OCA-T-6
Docket No. R2000-1

DIRECT TESTIMONY

OF

JAMES F. CALLOW

ON BEHALF OF

THE OFFICE OF THE CONSUMER ADVOCATE

MAY 22, 2000

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

Postal Rate and Fee Changes, 2000) Docket No. R2000-1

DIRECT TESTIMONY OF JAMES F. CALLOW

I. STATEMENT OF QUALIFICATIONS

My name is James F. Callow. I am a Postal Rate and Classification Specialist. I have been employed by the Postal Rate Commission since June 1993, and since February 1995 in the Office of the Consumer Advocate (OCA).

I have testified before the Commission in Docket Nos. MC98-1, R97-1, MC96-3, and MC95-1. In Docket No. MC98-1, I proposed a computer-implemented postage pricing formula for Mailing Online as an alternative to the single average discount rate, Automation Basic (within class and shape), proposed by the Postal Service for all mailings using Mailing Online. In Docket No. R97-1, I proposed a restructuring of post office box fee groups to better reflect costs of providing box service in high and low cost offices. My testimony in Docket No. MC96-3 opposed the Postal Service's non-resident surcharge on post office boxholders, and proposed alternative box fees designed to equalize inter-group cost coverages and reduce the disparity in cost coverages by box size. In Docket No. MC95-1, my testimony summarized the comments of persons

expressing views to the Commission and the Office of the Consumer Advocate on postal rates and services.

As a Special Assistant to former Commissioner H. Edward Quick, I participated in Docket Nos. R94-1, MC93-2 and MC93-1. In Docket No. R94-1, I was assigned responsibility for substantive subject areas considered by the Commission in its Opinion and Recommended Decision. Specifically, I analyzed quantitative testimony of the Postal Service with respect to the estimation of workers' compensation costs and evaluated rate design proposals of the Postal Service and other parties related to special postal services.

Prior to joining the Commission, I held positions on the legislative staff of a US Senator and a Member of Congress from Michigan, and served as an aide to the Governor of the State of Michigan in Washington.

I am an accountant by training. In 1985, I earned an MS degree in accounting from Georgetown University. My course work included cost accounting and auditing. In 1977, I obtained my BA degree from the University of Michigan-Dearborn with a double major in political science and history and a minor in economics.

II. PURPOSE AND SCOPE OF TESTIMONY

This testimony examines three issues related to First-Class Mail: the institutional cost burden on First-Class Letter Mail, a new approach for setting the single-piece First-Class rate for letters and cards, and the nonstandard surcharge for certain nonstandard mail. The testimony is divided into three parts.

In Part I, I propose that the current rate for First-Class Letters be maintained at 33 cents in order to mitigate the growing institutional cost burden on First-Class Letter Mail. During the past 12 years, First-Class Letter Mail has been carrying an increasing burden of the institutional costs of the Postal Service, and that burden has become more prominent in recent years. This conclusion is based upon an analysis of Postal Service data using several common measures of institutional cost. Moreover, the growth in institutional costs has occurred as the cost of First-Class Letter Mail has declined. Similarly, the institutional cost burden on First-Class Letter Mail has increased relative to the institutional cost burden on Standard (A) Regular Mail.

The institutional cost burden on First-Class Letter Mail has also grown relative to the institutional cost burden intended by the Commission, as expressed in several recent recommended decisions. As a result, First-Class Letter Mail has contributed $6.2 billion more than intended by the Commission to the institutional costs of the Postal Service since FY1988, and this additional revenue is expected to reach $11.2 billion through the test year. Mitigation of the institutional cost burden on First-Class Letter Mail should involve consideration of the additional contribution to institutional costs above that intended by the Commission.

In Part II, I propose that the Postal Service adopt a new approach for setting the single-piece First-Class rate for letters and cards that would benefit both household and business mailers. The Postal Service appears to have adopted plans to adjust rates every two years, in response to the concerns of business mailers for smaller, more predictable rate changes. However, more frequent rate changes can be inconvenient to household and smaller-volume mailers. The approach I propose would accommodate the differing interests of household and business mailers.

Under my proposal, the single-piece First-Class ("SPFC") rate 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 be set so that sufficient revenues would accumulate in a "reserve account" to permit the single-piece rate to remain the same for a period of two rate proceedings, a duration of approximately four years. In effect, the SPFC rate would be changed every other rate proceeding, with revenue generated during the first rate period covering any revenue deficiency in the second rate period. In this manner, household mailers would enjoy greater rate stability, while allowing business mailers smaller, more frequent and predictable rate adjustments.

Accommodating the differing interests of household and business mailers in this manner can be achieved while preserving Postal management's prerogatives with respect to rate changes, including the timing of the filing of rate cases and the effective date of new rates. It would also preserve the right of every participant to litigate any issue in every case. The only difference is that revenues generated in the first rate case period would permit the single-piece First-Class to remain in effect over two rate

cases. Nevertheless, this proposal recognizes that in changing economic conditions, the reserve account balance could prove inadequate, or that changing the SPFC rate every other proceeding while rates for workshare mail change each rate case could shift large volumes between single-piece and workshare mail. Under such circumstances, the single-piece rate could be adjusted in two consecutive cases.

Part III of my testimony proposes elimination of the current (and proposed) 11 cent nonstandard surcharge for First-Class "low aspect ratio" letter mail—letter-shaped mailpieces that are square or nearly square in shape. The nonstandard surcharge is no longer warranted for such mail, having been outdated by advances in the technology of mail processing. As a result, consumers are charged extra for low aspect ratio letter mail, such as seasons greeting cards or invitations, that requires little (if any) special processing. Moreover, the Postal Service's manual processing assumption underlying the costing on which the surcharge is based is unrealistic. Using more realistic assumptions about the costs of processing low aspect ratio letter mail reveals that costs are less than the surcharge. For these reasons, I propose elimination of the nonstandard surcharge for low aspect ratio letter mail as a matter of fairness for individual mailers.

PART I

I. THE INSTITUTIONAL COST BURDEN ON FIRST-CLASS LETTER MAIL IS INCREASING

First-Class Letter Mail has been carrying an increasing burden of the institutional costs of the Postal Service. This conclusion is based upon a review of Postal Service cost and revenue data over the past twelve years. Moreover, this trend, evident from an analysis of several common measures of institutional cost, has become even more prominent in recent years, and is expected to continue into the test year. Also, the continued growth in the burden on First-Class Letter Mail is evident by comparison with other subclasses of mail, most notably Standard (A) Regular.

A. Common Measures of Institutional Cost Show a High and Rising Burden Being Borne by First-Class Letter Mail

Several measures of institutional cost burden are commonly relied upon by the Commission and the Postal Service to analyze the relative institutional cost burden on various classes of mail over time.[1] The cost coverage is one commonly used measure.[2] Beginning with its opinion and recommended decision in Docket No. R87-1, the Commission introduced a "mark-up" index.[3] In recent years, the Postal Service has

[1] Institutional costs represent the amount of total costs remaining after subtracting costs that are directly "attributable" to each class or type of mail service.

[2] *See* PRC Op. R97-1, Appendix G, Schedule 1 at 1. The cost coverage, for example, is calculated by dividing revenues by attributable costs.

[3] *See* generally PRC Op. R87-1, Appendix G, Schedule 3, at 33. A mark up index is obtained by dividing the "mark-up" (the percentage by which the revenues exceed costs) of a class or subclass by the total "mark-up" for all mail and special services.

expressed a preference for a "cost coverage" index.[4] Using virtually any measure of institutional cost, the institutional cost burden on First-Class Letter Mail is high, and has been rising in recent years.

1. The First-Class Letter Mail cost coverage is high and rising

The First-Class Letter Mail cost coverage has traditionally been higher than the total, or "systemwide," average cost coverage. However, the cost coverage for First-Class Letter Mail has increased significantly in recent years compared to the systemwide average.

Table 1 shows the high and rising cost coverage for First Class Letters, and the total average cost coverage for all mail classes and services.[5] Figure 1 visually depicts the data. During the 12 year period FY 1988 through FY 1999, the First-Class Letter cost coverage has risen from 162 percent to 197 percent. In two fiscal years during this period, FY 1997 and 1998, the First-Class Letter cost coverage exceeded 200 percent, reaching 205 and 209 percent, respectively. For the most recent year, FY 1999, the cost coverage retreated to 197 percent, but remains well above the cost coverage for years prior to the two highest years of FY 1997 and 1998. To put this rapid advance in

[4] In Docket No. R97-1, witness O'Hara maintained that "for setting rate levels based on the new cost information, the cost coverage index provides a better starting point than the mark-up index." Docket No. R97-1, USPS-T-30 (O'Hara), at 20. The cost coverage index is calculated by dividing the cost coverage of a given class of mail by the cost coverage of all of the mail. The only difference between a mark-up index and a cost coverage index is cardinality. The calculation of a cost coverage index simply involves adding one to the numerator and denominator of the corresponding mark-up index. The value of a cost coverage index is closer to 1.0 than the corresponding mark-up index, but all subclasses retain their order. The cost coverage index simply reduces the magnitude of the difference between any two subclasses.

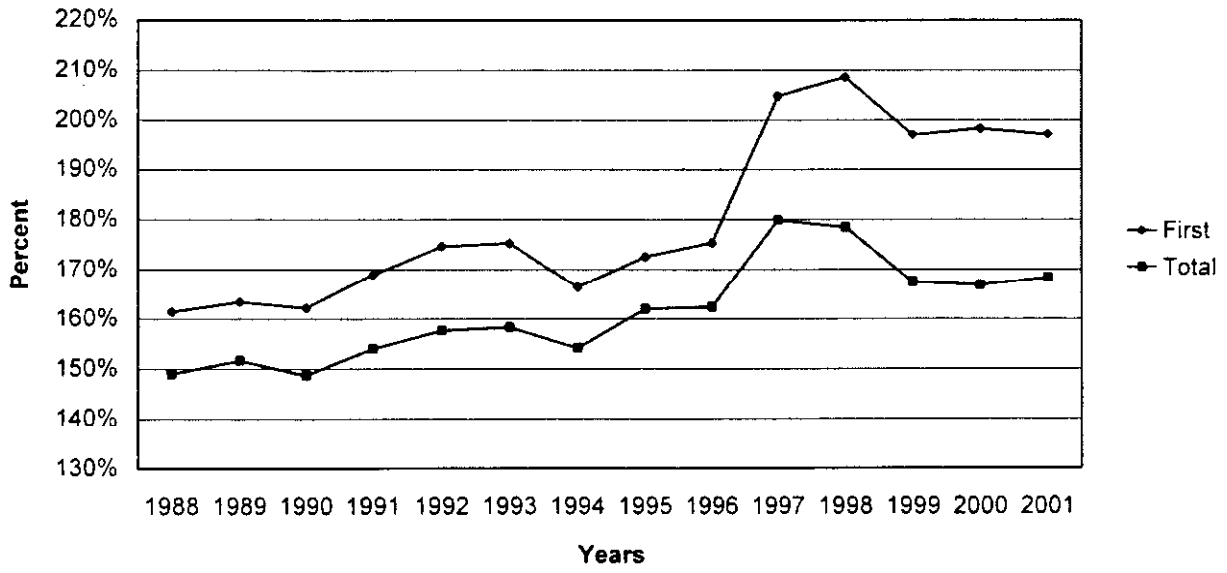
[5] The data in Tables 1-12 in Part I of this testimony are developed in Part I of Library Reference OCA-LR-3.

1 the cost coverage into perspective, from FY 1988 to FY 1996 the cost coverage rose
2 gradually from 162 percent to 175 percent. The First-Class cost coverage is expected
3 to remain in the upper 190's through the test year.

Table 1
COMPARISON OF THE FIRST-CLASS LETTER AND TOTAL AVERAGE COST COVERAGE

Cost Coverage	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
First	162%	164%	162%	169%	175%	175%	166%	173%	175%	205%	209%	197%	198%	197%
Total	149%	152%	149%	154%	158%	158%	154%	162%	162%	180%	178%	167%	167%	168%

Figure 1: Comparison of First-Class Letters and Total Average Cost Coverage



4 2. The mark-up index reveals a rising institutional cost burden on
5 First-Class Letter Mail

6 The mark-up index places the rising institutional cost burden on First-Class
7 Letter Mail on a more comparable basis from year-to-year.[6] Table 2 and accompanying

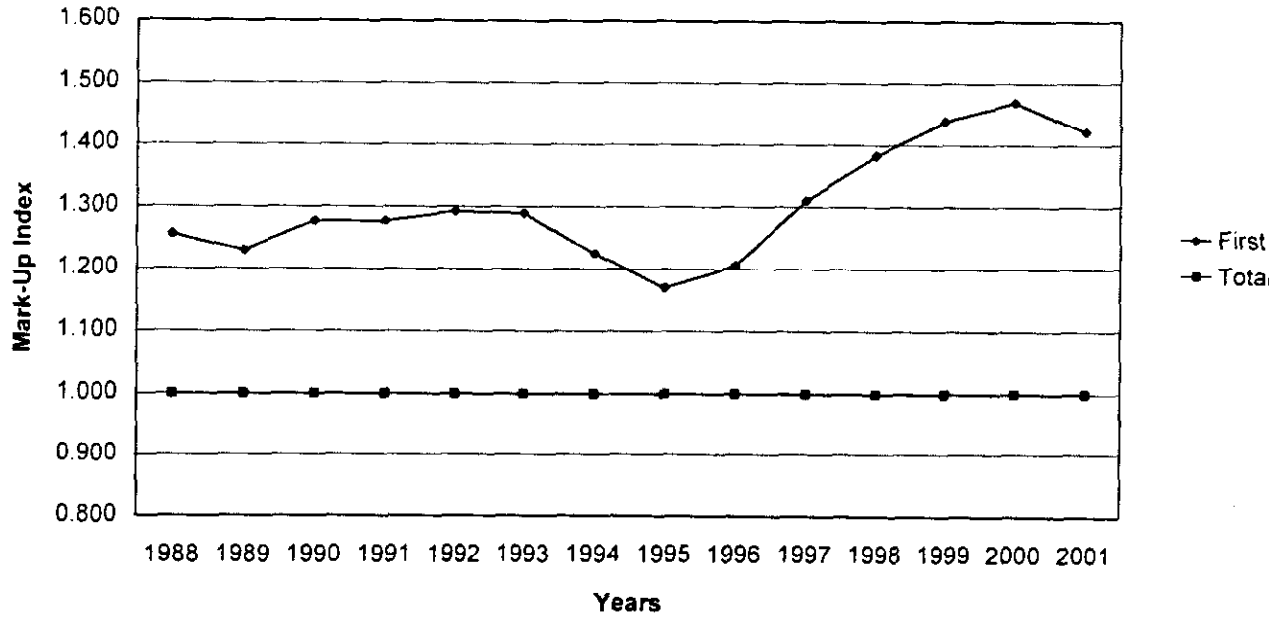
[6] The mark-up index can control for changes in the average level of attributable costs but does not control for changes in the relative share of costs attributed to different subclasses.

Figure 2 show the First-Class Letter mark-up index. As revealed in Table 2, the mark-up index for First-Class Letters rose from 1.256 to 1.439 during the 12 year period FY 1988 through FY 1999. In more recent years, the mark-up index shows a more rapid rise in the institutional cost burden on First-Class Letter Mail. During the five year period beginning in FY 1995, the mark-up index increased from 1.169 to a high of 1.439. The First-Class Letter mark-up index is expected increase still higher in FY 2000.

Table 2
FIRST-CLASS LETTER MARK-UP INDEX

Mark-Up Index	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
First	1.256	1.230	1.277	1.276	1.293	1.289	1.226	1.169	1.206	1.311	1.384	1.439	1.469	1.422
Total	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000

Figure 2: First-Class Letter Mark-Up Index



3. The cost coverage index also shows an increase in the institutional cost burden on First-Class Letters

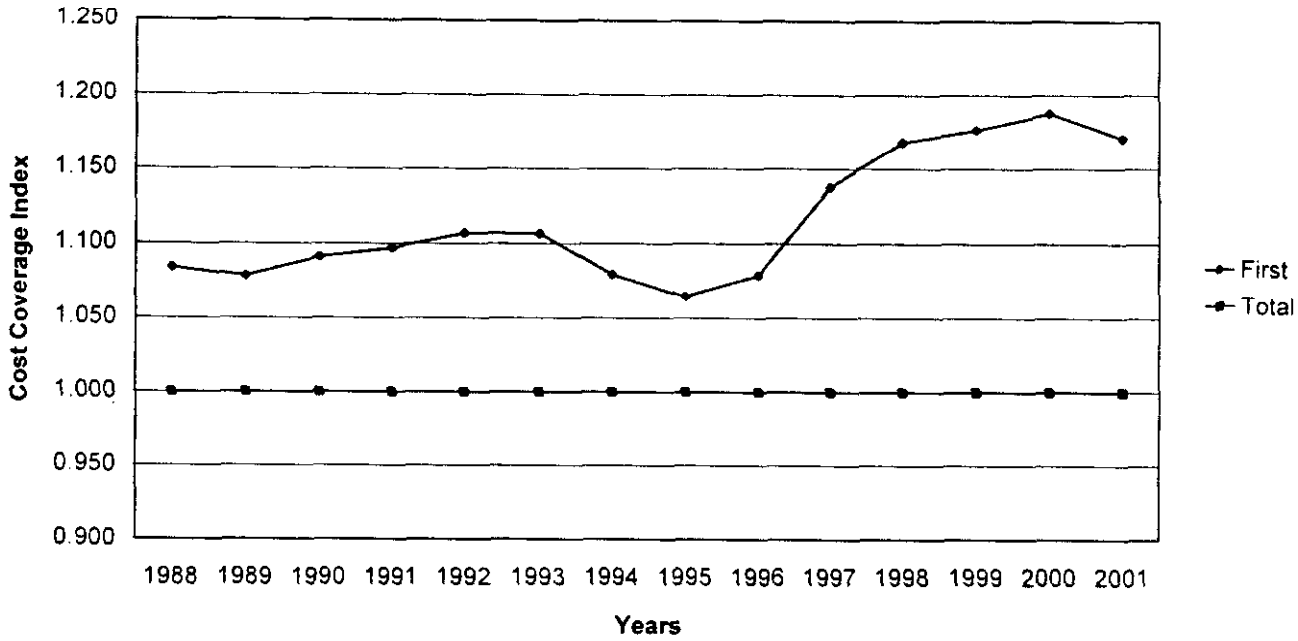
The cost coverage index shows the rising First-Class Letter institutional cost burden on a different yet comparable basis.[7] Table 3 and Figure 3 present the First-Class Letter cost coverage index. The cost coverage index shows, like the mark-up index, a similar increase in the institutional cost burden on First-Class Letter Mail. Based upon reported data, the cost coverage index for First-Class Letters grew from 1.084 in FY 1988 to 1.177 in FY 1999, and is expected to rise still higher in FY 2000. As with the mark-up index, the First-Class Letter cost coverage index shows a steady rise from 1.065 to 1.177 beginning with FY 1995 through FY 1999.

[7] *See* note 4, *supra*.

Table 3
FIRST-CLASS LETTER COST COVERAGE INDEX

Cost Coverage Index	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
First	1.084	1.078	1.091	1.097	1.107	1.107	1.079	1.065	1.079	1.138	1.169	1.177	1.188	1.171
Total	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000

Figure 3: First-Class Letter Cost Coverage Index



4. Cost coverage and mark-up indices reveal a high First-Class Letter Mail institutional cost burden when compared to Commission recommendations

The high and rising institutional cost burden on First-Class Letter Mail is revealed from another perspective: by comparison to Commission recommendations. Table 4 presents the First-Class Letter mark-up index compared to the recommended First-Class Letter mark-up index obtained from the four Commission opinions issued during the period covered by this analysis.[8] The First-Class Letter mark-up index is also

[8] PRC Ops. R87-1, R90-1, R94-1 and R97-1.

compared to the average recommended First-Class Letter mark-up index calculated for the four Commission opinions. Figure 4 visually depicts the data compared in Table 4.

During the 12 year period, FY 1988 through FY 1999, the actual First-Class Letter mark-up index is higher than the recommended index for all but three years. If the recommended First-Class Letter mark-up index from Docket No. R97-1 is extended through FY 2001, the actual First-Class Letter mark-up index is also expected to remain above the recommended index. When compared to the average First-Class Letter mark-up index, the actual First-Class Letter mark-up index remains above the average index for all but five of the 12 years from FY 1988 through FY 1999. The actual First-Class Letter mark-up index is also expected to be higher than the average index through FY 2001.

Table 4
COMPARISON OF FIRST-CLASS LETTER MARK-UP INDEX TO RECOMMENDED AND AVERAGE MARK-UP INDICES

Mark-Up Index	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
First	1.256	1.230	1.277	1.276	1.293	1.289	1.226	1.169	1.206	1.311	1.384	1.439	1.469	1.422
Recom'd	1.200	1.200	1.200	1.235	1.235	1.235	1.235	1.310	1.310	1.310	1.308	1.308	1.308	1.308
Average	1.263	1.263	1.263	1.263	1.263	1.263	1.263	1.263	1.263	1.263	1.263	1.263	1.263	1.263

Figure 4: Comparison of First-Class Letter Mark-Up Index to Recommended and Average

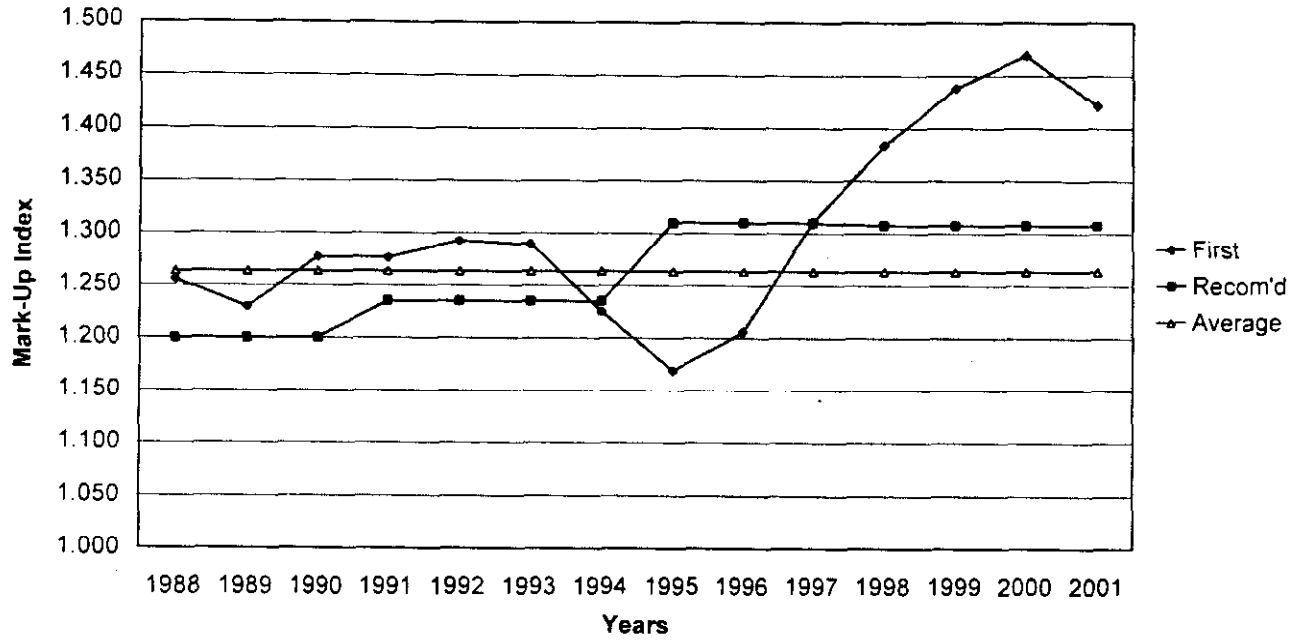


Table 5 shows the actual First-Class Letter cost coverage index compared to the recommended First-Class Letter cost coverage index, derived from the four Commission opinions issued during the period covered by this analysis. The average recommended First-Class cost coverage index is also calculated, and compared to the actual First-Class Letter cost coverage index. Figure 5 visually compares the data presented in Table 5 on the recommended and average recommended First-Class Letter cost coverage indices and the actual First-Class cost coverage index.

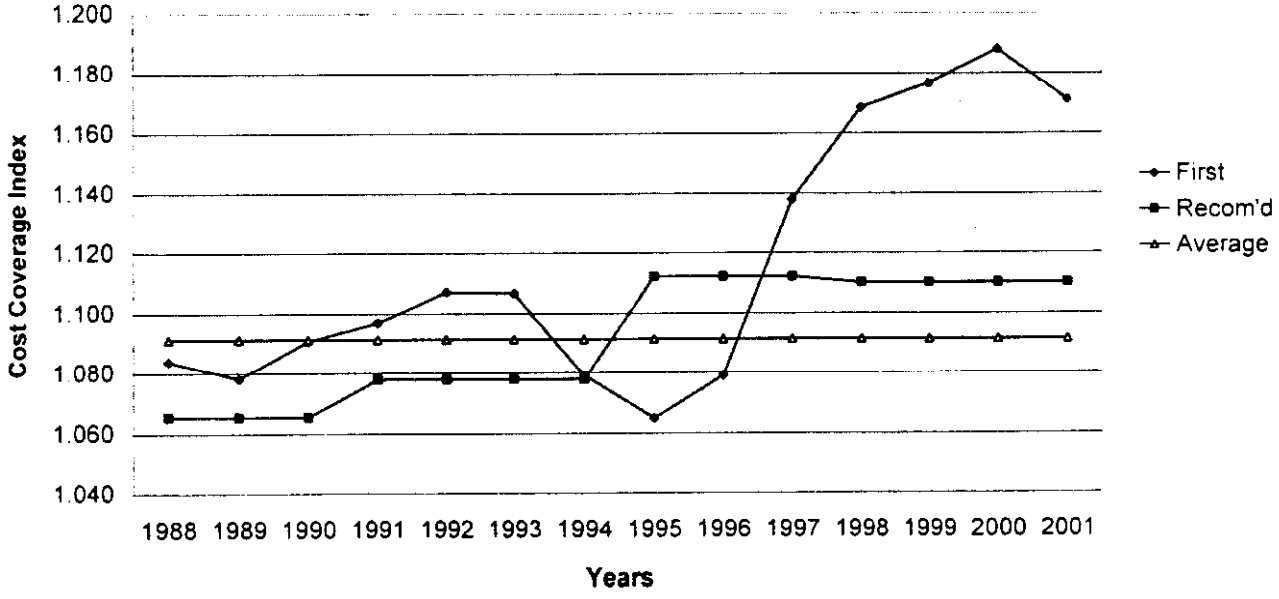
During the 12 year period, FY 1988 through FY 1999, the actual First-Class Letter cost coverage index is above the recommended index for all but two years. If the recommended First-Class Letter cost coverage index from Docket No. R97-1 is

extended through FY 2001, the actual First-Class Letter cost coverage index is also expected to remain higher than the recommended index. By comparison to the average First-Class Letter cost coverage index, the actual First-Class Letter cost coverage index remains above the average index for six of the 12 years from FY 1988 through FY 1999. The actual First-Class Letter cost coverage index is also expected to be higher than the average index through FY 2001.

Table 5
COMPARISON OF FIRST-CLASS LETTER COST COVERAGE INDEX TO RECOMMENDED AND AVERAGE INDICES

Cost Coverage Index	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
First	1.084	1.078	1.091	1.097	1.107	1.107	1.079	1.065	1.079	1.138	1.169	1.177	1.188	1.171
Recom'd	1.065	1.065	1.065	1.078	1.078	1.078	1.078	1.112	1.112	1.112	1.110	1.110	1.110	1.110
Average	1.091	1.091	1.091	1.091	1.091	1.091	1.091	1.091	1.091	1.091	1.091	1.091	1.091	1.091

Figure 5: Comparison of First-Class Letter Cost Coverage Index to Recommended and Average



B. The Institutional Cost Burden on First-Class Letter Mail Is Increasing Relative to the Institutional Cost Burden on Standard (A) Regular Mail

First-Class Letter Mail has long contributed more in absolute terms to the institutional costs of the Postal Service than the next largest class of mail, Standard (A)

Regular mail. Over time, the relative share of institutional costs contributed by First-Class Letter Mail has grown relative to the share contributed by Standard (A) Regular mail.

1. A comparison of First-Class Letter and Standard (A) Regular mark-up and cost coverage indices reveals a widening gap

The relative change in institutional cost contributions by First-Class Letters and Standard (A) Regular mail can be shown by comparing mark-up and cost coverage indices for each subclass. Table 6 and accompanying Figure 6 compares the First-Class Letter and Standard (A) Regular mark-up indices to the total average mark-up index for all mail classes and services. Table 6 reveals the widening gap in the relative institutional cost contribution of First-Class Letters and Standard (A) Regular in recent years. For the five year period beginning in FY 1995, the First-Class Letter mark-up index rises steadily from 1.169 to 1.439, while the Standard (A) Regular mark-up index reveals an overall decline from 1.080 to 0.828. Moreover, during FY 2000 and 2001, the Standard (A) Regular mark-up index is expected to decline further, ending at 0.777. By contrast, the First-Class Letter mark-up index is expected to rise still higher to 1.469 in FY 2000, and then decline in the test year to 1.422.

Table 6
COMPARISON OF FIRST-CLASS LETTERS AND STANDARD (A) REGULAR MARK-UP INDICES

Mark-Up Index	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
First	1.256	1.230	1.277	1.276	1.293	1.289	1.226	1.169	1.206	1.311	1.384	1.439	1.469	1.422
Std (A)	0.649	0.788	0.761	0.858	0.794	0.901	1.072	1.080	1.110	1.003	0.904	0.828	0.745	0.777
Total	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00

Figure 6: Comparison of First-Class Letters and Standard (A) Regular Mark-Up Indices

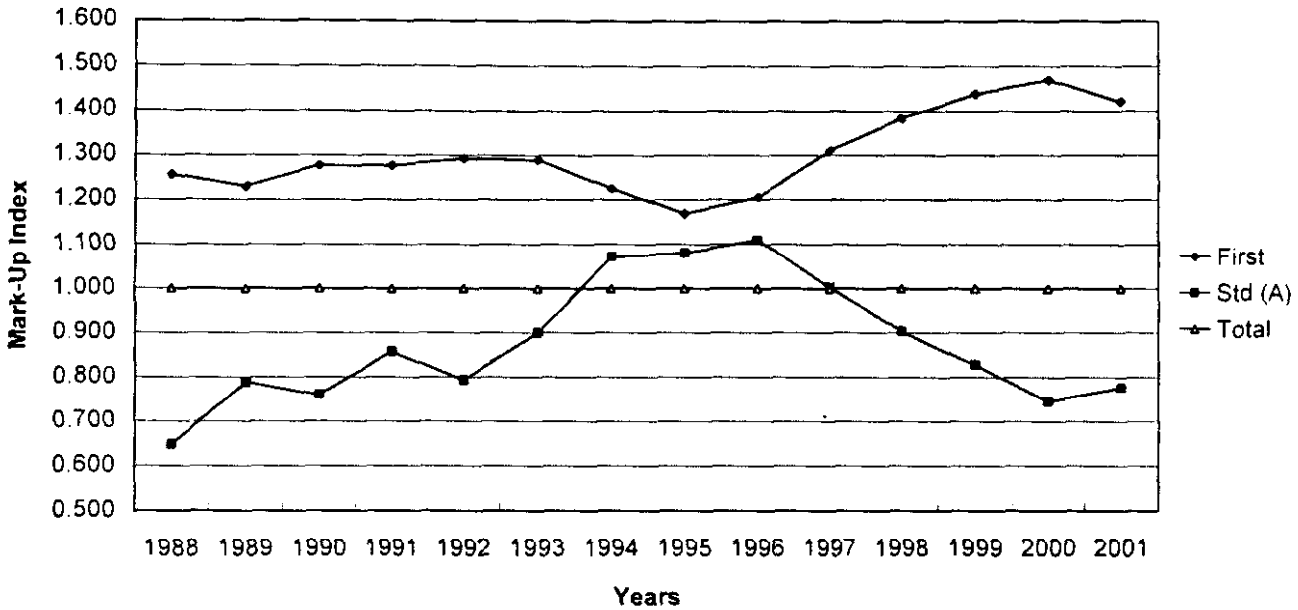


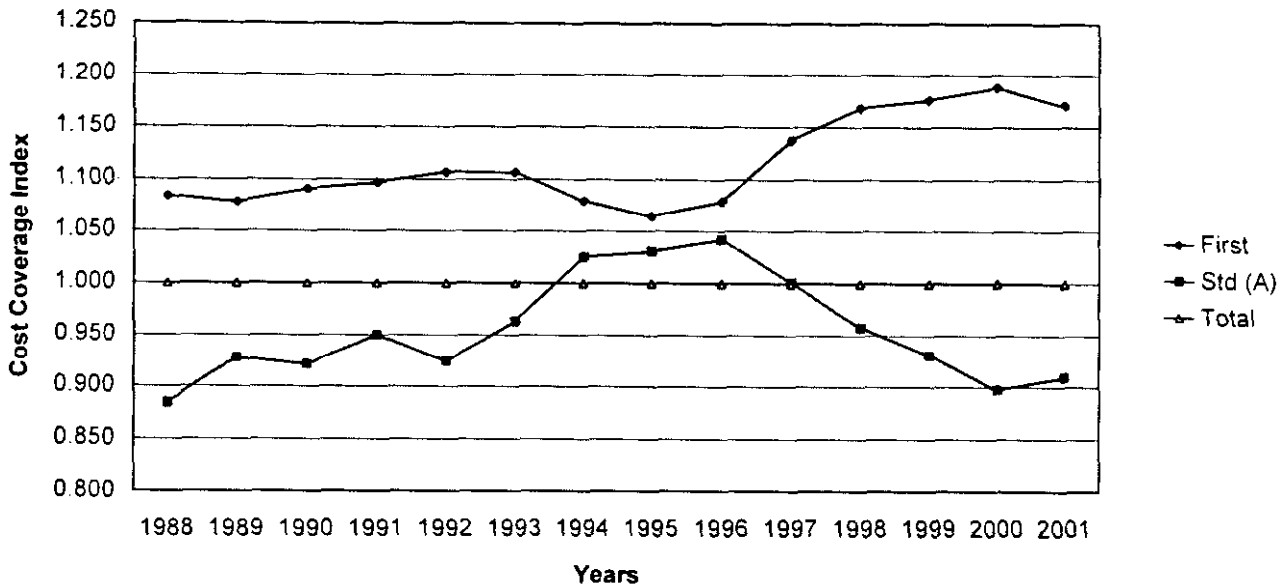
Table 7 and Figure 7 compare the First-Class Letter and Standard (A) Regular cost coverage indices to the cost coverage index for all mail. Comparing cost coverage indices for First-Class Letters and Standard (A) Regular shows a pattern similar to that of the mark-up indices—a widening gap in the relative institutional cost contribution of First-Class Letters vis-a-vis Standard (A) Regular in recent years. Like the mark-up index, the rising First-Class Letter cost coverage index is especially noticeable beginning in FY 1995. The First-Class Letter index rises steadily during the five years from FY 1995 through FY 1999, and is expected to rise still higher in FY 2000, falling in the test year. By contrast, the Standard (A) Regular cost coverage index exhibits an

overall decline during the same five year period, from 1.031 to 0.931, and is expected to be lower still in the test year.

Table 7
COMPARISON OF FIRST-CLASS LETTERS AND STANDARD (A) REGULAR COST COVERAGE INDICES

Cost Coverage Index	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
First	1.084	1.078	1.091	1.097	1.107	1.107	1.079	1.065	1.079	1.138	1.169	1.177	1.188	1.171
Std (A)	0.884	0.928	0.922	0.950	0.925	0.963	1.025	1.031	1.042	1.001	0.958	0.931	0.898	0.910
Total	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00

Figure 7: Comparison of First-Class Letters and Standard (A) Regular Cost Coverage Indices



2. A comparison of actual First-Class Letter and Standard (A) Regular cost coverage and mark-up indices to the Commission's recommendations also reveals a widening gap

The relative change in the institutional cost contribution of First-Class Letters compared to Standard (A) Regular can also be shown by reference to Commission recommendations. Comparing the actual First-Class Letter and Standard (A) Regular mark-up and cost coverage indices to the recommended mark-up and cost coverage

indices reveals a widening gap in the relative contributions by First-Class Letters and Standard (A) Regular mail.

Table 8 and accompanying Figure 8 compare the actual First-Class Letter and Standard (A) Regular mark-up indices to the Commission's recommended mark-up index for each subclass, and the average recommended index calculated for the four Commission opinions issued during the period covered by this analysis. The analysis for Table 8 for First-Class Letters is the same as presented with respect to Table 4. The actual First-Class Letter mark-up index roughly tracks, albeit somewhat higher, the recommended index until FY 1994, falling below the recommended index for three years. From FY 1995 through FY 1999, the actual First-Class Letter mark-up index increases, rising above the recommended index during the last three fiscal years. The actual First-Class Letter mark-up index follows a similar pattern vis-a-vis the average mark-up index. By contrast, the actual Standard (A) Regular mark-up index remains below the recommended index for all but four years, FY 1994 through FY 1997, and then returns below the recommended index through FY 1999. The actual Standard (A) Regular mark-up index follows the same pattern by comparison to the average mark-up index.

Table 8
COMPARISON OF FIRST-CLASS LETTER & STANDARD (A) REGULAR MARK-UP INDICES TO RECOMMENDED AND AVERAGE INDICES

Mark-Up Index	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
First	1.256	1.230	1.277	1.276	1.293	1.289	1.226	1.169	1.206	1.311	1.384	1.439	1.469	1.422
First, Rec.	1.200	1.200	1.200	1.235	1.235	1.235	1.235	1.310	1.310	1.310	1.308	1.308	1.308	1.308
First, Ave.	1.263	1.263	1.263	1.263	1.263	1.263	1.263	1.263	1.263	1.263	1.263	1.263	1.263	1.263
Std (A)	0.649	0.788	0.761	0.858	0.794	0.901	1.072	1.080	1.110	1.003	0.904	0.828	0.745	0.777
Std (A), Rec.	0.840	0.840	0.840	0.941	0.941	0.941	0.941	0.899	0.899	0.899	0.949	0.949	0.949	0.949
Std (A), Ave.	0.907	0.907	0.907	0.907	0.907	0.907	0.907	0.907	0.907	0.907	0.907	0.907	0.907	0.907

Figure 8: Comparison of First-Class Letter and Standard (A) Regular Mark-Up Indices to Recommended and Average

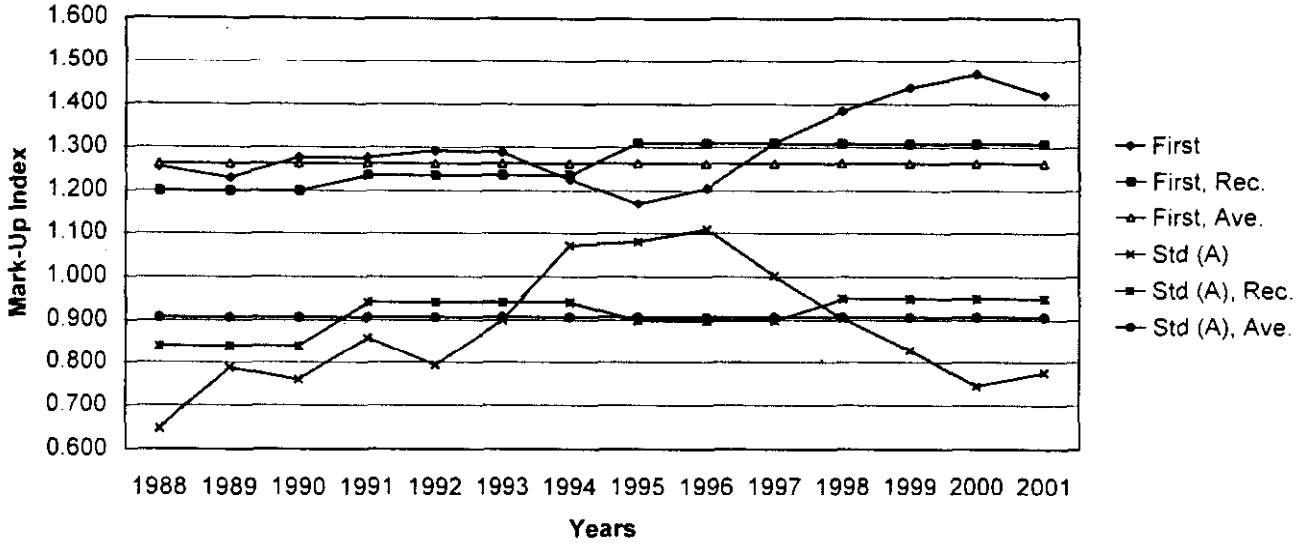


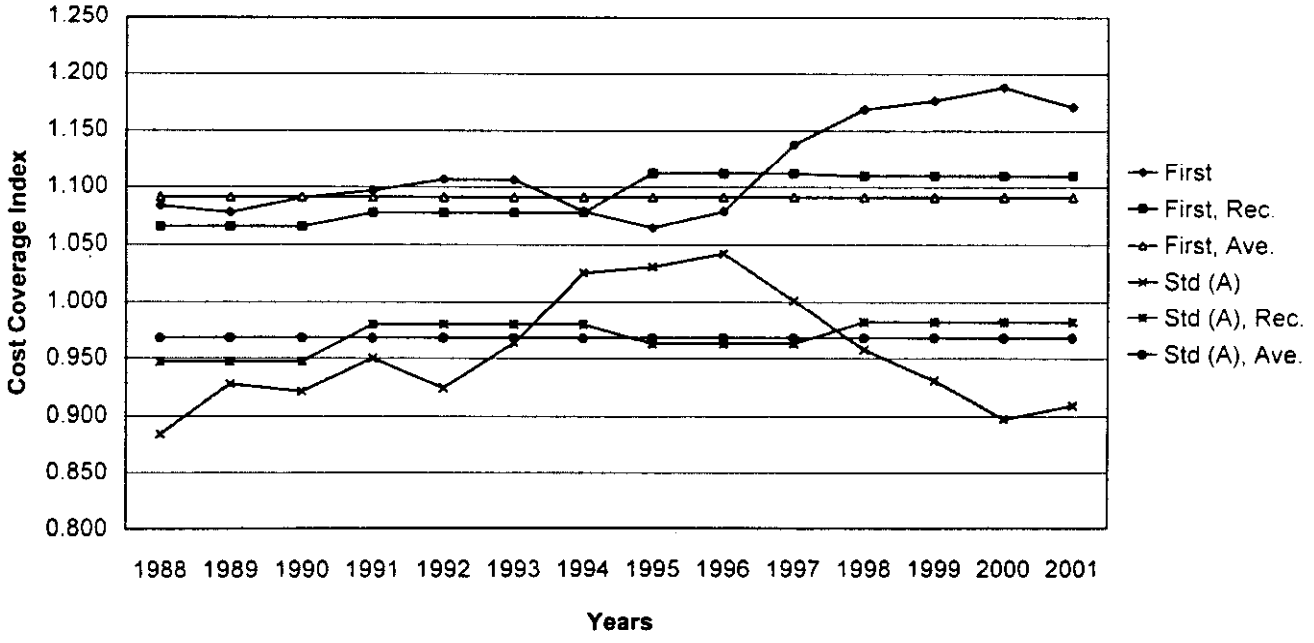
Table 9 and Figure 9 compare the actual First-Class Letter and Standard (A) Regular cost coverage indices against the Commission's recommended cost coverage index, and the average recommended index calculated for the four Commission opinions. The analysis of Table 9 for First-Class Letters is the same with respect to Table 5. Table 9 shows the actual First-Class Letter cost coverage index falls below the recommended index in only two years, FY 1995 and FY 1996, during the 12 years from FY 1988 through FY 1999. From FY 1995, it increases, rising above the recommended index during the last three years. The actual First-Class Letter cost coverage index is above the average index during six of the 12 year period, FY 1988 through FY 1999, and rises high above the average in the last three years. By contrast,

Table 9 shows the actual Standard (A) Regular cost coverage index below the recommended index for all but four years from FY 1988 through FY 1999. The Standard (A) Regular cost coverage index follows the same pattern when compared to the average cost coverage index. Again, the widening trend is most apparent in the latter years, as the Standard (A) Regular cost coverage index declines from the recommended and average indices.

Table 9
COMPARISON OF FIRST-CLASS LETTER & STANDARD (A) REGULAR COST COVERAGE INDICES TO RECOMMENDED AND AVERAGE

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
First	1.084	1.078	1.091	1.097	1.107	1.107	1.079	1.065	1.079	1.138	1.169	1.177	1.188	1.171
First, Rec.	1.065	1.065	1.065	1.078	1.078	1.078	1.078	1.112	1.112	1.112	1.110	1.110	1.110	1.110
First, Ave.	1.091	1.091	1.091	1.091	1.091	1.091	1.091	1.091	1.091	1.091	1.091	1.091	1.091	1.091
Std (A)	0.884	0.928	0.922	0.950	0.925	0.963	1.025	1.031	1.042	1.001	0.958	0.931	0.898	0.910
Std (A), Rec.	0.947	0.947	0.947	0.980	0.980	0.980	0.980	0.963	0.963	0.963	0.982	0.982	0.982	0.982
Std (A), Ave.	0.968	0.968	0.968	0.968	0.968	0.968	0.968	0.968	0.968	0.968	0.968	0.968	0.968	0.968

Figure 9: Comparison of First-Class Letter and Standard (A) Regular Cost Coverage Indices to Recommended and Average



II. THE INCREASING FIRST-CLASS LETTER INSTITUTIONAL COST BURDEN HAS RESULTED IN FIRST-CLASS LETTER MAIL CONTRIBUTING REVENUES IN EXCESS OF THE AMOUNT INTENDED BY THE COMMISSION

That the institutional cost burden on First-Class Letter Mail has risen from FY 1988 through FY 1999, and at an accelerating rate in recent years, has produced substantial additional revenues for the Postal Service. More significantly, the additional revenue contributed by First-Class Letter Mail to the Postal Service's institutional costs has exceeded the revenue contribution intended by the Commission.

In its Opinion and Recommended Decision in Docket No. R94-1, the Commission suggested the importance it placed on the role of cost coverages and mark-up indices in setting rates. There, the Commission expressed the belief that "setting target coverages [for First Class and third class mail] reasonably near the systemwide average represents the best accommodation of the section 3622(b) factors."[9] Moreover, the Commission concluded that, in the determination of rates, the mark-up relationships recommended in Docket No. R90-1 were a better guide to sound ratemaking than the prior rate relationships, for purposes of the section 3622(b) factors.[10]

Table 10 presents the systemwide average cost coverage for all mail classes and services, and the cost coverage and mark-up index for First-Class Letters, recommended by the Commission in several recent opinions. Using the systemwide average cost coverage recommended by the Commission as a "benchmark," it would

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9 PRC Op. R94-1, ¶4041.

10 *Id.*, ¶4043.

be possible to measure the excess revenue contributed to institutional costs by First-Class Letters.

Table 10
SYSTEMWIDE AVERAGE AND FIRST-CLASS LETTERS COST COVERAGE AND MARK-UP INDEX FROM SELECTED COMMISSION RECOMMENDED DECISIONS

	R-87	R-90	R-94	R-97
Systemwide Average Cost Coverage	148.3%	150.0%	156.9%	155.3%
First-Class Letters Cost Coverage	158.0%	161.7%	174.5%	172.4%
First-Class Letters Mark Up Index	1.200	1.235	1.310	1.308

Rather than measuring the excess revenues using the systemwide average cost coverage, a more conservative approach might consider the First-Class Letters cost coverage recommended by the Commission as "reasonably near" the systemwide average. For purposes of measuring the change in revenue, I calculate an average mark-up using the First-Class Letters mark-up index figures in Table 10. The conversion of the First-Class Letters cost coverage to a mark-up index is shown in the last line of Table 10.[11] Averaging the First-Class Letters mark-up index for all four rate cases (PRC Ops. R87-1 through R97-1) results in an average mark-up index of 1.263.

Using this 12-year average First-Class Letters mark-up index as a "benchmark," First-Class Letter Mail has contributed net additional revenues in the amount of $6.8 billion to the institutional costs of the Postal Service during the period FY 1988 through

[11] A systemwide average cost coverage would, of course, have a mark-up index of one.

FY 1999. This excess contribution has accelerated in recent years. Moreover, the amount of net additional revenues to be contributed from FY 1988 through the test year is expected to reach $11.2 billion.

Table 11 summarizes the annual contribution of First-Class Letter Mail to the institutional costs of the Postal Service, both greater than and less than the amount intended by the Commission, based upon the average First-Class Letters mark-up index benchmark. The amounts reported in Table 11 take into account the generally higher level of costs attributed by the Commission to mail classes than that of the Postal Service.[12]

Table 11
ANNUAL CONTRIBUTION TO INSTITUTIONAL COSTS BY FIRST-CLASS LETTERS IN EXCESS OF THE AVERAGE FIRST-CLASS MARK-UP INDEX
(amounts in millions)

1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	*Estimated 2000*	*2001*	Total 1988-99	1988-2001
$116	$555	$908	$522	$698	$685	$117	($747)	($354)	$599	$1,769	$1,964	$2,682	$1,729	$6,833	$11,245

[12] The specific adjustment factors and use of the Commission's version of the CRA that produce the higher level of attributable costs can be found in Table B, located in Part I of OCA-LR-3.

III. TO MITIGATE THE INCREASING INSTITUTIONAL COST BURDEN ON FIRST-CLASS LETTER MAIL, THE COMMISSION SHOULD MAINTAIN THE SINGLE-PIECE FIRST-CLASS RATE AT 33 CENTS

The Commission should mitigate the increasing institutional cost burden on First-Class Letter Mail by maintaining the single-piece First-Class rate at 33 cents. Maintaining the current single-piece First-Class rate will reduce the institutional cost burden on First-Class Letter Mail,[13] and directly benefit consumers, as revenues contributed by single-piece letters will decline by approximately $607 million.[14] Even with a 33 cent First-Class rate, the mark-up index will be approximately 1.452.[15]

A Commission decision to maintain the current single-piece First-Class rate will moderate the very high institutional cost burden that results from the Postal Service's proposed increase. Moreover, such a decision is supported by declining Postal Service costs for First-Class Letter Mail, and standards of fairness and equity.

A. The Proposed Increase in Rates for First-Class Letters Preserves the Already High Institutional Cost Burden on First-Class Letter Mail

The Postal Service's proposed increase in rates for First-Class Letter Mail largely preserves the status quo with respect to the institutional cost burden being borne by

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[13] There are, of course, other options for reducing the institutional cost burden on First-Class Letter Mail. These include reducing the extra ounce rate, reducing the current presort discounts, or increasing the "passthroughs" for presort mail. However, these options would be less beneficial for consumers.

[14] For single-piece letters, (($22,746,522 - $22,169,105) + ($167,072 - $137,713)), or single-piece ((TYAR revenues - TYBR revenues) + (TYAR Fees - TYBR Fees)). USPS-LR-I-169 (revised 4/17/00), at 2. The reduction in revenues for the entire First-Class Letter Mail subclass is approximately $1.076 billion (($35,976,352 - $34,933,727) + ($189,592 - $156,588)), or subclass ((TYAR revenues - TYBR revenues) + (TYAR Fees - TYBR Fees)). *Id.*

[15] Attachment USPS-32A (revised 4-12-00), adjusted for OCA costs. I will recalculate this mark-up index figure at the time OCA witness Thompson (OCA-T-9) files supplemental testimony concerning PESSA costs.

First-Class Letter Mail. In the test year, the Postal Service proposes a cost coverage for First-Class Letters of 197 percent. This is the same as the actual cost coverage for First-Class Letters in FY 1999 (see Table 1).

Similarly, when measured by the mark-up index, the proposed First-Class Letter institutional cost burden remains high in the test year. The First-Class Letter institutional cost burden is expected to rise from 1.439 in FY 1999 to 1.469 in FY 2000, and then decline to 1.422 in the test year. This mark-up index number is higher than the mark-up index for all but the two preceding years covered by this analysis (see Table 2). A review of the First-Class Letter cost coverage index reveals a similar change (see Table 3).

The institutional cost burden proposed for First-Class Letter Mail also remains high by comparison to Standard (A) Regular mail. Comparing mark-up indices, the First-Class Letter mark-up index in the test year remains near its actual historic high in FY 1999. By contrast, the Standard (A) Regular mark-up index in the test year is lower than in FY 1999.

B. The Proposed Increase in Rates for First-Class Letters Cannot be Justified by Higher Postal Service Costs

The Postal Service's proposed increase in the rates for First-Class Letters is not justified by reference to Postal Service costs for First-Class Letters. Costs for First-Class Letter Mail as a share of total postal costs have declined during the period covered by this analysis.[16] Moreover, the decline has accelerated in recent years.

[16] The decline in First-Class letter mail costs is confirmed by a separate analysis prepared by the Postal Service at the request of the Commission. That analysis shows unit mail processing (and city (continued on next page)

Table 12 and accompanying Figure 10 compare the attributable and institutional costs for First-Class Letters as a percent of total postal costs. Table 12 reveals that the First-Class Letter Mail attributable costs as a percentage of the total have declined from 52.98 percent to 45.71 percent during the 12 year period from FY 1988 through FY 1999. First-Class Letter attributable costs are expected to decline still further, to 44.99 percent in the test year. Moreover, the decline in First-Class Letter attributable costs is most apparent in recent years. Since FY 1995, First-Class Letter Mail costs have declined continuously from 53 percent and are expected to be 44.99 percent of total postal costs in the test year.

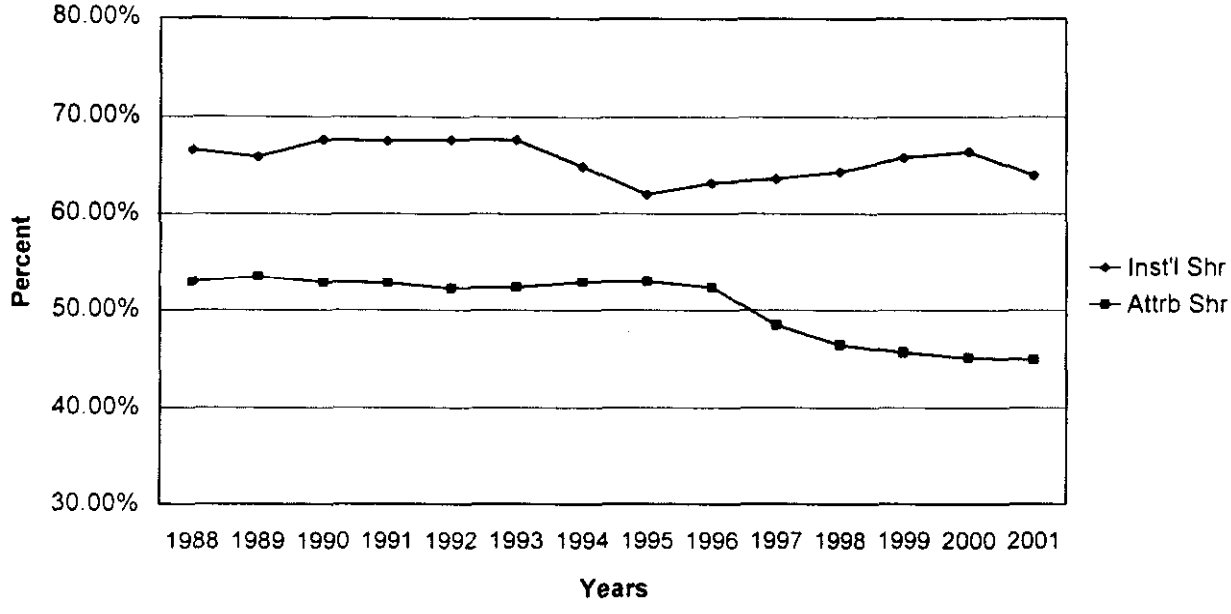
By contrast, First-Class Letter Mail institutional costs have remained nearly constant as a percent of the total institutional costs of the Postal Service. As Table 12 shows, First-Class Letter Mail institutional costs have declined slightly from 66.52 percent to 65.76 percent during the same 12 year period. First-Class Letter Mail institutional costs are expected to decline to 63.96 percent in the test year.

carrier in-office activity) costs for First-Class letter-shaped mail declining over the entire 11 year period between 1989 and 1999. *See* Response of Postal Service Witness Smith to Presiding Officer's Information Request No. 4, March 17, 2000, Question 1, Attachment at 1.

Table 12
COMPARISON OF INSTITUTIONAL AND ATTRIBUTABLE COST SHARES FOR FIRST-CLASS LETTERS

First-Class Letters	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Inst'l Shr	66.52%	65.83%	67.58%	67.44%	67.57%	67.57%	64.88%	61.98%	63.15%	63.60%	64.30%	65.76%	66.36%	63.96%
Attrb Shr	52.98%	53.53%	52.91%	52.84%	52.27%	52.40%	52.94%	53.00%	52.37%	48.52%	46.47%	45.71%	45.17%	44.99%

Figure 10: Comparison of Institutional and Attributable Cost Shares for First-Class Letters



C. Reducing the High Institutional Cost Burden on First-Class Letters Would Enhance Fairness and Equity

The first pricing criterion in section 3622(b) of the Postal Reorganization Act requires that consideration be given to the establishment and maintenance of a fair and equitable rate schedule. The placement of the "fairness and equity" criterion as the first of nine criteria suggests its importance in establishing rates.

Simple fairness suggests that the institutional cost burden for First-Class Letter Mail be mitigated. The cost coverage for First-Class Letter Mail has risen rapidly in recent years and will remain high by historic standards through the test year. Moreover, the attributable costs of First-Class Letters as a percent of total postal costs continues

to decline through the test year, while institutional costs of First-Class Letters as a percent of the total will remain high through FY 2000, before declining. Maintaining the single-piece First-Class rate at 33 cents would achieve the goal of moderating the First-Class Letter institutional cost burden in a manner providing the most benefit to consumers.

The Commission should mitigate the institutional cost burden on First-Class Letter Mail by considering the relationship between the recommended and actual institutional cost burden on First-Class Letter Mail. As shown in Table 4, the institutional cost burden on First-Class Letters has exceeded that intended by the Commission, as measured by the Commission-recommended mark-up index, for all but three of the 12 years from FY 1988 through FY 1999. Moreover, the actual First-Class Letter mark-up index has exceed the average Commission-recommended mark-up index in all but five of the past 12 years. The result has been substantial net additional revenues of $6.8 billion contributed to the institutional costs of the Postal Service by First-Class Letter Mail since FY1988. It bears emphasizing that this $6.8 billion in revenues contributed by First-Class Letter Mail is in excess of the amounts intended by the Commission.

The trend of a higher institutional cost burden borne by First-Class Letter Mail in excess of that intended by the Commission, on balance, requires mitigation. It would be appropriate for the Commission to consider this fact in determining the institutional cost burden on First-Class Letters. Moreover, such consideration would be consistent with criterion 9, which permits the Commission to consider such other factors as it deems appropriate.

IV. CONCLUSION

First-Class Letter Mail has been carrying an increasing burden of the institutional costs of the Postal Service. Using virtually any measure of institutional cost, the institutional cost burden borne by First-Class Letter Mail has risen during the past 12 years, and has become more prominent recently. The growth in institutional costs has occurred as the cost of First-Class Letter Mail has declined. Similarly, the institutional cost burden on First-Class Letter Mail has increased relative to the institutional cost burden on Standard (A) Regular Mail.

Moreover, the institutional cost burden on First-Class Letter Mail has grown relative to the institutional cost burden intended by the Commission, as expressed in several recent recommended decisions. As a result, First-Class Letter Mail has contributed net additional revenues in the amount of $6.8 billion to the institutional costs of the Postal Service during this 12 year period. Through the test year, the total net additional revenue is expected to reach $11.2 billion.

The increasing institutional cost burden on First-Class Letter Mail should be mitigated. For that reason, I propose that the single-piece First-Class rate be maintained at 33 cents. Doing so would reduce the institutional cost burden on First-Class Letter Mail, and provide the most benefit to individual and smaller mailers. In mitigating the increasing institutional cost burden, consideration should be given to the greater share of institutional costs borne by First-Class Letter Mail than intended by the Commission in the pricing of First-Class Letter Mail.

PART II

I. HOUSEHOLDS AND BUSINESS MAILERS HAVE DIFFERENT INTERESTS WITH RESPECT TO CHANGES IN THE FIRST-CLASS RATE

Changes in the First-Class rate generate differing concerns for households and business mailers. Consequently, households and business mailers have different interests with respect to such changes. The differing interests of households and business largely reflects their differing reliance on First-Class Mail.

Households rely on First-Class Mail more so than any other class of mail. Virtually all pieces mailed by households are mailed at single-piece rates. The average household mails approximately twelve First-Class Mail pieces per month.[17] In percentage terms, however, households mailed only 16.1 percent of the 101.4 billion pieces of First-Class Mail in 1999.[18]

By contrast, business mailers sent 82.7 percent of all First-Class Mail pieces,[19] a substantial portion of which were mailed at discounted rates that require entry in minimum quantities. Consequently, for many business mailers, rates paid for First-Class Mail represent a major item of cost and, as a result, occupy considerable management attention.

Not surprisingly, therefore, household and business mailers have different interests related to the amount and timing of rate changes related to First-Class Mail.

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[17] 1998 Household Diary Study, USPS-LR-116, p. I-8.

[18] USPS-T-6 (Tolley) at 25-26.

[19] *Id.*, at 25.

The response of the Postal Service to these differing interests is to propose rate adjustments on a more frequent and predictable basis.

A. Households Prefer Longer Periods of a Stable Single-Piece First-Class Rate

As less frequent users of First-Class Mail, households have an interest in preserving the single-piece First-Class ("SPFC") rate as long as possible.[20] Maintaining a stable SPFC rate is a matter of convenience and economy, and can minimize confusion, for household mailers.

1. Longer periods of rate stability reduce inconvenience for household mailers

Changes in the SPFC rate can be inconvenient to household mailers. A change in the single-piece rate is accompanied by new postage stamps related to First-Class. New stamps are issued for both the new single-piece rate and the difference between the old and new single-piece rates, *e.g.*, the "make-up" stamp.[21] The rate change requires the purchase of the new denomination of stamps that would otherwise be unnecessary in the absence of the rate change. In the past, retail post offices have often been crowded by household (and smaller-volume) mailers seeking to obtain the

[20] Some non-household smaller mailers whose volumes do not qualify for worksharing discounts, or whose volumes while sufficient, mail infrequently, may also view a more stable single-piece first-class rate favorably.

[21] Traditionally, the postal service has printed new first-class stamps bearing alphabetic rather than numeric denominations in advance of the commission's opinion, assigning a value once the decisions of commission and board of governors is known. This practice is being discontinued. After Docket No. R2000-1, the Postal Service will issue stamps bearing the new single-piece First-Class rate. Tr. 21/9104-05 (USPS Response to OCA/USPS-62).

new denomination stamps at the time of implementation.[22] Moreover, to the extent that household mailers have "left over" stamps of older denominations at the time of implementation, a hidden cost is imposed on households when such stamps go unused.

2. Longer periods of rate stability minimize confusion to household mailers

The prospect of more frequent rate changes can create confusion for household mailers—at least for a time after implementation. Where household mailers have "left over" stamps of older denominations (some of which may be non-denominated), the purchase of the new or "make-up" stamps introduces separate First-Class stamp "inventories." If the wrong denomination or non-denominated stamp is chosen, there is the possibility of inadvertent over or underpayment of postage. Longer periods of rate stability would minimize the need to purchase new stamps and therefore minimize confusion over the then-effective rate, at least in the period immediately following a rate change.

B. To the Extent Increased First-Class Rates Are Necessary, Smaller, More Frequent and Predictable Rate Adjustments Are Preferred by Business Mailers

Rate increases pose a different set of problems for business mailers compared to households. In particular, large rate increases can be disruptive to business' management, customer relationships and planning.

[22] Wilson, Scott. "In For A Penny (Stamp), In For A Long Wait," *Washington Post*, January 12, 1999, at B1.

1. More frequent rate increases minimize the likelihood of sharp increases in mailers' costs

Postal rates represent costs to business mailers. For some business mailers, large rate increases can mean sharply increased costs. Generally, such increases cannot be absorbed without affecting other aspects of business, including investments and prices charged to customers, among others. By contrast, smaller rate increases minimize the likelihood of sharp increases in mailers' costs and, consequently, the likelihood of price increases or other adjustments related directly to large increases in postage costs. To the extent postal prices are expected to increase, the possibility of larger rate increases exists as the duration between rate proceedings is extended. In the alternative, increases in smaller increments would require more frequent rate adjustments. Smaller, more frequent rate increases could avoid steeper general increases which might otherwise be necessary if rates were adjusted on a less frequent basis.

2. More predictable rate increases facilitate business planning

Uncertainty with respect to the timing of rate changes compounds concern about the amount of any rate change. As a result, business planning can be adversely affected. Where rate increases are larger as a consequence of an extended period between rate proceedings, planning for offsetting cost reductions, estimating the return on new investments, and planning the "best time" to raise prices on products or services (rather than immediately in response to a rate change) is made more difficult. More predictable rate increases can aid orderly business planning.

C. The Postal Service Recognizes That Business Mailers Desire Smaller, More Frequent and Predictable Rate Adjustments

In response to the desires of business mailers, the Postal Service is planning future rate adjustments on a more frequent and predictable basis—approximately every two years. Recently, it was reported that Deputy Postmaster General John Nolan, in a speech to the Direct Marketing Association, stated that postal management is beginning to plan for the 2003 and 2005 rate cases.[23] Previously, in estimating volumes in response to a request of the General Accounting Office (GAO), the Postal Service assumed rate increases would become effective beginning in January 2001, and every two years thereafter, *e.g.*, January 2003, 2005 and 2007.[24] Moreover, if recommended by the Commission, implementation of the proposed rate changes from this proceeding in January 2001 would be consistent with a two-year rate cycle, as the increases resulting from Docket No. R97-1 took effect in January 1999.

Business mailers expect the Postal Service to propose smaller, more frequent and predictable rate increases in the future. One association of business mailers considers smaller, more frequent rate increases to be postal "policy."[25] The Postal Service's proposals in Docket No. R97-1 are considered by some mailers to be

[23] Odell, Patricia. "USPS to Cut Jobs and Reevaluate Property," *DirectNewsLine*, May 3, 2000. *See also* Association for Postal Commerce, *PostCom Bulletin*, 21-00, May 5, 2000; and, Alliance of Nonprofit Mailers, *Alliance Report*, 00/14, May 10, 2000.

[24] *See* LR-I-179, p. 5.

[25] Letter of American Mail Marketing Association to the USPS Board of Governors, October 4, 1999.

responsive to the "longstanding desire of business mailers" for smaller, more predicable rate increases.[26]

Moreover, the expectation that rate increases will occur every two years appears to be widely held. According to the publication *Publishers Auxiliary*:[27]

> Another [rate] case will come two years after [the current case], since some in the postal community sought smaller, more frequent rate increases, and the Postal Service has responded with just such more frequent rate increases.

[26] Letter of Time, Inc. to the USPS Board of Governors, May 21, 1998.

[27] Boone, Xenia. "Major Shifts Seen In Public Policy Concerns," *Publishers Auxiliary*, April 3, 2000, at 1.

II. THE DIFFERING INTERESTS OF HOUSEHOLD AND BUSINESS MAILERS CAN BE ACCOMMODATED BY ADJUSTING THE SINGLE-PIECE FIRST-CLASS RATE EVERY OTHER RATE PROCEEDING

Household mailers seek the convenience and simplicity that would be promoted by maintaining a stable single-piece First Class rate for longer periods. That business customers prefer smaller, more predictable rate increases (when necessary) suggests that rate adjustments occur on a more frequent basis. The Postal Service has responded to the desires of business mailers in this regard.

However, the differing interests of households and business mailers with respect to rate adjustments need not be viewed as irreconcilable. There is a way to accommodate the interests of households for a longer period of stable rates with business mailers' desire for smaller, more predictable adjustments. To do so, I propose that the single-piece First-Class rate be adjusted every other rate proceeding.

A. Adjusting the Single-Piece Rate Every Other Rate Proceeding Would Involve Maintaining the "Whole Cent" Integer Rate for Households and Establishing Workshare Discounts Based upon a Non-Integer Rate

Setting the single-piece First-Class rate in whole cents is a long established policy in postal ratemaking to promote convenience and simplicity for household and smaller-volume mailers.[28] Rates for presort and automation compatible mail, expressed in tenths of a cent, represent discounts from the whole cent single-piece rate. To achieve the twin goals of longer periods of rate stability for household mailers and smaller, more frequent adjustments for business mailers, the relationship between the

[28] *See* PRC Op. R94-1 at ¶5005.

single-piece integer rate and the discounted rates for presorted and automation mail must be changed.

1. The single-piece First-Class rate should be changed every other rate proceeding

As envisioned here, the single-piece First-Class ("SPFC") rate for letters and cards would be established in an initial rate proceeding (such as Docket No. R2000-1), and remain in effect during the period following the next rate proceeding. The First-Class rate would be determined in the same manner as in past proceedings, including compliance with the test year break-even requirement, with one exception. In each rate proceeding, rates for First-Class Letters, based upon an appropriate mark-up for each subclass, would be set without regard to the "integer constraint." *The rate actually paid by households, by contrast, would be set at a whole cent.* This "integer rate" would remain the same for the time period covered by the two rate proceedings, a duration of approximately four years, assuming rate cases are filed every two years. The determination of First-Class rates other than single-piece would be based on the "calculated" non-integer rate in each rate proceeding.[29]

2. The difference between the "whole cent" integer rate and the non-integer "calculated" rate would be used to maintain the single-piece rate during the period following the second rate case

The SPFC integer rate established during the first rate proceeding would be selected so as to generate revenues greater than if the calculated non-integer rate were used for SPFC mail. The additional revenues generated would permit maintenance of

[29] For purposes of this testimony, I refer to estimation of costs and application of the pricing criteria as the "calculated" single-piece non-integer rate, as distinguished from the integer rate.

the SPFC integer rate through two rate cases. A positive balance would be created during the first rate case period and recorded in a "SPFC Reserve Account" on the books of the Postal Service. This amount would be the difference between the calculated non-integer rate and the SPFC integer rate, multiplied by the volume of single-piece letters.

If, during the second rate proceeding, maintenance of the same SPFC integer rate causes a revenue "deficiency," the positive balance in the SPFC Reserve Account would be used to make up the difference. The deficiency would be the difference between the new calculated non-integer rate established in the second rate proceeding and the SPFC rate previously established, multiplied by the volume of single-piece letters.

At the time of the third rate proceeding, when it would again be time to change the SPFC integer rate, the balance in the SPFC Reserve Account, positive or negative, would be taken into account in setting the new SPFC rate.

3. De-linking workshare discounts from the "whole cent" integer rate would more accurately reflect costs

Currently, the single-piece rate is the reference point for establishing all workshare discounts. Rates for workshare mail are based upon estimated cost savings and the percentage of those savings "passed-through" in discounts from the single-piece rate. Under this proposal, rates for workshare mail would be established by reference to the calculated non-integer rate in each rate case, set at one or more decimal places, rather than the whole cent integer rate used for SPFC mail. Rates for workshare mail would, therefore, more accurately reflect costs. During the period rates

from the first rate case are in effect, the result would be lower discount rates for workshare mail compared to the SPFC rate. In the second rate period, presuming postal costs rise in the interim, the calculated non-integer rate would also likely increase to a new level. If the size of the discount, determined by reference to the calculated non-integer rate, remains the same, the rates for workshare mail will increase while the SPFC integer rate paid by households remains unchanged. In effect, workshare discounts would shrink vis-à-vis the SPFC rate during the second rate period.

B. The Operation and Effect of Separating the Timing of Rate Adjustments for Household and Business Mailers can be Illustrated

Changing the SPFC rate every other rate proceeding while rates for workshare mail change each rate case will affect First-Class revenues and volumes. In particular, the changes in workshare discounts will vary workshare volumes, affecting certain business mailers. These changes can be illustrated.

1. First-Class revenues will vary, and volume will shift between single-piece and workshare

Table 13 illustrates the operation of this proposal and its effect on revenues. In the first rate change, Year 2001, the calculated single-piece non-integer rate (based upon the litigated revenue requirement, costing and pricing, etc.) is assumed for purposes of illustration to be 33 cents. After determining the calculated rate, a SPFC rate of 34 cents might be recommended and then held constant through the following rate case. The difference between the 34 cent SPFC rate and the calculated single-piece rate of 33 cents would be multiplied by the SPFC mail volume each accounting period to determine the amount of revenues credited to the SPFC Reserve Account for

that accounting period. Table 13 shows, for Years 2001 and 2002, the annual and cumulative total revenue credited to the SPFC Reserve Account.

Based upon a two-year rate cycle, the next rate case would be in Year 2003 in this example. In that rate proceeding, the litigation might result in a calculated single-piece rate of 34.8 cents. However, the SPFC rate charged consumers remains at 34 cents. The difference, now a negative 0.8 cents, is multiplied by the SPFC volume in each accounting period to determine the amount debited from the SPFC Reserve Account for that accounting period. In effect, the positive balance in the SPFC Reserve Account generated during the first rate case is used to "make-up" the expected revenue deficiency during the next rate case period. This effect is also shown in Table 13, for Years 2003 and 2004, where the total balance in the SPFC Reserve Account declines.

Table 13
ILLUSTRATIVE ANNUAL AND TOTAL CHANGE IN ESTIMATED REVENUES IN SPFC RESERVE ACCOUNT DURING TWO RATE CASES
(volumes and amounts in millions, except rates)

	Year 2000	*Year 2001*	Year 2002	*Year 2003*	Year 2004
Calculated Single-Piece Rate [1]		$0.330	$0.330	$0.348	$0.348
SPFC Rate [2]	$0.33	$0.34	$0.34	$0.34	$0.34
Difference [3]		$0.010	$0.010	-$0.008	-$0.008
SPFC Volume [4]	53,378	51,727	51,023	52,846	50,137
SPFC Reserve Acct - Annual [5]		$517	$510	-$423	-$401
SPFC Reserve Acct - Total [6]		$517	$1,027	$605	$204

In the third rate case, when the SPFC rate is expected to change, the balance in the SPFC Reserve Account, positive or negative, would be considered in deciding the new SPFC rate.

Over a two rate case cycle, volume will shift to and from single-piece and workshare categories. By holding the SPFC integer rate constant through two rate

cases as proposed, the workshare discount "cycles" up and down compared to the SPFC rate with each rate case (although the amount of the discount relative to the calculated single-piece rate is assumed not to change). In the first rate case, when the SPFC rate is greater than the calculated single-piece rate, there is a larger workshare discount. In theory, this should generate more workshare mail. The opposite effect results when the SPFC rate is less than the calculated single-piece rate after the second rate case, creating a smaller discount relative to the SPFC rate.

Table 14 illustrates the changing SPFC and workshare volume over a period of two rate cases. For purposes of Table 14, a discount for workshare mail of 6 cents (Automation Basic), representing the difference between the calculated single-piece rate and the workshare rate, is assumed. It is also assumed that the discount remains constant at 6 cents during the entire four year period.

Part A of Table 14 shows the SPFC integer rate of 34 cents and resulting volumes, and assumes the 34 cent rate remains constant for the duration of two rate cases—a period of four years in this example. The workshare rates and volumes are also shown. Part B shows the calculated single-piece non-integer rate and volumes and the workshare rate and volumes. The calculated single-piece rate is assumed to change from 33 cents in Years 2001 and 2002 to 34.8 cents in Years 2003 and 2004 for purposes of this illustration. In Year 2001, when the SPFC rate is 1 cent greater than the calculated single-piece rate and the workshare discount is 7 cents, there is an estimated 3.2 percent reduction in SPFC volume and a 3.5 percent increase in workshare volume. Total First-Class volume would decline by 21 million pieces, and then increase by 75 million in Year 2002. In 2003, when the SPFC rate is 0.8 cents

1 less than the calculated single-piece rate and the effective workshare discount
2 becomes 5.2 cents, there is an 1.8 percent increase in SPFC volume, and a 2.2 percent
3 decrease in workshare volume. Total First-Class volume would decrease by 54 million
4 in 2003 and by 93 million in 2004. Over the entire four year period, total First-Class
5 volume would decrease by 89 million. The resulting changes in SPFC and workshare
6 volume can be seen in Part C of Table 14.

Table 14
ILLUSTRATIVE CHANGE IN ESTIMATED SINGLE-PIECE AND WORKSHARE VOLUME DURING TWO RATE CASES
(volumes and amounts in millions, except rates)

PART A: SPFC INTEGER RATE

SPFC Integer	Year 2000		*Year 2001*		Year 2002		*Year 2003*		Year 2004		2001-2004
Rate	Rate	Volume	Rate	Volume	Rate	Volume	Rate	Volume	Rate	Volume	Total
SPFC	$0.33	53,378	$0.34	51,727	$0.34	51,023	$0.34	52,846	$0.34	50,137	205,733
Workshare	$0.27	45,253	$0.270	46,883	$0.270	49,024	$0.288	45,526	$0.288	44,899	186,332

PART B: CALCULATED SINGLE-PIECE NON-INTEGER RATE

Calculated Non-	Year 2000		*Year 2001*		Year 2002		*Year 2003*		Year 2004		2001-2004
Integer Rate	Rate	Volume	Rate	Volume	Rate	Volume	Rate	Volume	Rate	Volume	Total
Single-Piece	$0.33	53,378	$0.330	53,378	$0.330	52,651	$0.348	51,898	$0.348	49,238	207,164
Workshare	$0.27	45,253	$0.270	45,253	$0.270	47,320	$0.288	46,529	$0.288	45,887	184,990

PART C: CHANGE IN VOLUME AND PERCENT BETWEEN SPFC AND WORKSHARE

	Year 2000		*Year 2001*		Year 2002		*Year 2003*		Year 2004		2001-2004	
	Volume	Percent	Volume	Percent	Volume	Percent	Volume	Percent	Volume	Percent	Volume	Percent
SPFC			(1,651)	-3.2%	(1,628)	-3.2%	948	1.8%	899	1.8%	(1,431)	-0.70%
Workshare			1,629	3.5%	1,704	3.5%	(1,002)	-2.2%	(989)	-2.2%	1,342	0.72%
Net Change			(21)		75		(54)		(89)		(89)	

7 2. The shifting of volumes between single-piece and workshare
8 results from changes in the "calculated" single-piece non-integer
9 rate and the size of the workshare discount

10 Mail volumes shifting between single-piece and workshare will alternately
11 increase and decrease with changes in the workshare rate relative to changes in
12 calculated single-piece rate and SPFC rate. A change in the size of the workshare
13 discount compared to the SPFC rate shifts volumes to and from SPFC and workshare

mail. In the first rate case, where the discount is "large," workshare volume increases while SPFC volume decreases. This occurs because the SPFC integer rate is above the calculated single-piece rate. The higher SPFC rate reduces SPFC volume and offsets the increase in workshare volume. During the second rate period, when the SPFC rate is held constant, the rate for single-piece mail is declining on a real basis, causing SPFC volume to increase. This occurs because the SPFC rate is below the calculated single-piece rate, such that the workshare discount is smaller vis-à-vis the SPFC rate. Consequently, the SPFC volume increase offsets the volume-reducing effect of workshare mail shifting to single-piece because of the lesser discount.

Table 15 shows the magnitude of the change in SPFC and workshare volumes as the difference between SPFC rate and calculated single-piece rate change, and the size of the discount changes. More specifically, the effect of varying the SPFC rate by plus/minus 2 cents, in one quarter cent increments, from the calculated single-piece rate is shown. Again, the illustrated workshare discount (for Automation Basic), determined from the calculated single-piece rate, is assumed to remain constant at 6 cents. However, the workshare discount increases and decreases compared to the SPFC rate.

In Table 15, when it is assumed the SPFC integer rate is 2 cents greater than the calculated single-piece rate of 33 cents, the effective discount rate expands to 8 cents. The maximum reduction in SPFC volume is 3.281 billion, while workshare volume increases by 3.258 billion. Similarly, when it is assumed the SPFC integer rate is 2 cents less than the calculated single-piece rate of 33 cents, the effective discount rate decreases to 4 cents. The result: SPFC and workshare volumes shift in opposite

directions, with SPFC volumes increasing by a total of 3.360 billion and workshare volume decreasing by 3.258 billion. Overall, however, total First-Class Mail volume does not vary by more than 102 million pieces per year.

Table 15
ILLUSTRATIVE EFFECT OF CHANGE IN SPFC RATE ON SHIFT IN ESTIMATED SINGLE-PIECE AND WORKSHARE VOLUME
(volumes in millions)

Rate Difference	Workshare Discount	SPFC Volume Change	Workshare Volume Change	Net Volume Change	SPFC Volume % Change	Workshare Volume % Change	Net Volume % Change
-$0.0200	$0.0400	3,360	(3,258)	102	6.3%	-7.2%	0.103%
-$0.0175	$0.0425	2,936	(2,851)	85	5.5%	-6.3%	0.086%
-$0.0150	$0.0450	2,513	(2,444)	69	4.7%	-5.4%	0.070%
-$0.0125	$0.0475	2,091	(2,036)	54	3.9%	-4.5%	0.055%
-$0.0100	$0.0500	1,670	(1,629)	41	3.1%	-3.6%	0.042%
-$0.0075	$0.0525	1,251	(1,222)	29	2.3%	-2.7%	0.029%
-$0.0050	$0.0550	833	(815)	18	1.6%	-1.8%	0.018%
-$0.0025	$0.0575	416	(407)	8	0.8%	-0.9%	0.009%
$0.0000	$0.0600	0	0	0	0.0%	0.0%	0.000%
$0.0025	$0.0625	(414)	407	(7)	-0.8%	0.9%	-0.007%
$0.0050	$0.0650	(828)	815	(13)	-1.6%	1.8%	-0.013%
$0.0075	$0.0675	(1,240)	1,222	(18)	-2.3%	2.7%	-0.018%
$0.0100	$0.0700	(1,651)	1,629	(21)	-3.1%	3.6%	-0.022%
$0.0125	$0.0725	(2,060)	2,036	(24)	-3.9%	4.5%	-0.024%
$0.0150	$0.0750	(2,468)	2,444	(25)	-4.6%	5.4%	-0.025%
$0.0175	$0.0775	(2,876)	2,851	(25)	-5.4%	6.3%	-0.025%
$0.0200	$0.0800	(3,281)	3,258	(23)	-6.1%	7.2%	-0.024%

3. The shifting volumes between SPFC and workshare will affect certain mailers and the Postal Service

Changing rates for workshare mail while holding the SPFC rate constant will increase and decrease the volume of SPFC and workshare mail at different times. Consequently, presort mailers, and to a lesser extent, pre-barcode mailers, will be impacted, as well as the Postal Service.

With respect to the Postal Service, the shift in volume to and from SPFC mail and workshare mail from one rate case to another is likely to have little effect on total First-Class volume or overall Postal Service operations. As shown in Table 15, when

the price difference is -2 cents, the largest net percentage change in total First-Class volume is negligible at well under one percent, *i.e.*, 0.103 percent.

Nevertheless, the shift in volumes to and from SPFC and workshare would have some impact on Postal Service operations. As much as 3.4 billion pieces per year could shift between the two. However, such shifts can be anticipated and planned for, and are likely to be smaller and more gradual than seasonal fluctuations in mail volume.

With respect to presort mailers, changes in the size of the workshare discount will create cycles causing volumes and revenues to rise and fall. When the difference between the SPFC rate and the calculated single-piece rate is positive, mailers will see higher volumes and revenues, and potentially higher profits. When the difference between the SPFC rate and calculated single-piece rate is negative, however, they will operate with lower volumes and revenues and potentially lower profits.

As proposed here, the first cycle would occur when the difference between SPFC and calculated rate is positive, resulting in a period of higher workshare volumes and mailer revenues. This, in turn, should permit presort mailers to establish a financial base with which to offset lower volumes following the second rate case. Over the entire four year period, these cycles could induce greater efficiency, as some firms invest in new capital equipment during the period of higher volume in order to compete during the period of lower volumes.

C. Adjusting the Single-Piece Rate Every Other Rate Proceeding Should be Circumscribed Under Certain Circumstances

Holding the SPFC rate constant for a period of two rate cases creates a risk that the SPFC Reserve Account may prove insufficient to cover the likely revenue deficiency

during the second rate case period. This prospect becomes more likely in a period of high or rising inflation, increasing the possibility of a larger rise in the calculated single-piece non-integer rate than what otherwise might be necessary. This, in turn, could cause the workshare discount to shrink even more compared to the SPFC rate, reducing workshare volume even more.

As shown in Table 15, the largest shifts in volume could reach +6.3 percent for SPFC mail and -7.2 percent for workshare mail when the calculated single-piece rate is 2 cents greater than the SPFC rate. As noted above, a difference of this size or larger becomes more likely in an inflationary environment. Such a difference could produce a larger deficit in the SPFC Reserve Account at the end of the two rate case cycle compared to a low inflationary period. Moreover, while total First-Class volume would not change to any significant degree, a larger decrease in workshare volume could create greater difficulties for presort and pre-barcode mailers.

The possibility that the balance in the SPFC Reserve Account may be insufficient during the second rate case period suggests the need to permit an increase in the SPFC rate under certain circumstances, rather than maintaining it during the second rate case period. I propose that in circumstances where the calculated single-piece rate in the second rate case is expected to increase by more than 1.5 cents above the existing SPFC integer rate, a change in SPFC rate would be warranted. If changes in the calculated single-piece rate were limited to 1.5 cents, there would be less likelihood of a large deficit in the SPFC Reserve Account, and the volume shift between single-piece and workshare mail would be limited to approximately 5 percent, as shown in Table 15.

III. CONCLUSION

Changes in the First-Class rate generate differing concerns for households and business mailers. As a result, household and business mailers have different interests with respect to the amount and timing of rate changes related to First-Class Mail. As less frequent users of First-Class Mail, households have an interest in preserving the single-piece First-Class rate as long as possible. To the extent increased First-Class rates are necessary, business mailers prefer smaller, more frequent and predictable rate adjustments.

In order to accommodate the interests of households for a longer period of stable rates with business mailers' desire for smaller, more predictable adjustments, I propose that the single-piece First-Class rate for letters and cards be adjusted every other rate proceeding. In each rate proceeding, the First-Class rate would be determined without regard to the "integer constraint." The rate paid by households would be set at a whole cent so that revenues would accumulate in the SPFC Reserve Account during the first rate period to permit the single-piece rate to remain the same during the period after the second rate proceeding—a duration of approximately four years. Under this approach, household mailers would enjoy a longer period of rate stability while allowing business mailers smaller, more frequent and predictable rate adjustments. Moreover, accommodating the differing interests of household and business mailers in this manner can be achieved while preserving Postal management's prerogatives with respect to rate changes.

Changing the SPFC rate every other rate proceeding while rates for workshare mail change each rate case will cause volumes to shift between single-piece and workshare. The shifting of volumes to and from single-piece and workshare could become larger in a period of high or rising inflation than might otherwise be expected. Such an outcome could create difficulties for presort and pre-barcode mailers. In order to minimize such difficulties and ensure that sufficient revenues are available to sustain the SPFC rate during the second rate case period, I propose that the SPFC rate be increased at the time of a second rate case under certain circumstances.

PART III

I. THE NONSTANDARD SURCHARGE IS NO LONGER WARRANTED FOR LOW ASPECT RATIO NONSTANDARD LETTER MAIL

The nonstandard surcharge is a classification of longstanding in the mail classification system. In Docket No. MC73-1, the Commission recommended establishment of a classification for nonstandard single-piece First-Class, Airmail and third-class mail,[30] with the amount of the surcharge to be determined in a subsequent rate proceeding.[31] In Docket No. R78-1, the Commission initially set the surcharge at 7 cents after rejecting the Postal Service's proposed surcharge of 13 cents.[32] Subsequent increases have resulted in the current nonstandard surcharge of 11 cents for single-piece First-Class Mail.[33]

The nonstandard surcharge is no longer warranted for low aspect ratio mail.[34] Advances in the technology of mail processing since implementation of the surcharge have made the surcharge obsolete with respect to low aspect ratio mail, and rendered the assumptions underlying the costing on which the surcharge is based unrealistic.

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30 PRC Op. MC73-1 at 26.

31 *Id.*, at 27.

32 PRC Op. R78-1 at 1.

33 *See* USPS LR-I-118. The first nonstandard surcharge (seven cents) was established in 1979. In Docket No. R87-1, a reduced surcharge of 5 cents per piece was established for presorted First-Class Mail.

34 I use the phrase "low aspect ratio mail" to refer to letter-size mailpieces that are nonstandard by virtue of an aspect ratio from 1:1 up to 1:1.3. Such mailpieces are square or nearly square in shape.

A. Significant Changes in Mail Processing Have Occurred Since the First Nonstandard Surcharge Was Implemented

Nonstandard mailpieces are defined by reference to several physical measurements.[35] Currently, any piece of First-Class Mail weighing one ounce or less is subject to the applicable nonstandard surcharge if it has[36]

- a thickness exceeding 0.25 inches, or
- a height exceeding 6.125 inches, or
- a length exceeding 11.50 inches.

A separate defining characteristic of nonstandard mail is the "aspect" ratio. The aspect ratio is simply the ratio of the height to the length of a mailpiece.[37] Consequently, a mailpiece not exceeding the thickness, height, and length standards (above) may nevertheless be subject to the nonstandard surcharge if it has

- an "aspect" ratio of less than 1:1.3 or more than 1:2.5.

Examples of First-Class letter-size mailpieces available to consumers that would be nonstandard by virtue of the aspect ratio "test" might include seasons greeting cards or invitations that are square (aspect ratio of 1:1) or nearly square in shape.

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[35] It should be noted that all First-Class Mail must meet certain minimum and maximum standards, or it is unmailable. *See* DMM §C010.1.2 and §C010.1.3.

[36] *See* DMM § C100.4.0.

[37] Dividing the length of a letter-size mailpiece by its height produces the aspect ratio. A letter that is square in shape has an aspect ratio of 1-to-1. A letter that is 6.5 inches long and five inches in height has an aspect ratio of 1:1.3.

These four defining limits of nonstandard mail have not changed since establishment of the classification in Docket No MC73-1.[38]

1. The nonstandard surcharge was intended to facilitate machine processing by encouraging use of standard envelopes and thus reduce costs

In recommending a classification for nonstandard mail, the Commission focused on the growing importance of mechanization to process the mail. At the time the classification was established, 56 percent of standard size letters were manually processed.[39] Accordingly, the Commission determined that

> mechanization requires that some definition of maximum size be specified for purposes of machine design and procurement. This is especially true since the Postal Service anticipates eventually moving to a fully mechanized system.[40]

The resulting maximum thickness, height, and length standards were therefore established "in order to encourage the use of standard mail pieces, and to compensate the Postal Service for the added costs of handling nonstandard items."[41] The Commission separately identified the aspect ratio as another defining characteristic of nonstandard mail because of its effect on the machinability of mail. Based upon Postal Service evidence, the Commission found "as envelopes move away from a square configuration, or an aspect ratio of 1:1, significant improvement in machinability occurs

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38 *Compare* PRC Op. MC73-1 at 26 and DMM §C100.4.0.

39 PRC Op. R78-1 at 36.

40 *Id.*, citations omitted.

41 PRC Op. MC73-1 at 26.

after a ratio of 1:1.4 to 1:1.5."[42] The Commission, however, recommended an aspect ratio of 1:1.3 as the lower bound on the range for standard mail.[43]

2. Mail processing now relies on automated equipment, permitting processing of low aspect ratio nonstandard letter mail

Technology has changed significantly the processing of mail since establishment of the nonstandard classification. Most standard letter mail was initially processed manually, with manual processing subsequently supplanted largely by Letter Sorting Machines ("LSMs"). Over time, the Postal Service's mail processing equipment has become increasingly sophisticated.[44] Virtually all LSMs have now been removed from service.[45] Letter mail is now processed almost entirely on highly sophisticated automated equipment.[46]

The importance of automation for letter mail processing is revealed by the prevalence and use of automated equipment in mail processing. The latest equipment for processing letters includes the Advance Facer Canceller System ("AFCS"), which "faces," cancels and sorts letters (and cards) into separate mailstreams for additional processing. Optical Character Readers ("OCRs") read printed addresses, print barcodes on such letters and sort the letters. There are several types of Bar Code

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42 *Id.*, at 28.

43 *Id.*

44 PRC Op. R97-1, para. 5227.

45 USPS-T-10 (Kingsley) at 3-4.

46 An exception is letter mail that, at the request of a mailer, may be processed manually by the Postal Service. *See* DMM § M130.1.5.

Sorters ("BCSs") that read letter mail with barcodes applied by Postal Service OCRs or mailers, including Mail Processing Bar Code Sorters ("MPBCSs") Delivery Bar Code Sorters ("DBCSs") and Carrier Sequence Bar Code Sorters ("CSBCSs") that can sort barcoded mail into the delivery sequence followed by the carrier.

The increasing sophistication of automated equipment permits certain nonstandard letter mail, previously unsuited for mechanized processing, to be processed on the automated equipment. In the case of low aspect ratio letter mail, there is no feature of the AFCS (or other mail processing equipment) that is designed to cull out such mail.[47] The result is that some "mail pieces with nonstandard aspect ratios will be processed correctly on the AFCS and will therefore be routed to downstream automation operations."[48] In fact, it has been shown that some seasonal greetings that are square in shape (aspect ratio of 1:1) are processed either partially, or entirely, on automated equipment.[49]

B. The Commission's Opinion in Docket No. R97-1 Found Important Reasons To Doubt the Basis for the Nonstandard Surcharge

In its Opinion and Recommended Decision in Docket No. R97-1, the Commission rejected the Postal Service's proposed 45 percent increase in the nonstandard surcharge for single-piece mail, from 11 cents to 16 cents, and the 120

47 Tr. 5/2078.

48 *Id.*

49 *See* Docket No. R97-1, Testimony of NDMS witness Haldi (NDMS-T-1), at 11-12, and Library Reference LR-NDMS-1.

percent increase for presorted mail, from 5 to 11 cents. The Commission's decision was based largely on the testimony of NDMS witness Haldi.

The Commission found "compelling reasons" for maintaining the surcharge for single-piece and presort mail at 11 and 5 cents, respectively. Specifically, the Commission questioned the "validity of the assumption that the surcharge is an operational necessity for all types of pieces now subject to it."[50] With the advance of technology, "automation capabilities have expanded, at least for low aspect ratio mail pieces."[51] The Commission also found the cost support "defective" in several respects, including, among others, the assumption of 100 percent manual processing for nonstandard letter mail.[52] The Commission concluded its analysis by admonishing, if the Postal Service "intends to continue to assess these surcharges in the future, it should provide a justification that accurately depicts the current mail processing environment."[53]

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50 PRC Op. R97-1, ¶5226.

51 *Id.*, ¶5227.

52 *Id.*, ¶5228.

53 *Id.*, ¶5230.

II. THERE IS NO COST BASIS TO APPLY THE NONSTANDARD SURCHARGE TO LOW ASPECT RATIO LETTER MAIL

The Postal Service's cost estimate justifying the proposed nonstandard surcharge is highly problematic. Specifically, the assumption that all nonstandard mail is manually processed, which assumption underlies its cost estimate for the surcharge, is unrealistic. An alternative to the Postal Service's problematic cost estimate can be developed that relies on more realistic assumptions involving estimated probabilities for the processing of low aspect ratio mail.

A. The Postal Service, Through the Testimony of Witness Miller, Presents Unrealistic Assumptions to Justify the Nonstandard Surcharge for Low Aspect Ratio Mail

The testimony of witness Miller (USPS-T-24) provides the Postal Service's cost analysis for the nonstandard surcharge. Witness Miller addresses three issues that were the subject of criticism in Docket No. R97-1 with respect to the Postal Service's nonstandard surcharge proposal: the validity of the nonstandard letter definition, the assumption of 100 percent manual processing for nonstandard letters, and cost data for mailpieces weighing less than one ounce.

Witness Miller maintains that the definition of nonstandard letter mail "is not an outdated remnant from the past."[54] He states that the current generation of letter processing equipment is designed around the existing definition of nonstandard mail, and that specific features of the AFCS cull letter mail exceeding the thickness, height, and length standards from the mailstream. Witness Miller acknowledges, however, that

[54] USPS-T-24 (Miller) at 19.

unlike letters exceeding the maximum thickness, height, and length standards, letters with a low aspect ratio cannot be culled by the AFCS. Such letters may nevertheless be rejected during subsequent processing.[55]

Witness Miller assumes, as was the case in Docket No. R97-1, that "*all* nonstandard letters are processed manually."[56] Witness Miller recognizes that this is not always true in fact, but observes that, even if it were, this assumption would make "little impact on the total results as nonstandard mail pieces are overwhelmingly flat shaped."[57]

With respect to costs, witness Miller uses average mail processing unit costs, despite the existence of testimony (USPS-T-28, Daniels) estimating mail processing unit costs for letters, flats, and parcels weighing less than one ounce. However, witness Miller rejected use of this testimony because "it may be difficult to precisely estimate CRA mail processing costs by both ounce increment and shape for low volume categories such as nonstandard First-Class Mail pieces."[58] In other words, witness Daniel's cost data by shape do not look reasonable for one-ounce pieces.

B. The Assumption that All Nonstandard Letter-Shaped Mail Is Processed Manually Is Not Justified for Low Aspect Ratio Mail

There is no basis for the Postal Service's assumption that all nonstandard letter-shaped mailpieces are manually processed. To the contrary, it is known that low

55 *Id.*, at 20-21.

56 *Id.*, at 22, emphasis added.

57 *Id.*, citation omitted.

58 *Id.*

aspect ratio letter-shaped pieces can be processed partially, if not entirely, through the Postal Service's network of automated equipment.

The assumption that 100 percent of nonstandard letter-shaped mail is manually processed is not supported by the testimony of witness Miller. Witness Miller confirms that the assumption of 100 percent manual processing for nonstandard letter mail "may not always be true" in fact.[59] With respect to low aspect ratio letters, it is clear there is some automated mail processing at least through what is known as the "outgoing primary" operation.[60] According to witness Miller, "the presence of a barcode on a delivered nonstandard letter shows that this letter has been successfully processed on either the Optical Character Reader (OCR) or the Output Sub System (OSS)."[61] This is consistent with the Postal Service's efforts to process as much letter mail as possible on automated equipment.

While the assumption of all manual processing is not realistic, the extent to which low aspect ratio mail can be successfully processed through the Postal Service's entire mail processing network is unknown. The Postal Service does not "fully understand" how the aspect ratio affects mail processing operations.[62] Nor does the Postal Service intend to undertake a study of processing operations involving low aspect ratio mail, as

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59 *Id.*

60 Tr. 7/3225.

61 USPS-T-24 at 21.

62 *Id.*, at 21.

"benefits obtained from such a study would outweigh the costs."[63] In other words, the revenue and cost associated with low aspect ratio letters are so small that the Postal Service is essentially unconcerned with what (if any) surcharge should be imposed on such mail.

C. The Assumption of All Manual Processing Should Be Replaced for Purposes of Estimating Mail Processing Costs for Low Aspect Ratio Mail

The assumption that all low aspect ratio letter mail is manually processed is not representative of mail processing by the Postal Service. The existence of a barcode on a delivered low aspect ratio mailpiece confirms there is a probability greater than zero that such mailpieces were processed on automated equipment, at least to some extent. For these reasons, the assumption of manual processing is not a realistic basis for estimating mail processing costs for low aspect ratio letter mail.

1. A high degree of automated processing is a more realistic assumption for estimating mail processing costs for low aspect ratio letter mail

In the case of one operation—the Advanced Facer Canceller System—the statistical probability of canceling and initially sorting a square mailpiece is 50 percent.[64] Theoretically, at least, there is 50 percent probability of square letters being presented for further automated mail processing after the AFCS operation. As the aspect ratio of a letter moves from 1:1 and approaches 1:1.3—the minimum aspect ratio for *standard* mail—it is reasonable to assume that this probability would increase, meaning an even

63 *Id.*, at 21-22.

64 Tr. 5/2082.

higher percentage of letters will be forwarded for further processing on automated equipment.

For purposes of estimating the volume of low aspect ratio letters suitable for automated mail processing, I assume that 50 percent of square letters, and 100 percent of letters having an aspect ratio of 1:1.3, will be forwarded to downstream automated processing operations. However, the Postal Service does not know the true percentage of low aspect ratio letters forwarded to automated processing.[65] Therefore, I have assumed that the probability of additional processing beyond the AFCS operation increases in a linear fashion as the aspect ratio of a letter increases.[66] I use selected percentages between 50 percent and 100 percent to allocate low aspect ratio letter volumes between automated and manual processing in the mail processing cost model in order to calculate a range of mail processing unit costs for low aspect ratio mail.

Table 16 presents the linear probabilities (and, therefore, the percentages) of letter mail by aspect ratio that I assume will be advanced for further processing on automated equipment.

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[65] Tr. 7/3132 (OCA/USPS-T-24-5(f)). *See also* USPS-T-24 at 21.

[66] Other probability distributions could, of course, be assumed. The probabilities of acceptance for further automated processing could be distributed exponentially; that is, probabilities would rise more dramatically as the aspect ratio approaches 1:1.3. Conversely, the probabilities could be distributed in a logarithmic fashion, resulting in a more rapid rise nearer the aspect ratio 1:1.

Table 16
PROBABILITIES ASSOCIATED WITH ASPECT RATIOS 1:1.0 TO 1:1.3, INCLUSIVE: LINEAR MODEL

Aspect Ratio (x)	Probabilities (y)
1	0.500
1.0125	0.521
1.025	0.542
1.0375	0.563
1.05	0.583
1.0625	0.604
1.075	0.625
1.0875	0.646
1.1	0.667
1.1125	0.687
1.125	0.708
1.1375	0.729
1.15	0.750
1.1625	0.771
1.175	0.792
1.1875	0.812
1.2	0.833
1.2125	0.854
1.225	0.875
1.2375	0.896
1.25	0.917
1.2625	0.937
1.275	0.958
1.2875	0.979
1.3	1.000

The probabilities associated with aspect ratios in Table 16 are also used to adjust the mail processing "acceptance rates" developed by the Postal Service and used in the mail processing cost model I have selected.[67] The linear progression of probabilities assumed here suggests that as letters move away from a square

[67] The "acceptance" and "upgrade" rates used by witness Miller are found in USPS-LR-I-162, "Accept Rates."

configuration toward an aspect ratio of 1:1.3, there is a greater probability such letters will be accepted during mail processing operations utilizing automated equipment.

2. The mail processing cost model for manual mail, with adjustments, is appropriate for estimating the costs of low aspect ratio mail

The Postal Service develops numerous mail processing cost models to estimate the unit cost of processing various types of mail.[68] I have selected the "manual" mail flow model, developed by witness Miller (USPS-T-24),[69] and adjust that model for the processing of low aspect ratio letter mail.

Several assumptions are made about the processing of low aspect ratio letter mail. Single-piece low aspect ratio letter mail is likely to be handwritten, consisting of holiday greetings or invitations sent by consumers. Moreover, nonstandard single-piece mail that is letter-shaped is likely to be entered as collection mail and, therefore, will not be identified as nonstandard by the Postal Service prior to (or during) the AFCS operation. Consequently, the manual mail flow model, after allocating low aspect ratio mail to reflect the percent of such mail forwarded from the AFCS operation, represents a more realistic model of the processing of low aspect ratio letter mail than assuming all nonstandard mail is manually processed in the "manual" model.

Table 17 presents the mail processing unit costs for low aspect ratio nonstandard letter mail based upon the manual mail flow model, as adjusted. A range of mail processing unit costs are presented along with the probabilities and aspect

68 *See* USPS-T-24, Appendix 1.

69 USPS-T-24, Appendix I at I-35.

ratios shown in Table 16. The derivation of this range of mail processing unit cost requires several adjustments in the manual cost model. As presented by witness Miller, all 10,000 mailpieces are entered at the "Outgoing Primary Manual" operation, consistent with his assumption of 100 percent manual processing. Because the true percentage of low aspect ratio letter volume receiving automated processing is unknown, I enter 100 percent, 75 percent, and 50 percent of the 10,000 mail pieces at the "Outgoing RCR." The remaining 0 percent, 25 percent, and 50 percent, respectively, of mailpieces are entered at the "Outgoing Primary Manual" operation. Moreover, the rates for "acceptance" and "upgrade" are multiplied by the probabilities associated with each aspect ratio. These changes produce the range of unit costs presented in Table 17. The specific adjustments to the manual model used to develop the unit costs for low aspect ratio letter mail are presented in my workpapers.[70]

[70] Electronic copies of the spreadsheets containing the "adjusted" manual processing model are available in OCA-LR-3, Part III.

Table 17
UNIT COSTS FOR LOW ASPECT RATIO NONSTANDARD LETTER MAIL FOR SELECTED VOLUMES ALLOCATED TO AUTOMATED MAIL PROCESSING

Probability (Percent)	Aspect Ratio	Percent of Volume Allocated to Automated and Manual Processing 100 / 0 Unit Cost	75 / 25 Unit Cost	50 / 50 Unit Cost
[1]	[2]	[3]	[4]	[5]
0.500	1	19.348	20.496	21.644
0.521	1.0125	19.177	20.368	21.559
0.542	1.025	19.000	20.235	21.470
0.563	1.0375	18.815	20.097	21.378
0.583	1.05	18.633	19.960	21.287
0.604	1.0625	18.435	19.811	21.188
0.625	1.075	18.228	19.656	21.085
0.646	1.0875	18.014	19.496	20.977
0.667	1.1	17.791	19.329	20.866
0.687	1.1125	17.571	19.163	20.756
0.708	1.125	17.330	18.983	20.635
0.729	1.1375	17.080	18.795	20.510
0.750	1.15	16.820	18.600	20.380
0.771	1.1625	16.549	18.397	20.245
0.792	1.175	16.268	18.186	20.104
0.812	1.1875	15.989	17.977	19.965
0.833	1.2	15.685	17.749	19.813
0.854	1.2125	15.368	17.511	19.655
0.875	1.225	15.039	17.264	19.490
0.896	1.2375	14.696	17.007	19.319
0.917	1.25	14.340	16.740	19.140
0.937	1.2625	13.987	16.475	18.964
0.958	1.275	13.601	16.186	18.771
0.979	1.2875	13.200	15.885	18.570
1.000	1.3	12.783	15.572	18.362

In the case of letters having an aspect ratio of 1:1.3 (*e.g.*, standard-size letter mail) that are processed entirely on automated equipment in the same manner as standard-size letter mail, the model mail processing unit cost is 12.783 cents. This unit cost is not significantly different from the average test year mail processing unit cost of

12.296 cents, based upon the CRA, presented by witness Miller.[71] Nor is this result unexpected, since letter mail of standard size (*i.e.*, 1:1.3) processed entirely on automated equipment should exhibit a model mail processing unit cost somewhat similar to the average CRA unit cost.

In the case of letters that are square in shape, where only 50 percent are presented to automated equipment, the model mail processing unit cost is 21.644 cents. The assumption of 50 percent presented for automated processing and acceptance rates adjusted by 50 percent is reasonable, and represents a "worst case" for the automated processing of square letter mail. This unit cost figure is less than the Postal Service's model mail processing unit cost, where 100 percent manual processing is assumed, of 23.941 cents.[72] Moreover, the 21.664 cents model unit cost is only 2.056 cents more than the average test year mail processing unit cost for letters weighing less than or equal to 1 ounce.[73] As a "worst case," the unit cost figure is only 9.348 cents (21.644 - 12.296) greater than the average test year CRA mail processing unit cost.

Selecting a midpoint of 75 percent for initial automated processing and adjusting accept rates to 75 percent of those of the Postal Service results in an "adjusted" manual mail processing unit cost of 18.6 cents. This unit cost figure compares with witness Miller's average test year CRA mail processing unit cost of 12.296, the manual letter

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71 Attachment USPS-T-24B (revised 3/3/2000).

72 Attachment USPS-T-24B (revised 3/3/2000).

73 Tr. 7/3234-35, Attachment USPS-T-24B (revised 4/25/2000).

mail processing unit cost of 23.941, and the 19.588 cent average test year CRA mail processing unit cost for letter-shaped pieces weighing less than or equal to 1 ounce. The largest cost difference is 6.304 cents (18.6 - 12.296), a far cry from the 11-cent surcharge sought by the Postal Service.

III. THE COMMISSION SHOULD RECOMMEND ELIMINATION OF THE NONSTANDARD SURCHARGE FOR LOW ASPECT RATIO NONSTANDARD LETTER MAIL

The nonstandard surcharge for low aspect ratio letter mail should be eliminated. The surcharge is no longer warranted for such mail based upon the costs of mail processing. As the testimony of witness Miller makes clear, low aspect ratio letter mail can be processed at least partially on automated mail processing equipment. Moreover, the assumption of all manual processing of low aspect ratio mail, and the resulting estimated mail processing costs for such mail, are unrealistic. Finally, the lost revenue resulting from elimination of the nonstandard surcharge for low aspect ratio mail is minuscule.

A. The Reduction in Revenues Associated With Eliminating the Nonstandard Surcharge for Low Aspect Ratio Letter Mail Is Minimal

Eliminating the 11 cent nonstandard surcharge for low aspect ratio letter mail would slightly reduce First-Class Mail revenues to the Postal Service. In the test year after rates (TYAR), the total volume of nonstandard single-piece First-Class mailpieces is 360,307,000.[74] Assuming all nonstandard mailpieces were low aspect ratio letters, the total estimated reduction in revenue in the test year after rates would be $39,634,000.[75]

A more realistic estimate of the reduction in revenue to the Postal Service would consider only letter-shaped pieces. Nonstandard letter-shaped mailpieces represent

[74] USPS-LR-I-169, at 4, revised 4/17/00.

[75] *Id.*

17.41 percent of the total nonstandard single-piece First-Class volume.[76] In the test year after rates, nonstandard letter-shaped volume would equal 62,718,000 (360,307,000 * 0.174068). However, the volume of letter-shaped pieces that are low aspect ratio letters is unknown. Assuming all 62,718,000 nonstandard letter-shaped pieces were low aspect ratio letters, the estimated revenue loss would be $6,899,000 (62,718,000 * $0.11).

B. Elimination of the Nonstandard Surcharge for Low Aspect Ratio Letter Mail is Consistent With the Classification Criteria of the Postal Reorganization Act

Eliminating the nonstandard surcharge for low aspect ratio letter mail is justified from a review of the classification criteria, found in Section 3623(c), of the Postal Reorganization Act. In developing my proposal, I have considered the relevant classification criteria. Elimination of the nonstandard surcharge for low aspect ratio letter mail reflects my judgment as to the application of those criteria.

The low aspect ratio as a defining characteristic of nonstandard mail is no longer warranted. Removing this defining characteristic of nonstandard mail (and eliminating the surcharge on such mail) from the DMCS would promote fairness and equity for consumers mailing low aspect ratio nonstandard mail (Criterion 1). Given the huge variance in cost estimates for low aspect ratio letters and the refusal of the Postal Service to conduct a future study that could reduce that variance, it is patently unfair to impose an 11-cent surcharge on low aspect ratio letters.

[76] Attachment USPS-T-24B (revised 3/3/2000).

In the test year after rates, the combined rate for low aspect ratio nonstandard letter mail would amount to 45 cents (34 cents + 11 cents). This amount far exceeds the test year after rates average cost per piece of 25.2 cents ($13,326,042 / 52,877,657) for all single-piece First-Class Letters.[77] In fact, under the "worst case" assumptions presented above, a test year single-piece rate of 34 cents is approximately one-half cent less than the total estimated cost to process low aspect ratio letter mail of 34.548 cents (25.20 cents + 9.348). Moreover, the effect of eliminating the surcharge on First-Class revenues would be negligible, and would not materially affect the cost coverage of single-piece First-Class Mail.

The low aspect ratio characteristic that defines certain nonstandard mail as a special classification is no longer justified (Criterion 2). The technology of mail processing has improved to the point that low aspect ratio letter mail is processed in much the same manner as standard-size letter mail. Consequently, this provision is no longer desirable from the point of view of consumers (Criterion 5). Consumers are charged extra for low aspect ratio letter mail that requires little (if any) special processing. And, elimination of the nonstandard surcharge on low aspect ratio letters would simplify the First-Class rate structure, and be more convenient for consumers. Moreover, from the point of view of the Postal Service, imposing a surcharge on low aspect ratio letter mail is unnecessary because of improved mail processing technology, and the minimal reduction in First-Class revenues to the Postal Service.

[77] USPS-LR-I-169, at 2 (revised 4/17/2000).

IV. CONCLUSION

The 11 cent nonstandard surcharge is no longer warranted for low aspect ratio letter mail. Advances in technology with respect to mail processing since implementation of the surcharge in the 1970's have made the surcharge obsolete for low aspect ratio mail, and rendered the assumptions underlying the costing on which the surcharge is based unrealistic. Consequently, consumers are charged extra for low aspect ratio letter mail that requires little (if any) special processing. Using more realistic assumptions related to the costs of processing low aspect ratio letter mail reveals costs that are less than the surcharge. For these reasons, the nonstandard surcharge for low aspect ratio letter mail should be eliminated as a matter of fairness for individual mailers.