

UNITED STATES OF AMERICA
Before The
POSTAL RATE COMMISSION
WASHINGTON, D.C. 20268-0001

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Postal Rate and Fee Changes

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Docket No. R2000-1

OFFICE OF THE CONSUMER ADVOCATE
EXECUTIVE SUMMARY OF DIRECT TESTIMONY
(MAY 22, 2000)

The Office of the Consumer Advocate ("OCA") herein files an Executive Summary of the nine pieces of testimony filed this date as the direct case of the OCA. The overarching theme of the OCA's direct case is to define issues that directly affect the interests of individuals and small businesses, and to present modifications or alternatives to Postal Service proposals that best promote the interests of the general public. In some instances, the OCA recommends rejection of proposals or methodologies advocated by the Postal Service. Two pieces of testimony—OCA-T-2 and OCA-T-3—urge the Commission to reject the 2.5 percent contingency proposed by the Postal Service and to retain the one percent contingency underlying current rates. This recommendation benefits high-volume mailers as well as individuals and other low-volume mailers. Below is a complete list of OCA testimony and subjects addressed, followed by the summaries of each piece of testimony.

- OCA-T-1 **Testimony of Ted P. Gerarden**

 Overview of OCA Case
 Transition to New Stamp Rate
 Rates Working Group

- OCA-T-2 **Testimony of Robert E. Burns**

 Contingency Provision

- OCA-T-3 **Testimony of Edwin A. Rosenberg**

 Contingency Provision

- OCA-T-4 **Testimony of J. Edward Smith**

 Volume Variability of Mail Processing Costs

- OCA-T-5 **Testimony of Mark D. Ewen**

 Volume Variability of City Carrier Costs
 Elimination of "Stops Effect"

- OCA-T-6 **Testimony of James F. Callow**

 Retention of 33 cent First-Class Rate
 Rate Stability for Single-Piece First-Class Rates
 Elimination of Nonstandard Surcharge for Low Aspect Ratio Mailpieces

- OCA-T-7 **Testimony of Gail Willette**

 Courtesy Envelope Mail Discount

- OCA-T-8 **Testimony of Sheryda C. Collins**

 Reduction of Fees for Money Orders
 Electronic Money Orders
 Insured Mail Fees
 Electronic Delivery Confirmation for Individuals

- OCA-T-9 **Testimony of Pamela A. Thompson**

 Replication of Postal Service Base Year and Test Year Costs
 Demonstration of Recommendations of OCA witnesses Smith and Ewen

1. **Overview of OCA Case; Transition to New Stamp Rate; Rates Working Group**

Ted P. Gerarden, OCA-T-1

Mr. Gerarden provides an overview of the positions taken in the OCA's direct evidence on various issues addressed. These include: (1) rejecting the Postal Service's 2.5 percent contingency request and retaining the present one percent contingency provision; (2) eliminating the proposed "stops" effect in city carrier costing; (3) rejecting the mail processing volume variabilities requested by the Postal Service and retaining the existing 100 percent volume variability; (4) rejecting the proposed one cent increase in the First-Class first-ounce rate and retaining the existing 33 cent rate; (5) suggesting that the Postal Service adopt a plan to provide greater stability for single-piece First-Class rates by changing those rates only every other case; (6) eliminating the nonstandard surcharge for "low aspect ratio" mailpieces; (7) implementing a discount rate for Courtesy Envelope Mail with a three cent reduction from the First-Class rate; and (8) reducing the fee for Postal money orders.

Mr. Gerarden suggests that the Postal Service adopt a more aggressive form of outreach to consumers when the First-Class stamp rate changes by delivering to every delivery address an explanatory mailpiece accompanied by a pane of ten courtesy make-up stamps. Mr. Gerarden shows that the net cost to the Postal Service of providing courtesy make-up stamps would not be significant. Providing courtesy make-up stamps would make the transition to new rates more convenient to the public and would provide the Postal Service with an opportunity for improved public relations.

Mr. Gerarden also suggests that the Postal Service form a "Rates Working Group" between omnibus rate cases to provide a non-litigation forum in which

interested parties and the Postal Service could discuss selected issues. Such meetings would be conducted by the Postal Service under ground rules agreed upon by all participants. A "Rates Working Group" would give the Postal Service the opportunity to refine cost and rate proposals and potentially reduce controversy and/or the scope of litigation over issues during rate cases.

2. **Reduction in Contingency Provision**

Robert E. Burns, OCA-T-2

Witness Burns reviews the purposes for a contingency provision. He points out that the determination of an appropriate contingency amount must be founded upon systematic analysis, and cannot rely solely on the subjective judgment exercised by Postal Service management.

Mr. Burns first compares a postal contingency reserve to analogous catastrophic reserves in the insurance industry. One important restriction on such reserves in the insurance industry is that they must reflect a current liability of an insurance company for a future occurrence, and may not be used to smooth out irregularities or volatility in earnings.

Mr. Burns also draws upon his experience in energy regulation, pointing out that automatic fuel adjustment clauses have a tendency to drive up the fuel costs paid by utility customers since these clauses cushion managers from their failure to negotiate fuel prices effectively with suppliers. Mr. Burns cautions that an excessive postal contingency likewise acts as a perverse managerial incentive, condoning laxness in postal managers.

Witness Burns reviews past Commission opinions for guidance on the methodology that should be followed in determining a proper contingency amount. Mr. Burns' review of these decisions allows him to boil down principles expressed over three decades into three essential axioms: (1) the Commission will thoroughly review and evaluate the adequacy of the Postal Service's explanations for its subjective judgment on the appropriate level of the contingency; (2) the Commission will undertake an objective review of potential forecasting errors; and (3) the Commission will give considerable weight to external factors such as indicators of overall economic stability and strength.

Witness Burns critiques witness Tayman's (USPS-T-9) reasons for requesting a 2.5 percent contingency and finds that they are not well-articulated or well-substantiated. Mr. Burns considers each of the uncertainties raised by witness Tayman. Mr. Burns points out that many, such as planned reductions in test-year workhours, health benefit costs, and labor contract costs, are to a large extent controllable by postal management. Still other uncertainties, such as increasing competition for some postal volume, have already been taken into account by other Postal Service witnesses. Overall, Mr. Burns finds that Mr. Tayman's reliance on subjective management judgment fails to articulate a rational connection between potential uncontrollable risks in the test year and the \$1.68 billion annual contingency request, and that the Postal Service has failed to support its contingency request with substantial evidence.

3. Reduction in Contingency Provision
Dr. Edwin A. Rosenberg, OCA-T-3

OCA witness Rosenberg recommends to the Commission that the present contingency of one percent be retained. Dr. Rosenberg shows that the consensus among respected financial forecasters is for continued low inflation and a strong economy during the FY 2001 test year. Stable economic conditions permit the Postal Service to forecast more accurately. Dr. Rosenberg reviews economic data from 1970 and correlates average inflation rates over time with approved contingency provisions, showing that contingency provisions have decreased as inflation has abated. Dr. Rosenberg also notes that the contingency relates to other protections that ensure the viability of the Postal Service, and that an increase in the contingency provision in light of current stable economic conditions is not justified.

Dr. Rosenberg also notes that the variance analysis reluctantly provided by witness Tayman (USPS-T-9) does not support the requested increase in the contingency. Dr. Rosenberg points out that the 2.5 percent contingency proposed by the Postal Service lies entirely outside the range of variances calculated, and that the mid-point of the four scenarios is nearly zero. In addition, Dr. Rosenberg analyzes the Postal Service's forecasts of revenues and expenses for the test years of the four preceding omnibus rate cases—Docket Nos. R87-1, R90-1, R94-1, and R97-1—and concludes that the Postal Service's ability to forecast its net position is much closer to one percent than to 2.5 percent.

Dr. Rosenberg suggests that other analytical methods also could be used to evaluate the reasonableness of a requested contingency, and notes that needlessly

large contingencies tend to encourage slackness in controlling costs. Furthermore, Dr. Rosenberg notes that an unnecessarily large contingency bears an economic cost by taking monies out of the hands of consumers and business customers, preventing them from using the monies for other purposes. This opportunity cost must be taken into account in evaluating the reasonableness of the contingency.

The trend toward shorter rate cycles (e.g., Docket No. R97-1 rates will be in place for only two years) enhances the Postal Service's ability to forecast costs and revenues for the relevant test periods, thereby permitting the Postal Service to operate with relatively smaller contingency provisions.

Finally, Dr. Rosenberg sounds a cautionary note: witness Tayman cites increasing competition as a reason to enlarge the contingency, but Dr. Rosenberg warns that an unnecessarily high contingency pushes up rates, actually weakens the Postal Service's ability to compete, and can create a vicious cycle that gives more headroom to competitors to erode volumes further.

**4. Volume Variability of Mail Processing Costs; Retention of 100 percent
Volume Variability**
Joseph E. Smith, OCA-T-4

Witness Smith's testimony responds to the testimony of Postal Service Witness Bozzo (USPS-T-15). Dr. Bozzo's work was a continuation of Dr. Michael D. Bradley's work on Segment 3 mail processing cost variability presented in Docket No. R97-1. Volume variability measures the percentage change in cost with respect to the percentage change in volume. Dr. Bozzo measured the variability of cost, measured in hours worked, with respect to changes in the volume of mail, as measured in terms of total pieces handled (TPH) or total pieces fed (TPF) for ten mail processing activities.

Traditionally, the Commission has found that mail processing volume variability is 100 percent. Dr. Bozzo found estimated variabilities ranging from 52 percent to 95 percent. Volume variability is an important issue, for segment 3 mail processing costs are in excess of \$17 billion, and the variabilities applied to the various cost pool costs associated with the activity are used to yield a measure of attributable costs. Costs that are not attributable become institutional, requiring that the Commission recommend assignment of the costs to various rates, classes and categories.

Dr. Smith's evaluation of Dr. Bozzo's study is based on whether the study meets the Commission's evaluation criteria set out in Docket No. R97-1. Dr. Smith concludes that Dr. Bozzo's study has significant flaws. The major problems found were: (1) the questionable accuracy of the data base; (2) the short-run nature of the study, which failed to focus on longer-run expansion paths as they affect costs; (3) the continued use of the fixed effects model; (4) conceptual problems associated with variables such as the manual ratio, the network variable, and the capital (QICAP) variable; (5) the omission of important variables such as capacity utilization; (6) a lack of a clear presentation and derivation of the model being estimated from microeconomic theory; and (7) the failure to consider the possibly endogenous nature of capital investment.

Dr. Smith also points out that the justification for 100 percent variability is visually compelling. He presents a theoretical analysis of the underlying economic basis for an analysis of the longer-term expansion path by which volume variability should be measured. He recommends that the Commission continue with the 100 percent volume variability finding, and identifies the ten mail processing cost pools that OCA witness Thompson (OCA-T-9) modifies in her cost analysis. Dr. Smith further advises that the

Commission recommend the establishment of a working group to discuss, evaluate, and comment on the theoretical data, and modeling approaches for mail processing volume variability. Dr. Smith also sponsors OCA-LR-I-2, a Category 2 Library Reference.

5. **Volume Variability of City Carrier Costs; Elimination of “Stops Effect”**
Mark D. Ewen, OCA-T-5

Postal Service witness Baron (USPS-T-12) again proposes to discard certain components of the Commission’s established treatment of volume variable load-time costs, arguing that a certain increment of estimated accrued load time for each and every stop should be regarded as independent of mail volume, and therefore should not vary as loaded volume at a stop changes. Witness Baron defines this concept as the “stops effect.” He then defines a measure of “fixed time at stop” with available load-time data and argues that this portion of accrued load-time costs should be treated as access costs. Furthermore, after estimating the direct volume variability of the remaining load-time accrued cost pool (commonly referred to as “elemental” load time), he considers the residual component, or coverage-related load-time, to be an unattributable institutional cost. This treatment differs from the Commission’s established approach of attributing coverage-related load-time based on the proportion of mail delivered to single subclass stops.

In its Opinion and Recommended Decision, Docket No. R97-1, the Commission specifically rejected this approach, concluding that the stops effect concept is theoretically flawed. Based upon review of the relevant testimony and supporting data, Mr. Ewen concurs that the proposed stops effect approach is not justified. It is a

fictional construct founded upon an incorrect interpretation of prior Commission opinions. Additional justification offered for the approach is based on a strained and unnecessary extension of the activity-based functional approach for allocating total street-time among the major carrier activities into the assessment of load-time volume variability. No data exist that directly measure the effect, nor do the results of the load-time regression equations provide a hint that carriers might spend some fixed amount of time at each stop. Furthermore, even if such an effect exists, it cannot be accurately imputed using available data. As a result, the Postal Service's analysis of the stops effect is neither theoretically nor empirically supported. For these reasons, Mr. Ewen recommends that the Commission maintain its established treatment of load-time costs.

6. **Retention of 33-cent First-Class rate; Rate Stability for Single-Piece First-Class Rates; Elimination of Nonstandard Surcharge for Low Aspect Ratio Mailpieces**

James F. Callow, OCA-T-6

Part I of witness Callow's testimony addresses the growing institutional cost burden on First-Class letter mail. Mr. Callow demonstrates that during the past 12 years, all relevant measures show that the institutional costs borne by First-Class letter mail have risen, particularly in recent years. Moreover, the institutional cost burden on First-Class letter mail has been and remains greater than that intended by the Commission, as expressed in several recommended decisions. This growth in the institutional cost burden has occurred as the cost of First-Class letter mail has declined. The institutional cost burden is expected to remain high through the test year.

Witness Callow demonstrates that there is no cost justification for increasing First-Class rates in this case, and proposes that the single-piece First-Class rate be

maintained at 33 cents. This would provide the a significant benefit to individual and smaller mailers, and would moderate the substantially increased institutional cost burden that the Postal Service's proposed 34 cent rate would put on First-Class letter mail.

Part II of witness Callow's testimony proposes a new approach for setting the single-piece First-Class ("SPFC") rate. Under this proposal, the First-Class rate for workshare categories of First-Class mail would be determined without regard to the "integer constraint." The rate paid by households, by contrast, would be set at a whole cent, as in the past. The SPFC integer rate would remain the same for the time period covered by two rate proceedings. The SPFC rate would thus be changed every other rate proceeding, providing greater rate stability and convenience for household mailers, while accommodating the interests of business mailers for smaller, more frequent and predictable rate adjustments.

Part III of witness Callow's testimony proposes that the nonstandard surcharge for "low aspect ratio" letter mail—letter-shaped mailpieces that are square or nearly square in shape—be eliminated. The nonstandard surcharge is no longer warranted for such mail, having been outdated by advances in the technology of mail processing. Moreover, more realistic assumptions about the extra costs of processing low aspect ratio letter mail suggest that such costs are less than the surcharge.

Mr. Callow also sponsors OCA-LR-I-3, a Category 2 Library Reference.

7. **Courtesy Envelope Mail Discount**
Gail Willette, OCA-T-7

The OCA again proposes Courtesy Envelope Mail ("CEM") as a category of First-Class Mail. Ms. Willette provides several reasons to recommend CEM. First, CEM can provide a less costly method for consumers to pay bills. Discounted rates have been offered to large-volume mailers for many years in consideration of the processing steps avoided by that mail. It makes sense to offer a discount for CEM for the same reason. Second, CEM can help stem the decline in household-generated mail.

Third, CEM can help the Postal Service retain some transactions mail which would otherwise migrate to alternatives such as electronic bill payment or account debiting. As the methods for electronic payment become more attractive to consumers, it is inevitable that some, if not all, of the transactions that are mailed today will disappear from the First-Class mailstream. The Postal Service can and should work to keep as much of this mail for as long as it can. A discount rate for qualifying payment mail would dove-tail with the Postal Service's new *eBillPay* product. Fourth, CEM would provide a benefit to consumers from the Postal Service's advances in automation.

The Postal Service has objected to the establishment of CEM, arguing that consumers do not want to maintain two denominations of stamps, that consumers will try to use CEM stamps for other correspondence, that it will be too costly to educate consumers, and that it complicates the rate schedule. Ms. Willette reviews each of these objections and demonstrates that they are groundless. CEM is a workable solution to a problem facing the Postal Service.

8. **Reduction in Fees for Money Orders; Electronic Money Orders; Insured Mail Fees; Electronic Delivery Confirmation for Individuals**
OCA-T-8, Testimony of Sheryda C. Collins

OCA witness Collins urges the Commission to reject the proposal of Postal Service witness Mayo (USPS-T-39) to increase the fees of domestic and military money orders. On the contrary, witness Collins proposes a reduction of 5 cents for each of these fees. Domestic money order fees should be reduced from the current 80-cent level to 75 cents; and military money order fees should be reduced from their present 30-cent level to 25 cents. Ms. Collins notes that the Commission has long held the view that money orders, an essential financial instrument for low-income individuals and rural customers, should be priced at a cost coverage lower than the system-wide average. The 123 percent cost coverage resulting from witness Collins' reduction in fees comports with past cost coverages recommended by the Commission.

In addition, witness Collins recommends that the Postal Service establish an electronic money order service that would be available on the Internet, possibly in partnership with private Internet companies. Ms. Collins notes that electronic money orders can function as a convenient, secure means for purchasing goods.

Witness Collins urges the Commission not to raise insurance fees as proposed by Postal Service witness Mayo, but to maintain these fees at their present level. Furthermore, she advocates that the Postal Service and the Commission carefully consider the possibility of establishing different fees to cover larger incremental values than the per \$100 currently in place. For mailed articles valued at over \$1000, serious consideration should be given for increments of \$250 or \$500, with an appropriate adjustment in the per increment fee.

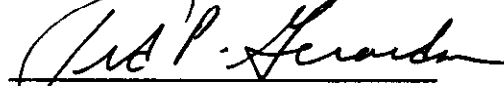
Ms. Collins notes that the Postal Service is experimenting with electronic delivery confirmation service, including service to individuals, offered through Internet sites of private companies. Because it would be no more costly for individuals to access that service than bulk users, witness Collins urges the Postal Service to make Priority Mail electronic delivery confirmation available to the public on its website at no charge.

**9. Replication of Postal Service Base Year and Test Year Costs;
Demonstration of Recommendations of OCA witnesses Smith and Ewen
Pamela A. Thompson, OCA-T-9**

The purpose and scope of OCA witness Thompson's testimony is three-fold. First, witness Thompson replicates the Postal Service costs as provided in witness Kashani's testimony and workpapers (USPS-T-14). Then, she incorporates the corrections proposed by Postal Service witness Kashani. Finally, she incorporates into the base year cost model the changes OCA witnesses Smith (OCA-T-4) and Ewen (OCA-T-5) are proposing and rolls them forward to determine the test year after rate costs with the workyear mix adjustment. In addition to this testimony, witness Thompson sponsors OCA-LR-I-1, a Category 2 Library Reference.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that I have this date served the foregoing document upon all participants of record in this proceeding in accordance with section 12 of the rules of practice.


JENNIE WALLACE

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May 22, 2000