

Both witness Plunkett and the OCA suggest rounding costs up before application of a markup. As discussed below, such an approach may not be justified. In any case, the revenue based on the rounded cost should be compared to the actual cost estimate in computing cost coverages. Thus, the cost coverage based on witness Plunkett's proposal, excluding product specific costs, is more than 130 percent. Costs, as shown in Exhibit USPS-5D, are \$353,010,485, based on printer costs and volume variable IT costs shown by witness Poellnitz. Revenues are 130 percent of the same printer costs, plus rounded IT costs of 0.1 cents time total impression volume (10,961,695,139 from Exhibit USPS-5A), or \$10,961,695. The resulting total revenue is \$466,908,540. Thus, the cost coverage is over 132 percent. This higher cost coverage exists because the overall markup for volume variable IT costs is 196 percent, rather than 30 percent, because of the rounding of 0.0439 cents to 0.1 cent, prior to application of a 30 percent markup.

Similarly, the ratio of revenue to incremental costs is higher than the ratio shown in Exhibit USPS-5D. Revenue, as calculated above, is \$466,908,540, while incremental costs, as shown in the Exhibit, are \$385,489,402. The resulting ratio is 121.1 percent.

VII. NO CHANGES TO THE CONTENT OR FREQUENCY OF REPORTS PURSUANT TO THE EXPERIMENTAL DATA COLLECTION PLAN ARE NECESSARY

The OCA argues that additional data elements should be included in the data collection plan (OCA Initial Brief at 8, 22-28). This position is somewhat remarkable, given that the Postal Service proposes to provide more detail than was provided during the market test, Tr. 2/253, and that the OCA admits to being "well satisfied" regarding that level of detail. Tr. 2/254.

Any misunderstanding on the OCA's part may arise from a failure to appreciate what the Postal Service has already agreed should be provided. Unlike in the market test, when compilation of the respective reports required a great deal of time-consuming effort to aggregate respective data sources, the version of Mailing Online for the experiment (denoted as Version 3) will collect most of the data required for reports without the need for additional manual intervention. Thus, the difficulty in ascertaining presort levels achieved will be eliminated. Tr. 2/147, 181. The data collection plan was instead formulated based on Version 3's designed capabilities, rather than by focusing upon the quite different methods required during the market test. Tr. 2/252-53. Information reported about the jobs that flow through Mailing Online will be in electronic form, so that any interested analyst can cut the data as she sees fit. Tr. 3/467.

The OCA's approach apparently does not recognize the fact that the various data elements it seeks (*see, e.g.*, OCA Initial Brief at 22-24) will be included in the data provided (Tr. 2/155; 3/468-70). The Postal Service does object to being asked both to report the base information and to tabulate it separately, when the former suffices to permit extraction of the latter. The redundancy of effort serves no useful purpose.

One type of information that Version 3 cannot collect is advertising costs. In the previous Mailing Online docket, an unusual mix of responsibilities for advertising decisionmaking constrained the Postal Service position in the litigation – while also triggering a useful examination of how shared costs should or should not be treated. This is one reason witness Takis appeared in that proceeding as well as this one.

In Docket No. MC98-1, Postal Service was promoting its PostOffice Online channel in which Shipping Online was the most significant component. (This is borne out by the fact that so few of the PostOffice Online market test customers were actual users of Mailing Online.) The manager responsible for PostOffice Online was focused on Shipping Online to the exclusion of Mailing Online, for which he bore no specific responsibility. This led the Postal Service to conclude that all of the PostOffice Online advertising would have occurred, even if Mailing Online did not exist. As a consequence, Mailing Online caused none of the PostOffice Online advertising because that manager would have spent the money – and did spend it – regardless of how Mailing Online did or did not mature. See PRC Op., MC98-1, at 9-10. That unusual confluence of circumstances led the Commission to require the collection and reporting of all PostOffice Online advertising costs, with the expectation that proper allocation or attribution would be sorted out during consideration of the originally proposed experiment. *Id.* at 49. In that case, the originally planned experiment never occurred, the Mailing Online system was redesigned, and the market test fully lapsed before the Postal Service made the instant proposal. The current proposal, moreover, while similar on the surface to users, is quite different in its underlying structure from the one previously proposed.

The experiment now proposed involves an advertising budget specific to Mailing Online, not shared with any other product line. (This situation is also consistent with changes made in managerial responsibility.) Accordingly, the Commission can safely require the reporting of just Mailing Online specific advertising expenditures.

The OCA urges an unprecedented change in the data collection and reporting frequency triggered by the filing of a Postal Service request for permanent Mailing Online service:

The OCA agrees that no unnecessary reporting burdens should be placed on the Postal Service prior to the filing of a request for a permanent Mailing Online classification. However, the OCA believes that it is prudent to anticipate data needs in the event that the Postal Service does file a request for permanent Mailing Online service prior to the end of the experiment.

OCA Initial Brief at 28.

This request should be rejected for two reasons implicit in the OCA's own reasoning. First, if additional reports are unnecessary when no request for permanent authorization is pending, nothing inherent in the filing of such a request makes the information any more necessary thereafter. Under the Commission's Rules of Practice, the Postal Service would have to justify its request for permanent authorization based upon information then available. As such, the request would need to stand on its own in justifying any favorable Commission decision.

The second quoted sentence from the OCA Initial Brief further illustrates why the OCA's request for a change in the frequency of reporting should be rejected: "OCA 'anticipates data needs.' Hence, the OCA is already conducting discovery in this docket in anticipation of what it might seek in the next one. There is no basis in the experiment for imposing any information requirements the OCA foresees itself having in

a subsequent case. The burden of collecting and reporting information should be evaluated against its relevance at that time, not now.

Respectfully submitted,

UNITED STATES POSTAL SERVICE

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A handwritten signature in dark ink, appearing to read "K N Hollies", is written over a horizontal line.

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March 27, 2000

CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing document upon all participants of record in this proceeding in accordance with section 12 of the Rules of Practice.

SC L. Reiter (for)
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March 27, 2000