MPA-T-3

**BEFORE THE**
**POSTAL RATE COMMISSION**
**WASHINGTON DC 20268-0001**

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| POSTAL RATE AND FEE CHANGES, 2000 | ) | Docket No. 2000-1 |

# DIRECT TESTIMONY
# OF
# MICHAEL A. NELSON
# ON BEHALF OF
# MAGAZINE PUBLISHERS OF AMERICA, INC.
# ALLIANCE OF NONPROFIT MAILERS
# AMERICAN BUSINESS MEDIA
# COALITION OF RELIGIOUS PRESS ASSOCIATIONS
# DOW JONES & CO., INC.
# THE McGRAW-HILL COMPANIES, INC.
# NATIONAL NEWSPAPER ASSOCIATION
# TIME WARNER INC.

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# DIRECT TESTIMONY OF MICHAEL A. NELSON

## I. INTRODUCTION

My name is Michael A. Nelson. I am an independent transportation systems analyst with more than 17 years of experience advising clients on postal costing issues. My office is in North Adams, Massachusetts. Prior to February 1984, I was a Senior Research Associate at Charles River Associates, an economic consulting firm in Boston, Massachusetts.

I have directed or participated in numerous consulting assignments and research projects in the general field of transportation. My work typically involves developing and applying methodologies based on operations research, microeconomics, statistics and/or econometrics to solve specialized analytical problems. I have extensive experience related to analysis of the cost structure of the Postal Service, with a particular focus on delivery activities. On behalf of the Postal Service, I provided testimony before this Commission in Docket No. R97-1, primarily related to the gathering and analysis of field survey data involving carrier and messenger delivery. From 1992-1996, I also assisted Postal Service management in product development and various marketing issues related to expedited mail. On behalf of United Parcel Service, I provided testimony regarding delivery issues in Docket Nos. RM86-2B, R87-1 and R90-1, and served as principal investigator for the studies of carrier street time underlying the testimony of A. Lawrence Kolbe in Docket No. R84-1.

Of equal or greater importance for the purpose of this testimony, I have extensive experience in analyzing management, cost and competitive issues for the different modes of surface transportation relied upon by the Postal Service to move mail. For example:

- On May 16, I filed a statement on behalf of a group of major freight rail shippers recommending changes in merger and regulatory policies administered by the Surface Transportation Board (STB) in Ex Parte No. 582 (Sub-No.1);

- On behalf of Amtrak, a major supplier of transportation to the Postal Service, I provided testimony before the STB regarding the appropriate definition of Amtrak's "express" service (Finance Docket No. 33469). This included analysis of the substitutability of Amtrak, truck and freight rail services, and examination of factors affecting the use of Amtrak by the Postal Service. The STB adopted the definition I proposed, facilitating the recent expansion of Amtrak's mail and express service offerings;

- I assisted Canadian Pacific Railway (CP) in assessing the traffic impacts, competitive issues and potential remedial conditions associated with the division of Conrail between Norfolk Southern (NS) and CSX (STB Finance Docket No. 33388). Conrail was the largest single provider of freight rail transportation for the Postal Service. CP relied upon the results of my studies in reaching its settlements with NS and CSX in that case; and,

- I provided testimony regarding competitive and/or statistical issues in six freight rail merger proceedings before the Interstate Commerce Commission. In the proposed merger of Southern Pacific and Santa Fe (Finance Docket No. 30400) I provided extensive testimony regarding the degree of competition between truck and rail services that provided the only analytical foundation cited by the ICC in denying that merger on competitive grounds.

I have assisted in the preparation of numerous other verified statements presented before various regulatory and legal bodies, and authored many other studies, technical reports and articles in transportation journals.

I received my bachelor's degree from the Massachusetts Institute of Technology in 1977. In 1978, I received two master's degrees from MIT, one in Civil Engineering (Transportation Systems) and one from the Alfred P. Sloan School of Management, with concentrations in economics, operations research, transportation systems analysis and public sector management.

## II. PURPOSE AND SCOPE OF TESTIMONY

I have been asked by MPA to investigate issues related to operational and costing practices in the area of purchased transportation, with a particular focus on highway, freight rail and Amtrak. In addition, I address one carrier costing issue related to routine looping and dismount points on motorized letter routes.

In the transportation area, my testimony addresses costing issues and operating practices that have prevented the Postal Service and its mailers from realizing the full benefits of the market forces that have been unleashed in U.S. surface transportation. For the past two decades, U.S. transportation policies have emphasized competition and market forces as a replacement for historical regulatory practices. Freight railroads have been given freedoms to engage in contracts and price competition, and through innovation and aggressive pricing have succeeded in diverting a significant share of long-haul truck traffic to rail. Trucking itself has been largely deregulated and provides ubiquitous, highly competitive transportation options, particularly for high-value, service-sensitive traffic. Even Amtrak, long a recipient of substantial federal operating subsidies, is now operating under a mandate to become self-sufficient, and has aggressively implemented innovations to increase its transportation of mail and other freight.

Against this background of an increasingly competitive transportation environment, the experience of mailers who attempt to rely on the transportation services procured by the Postal Service stands in stark contrast. Some types of mail, including Periodicals, have experienced rapid growth in transportation cost per piece. Mailers of many types are making dramatically higher use of dropshipping and destination-entry products to bypass most or all of the surface transportation purchased by the Postal Service. In effect, these mailers are finding that they can provide themselves with more economical transportation than the Postal Service provides for them. In this light, dropship discounts serve an important efficiency function by making available to mailers the benefits of improved competitiveness in transportation markets.

From a transportation perspective, however, the apparent inability of the Postal Service to compete effectively with dropshipping options is quite incongruous. A typical parcel shipper, whose mail might average 8 lb./c.f., can almost never utilize the full capacity (by weight) of a standard highway trailer. Similarly, a periodicals shipper, whose mail might exceed 20 lb./c.f., may not be able to utilize the full cubic capacity of a standard highway trailer. The Postal Service should be able to create significant economies by combining these (and

other) diverse types of mail in transportation. Recent trends in transportation costs and mailing patterns indicate that the Postal Service is failing to achieve such economies, or is failing to develop its costs and rates in a manner that reflects such economies.

One obvious possible explanation for these circumstances is that Postal Service costing methods do not accurately measure the surface transportation costs associated with different mail subclasses. This testimony examines those methods, focussing primarily on the volume variability determinations for purchased highway transportation made by witness Bradley (USPS-T18).

A second possible explanation for observed transportation-related problems relates to the (in)efficiency of the Postal Service's procured transportation services. Specifically, while transportation services are generally procured through market processes, this testimony identifies ways in which they appear to be unnecessarily costly in satisfying overall transportation requirements.

In the following sections, I first identify aspects of witness Bradley's models that lead to overstatement of volume variable purchased highway costs, and develop and present an alternative analysis that avoids much of this overstatement. I then identify two other transportation costing issues that require corrective action, including the Base Year treatment of rail movements involving Amtrak "Roadrailers" and empty equipment. In the carrier area, I present a refinement that is needed in the analysis of variability for routine looping/dismount points on motorized letter routes. Finally, I present a series of proposed roll-forward adjustments to account for attainable efficiency improvements and future cost savings in transportation.

## III. ANALYSIS OF PURCHASED HIGHWAY TRANSPORTATION COSTS

The models of purchased highway transportation costs estimated by witness Bradley are inconsistent in two important respects with the operating

practices of the Postal Service. These inconsistencies cause the highway transportation models to overstate volume variability.

As described by USPS rebuttal witness Young (USPS-RT-3) in Docket R97-1, USPS transportation requirements are set primarily by processing and delivery schedules at the facilities being served. Furthermore, transportation schedules are set "to make efficient use of postal employees, who account for about 80 percent of postal operating costs." Docket R97-1, Testimony of witness Young, USPS-RT-3, at p. 8, ll. 11-13. Because transportation routes and schedules are set primarily according to these types of constraints, and not a process that attempts to minimize transportation costs, the Postal Service procures transportation using vehicles with a wide range of capacities. These vehicles are typically not the largest capacity vehicles (vans or trailers) that are available.

As a result, the Postal Service has considerable latitude to alter the sizes of vehicles used on most routes in response to volume changes without adding trips. Witness Young specifically described how increasing the capacity of a contracted vehicle costs little in comparison with the cost of additional runs, and how the Postal Service seeks to tailor the capacity it procures to the peak volume requirement on a route without adding runs. Docket R97-1, Testimony of witness Young, USPS-RT-3, at p. 6.

*Of course, there are some circumstances where it is not possible to add* capacity without adding vehicle mileage. In cases where the vehicle serving the route is already the biggest van or trailer available, it is not possible for the Postal Service to increase the vehicle size. However, when a run must be added, it typically provides an opportunity for the Postal Service to adjust routes in a way that provides more direct service, and reduce the gross CFM that must be procured to satisfy a given transportation requirement. Witness Young presented an example of how a route from the Washington BMC to Merrifield and Norfolk could be "re-worked ...to skip a stop at the Merrifield P&DC..." in response to an increase in volume destined for Norfolk. Docket R97-1, Testimony of witness Young, USPS-RT-3, at p. 7, ll. 8-18. In a transportation network of this type,

skipping a stop and establishing a direct run inherently reduces circuity, and the gross CFM needed to move a given amount of mail. In short, there is an elasticity of gross CFM with respect to net CFM that is less than 1.0, and that causes the Postal Service highway transportation models to overstate the true variability of cost with respect to the volume of mail being moved (as opposed to the CFM procured).

The highway transportation models also overstate variability because they fail to reflect the propensity of the Postal Service to adjust capacity through changes in vehicle size rather than changes in trip frequency to accommodate volume changes in the context of a given transportation schedule. Instead, the highway transportation models measure variability as if changes in capacity requirements are routinely satisfied through changes in trip frequency as well as vehicle capacity. The observations in those models include observations from contracts that vary widely with respect to the number of trips supplied. The elasticities estimated by witness Bradley therefore include the impacts on costs associated with hypothetically changing the number of trips to obtain CFM, as well as changing vehicle size.

The type of biased variability resulting from the Postal Service highway models can be illustrated in a simple example. In this example, assume that there are two highway contracts for routes serving different facilities. The route on each contract is 50 miles long, costs $100, and is served by a 40-foot tractor/trailer combination. However, because of schedule differences between the two facilities, the contact at the first facility calls for one run, while the contract at the second facility calls for two runs. In witness Bradley's model formulation, which relies on annual cost and CFM data, the second contract would appear to be providing twice as much transportation (as measured by annual CFM) at twice the cost. All else equal, the model would suggest that there is essentially 100 percent volume variability.

If volume increased at either facility, however, the Postal Service would avail itself of the fact that increasing the size of the trailer would generally only increase cost by a small amount[1]. As indicated by the Postal Service:

> ...the cubic capacity of a vehicle is generally regarded as being inexpensive relative to the cost of adding extra trips. For this reason it makes economic sense to buy a large vehicle to avoid paying for extra trips.

MPA/USPS-28 (response of USPS).

In the given example, if the Postal Service could obtain service from a 45-foot trailer by increasing the contract rate by 5 percent, it could accommodate up to a 12.5 percent increase in volume. "To avoid paying for extra trips," this would most likely be the way an actual volume change would be accommodated, and the volume variability would be only 40 percent. Unless the vehicle in use is already of a maximum size, or some unusual situation exists, the Postal Service's rational response to a volume increase is to increase the size of the vehicle without increasing trip frequency when it is feasible to do so. Because of this, the degree of volume variability that occurs in practice is lower than that suggested by witness Bradley's model.

In addition to these two major factors, the Postal Service's highway models appear to be questionable with respect to at least two items:

- the treatment of power-only contracts appears to be circular at best, as a constant cubic foot estimate is developed for each area, then used in a model that contains a constant term for each area; and,

- the methods used by witness Bradley to identify outliers appear in some instances to exclude good data.

To develop an analysis of highway volume variability that is consistent with Postal Service operating practices, I began by partitioning the contracts to segregate the largest vans and the largest trailers from the others. For each vehicle type, I defined "largest" to include vehicles within 300 cubic feet of the maximum possible size. For trailers, this included vehicles ranging from 3001-3300 cubic feet, encompassing 53-foot trailers and tandem 28-foot trailers. For

[1] Professor Bradley appears to acknowledge that trailer costs represent a small fraction of the total cost of a given contract. USPS-T-18 at

vans, this included vehicles ranging from 1350-1649 cubic feet. Contracts in each of these categories were treated as 100 percent volume variable, reflecting an assumption that capacity increases could only be obtained through the addition of trips.

For the remaining contracts, I revised the econometric analysis so that it isolated the effects of vehicle capacity changes on costs, holding aside the effects of trip frequency changes. The basic method I used to achieve this was to divide the annual cost and CFM data by the number of runs made on the contract, so that the data for each contract reflected the "cost per run" and "CFM per run". In this way, the model observations no longer differ with respect to the number of runs they represent, and variations in cost associated with variations in vehicle size can be measured.[2]

Initially, I attempted to implement this refinement directly within witness Bradley's models. However, I encountered immediate difficulties with witness Bradley's evaluation method, in which the model is estimated on mean-centered data and the variability is taken from the coefficient on the relevant first-order term. To avoid a digression into lengthy debate over proper methods of evaluation[3], the balance of my work was conducted using log-log models, for which methods of interpretation are unambiguous.

This work consisted of the estimation of two sets of models. In the first set, the "per run" data are further divided by the route length, so the model analyzes cost per mile as a function of cubic feet (and other variables). In the second set, cost per run is analyzed as a function of CFM per run. In both sets, I excluded power-only contracts from the estimation process (applying to power-only contracts and trailer leasing costs the variability found in the analysis of the remaining contracts), and I excluded "outliers" using a small number of consistent criteria. Even with the simpler specifications, the models used in my analysis

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24, lines 5-7.

[2] In the model estimation process, each observation was weighted according to the number of runs it represented from the original contract data.

[3] A partial history of various theories and arguments in this area is presented in the testimony of Postal Service witness Bozzo (USPS-T15).

generally exhibited a high degree of explanatory power, and high statistical significance for the variables needed to estimate the relevant elasticity.

The details of this analysis are presented in a library reference accompanying this testimony. I note that because these models, like the Postal Service models, do not account for the elasticity of gross CFM with respect to net CFM, they likely overstate true variability. Nevertheless, the results of my analysis, which are summarized in Table 1, indicate that total volume variability for purchased highway transportation is approximately 53.1 percent, and that the Postal Service methodology overstates this variability by approximately 28.5 percentage points. For Periodicals, the Postal Service methodology overstates volume variable highway transportation costs in BY98 by $87.8M.

## IV. OTHER TRANSPORTATION COSTING ISSUES

### A. Amtrak Roadrailers

As part of its effort to obtain increased revenues from its mail and "express" business, Amtrak has begun using "Roadrailers". A Roadrailer is a type of trailer that can operate over the highway in a normal tractor/trailer combination, or be quickly adapted to ride on rails without the types of intermodal rail cars normally required to transport highway trailers and shipping containers. When added to the roster of Amtrak service offerings, Roadrailers provided a new capability for truckload movement.

Roadrailer movements are not sampled by TRACS,[4] so the precise composition of mail moving on Roadrailers is not known. However, because Amtrak is only investing in this technology to attract new business, it can reasonably be concluded that Roadrailers are not being used to divert the Postal Service volume that Amtrak already moves (and that is sampled by TRACS). Rather, the speed, reliability, distance and truckload volume characteristics of Roadrailer service make it most analogous to inter-SCF highway transportation

[4] *See* MPA/USPS-T1-6 (response of Postal Service witness Xie).

with respect to the types of movements for which it could beneficially be used to attract traffic from the Postal Service.

The Postal Service has indicated that $4.5M of BY98 Amtrak accrued costs were associated with Roadrailer movements.[5] I have removed this amount from the pool of accrued Amtrak costs, and distributed it to classes and subclasses using the inter-SCF distribution key. On this basis, I estimate that the USPS BY98 treatment of Amtrak Roadrailer movements overstates Periodicals costs by $3.1M.

B. Empty Equipment Movement – Rail

The USPS analysis of empty equipment movements via rail improperly treats such costs as if they were caused by the mail that moves on freight rail and Amtrak. Empty equipment movements via rail include equipment moving to/from MTESCs that was or will be used for other types of surface transportation.

To account for this, I have revised the distribution key applied to rail empty equipment moves so that it reflects the combined distribution of volume variable costs associated with purchased highway, freight rail, Amtrak and water movements. The USPS BY98 treatment of empty equipment movements via rail overstates Periodicals costs by $5.3M.

## V. VARIABILITY OF ROUTINE LOOPING/DISMOUNT STOPS ON MOTORIZED LETTER ROUTES

MPA also requested that I examine an issue relating to city carrier costs, about which I testified in Docket R97-1. My reexamination of this issue leads me to suggest a refinement in my previous analysis.

The variability of routine loops/dismounts, which is applied in the analysis of driving time on motorized letter routes in CRA worksheet 7.0.4.4, was first estimated in Docket No. R97-1. The value of 40.99% was determined by me on the basis of the variability characteristics of different types of routine

[5] *See* MPA/USPS-22 (supplemental response of the Postal Service).

looping/dismount stops, and their relative proportions, using input from a survey of delivery supervisors. The rationale for the specific computation was described in my response to an interrogatory. *See* Docket R97-1, ADVO/USPS-T19-9 (response of USPS witness Nelson).

Basically, routine loops that are established on the basis of volume/weight were treated as 100% volume variable because of the constraints on the formation of such loops imposed by the 35-lb. weight limit on carrier satchel loads. Routine loops and dismounts established for reasons other than the volume/weight of mail were treated as 0% volume variable, as the number of such stops would remain fixed as volume changes. The proper treatment for the remaining stops – dismounts established on the basis of mail volume/weight – was somewhat ambiguous.

On the one hand, existing dismounts made because of volume/weight will remain fixed if volume increases. On the other hand, volume increases likely will cause new dismounts to be made because of volume/weight. In the absence of any other information, this group of dismounts was ascribed the cumulative variability of the other 3, leading to the overall estimated variability of 0.4099, as shown below:

| Stop Type | Total Stops | % of Stops | Volume Variability |
|---|---|---|---|
| Loops Due to Volume/Weight | 242,294,460 | 0.3215 | 1.0000 |
| Loops Due to Other Factors | 85,273,149 | 0.1131 | 0 |
| Dismounts Due to Other Factors | 263,516,968 | 0.3496 | 0 |
| Dismounts Due to Volume/Weight | 162,610,282 | 0.2158 | 0.4099[6] |
| Total | 753,694,859 | 1.0000 | 0.4099 |

Further consideration has led me to conclude that there is an interaction between volume-driven looping points and volume-driven dismounts that was not accounted for in the R97-1 analysis. Basically, stops that would become new volume-driven dismounts in the presence of a volume increase are currently

[6] Calculated as (242,294,460/(242,294,460 + 85,273,149 + 263,516,968)).

served on loops. The conversion of such stops from loop delivery points to (volume-driven) dismounts as volume increases moderates the need to add looping points. If the analysis assumes that a volume increase on volume-driven loops is accommodated entirely by an equal percentage increase in the number of loop parking points, none of the stops on those loops will need to be converted to dismounts, and the number of volume-driven dismounts will not change. In light of these considerations, if the 100% figure is used for volume-driven looping points, it would be most reasonable to treat volume-driven dismounts as fixed (i.e., 0% variable). This treatment yields an overall variability of 0.3215, and is shown below:

| Stop Type | Total Stops | % of Stops | Volume Variability |
|---|---|---|---|
| Loops Due to Volume/Weight | 242,294,460 | 0.3215 | 1.0000 |
| Loops Due to Other Factors | 85,273,149 | 0.1131 | 0 |
| Dismounts Due to Other Factors | 263,516,968 | 0.3496 | 0 |
| Dismounts Due to Volume/Weight | 162,610,282 | 0.2158 | 0 |
| Total | 753,694,859 | 1.0000 | 0.3215 |

## VI. ROLL-FORWARD ISSUES

### A. Highway Contract Renewal Process

Under current contracting procedures, the rates paid when highway contracts are renewed are, on average, materially higher than the rates paid when the Postal Service obtains (competitive) bids for new contracts. As shown in Table 2, the "premium" being paid on renewed contracts is over $100M annually, and in BY98 cost Periodicals over $19M. This represents 8.9 percent of total BY98 highway transportation costs for Periodicals.

The Postal Service may pay such a premium in the belief that it is required to retain contractors who are prepared to provide the Postal Service with a high level of performance. For the trucking industry, however, the security and

processing requirements of the Postal Service are not unlike those of many shippers of high-value, expedited and just-in-time shipments that are handled successfully every day. The Postal Service, like any shipper, must select contractors and manage purchased services with care. However, it is simply unnecessary for them to pay a premium to retain qualified highway contractors. In the highly competitive trucking industry, where modest shifts in the economy or factor prices can wreak havoc with individual firms, the stability provided by the 4-year duration of a standard USPS highway contract, the regularity of USPS schedules and the durability of the organization itself provides a comfort level unattainable from most shippers. If anything, USPS should be commanding a discount, and not paying a premium, to fulfill its highway contracting requirements.

Tightening administrative requirements to ensure competitive terms on renewed contracts would enable these costs to be saved. Because of the 4-year duration of highway contracts, 1/3 of these savings could be implemented by the end of the test year. To reflect this in the Test Year, purchased highway costs should be reduced by (8.9/3=) 3.0 percent. This would result in savings for Periodicals of approximately $3.9M.

B. Highway Contract Obsolescence

There is an inherent tension between the Postal Service's practice of using long-term contracts to foster a stable operating system, and the provision of a system that can be efficient and flexible in the face of change. Within the duration of a standard highway contract (4 years), there have been multiple railroad mergers (affecting the competitiveness of freight rail services); wide fuel price swings; freight rail service disruptions; new Amtrak service initiatives (e.g., Roadrailers, Acela); changes in USPS product offerings and changes in USPS operations (e.g., DPS). Any of these changes have the potential to alter the preferred mix of ground transportation services procured by the Postal Service.

The attachment to the Postal Service's response to MPA/USPS-16 shows that upon expiration, approximately 3.2 percent of highway contracts are for service that is no longer needed. If the events that produce such obsolescence occur at a uniform rate over time, on average 1.6 percent of highway contracts in effect at any given time are for service that is no longer needed.

Except in very unusual circumstances, highway contractors should be amenable to renegotiation of unneeded contracts to serve needed routes and schedules, particularly if such renegotiation would in effect extend the term of their contract (i.e., by restarting the 4-year contract term on the new route). A program to identify and renegotiate unneeded contracts prior to their expiration would affect approximately $29.4M of BY98 purchased highway costs, of which $3.5M was distributed to Periodicals. To account for the effects of such a program in the Test Year, 1.6 percent of purchased highway cost should be removed. This would result in savings for Periodicals of approximately $2.0M.

C. Amtrak Premium and Terms

In the response to an interrogatory (MPA/USPS-26), the Postal Service characterizes Amtrak as a less-than-truckload network. However, in BY98 approximately $58.3M (over 94%) of the $61.5M spent on regularly-contracted Amtrak segments accrued on movements where the cubic feet of procured Amtrak capacity exceeded the cubic capacity of a tractor-trailer.[7]

I have analyzed the relationship between Amtrak costs on these segments, and cost that would be incurred by the Postal Service to obtain equivalent capacity through additional procurement of inter-SCF highway transportation. Specifically, I compared the cost incurred by the Postal Service for each Amtrak segment, as shown in Appendix I of USPS-LR-I-50, with the estimated cost of inter-SCF transportation over the mileage of the corresponding point-to-point highway movement. To estimate the highway cost, I used the cost per CFM (by mileage block) for inter-SCF transportation supplied by tractor-

[7] This is approximated as 30 or more linear feet of Amtrak space.

trailers on non-renewal contracts shown in HCSS, and an assumption that each linear foot of Amtrak space corresponds to 90 cubic feet of capacity.

This assumption may overstate the amount of capacity actually supplied by Amtrak, as most Amtrak capacity is believed to be supplied using MHC's, which provide 69.8 to 78.3 cubic feet per linear foot.[8] The analysis may also overstate the cost of substitute highway transportation, since it assumes that the trucks will follow the Amtrak route, and will not take advantage of shorter paths that likely exist between origins and destinations that utilize transfers between Amtrak routes.

Despite these conservative assumptions, my conclusion is that approximately $57.3M is spent on Amtrak segments where the payments to Amtrak exceed the cost of purchased highway transportation. As shown in Figure 1, these segments comprise virtually the entirety of Amtrak's transcontinental service, as well as its north-south service on the East Coast. If the Postal Service replaced this Amtrak service with new contract highway service procured at the rates it paid in BY98 for tractor trailers providing inter-SCF transportation, at least $19.0M would be saved. Put another way, 30.9% (= 19.0/61.5) of BY98 Amtrak contracted capacity costs reflect a premium above the cost of equivalent and readily available truck transportation.

If the Postal Service is already consolidating LTL shipments to truckload volumes, it receives no particular benefit from paying Amtrak supra-competitive rates to move those volumes. Indeed, this situation produces disadvantages for all parties:

- Mailers pay a "premium" of over 30 percent without discernible benefit;

- The cost floor of Postal Service products is pushed upwards by the assumed 100% variability of these costs; and,

- Amtrak, by pricing higher than truck, fails to attract highway volume from the Postal Service that could economically move via Amtrak, and would enhance Amtrak's net revenues and prospects for self-sufficiency.

[8] See the response of the Postal Service to MPA/USPS-44.

Several approaches are available to address this issue:

i. USPS could use this information to negotiate more vigorously with Amtrak to obtain a truck-competitive rate;

ii. If this does not produce satisfactory results, USPS could actually convert the traffic to truck and obtain an appropriately reduced rate; or,

iii. USPS and Amtrak could create additional benefits for all parties by restructuring their agreement so that for a fixed payment, USPS obtains the option to use Amtrak at marginal rates that are somewhat below truck rates. On a terms-of-incurrence basis, this would produce volume-variability of less than 100%, while creating an opportunity for the Postal Service to economize on a portion of the $660+ million it spends annually on inter-SCF and inter-BMC highway transportation, and an opportunity for Amtrak to make money from that traffic.

If the Postal Service undertakes any of these options, volume variable Amtrak costs would be reduced by at least the amount of the premium. To account for this in the Test Year, Amtrak costs should be reduced by $19.0M. The portion of this savings associated with Periodicals is $15.4M. If option (iii) is developed, it would produce additional savings for mail now moving on purchased highway transportation.

D. Freight Rail Rates

In its response to an MPA interrogatory[9], which included a request for "documentation of any and all volume incentive rate, discount or credit terms in effect for [freight rail] transportation provided to the Postal Service in BY98". The Postal Service states:

> "(t)here are no such rates, discounts or terms. There is not even language in postal contracts with the freight railroads that provides for the credit, volume discounts, incentive rates and the like. The Postal Service simply does not have the volume of business with the freight railroads required to obtain these terms."

[9] See the supplemental response of the Postal Service to MPA/USPS-40 (b), dated 5/2/00.

With approximately $200M in annual freight rail traffic, USPS is not the largest intermodal customer. By comparison, in public statements UPS estimates its use of freight rail to be approximately $750M annually. However, UPS has so much clout that entire trains are scheduled to accommodate its needs.

The Postal Service may have come to believe that it isn't big enough to qualify for volume discount rates by virtue of having been primarily a customer of Conrail. Over 54 percent of USPS freight rail expenses in BY98 were for service from Conrail, by far the largest USPS expenditure on any single freight railroad.

Operating as a near-monopoly over much of its service area, Conrail historically did not experience the type of intramodal competitive pressure that has driven the proliferation of volume discount rates among other carriers. However, because of the recent break-up of Conrail, the Test Year will see competition between 2 and in some cases 3 Class I railroads take the place of Conrail.

A fundamental premise of the Conrail break-up transaction was that intermodal rates in the Conrail service area would drop by approximately 10% as a result of increased competition. To account for this, Test Year freight rail costs should be reduced by 5.4 percent. This reflects a 10 percent reduction on Conrail's 54 percent share, and would lead freight rail costs for Periodicals to be reduced by $0.9M.

In addition to this reduction, the Postal Service should be able to obtain volume discounts from at least some of the other railroads from which it purchases transportation services. Freight railroads generally seek to obtain high utilization of their infrastructure, and volume discounts have been a common tool used to ensure that the traffic of even moderately large shippers is tendered to a given railroad, and not to its competitor(s). The Postal Service may not be the largest of rail intermodal shippers, but it is easily large enough to command volume discounts in a competitive marketplace. Greater aggressiveness on the part of the Postal Service in seeking such terms could be expected to lead to additional savings.

E. Additional Items For Which Data Not Yet Available

A number of additional items may produce savings for Periodicals that are achievable by TY01. These include the following:

1. Conversion from Freight Rail to Highway

In the response to MPA/USPS-31b, the Postal Service indicates that it anticipates higher costs as a result of the service-driven conversion of freight rail traffic to highway. Current post-merger rail service disruptions in the East, like those that occurred in the West beginning in 1997, are expected to dissipate by the Test Year, removing any need for conversion to highway.

The Postal Service should remove from the Test Year any increment in costs associated with an assumed need to convert freight rail traffic to highway.

2. Stacking of Pallets

The generally low capacity utilization in purchased highway transportation interacts with methods used to collect TRACS data to overstate cost causality for some types of mail. Specifically, pallets (typically used for bulk movement of Periodicals) may not be stacked when floorspace utilization is low. In a TRACS test, no adjustment is made for the fact that such pallets do not preclude use of the airspace above them (up to 72"), and could be stacked on each other if required[10]. The Postal Service should modify the TRACS-Highway data collection process so that it collects information about the stacking of pallets similar to TRACS-Amtrak tests. In the meantime, the Postal Service should estimate the potential reduction in floorspace utilization that would be associated with the stacking of pallets, and make appropriate adjustments in the TRACS-Highway distribution keys.

[10] See the response of Postal Service witness Xie to FGFSA/USPS-T1-25.

3. Study of Transportation Utilization and "Reductions in Unutilized Capacity"

As described in its response to MPA/USPS-17c, the Postal Service is conducting a study of transportation utilization, and may be able to realize savings through reductions in unutilized capacity. Any such savings that are identified for the Test Year should be applied.

4. $100M Future Cost Reduction

As described in its response to MPA/USPS-30 the Postal Service is expecting to realize $100M savings in purchased highway transportation through reductions in vehicle mileage, fuel and trailer leasing expenses. Any such savings that are identified for the Test Year and do not duplicate savings reported elsewhere should be applied.

5. Process Improvements, Cycle Time Reductions, and Possible Unit Cost Reductions

As described in its response to MPA/USPS-45, the Postal Service may be able to achieve savings through process improvements, cycle time reductions and unit cost reductions. Any such savings that are identified for the Test Year and do not duplicate savings reported elsewhere should be applied.

## Table 1

## Summary of Results Regarding Analysis of Purchased Highway Transportation Volume Variability

| Account Type | Accrued Cost | Volume Variable Cost - USPS BY98 | Volume Variable Cost - Revised |
|---|---|---|---|
| | | | |
| Intra-SCF | 780,882 | 501,814 | 350,327 |
| % | | 0.643 | 0.449 |
| | | | |
| Inter-SCF | 451,826 | 409,337 | 350,340 |
| % | | 0.906 | 0.775 |
| | | | |
| Intra-BMC | 272,745 | 268,989 | 171,348 |
| % | | 0.986 | 0.637 |
| | | | |
| Inter-BMC | 264,390 | 259,271 | 79,855 |
| % | | 0.981 | 0.302 |
| | | | |
| Plant Load | 45,685 | 41,025 | 9,228 |
| % | | 0.898 | 0.202 |
| --- | | | |
| | | | |
| Total Highway | 1,838,700 | 1,500,532 | 976,651 |
| % | | 0.816 | 0.531 |

## Table 2

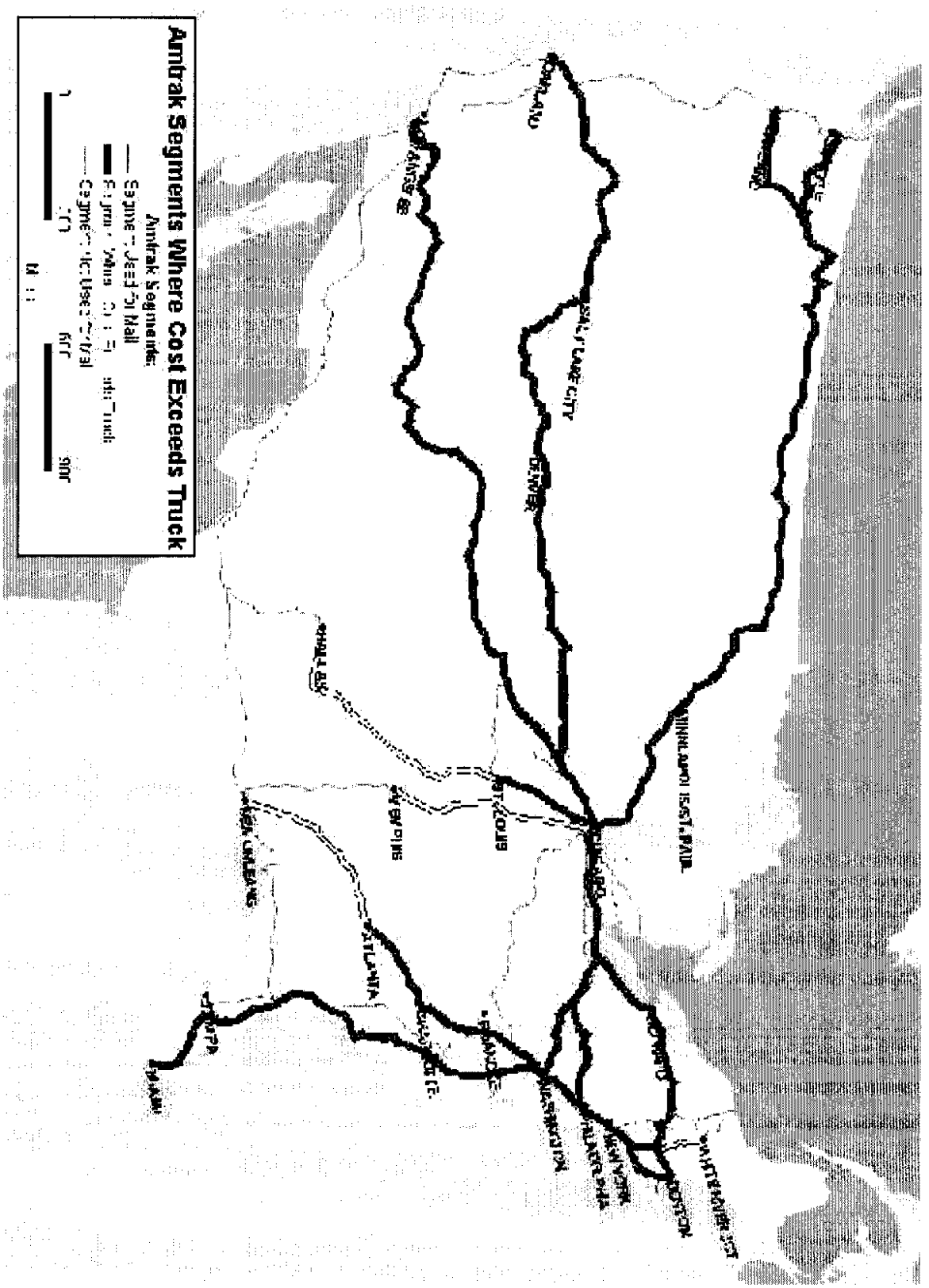
### Estimated Savings from Highway Contract Renewal at Market Rates

| Type | Mileage | Cost ($M) | Cost/ CFM | Non-renewal Cost/CFM[11] | Savings ($M) | % | BY98 2C Savings ($M) |
|---|---|---|---|---|---|---|---|
| | | | | | | | |
| Inter | 0-250 | 164.3 | .000555 | .000481 | 21.9 | | |
| -SCF | 251-500 | 55.9 | .000409 | .000313 | 13.1 | | |
| | 500+ | 27.6 | .000353 | .000296 | 4.5 | | |
| | Total | | | | 39.5 | 8.7 | 4.7 |
| | | | | | | | |
| Inter | 0-250 | 12.3 | .000497 | .000481 | 0.4 | | |
| -BMC | 251-500 | 35.3 | .000401 | .000313 | 7.7 | | |
| | 500+ | 181.2 | .000376 | .000296 | 38.6 | | |
| | Total | | | | 46.7 | 17.7 | 8.7 |
| | | | | | | | |
| Intra | 0-250 | 85.1 | .000454 | .000481 | (5.1) | | |
| -BMC | 251-500 | 45.4 | .000399 | .000313 | 9.8 | | |
| | 500+ | 9.6 | .000325 | .000296 | 0.9 | | |
| | Total | | | | 5.6 | 2.1 | 0.6 |
| | | | | | | | |
| Intra | 0-250 | 476.9 | .001033 | .001044 | (5.1) | | |
| -SCF | 251-500 | 6.0 | .000455 | .000323 | 1.7 | | |
| | 500+ | 2.0 | .000525 | .000296 | 0.9 | | |
| | Total | | | | (2.5) | (0.3) | (0.2) |
| | | | | | | | |
| Plant | 0-250 | 15.3 | .000773 | .000235 | 10.6 | | |
| Load | 251-500 | 2.2 | .002991 | .000627 | 1.7 | | |
| | 500+ | 0.4 | .000505 | .000382 | 0.1 | | |
| | Total | | | | 12.4 | 27.1 | 5.5 |
| | | | | | | | |
| | | | | GRAND TOTAL | 101.7 | | 19.3 |

Source: HCSS.

[11] Intra-SCF over 500 mi., inter-BMC and intra-BMC have at most 1 non-renewed contract in each cell. Inter-SCF cost is used as proxy.

Figure 1


Amtrak Segments Where Cost Exceeds Truck
Amtrak Segments:
Segment Used by Mail
Segment Used by Mail
Segment Not Used by Mail
0
300
SALT LAKE CITY
DENVER
MINNEAPOLIS-ST. PAUL
CHICAGO
NEW ORLEANS
ATLANTA
WASHINGTON
NEW YORK
BOSTON
PHILADELPHIA

CERTIFICATE OF SERVICE

I hereby certify that I have this date served the foregoing document upon all participants of record in this proceeding in accordance with the Commission's Rules of Practice.

Anne R. Noble

Washington DC
May 22, 2000