

BEFORE THE
POSTAL RATE COMMISSION

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POSTAL RATE COUNCIL
OFFICE OF THE SECRETARY

POSTAL RATE AND FEE CHANGES, 2000

DOCKET NO. R2000-1

TRIAL BRIEF OF
UNITED PARCEL SERVICE

I. INTRODUCTION

United Parcel Service ("UPS") submits this trial brief in order to set forth its positions that:

(1) The volume variability of mail processing labor costs is essentially 100 percent, and, with minor modifications, those costs should be distributed to the classes of mail using the MODS-based approach proposed by the Postal Service;

(2) The Postal Service's belated substitution of vastly increased Parcel Post revenue, piece, and weight estimates based on an untested and potentially unreliable "BRPW/DRPW" approach in place of the established DRPW methodology should be rejected;

(3) The Postal Service's proposed treatment of purchased transportation costs should be revised to (a) attribute the premium costs of its dedicated air networks to Priority Mail as well as to Express Mail, and (b) allocate empty space in purchased highway transportation to the classes of mail that give rise to the need for the capacity purchased;

(4) The Postal Service has admittedly failed to attribute sufficient advertising costs to Priority Mail, Parcel Post, and Express Mail;

(5) The methods used to distribute City Carrier elemental load time and other city carrier costs to parcels understate the costs of parcel delivery and should be modified;

(6) The Postal Service's treatment of Parcel Post OMAS and Alaska volumes and revenues results in an overstatement of Parcel Post revenues;

(7) The proposed Parcel Post discounts are overstated and are based on overly high passthroughs of DDU and DSCF worksharing cost avoidance;

(8) The Postal Service's recommended cost coverages for Parcel Post and for Priority Mail fail to meet the pricing criteria of 39 U.S.C. § 3622 and should be revised.

II. ARGUMENT

A. The Commission Should Continue to Attribute Essentially 100% of Mail Processing Labor Costs.

In this docket, the Postal Service once again advances a study which purportedly establishes that the volume variability of mail processing labor costs is substantially less than 100%. In previous proceedings, the Commission has, with minor exceptions, attributed essentially 100% of mail processing labor costs. In Docket No. R97-1, Postal Service witness Bradley presented testimony intended to establish that mail processing labor costs do not vary fully with changes in mail volume. Finding the study unreliable, the Commission refused to depart from its traditional treatment of mail processing labor costs. It should do so again.

Postal Service witness Bozzo has in large part accepted Dr. Bradley's R97-1 conceptual and empirical framework. While Dr. Bozzo's analysis represents an improvement over the R97-1 study, his analysis remains flawed and should not be adopted. On the other hand, the alternative analyses of UPS witness Neels indicate that, as the Commission has consistently found, mail processing labor costs are in fact 100% volume variable.

1. Dr. Bozzo's reliance on piece handlings as a proxy for true volume should be rejected.

Instead of focusing on the relationship between costs and volume, Postal Service witness Bozzo analyzes labor hours and "total piece handlings," a measure that is distinctly different from volume. Dr. Neels demonstrates that using piece handlings as a proxy for volume leads to erroneous conclusions about the volume variability of mail processing labor costs. The data provided by the Postal Service shows that growth in the volume of mail entering a plant causes a disproportionate growth in piece handlings. This undercuts an essential assumption underlying Dr. Bozzo's analysis, i.e., that the number of total piece handlings -- the variable used in the analysis -- is proportional to volume.

In short, like Dr. Bradley in Docket No. R97-1, Dr. Bozzo analyzes the wrong thing.

2. The Postal Service's data continues to exhibit quality problems of the type identified by the Commission in Docket No. R97-1.

One of the Commission's main criticisms of the Docket No. R97-1 analysis was the use of a data set that contained a large number of errors. That problem continues

to exist in this case. Indeed, Dr. Bozzo acknowledges that there are errors in the data, but he asserts that the errors are acceptable and that his model minimizes their impact.

As UPS witness Neels has demonstrated, the data errors are serious. At a minimum, 7.16% of the manual flats data, 28.07% of the manual parcels observations, and 22.04% of the Priority Mail observations are erroneous. Errors of this size raise questions about the entire data set and are not an acceptable basis for the Commission to turn its back on thirty years of precedent.

As Dr. Neels demonstrates, these data problems have serious implications for the Postal Service's econometric results. Measurement error in an explanatory variable of a linear regression model renders the estimator inconsistent and frequently biases coefficient estimates towards zero. The lower volume variabilities resulting from Dr. Bozzo's analysis may very well be the result of this measurement error rather than economies of scale. Dr. Bozzo's econometric model cannot overcome these data errors.

3. Dr. Bozzo's analysis ignores the Postal Service's ability to adjust in response to changes in volume.

While Dr. Bozzo has modified Dr. Bradley's R97-1 econometric specifications to permit adjustments to changes in volume to take place over a longer period of time than in the R97-1 analysis, his study still takes an extremely narrow, short run view of how the Postal Service accommodates changes in mail volume. "Long run" decisions on staffing levels, mechanization and automation, and the construction, expansion, or modification of mail processing plants are all affected by mail volume.

Dr. Bozzo attempts to downplay the impact of such long run changes on mail processing labor costs. However, the Commission cannot ignore that a proper analysis

must consider that the economic concept of the "long run" involves a period of time sufficient to allow a firm to adjust all of its operations fully to changes in volume.

Dr. Bozzo's short run view does not permit the Commission to review the Postal Service's systemwide response to changes in volume and therefore should be rejected.

4. Dr. Bozzo's results have unreasonable implications for the efficiency of manual operations.

Dr. Bozzo's variabilities for manual operations are uniformly smaller than his variabilities for automated or mechanized operations. This implies that manual operations exhibit greater economics of scale than do mechanized or automated operations. That leads to the implausible situation in which, according to Dr. Bozzo's model, manual processing is less costly per piece than automated or mechanized processing in many of the plants in his sample.

This counter-intuitive indictment of the Postal Service's mechanization/automation efforts calls into serious question the validity of the analysis.

5. Mr. Degen's hypotheses do not provide a basis for concluding that mail processing labor is not 100 percent volume variable.

Dr. Bozzo relies on Mr. Degen's explanation of postal operations to support his conclusion that mail processing costs are not 100% volume variable. However, Mr. Degen oversimplifies the effects of mail flow on mail processing operations and makes assumptions that are contradicted by the realities of mail processing, many of which are testified to by Postal Service witness Kingsley. To take some examples:

1. While machine set up and take down times may not vary for small increases in volume, larger, longer run increases in volume will necessitate the

modification or even the replication of mail processing operations. Instead of indicating economies of scale -- necessary to less than 100% variability -- the evidence indicates that mail processing operations often exhibit diseconomies of scale as volume increases.

2. Mr. Degen assumes that incremental volume growth occurs in "the shoulders of the peak," i.e., at times when volume can be processed simply by increasing existing resources such as staffing levels. That assumption is unsupported. Incremental volume growth could just as easily occur when there is no excess capacity to absorb it. Over the long term, if volumes grow proportionately, then staffing levels should grow proportionately in response.

3. Mr. Degen asserts that gateway staffing levels are driven not by volume, but by pressure to get mail downstream, into processing. However, this itself implies that gateway staffing levels are in fact volume driven, albeit by the volume in the downstream operations that drive the gateway staffing levels.

4. Mr. Degen also asserts that manual processing operations respond to increases in volume with increased productivity, not with increased hours. While this could be true in the short run, sustained increases in volume must inevitably result in additional employees in the long run.

None of Mr. Degen's speculations provides sufficient reason for the Commission to depart from its historical treatment of mail processing labor costs.

6. Dr. Neels' alternative analyses demonstrate that the Commission's established treatment of mail processing labor costs as essentially fully volume variable is correct.

UPS witness Neels has performed alternative calculations that address biases in the Postal Service's analysis. For example, Dr. Neels aggregated the data by shape in order to eliminate the impact of data reporting errors. Aggregation of the data by shape also helps to measure the volume variability of mail processing costs as an integrated whole. This results in noticeably higher volume variabilities. Dr. Neels also takes into account the relationship between TPH/F and first handling pieces. These steps produce volume variabilities in excess of 100%, suggesting the existence of diseconomies of scale in mail processing.

Dr. Neels also performed a time series analysis of systemwide mail processing costs, since the other analyses fail to reflect the full response of the Postal Service to volume changes over the long run. This systemwide, long run approach is superior to the micro-level, short run analyses relied on by the Postal Service. The results of the time series analysis strongly indicate that the volume variability of mail processing labor costs is at least equal to 100%. Indeed, the variabilities range from 98% to 123% (indicating diseconomies of scale).

In short, the evidence shows that the Commission's long-held treatment of mail processing labor costs as essentially 100% volume variable is correct. Dr. Neels suggests how a more definitive study should be conducted. Until such a study is performed, however, the Commission should adhere to its well-established attribution of virtually all mail processing labor costs.

B. Mail Processing Labor Costs Should Be Distributed Using the Postal Service's MODS-Based Approach, With Minor Modifications.

UPS agrees with the Postal Service's improved MODS-based distribution key method for distributing mail processing labor costs to the subclasses of mail, as developed by Postal Service witnesses Degen (USPS-T-16) and Van-Ty-Smith (USPS-T-17). The Postal Service's refinement of the MODS-based approach in this case addresses the Commission's concerns raised in Docket No. R97-1 by:

1. Breaking costs at Non-MODS facilities into eight processing-based functional cost pools rather than on the basis of the "Basic Function" (e.g., incoming, outgoing, transit, and other) cost pools used in Docket No. R97-1;
2. Distributing the costs associated with "not handling" mail in allied pools on a broader basis than in Docket No. R97-1; and
3. Distributing costs in MODS "support" pools in a "piggyback" fashion, based on the cost pools which those pools support.

The Postal Service's distribution method can be implemented while treating mail processing labor costs as 100% volume variable, and it should be applied with the minor modifications made by UPS witness Sellick -- reversing the "migration" of some costs previously defined as Window Service (and assigned to Cost Segment 3.2) and Administrative (and assigned to Cost Segment 3.3). These migration reversals are the same as those that were required in Docket No. R97-1 to conform to established Commission practice.

C. The Postal Service's Last-Minute Substitution of an Untested Volume and Revenue Estimation Method for Parcel Post in Place of the Established Method Should Be Rejected.

1. The Postal Service's use of untested and potentially unreliable BRPW data is inconsistent with procedural fairness and undercuts due process rights.

The Commission has recognized that participants should have "an opportunity to evaluate existing data in a meaningful way." Docket No. RM92-2, Order No. 1002 (January 14, 1994), at 16. That opportunity has not been provided here in the case of the Postal Service's proposed estimates of Parcel Post revenue, pieces, and weight.

UPS witness Sellick establishes in UPS-T-4 that adoption of the Postal Service's hybrid BRPW/DRPW Parcel Post estimates is at best premature. The Postal Service's Parcel Post estimates are inadequately documented, untested, and potentially unreliable. The Commission should instead adopt the DRPW-based estimates initially adopted by the Postal Service itself in its FY1998 Cost and Revenue Analysis report.

2. The Postal Service's Parcel Post estimates are not adequately documented.

The Postal Service's Parcel Post estimates rely on highly aggregated data that make it impossible to determine the reliability of that data. Indeed, the Postal Service's witness who sponsored the BRPW portion of the Parcel Post estimates admitted repeatedly on cross-examination that he is not familiar with the underlying PERMIT System data base from which his estimates are derived. The data he used is aggregated to such a high level that it could easily hide significant errors. Yet, the Postal Service has accepted that data completely on faith. As the witness himself put it:

"All I can say is that we collect the permit data. It's given to us and it's an input to my model." Tr. 2/902.

This is particularly surprising since the untested BRPW/DRPW approach estimates total Parcel Post volume in GFY1998 to be **50 million** more pieces than estimated by DRPW alone – an increase of approximately 19%. The Postal Service simply ignores this troubling discrepancy and merely assumes that the data on which it now relies, for the first time, is correct without any external verification of it.

3. The BRPW Parcel Post estimates are untested and unreliable.

UPS witness Sellick points out that the BRPW Parcel Post estimates are untested and unreliable. Moreover, unlike virtually all other BRPW estimates of any significance, the Parcel Post BRPW estimates are not adjusted to accord with actual Postal Service revenues. The trial balance revenue account adjustment described by Mr. Sellick is an important check on the reasonableness of BRPW estimates and, implicitly, on the accuracy of the underlying PERMIT System postage statement data.

To make matters worse, the BRPW/DRPW approach as implemented by the Postal Service eliminates the overall RPW Adjustment System's Book Revenue Adjustment, an adjustment process that was previously applied to the portion of the Parcel Post estimates that, under the Postal Service's approach, is now based on BRPW data alone. In FY1998, the implicit Book Revenue Adjustment Factor was approximately 0.94, representing a downward adjustment to revenues, volumes, and weight of 6%. If the BRPW portion of the Parcel Post estimates had been adjusted, the Postal Service's own Parcel Post volume and revenue estimates for FY1998 would be lower by approximately 13.4 million pieces and \$35.2 million. This fact by itself

demonstrates that the Parcel Post BRPW data, regardless of any other infirmities in it, is substantially overstated.

4. There are substantial reasons to question the accuracy of the BRPW Parcel Post data.

The BRPW error-checking process is clearly flawed. Even at the high level of aggregation of the data there are nonsensical results. This raises the clear danger that, for example, Bound Printed Matter pieces -- reported on the same postage statement as Parcel Post -- could easily be mistakenly entered into the PERMIT System data base as Parcel Post, and the error flags relied on by the Postal Service would not bring the error to light. Indeed, given the level of aggregation of the BRPW data, even heavier Standard (A) Mail pieces could be mistakenly counted as Parcel Post pieces without detection. And there is evidence in the relatively small number of data forms produced by the Postal Service that this has in fact occurred.

By comparison, the DRPW sample system is based on a thorough review of individual mail pieces by trained data collectors who provide rate cell detail for all sampled Parcel Post pieces. DRPW determines with certainty the weight of the sampled piece, the zone to which it is sent, and its rate category. Such a carefully performed sample is clearly superior to a data base that purports to be a "census" but that in fact may be nothing more than a hodgepodge of information taken from unverified forms. The BRPW error checks stand in stark contrast to the record-by-record editing and verification procedures performed on DRPW data.

That the individual, non-aggregated data in the PERMIT System data base upon which the Parcel Post BRPW estimates are based may be inaccurate is supported by

the Postal Service's own Inspection Service audit reports of bulk mail acceptance facilities and procedures. These audits found repeated instances in which:

1. Postal Service employees who accepted bulk mailings did not verify the accuracy of the information on the postage statements from which the PERMIT System data is derived;
2. Untrained personnel performed PERMIT System tasks;
3. Non-supervisory personnel used supervisory ID codes to override the data in the data base and to effect reversals of prior data entries without supervisory review;
4. Mailers did not use the correct versions of mailing statements.

Indeed, a sample of 50 permit imprint mailer accounts revealed inaccuracies in half of the accounts. And an examination of 1,311 First Class, Standard A, and Standard B mailing statements revealed a 5% error rate.

The few documents that the Postal Service has produced include instances in which the mail class indicated is Parcel Post when in fact the piece weight establishes that the mailing must actually have been Standard (A) Mail. Thus, Standard (A) Mail pieces have apparently been recorded as Parcel Post mail in the PERMIT System data.

This evidence calls into serious question the integrity of the unexamined PERMIT System data base and the BRPW Parcel Post estimates based on that data.

5. **The unadjusted joint use of BRPW and DRPW data leads to possible double-counting of Parcel Post pieces and revenue.**

For most mail subclasses, RPW estimates are derived almost exclusively from one or the other of the two systems, either BRPW or DRPW. The unusually heavy reliance on both systems simultaneously in the case of Parcel Post places special

importance on ensuring that mail counted in one system is not also counted in the other. The only way to avoid a double-count of permit imprint Parcel Post under these circumstances is for permit imprint Parcel Post observations sampled in DRPW to be excluded from the DRPW estimate. Thus, ensuring that Parcel Post volume and revenue is not overstated depends heavily on the ability to identify correctly whether a particular piece of Parcel Post sampled in DRPW was paid for under a permit imprint or not, and to correctly record the payment indicia for the piece.

The correct assignment of the permit imprint RPW code for Parcel Post in DRPW rests entirely on the response the DRPW data collector makes to only one question in the RPW software, a question that had no importance at the time the data was collected. When Parcel Post estimates were derived entirely from the DRPW system, the accuracy of this one response made no difference: regardless of the indicia type recorded, the piece was counted in arriving at the Parcel Post estimates. Under the hybrid BRPW/DRPW system, however, if a permit imprint Parcel Post piece is incorrectly recorded as, say, a metered piece, it is incorrectly counted in both the DRPW estimate and in the BRPW estimate.

In short, the integrity and reliability of the Postal Service's FY1998 hybrid system rests in large part on one data collection question which was of no consequence when the data at issue was collected. Indeed, since the decision to restate the FY1998 Parcel Post estimates was not made until after FY1998 was over, the data collectors could not possibly have been aware of the importance of this question when they collected the DRPW data in 1998.

* * *

Given the absence of documentation, the lack of any revenue account adjustment, the inadequacy of the error checking process, and the numerous audit findings that call into question the reliability of postage statement data, the Commission should not use the hybrid BRPW/DRPW Parcel Post estimates in this case, but should instead use the FY1998 DRPW-only estimates for Parcel Post that the Postal Service originally adopted, as contained in the record. That is especially so since the data system at issue is in the process of being replaced by the Postal Service.

D. The Postal Service's Treatment of Purchased Transportation Costs Should Be Revised.

1. The "network premium" for the Postal Service's dedicated air networks should be attributed both to Express Mail and to Priority Mail.

The testimony of Dr. Neels in UPS-T-3 establishes that the "network premium" associated with the Postal Service's dedicated air network costs for the Eagle and Western networks should be attributed to Priority Mail as well as to Express Mail. The network premium is the difference between the actual cost of the Eagle and the Western networks and the imputed "commercial air equivalent" for the same transportation. In Docket No. R97-1, the Commission attributed these dedicated air network premium costs solely to Express Mail, based essentially on one unchallenged statement by one Postal Service witness. This represented a break from prior practice, under which the Commission had attributed the premium to both Express Mail and Priority Mail.

The evidence in this case indicates that the Commission's pre-Docket No. R97-1 treatment was correct. Achieving Priority Mail service standards is at least as important

to the Postal Service's current network design as is achieving Express Mail service performance. Moreover, Priority Mail is a far larger user of these networks than is Express Mail: in the base year, 47% of the volume on the Eagle network and 54% of the volume on the Western network was Priority Mail. In comparison, only 24% of the volume on the Eagle network and a mere 9% of the volume on the Western network was Express Mail in the base year.

Based on these facts, it is grossly unfair to impose the entire network premium on Express Mail users alone. The Commission should return to its pre-Docket No. R97-1 approach and attribute the dedicated air network premium both to Express Mail and to Priority Mail. As Dr. Neels shows in UPS-T-3, this results in a 59.66 percent decrease in domestic air costs attributed to Express Mail and a 13.18 percent increase in domestic air costs attributed to Priority Mail.

2. The cost of empty space in purchased highway transportation should be allocated to the classes of mail that generate the need for the purchased capacity.

The Postal Service's allocation of the cost of empty space in purchased highway transportation is determined by the mix of all mail unloaded from the truck as sampled in TRACS. Dr. Neels develops an improved distribution method. His approach gives more weight to those mail classes and subclasses that are on the more highly utilized trips, and which therefore are the driving force in determining the total capacity purchased by the Postal Service.

Giving greater weight in the distribution process to the classes and subclasses of mail that travel on the more fully-loaded trucks more closely aligns costs with the classes of mail that give rise to those costs. Under this approach, costs for occupied

space are still distributed to the mail that occupies that space, while the cost of empty space is distributed to a mix of mail representative of that found on the more fully-loaded trucks, based on a distribution key for the "capacity-causing mail mix."

Dr. Neels' alternative method of allocating empty space costs results in an increase in base year costs as follows: First Class Mail, 3.78 percent; Priority Mail, 7.33 percent; Parcel Post, 2.37 percent. The costs assigned to Periodicals, Standard (A) Mail, Express Mail, and non-Parcel Post Standard (B) mail decline.

The fact that Priority Mail's share goes up the most is not surprising. The TRACS sampling system has a number of flaws which, while not quantifiable, likely result in undersampling time-sensitive mail.¹ For example, the TRACS sample excludes "emergency" contracts and "exceptional service" highway movements. The cost of these two types of movements are substantial, together comprising almost 16 percent of total purchased highway transportation costs. Evidence about the nature of these movements suggests that emergency contract and exceptional service movements contain, on average, a mail mix with higher proportions of time-sensitive mail than do regular movements. Thus, if such mail movements were sampled in TRACS, the TRACS distribution keys would likely reflect a greater volume of mail than is now recorded for these time-sensitive subclasses, and a greater portion of costs would be attributed to them.

1. While the costs assigned to Express Mail decline under Dr. Neels' approach, the costs involved are not large.

E. The Postal Service Has Understated the Costs of the Package Delivery Classes of Mail.

- 1. The Postal Service has admittedly failed to attribute sufficient advertising costs to Priority Mail, Parcel Post, and Express Mail.**

The Postal Service has agreed that its initial filing contained incorrect estimates of advertising costs for Parcel Post, Priority Mail, and Express Mail. Postal Service witness Kay issued an errata to her testimony including these additional costs as product-specific costs under the Postal Service's costing method. Therefore, Test Year After Rates attributable costs must be increased by \$18.5 million for Parcel Post, \$38.3 million for Priority Mail, and \$0.4 million for Express Mail.

- 2. The method used to distribute city carrier elemental load time and certain other city carrier costs to parcels should be modified.**

- (a) All elemental load costs should be distributed to the subclasses of mail on the basis of weight.**

Elemental load time is the time carriers spend handling mail pieces at the point of delivery. Postal Service witness Daniel (USPS-T-28) states that the cost of delivering parcels should increase with weight. Therefore, elemental load time costs should be distributed by weight, and that is in fact how Ms. Daniel distributes those costs within First Class Mail and Standard (A) Mail.

However, the Postal Service does not use weight to distribute elemental load time among (as opposed to within certain) subclasses of mail. Instead, it uses pieces. This is inconsistent with Ms. Daniel's conclusion.

Mr. Luciani develops a new distribution key based on average weight and volume data for each subclass for parcel-shaped items. The results of Mr. Luciani's analysis are presented in Table 3 of his testimony. Those results should be adopted.

(b) The Postal Service has understated the costs of sorting parcels.

Much of the city carrier cost of sequencing (sorting) parcels is currently included in City Carrier Street Support costs or Driving Time because parcels are largely sequenced for delivery at the loading dock or in the delivery vehicle. This cost, which is the direct result of delivering parcels, should be attributed to parcels.

Mr. Luciani develops a distribution key to achieve this goal. His result is contained in Exhibit UPS-T-5C of his testimony. It too should be adopted.

(c) Parcels are not allocated their proper share of the costs of Special Purpose Routes.

Postal Service witness Meehan's distribution of Special Purpose Route costs is based on a study from Docket No. R97-1 which lacks distribution keys for the individual types of Special Purpose Routes. The result appears to be that parcels do not receive a fair share of these costs.

While it may not be possible based on current data to achieve the optimum result, some measure of improvement is possible. A conservative approach would be to attribute just the amount of the cost of Exclusive Parcel Post routes, or \$37.4 million in the base year, to Parcel Post. Thus, Parcel Post specific fixed costs would be increased by \$26.4 million above the \$11 million already assigned to Parcel Post. If better information on the classes of mail carried on the different types of Special

Purpose Routes becomes available, further refinement may be possible. In the absence of such data, however, Mr. Luciani's approach should be used.

F. The Postal Service's Treatment of Parcel Post OMAS and Alaska Volumes and Revenues Results in an Overstatement of Parcel Post Revenues.

Postal Service witness Plunkett projects a significant decline in OMAS and Alaska volume from the base year to the test year, but, inexplicably, assumes that OMAS and Alaska revenues will increase significantly over this same period. That is clearly wrong.

Mr. Plunkett stated that his projection of OMAS and Alaska revenue based on the underlying growth of Parcel Post as a whole conforms with historical practice. Such an approach might be proper if there were a projected increase in OMAS and Alaska volume based on the underlying growth of Parcel Post. But it makes no sense to project OMAS and Alaska revenue increases based on the overall volume of Parcel Post in the face of a projected substantial decline in OMAS and Alaska volume.

Since OMAS and Alaska pieces are subsets of the other Parcel Post rate categories, Mr. Plunkett's approach double-counts revenues. Mr. Luciani corrects this overstatement of Parcel Post revenues. He adjusts Mr. Plunkett's base year revenue per piece for Alaska and OMAS to reflect the rate increase from Docket No. R94-1 to Docket No. R97-1 that took place in FY1999 (approximately 21%, given that the Alaska and OMAS pieces are largely charged intra-BMC and inter-BMC rates), and then multiplies the result by Mr. Plunkett's volume estimates for Alaska and OMAS in the Test Year Before Rates. As a consequence, the total revenue for Parcel Post

decreases by \$8.1 million (\$23.5 million as filed minus \$15.4 million corrected) in the Test Year Before Rates.

G. The Proposed Parcel Post Discounts Are Overstated and Are Based on Overly High Passthroughs for DDU and DSCF Worksharing Cost Avoidance.

Mr. Luciani identifies a number of instances where the Postal Service's calculation of proposed worksharing discounts overstates avoided costs.

1. The method used to calculate DBMC-entry mail processing cost avoidance results in overstatements.

The Postal Service's estimates of dropshipment mail processing cost avoidance are largely a result of its outdated "top-down" estimation technique, which uses the old LIOCATT cost breakdown in Cost Segment 3.1 (abandoned in favor of the MODS-based approach) and a rough estimate of the volume entered upstream of the BMC based on outdated studies performed in 1990 and 1993. The Postal Service determines the other Parcel Post discounts using a bottom-up approach based on workflow models. Now that the Postal Service has developed similar workflow models for DBMC parcels, those models should be used to develop the DBMC-entry discount. Mr. Luciani provides the necessary adjustment.

2. The calculation of costs avoided by DBMC Parcels incorrectly includes \$9.34 million in mail processing costs incurred by DBMC-entry parcels.

The Postal Service's calculation of the DBMC avoided costs is too high. It incorrectly includes mail processing costs that are in fact incurred by DBMC-entry parcels. By using IOCS data, UPS witness Sellick determines the proportion of IOCS tally dollars that can be ascribed to DBMC Parcel Post and to non-DBMC Parcel Post.

This calculation shows that \$9.34 million in base year attributable mail processing costs should be deducted from the estimated DBMC cost savings.

3. The Postal Service's DDU-entry and DSCF-entry transportation cost avoidance is incorrect.

(a) Cubic feet per piece for DDU-entry and DSCF-entry parcels should be based on DBMC-entry Parcel Post.

Mr. Luciani points out that the Postal Service has used the wrong proxy for cubic feet per piece for purposes of calculating the transportation costs avoided by DDU-entry and DSCF-entry Parcel Post. Cubic feet per piece for DDU and DSCF parcels should be based on the cubic feet per piece of DBMC-entry Parcel Post, not that for intra-BMC parcels, because, as Postal Service witnesses Plunkett and Daniel assume, DDU-entry and DSCF-entry parcels are more likely to share the characteristics of DBMC-entry parcels.

(b) Alaska air costs should be distributed to the DSCF-entry and DDU-entry rate categories.

Mr. Luciani also points out that the Postal Service has failed to distribute any Alaska air costs to the DSCF-entry and DDU-entry rate categories even though those rate categories are now offered in Alaska. This requires allocating an additional \$9.44 million of test year Alaska air costs to the DSCF-entry and DDU-entry rate categories.

4. DDU-entry mail processing cost avoidance is overstated.

(a) Sack shakeout costs are not avoided.

As it did in Docket No. R97-1, the Postal Service asserts that DDU-entry cost avoidance includes a 2.1 cents cost per piece of sack shakeout, which the Postal Service alleges is performed by the mailer, not the Postal Service. However, the *Domestic Mail Manual* contains no requirement that the mailer perform sack shakeout, and the evidence indicates that sack shakeout is likely performed by the Postal Service. Therefore, those costs are actually incurred, not avoided, by the Postal Service, and they should be deducted from the cost avoidance calculation.

(b) The DDU-entry discount should be based solely on machinable cost differences.

Mr. Luciani also points out the Postal Service's nonsensical result that a machinable DBMC-entry parcel with 67.3 cents per piece of mail processing costs avoids (according to the Postal Service) 73.0 cents of costs if entered at the DDU. This results from basing the calculated savings on the cost of machinable and of surcharged non-machinable parcels. Using only the machinable savings to derive the DDU-entry cost avoidance, as is proper, reduces DDU-entry cost avoidance by 5.7 cents per piece.

5. The Parcel Post final adjustments incorrectly calculate DSCF-entry cost savings.

The Postal Service's proposal for DSCF-entry rates also overstates transportation cost savings. The Postal Service's calculation does not reflect the fact that 7.11% of DBMC-entry volume is already entered at a DSCF in the pre-mix starting point. Therefore, Ms. Daniel's calculated DSCF-entry transportation savings must be

reduced. Ms. Eggleston's estimate of transportation costs incurred by DBMC-entry Parcel Post in the base year already reflects the cost savings of DSCF-entry, which result from the 7.11% of those DBMC parcels that were actually entered at a DSCF in the base year even in the absence of a DSCF-entry discount.

Again, Mr. Luciani has corrected this error, and his correction should be adopted.

6. The Postal Service's DBMC-entry rates improperly result in a reduction of DBMC's institutional cost contribution.

As it did in Docket No. R97-1, the Postal Service has attempted to derive DBMC-entry rates by essentially applying a markup factor (this time, 21%) to the estimated DBMC-entry avoided transportation costs per piece. The Commission rejected this approach in Docket No. R97-1 and should do so again. DBMC-entry parcels should be treated like all other worksharing discounts, i.e., they should be determined by simply subtracting the passed through avoided DBMC-entry costs off of intra-BMC rates.

H. The Postal Service's Proposed Passthroughs For the DDU and DSCF Worksharing Discounts Should Be Reduced.

1. DDU Entry

DDU-entry Parcel Post is attracting substantial volumes with the expectation of next-day delivery (97% of the time) and low rates. As a practical matter, there is little or no difference in the parcel handling practices for Priority Mail and for Parcel Post once the parcels arrive at the DDU. In short, Parcel Post DDU entry is essentially equivalent to Priority Mail once it reaches the DDU.

However, unlike Parcel Post, Priority Mail provides a significant contribution to institutional costs on every underlying dollar of attributed cost. Thus, Mr. Luciani applies the Priority Mail markup to the cost of DDU-entry pieces in order to determine the

appropriate passthrough for DDU avoided costs. He concludes that the passthrough needed to provide a markup on DDU-entry costs similar to that for Priority Mail would be approximately 50%.

As a check of Mr. Plunkett's estimate of a per piece cost of \$0.96 for a DDU-entry parcel, Mr. Luciani conducted a bottom-up costing of parcel delivery costs using the Engineered Standards study and determined that the cost was \$1.14 per piece, at a minimum. As a result, a lower passthrough is required on DDU-entry parcels to avoid underattributing their costs.

2. DSCF Entry

Mr. Plunkett's passthrough proposal yields a paltry DSCF-entry rate increase of 0.7%. *At a minimum, the passthrough for DSCF-entry should be set midway between that for DDU-entry and DBMC-entry.*

I. The Postal Service's Recommended Cost Coverage for Priority Mail Does Not Accord With the Pricing Criteria of 39 U.S.C. § 3622.

UPS witness Sappington recommends a markup of 76% and a markup index of 1.395 for Priority Mail based on his review of the pricing criteria of § 3622(b). He concludes that, based on the costing changes recommended by other UPS witnesses and this markup, an increase of 40.3% in the average rate for Priority Mail is required *under the statutory ratemaking factors.*

Professor Sappington noted that in Docket No. R97-1, the Commission recommended a deviation from the consistent policy of affording Priority Mail a higher cost coverage than First Class Mail due to (1) questions about the level of service quality delivered by Priority Mail as compared to First Class Mail; (2) a dramatic

increase in Priority Mail's attributable costs between R94-1 and R97-1; and (3) concerns that a large rate increase for Priority Mail might jeopardize its ability to compete in the marketplace.

The evidence shows that Priority Mail has experienced sustained volume and revenue growth since Docket No. R97-1, and that Priority Mail provides a high level of service quality relative to First Class Mail. Consequently, absent another unusually large increase in Priority Mail's attributable costs, a return to the historic markup relationship of a greater cost coverage for Priority Mail as opposed to First Class Mail would be appropriate.

Priority Mail is a valuable service that has experienced steady growth in volume and revenue in recent years with a dominant share of the two-day to three-day delivery market. Delivery confirmation, which is available at no extra charge to larger Priority Mail users, enhances the appeal of Priority Mail relative to other postal services and to competing services, and it is projected to increase volume by at least 1% in 2000. *Priority Mail's competitive position will be further strengthened under the Postal Service's proposal to introduce a new, lower one-pound rate for Priority Mail (39% of Priority Mail pieces weigh less than one pound).*

Priority Mail also systematically delivers higher absolute service quality in the form of more expeditious delivery than does First Class Mail, even though Priority Mail may meet its more exacting service standard less frequently. Moreover, Priority Mail: (1) is generally cleared before First Class Mail, and is afforded priority for transportation resources; (2) has many origin-destination pairs between which it travels by air while First Class Mail remains in the surface network; (3) is typically assigned to earlier flights

than First Class Mail on the Eagle Network and on commercial airlines; (4) is delivered before First Class Mail if it is not possible to deliver both; and (5) during the peak year-end season, is sometimes delivered on Sunday, while First Class Mail is not.

The high value of Priority Mail is also shown by the fact that in 1999, mailers sent more than 215 million pieces by Priority Mail even though they could have sent them by less expensive First Class Mail.

However, in light of the increase in Priority Mail's costs, Professor Sappington recommends mitigation of the Priority Mail markup. He recommends that the markup ratio for Priority Mail be equal to that for First Class Mail. The resulting average rate increase of 40.3% largely reflects the 36% increase in Priority Mail's attributable costs since Docket No. R97-1.

J. Parcel Post Requires a Substantial Rate Increase.

Professor Sappington recommends a 24.9% rate increase for Parcel Post, which reflects a cost coverage of 111%. Parcel Post's attributable costs have increased by 41% since Docket No. R97-1. Moreover, a cost coverage of 111% -- lower than that proposed by the Postal Service -- would reduce the likelihood that Parcel Post revenues would fall below attributable costs.

Given Parcel Post's relatively strong volume growth in the past few years and an improvement in its value of service, this modest increase in cost coverage from the 108% coverage recommended by the Commission in Docket No. R97-1 is certainly justified.

III. CONCLUSION

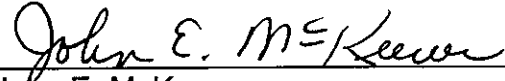
For the reasons set forth above and on the basis of the evidence in the record, the Commission should:

- (1) Find that the volume variability of mail processing labor costs is 100 percent, and, with minor modifications, distribute those costs using the MODS-based approach proposed by the Postal Service;
- (2) Reject the Postal Service's belated substitution of vastly increased Parcel Post revenue, piece, and weight estimates based on an untested and potentially unreliable "BRPW/DRPW" approach and instead adopt the Parcel Post estimates produced by the established DRPW methodology;
- (3) Modify the Postal Service's proposed treatment of purchased transportation costs by (a) attributing the premium costs of its dedicated air networks to Priority Mail as well as to Express Mail, and (b) allocating the costs of empty space in purchased highway transportation to the classes of mail that give rise to the need for the capacity purchased;
- (4) Modify the methods used to distribute City Carrier elemental load time and other city carrier costs to parcels as recommended by UPS witness Luciani;
- (5) Attribute to Priority Mail, Parcel Post, and Express Mail those advertising costs which the Postal Service has acknowledged are incurred by those services;
- (6) Revise the Postal Service's Parcel Post revenues to reflect Mr. Luciani's treatment of OMAS and Alaska volumes and revenues;
- (7) Adjust the proposed Parcel Post discounts; and

(8) Adopt the recommended cost coverages for Parcel Post and for Priority

Mail recommended by UPS witness Sappington.

Respectfully submitted,




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CERTIFICATE OF SERVICE

I hereby certify that I have this date served the foregoing document by first class mail, postage prepaid, in accordance with Section 12 of the Commission's Rules of Practice.



John E. McKeever
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Dated: June 29, 2000
Philadelphia, Pa.

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