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POSTAL RATE COMMISSION
OFFICE OF THE SECRETARY

**BEFORE THE
POSTAL RATE COMMISSION**

POSTAL RATE AND FEE CHANGES, 2000

DOCKET NO. R2000-1

**DIRECT TESTIMONY
OF
DAVID E. M. SAPPINGTON
ON BEHALF OF
UNITED PARCEL SERVICE**

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AUTOBIOGRAPHICAL SKETCH

1
2 My name is David E. M. Sappington. I am the Lanzillotti-McKethan Eminent
3 Scholar in the Warrington College of Business at the University of Florida. I am also the
4 Director of the University of Florida's Public Policy Research Center.

5 I earned my B.A. in Economics from Haverford College in 1976, my M.A. in
6 Economics from Princeton University in 1978, and my Ph.D. in Economics from
7 Princeton University in 1980. Since that time, I have served on the faculties of the
8 University of Michigan, the University of Pennsylvania, and the University of Florida. I
9 have also served as a Visiting Professor with the title of Full Professor at Princeton
10 University, and as a District Manager at Bell Communications Research.

11 My research examines various aspects of industrial organization, with particular
12 emphasis on the design of regulatory policy. Several organizations have supported my
13 research, including the National Science Foundation. My research has culminated in
14 more than ninety published articles.

15 I presently serve on the editorial boards of five leading economics journals,
16 including The Rand Journal of Economics, The Journal of Regulatory Economics, and
17 The Journal of Economics and Management Strategy. I have served on the editorial
18 boards of other major journals in recent years, including The American Economic
19 Review. I have also served as an advisor on the design of regulatory policy to many
20 firms and organizations, including The World Bank, the New York State Public Service
21 Commission, and The Governor's Office in the State of New Jersey.

1 I have testified before the California Public Utility Commission and the Canadian
2 Radio-Television and Telecommunications Commission.

3 **I. PURPOSE OF TESTIMONY**

4 The purpose of my testimony is to recommend cost coverages (the ratio of
5 revenue to attributed cost) and average rate increases for Priority Mail and Parcel Post,
6 and to explain why the rate increases that I recommend are consistent with the
7 ratemaking criteria specified in the Postal Reorganization Act.

8 **II. GUIDE TO TESTIMONY**

9 My testimony proceeds as follows. In Section III, I review the nine ratemaking
10 criteria specified in the Postal Reorganization Act. I focus on the proper implementation
11 of two of these criteria: the value of service criterion (§ 3622(b)(2)) and the cost criterion
12 (§ 3622(b)(3)). The cost coverage and rate increase that I recommend for Priority Mail
13 are described and justified in Section IV. My corresponding recommendations for
14 Parcel Post are presented and explained in Section V.

15 **III. RATEMAKING PRINCIPLES**

16 **A. The Nine Ratemaking Criteria**

17 Section 3622(b) of the Postal Reorganization Act (hereafter, "the Act") requires
18 the Postal Rate Commission to consider nine specific factors when formulating its
19 recommended decision on rates and fees. These factors, hereafter referred to as
20 criteria, are the following:

1 Criterion 1. Fairness and Equity

2 The first criterion is “the establishment and maintenance of a fair and equitable
3 schedule” (§ 3662(b)(1)). Fairness and equity require a delicate balancing of the
4 interests of all mailers and suppliers of delivery services when setting rates and fees.
5 This balancing is fostered by careful consideration of the policies of the statute and the
6 other eight criteria specified in the Act.¹

7 Criterion 2. Value of Service

8 The second criterion is “the value of the mail service actually provided each class
9 or type of mail service to both the sender and the recipient, including but not limited to
10 the collection, mode of transportation, and priority of delivery” (§ 3622(b)(2)). Additional
11 factors that influence the value of a mail service to senders and recipients include its
12 speed and reliability, the level of priority it is afforded in mail processing and
13 transportation, its success in avoiding content damage, and the opportunity it affords
14 users to purchase value-added services such as delivery confirmation.

15 The measurement of the value of mail services is discussed further in Section
16 III(B), below.

1. Section 101 of the Act states that the basic function of the Postal Service is “to provide postal services to bind the Nation together through the personal, educational, literary, and business correspondence of the people.” Section 403(c) prohibits the Postal Service from making any “undue or unreasonable discrimination among users of the mails.”

1 Criterion 3. Cost

2 The third criterion is “the requirement that each class or type of mail service bear
3 the direct and indirect postal costs attributable to that class or type plus that portion of
4 all other costs of the Postal Service reasonably assignable to such class or type”
5 (§ 3622(b)(3)). The Postal Rate Commission (hereafter, “the Commission”) has
6 identified this third criterion as “the most important” of the nine criterion, in part because
7 it is “the only factor cast by Congress as a requirement.”² This requirement leads to the
8 two-step procedure that the Commission uses to develop its rate recommendations.
9 First, the Commission determines the costs that are attributable to each mail subclass.
10 In doing so, the Commission also necessarily determines the magnitude of unattributed
11 costs, which are called institutional costs. Second, the Commission assigns the
12 institutional costs to mail subclasses in accordance with the eight other criteria specified
13 in the Postal Reorganization Act.

14 The importance of this two-step procedure and the appropriate calculation of
15 attributable costs are discussed in Section III(C).

16 Criterion 4. The Effect of Rate Increases

17 The fourth criterion is “the effect of rate increases upon the general public,
18 business mail users, and enterprises in the private sector of the economy engaged in
19 the delivery of mail matter other than letters” (§ 3622(b)(4)). High rates and large rate

2. Postal Rate Commission, Opinion and Recommended Decision, Docket No. R87-1, ¶ 4031.

1 increases can be onerous for individual and business mailers alike, and so should be
2 avoided whenever possible. The Senate Report on the Act suggests that Congress
3 was particularly concerned with avoiding undue rate increases for individual mailers.³

4 Although low rates and significant rate reductions can benefit some mailers, they
5 can unfairly disadvantage other mailers who must pay higher rates as a result. Low
6 rates and significant rate reductions can also unfairly disadvantage competing suppliers
7 of delivery services. Rates that disadvantage competitors unfairly should be avoided.
8 They can be avoided through appropriate implementation of all of the criteria specified
9 in the Act, and of the cost criterion (§ 3622(b)(3)) in particular. The implementation of
10 the cost criterion is discussed in detail in Section III(C).

11 Criterion 5. Available Alternatives

12 The fifth criterion is “the available alternative means of sending and receiving
13 letters and other mail matter at reasonable costs” (§ 3622(b)(5)). When mailers can
14 obtain comparable services at reasonable cost from suppliers other than the Postal
15 Service, high postal rates impose fewer hardships on those mailers. Consequently,
16 higher rates for postal services are appropriate in such situations, *ceteris paribus*.

3. The Senate Report states: “The temptation to resolve the financial problems of the Post Office by charging the lion’s share of all operational costs to first class is strong; that’s where the big money is. The necessity for preventing that imposition upon the only class of mail which the general public uses is one of the reasons why the Postal Rate Commission should be independent of operating management.” S. Rep. No. 912, 91st Cong., 2d Sess. (1970) at 13.

1 Criterion 6. Degree of Mail Preparation

2 The sixth criterion is “the degree of preparation of mail for delivery into the postal
3 system performed by the mailer and its effect upon reducing costs to the Postal
4 Service” (§ 3622(b)(6)). It is reasonable to pass on to a mailer some or all of the cost
5 savings that accrue to the Postal Service because of mail preparation or transportation
6 activities performed by the mailer. Doing so encourages mailers to undertake the mail
7 functions that they can perform at lower cost than the Postal Service. An appropriate
8 portion of the realized cost savings can be passed on in the form of rate discounts or
9 more modest rate increases.

10 Criterion 7. Simplicity

11 The seventh criterion is the “simplicity of structure for the entire schedule and
12 simple, identifiable relationships between the rates or fees charged the various classes
13 of mail for postal services” (§ 3622(b)(7)). Simple rate schedules that render apparent
14 the underlying rationale for differences among rates help to promote the perceived
15 equity and fairness of the rate structure.

16 Criterion 8. ECSI Value

17 The eighth criterion is the “educational, cultural, scientific and informational value
18 to the recipient of mail matter” (§ 3622(b)(8)). Lower rates for mail subclasses which
19 convey a great deal of material with educational, cultural, scientific, or informational
20 (“ECSI”) value help to expand the dissemination of this material. Section 101 of the Act
21 identifies such dissemination as an important function of the Postal Service.

1 Criterion 9. Other Factors

2 The ninth and final criterion is “such other factors as the Commission deems
3 appropriate” (§ 3622(b)(9)). This criterion empowers the Commission to employ its
4 considerable expertise to consider important criteria other than the first eight when
5 developing its rate recommendations.

6 Two of the Act’s nine criteria warrant special emphasis: the value of service
7 criterion (§ 3622(b)(2)) and the cost criterion (§ 3622(b)(3)). The value of service
8 criterion merits emphasis because service value is particularly difficult to measure and
9 because this difficulty may tempt some to afford undue influence to particular imperfect
10 indicators of service value. The cost criterion merits additional emphasis because it is
11 the only one of the nine criteria that is stated as a requirement and because it plays a
12 fundamental role in promoting fair competition and fair treatment of all mailers.

13 B. Implementing the Value of Service Criterion

14 1. Intrinsic vs. Economic Value

15 The value that customers derive from a service is typically difficult to quantify and
16 measure precisely. Section 3622(b)(2) lists some of the factors that merit explicit
17 attention when attempting to assess the value that a mail service provides to senders
18 and recipients. These factors, along with other relevant factors like those identified
19 above in the discussion of the value of service criterion, together are said to influence
20 the “intrinsic value” of a mail service.

1 It has been suggested in the present rate case and in preceding rate cases that
2 both the intrinsic value and what has been called the “economic value” of a mail service
3 should be considered in assessing the service’s value to senders and recipients.⁴ The
4 economic value of a mail service is described as a measure of “the degree to which
5 usage of the service declines in response to price increases.”⁵ Thus, the economic
6 value of a service is simply the own-price elasticity of demand for the service.⁶

7 Any distinction between the “intrinsic” and the “economic” components of value is
8 problematic because the two are inextricably linked. The extent to which the usage of a
9 service declines as its price increases is influenced by the characteristics of the service,
10 including its many “intrinsic” characteristics. Therefore, except for the fact that the
11 definition of economic value renders it susceptible to measurement, the rationale for
12 distinguishing between intrinsic value and economic value is not apparent.

13 2. Inappropriate Use of the Own-Price Elasticity

14 Undue reliance on the own-price elasticity of a service as a measure of its value
15 can be inappropriate for at least three reasons. First, the own-price elasticity is not an
16 accurate measure of value. Second, its use as a measure of value can contradict the
17 pricing criteria specified in § 3622(b) of the Act and can afford the Postal Service undue

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4. See, for example, the testimonies of Postal Service witnesses Mayes (USPS-T-32) in this case and O’Hara (USPS-T-30) in Docket No. R97-1.
5. Testimony of Postal Service witness Mayes, USPS-T-32 at 5.
6. The own-price elasticity of demand for a service is defined as the percentage change in the usage of the service that results from a one percent increase in the price of the service, holding constant all other determinants of demand. Jeffrey M. Perloff, Microeconomics, 1999, Addison Wesley Longman, Inc., p. 53.

1 protection from competition. Third, use of the own-price elasticity as a measure of value
2 is essentially the same as Ramsey pricing.⁷ These three conclusions are now
3 explained in detail.

4 a. Imperfect Measure of Value

5 The first conclusion is that, even when it is estimated accurately, the own-price
6 elasticity of demand is, at best, a very imperfect measure of the value that senders and
7 receivers derive from a mail service. It is an imperfect measure of value in part because
8 demand is influenced by many factors other than price. Therefore, even if the demand
9 for a service declines substantially as its price increases, customers may value the
10 service highly. To illustrate this fact, notice that a price increase may force customers
11 with limited wealth to reduce their usage of a service substantially even though they
12 cherish the service dearly.

13 b. Inverted Rate Changes and Undue Protection

14 The second conclusion is that the use of the own-price elasticity as a primary
15 measure of value can have undesirable consequences. The own-price elasticity of
16 demand for a service can reflect, in part, the availability of alternative means of sending
17 and receiving mail (§ 3622(b)(5)). The volume of a particular service supplied by the
18 Postal Service may decline substantially as the rate charged for the service increases if

7. Ramsey prices are the prices that maximize the combined welfare of the consumers and the producer of a set of services, while ensuring a specified level of profit for the producer. See William J. Baumol and David F. Bradford, "Optimal Departures From Marginal Cost Pricing," 60 American Economic Review 265 (June 1970).

1 mailers can secure comparable services from competing suppliers at reasonable cost.
2 When mailers have ready access to reasonable alternatives, they can protect
3 themselves from the adverse consequences of rate increases on services supplied by
4 the Postal Service. Therefore, they have less need for protection from the Commission
5 than do mailers who use a monopoly service. Thus, more substantial increases in
6 Postal Service rates are appropriate when mailers have ready alternatives to the Postal
7 Service, ceteris paribus. This conclusion implies that a higher own-price elasticity may
8 appropriately be associated with a higher rate increase. In contrast, when own-price
9 elasticity is interpreted primarily as a measure of "economic value," a higher own-price
10 elasticity can (inappropriately) be associated with a lower rate increase.

11 Since high own-price elasticities can reflect the presence of effective
12 competition, a policy that implements lower rates and smaller rate increases in
13 response to higher own-price elasticities for Postal Service products can serve primarily
14 to protect the Postal Service from effective competition. Section 3622(b) of the Act
15 does not explicitly list such protection as one of the specific factors that should be
16 considered when formulating rate recommendations. Its omission is appropriate. If the
17 Postal Service cannot successfully market a service with rates that cover attributable
18 costs and a reasonable share of institutional costs (as determined by the criteria listed
19 in § 3622(b)), then society may be better served when competitors, not the Postal
20 Service, are the primary providers of the service in question.

21 In addition, systematic protection of the Postal Service against effective
22 competition can discourage innovation and entry in the postal industry, and can thereby

1 harm mailers and mail recipients alike. A policy that reduces Postal Service rates as
2 competition increases and permits revenues to fall toward incremental cost can also
3 encourage the Postal Service to choose an inefficient production technology with
4 unnecessarily large institutional costs and relatively low incremental costs for
5 competitive services. By doing so, the Postal Service can drive competitors from the
6 market if it is permitted to reduce rates toward (artificially low) incremental costs
7 whenever effective competition develops. It can even eliminate more efficient
8 competitors, i.e., those who could serve customers at lower cost than the Postal
9 Service if the Postal Service operated with the technology that minimized its overall
10 operating costs. Unnecessarily large institutional costs can also increase rates unduly
11 for captive users of monopoly mail services. Such harm to competition and to captive
12 customers should be avoided, and it can be avoided if rates are not systematically
13 lowered as own-price elasticities rise.⁸

14 c. Ramsey Pricing in Disguise

15 The third conclusion is that a process which uses the own-price elasticity of a
16 service to measure its value is essentially the same as Ramsey pricing. When high
17 own-price elasticities are presumed to indicate low-value services and when lower rates
18 are established for such services, the lowest rates will be set for those services that
19 exhibit the highest own-price elasticities. This is precisely the prescription of the

8. The Commission has astutely recognized both the incentive the Postal Service may have to choose an inefficient technology and the undesirable consequences of such a choice. Opinion and Recommended Decision, Docket No. R97-1, ¶ 4047-49.

1 famous inverse-elasticity rule,⁹ which is commonly employed to characterize Ramsey
2 prices. The Commission has “reject[ed] the use of a Ramsey model as a proper
3 measure of value of service”.¹⁰ Consequently, the mechanistic use of own-price
4 elasticities as proxies for service value should similarly be rejected.

5 In summary, the factors that influence the intrinsic value of a mail service (e.g.,
6 its priority in processing, transportation, and delivery and its success in avoiding content
7 damage) merit careful consideration in assessing the value of a mail service.¹¹ In
8 contrast, the own-price elasticity of demand for a service does not merit corresponding
9 consideration in this regard. Such consideration can lead more to the implementation of
10 Ramsey prices and to unwarranted protection of the Postal Service from competition
11 than to an accurate assessment of service value.

12 C. Implementing the Cost Criterion

13 As noted above, the cost criterion (criterion 3) requires that rates be set to
14 generate revenue for each mail subclass that is at least as great as the direct and
15 indirect costs attributed to the subclass plus a reasonable contribution to unattributed
16 costs. This requirement is crucial because it helps to ensure that no mail subclass
17 cross subsidizes another. For the reasons identified below, the requirement thereby

9. Baumol and Bradford, *op. cit.*, at 270.

10. Opinion and Recommended Decision, Docket No. R87-1, p. 372.

11. Section IV(C) provides a more detailed discussion of these factors in the case of Priority Mail.

1 helps to ensure that the Postal Service treats mailers fairly and does not disadvantage
2 competitors unfairly.

3 1. Incremental Cost

4 The costs that are properly attributed to a mail subclass are the costs that the
5 Postal Service incurs because it produces that subclass. These costs can be viewed
6 alternatively as the cost savings that the Postal Service would realize if it decided to
7 discontinue its supply of the mail subclass in question, without changing the volumes of
8 the other subclasses it supplies. These cost savings are commonly referred to as the
9 incremental cost of producing the mail subclass in question.¹² Incremental costs can
10 include costs that vary with volume and costs that do not vary with volume. The former
11 are commonly called volume variable costs, and the latter include what are called
12 specific fixed costs.

13 If the incremental cost of a service were to exceed the revenues it generated, the
14 service would be cross subsidized by other services. This is because when customers
15 of one service pay less than it costs to serve them, consumers of other services are
16 forced to pay higher rates than they otherwise would in order to make up for this
17 shortfall in net revenue. Cross subsidies are undesirable because they encourage
18 excessive consumption of those services for which prices are unduly low, and because
19 they impose inappropriate burdens on customers of other services.

12. William J. Baumol, John C. Panzar, and Robert D. Willig, Contestable Markets and the Theory of Industry Structure 1982 Harcourt Brace Jovanovich, Inc., p. 352.

1 Cross subsidies are also undesirable because they can disadvantage
2 competitors unfairly. A competitor of the Postal Service may be driven from the
3 marketplace even though it is the least-cost supplier of a service if the competing
4 service offered by the Postal Service is being cross subsidized. Total industry costs
5 rise and consumers are harmed if the least-cost supplier is driven from the marketplace.
6 The cost criterion (criterion 3) guards against such unfair and undesirable competition
7 by requiring each mail subclass to generate at least enough revenue to cover its
8 attributable (incremental) cost of production.¹³ To ensure the solvency of the Postal
9 Service and to further guard against unfair competition, the cost criterion also requires
10 each mail subclass to bear some portion of the Postal Service's institutional costs.¹⁴
11 Institutional costs are the costs that remain after all attributable (incremental) costs
12 have been assigned to their relevant mail subclasses.

13. The Commission has emphasized the importance of avoiding cross subsidies. In its R94-1 Decision, the Commission stated that "if there is to be one 'benchmark' or starting point from which all other pricing analysis proceeds, a benchmark that minimizes the risk of cross-subsidy of one class of mail users by another is preferable." Opinion and Recommended Decision, Docket No. R94-1, ¶ 4010.

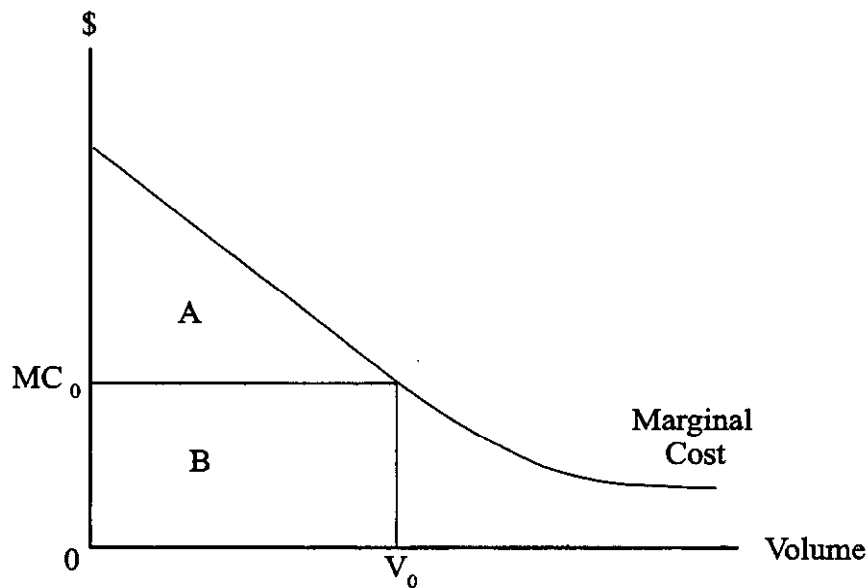
14. The Postal Service derives significant financial benefits from its status as a public enterprise. For instance, the Postal Service is not required to pay all of the taxes and fees that its competitors must pay. The Postal Service also enjoys privileged access to the United States Treasury. Because of these artificial cost advantages, the Postal Service may be able to drive more efficient producers from the market even if revenues exceed incremental costs on every service that the Postal Service supplies. To limit the likelihood that more efficient producers are excluded from the market as a result of these Postal Service advantages, it is wise to ensure that each service for which the Postal Service faces competition bears a meaningful portion of institutional costs.

2. Calculating Incremental Cost

One must know how production costs vary with volume in order to calculate precisely the incremental cost of providing a specified volume of a service. To understand why this is the case, consider Figure 1. The figure depicts a setting in which the extra cost of producing each additional unit of the service (i.e., the service's marginal cost of production) declines with volume. The incremental cost of producing V_0 units of the service in this setting is the sum of the areas labeled A and B in Figure 1, plus any fixed costs that would disappear if the service were not provided.

FIGURE 1

Calculating Incremental Cost



Areas A and B together represent the sum of the extra costs incurred from producing all of the additional units of output between 0 and V_0 . If the service were no longer produced, none of these extra costs would be incurred, and any fixed costs that

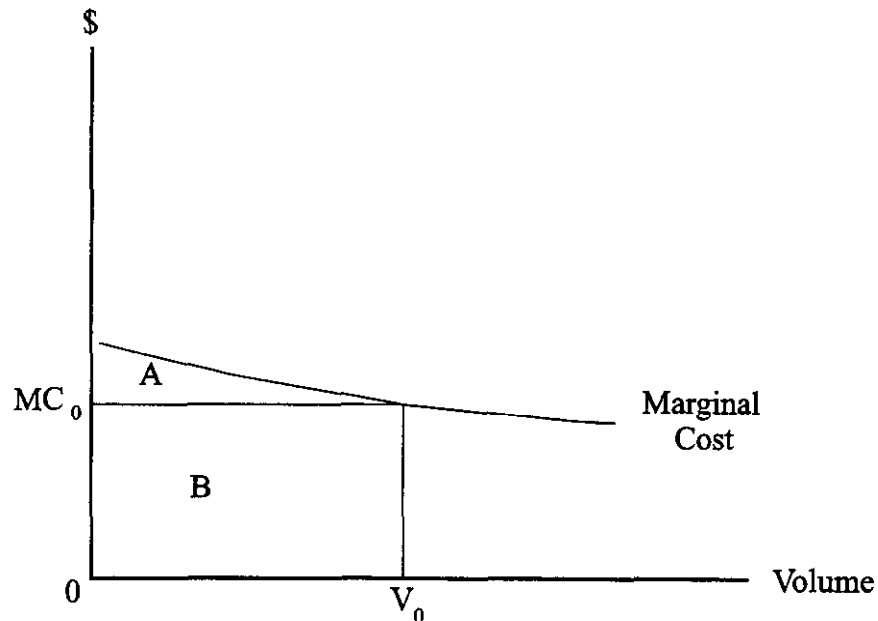
1 disappeared when production of the service ceased would also be avoided. Therefore,
2 the incremental cost of producing V_0 units of the service is the sum of these extra costs
3 (areas A and B) plus any fixed costs incurred to provide the service.

4 3. Approximating Incremental Cost

5 A reasonable approximation of the incremental cost of producing a service is
6 available when the marginal cost of producing the service varies little as volume
7 changes. A marginal cost that varies little with volume is represented graphically by a
8 marginal cost curve that is nearly horizontal, like the one drawn in Figure 2.

FIGURE 2

Approximating Incremental Costs



9 The reasonable approximation of incremental cost that is available when
10 marginal cost varies little with volume is simply the cost savings that would be realized

1 from discontinuing a service if the marginal cost of producing each unit of the service
2 were equal to the marginal cost of producing the last unit of the service. In Figures 1
3 and 2, this approximation to the incremental cost of producing volume V_0 is the product
4 of V_0 and the marginal cost of producing V_0 (plus the related fixed costs). The marginal
5 cost of producing V_0 is labeled MC_0 and the product of V_0 and MC_0 is simply area B in
6 both Figures. Thus, the approximation of incremental cost omits area A. The omission
7 is inconsequential if marginal cost does not vary with volume (so that the marginal cost
8 curve is horizontal). The omission becomes more consequential, but may still provide a
9 reasonable estimate of incremental cost, if marginal cost varies little with volume (so
10 that the marginal cost curve is nearly horizontal, as in Figure 2). If marginal cost varies
11 substantially with volume (as in Figure 1), then an approximation that omits area A may
12 understate incremental cost substantially.

13 Historically, the Commission has employed such approximations of incremental
14 cost when formulating its rate recommendations because incremental cost measures
15 were not available. As noted, these approximations systematically understate
16 incremental cost when marginal cost declines with volume. Therefore, modest markups
17 of these under-estimates of incremental cost can permit revenue to fall below
18 incremental cost, and thereby lead to cross subsidies. To provide stronger safeguards
19 against cross subsidies, reasonable estimates of incremental cost should be employed
20 when they are available. However, the Commission has not yet adopted any such
21 estimates. Therefore, the rate recommendations that follow employ the historic
22 approximation of incremental cost as the sum of volume variable cost (the product of

1 volume and marginal cost, which corresponds to area B in Figures 1 and 2) and specific
2 fixed costs. The sum of these costs serves as the attributable cost markup base for
3 determining a service's appropriate share of institutional costs.

4 Once the Commission is presented with incremental cost estimates that it
5 believes to reasonably approximate incremental costs as properly defined and
6 measured, those estimates of incremental cost should be used as the attributable cost
7 base that is marked up in determining each service's appropriate contribution to
8 institutional costs.

9 IV. PRIORITY MAIL RATE RECOMMENDATION

10 A. The Recommendation

11 Based upon careful consideration of both the criteria specified in § 3622(b) of the
12 Act and the special circumstances in this case and in the R97-1 rate case, I recommend
13 a 40.3% increase in the average rate for Priority Mail. This rate increase represents a
14 cost coverage of 176% and a markup (the ratio of contribution to attributed cost) of
15 76%, which is the same markup that the Postal Service proposes for First Class Mail in
16 this case. Under this recommendation, Priority Mail's markup index (the ratio of its
17 markup to the systemwide markup) is 1.395.

18 B. Basis for the Recommendation

19 Prior to R97-1, Priority Mail had consistently been assigned a cost coverage that
20 exceeded both the systemwide average cost coverage and the cost coverage assigned
21 to First Class Mail. A higher cost coverage for Priority Mail is appropriate, given the

1 priority it is afforded in the mail stream, the extra services and service options it
2 provides, and the Commission's long-standing emphasis on protecting users of
3 monopoly mail services.¹⁵

4 In R97-1, the Commission recommended a deviation from the consistent policy
5 of affording Priority Mail a higher cost coverage than First Class Mail. It did so for three
6 main reasons. First, Priority Mail's attributable costs increased dramatically between
7 the R94-1 and the R97-1 rate cases. Therefore, applying historic coverages to Priority
8 Mail's higher base of attributable costs would have caused Priority Mail's rates to rise
9 more rapidly than they had historically.¹⁶ Second, the Commission expressed the
10 concern that a large rate increase for Priority Mail might jeopardize its ability to compete
11 in the marketplace.¹⁷ Third, the Commission questioned the level of service quality
12 delivered by Priority Mail relative to the corresponding level delivered by First Class
13 Mail.¹⁸

15. See, for example, the Commission's Opinion and Recommended Decision in Docket No. R90-1, ¶ 4021.

16. The Commission stated in R97-1 that its recommendation to reduce Priority Mail's markup index substantially from historic levels was appropriate "especially in light of the magnitude of growth in the estimated costs of providing the service." Opinion and Recommended Decision, Docket No. R97-1, ¶ 5306.

17. The Commission cited NDMS witness Haldi's observation that "Priority Mail's overall market share has continued to decline since R94-1," and suggested that it would be "premature" to conclude that its increased growth rates in 1995 and 1996 "portend a reversal of the long-term trend of diminishing market share." *Ibid.* at ¶ 5307.

18. The Commission stated that "witness Haldi's testimony in this case raises significant concerns regarding the intrinsic quality and value of Priority Mail service. His analysis of delivery performance suggests that Priority Mail often

1 The evidence shows that Priority Mail has continued to experience sustained
2 volume and revenue growth since R97-1, and has continued to maintain a lion's share
3 of the two- to three-day delivery market. The evidence in its entirety also suggests that
4 Priority Mail provides a high level of service quality relative to First Class Mail.
5 Consequently, absent another unusually large increase in Priority Mail's attributable
6 costs and absent any other unusual developments, a return to historic markup
7 relationships would be appropriate. Historically, the markup assigned to Priority Mail
8 has exceeded the markup assigned to First Class Mail by a substantial margin.¹⁹

9 However, Priority Mail's attributable cost per piece has increased substantially
10 since R97-1. Consequently, a very large rate increase for Priority Mail would be
11 required to restore the historic relationship between the markups assigned to Priority
12 Mail and First Class Mail. Some mitigation of this rate increase is appropriate in light of
13 its potential impact on Priority Mail users (§ 3622(b)(4)). The mitigation I recommend is
14 to assign the same markup to Priority Mail that is assigned to First Class Mail. The rate
15 increase proposed by the Postal Service in this case entails a 76% markup for First
16 Class Mail. An average rate increase of 40.3% achieves the same 76% markup for
17 Priority Mail.

fails to provide a standard of service superior to, or at times even equal to, that of First-Class Mail." Ibid. at ¶ 5308.

19. In R94-1, the markup assigned to Priority Mail exceeded the markup assigned to First Class Mail by more than 30%. Opinion and Recommended Decision, Docket No. R97-1, Appendix G, Schedule 1.

1 C. Explanation of the Recommendation

2 A more complete explanation of my rate recommendation for Priority Mail follows
3 in five steps. First, I review the sustained volume and revenue growth that Priority Mail
4 has experienced in recent years. I also document the large market share that Priority
5 Mail continues to enjoy, and note an enhanced feature that Priority Mail has added
6 recently. Together, these facts suggest that Priority Mail can sustain a significant rate
7 increase.

8 Second, I review the available evidence regarding Priority Mail's service quality. I
9 explain why it is difficult to compare the service qualities of Priority Mail and First Class
10 Mail directly using existing data. I also explain why the evidence, when viewed in its
11 entirety, indicates that Priority Mail provides a high level of service quality relative to
12 First Class Mail.

13 Third, I explain why a balanced consideration of the criteria in § 3622(b) of the
14 Act justifies a higher markup for Priority Mail than for First Class Mail. Fourth, I
15 document the large increase in Priority Mail's attributable cost per piece since R97-1.
16 Fifth, I review my recommendation to equate the markups for Priority Mail and First
17 Class Mail in order to mitigate the large rate increase for Priority Mail that would be
18 needed to restore the appropriate historic markup relationships.

1 1. Priority Mail's Strong Competitive Position

2 a. Volume, Revenue, and Market Share

3 Any relevant concerns that may have arisen in the R97-1 rate case regarding the
4 ability of Priority Mail to compete successfully in the marketplace appear to be less
5 pressing in the present rate case. Tables 1, 2, and 3 indicate that Priority Mail has
6 experienced steady growth in volume and revenue in recent years, and has maintained
7 the lion's share of the two- to three-day delivery market.²⁰

20. The data in Tables 1 and 2 are taken from: (1) United States Postal Service Domestic Mail Volume History: 1970-1998, May 1999, USPS-LR-I-117, p. 5; (2) United States Postal Service Domestic Mail Revenue History: 1970-1998, May 1999, USPS-LR-I-117, p. 16; and (3) United States Postal Service Cost and Revenue Analysis: Fiscal Year 1999, USPS-LR-I-275, September 30, 1999, pp. 1, 3. The data in Table 3 are derived from Postal Service witness Robinson's response to interrogatory APMU/USPS-T34-48 (Revised 5/2/2000). The 1999 data in Table 3 reflect performance through the third quarter of CY1999.

TABLE 1
PRIORITY MAIL VOLUME GROWTH

Fiscal Year	Priority Mail Volume (millions of pieces)	Annual % Change in Volume
1990	518	10.0%
1991	530	2.3%
1992	584	10.2%
1993	664	13.7%
1994	770	16.0%
1995	869	12.9%
1996	937	7.8%
1997	1,068	14.0%
1998	1,174	9.9%
1999*	1,279*	8.9%*

*Excluding estimated migration to First Class Mail. Priority Mail's reported 1999 volume after migration is 1,189 million. USPS-LR-I-275, p. 1.

TABLE 2
PRIORITY MAIL REVENUE GROWTH

Fiscal Year	Priority Mail Revenue (millions of dollars)	Annual % Change in Revenue
1990	1,555	9.8%
1991	1,764	13.4%
1992	2,071	17.4%
1993	2,300	11.1%
1994	2,653	15.4%
1995	3,075	15.9%
1996	3,321	8.0%
1997	3,856	16.1%
1998	4,186	8.6%
1999	4,533	8.3%

TABLE 3

PRIORITY MAIL MARKET SHARES

Calendar Year	Priority Mail Market Share of Two- to Three-Day Market	
	Volume	Revenue
1997	62.7%	45.2%
1998	62.8%	45.3%
1999	61.9%	45.8%

1 Table 1 shows that Priority Mail volume has increased at an average annual rate
2 of more than 10% between 1990 and 1998. Table 2 shows that the corresponding
3 average annual increase in Priority Mail revenue exceeds 12%. The migration
4 mentioned in the footnote to Table 1 stems from the increase (from 11 ounces to 13
5 ounces) in the weight break between First Class Mail and Priority Mail that was
6 implemented on January 10, 1999. The Postal Service estimates that this change
7 caused approximately 90 million pieces of Priority Mail volume to migrate to First Class
8 Mail.²¹

9 This migration is likely to have reduced the estimate of Priority Mail's 1999
10 revenue and its market share reported in Tables 2 and 3.²² Nevertheless, Priority Mail

21. Response of Postal Service Witness Musgrave to interrogatory UPS/USPS-T34-8(a), Tr. 9/3578.

22. To illustrate the potential impact of the increase in the maximum weight for First Class Mail on Priority Mail's market share, suppose that the increase caused no change in the volumes of competitors in the two- to three-day delivery market. Then the additional 90 million pieces would have increased Priority Mail's share of 1999 volume from the 61.9% reported in Table 3 to 63.6%.

1 continues to enjoy a dominant share of both volume and revenue in the two- to three-
2 day delivery market.

3 b. Delivery Confirmation and One-Pound Rate

4 Tables 1, 2, and 3 do not reflect fully the availability of Priority Mail's new
5 Delivery Confirmation Service, since the service was only implemented on March 14,
6 1999, half-way through FY1999. Delivery Confirmation, which is available at no extra
7 charge to larger Priority Mail users, enhances the appeal of Priority Mail relative to other
8 postal services and to competing services.²³ Priority Mail's competitive position will be
9 further strengthened if the Postal Service's proposal to introduce a new, lower one-
10 pound rate for Priority Mail is approved. This new rate will enhance the ability of Priority
11 Mail to deliver relatively low rates to a large portion of its customers, and thereby
12 sustain solid volume growth and a dominant market share.²⁴

13 2. Service Quality

14 The attention that the Commission devoted to service quality in R97-1 was
15 appropriate. Service quality typically affects the value that senders and recipients

23. Postal Service witness Robinson estimates "conservatively" that Priority Mail's new Delivery Confirmation Service will increase Priority Mail volume by 1% in 2000 and will increase the growth rate for Priority Mail volume by 1% in 2001. USPS-T-34, p. 20.

24. In FY1999, nearly 39% of Priority Mail volume consisted of pieces weighing less than one pound, even in the absence of a lower one-pound rate. USPS-LR-I-250, PRO_Z99R.XLS.

1 derive from a mail service, and § 3622(b)(2) of the Act cites the value of mail service as
2 a relevant factor when formulating rate recommendations.

3 a. Measurement Difficulties

4 Unfortunately, service quality and the value that senders and recipients derive
5 from a mail service can be difficult to measure accurately. To illustrate this point,
6 consider Table 4, which reports the success of Priority Mail and First Class Mail in
7 meeting their service standards in 1999.²⁵

TABLE 4

PERCENT OF STANDARDS ACHIEVED IN FY1999

	% of Time Overnight Standard is Achieved	% of Time Two-Day Standard is Achieved
Priority Mail	90.4	79.3
First Class Mail	93.3	86.5

8 Table 4 indicates that Priority Mail does not meet its service standards as
9 frequently as First Class Mail meets its standards.²⁶ One might be tempted to conclude

25. The data in Table 4 reflect PETE and EXFC statistics, and are derived from the Postal Service's responses to interrogatories UPS/USPS-T34-19, Tr. 21/9372, and UPS/USPS-T34-20, Tr. 21/9373. Corresponding statistics based upon ODIS data and Delivery Confirmation data are provided in the Postal Service's responses to interrogatories APMU/USPS-T34-52, DFC/USPS-T34-8, UPS/USPS-T34-18, and UPS/USPS-T34-33, Tr. 7/2736, 21/8875-76, 9371, 9387.

26. This difference may stem in part from the fact that the Priority Mail PMPC dedicated network only became fully operational in July, 1998. The data provided in the Postal Service's response to interrogatory UPS/USPS-T34-26, Tr. 21/9376, reveals that Priority Mail achieved its service standards more frequently on average in FY1999 than it did in FY1997.

1 from this fact that Priority Mail provides a lower level of service quality than does First
2 Class Mail. The facts do not support this conclusion, however, in part because Priority
3 Mail has a more stringent service standard than First Class Mail, especially in two-day
4 delivery service areas.²⁷ Consequently, Priority Mail may systematically deliver higher
5 service quality in the form of more expeditious delivery than First Class Mail even
6 though Priority Mail meets its more exacting service standard less frequently.

7 Priority Mail's more stringent service standard takes the form of faster delivery
8 times for items traveling between identical origin-destination 3-digit ZIP code pairs.
9 Table 5 reports the number of ZIP code pairs with a one-, two-, and three-day standard
10 for Priority Mail and for First Class Mail.²⁸

27. PETE data indicate that in 1999, the volume of Priority Mail sent to destinations with a two-day service standard was more than five times the volume of Priority Mail sent to destinations with a one-day service standard. USPS response to interrogatory UPS/USPS-21, Tr. 21/9374. ODIS data place this ratio at approximately 3.5 to 1.0. Response of Postal Service witness Robinson to questions posed during oral examination, Tr. 21/8564.

28. The data in Table 5 are derived from: (1) Postal Service witness Robinson's Response to the Presiding Officer's Information Request No. 6, Question 10, page 2 of 2, Tr. 21/8560; and (2) the response of the United States Postal Service to interrogatories DFC/USPS-53, Tr. 21/8851-56, and UPS/USPS-36 (filed May 8, 2000). The data provided by these sources appear to conflict. The most recent response (UPS/USPS-36) reports that there are 780,514 ZIP code pairs for which Priority Mail has a two-day service standard. An earlier response (DFC/USPS-53, Tr. 21/8851-56) suggests that this number should be 780,757. Table 5 presents from among the reported statistics those that are least favorable to Priority Mail.

TABLE 5

PRIORITY MAIL AND FIRST CLASS SERVICE STANDARDS

	Number of 3-Digit ZIP Code Pairs With:		
	One-Day Service Standard	Two-Day Service Standard	Three-Day Service Standard
Priority Mail	8,786	780,514	59,562
First Class Mail	8,744	157,081	683,281

1 Table 5 indicates that there are more than 600,000 three-digit ZIP code pairs
2 between which Priority Mail's service standard is two days whereas First Class Mail's
3 service standard is more than two days.²⁹ This fact helps to explain why Priority Mail
4 may systematically provide faster delivery than First Class Mail, despite the statistics in
5 Table 4.³⁰

6 To illustrate this point more concretely, assume that all instances where Priority
7 Mail fails to achieve its two-day service standard occur between ZIP code pairs where

29. In her response to a question posed during oral cross-examination, Postal Service witness Robinson stated that "There are no ZIP Code pairs where Priority Mail has a slower service standard than First-Class Mail." Tr. 7/2857.

30. As the Postal Service states, a comparison of First Class Mail and Priority Mail performance on "two-day committed mail is not meaningful because it would match performance between shorter distance, First-Class Mail network legs with longer distance, Priority Mail legs." Postal Service response to interrogatory UPS/USPS-36 (filed May 8, 2000).

1 Priority Mail has a two-day service standard and First Class Mail has a three-day
2 standard. In that case, even if First Class Mail always achieved its (three-day) standard
3 exactly while Priority Mail achieved its (two-day) standard only half of the time and
4 provided three-day delivery the remainder of the time, Priority Mail would never provide
5 slower delivery than First Class Mail. This would be the case even though Priority Mail
6 met its more challenging service standard far less often than First Class Mail met its
7 standard, which is not the case in practice.³¹

8 Even identical delivery standards between identical ZIP code pairs can present
9 greater challenges to Priority Mail than to First Class Mail because of differences in
10 their mail mixes. Priority Mail includes pieces that weigh up to 70 pounds, while no First
11 Class Mail piece weighs more than thirteen ounces. Furthermore, Priority Mail consists
12 primarily of flats and parcels, whereas the majority of First Class Mail is letters.³²

31. Higher "failure rates" can be indicative of higher service quality in other important settings also. Consider mortality rates in hospitals, for example. Some highly regarded hospitals experience higher mortality rates than do less highly regarded hospitals. Higher mortality rates can arise at the best hospitals because the most seriously ill patients seek treatment at those hospitals. When they agree to treat the most seriously ill patients, the best hospitals implicitly set more exacting standards for themselves. The higher standards can cause the best hospitals to "fail" more often than do more mediocre hospitals, even though the former unquestionably deliver superior service quality. Lisa I. Iezzoni, "Risk Adjustment and Current Health Policy Initiatives," in Risk Adjustment for Measuring Healthcare Outcomes, Second Edition, 1997, Lisa I. Iezzoni (ed.), Chicago: Health Administration Press.

32. Flats, parcels, and irregular pieces and parcels accounted for more than 99% of Priority Mail volume in PFY1998. Less than 1% of Priority Mail volume was letters. In contrast, letters accounted for more than 88% of First Class Mail volume in PFY1998. Origin-Destination Volume Summary Report, Origin-Destination Information System Report HSA369P1, Attachment A to the Postal Service's Request.

1 Some mail mixes can be more difficult and more time-consuming than others to
2 process, transport, and deliver. For example, flats may take more time to deliver than
3 letters. In 1999, First Class letters achieved their service commitments 90.2% of the
4 time; in contrast, First Class flats achieved their service commitments only 78.5% of the
5 time.³³ These statistics suggest that because of differences in mail mixes, even an
6 identical delivery standard for an identical ZIP code pair may not pose an identical
7 challenge to Priority Mail and to First Class Mail. Consequently, comparisons of
8 performance statistics that do not control for mail mix may not permit meaningful
9 inferences about relative levels of service quality and customer value.³⁴

10 Difficulties in drawing meaningful conclusions about relative service qualities
11 from the available data are further compounded by concerns about the accuracy of the
12 data. The Priority Mail performance statistics reported in Table 4 reflect Priority-End-to-
13 End (“PETE”) data. As the name suggests, the PETE system tracks Priority Mail pieces
14 from the time they enter the mail stream to the time they are delivered to the
15 addressee. In contrast, the Postal Service’s Origin/Destination Information System
16 (“ODIS”) tracks pieces from the time they are received at the originating Post Office to
17 the time they arrive at the destination Post Office.³⁵ The time between entry into the

33. Response of the United States Postal Service to interrogatory DFC/USPS-70 (filed May 12, 2000).

34. When attention is restricted to flats, Priority Mail’s on-time performance in FY1999 (81.2%) exceeds First Class Mail’s on-time performance (78.5%), despite Priority Mail’s more exacting service standard. Revised Response of United States Postal Service to Interrogatory UPS/USPS-10 (filed May 16, 2000).

35. Tr. 21/8843-48, 8875-76.

1 mail stream and delivery to the addressee cannot be shorter than the time between
2 receipt at the originating Post Office and arrival at the destination Post Office.
3 Therefore, any Priority Mail piece that achieves its service standard as measured by the
4 PETE system should also achieve its service standard when measured by ODIS. Yet,
5 ODIS often reports Priority Mail to have achieved its service standards less frequently
6 than does the PETE system.³⁶ This is counter-intuitive. Apparent anomalies of this sort
7 raise concerns about the accuracy of the reported service quality statistics.

8 **b. Other Direct Measures of Value**

9 In light of concerns about the accuracy of available data and difficulties in
10 interpreting even the most accurate data, excessive focus on a single imperfect
11 measure of service quality should be avoided. Instead, all available direct measures of
12 service quality and value should be studied carefully. A thorough consideration of
13 more indirect potential indicators of service quality and value can also be instructive.

14 Direct measures of service quality and value other than achievement of service
15 standards include measures of the reliability, convenience, security, and freedom from
16 content damage that a service delivers, as well as the options it provides to purchase
17 additional value-added features. Priority Mail fares well on many of these direct
18 measures of service quality. To illustrate, Priority Mail (like First Class Mail) is sealed
19 against inspection. It also enjoys the convenience of the collection system for a large

36. For FY1999, ODIS data report that Priority Mail achieved its one-day service standard 85% of the time and its two-day service standard 74% of the time. APMU/USPS-T34-52, Tr. 7/2736. Both of these percentages are less than the corresponding percentages reported in Table 5, which reflect PETE data.

1 portion (nearly 39% in FY1999) of the pieces it carries, those that weigh less than one
2 pound.³⁷ Pick-up service is available for Priority Mail for an additional fee, whereas
3 pick-up service is not available at all for First Class Mail. Priority Mail also provides
4 electronic Delivery Confirmation at no extra charge to large users, and other Priority
5 Mail customers can purchase manual Delivery Confirmation Service. The Postal
6 Service also supplies packaging materials at no charge to Priority Mail customers.

7 c. Operating Procedures

8 The operating procedures of a mail service also serve as indirect indicators of
9 service quality and value, as the references to “collection, mode of transportation, and
10 priority of delivery” in § 3622(b)(2) of the Act suggest. Priority Mail exhibits at least six
11 distinguishing features in this regard.³⁸

12 First, Priority Mail has its own dedicated processing and transportation network
13 in the Northeast and Florida, which is supplemented by the main mail network.³⁹
14 Second, Priority Mail is generally cleared before First Class Mail, and is thereby
15 afforded priority for transportation resources. Third, there are many origin-destination
16 pairs for which Priority Mail travels by air while First Class Mail remains in the surface

37. USPS-LR-I-250, PR_OZ99R.XLS. Priority Mail pieces that weigh more than one pound can also be deposited in the collection system if postage is paid by meter imprint. Domestic Mail Manual, Issue 55, § D100(2.3) (January 10, 2000).

38. These six features of Priority Mail operating procedures are described by Postal Service witness Robinson in her response to interrogatory APMU/USPS-T34-45, Tr. 2724-25.

39. Tr. 27/2724-25. Priority Mail is processed at the local Processing and Distribution Center if volume exceeds capacity at, or if mail arrives late at, a Priority Mail Processing Center. DBP/USPS-128, Tr. 7/2751.

1 network. Fourth, Priority Mail is typically assigned to earlier flights than First Class Mail
2 on the Eagle Network and on commercial airlines. Fifth, Priority Mail is delivered before
3 First Class Mail if it is not possible to deliver both. Sixth, during the peak year-end
4 season, Priority Mail is sometimes delivered on Sunday, while First Class Mail is not.

5 d. Customer Behavior

6 Customer behavior is another indirect measure of service value. If customers
7 repeatedly choose a more expensive mail service when a less expensive service is
8 available, their choice provides strong evidence that they value the more expensive
9 service more highly. In 1996, more than 136 million pieces were sent as Priority Mail,
10 even though these pieces could have been sent more cheaply as First Class Mail.⁴⁰ By
11 1999, the number of such pieces sent by Priority Mail had grown to more than 215
12 million.⁴¹ These numbers suggest that many customers value Priority Mail more highly
13 than they do First Class Mail. The fact that the numbers have grown impressively
14 suggests that customer perceptions are matched by actual customer experience.

15 3. The Criteria in § 3622(b) of the Act

16 To the extent that its extra enhanced features enable Priority Mail to deliver
17 greater value to its users than First Class Mail delivers to its users, § 3622(b)(2) of the
18 Act suggests that the markup established for Priority Mail should exceed the markup

40. This statistic is derived from Postal Service witness Sharkey's response to interrogatory NDMS/USPS-T33-7 in Docket No. R97-1.

41. This statistic counts only Priority Mail volume weighing less than 11 ounces. The number of Priority Mail pieces weighing less than 13 ounces in 1999 exceeds 289 million. USPS-LR-I-250, PR_OZ99R.XLS.

1 established for First Class Mail. A higher markup for Priority Mail is also supported by
2 other criteria in the Act.

3 Section 3622(b)(4)'s concern with the effect of rate increases on private
4 competitors is particularly relevant to Priority Mail, since First Class Mail letters are
5 largely sheltered from competition by the Postal Service's letter monopoly. The
6 concern with the effect of rate increases on private competitors justifies a higher
7 markup for Priority Mail than for First Class Mail, *ceteris paribus*. A smaller markup for
8 First Class Mail is also consistent with the Commission's desire to "avoid unfairly
9 penalizing First-Class Mail" and to have First Class Mail "bear a markup at, or only
10 slightly above, systemwide average."⁴² A smaller markup for First Class Mail also helps
11 to target rate relief to individual mailers, as opposed to business mailers.⁴³

12 Under the Postal Service's letter monopoly, Priority Mail users often have more
13 alternatives than do First Class Mail users (§ 3622(b)(5)). Numerous private carriers
14 transport non-letter items weighing up to 70 pounds, just as Priority Mail does.
15 Competitive alternatives also exist even for Priority Mail letters due to the suspension of
16 the letter monopoly for expedited shipments. Consequently, Priority Mail users are

42. Opinion and Recommended Decision, Docket No. R90-1, ¶ 4022.

43. Only 12% of 1998 Priority Mail volume was sent by households, whereas almost 27% of First Class single piece letters were sent by households in 1998; approximately 55% of First Class single piece letters were sent to or from households in 1998, compared to 45% for Priority Mail. Response of Postal Service witness Tolley to interrogatory UPS/USPS-T6-5, Tr. 9/3659-61, and Response of Postal Service witness Musgrave to interrogatory UPS/USPS-T8-1, Tr. 9/3566-67.

1 often better able to mitigate any adverse consequences of rate increases, which
2 suggests that a higher markup for Priority Mail than for First Class Mail is appropriate.

3 The Commission has also indicated that rate increases for First Class Letters
4 (and for Regular Periodicals, Special Standard Mail, and Bound Printed Matter) merit
5 some mitigation because of the ECSI value of their content (§ 3622(b)(8)).⁴⁴ This
6 consideration is less applicable to Priority Mail in light of its greater “non-letter” content.
7 The consideration of ECSI value is one additional reason to establish a markup for
8 Priority Mail that exceeds the markup for First Class Mail.

9 4. The Increase in Attributable Costs

10 The Commission reversed a well-established precedent in R97-1 when it
11 recommended a lower markup for Priority Mail than for First Class Mail. As noted, the
12 Commission’s recommendation was based in part on the substantial increase in Priority
13 Mail’s attributable costs that occurred between R94-1 and R97-1.

14 The corresponding increase in Priority Mail’s attributable costs since R97-1,
15 while substantial, is less pronounced.⁴⁵ As reported in the fourth column of Table 6,
16 Priority Mail’s attributable costs have increased by 35.9% since R97-1. (The
17 corresponding increase in real (inflation-adjusted) terms is 29.5%, as the fifth column in

44. USPS-T-32, p. 11 (Mayes).

45. The data in Table 6 are taken from: (1) Opinion and Recommended Decision, Docket Nos. R80-1, R84-1, R87-1, R90-1, R94-1, and R97-1, Appendix G, Schedule 1; and (2) UPS-T-5, p. 19, Table 8, and workpaper UPS-Luciani-WP-3-1.1.

1 Table 6 reveals.)⁴⁶ This increase is comparable to the corresponding average increase
 2 between recent rate cases prior to R97-1, and less than half of the corresponding
 3 increase in R97-1. In this respect, the unusually large increase in Priority Mail's
 4 attributable costs in R97-1 is not replicated in the present case. Consequently, a
 5 restoration of the historic markup relationship between Priority Mail and First Class Mail
 6 might seem to be appropriate.

TABLE 6
 CHANGES IN PRIORITY MAIL ATTRIBUTED COST

Rate Case	Test Year Estimated Volume (000 Pieces)	Test Year Attributed Cost (\$ 000)	% Change in Attributed Cost	% Change in Real Attributed Cost	Average Annual % Change in Attributed Cost per Piece	Average Annual % Change in Real Attributed Cost per Piece
R80-1	237,720	465,774				
R84-1	296,017	462,436	- 0.7	- 17.5	- 5.1	- 8.4
R87-1	394,781	712,925	54.2	41.0	5.2	1.9
R90-1	518,458	1,002,899	40.7	26.4	2.4	- 1.2
R94-1	762,115	1,401,597	39.8	27.3	- 1.2	- 3.4
R97-1	1,058,687	2,419,687	72.6	64.0	8.1	6.0
R2000-1	1,069,968	3,288,209	35.9	29.5	11.5	9.4

46. The inflation adjustment uses the Gross Domestic Product Implicit Price Deflator (1996=100). <http://www.economagic.com/em-cgi/data.exe/fedstl/gdpef>. The test year attributed costs reported in the third column of Table 6 were translated into 1981 dollars by multiplying each entry by the ratio of the Deflator in the first quarter of calendar year 1981 to the Deflator in the first quarter of the calendar year following the rate case (e.g., 1998 for R97-1). The Deflator for the first quarter of 2001 was estimated to be the Deflator for the first quarter of 2000 (105.90) and the percent increase in the Deflator (1.758) between the first quarter of 1999 and the first quarter of 2000.

1 However, as the last two columns in Table 6 indicate, Priority Mail's attributable
2 cost per piece has increased even more rapidly since R97-1 than it increased between
3 R94-1 and R97-1.⁴⁷ This increase reflects in part the migration of a significant portion of
4 Priority Mail weighing between 11 and 13 ounces to First Class Mail, due to the
5 increase in the weight break between First Class Mail and Priority Mail. That migration
6 has reduced Priority Mail volume. The reduced volume implies that a larger rate
7 increase is required to generate enough extra revenue to offset any given increase in
8 attributable costs, *ceteris paribus*.

9 5. Mitigation of the Rate Increase

10 A very large rate increase for Priority Mail would be required to restore the
11 historic relationship between the markups assigned to Priority Mail and to First Class
12 Mail, given the relatively large markup that the Postal Service proposes for First Class
13 Mail. Some mitigation of this rate increase is appropriate in light of its potential impact
14 on Priority Mail users (§ 3622(b)(4)). The mitigation I recommend takes the form of
15 implementing the same markup for Priority Mail as for First Class Mail, assuming that
16 the Commission recommends the rate increase for First Class Mail that the Postal

47. Attributed cost per piece is the ratio of attributed cost to volume. The percentage increase in this statistic between two successive rate cases is the product of 100 and the ratio of the difference between the statistics to the statistic in the earlier rate case. The average annual percentage increase between two successive rate cases is simply the total percentage increase divided by the number of years between rate cases. The number is taken to be three in all cases except between R80-1 and R84-1 and between R90-1 and R94-1, where it is taken to be four.

1 Service proposes. If the Commission does so, a 40.3% average rate increase for
2 Priority Mail will secure an equal (76%) markup for Priority Mail and First Class Mail.

3 This recommended rate increase is substantial. However, it mainly reflects the
4 35.9% increase in Priority Mail's attributable costs since R97-1. Furthermore, the
5 recommended rate increase provides a cumulative average rate increase for Priority
6 Mail since R94-1 of approximately 48%.⁴⁸ This increase is much less than half of the
7 corresponding increase (135%) in Priority Mail's attributable costs.

8 Historically, Priority Mail volumes have continued to grow rapidly despite
9 substantial rate increases.⁴⁹ This sustained growth indicates that Priority Mail users
10 have been able to adapt to substantial rate increases (§ 3622(b)(4)) in the past, and so
11 are likely to be able to do so in the future. However, if convincing evidence to the
12 contrary arises which demonstrates that the recommended 40.3% rate increase would
13 unduly affect Priority Mail users, then some further mitigation of the rate increase might
14 be appropriate.

48. The 5.6% average rate increase from R97-1 (R97-1 Opinion and Recommended Decision, Summary, at iii) combined with the recommended 40.3% increase provides a cumulative rate increase of 48.2% (since $1.056 \times 1.403 = 1.482$).

49. Priority Mail rates increased by 19% on February 3, 1991, for example. USPS-T-34, p. 7. Nevertheless, Priority Mail's volume and revenue grew substantially in the succeeding years. See Tables 1 and 2 on page 23, above.

1 V. PARCEL POST RATE RECOMMENDATION

2 A. The Recommendation

3 Based upon careful consideration of the criteria specified in § 3622(b) of the Act
4 and relevant changes that have occurred since the R97-1 rate case, I recommend a
5 31.1% percent increase in the average rate for Parcel Post. This rate increase reflects a
6 cost coverage of 111%, a markup of 11%, and a markup index of 0.202.

7 B. Basis for the Recommendation

8 The 31.1 percent rate increase that I recommend reflects in large part the
9 substantial increase in Parcel Post's attributable costs since the R97-1 rate case. It
10 also reflects the solid volume and revenue growth that Parcel Post has experienced in
11 recent years, which suggests that Parcel Post can reasonably bear a markup closer to
12 the systemwide average than it does presently. The 11% markup that I recommend is
13 also important to reduce the risk that Parcel Post revenue will fall below its attributable
14 costs in the future, as it has done repeatedly in the past. The recommended markup
15 also reflects the higher value that its new Delivery Confirmation Service and its new rate
16 categories enable Parcel Post to deliver to its customers.

17 C. Explanation of the Recommendation

18 A more complete explanation of my rate recommendation for Parcel Post follows
19 in five steps. First, I review the substantial increase in Parcel Post's attributable costs
20 since the R97-1 rate case. Second, I document the solid growth in volume and revenue
21 that Parcel Post has experienced in recent years. Third, I explain how the low cost

1 coverage that Parcel Post was assigned in the R97-1 rate case may have caused
2 Parcel Post revenue to fall below its attributed cost in FY1998, the R97-1 test year.
3 Fourth, I note that Parcel Post may no longer be the low-value service that it has
4 historically been considered to be, in part because the new rate categories introduced
5 in R97-1 have enabled Parcel Post to become an integral component of higher value
6 mail services. Fifth, I point out that if the Postal Service's estimates of Parcel Post
7 volume are accurate, then earlier Commission concerns that higher Parcel Post rates
8 would cause unacceptably low volumes are no longer applicable.

9 1. Increased Attributable Costs

10 Parcel Post's attributable costs have increased substantially since R97-1. Parcel
11 Post's estimated attributable costs in the R97-1 test year were \$685.9 million.⁵⁰ Parcel
12 Post's estimated attributable costs in the current test year are 31% higher, at \$898.7
13 million.⁵¹ This substantial increase in Parcel Post's attributable costs since R97-1
14 necessitates a commensurate increase in rates to ensure that revenues exceed
15 attributable costs, as required by § 3622(b)(3) of the Act.

16 2. Solid Volume and Revenue Growth

17 Recent data suggest that Parcel Post can sustain a rate increase designed to
18 ensure that its revenues exceed its attributable costs by a more healthy margin than the
19 margin adopted in R97-1. In contrast to the years immediately prior to the R97-1 rate

50. Opinion and Recommend Decision, Docket No. R97-1, Appendix G, Schedule 1.

51. UPS-T-5, p. 19 (Table 8) (Luciani).

- 1 case, Parcel Post volume and revenue have grown substantially in recent years, as
- 2 Tables 7 and 8 show.⁵²

TABLE 7

PARCEL POST VOLUME GROWTH

Fiscal Year	Parcel Post Volume (millions of pieces)	% Change in Parcel Post Volume
1990	128	5.8%
1991	138	7.8%
1992	165	19.6%
1993	187	13.3%
1994	224	19.8%
1995	218	- 2.7%
1996	213	- 2.3%
1997	237	11.3%
1998	267	12.7%
1998 [†]	316 [†]	--
1999 [†]	319 [†]	0.9% [†]

[†] Based on the Postal Service's proposed new methodology.

52. The data in Tables 7 and 8 are taken from: (1) United States Postal Service Domestic Mail Volume History: 1970-1998, May 1999, USPS-LR-I-117, p. 8; (2) United States Postal Service Domestic Mail Revenue History: 1970-1998, May 1999, LR-I-117, p. 8; (3) United States Postal Service Cost and Revenue Analysis: Fiscal Year 1999, September 30, 1999, USPS-LR-I-275, p. 4; and (4) United States Postal Service Cost and Revenue Analysis: FY1998, PRC Version, Revised June 11, 1999, pp. 6, 8. Volume and revenue statistics for FY1998 are reported as measured using both the Postal Service's traditional methodology and its new proposed methodology for measuring Parcel Post volume and revenue.

TABLE 8

PARCEL POST REVENUE GROWTH

Fiscal Year	Parcel Post Revenue (millions of dollars)	% Change in Parcel Post Revenue
1990	419	7.2%
1991	455	8.6%
1992	560	23.1%
1993	576	2.9%
1994	667	15.8%
1995	703	5.4%
1996	691	- 1.7%
1997	771	11.6%
1998	824	6.9%
1998 [†]	948 [†]	--
1999 [†]	1,021 [†]	7.7% [†]

[†] Based on the Postal Service's proposed new methodology.

1 it is important to note that Parcel Post volume and revenue continued to
2 increase in 1999 even in the face of the average rate increase of more than 12% that
3 was implemented on January 10, 1999. In fact, the rate increase contributed to a
4 nearly 8% increase in Parcel Post revenue in 1999.

5 3. 1998 Revenue Below Cost

6 The extremely low cost coverage that Parcel Post has had in recent years runs a
7 high risk of violating the requirement that the revenues derived from each mail subclass
8 exceed its attributable costs (§ 3622(b)(3) of the Act). Since revenue and cost cannot
9 be predicted perfectly, actual revenue may fall below actual cost if rates are set to
10 generate revenues that are expected to exceed costs by only a modest amount.

1 To illustrate this point, note that FY1998 Parcel Post revenue and attributable
2 cost were predicted in the R97-1 rate case to be \$740.5 million and \$685.9 million,
3 respectively.⁵³ Realized revenue and attributable cost in 1998 were measured to be
4 \$823.6 million and \$840.0 million, respectively, using the Postal Service's historic
5 measurement methodology.⁵⁴ These observations lead to two important observations.
6 First, in practice, revenue and cost forecasts can diverge substantially from actual
7 levels of revenue and cost. In FY1998, attributable cost exceeded predicted
8 attributable cost by more than 22%. Second, using the historic methodology, Parcel
9 Post's measured revenue was below its measured attributable cost in 1998.⁵⁵ Revenue
10 below attributable cost is inconsistent with § 3622(b)(3) of the Act. The cross subsidy it
11 entails is unfair to competitors and to the users of other postal services who must make
12 up the shortfall in net revenue.

13 FY1998 is not the only year in which Parcel Post revenue seems to have failed
14 to cover its attributable costs. In fact, with only two exceptions, Parcel Post revenues
15 have fallen short of attributable costs in every year between FY1989 and FY1997.⁵⁶ The
16 risk of continuing this history of unfair and illegal cross subsidy can be reduced by

53. Opinion and Recommend Decision, Docket No. R97-1, Appendix G, Schedule 1.

54. United States Postal Service Cost and Revenue Analysis: Fiscal Year 1998,
PRC Version, Revised June 11, 2000, p. 6.

55. Recall also from the discussion in Section III(C), above, that the sum of volume
variable cost and specific fixed cost typically understates incremental cost.
Therefore, even if measured revenue exceeds measured attributable cost,
revenue may still fall below incremental cost.

56. The exceptions are FY1992 and FY1995. United States Postal Service Cost and
Revenue Analysis, Fiscal Years 1989-1998.

1 avoiding very low cost coverages like the one adopted for Parcel Post in the R97-1 rate
2 case. The 111% cost coverage I recommend for Parcel Post is designed in part to
3 reduce the likelihood of violating § 3622(b)(3) of the Act and of disadvantaging
4 competitors and other mail users unfairly, without burdening Parcel Post mailers unduly
5 (§ 3622(b)(4)).

6 4. Higher-Value Services

7 In part because of the relatively low priority it is afforded in the mail stream,
8 Parcel Post has traditionally been viewed as a lower-value service. However, the
9 average time for delivery of Parcel Post packages has been less than four days on a
10 fairly consistent basis since 1995.⁵⁷ Furthermore, the Destination Delivery Unit (“DDU”)
11 and Destination Sectional Center Facility (“DSCF”) discounts introduced in R97-1 have
12 enabled Parcel Post to become an integral component of even more expedited parcel
13 services. To illustrate, the Airborne@Home service provided by Airborne Express
14 delivers parcels to the DDU and obtains next-day delivery by the Postal Service with
15 great regularity.⁵⁸ This timely, reliable delivery of parcels enables Airborne Express to
16 promise three-day delivery from “virtually any business to any residential destination in

57. Parcel Post’s average time to delivery has been less than four days in all Postal Quarters since 1995, with the exception of the First Postal Quarter in 1995, 1997, and 1998, and the Fourth Postal Quarter in 1997. The average days to delivery in these quarters were 4.08, 4.07, 4.12, and 4.56, respectively. ODIS Quarterly Statistics Reports, Table 4, Postal Quarter 1, PFY 1995 through Postal Quarter 4, PFY 1999.

58. Postal Service witness Kingsley reports that the “stated delivery expectation is next day delivery for parcels entered at the DDU,” and although delivery times are not tracked, “anecdotal customer feedback” suggests that next day delivery is achieved approximately 97% of the time. UPS/USPS-T10-21, Tr. 5/1912.

1 the U.S.⁵⁹ Arrangements of this sort make DDU Parcel Post an integral component of
2 a service that provides high value to both the senders and the recipients of parcels.

3 As of March 14, 1999, Parcel Post shippers have the option of purchasing
4 Delivery Confirmation for their shipments. This new feature further increases the value
5 of service that Parcel Post now delivers to its users. Consequently, the value of service
6 criterion (§ 3622(b)(2) of the Act) suggests that the appropriate markup for Parcel Post
7 should exceed the markup that the Commission recommended in the R97-1 rate case.

8 5. Revised Volume Forecasts

9 The Postal Service changed its methodology for measuring Parcel Post volume
10 and revenue after the R97-1 rate case. The change provides a substantial increase in
11 measured Parcel Post volume.⁶⁰ UPS witness Sellick (UPS-T-4) documents flaws in
12 this new methodology. However, if the new methodology accurately reflects Parcel
13 Post volume, the much higher volume it reveals should allay any concerns the
14 Commission might have had in R97-1 that a sizeable increase in rates would reduce
15 Parcel Post volumes to unacceptably low levels.

16 To the extent that a concern over low Parcel Post volumes led the Commission
17 to recommend an extremely modest cost coverage for Parcel Post in R97-1, a more

59. Airborne Express web site, <<http://www.airborne.com/factsheet2/currenthtml/19990603928368205.html>>.

60. As noted above, 1998 Parcel Post volume, as measured using the historic methodology, is 266.5 million pieces. As Table 7 indicates, the corresponding volume is nearly 19% higher (316 million pieces) when measured using the new methodology.

1 robust cost coverage is appropriate in the present rate case, since that concern is less
2 pressing now. Indeed, under the new methodology, 1999 Parcel Post volume achieved
3 its highest level since 1977. This peak volume represents an increase of more than
4 163% in the past decade.⁶¹

5 6. Summary

6 In summary, the changes that have occurred since R97-1 lead to the conclusion
7 that the markup for Parcel Post should be increased to a level that is closer to the
8 systemwide average, thereby requiring Parcel Post to shoulder a larger share of the
9 institutional cost burden that has been shouldered primarily by other mailers in recent
10 years.

11 The 11% markup that I recommend reflects a balanced consideration of all of the
12 criteria specified in § 3622(b) of the Act. The recommended markup is only 3
13 percentage points higher than the markup recommended by the Commission in R97-1,
14 and is lower than the markups recommended by the Commission in R84-1, R87-1, and
15 R90-1. A more substantial markup would be appropriate, if not for the large increase in
16 Parcel Post's attributable costs since R97-1. This substantial increase in costs requires
17 a commensurate increase in rates to limit the risk of cross subsidy.

61. Parcel Post volume was 121 million pieces in 1989. USPS-LR-I-117, op. cit.,
p. 4.