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Before the
UNITED STATES POSTAL RATE COMMISSION

In the Matter of: **POSTAL RATE AND FEE CHANGE**

Docket No. **R2000-1**

VOLUME 22

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BEFORE THE
POSTAL RATE COMMISSION

- - - - -X
In the Matter of: :
POSTAL RATE AND FEE CHANGE : Docket No. R2000-1
- - - - -X

Third Floor Hearing Room
Postal Rate Commission
1333 H Street, N.W.
Washington, D.C. 20268

Volume XXII
Thursday, July 6, 2000

The above-entitled matter came on for hearing,
pursuant to notice, at 9:31 a.m.

BEFORE:

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HON. GEORGE A. OMAS, VICE CHAIRMAN
HON. W.H. "TREY" LeBLANC, COMMISSIONER
HON. DANA B. "DANNY" COVINGTON, COMMISSIONER
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P R O C E E D I N G S

[9:31 a.m.]

CHAIRMAN GLEIMAN: Good morning, ladies and gentlemen. Today we begin our hearings to receive the direct cases of participants other than the Postal Service in Docket R2000-1.

I have a couple of items I would like to mention before we begin to hear testimony this morning.

First, I want to thank those participants that submitted trial briefs. We have been reviewing those briefs and we found them to be extremely helpful. There's been a great deal of testimony submitted in this case and the briefs are very helpful in putting the testimony in proper context.

Next, I would like to renew a request that I made at the first prehearing conference relating to acronyms. There are an awful lot of acronyms that have been used in this case. Expert witnesses and counsel tend to assume that everyone associates a particular set of initials with the same piece of equipment or data collection system. I will just, as an aside, tell you that I e-mailed a former colleague from Capitol Hill yesterday and he saw my e-mail address and saw PRC and assumed I worked for the Planning Research Corporation. Now he wanted to know when I had left Government, so it's just an indication of how dangerous it

1 can be sometimes to rely simply on acronyms. Different
2 people are looking at things from different perspectives.

3 Sitting on the bench it takes awhile mentally, at
4 least for me, to transfer some of the acronyms into the
5 appropriate equipment or data system name, so I would
6 request that you try to include the full name of equipment
7 or data systems in your questions and answers, at least the
8 first time or two that you are referring to the equipment or
9 the data system, and that certainly will help us follow the
10 cross examination, and I am sure it would help others also.

11 Does any participant have a matter that they would
12 like to raise today?

13 MS. DREIFUSS: The OCA -- oh, the speakers are
14 working great today -- the OCA does have one matter, Mr.
15 Chairman. OCA Witness Pamela Thompson is scheduled for oral
16 cross examination tomorrow.

17 It is our understanding that there isn't any oral
18 cross examination for her. We wanted to see if it would be
19 agreeable to you and to the Postal Service to schedule her
20 first in the morning and simply accept her testimony into
21 the record.

22 CHAIRMAN GLEIMAN: Assuming that there indeed is
23 no oral cross examination, and even if there is I don't have
24 an objection. We can talk with the Postal Service and also
25 if you would consult with the other parties who have

1 witnesses scheduled for tomorrow to just make sure that this
2 doesn't create a problem, and then we can proceed in that
3 manner.

4 MS. DREIFUSS: We will be happy to contact the
5 other witnesses certainly.

6 CHAIRMAN GLEIMAN: Is there anything else?

7 If not, there are seven witnesses that are
8 scheduled to appear today. The witnesses are Mr. Buc, Mr.
9 Haldi, Burns, Rosenberg, Buckel, White and Callow.

10 Mr. Ackerly, if you would please introduce your
11 first witness.

12 MR. ACKERLY: Good morning, Mr. Chairman, and
13 members of the Commission.

14 With the permission of the Chair before I do that
15 I would like to introduce to the Commission and everybody
16 present my colleague, Gerard Magliocca. This is his first
17 time at the Commission. He will be helping me throughout
18 the rest of the case.

19 CHAIRMAN GLEIMAN: Welcome.

20 MR. ACKERLY: I call Lawrence G. Buc to the stand.

21 CHAIRMAN GLEIMAN: Mr. Buc, could I please get you
22 to stand up for a moment and raise your right hand?
23 Whereupon,

24 LAWRENCE G. BUC,
25 a witness, was called for examination by counsel on behalf

1 of the Direct Marketing Association and, having been first
2 duly sworn, was examined and testified as follows:

3 CHAIRMAN GLEIMAN: Counsel, you can proceed when
4 ready.

5 MR. ACKERLY: Thank you, Mr. Chairman.

6 DIRECT EXAMINATION

7 BY MR. ACKERLY:

8 Q Mr. Buc, I am handing you a copy of a document
9 entitled Direct Testimony of Lawrence G. Buc on behalf of
10 Direct Marketing Association and a relatively long list of
11 other participants in this case.

12 The document is labelled DMA-T-1. Do you adopt
13 that document and the attachments as your testimony in this
14 proceeding?

15 A Yes.

16 MR. ACKERLY: Mr. Chairman, I will give two copies
17 of this document to the Reporter and ask that it be admitted
18 into evidence.

19 CHAIRMAN GLEIMAN: Is there any objection?

20 Hearing none, I will direct that counsel provide
21 those two copies to the Reporter of Witness Buc's testimony
22 and that testimony is to be transcribed into the record and
23 received into evidence.

24 [Direct Testimony and Exhibits of
25 Lawrence G. Buc, DMA-T-1, was

1 received into evidence and
2 transcribed into the record.]
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DMA-T-1

BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON DC 20268-0001

POSTAL RATE AND FEE CHANGES, 2000

Docket No. R2000-1

DIRECT TESTIMONY
OF

LAWRENCE G. BUC

ON BEHALF OF

DIRECT MARKETING ASSOCIATION, INC.
ALLIANCE OF INDEPENDENT STORE OWNERS AND PROFESSIONALS
ALLIANCE OF NONPROFIT MAILERS
AMAZON.COM, INC.
AMERICAN BUSINESS MEDIA
ASSOCIATION FOR POSTAL COMMERCE
ASSOCIATION OF PRIORITY MAIL USERS, INC.
DOW JONES & COMPANY, INC.
FLORIDA GIFT FRUIT SHIPPERS ASSOCIATION
GREETING CARD ASSOCIATION
MAGAZINE PUBLISHERS OF AMERICA
MAIL ORDER ASSOCIATION OF AMERICA
MAJOR MAILERS ASSOCIATION
THE MCGRAW-HILL COMPANIES, INC.
PARCEL SHIPPERS ASSOCIATION
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1 **AUTOBIOGRAPHICAL SKETCH**

2 My name is Lawrence G. Buc. I am the President of Project Performance
3 Corporation (PPC), a consulting firm headquartered in McLean, Virginia. PPC
4 provides management, information technology, and environmental consulting
5 services to private and public sector clients. At the firm, I co-direct a practice that
6 focuses on economic and cost analysis, usually in a postal or environmental
7 context. I am also responsible for the overall finances of the firm.

8 I attended Brown University and graduated in 1968 with an AB with honors
9 in mathematics and economics. In 1978, I received an MA degree in economics
10 from the George Washington University of America. While there, I was a
11 member of Omicron Delta Upsilon, the national honorary economics society. I
12 am a member of the American Economic Association.

13 I have participated in United States Postal Service (Postal Service) rate
14 and classification cases for over 25 years; I joined the Revenue and Cost
15 Analysis Division of the Postal Service in March of 1975 and have analyzed
16 postal issues ever since. I have worked not only for the Postal Service, but also
17 for the United States Postal Rate Commission (the Commission) and private
18 clients with interests in postal topics. I have been involved in seven previous rate
19 cases: R74-1, R76-1, R77-1, R84-1, R87-1, R90-1, and R97-1.

20 This is the seventh case in which I have submitted testimony to the
21 Commission. In R84-1, R90-1, and R97-1, I appeared as a witness for
22 intervenors before the Commission; in MC76-1, I appeared as a witness for the
23 Postal Service; in MC77-2, I appeared as a witness for the Office of the
24 Consumer Advocate, and in C99-4, I appeared as a witness for the complainant.

DMA-T-1
Revised 6/23/00

I. PURPOSE AND SCOPE OF TESTIMONY

In this testimony, I analyze the revenue requirement of the Postal Service. In particular, I analyze the proposed contingency and cost reduction and other programs presented by witness Tayman in USPS T-9. I show that the Postal Service has overstated its revenue requirement by at least \$1.31 billion, by overstating the contingency by \$1.01 billion and understating cost reduction and other programs by \$295 million. Table 1, below, shows the adjustments I make to the Postal Service's proposed revenue requirement.

TABLE 1

TEST YEAR AFTER RATES

REVENUE REQUIREMENT ADJUSTMENTS

	USPS (\$Thousands)	DMA (\$Thousands)	ADJUSTMENT (\$Thousands)
Contingency ¹	\$1,679,766	\$ 668,978	\$ (1,010,788)
Rollforward Flaw ²			(92,943)
AFSM 100 ³	169,379	371,510	(202,131)
Total Adjustment			\$ (1,305,862)

¹ Attachment A, pg 1.

² Attachment B, pg 1.

³ Attachment C, pg 1.

The Postal Service has requested a contingency of \$1.68 billion in the Test Year, which is two and one half percent of the total costs (including final adjustments). Section II of my testimony shows that this request is neither reasoned nor reasonable and that the logic described by the Commission in previous rate cases for determining a reasonable contingency would result in a contingency of one percent of total costs, which is \$669 million (after adjusting for two other overstatements to the revenue requirement, discussed next.)

DMA-T-1
Revised 6/23/00

1 Thus, the Postal Service has overstated its contingency requirement by \$1.01
2 billion.

3 In addition to the unreasonable request for contingency, there are also two
4 errors in cost reduction and other programs that lead witness Tayman to
5 overstate the revenue requirement by an additional \$295 million. In Section III, I
6 describe and then correct these errors. The first is a flaw in the rollforward
7 program for supervisors of clerks and mailhandlers and carriers, which the
8 Commission corrected in the last case, but which the Postal Service has
9 apparently not yet adopted. The second is an error in cost reduction programs
10 for the Advanced Flat Sorting Machine 100 (AFSM 100).

11 II. CONTINGENCY

12 Under the Postal Reorganization Act, the revenue requirement includes "a
13 reasonable provision for contingencies". 39 U.S.C. §3621. As the Commission
14 wrote in its R76-1 Opinion and Recommended Decision, the purpose of the
15 contingency is to cover "expenses which could be neither foreseen nor
16 prevented through the exercise of honest, efficient, and economical
17 management..." Op. R76-1 at 52. In this case, the Postal Service requests a
18 contingency of 2.5 percent of its costs, or \$1.68 billion.

19 Although the Commission has accepted all but one of the Postal Service's
20 previous contingency requests, the Commission has also said that the
21 requirement for a reasonable provision for contingency "requires that the amount
22 be reasoned." Op. R97-1 at 21.

23 In the following section of this testimony, I will first review the
24 Commission's body of writing pertaining to the contingency. I will next
25 summarize the Postal Service's support for its request in this case. I will then
26 show that witness Tayman provides little support for a contingency of 2.5 percent
27 and that this request is neither reasoned nor reasonable given the Commission's
28 past decisions. By contrast, a contingency of one percent is both.

1 **A. The Commission has clearly explained how a reasonable contingency**
 2 **should be determined**

3 On many occasions, the Commission has reiterated the principles that
 4 govern the size of a "reasonable" contingency. In preparing this testimony, I
 5 reviewed the section of the Opinion and Recommended Decision pertaining to
 6 the contingency in the eight omnibus cases from R76-1 to R97-1. In these eight
 7 decisions, the Commission has clearly articulated (1) what a "reasonable"
 8 contingency should cover and what it conversely should not cover and (2) how
 9 the size of a "reasonable" contingency should be determined. To provide context
 10 for my analysis of the contingency request in this case, I first review the
 11 Commission's statements of these principles.

12 Writing in R76-1, the Commission stated: "[t]he general standard should
 13 be that expenses which could be neither foreseen nor prevented through the
 14 exercise of honest, efficient, and economical management are properly provided
 15 against by the creation of a contingency provision." Op. R76-1 at 52. Then, in
 16 R77-1, the Commission described why a contingency was necessary: "[t]he
 17 contingency allowance is a recognized provision designed to offset the effects of
 18 misestimates in the test year relating to revenue and costs." Op. R77-1 at 29.
 19 Writing in R80-1, the Commission expanded on its view of why misestimates
 20 were likely to occur:

21 ...the discipline of detailed line item forecasting makes it
 22 probable that the ratemaking projections will differ from
 23 actual results. Generally, the causes of these differences,
 24 or variances, between estimated and actual results will
 25 occur as a result of errors in assumptions underlying
 26 projections contained in the rate filing estimates arising
 27 from unforeseen events and/or errors in forecasting
 28 techniques. Op. R80-1 at 20.

29 By R84-1, the Commission had synopsized its view:

30 [a]s our opinions in prior omnibus rate proceedings have
 31 emphasized, the purpose of the contingency provision set
 32 forth in 39 U.S.C. section 3621 is two-fold. First, it provides
 33 insurance against the possibility of misestimates of test

1 year accrued revenues and expenses. As we have stated
2 in the past, such variances are inherent in the forecasting
3 process. Second, the provision is intended to protect
4 against unforeseeable events, not capable of being
5 prevented through honest, efficient and economical
6 management, and which might have a significant adverse
7 impact on the financial position of the Service or its
8 operations. Op. R84-1 at 13.

9 The Commission has also made it clear that the contingency should not
10 cover all unforeseen costs. It clearly expressed this position in R 76-1:

11 [t]hus we do not contemplate that every unforeseen cost
12 increase is appropriate for contingency treatment. If, in the
13 exercise of sound and efficient management, a necessary
14 cost increase should reasonably have been foreseen, it
15 should be reflected in the specific cost justification offered
16 for increased rates, not in the provision for contingencies.
17 Op. R76-1 at 52.

18 Equally, the contingency does not cover revenue shortfalls that could have
19 been foreseen. Writing about the Postal Service's plan to delay implementation
20 of rates until part way through the Test Year in R94-1, the Commission wrote,
21 "first, as a conceptual matter, this anticipated development cannot properly be
22 included among the "unforeseen adversities" for which the contingency provision
23 is intended to provide..." Op. R94-1 at II-14.

24 The Commission has been equally clear about both the process and the
25 analysis for determining the permissible size of the contingency. First of all, a
26 reasonable contingency cannot be arbitrary; nor can it be determined by a rigid
27 formula. In R97-1, the Commission wrote, "Arguments attempting to justify an
28 arbitrary amount will not be accorded much weight." Op. R97-1 at 21. In R76-1
29 it stated: "[w]e may add that the use of any formula or set percentage--except as
30 a starting point for inquiry--does not seem to us an appropriate method for
31 determining the contingency allowance." Op. R97-1 at 59. Rather, a reasonable
32 contingency should be based on a variance analysis and a consideration of both
33 the financial condition of the Postal Service and general economic conditions.

1 Although the Commission did not use the words "variance analysis" in
2 their R76-1 Opinion and Recommended Opinion, it discussed the general
3 concept:

4 [t]he contingency provision could in this way be accounted
5 for by a suitable post-audit procedure showing how far the
6 actual costs have departed from estimates. The treatment
7 of the contingency provision just suggested would assist
8 the Postal Service in determining any areas in which its
9 estimates of future costs are particularly liable to
10 inaccuracy. Op. R76-1 at 53-54.

11 And even in this early Opinion, the Commission recognized that general
12 economic conditions should affect the size of the contingency: "...we believe it is
13 appropriate to look to national economic conditions first for general guidance as
14 to the usefulness of such predictions." Op. R76-1 at 56. It also recognized that
15 the financial condition of the Postal Service was relevant in setting the
16 contingency: "[w]e must also take into account, in this connection, the ability of
17 the Postal Service to absorb the consequences of erroneous predictions of costs
18 and revenues." Op. R76-1 at 57.

19 The Commission reiterated these views in the R77-1 case. Its third Notice
20 of Inquiry formally solicited views on the use of variance analysis in establishing
21 the contingency and noted,

22 The purely judgmental means employed by Postal Service
23 witness Kluttz for estimating a contingency were
24 technically deficient and that more 'analytic methods' are
25 needed to measure the Postal Service's needs for a
26 contingency. We have reviewed the comments of the
27 parties to the Third Notice of Inquiry and conclude that
28 historical variance analysis supplemented by other
29 pertinent factors is a proper and feasible procedure to
30 employ in establishing a reasonable contingency provision.
31 Op. R77-1 at 31.

32 Later, in its Opinion, the Commission expanded on this statement:

33 ...it is our view that over the long run the relative
34 magnitude of unforeseen events (variances between
35 estimates and actual results caused by uncontrollable
36 external events) will prospectively tend to display a certain

1 degree of predictability, albeit not precise, with historical
 2 results [footnote omitted]. Specifically, we believe that
 3 historical variance analysis will allow the Commission to
 4 project on a reliable basis the magnitude of adverse events
 5 befalling the Postal Service in any particular test year and
 6 thus provide a basis for the Commission to make
 7 allowances for these uncertainties in the revenue
 8 requirement. Thus, we find appropriate the utilization of
 9 variance analysis as a starting point in evaluating the
 10 Postal Service's contingency request. Op. R77-1 at 31-
 11 32.

12 As in the R76-1 Opinion, the Commission expressed the importance of the
 13 financial condition of the Postal Service: "[a]lso we must be mindful of the degree
 14 to which the Postal Service is able to absorb unforeseen expenses or
 15 unfavorable revenue variances." Op. R76-1 at 39. And, again as in R76-1, it
 16 expressed the importance of the economy: "...uncertainties relating to the
 17 economy generally, in our judgment, remain substantial and thus support the
 18 reasonableness of a four percent contingency." Op. R77-1 at 40.

19 By R80-1, the Commission had refined its presentation on the proper way
 20 to set a contingency while remaining true to its previous Opinions. It wrote,

21 Albeit a sound analytical tool which we continue to
 22 endorse, it was never our intent ...to rely on variance
 23 analysis to the exclusion of other factors which have a
 24 bearing on our judgmental determination of an appropriate
 25 contingency allowance. The role of variance analysis is
 26 that it serves as a tool which provides a precise figure to
 27 which we apply other factors pertinent to the determination
 28 of an adequate contingency provision. Factors such as
 29 the financial condition of the Postal Service [footnote
 30 omitted], the state of the economy [footnote omitted], the
 31 causes for the variances [footnote omitted], and such other
 32 relevant factors which may arise must be considered in
 33 arriving at a contingency provision. Op. R80-1 at 21-22.

34 The Opinion in R84-1 issued following the opinion of the U.S. Court of
 35 Appeals for the Second Circuit in the Newsweek case. In this Opinion, the
 36 Commission stated that it had not only the authority but also the responsibility to
 37 modify the revenue requirement requested by the Postal Service as long as the
 38 Commission complied with certain criteria:

1 [a]ccordingly, we have concluded that the Commission has
2 both the authority and the responsibility to make
3 adjustments in the Postal Service's proposed revenue
4 requirement, so long as our adjustments are not arbitrary,
5 our reasoning is fully articulated and based upon
6 substantial evidence in the record, and where our
7 adjustments have neither the intent nor the effect of
8 causing more frequent rate filings nor constitute an
9 intrusion into policymaking domain of the Board in
10 accordance with the holding in Newsweek [footnote
11 omitted]. Op. R84-1 at 25.

12 In this decision, the Commission again articulated its position on how to
13 set the contingency:

14 [f]urthermore, the Commission has emphasized that
15 variance analysis should not be the exclusive determinant
16 of a contingency provision. PRC Op. R80-1 at 21. Other
17 items which should be considered in arriving at an
18 appropriate contingency include the Postal Service's
19 financial condition, the state of the economy, and other
20 factors deemed appropriate by the Commission. Id. At 21-
21 22. Op. R84-1 at 27.

22 In R87-1, the Commission repeated that it had the authority to review the
23 contingency request:

24 [i]t is understandable that the Postal Service would
25 emphasize the subjective element of the determination of
26 the contingency reserve above all others, since it tends to
27 relegate that determination to the province of
28 management. It is also understandable that the parties
29 with an interest in adjusting the proposed contingency
30 should emphasize the objective element of that
31 determination, since it tends to subject that determination
32 to outside criticism and analysis. In prior dockets, we have
33 concluded that the subjective element of the contingency
34 determination entitles management's determination to a
35 good measure of deference, but that it does not render that
36 judgment unreviewable. As we noted in Docket No. R84-1,
37 judgment implies opinion or assessment, and is not
38 necessarily equated to management discretion. Because
39 the statutory requirement that a contingency be supported
40 by substantial evidence remains in effect, management still
41 must provide such evidence, and the Commission must
42 still review it. Op. R87-1 at 35-36.

1 The Commission also addressed the issue of how the contingency should
2 be set:

3 [t]he Postal Service argues that unforeseeable risks,
4 because they are unknown, by their very nature cannot be
5 articulated or analyzed, but must remain in an intuitive
6 realm. But in our view, if such risks are to be the
7 predominant basis of the Postal Service's contingency
8 determination, management's perception of those risks
9 must be articulated to a reasonable degree in order to
10 satisfy the substantial evidence requirement. Without
11 laying down any particular guidelines for articulating such
12 risks, we would offer as possible guidelines an
13 identification of at least the set of events from which the
14 intuitively sensed risks might be drawn, the role of past
15 experience in influencing the sensed magnitude and
16 likelihood of the unforeseen risk, and some indication of
17 the importance of unforeseeable risks relative to
18 recognized-but-unquantifiable risks, and the assumed level
19 of error in forecasting quantifiable factors that went into its
20 contingency determination. Op. R87-1 at 36.

21 In its Opinion, the Commission also discussed the issue of addressing
22 both forecasting errors and unknown risks:

23 ...the Commission views the contingency determination as
24 a blending of subjective judgment concerning unknown
25 risk, and objective judgment concerning forecast errors
26 and their sources. The former can and should be
27 articulated, even if primarily intuitive, while the latter can
28 and should be subjected to statistical analysis. The
29 Commission has never advocated that statistical analysis
30 be the exclusive determinant of the proper contingency
31 amount, nor that it should be accepted uncritically, in terms
32 of its precision, or its ability to account for external factors.
33 See PRC Op. R84-1 at para. 1051; PRC Op. R77-1 at 30-
34 31. We maintain our view, however, forecasting errors
35 have sources, and that much can be learned by
36 systematically evaluating the behavior of those sources
37 over time. We also adhere to our view expressed in
38 Docket No. R77-1 that the relative magnitude of
39 unforeseen events, including external events, over the long
40 run will tend to display a degree of predictability, based
41 upon historical results. PRC Op. R77-1 at 31. Op. R87-1
42 at 37.

43 Finally, the Commission said, "we view variance analysis, both adjusted
44 and unadjusted, as reliable enough to indicate a range within which a reasonable

1 contingency should fall, but not sufficiently reliable to determine the specific
2 contingency amount." Op. R87-1 at 40.

3 Then, in R94-1, reflecting its position on the use of variance analysis to set
4 a contingency, the Commission approved the Postal Service's request for a two
5 percent contingency even though the analysis presented by the Postal Service
6 showed variances ranging from 3.9 to 5.0 percent. The Commission wrote:

7 [t]he mathematical incompatibility of a 2 percent
8 contingency provision with the variance analysis... does not
9 necessarily invalidate management's informed choice of
10 that figure. While variance analysis provides statistical
11 results on which the Commission has frequently relied in
12 appraising the Postal Service's proposed contingency
13 allowance, its guidance is neither definitive nor without
14 potential flaws. Op. R94-1 at 11-13.

15 **B. Witness Tayman provides little support for his contingency proposal in**
16 **this case other than subjective judgment**

17
18 Witness Tayman's support for the proposed \$1.68 billion contingency
19 appears in three pages of his testimony, between pages 43 and 46, as well as
20 his responses to interrogatories. Because of the size of the contingency and the
21 paucity of support, DMA sought to obtain additional supporting information.
22 DMA/USPS-T9-36 asked witness Tayman to provide "any analysis, decision
23 memos, options analysis, briefings, etc, relating to the contingency for this rate
24 case." The Postal Service, however, objected to this interrogatory and a similar
25 one from the OCA. Subsequently, witness Tayman testified on oral cross-
26 examination that his written testimony contains all the factors he considered in
27 deciding on the proper size of the contingency, "I think pages 43 through 45 of
28 the testimony pretty much delineate all the factors we considered in coming up
29 with our decision." Tayman, Tr. 2/505. Thus, the entire support for the
30 contingency lies in the three pages of testimony.

31 Of these three pages of testimony, only about two pages explain his
32 position, because over a page is devoted to his discussion of the variance

1 analyses. Although witness Tayman presents a variance analysis, "in deference
2 to the Commission's desire to evaluate forecast errors and their sources," USPS-
3 T-9 at 44, he places little stock in it. In discussing the use of variance analysis,
4 he says, "I am convinced that variance analysis cannot be relied upon in a
5 vacuum as the basis for determining an appropriate contingency level." USPS-T-
6 9 at 45.

7 Instead of relying on variance analysis, witness Tayman apparently is
8 comfortable relying mainly on management discretion, "Regardless of what
9 history shows, management must be allowed to assume its responsibility to
10 determine the amount of contingency most appropriate for achieving its goals."
11 USPS-T-9 at 45. He also relies heavily on subjective judgment. When asked to
12 "identify and explain each new or increased concern, risk, issue or other criteria
13 management considered when deciding that the contingency should be
14 increased in this docket from the level requested in Docket No. R97-1" he
15 responded, "The determination was largely subjective" Tayman, Tr. 2/385.

16 Witness Tayman attempts to provide support for the request by discussing
17 recent challenges: "[r]ecent financial performance has not been as favorable as
18 in the mid 1990's." USPS-T-9 at 43. He further states:

19 [s]pecifically, in Fiscal Year 1999, the Postal Service fell
20 significantly short of its revenue plan, with revenue more
21 than \$600 million below plan. To achieve our net income
22 plan for the year required significant cost cutting. This was
23 in addition to funding greater than expected costs
24 associated with the year 2000 computer transition and
25 higher than planned labor costs. USPS-T-9 at 43.

26 Perhaps in deference to the Commission's Decision in R87-1
27 ("management's perception of ...risks must be articulated to a reasonable degree
28 in order to satisfy the substantial evidence requirement." Op. R87-1 at 36),
29 witness Tayman also recites a litany of other factors, which could affect future
30 costs or revenues:

31 1. "[v]olume growth is below historical norms." USPS-T-9 at 43.

- 1 2. "...projections of Fiscal Year 2000 require workyears to be held
2 at the Fiscal Year 1999 level while mail volume and the delivery
3 network continue to grow." USPS-T-9 at 43-44.
- 4 3. "[h]ealth benefit cost increases have now returned to near
5 double digit rates. Also, the labor contracts which have become
6 effective since the last rate filing are significantly more costly
7 than the previous contracts." USPS-T-9 at 44.
- 8 4. "...the internet appears to be making inroads into the Postal
9 Service's transaction and correspondence mail volume and may
10 be diverting advertising and marketing revenues from the Postal
11 Service as well." USPS-T-9 at 44.
- 12 5. "[o]ur more traditional competitors appear to be more
13 aggressively pursuing legislative limitations on the Postal
14 Service's ability to operate in a business-like manner." USPS-T-
15 9 at 44.
- 16 6. "...foreign postal administrations have been expanding their
17 operations into the United States." USPS-T-9 at 44.
- 18 7. "[f]inally, the earliest the rates can be implemented is in January
19 of the Test Year." USPS-T-9 at 44.

20 **C. The Postal Service's contingency request is not reasonable; a**
21 **contingency of one percent is reasonable**

22 In this section, I first address specific elements of witness Tayman's
23 justification of a 2.5 percent contingency and show that most of the challenges
24 and risks he relies upon are not germane to determining a reasonable
25 contingency, according to the proper approach articulated so often by the
26 Commission. Accordingly, these challenges and risks do not support witness
27 Tayman's request. Then, I use the framework developed by the Commission
28 over the last 25 years and show that a one percent contingency is more
29 reasoned and reasonable.

1 ***Five of witness Tayman's seven factors do not support his contingency***
2 ***proposal***

3 In analyzing specific elements of witness Tayman's proposal, I started with
4 the Commission's view on what the contingency should cover: "[t]he general
5 standard should be that expenses which could be neither foreseen nor prevented
6 through the exercise of honest, efficient, and economical management are
7 properly provided against by the creation of a contingency provision" Op. R76-1
8 at 52.

9 Under this standard, Witness Tayman's lamentations pertaining to
10 financial challenges in Fiscal Year 1999 are irrelevant in setting the proper
11 contingency for the Test Year. A contingency is to provide for "unforeseen and
12 unforeseeable events", not those that have already transpired. Further,
13 regardless of the challenges it faced in FY 1999, the Postal Service still made net
14 income of \$363 million. Consequently, it further improved its equity position so
15 that equity improved for the fifth year in a row, to negative \$447 million, from a
16 low of almost negative \$6 billion at the end of 1994. Thus, the positive net
17 income in FY 1999 should actually reduce the need for a contingency.

18 Similarly, application of the Commission's standard to witness Tayman's
19 listing of future challenges shows that the majority of them are not relevant to the
20 contingency. Witness Tayman confirmed that the Postal Service took account of
21 the first three challenges in the rollforward model. Tayman, Tr. 2/280. Thus,
22 since they are foreseen and already accounted for in cost and revenue estimates
23 of the Test Year, they cannot be considered in the contingency. Also, to the
24 extent that the internet is diverting volumes, witness Tolley describes at great
25 length all electronic diversion of first-class and Standard A mail in his testimony.
26 USPS-T-6 at 43-52, 63-64, 120-123, 125, and 140-143. According to witness
27 Tayman, "diversion is implied by the trend variables in the equation used to
28 develop the volume forecast." Responses of United States Postal Service
29 Witness Tayman to Questions Posed During Oral Cross-Examination, response
30 to question posed by Chairman Gleiman, Tr. 2/570.

1 Similarly, the fact that rates will not go into effect until part way through
2 the Test Year is foreseeable, and the Commission has previously stated that the
3 revenue loss from an implementation of rates part way through a test year is not
4 properly part of the contingency. Op. R94-1 at II-14. In fact, witness Tayman,
5 under questioning from Chairman Gleiman, stated that his contingency includes
6 about \$425 million to mitigate the fact that rates will be implemented in the
7 second quarter of the test year. Tayman, Tr. 2/561-563.

8 Thus, of the seven factors that witness Tayman presents as justifying his
9 contingency, the first four are foreseen and foreseeable, have already been
10 accounted for in the cost and revenue forecasts, and therefore, according to the
11 Commission, do not support a contingency request. And the seventh reason
12 witness Tayman presents (the fact that rates go into effect part way through the
13 test year) is actually a reason for reducing his proposed contingency.

14 ***Witness Tayman gives no weight to a variance analysis***

15 Although witness Tayman is quite dismissive of the variance analysis, the
16 Commission clearly believes that it is the necessary starting point for analysis of
17 the contingency request, as I have described above. In this case, Tayman
18 calculated four different variances which produce results ranging from -2.2
19 percent to 2.3 percent.

20 Table 2, below, shows the Postal Service's proposed contingency in this
21 case and the two previous cases, the amount the Commission accepted for the
22 last two cases, and the range of results produced by the variance analysis in this
23 case and the last two cases. As the table shows, in the last two cases, the
24 variance analyses by itself indicated the need for a much higher contingency
25 than in this case.

26 Further, it is important to note that in this case, unlike either of the last two
27 cases, witness Tayman has proposed a contingency higher than any of the
28 variances produced by the variance analyses. In R97-1, he proposed a
29 contingency within the range covered by the variance analysis and in R94-1 the

1 Postal Service proposed a variance smaller than the range produced by the
2 variance analysis.

3

4

TABLE 2

5

PROPOSED AND ACCEPTED CONTINGENCIES

6

AND VARIANCE RESULTS

	USPS PROPOSED CONTINGENCY (%)	PRC APPROVED CONTINGENCY (%)	VARIANCE ANALYSIS RANGE (%)
R2000-1	2.5 ¹		-2.2 – 2.3 ²
R97-1	1.0 ³	1.0 ⁴	-.2 – 3.5 ⁵
R94-1	2.0 ⁶	2.0 ⁷	3.9 – 5.0 ⁸

7 ¹Direct Testimony of Witness Tayman, R2000-1 USPS-T-9, pg 44.

8 ²Direct Testimony of Witness Tayman, R2000-1 USPS-T-9, pg 45.

9 ³Direct Testimony of Witness Tayman, R97-1 USPS-T-9, pg 38.

10 ⁴PRC, Opinion and Recommended Decision R97-1, pg 21.

11 ⁵Direct Testimony of Witness Tayman, R97-1 USPS-T-9, pg 38.

12 ⁶Direct Testimony of Witness Ward, R94-1 USPS-T-8, pg 42.

13 ⁷PRC, Opinion and Recommended Decision R94-1, pg II-16.

14 ⁸Direct Testimony of Witness Ward, R94-1 USPS-T-8, pg 44.

15 ***Neither the Postal Service's financial condition nor general economic***
16 ***conditions support witness Tayman's contingency request***

17 While the Commission considers the variance analysis as the starting
18 point in setting the contingency, it has indicated consistently that the Postal
19 Service's financial condition is also germane, as are general conditions in the
20 economy at large.

21 The Postal Service is in far better financial condition in this case than it
22 was in the last two cases. Table 3, below, shows for this case and the previous
23 two cases the equity position of the Postal Service at the end of the fiscal year
24 immediately before the year in which it filed a rate request, together with the

1 amount of the contingency request and, for the last two cases, the amount the
2 Commission approved.

3 Measured from the fiscal year ended immediately before filing, the Postal
4 Service's equity has improved by \$2.2 billion since the last case and \$4.6 billion
5 since the case before that. Thus, as the Commission has articulated, the Postal
6 Service is better able to withstand adverse unforeseen events than it was in the
7 last two cases when the Commission approved contingency requests of one and
8 two percent.

9 **TABLE 3**
10 **EQUITY IN YEAR PRECEDING RATE FILING**

	USPS PROPOSED CONTINGENCY (%)	PRC CONTINGENCY (%)	EQUITY AT END OF YEAR BEFORE FILING (\$Thousands)
R2000-1	2.5 ¹		\$ (445,992) ²
R97-1	1.0 ³	1.0 ⁴	(2,623,500) ⁵
R94-1	2.0 ⁶	2.0 ⁷	(5,047,700) ⁸

11 ¹Direct Testimony of Witness Tayman, R2000-1 USPS-T-9, pg 44.

12 ²Direct Testimony of Witness Tayman, R2000-1 USPS-T-9, Exhibit 9L for FY 1999.

13 ³Direct Testimony of Witness Tayman, R97-1 USPS-T-9, pg 38.

14 ⁴PRC, Opinion and Recommended Decision R97-1, pg 21.

15 ⁵Direct Testimony of Witness Tayman, R2000-1 USPS-T-9, Exhibit 9L for FY 1996.

16 ⁶Direct Testimony of Witness Ward, R94-1 USPS-T-8, pg 42.

17 ⁷PRC, Opinion and Recommended Decision R94-1, pg II-16.

18 ⁸Direct Testimony of Witness Tayman, R2000-1 USPS-T-9, Exhibit 9L for FY 1993.

19 Not only has equity improved, but the Postal Service is actually ahead of
20 its cumulative target for equity restoration, as displayed in witnessTayman's
21 Exhibit USPS 9N.

22 The Commission has indicated that general financial conditions in the
23 economy are important in setting the contingency and projected inflation rates
24 are often taken as a measure of these conditions. If projected inflation is high,
25 there is a greater need for a contingency since the future is less certain. Table 4,
26 below, shows three selected estimated inflation rates presented by the Postal

1 Service in this case and the two previous cases: the consumer price index (CPI-
2 W), the Employment Cost Index (ECI), and the Producer Price Index (WPI).

3 The CPI-W is an important measure of inflation because changes in it
4 trigger changes in craft cost of living adjustments; the ECI may be important if
5 projections of increases lead to higher wage demands from crafts whose
6 contracts are expiring. The WPI is also important as a measure of inflation for
7 inputs other than labor.

8 As the table shows, projected inflation in the test year does not indicate
9 the need for a higher contingency in this case than in the previous two. The CPI-
10 W estimate for the Test Year is lower in this case than it was in the previous two
11 cases although the ECI estimate is higher. While projected inflation in wholesale
12 prices is higher in this case than in the previous one, it is far lower than in R94-1.

13 **TABLE 4**
14 **PROJECTED TEST YEAR INFLATION**

	USPS PROPOSED CONTINGENCY (%)	PRC CONTINGENCY (%)	TEST YEAR CPI-W (%)	TEST YEAR ECI (%)	TEST YEAR WPI (%)
R2000-1	2.5 ¹		2.0 ²	3.9 ³	.5 ⁴
R97-1	1.0 ⁵	1.0 ⁶	2.6 ⁷	3.3 ⁸	.2 ⁹
R94-1	2.0 ¹⁰	2.0 ¹¹	3.2 ¹²	3.2 ¹³	2.6 ¹⁴

15 ¹Direct Testimony of Witness Tayman, R2000-1 USPS-T-9, pg 44.

16 ²Direct Testimony of Witness Tayman, R2000-1 USPS-T-9, pg 21.

17 ³Ibid.

18 ⁴Workpaper of Witness Tayman, R2000-1 LR-I-127, Workbook Dri_00, Worksheet ANNUAL,
19 Wholesale Price Index.

20 ⁵Direct Testimony of Witness Tayman, R97-1 USPS-T-9, pg 38.

21 ⁶PRC, Opinion and Recommended Decision R97-1, pg 21.

22 ⁷Direct Testimony of Witness Tayman, R97-1 USPS-T-9, pg 19.

23 ⁸Workpaper of Witness Tayman, R97-1 H-12, Workbook Dri_2_97, Worksheet ANNUAL,
24 Employment Compensation Index - Wages and Salaries - Private Industry

25 ⁹Workpaper of Witness Tayman, R97-1 H-12, Workbook Dri_2_97, Worksheet ANNUAL,
26 Wholesale Price Index.

27 ¹⁰Direct Testimony of Witness Ward, R94-1 USPS-T-8, pg 42.

28 ¹¹PRC, Opinion and Recommended Decision R94-1, pg II-16.

29 ¹²Direct Testimony of Witness Ward, R94-1 USPS-T-8, pg 24.

30 ¹³Ibid.

31 ¹⁴Ibid.

1 Given the results of the variance analysis, the financial condition of the
2 Postal Service, the state of the economy, and the Commission's decisions over
3 the last 25 years, it is clear that a reasoned and reasonable contingency in this
4 case should not be larger than in either of the previous two cases. In comparing
5 R94-1 to R2000-1, the variance analysis and the financial condition of the Postal
6 Service both indicate the need for a much smaller contingency in R2000-1 and
7 the general state of the economy, as measured through inflation indices, could
8 support a lower contingency in R2000-1. And in comparing R97-1 to R2000-1,
9 the variance analysis and the financial condition of the Postal Service also both
10 indicate the need for a smaller contingency in R2000-1 and the general state of
11 the economy, as measured through the inflation indices, could support the same
12 contingency in R2000-1. Since the contingency was two percent in R94-1 and
13 one percent in R97-1, I conclude that a reasoned and reasonable contingency is
14 one percent in R2000-1.

15 **III. COST REDUCTION AND OTHER PROGRAMS**

16 In this section of my testimony, I discuss two errors in cost reduction and
17 other programs. First, although corrected by the Commission in the R97-1
18 Opinion, the Postal Service again has a flaw in the rollforward model. Second,
19 as can be shown by using estimates from Postal Service witnesses, witness
20 Tayman has underestimated savings from the AFSM 100 program. I discuss
21 each of these errors below.

22 **A. Correcting a flaw in the rollforward model**

23 In R97-1, I pointed out that cost reductions for clerks and mailhandlers and
24 carriers should be, but were not, accompanied by reductions in costs for their
25 supervisors. I also pointed out that the rollforward model keeps the ratio of
26 supervisors to those supervised constant, so that increases in craft costs are
27 accompanied by increases in supervisors' costs.

28 The Commission corrected this flaw:

1 Buc's contention that supervisor's work hours and costs
 2 should go down when their managed employees' work
 3 hours and costs go down is both consistent with the
 4 technique the Postal Service has used in this case to
 5 project test year supervisor costs and essentially
 6 unrebutted. Consequently, the Commission has
 7 concluded that it will make the adjustment suggested by
 8 witness Buc. Op. R97-1 at 62.

9 In this case, the Postal Service again presents cost reductions for clerks and
 10 mailhandlers and for carriers that are not accompanied by corresponding cost
 11 reductions for their supervisors. The Postal Service did so even though it
 12 realized that changes in craft labor induce changes in supervisor labor:

13 [t]he workhours, and therefore the costs, for first line
 14 supervisors are largely a function of the workhour-related
 15 costs of the supervised activities and supervisory span of
 16 control (number of employees per supervisor). Mail
 17 processing supervisors have a span of control that is
 18 essentially constant in a given work organization structure.
 19 It is recognized that a change in employees workhours,
 20 caused by a change in mail volume, may not be
 21 accompanied immediately by a corresponding change in
 22 first line supervisory workhours. However, for any
 23 substantial or prolonged change in the level of
 24 nonsupervisory employee effort for a given work activity,
 25 there will be an accompanying change in first line
 26 supervisory requirements. Summary Description of USPS
 27 Development of Costs by Segments and Components,
 28 Fiscal Year 1998; USPS LR-I-1 at 2-2.

29 The Postal Service also provides support for this view for supervision of
 30 delivery and collection, "As in the case of mail processing supervision, these
 31 costs are largely a function of the workhour-related costs of each of the
 32 supervised activities." Summary Description of USPS Development of Costs by
 33 Segments and Components, Fiscal Year 1998; USPS LR-I-1 at 2-4.

34 Correcting this flaw again would result in savings of \$93 million in 2001 as
 35 displayed in Table 5, below. Attachment B shows the derivation of my estimates.

TABLE 5
CORRECTING THE FLAW IN THE ROLLFORWARD MODEL¹

Supervision of:	USPS (\$Thousands)	DMA (\$Thousands)	Difference (\$Thousands)
Mail Processing	\$989,776	\$920,374	(\$69,402)
City Carriers (In-Office)	291,243	259,143	(32,100)
City Carriers (Street)	622,338	630,898	8,560
Total	\$1,903,357	\$1,810,414	(\$92,943)

¹ Attachment B, pg 1.

B. Correcting an error in the AFSM 100 cost reduction estimate

There has been enormous confusion surrounding the cost reduction program for the AFSM 100. In fact, even witness Tayman concedes that the presentation has been confusing. Tayman, Tr.2/532. Presumably to help clarify the issues, witness Tayman filed errata to his original testimony and library references pertaining to the AFSM 100. In response, intervenors served interrogatories asking questions about the new numbers and the underlying calculations, and witness Tayman reinterpreted his presentations yet again. Fortunately, there is no reason to rely on witness Tayman's estimates of the cost reductions in this program; it is possible to estimate them directly using numbers in the testimony and library references of other Postal Service witnesses.

In his testimony, witness Tayman originally described three cost savings programs related to increased automation of flat-shaped mail through deployment of the new, high-speed flat sorting machines, the AFSM 100. Table 6, below, shows the workhour and cost savings originally projected in the Test Year for each of these.

TABLE 6
USPS ORIGINAL AFSM 100 COST SAVINGS ESTIMATES

Program	Number of Machines	Workhour Savings per Machine	Total Workhour Savings	Cost Savings ⁴ (\$ dollars)
AFSM ¹	1086	2,500	2,715,000	\$76,070,000
Accelerate AFSM Buy ²	44	29,727.3	1,308,000	36,648,000
AFSM to Upper Bound ³	44	43,181.8	1,900,000	53,235,000

¹USPS-LR-I-126 at 6.

²USPS-LR-I-126 at 6.

³USPS-LR-I-126 at 18.

⁴Docket No. R2000-1, USPS-LR-I-126, PRG_ANAL-revised.xls, 'Data'. Cost savings obtained by multiplying \$27.99 (hourly wage rate) by work total work hour savings. Hourly wage rate calculated from dividing Clerk/Mailhandler Avg. Personnel Cost (50,125) by Workhours Per Workyear (1,791).

The first row in the table describes the initial AFSM 100 program; i.e., the procurement and installation of the first set of machines. As witness Kingsley described, "The first deployment of ... AFSM 100s will be primarily used to add additional capacity to our flat mail processing network. They will handle *incoming* secondary (not outgoing secondary) flats that are currently sorted manually to carrier route at our plants and associated offices." Kingsley, Tr. 5/1782. The second and third programs buy additional machines "to replace existing FSM 881s." Tayman, Tr. 2/164.

It is obvious that the data were incorrect in the first of the three cost savings programs. They showed deployment of 1086 AFSM 100 machines when the Postal Service planned to buy only about 175 machines in its initial purchase. They also showed a workhour savings figure per machine that is much lower than the savings per machine used in the other two cost reduction programs for the same machine.

1 Witness Tayman filed errata on February 18, revising his testimony and
2 changing the number of machines from 1086 to 173. He also provided a revised
3 workhour savings per machine that kept intact the original total workhour savings
4 for the cost savings program. Table 7, below, compares the original estimates
5 for number of machines, workhour savings per machine, and total workhour
6 savings in the Test Year for the first deployment of the AFSM 100 with the
7 revised estimate.

8 **TABLE 7**
9 **COMPARISON OF USPS ORIGINAL AND REVISED**
10 **AFSM 100 FIRST DEPLOYMENT COST SAVINGS ESTIMATE**

Program	Number of Machines	Workhour Savings per Machine	Total Workhour Savings	Cost savings (\$ Thousands)
Original estimate ¹	1086	2500	2,715,000	\$76,070
Revised estimate ²	173	15,693.6	2,715,000	76,070

11 USPS-LR-I-126 at 6.

12 ²USPS-LR-I-126, 2/18/00 Revised version

³Docket No. R2000-1, USPS-LR-I-126, PRG_ANAL-revised.xls, 'Data'. Cost savings obtained by multiplying \$27.99 (hourly wage rate) by work total work hour savings. Hourly wage rate calculated from dividing Clerk/Mailhandler Avg. Personnel Cost (50,125) by Workhours Per Workyear (1,791).

17 Witness Tayman's revision is no more defensible than his original
18 estimates: his revised cost savings per machine are very low compared to the
19 other two programs, even though they do have the apparent "virtue" of
20 preserving his original total workhours savings.

21 In response to interrogatories from MPA and DMA and in a revised
22 response to an ANM interrogatory, witness Tayman tried to clarify the issue;
23 there are only two buys of machines and the program "accelerate AFSM to upper
24 bound" means that productivity on the first buy will be enhanced above the
25 original estimate. Tayman, Tr.2/319-322, 314, 164-166. Regardless of all
26 explanations, the ultimate source of the estimates remains with Postal Service
27 "Program managers" and not with witness Tayman. Tayman, Tr. 2/ 490, 492,

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1 540, 542, and 543. Further, in spite of all attempts at explanations, witness
2 Tayman did not provide any underlying calculations showing the derivation of the
3 cost reductions.

4 Because witness Tayman's explanations are so unsatisfying, I estimated
5 savings for the AFSM 100 based on other available information, including the
6 number of AFSM 100 sorts in the Test Year, sorting productivity on the AFSM
7 100, and savings per AFSM 100 sort, which is provided in the testimony and
8 Library References of Postal Service witnesses. I also used a conservative
9 estimate of savings. First, consistent with witness Tayman's and witness
10 Yacobucci's (USPS-T-25) cost estimating methods, I used an average wage rate
11 to determine cost savings. This completely ignores the additional savings that
12 will result from paying AFSM 100 clerks at a lower wage rate than the manual
13 clerks and keyers that the AFSM 100s will partially replace. Kingsley, Tr. 5/1803-
14 1804, 1840-1842, 1941. Second, I assumed that one half of the sorts the AFSM
15 100 will replace are low-cost sorts when the Postal Service will at least partially
16 use these machines to replace higher-cost sorts in the Test Year. Third, I
17 included savings only from the original set of machines and did not include any
18 savings from the portion of the additional 363 machines the Postal Service will
19 install during the test year. O'Tormey, Tr. 21/8349-8351.

20 For the Test Year, it was possible to develop cost reduction estimates
21 directly from information on the record rather than relying on estimates from
22 "Program Mangers". Attachment C provides the derivation of my estimates.

23 Table 8, below, provides witness Tayman's estimates and my estimates.
24 As the table shows, witness Tayman has understated AFSM 100 cost reductions
25 by at least \$202.1 million in the Test Year.

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1 **TABLE 8**
2 **COMPARISON OF USPS AND DMA**
3 **AFSM 100 TYAR COST SAVINGS ESTIMATE¹**

	USPS (\$Thousands)	DMA (\$Thousands)	Difference (\$Thousands)
Clerk and MH Savings	\$ 169,379	\$ 371,510	\$ (202,131)

4 ¹ Attachment C, pg 1.

5 **IV. CONCLUSION**

6 As I have demonstrated, the Postal Service ignores the Commission's
7 principles for setting a reasonable contingency and consequently overstates their
8 contingency request by \$1.01 billion dollars. Correcting the flaw in the rollforward
9 program per the Commission's Opinion in R97-1 reduces the revenue request by
10 an additional \$93 million dollars. And calculating cost savings for the AFSM 100
11 using the Postal Service's own data increases these cost savings by \$202
12 million. Thus, the revenue requirement should be reduced by \$1.31 billion.

Attachment A

Test Year Revenue Requirement with Contingency Adjustment (all dollar figures in thousands)

USPS			Cost Adjustments		DMA				Total Contingency Adjustment	Total Revenue Req. Adjustment
Total Accrued Cost	Contingency	Accrued Cost (w/ Contingency)	Rollforward Flaw	AFSM 100	Total Accrued Cost	% Contingency	Contingency	Total Accrued Cost (w/ Contingency)		
[1]	[2]	[3]=[1]+[2]	[4]	[5]	[6]=[1]+[4]+[5]	[7]	[8]=[6]*[7]	[9]=[6]+[8]	[10]=[8]-[2]	[11]=[9]-[3]
\$67,190,634	\$1,679,766	\$68,870,400	(\$92,943)	(\$199,933)	\$66,897,758	1.0%	\$668,978	\$67,566,735	(\$1,010,788)	(\$1,303,665)

Sources:

[1],[2] Direct Testimony of Witness Tayman, R2000-1 USPS-T-9, pg. 22, Table 15.

[4] Attachment B, pg 1.

[5] Attachment C, pg 1.

[7] Contingency rate proposed by DMA.

Summary

Attachment B

Calculation of DMA/Buc Adjustment (in thousands of dollars)

Supervisor Type	FY 1999 Cost			FY 2000 Cost			Test Year After Rates		
	Initial	Adjusted	Adjustment	Initial	Adjusted	Adjustment	Initial	DMA Adjust.	Adjusted
	[1]	[2]	[3]=[2]-[1]	[4]	[5]	[6]=[5]-[4]	[7]	[8]	[9]=[8]-[7]
Mail Processing /1	\$930,540	\$915,804	(\$14,736)	\$958,256	\$930,058	(\$28,198)	\$989,776	\$920,374	(\$69,402)
City Carriers (In-Office) /2	\$277,121	\$267,810	(\$9,311)	\$281,473	\$258,093	(\$23,380)	\$291,243	\$259,143	(\$32,100)
City Carriers (Street) /3	\$595,310	\$594,180	(\$1,130)	\$599,718	\$608,603	\$8,885	\$622,338	\$630,898	\$8,560
Total:	\$1,802,971	\$1,777,793	(\$25,178)	\$1,839,447	\$1,796,755	(\$42,692)	\$1,903,357	\$1,810,414	(\$92,943)

Sources:

[4] Workpaper of Witness Kashani, R2000-1, USPS-T-14, WP-E, pg. 3, 4, 6, 7.

[7] Workpaper of Witness Kashani, R2000-1, USPS-T-14, WP-I, pg. 3, 4, 6, 7.

[1],[2],[5],[8] Attachment B, pg. 2-3.

/1 Segment/Component Code 0004

/2 Segment/Component Code 0013

/3 Segment/Component Code 0020 - Segment/Component Code 0013

AFSM 100 Savings Comparison

Attachment C
Revised 6/23/00

AFSM 100 Cost Savings Comparison
(all numbers in thousands)

	DMA	USPS	Difference
	[1]	[2]	[3]=[1]-[2]
Total Savings	\$ 371,510	\$ 169,379	\$ 202,131

Sources:

[1] Attachment C, pg 2.

[2] Attachment C, pg 3.

USPS AFSM 100 Clerks TY Savings

Attachment C
Revised 6/23/00

USPS AFSM 100 Clerks Test Year Savings			
Clerks Workhour Savings (hours)	Hourly Clerk Wage Rate	Clerks Workhour Cost Savings (thousands)	
[1]	[2]	[3]=[1]*[2]	
6,052,003	\$ 27.99	\$ 169,379	

Sources:

[1] Docket No. R2000-1, Tayman, Tr. 2/322.

[2] Docket No. R2000-1, USPS-LR-I-126, PRG_ANAL-revised.xls, 'Data'. Hourly wage rate obtained from dividing Clerk/Mailhandler Avg. Personnel Cost (50,125) by Workhours Per Workyear (1,791).

DMA AFSM 100 Clerks TY Savings

Attachment C
Revised 6/23/00

DMA AFSM Clerks Test Year Savings

		[1]	[2]	[3]	[4]	[5]	[6]	[7]	[8]	[9]
		Direct Cost per Handling (cents)	Plant/Delivery Unit Manual IS Factor	AFSM Productivity (units/hour)	Number of Machines	Operational Hours per Workday	Operational Days per Year	Total Sorts Per Year (millions)	Allocated Sorts (millions)	Total Cost Savings
S	IS - Manual, Plant	6.184	26.10%							
	IS - Manual, Delivery Unit	3.339	73.90%							
	IS - AFSM 100	0.941	N/A							
	Difference*	3.140		15,000	166.5	20	313	15,634	5,916	\$ 185,755
P										
	IP - FSM 881 OCR/BCR	2.853								
	IP - AFSM 100	0.941								
	Difference**	1.911		15,000	166.5	20	313	15,634	9,718	\$ 185,755
TOTAL SAVINGS										\$ 371,510

Sources:

* Difference (IS only) is calculated by taking 26.10% of the difference between IS - Manual, Plant and IS - AFSM 100 added to 73.90% of the difference between IS - Manual, Delivery Unit and IS - AFSM 100 per Docket No. R2000-1, LR-I-90, R2000_1_Flats Cost Model_Final USPS.xls, 'Data', Plant/Delivery Unit Manual IS Factor.

** Difference (IP only) selected as conservative estimate as smallest difference between cost of current sort and cost of AFSM 100 sort.

[1] Docket No. R2000-1, LR-I-90, R2000_1_Flats Cost Model_Final USPS.xls, 'Mailflow Model Costs', Cents per Piece Handling, with a modification to set a volume variability factor equal to 1.00.

[2] Docket No. R2000-1, LR-I-90, R2000_1_Flats Cost Model_Final USPS.xls, 'Data', Plant/Delivery Unit Manual IS Factor.

[3] Docket No. R2000-1, LR-I-90, R2000_1_Flats Cost Model_Final USPS.xls, 'Productivities', Footnotes [7] and [8]

[4] LR-I-83, page I-12

[5] Kingsley, TR.5/1961.

[6] Kingsley, TR.5/1960.

[7] = [3]*[4]*[5]*[6]

[8] = Allocated Sorts is the number of sorts allocated to each scenario to yield equal cost savings, Kingsley, TR.5/1660.

[9] = [8]*[1]

1 CHAIRMAN GLEIMAN: Mr. Buc, have you had an
2 opportunity to examine the packet of designated written
3 cross examination that was made available to you earlier
4 today, or was there any?

5 THE WITNESS: Yes, there was.

6 CHAIRMAN GLEIMAN: If you have not had a chance to
7 examine it, would you take a moment and look through it and
8 the question I put to you is if these questions were posed
9 to you orally today would your answers be the same as those
10 you previously provided in writing?

11 THE WITNESS: They would be, yes.

12 CHAIRMAN GLEIMAN: No corrections or additions?

13 THE WITNESS: No.

14 CHAIRMAN GLEIMAN: Counsel, if you would please
15 provide two copies of the designated written cross
16 examination of this witness to the Reporter, the material
17 will be received into evidence and transcribed into the
18 record.

19 [Designation of Written
20 Cross-Examination of Lawrence G. Buc,
21 DMA-T-1, was received into evidence and
22 transcribed into the record.]

23
24
25

BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, DC 20268-0001

Postal Rate and Fee Changes, 2000

Docket No. R2000-1

DESIGNATION OF WRITTEN CROSS-EXAMINATION
OF DIRECT MARKETING ASSOCIATION, INC.
WITNESS LAWRENCE G. BUC
(DMA-T-1)

Party

United States Postal Service

Interrogatories

USPS/DMA-T1-1-17

Respectfully submitted,


Cyril J. Fittack
Acting Secretary

INTERROGATORY RESPONSES OF
DIRECT MARKETING ASSOCIATION, INC.
WITNESS LAWRENCE G. BUC (T-1)
DESIGNATED AS WRITTEN CROSS-EXAMINATION

<u>Interrogatory</u>	<u>Designating Parties</u>
USPS/DMA-T1-1	USPS
USPS/DMA-T1-2	USPS
USPS/DMA-T1-3	USPS
USPS/DMA-T1-4	USPS
USPS/DMA-T1-5	USPS
USPS/DMA-T1-6	USPS
USPS/DMA-T1-7	USPS
USPS/DMA-T1-8	USPS
USPS/DMA-T1-9	USPS
USPS/DMA-T1-10	USPS
USPS/DMA-T1-11	USPS
USPS/DMA-T1-12	USPS
USPS/DMA-T1-13	USPS
USPS/DMA-T1-14	USPS
USPS/DMA-T1-15	USPS
USPS/DMA-T1-16	USPS
USPS/DMA-T1-17	USPS

**RESPONSE OF WITNESS BUC TO INTERROGATORIES OF
OFFICE OF THE UNITED STATES POSTAL SERVICE**

USPS/DMA-T1-1. Please confirm that over the course of almost 30 years of ratemaking under the Postal Reorganization Act, the Postal Rate Commission has accepted the level of all but one of the Postal Service's contingency amounts. If you do not confirm, please explain fully.

Response

Confirmed.

**RESPONSE OF WITNESS BUC TO INTERROGATORIES OF
OFFICE OF THE UNITED STATES POSTAL SERVICE**

USPS/DMA-T1-2. On page 2, line 27, of your testimony, you state that "witness Tayman provides little support for a contingency of 2.5 percent and that this request is neither reasoned nor reasonable given the Commission's past decisions."

- (a) With reference to past contingency amounts proposed by the Postal Service and accepted by the Commission, please explain which ones were reasoned and which ones were not reasoned and why.
- (b) For any previous contingency amounts considered by you to be reasoned, please explain how the support provided by the Postal Service for such contingency amounts differs from the support provided for the contingency in this docket which you say is not reasoned.

Response

(a) Please note that I have read only the Commission's Decisions and the Postal Service's requests in omnibus rate cases from R76-1 through R97-1. I do not believe the Postal Service has ever employed in its requests for contingencies the framework the Commission has outlined in its decisions. Thus, I do not believe that any of the requests is reasoned.

(b) Not applicable.

**RESPONSE OF WITNESS BUC TO INTERROGATORIES OF
OFFICE OF THE UNITED STATES POSTAL SERVICE**

USPS/DMA-T1-3. Please refer to USPS-T-15, Direct Testimony of Charles Holder in Docket No. R90-1.

- (a) Please confirm that six potential uncertainties are listed on page 11: potential adverse impacts from 3 legislative proposals, a possible change in accounting standards, the outcome of a labor arbitration, and the possibility that inflation could be greater than projected. Please also confirm that these uncertainties are reiterated on pages 47 and 48, along with an additional uncertainty related to interest rates. If you do not confirm, please explain fully.
- (b) Do you consider the support provided for the contingency in USPS-T-15, Direct Testimony of Charles Holder in Docket No. R90-1 to be reasoned? If your answer is other than yes please explain why.

Response

(a) Confirmed that Charles Holder lists six uncertainties on page 11. Not confirmed that Holder lists these same uncertainties on pages 47 and 48. He does not list on these pages (1) an administration proposal to require creation of a new set of subclasses for Government mail or (2) the labor arbitration. Confirmed that he does add interest rate uncertainty on page 48.

(b) Please see my response to USPS/DMA-T1-2 above.

**RESPONSE OF WITNESS BUC TO INTERROGATORIES OF
OFFICE OF THE UNITED STATES POSTAL SERVICE**

USPS/DMA-T1-4. Please refer to Table 3 on page 15 of your testimony. Please confirm that projected FY 2000 equity is negative. If you do not confirm, please explain.

Response

Table 3 of my testimony does not contain an entry showing USPS projected equity for FY 2000.

**RESPONSE OF WITNESS BUC TO INTERROGATORIES OF
OFFICE OF THE UNITED STATES POSTAL SERVICE**

USPS/DMA-T1-5. Please refer to the table below and to Table 3 at page 15 of your testimony:

DOCKET NO.	USPS CONTINGENCY	PRC CONTINGENCY	EQUITY AT END OF YEAR BEFORE FILING (\$000)
R84-1	3.5%	3.5%	112,000
R87-1	3.5%	3.5%	362,000
R90-1	3.5%	3.5%	-402,000

Sources: USPS-T-9; PRC Op., R84-1, R87-1, and R90-1, App. A.

Please confirm that equity was more favorable in all three of the years prior to the filing of Docket Nos. R84-1, R87-1, and R90-1 than equity was in the year prior to filing the current case. If you do not confirm, please provide the correct data and your source.

Response

Confirmed. However, please note that the Postal Service has continued to carry equity at book value rather than market value. As witness Tayman confirmed on April 19, 2000 in response to DMA/USPS-T9-58, the appraised value of Postal Service headquarters is \$76.8 million. It is carried on the books at a very small fraction of that amount. I suspect that if the Postal Service rationally managed its real estate by selling real estate in selected high value areas and relocating some operations, it could not only restore equity to a positive value, but also eliminate the need for prior year losses as a component of the revenue requirement.

**RESPONSE OF WITNESS BUC TO INTERROGATORIES OF
OFFICE OF THE UNITED STATES POSTAL SERVICE**

USPS/DMA-T1-6. Please refer to page 15, lines 24 and 25, of your testimony where you state that "if projected inflation is high, there is a greater need for a contingency since the future is less certain." Please define high inflation as you have used the term.

Response

I do not mean to imply that there is a bright line between "high inflation" and "low inflation" or that either term has a precise, objective definition. Historically, double-digit annual inflation rates have been considered "high," while inflation rates of two, three, and four percent have been considered low.

**RESPONSE OF WITNESS BUC TO INTERROGATORIES OF
OFFICE OF THE UNITED STATES POSTAL SERVICE**

USPS/DMA-T1-7. Please refer to Table 4 on page 16 of your testimony. Please confirm that the ECI forecast for Docket No. R2000-1 is higher than the forecast for both the previous two test year forecasts. If you do not confirm please explain.

Response

Confirmed as indicated on page 16 of my testimony where I state, "The CPI-W estimate for the Test Year is lower in this case than it was in the previous two cases although the ECI estimate is higher."

**RESPONSE OF WITNESS BUC TO INTERROGATORIES OF
OFFICE OF THE UNITED STATES POSTAL SERVICE**

USPS/DMA-T1-8. Please refer to page 16 lines 3 through 6 of your testimony where you state that "the CPI-W is an important measure of inflation because changes in it trigger changes in craft cost of living adjustments: the ECI may be important if projections of increases lead to higher wage demands from crafts whose contracts are expiring." Please also refer to USPS-9Q, page 3 of 3.

- (a) Please confirm that new COLAs effective in the test year are only reflected for city carriers and amount to only \$32 million and that pay costs for other bargaining unit crafts are much greater than \$32 million. If you do not confirm, please provide explain fully and provide the COLA amounts you assume to be effective in the test year for other employee groups and provide your sources.
- (b) Please refer to USPS-T-9, page 19, and confirm that the ECI was used to estimate wage changes in the test year for all bargaining units except city carriers. If you do not confirm, please explain why.
- (c) Please refer to LR-I-127, Chapter 1, pages 8 and 9, and Chapter 12, page 644. Please confirm that the WPI was applied only to cost components 168, 169, and 171. If you do not confirm please provide the components to which the WPI was applied and provide documentation. Please confirm that the test year cost level changes applicable to components 168, 169, and 171 is only \$1.628 million.

(a) Confirmed.

(b) Confirmed.

(c) Confirmed.

**RESPONSE OF WITNESS BUC TO INTERROGATORIES OF
OFFICE OF THE UNITED STATES POSTAL SERVICE**

USPS/DMA-T1-9. Please refer to Table 4 in your testimony.

- (a) Please confirm that the only information you have provided related to the state of the economy is reflected in Table 4 in your testimony. If you do not confirm please provide all other information you have provided to document the state of the economy and provide all sources.
- (b) Is it your testimony that the indices reflected in your Table 4 provide a comprehensive view of the state of the economy? If your answer is other than yes, please explain fully what other factors should be considered in understanding the state of the economy.

Response

(a) Confirmed.

(b) It is not my testimony that Table 4 provides a comprehensive view of the state of the economy. At a high level, economists often characterize the state of the economy as a function of two factors: inflation and unemployment. While the CPI-W, the ECI, and the WPI all provide measures of inflation, they do not provide a measure of unemployment.

Unemployment rates can be found on the web site of the Bureau of Labor Statistics. The series LFS21000000 shows unemployment rates for the civilian labor force, ages 16 and older. I have attached the series to this interrogatory response. In general, the data show that unemployment rates are lower now – around four percent – than they have been since the late 1960s. In particular, they are lower now than when the Postal Service filed its last two requests and far lower than when the Postal Service filed its requests in all the cases from R77-1 to R90-1.

The current state of our economy is very good. In fact, Chapter 1 of this year's Economic Report of the President begins, "The policy strategy of maintaining fiscal discipline, investing in people and technologies, and opening international markets has borne rich fruit, allowing the nation to exploit new opportunities and reap the benefits of major scientific and technical advances. The results have been a 20-million-job increase in payroll employment since January 1993, the lowest unemployment rate since 1969, the lowest core inflation rate since 1965, the lowest poverty rate since 1979, rising productivity, significant gains all across the income distribution, and a Federal budget surplus for 2 years in a row after nearly three decades of deficits. The current economic expansion, already the longest peacetime expansion on record, is on the threshold of becoming the longest ever."

Bureau of Labor Statistics Data

Data extracted on: June 15, 2000 (09:21 AM)

Labor Force Statistics from the Current Population Survey

Series Catalog:

Series ID : LFS21000000

Seasonally Adjusted

Series Title : UNEMP. RATE - Civilian labor force

Age : 16 Years And Older (null)

Class of Worker : N/A

Ethnicity Origin : N/a

Industry : N/A

Occupation : N/a

Race : N/a

Sex : N/a

Status : Civilian Labor Force (Null)

Data:

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Ann
1948	3.4	3.8	4.0	3.9	3.5	3.6	3.6	3.9	3.8	3.7	3.8	4.0	n/a
1949	4.3	4.7	5.0	5.3	6.1	6.2	6.7	6.8	6.6	7.9	6.4	6.6	n/a
1950	6.5	6.4	6.3	5.8	5.5	5.4	5.0	4.5	4.4	4.2	4.2	4.3	n/a
1951	3.7	3.4	3.4	3.1	3.0	3.2	3.1	3.1	3.3	3.5	3.5	3.1	n/a
1952	3.2	3.1	2.9	2.9	3.0	3.0	3.2	3.4	3.1	3.0	2.8	2.7	n/a
1953	2.9	2.6	2.6	2.7	2.5	2.5	2.6	2.7	2.9	3.1	3.5	4.5	n/a
1954	4.9	5.2	5.7	5.9	5.9	5.6	5.8	6.0	6.1	5.7	5.3	5.0	n/a
1955	4.9	4.7	4.6	4.7	4.3	4.2	4.0	4.2	4.1	4.3	4.2	4.2	n/a
1956	4.0	3.9	4.2	4.0	4.3	4.3	4.4	4.1	3.9	3.9	4.3	4.2	n/a
1957	4.2	3.9	3.7	3.9	4.1	4.3	4.2	4.1	4.4	4.5	5.1	5.2	n/a
1958	5.8	6.4	6.7	7.4	7.4	7.3	7.5	7.4	7.1	6.7	6.2	6.2	n/a
1959	6.0	5.9	5.6	5.2	5.1	5.0	5.1	5.2	5.5	5.7	5.8	5.3	n/a
1960	5.2	4.8	5.4	5.2	5.1	5.4	5.5	5.6	5.5	6.1	6.1	6.6	n/a
1961	6.6	6.9	6.9	7.0	7.1	6.9	7.0	6.6	6.7	6.5	6.1	6.0	n/a
1962	5.8	5.5	5.6	5.6	5.5	5.5	5.4	5.7	5.6	5.4	5.7	5.5	n/a

Bureau of Labor Statistics Data

Page 2 of 3

1963	5.7	5.9	5.7	5.7	5.9	5.6	5.6	5.4	5.5	5.5	5.7	5.5	n/a
1964	5.6	5.4	5.4	5.3	5.1	5.2	4.9	5.0	5.1	5.1	4.8	5.0	n/a
1965	4.9	5.1	4.7	4.8	4.6	4.6	4.4	4.4	4.3	4.2	4.1	4.0	n/a
1966	4.0	3.8	3.8	3.8	3.9	3.8	3.8	3.8	3.7	3.7	3.6	3.8	n/a
1967	3.9	3.8	3.8	3.8	3.8	3.9	3.8	3.8	3.8	4.0	3.9	3.8	n/a
1968	3.7	3.8	3.7	3.5	3.5	3.7	3.7	3.5	3.4	3.4	3.4	3.4	n/a
1969	3.4	3.4	3.4	3.4	3.4	3.5	3.5	3.5	3.7	3.7	3.5	3.5	n/a
1970	3.9	4.2	4.4	4.6	4.8	4.9	5.0	5.1	5.4	5.5	5.9	6.1	n/a
1971	5.9	5.9	6.0	5.9	5.9	5.9	6.0	6.1	6.0	5.8	6.0	6.0	n/a
1972	5.8	5.7	5.8	5.7	5.7	5.7	5.6	5.6	5.5	5.6	5.3	5.2	n/a
1973	4.9	5.0	4.9	5.0	4.9	4.9	4.8	4.8	4.8	4.6	4.8	4.9	n/a
1974	5.1	5.2	5.1	5.1	5.1	5.4	5.5	5.5	5.9	6.0	6.6	7.2	n/a
1975	8.1	8.1	8.6	8.8	9.0	8.8	8.6	8.4	8.4	8.4	8.3	8.2	n/a
1976	7.9	7.7	7.6	7.7	7.4	7.6	7.8	7.8	7.6	7.7	7.8	7.8	n/a
1977	7.5	7.6	7.4	7.2	7.0	7.2	6.9	7.0	6.8	6.8	6.8	6.4	n/a
1978	6.4	6.3	6.3	6.1	6.0	5.9	6.2	5.9	6.0	5.8	5.9	6.0	n/a
1979	5.9	5.9	5.8	5.8	5.6	5.7	5.7	6.0	5.9	6.0	5.9	6.0	n/a
1980	6.3	6.3	6.3	6.9	7.5	7.6	7.8	7.7	7.5	7.5	7.5	7.2	n/a
1981	7.5	7.4	7.4	7.2	7.5	7.5	7.2	7.4	7.6	7.9	8.3	8.5	n/a
1982	8.6	8.9	9.0	9.3	9.4	9.6	9.8	9.8	10.1	10.4	10.8	10.8	n/a
1983	10.4	10.4	10.3	10.2	10.1	10.1	9.4	9.5	9.2	8.8	8.5	8.3	n/a
1984	8.0	7.8	7.8	7.7	7.4	7.2	7.5	7.5	7.3	7.4	7.2	7.3	n/a
1985	7.3	7.2	7.2	7.3	7.2	7.4	7.4	7.1	7.1	7.1	7.0	7.0	n/a
1986	6.7	7.2	7.2	7.1	7.2	7.2	7.0	6.9	7.0	7.0	6.9	6.6	n/a
1987	6.6	6.6	6.6	6.3	6.3	6.2	6.1	6.0	5.9	6.0	5.8	5.7	n/a
1988	5.7	5.7	5.7	5.4	5.6	5.4	5.4	5.6	5.4	5.4	5.3	5.3	n/a
1989	5.4	5.2	5.0	5.2	5.2	5.3	5.2	5.2	5.3	5.3	5.4	5.4	n/a
1990	5.4	5.3	5.2	5.4	5.4	5.2	5.5	5.7	5.9	5.9	6.2	6.3	n/a
1991	6.4	6.6	6.8	6.7	6.9	6.9	6.8	6.9	6.9	7.0	7.0	7.3	n/a
1992	7.3	7.4	7.4	7.4	7.6	7.8	7.7	7.6	7.6	7.3	7.4	7.4	n/a
1993	7.3	7.1	7.0	7.1	7.1	7.0	6.9	6.8	6.7	6.8	6.6	6.5	n/a
1994	6.6	6.6	6.5	6.4	6.1	6.1	6.1	6.0	5.9	5.8	5.6	5.5	n/a
1995	5.6	5.4	5.4	5.8	5.6	5.6	5.7	5.7	5.6	5.5	5.6	5.6	n/a
1996	5.7	5.5	5.5	5.5	5.6	5.3	5.5	5.1	5.2	5.2	5.4	5.4	n/a

1997	5.3	5.3	5.2	5.0	4.9	5.0	4.8	4.8	4.9	4.7	4.6	4.7
1998	4.7	4.6	4.7	4.3	4.4	4.5	4.5	4.5	4.5	4.5	4.4	4.4
1999	4.3	4.4	4.2	4.3	4.2	4.3	4.3	4.2	4.2	4.1	4.1	4.1
2000	4.0	4.1	4.1	3.9	4.1							



Labor Force Statistics from the Current Population Survey Home Page



Data Home Page



BLS Home Page

Bureau of Labor Statistics
cpsinfo@bls.gov

**RESPONSE OF WITNESS BUC TO INTERROGATORIES OF
OFFICE OF THE UNITED STATES POSTAL SERVICE**

USPS/DMA-T1-10. Refer to Exhibit USPS-9J, page 1 of 8. Please confirm that actual FY 98 supervisor personnel costs of \$3.512 billion were within 0.1% of the original Postal Service estimate of \$3.515. If you do not confirm, please explain and provide the correct amount and your source.

Response

Confirmed.

**RESPONSE OF WITNESS BUC TO INTERROGATORIES OF
OFFICE OF THE UNITED STATES POSTAL SERVICE**

USPS/DMA-T1-11. Please refer to Appendix C of the PRC Docket No. R97-1 Opinion and Recommended Decision.

- (a) Please confirm that the amount recommended by the Commission for test year (FY 98) supervisor costs was \$3.420 billion or \$95 million less than estimated by the Postal Service.
- (b) Please confirm that the Commission reduced the Postal Service's test year estimate by \$101 million to correct an alleged flaw in the rollforward model related to the calculation of supervisor costs. If you do not confirm, please explain and provide the correct amount and your source.
- (c) Please confirm that had the Commission not made this adjustment, its recommended amount would have been \$3.521 billion or only \$9 million and 0.3% more than the actual cost.

Response

(a) Confirmed that the amount that the Commission recommended rounds to \$3.420 billion. Not confirmed that this is \$95 million less than the amount requested by the Postal Service.

(b) Confirmed that the Commission reduced the Postal Service's Test Year estimate by \$101.294 million. Opinion and Recommended Decision, Docket No. R97-1, Appendix C, page 2 of 2. I can not say whether the Commission thought it was correcting an alleged flaw or an actual flaw. In its Opinion and Recommended Decision, it did say, "The Service seems to have no explanation for its failure to make a corresponding adjustment to supervisors' work hours when craft employee work hours are reduced." P 62.

(c) Confirmed that if it had not made this adjustment it would have recommended \$101 million more, or \$3.521 billion.

**RESPONSE OF WITNESS BUC TO INTERROGATORIES OF
OFFICE OF THE UNITED STATES POSTAL SERVICE**

USPS/DMA-T1-12. On page 18 of your testimony, you quote the following section from the Summary Description of USPS Development of Costs by Segments and Components, Fiscal Year 1998, USPS LR-I-1, at 2-2. "Mail processing supervisors have a span of control that is essentially constant in a given work organization structure. It is recognized that a change in employees workhours, caused by a change in mail volume, may not be accompanied immediately by a corresponding change in first line supervisory workhours."

- (a) Please confirm that the section quoted specifies two conditions that must exist concurrently in order for supervisor workhours to change in direct relation to supervised craft workhours: the "organization structure" is constant, and the change in employee workhours is caused by a "change in mail volume...." If you do not confirm, please explain.
- (b) Please confirm that your testimony on page 18, in citing the section above in support of your position, implies your belief that changes in workhours due to cost reductions and other programs are due to changes in mail volume. If you do not confirm, please explain.
- (c) Please confirm that your testimony on page 18, in citing the section above in support of your position, implies your belief that cost reductions and other programs, including those have significant changes in processing methodologies and equipment, would not produce changes in the "organizational structure" in the mail processing plant environment. If you do not confirm, please explain.

(a) Not confirmed. I interpret the section I quoted to mean that organizational constancy and mail volume changes is one condition under which supervisory labor will change, but not the only condition.

(b) Not confirmed. I believe that absent a change in organizational structure, changes in mail volume and increased efficiency from cost reduction programs will induce similar changes in supervisors. Anything that results in reductions in craft labor, ceteris paribus, will result in reductions in supervisory labor.

(c) Not confirmed. Because the Postal Service did not present testimony that there would be changes in organizational structure in the mail processing environment, I did not consider the ramifications of any such changes.

**RESPONSE OF WITNESS BUC TO INTERROGATORIES OF
THE UNITED STATES POSTAL SERVICE**

USPS/DMA-T1-13 Please refer to AttC-dma-t-1.xls that accompanies your testimony.

- a. Please provide the source for the IS-Manual, Delivery Unit amount of 3.273 that appears in column [1].
- b. Please provide the source for the IS-AFSM 100 and IP-AFSM 100 direct costs per handling of 0.941 cents. Please confirm that these direct costs only relate to the AFSM 100s processing of barcoded mail. If you do not confirm, please explain fully.
- c. Please provide the calculation underlying the 313 operational days per year shown in column [6].
- d. Please refer to the table below that provides Attachment C information in a format similar to that provided in Table 6 of your testimony.

AFSM Cost Savings Estimates

<u>Number of Machines</u>	<u>Workhour Savings per Machine</u>	<u>Total Workhour</u>	<u>Cost Savings (\$ dollars)</u>
166.5	79,246	13,194,427	369,312,000

- i. Please confirm that the number of machines appears in column [4] and the cost savings appears in column [9] of Attachment C. If you do not confirm, please explain fully.
 - ii. Please confirm that dividing the cost savings of 369,312,000 by the hourly wage rate of \$27.99 shown in footnote 4 of Table 6 of your testimony yields the total workhour amount of 13,194,427. If you do not confirm, please explain fully.
 - iii. Please confirm that dividing the total workhour amount of 13,194,427 by 166.5 machines yields 79,246 workhour savings per machine. If you do not confirm, please explain fully.
- e) Please confirm that USPS witness Kingsley, TR.5/1961 describes the number of AFSM operational hours per day as being in the range of 12-20 hours per day. If you do not confirm, please explain fully.

Response

- (a) The IS-Manual, Delivery Unit amount of 3.273 cents per piece is incorrect. The correct figure is 3.339. An errata will be filed to accompany these responses. Correcting this error increases the cost savings by approximately \$2.2 million.
- (b) The source for the IS-AFSM 100 and IP-AFSM 100 direct costs per handling of 0.941 cents is USPS-LR-I-90, worksheet 'Mailflow Model Costs', cell M49, with a modification to assume a volume variability factor of 1.00. Confirmed that USPS-LR-I-90 uses this figure only for barcoded flats. My analysis of USPS-LR-I-90 indicates

**RESPONSE OF WITNESS BUC TO INTERROGATORIES OF
THE UNITED STATES POSTAL SERVICE**

that the 0.941 cents per sort figure is for an AFSM 100 sort when the Video Coding System (VCS) is not being used. Because the Postal Service would only use the VCS when its benefits justify its costs, ignoring both the costs and the benefits of the VCS (as I have done) understates AFSM 100 cost savings.

- (c) Witness Kingsley stated on oral cross examination that AFSM 100s will be used six or more days a week and 52 weeks a year. Tr. 5/1960 To be conservative, I assumed that they would only be used six days a week. I calculated 313 by multiplying 6/7 times 365 and rounding to the nearest integer.
- (d) All confirmed.
- (e) Witness Kingsley indicates that the phase 2 machines will run from between 12 and 20 hours per day while the phase 1 machines will run 20 hours per day. The savings I developed were only for phase 1 machines.

**RESPONSE OF WITNESS BUC TO INTERROGATORIES OF
THE UNITED STATES POSTAL SERVICE**

USPS/DMA-T1-14 Please confirm that you exclude piggyback costs from your analysis. If you do not confirm, please explain fully how the piggyback costs are included in your analysis and provide all calculations showing their inclusion.

Response

Confirmed.

**RESPONSE OF WITNESS BUC TO INTERROGATORIES OF
THE UNITED STATES POSTAL SERVICE**

USPS/DMA-T1-15 Please confirm that USPS LR-I-83, page I-12 indicates that the AFSM 100 requires more floor space (square feet) than either the FSM 881 or the FSM 1000. If you do not confirm, please explain fully.

Response

Confirmed. Note that I made no adjustments to the USPS's estimate of the floor space requirements for the AFSM 100s.

**RESPONSE OF WITNESS BUC TO INTERROGATORIES OF
THE UNITED STATES POSTAL SERVICE**

USPS/DMA-T1-16 Please indicate if your analysis considers any other cost impacts from deploying the AFSM 100. For example, does your analysis consider any allied labor cost impacts? If your analysis does not include any additional costs, please explain why not. If your analysis does include additional costs, please explain the rationale and provide all calculations showing their inclusion.

Response

My analysis does not consider any cost impacts other than the ones I presented. It does not consider allied labor cost impacts for two reasons: (1) I did not find any discussion of allied cost impacts in USPS testimony; and (2) although it seems likely that allied costs as a percentage of total flat processing costs will increase following the introduction of the AFSM 100, it seems unlikely that allied cost per piece will increase.

**RESPONSE OF WITNESS BUC TO INTERROGATORIES OF
THE UNITED STATES POSTAL SERVICE**

USPS/DMA-T1-17 Please confirm that you assume the USPS will realize 100% of your calculated cost savings in the test year. If you do not confirm, please explain why you believe the Postal Service will not realize 100% of the savings and provide all evidence you rely on for your judgment. If you do confirm, please explain why you believe the Postal Service will realize the entire 100% of the savings and provide all evidence you rely on for your judgment.

Response

My analysis assumes that the Postal Service will realize 100 percent of the Test Year cost savings that I calculated. This seems reasonable given that every number I used in my calculations was provided by the Postal Service or derived from numbers it provided. In my opinion, my analysis is conservative and understates the probable cost savings in the following ways: (1) the cost savings I calculated entirely ignored savings from the second deployment of AFSM 100s in the test year; (2) the cost savings I calculated ignored the savings that will result from paying AFSM 100 clerks at a lower rate than the manual clerks and keyers that the AFSM 100s will replace; and (3) the cost savings I calculated assumed that half of the cost savings from the AFSM 100 deployment will come from replacing low cost sorts, whereas some of the savings will come from replacing higher cost sorts.

1 CHAIRMAN GLEIMAN: In our effort to become high
2 tech we obviously have set up some traps up in the front of
3 the room. I caution everyone to take great care. We
4 wouldn't want to have a lawsuit from someone who was injured
5 tripping over wires.

6 Is there any additional written cross examination
7 for Witness Buc?

8 MR. REITER: I have some, Mr. Chairman.

9 CHAIRMAN GLEIMAN: Certainly. Mr. Reiter?

10 MR. REITER: And while I have my first opportunity
11 at the microphone, may I also introduce new colleagues?

12 CHAIRMAN GLEIMAN: Certainly.

13 MR. REITER: I would like to introduce Joe Moore,
14 who is an attorney starting to work in our section and he
15 will be appearing later on, and also Dan Scott, who is our
16 summer law clerk.

17 CHAIRMAN GLEIMAN: Welcome to both of you. Look
18 forward to seeing you in the proceedings.

19 MR. REITER: I would like to designate as written
20 cross examination of the Postal Service of Witness Buc, his
21 answers to our interrogatories 18 through 25.

22 CROSS EXAMINATION

23 BY MR. REITER:

24 Q Mr. Buc, if I were to ask you those questions
25 orally today, would your answers be the same?

1 A Yes, they would be.

2 MR. REITER: Mr. Chairman, I will give two copies
3 of those answers to the Reporter and ask that they be
4 entered into the record.

5 CHAIRMAN GLEIMAN: The material will be received
6 into evidence and transcribed into the record.

7 [Additional designation of Written
8 Cross-Examination of Lawrence G.
9 Buc, USPS/DMA-T-1-18 through
10 USPS/DMA-T-25 was received into
11 evidence and transcribed into the
12 record.]

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**RESPONSE OF WITNESS BUC TO INTERROGATORIES OF
THE UNITED STATES POSTAL SERVICE**

USPS/DMA-T1-18. Please refer to AttC-dma-t-1.xls that accompanies your testimony.

- a. Please confirm that the "AFSM Productivity" in column [3] is an estimated throughput of the AFSM 100 and is not pieces sorted per workhour. If you do not confirm, please explain.
- b. Please explain if you believe the throughput takes into account the time the AFSM is not feeding mail due to scheme changes, sweeping, jams, and other operational stoppages.
- c. Please explain why for column [1] "Direct Cost per Handling" you assume a volume variability factor of 1.0, instead of what was contained in the LR-I-90 mailflow models?
- d. Please provide the same information in your DMA AFSM100 Clerk TY Savings chart using the volume variability factors found in LR-I-90.

Response

(a) Not confirmed. In her testimony, Postal Service witness Kingsley stated that the throughput of the AFSM 100 is approximately 17,000 pieces per hour. USPS-T-10 at 11; Tr. 5/1838 (Kingsley). The 15,000 pieces per hour figure in column [3] represents productivity (in terms of pieces fed per workhour) times crew size. USPS-LR-I-90, R2000_1_Flats Cost Model_Final USPS.xls, worksheet "Productivities," column (1) and footnotes [7] and [8].

(b) The 17,000 pieces per hour throughput provided by witness Kingsley does not take these factors into account. If the AFSM productivity figure in USPS-LR-I-90, worksheet "Productivities," Column (1) is analogous to the other figures in the same column, then it does take these factors into account. This is because the other productivity figures in this column are actual productivities from MODS.

Furthermore, at the June 14-15, 2000 PostCom Postal Policy and Operations Conference, I am informed that Nick Barranca (USPS Vice President of Operations Planning) stated that the actual productivity of the AFSM 100 in the field has been approximately 16,000 pieces per machine-hour.

(c) I used average direct cost per handling rather than marginal direct cost per handling because I believe that average cost is the proper cost construct when talking about large changes in the system.

(d) See attached spreadsheet.

AFSM 100 Savings Comparison

Attachment to
USPS/DMA-T1-18

AFSM 100 Cost Savings Comparison - Marginal Productivities
(all numbers in thousands)

	DMA	USPS	Difference
	[1]	[2]	[3]=[1]-[2]
Total Savings	\$ 312,516	\$ 169,379	\$ 143,137

Sources:

[1] Attachment C, pg 2.

[2] Attachment C, pg 3.

USPS AFSM 100 Clerks TY Savings

USPS AFSM 100 Clerks Test Year Savings - Marginal Productivities

Clerks Workhour Savings (hours)	Hourly Clerk Wage Rate	Clerks Workhour Cost Savings (thousands)
[1]	[2]	[3]=[1]*[2]
6,052,003	\$ 27.99	\$ 169,379

Sources:

[1] Docket No. R2000-1, Tayman, Tr. 2/322.

[2] Docket No. R2000-1, USPS-LR-I-126, PRG_ANAL-revised.xls, 'Data'. Hourly wage rate obtained from dividing Clerk/Mailhandler Avg. Personnel Cost (\$0.125) by Workhours Per Workyear (1,791).

DMA AFSM 100 Clerks TY Savings

Attachment to
USPS/DMA-T1-18

DMA AFSM Clerks Test Year Savings Using Marginal Productivities

	[1]	[2]	[3]	[4]	[5]	[6]	[7]	[8]	[9]
	Direct Cost per Handling (cents)	Plant/Delivery Unit Manual IS Factor	AFSM Productivity (units/hour)	Number of Machines	Operational Hours per Workday	Operational Days per Year	Total Sorts Per Year (millions)	Allocated Sorts (millions)	Total Cost Savings
IS - Manual, Plant	4.774	26.10%							
IS - Manual, Delivery Unit	3.112	73.90%							
IS - AFSM 100	0.769	N/A							
Difference*	2.776		15,000	166.5	20	313	15,634	5,628	\$ 156,258

	Direct Cost per Handling	AFSM Productivity (units/hour)	Number of Machines	Operational Hours per Workday	Operational Days per Year	Total Sorts Per Year (millions)	Allocated Sorts (millions)	Total Cost Savings
IP - FSM 881 OCR/BCR	2.331							
IP - AFSM 100	0.769							
Difference**	1.562	15,000	166.5	20	313	15,634	10,006	\$ 156,258

TOTAL SAVINGS									\$ 312,516
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Sources:

* Difference (IS only) is calculated by taking 26.10% of the difference between IS - Manual, Plant and IS - AFSM 100 added to 73.90% of the difference between IS - Manual, Delivery Unit and IS - AFSM 100 per Docket No. R2000-1, LR-I-90, R2000_1_Flats Cost Model_Final USPS.xls, 'Data', Plant/Delivery Unit Manual IS Factor.

** Difference (IP only) selected as conservative estimate as smallest difference between cost of current sort and cost of AFSM 100 sort.

[1] Docket No. R2000-1, LR-I-90, R2000_1_Flats Cost Model_Final USPS.xls, 'Mailflow Model Costs', Cents per Piece Handling.

[2] Docket No. R2000-1, LR-I-90, R2000_1_Flats Cost Model_Final USPS.xls, 'Data', Plant/Delivery Unit Manual IS Factor.

[3] Docket No. R2000-1, LR-I-90, R2000_1_Flats Cost Model_Final USPS.xls, 'Productivities', Footnotes [7] and [8]

[4] LR-I-83, page I-12

[5] Kingsley, TR.5/1961.

[6] Kingsley, TR.5/1960.

[7] = [3]*[4]*[5]*[6]

[8] = Allocated Sorts is the number of sorts allocated to each scenario to yield equal cost savings, Kingsley, TR.5/1660.

[9] = [8]*[1]

**RESPONSE OF WITNESS BUC TO INTERROGATORIES OF
THE UNITED STATES POSTAL SERVICE**

USPS/DMA-T1-19. Please refer to your response to USPS/DMA-T1-2(a), where you state:

Please note that I have read only the Commission's Decisions and the Postal Service's requests in omnibus rate cases from R76-1 through R97-1. I do not believe the Postal Service has ever employed in its requests for contingencies the framework the Commission has outlined in its decisions. Thus, I do not believe that any of the requests is reasoned.

Please explain how you were able to determine that the basis for the contingency in Docket R76-1 was not reasoned with respect to the Commission's framework when you have not read the Commission's Opinions prior to Docket R76-1.

Response

I did not make such a determination with respect to the USPS request in R76-1. To the best of my knowledge, the Postal Service has never employed in its requests for contingencies the framework the Commission has outlined in its decisions. It is possible, however, that I am mistaken with respect to the filings in R74-1 and R76-1.

**RESPONSE OF WITNESS BUC TO INTERROGATORIES OF
THE UNITED STATES POSTAL SERVICE**

USPS/DMA-1-20. Please refer your response to USPS/DMA-T1-4. Please confirm that the amount you show for equity at the end of the year before filing for Docket No. R2000-1 is a negative \$446 million. If you do not confirm, please explain.

Response

Confirmed.

**RESPONSE OF WITNESS BUC TO INTERROGATORIES OF
THE UNITED STATES POSTAL SERVICE**

USPS/DMA-T1-21. Please refer to your response to USPS/DMA-T1-5 where you state:

[P]lease note that the Postal Service has continued to carry equity at book value rather than market value. As witness Tayman confirmed on April 19, 2000 in response to DMA/USPS-T9-58, the appraised value of Postal Service headquarters is \$76.8 million. It is carried on the books at a very small fraction of that amount. I suspect that if the Postal Service rationally managed its real estate by selling real estate in selected high value areas and relocating some operations, it could not only restore equity to a positive value, but also eliminate the need for prior year losses as a component of the revenue requirement.

- (a) Do you consider yourself an expert on real estate? If so provide your credentials.
- (b) Do you consider yourself an expert on accounting theory? If so provide your credentials.
- (c) Do you consider yourself an expert on the Postal Service's operations network? If so provide your credentials.
- (d) Is it your testimony that the Postal Service should increase the value of real estate on its books to market value? If so, please provide any basis for this position other than your personal opinion. Please provide examples of other entities, private or public, that carry real estate on their books at market value and provide the source(s) of your information.
- (e) What would happen to depreciation expense if USPS real estate were revalued to market value and what effect would this have on postage rates? Please explain your answer fully and include calculations supporting your response.

Response

- (a) No.
- (b) No.
- (c) No.
- (d) My testimony does not address the issue of whether real estate should be carried at market rather than book value.
- (e) I do not have enough information to be able to determine what would happen to depreciation expenses if USPS real estate were revalued to market value. The Postal Service has declined to provide market values of its real estate in response to DMA interrogatories in this case and in the previous case, so I do not have data on book versus market value, nor on appropriate depreciation lives. However, it is important to remember that land is not depreciated, so the new method would not affect its depreciation.

The change would probably reduce rates. Any increase in depreciation expense would most likely be more than offset by the elimination of Prior Years Losses.

**RESPONSE OF WITNESS BUC TO INTERROGATORIES OF
THE UNITED STATES POSTAL SERVICE**

USPS/DMA-T1-22. Please refer to your response USPS/DMA-T1-9.

(a) Please confirm that the state of the economy is useful in evaluating the appropriate level of contingency only to the extent that it could affect Postal Service test year revenues and expenses. If you do not confirm please explain.

(b) Please confirm that one recent result of low unemployment is tight labor markets. If you do not confirm please explain.

(c) Please confirm that, according to many economists and the Federal Reserve, tight labor markets have recently resulted in pressure to increase wages. If you do not confirm please explain.

(d) Please confirm that the Federal Reserve has recently been raising interest rates and that the purpose of doing so is to slow down economic growth. If you do not confirm please explain.

(e) Please confirm that a slowdown in economic growth could have an adverse effect on Postal Service volume and revenue growth. If you do not confirm please explain.

(f) Please confirm that higher interest rates would increase Postal Service borrowing costs. If you do not confirm please explain.

(g) Please confirm that fuel costs have recently risen dramatically and are currently much higher than was assumed in the Postal Service's revenue requirement. If you do not confirm please explain.

Response

(a) Confirmed.

(b) Confirmed.

(c) Confirmed. Given that the Postal Service believes, however, that its employees receive a compensation premium, it is not clear how much tighter labor markets will exert pressure on wages of Postal Service employees.

(d) Confirmed although it is not clear that growth is actually slowing.

(e) Confirmed.

(f) Confirmed. Note, however, that the potential exposure is relatively small and may be somewhat offset by interest earned.

(g) Confirmed that they have risen and are higher.

**RESPONSE OF WITNESS BUC TO INTERROGATORIES OF
THE UNITED STATES POSTAL SERVICE**

USPS/DMA-T1-23. Please refer to USPS/DMA-T1-9 where you state that "at a high level, economists often characterize the state of the economy as a function of two factors: inflation and unemployment."

- (a) Please confirm that economic growth as measured by GDP or GNP, which you have neglected to mention in your answer, is also a significant indicator of the state of the economy. If you do not confirm, please explain.
- (b) Please confirm that economic growth as measured by GNP and GDP has recently been exceptionally high. If you do not confirm, please explain.
- (c) Please refer to the A/P 8 FOS and confirm that mail volume and revenue growth through Accounting period 8 are below plan despite record growth in the overall economy. If you do not confirm, please explain.

Response

- (a) Economic growth is an indicator of the state of the economy. Growth is correlated with unemployment rates.
 - (b) Confirmed that growth has been high.
 - (c) Confirmed.
-

**RESPONSE OF WITNESS BUC TO INTERROGATORIES OF
THE UNITED STATES POSTAL SERVICE**

USPS/DMA-T1-24. Please refer to you response to USPS/DMA-T1-11 and to the Commission's Opinion and Recommended Decision in Docket R97-1, Appendix C, page 1 of 2. Please confirm that the amount recommended by the Commission for test year (FY 98) supervisor costs was \$3.420 billion, or \$98 million less than the \$3.518 billion originally estimated by the Postal Service. If you do not confirm please explain.

Response

Confirmed.

**RESPONSE OF WITNESS BUC TO INTERROGATORIES OF
THE UNITED STATES POSTAL SERVICE**

USPS/DMA-T1-25. Please refer to your response USPS/DMA-T1-12.

(a) Is it your testimony that a savings in clerk workhours resulting from the introduction of automated equipment will automatically result in a proportional reduction in supervisor workhours, regardless of what decisions are made by management regarding the supervisory requirements of the new operating environment? If your answer is yes, please explain how you know this to be true.

(b) Is it possible that the new operating environment created by the introduction of automated equipment could result in additional complexities and supervisor responsibilities within the new operation? If you do not believe this is possible, please explain why.

Response

(a) No, my testimony is that if supervisory workhours vary directly with clerk workhours, then a savings in clerk workhours from the introduction of automation equipment will, ceteris paribus, result in supervisory workhour savings. If management changes the supervisory requirements of the new operating environment, the ceteris paribus conditions will no longer hold.

(b) Many things are possible that are not likely. Although it is possible that a new operating environment created by the introduction of automation equipment could add complexity and supervisory responsibilities, I did not find any indication in the testimony of its witnesses that the Postal Service believes this has happened.

1 CHAIRMAN GLEIMAN: Does anyone else have
2 designated written cross for this witness?

3 If not, that brings us to oral cross examination,
4 and we will give Mr. Reiter a chance to get back into his
5 spot there and since only one party has requested oral cross
6 examination, the Postal Service, and if there is no one else
7 who wishes to cross this witness, then Mr. Reiter, you may
8 proceed.

9 MR. REITER: Thank you.

10 BY MR. REITER:

11 Q Good morning, Mr. Buc.

12 A Good morning, Mr. Reiter.

13 Q If you would look at your answer to our
14 Interrogatory Number 2, please --

15 A I've got it.

16 Q -- I believe you said there that in your opinion
17 none of the past contingency amounts were properly reasoned.
18 Is that right?

19 A It's correct.

20 Q So is it your opinion that the Commission
21 recommended unreasoned amounts on those instances where it
22 recommended the same amount that the Postal Service
23 requested?

24 A No, actually the Commission can come up with a
25 reasonable decision even if the request wasn't reasonable, I

1 believe.

2 Q So what did the Commission do to transform an
3 unreasoned request into a reasoned amount when it was the
4 same amount?

5 A Well, the Commission, as they have articulated
6 their framework, has always thought about what the variance
7 showed. They have always thought about what economic
8 conditions looked like, and they have put those two together
9 and decided that in view of those the amount that the
10 Service asked for is okay.

11 Q Is it your testimony that in the past the Postal
12 Service did not look at economic conditions?

13 A No. I think the Postal Service does look at
14 economic conditions.

15 Q So the missing piece is purely the historical
16 variance analysis?

17 A No. I think the Commission, as I outlined in my
18 testimony, approaches it in a whole different way.

19 Q Could you articulate what that is?

20 A Sure. We can go through it if you care to do
21 that.

22 I believe that the Commission says that the
23 variance analysis is the starting point for thinking about
24 the contingency. It is the point of departure. It is what
25 they think about first, but having thought about what the

1 Postal Service variance analysis shows as the starting
2 point, they then think about what sort of shape the Postal
3 Service is in financially. They then think about what
4 general economic conditions are. They put all those
5 together and they come up with an answer on what they think
6 the contingency ought to be.

7 Q And when the Postal Service has done this in the
8 past, have they thought about what shape they are in
9 financially and what they think the outlook is economically
10 for the future? I think those are the two things you just
11 mentioned.

12 A They do present those numbers.

13 Q So the missing part is reliance on the historical
14 variance analysis?

15 A No, because I think that the Postal Service just
16 reasons slightly differently. If you review the Postal
17 Service requests, the Postal Service basically talks a lot
18 about management discretion and they talk a lot about this
19 is what we think we need, but there is not a whole lot of
20 what I see as reasoning in the request.

21 Q So there isn't reasoning with regard to their
22 financial condition, there isn't reasoning with regard to
23 predictions of economic conditions in the future --

24 A I think there is micro-reasoning. I don't think
25 they followed the outline, the approach that the Commission

1 has told them they should follow.

2 Q How did the Commission evaluate economic forecasts
3 differently from the Postal Service?

4 A I am not sure that they do.

5 Q How did the Commission evaluate the Postal
6 Service's financial position differently for the future from
7 how the Postal Service did?

8 A It is not clear that they do.

9 Q Do you agree that one of the purposes of the
10 contingency is to provide a cushion when known costs end up
11 being higher than could have been predicted?

12 A Yes.

13 Q Would you look at your answer to Question Number
14 5, please.

15 A I've got it.

16 Q Is it your testimony that the Postal Service does
17 not rationally manage its real estate?

18 A Well, I think I have already said that I am not a
19 real estate expert so people would probably discount what it
20 is that I have to say, but if you are asking for my garden
21 variety opinion, yes, that would be my testimony.

22 Q Is it your testimony that the Postal Service does
23 not sell its real estate in high value areas and relocate
24 its operations?

25 A I haven't made an extensive study of that topic.

1 Q Have you made any study?

2 A No, except that I know that there is a lot of
3 valuable real estate that doesn't seem to be being sold.

4 Q Of course, if it were sold there would still need
5 to be another location for postal operations?

6 A In most cases that is absolutely correct.

7 Q And you haven't looked at all at the costs and
8 benefits of those types of transactions?

9 A No, we haven't looked at the costs and benefits,
10 but we do know that when real estate gets sold it does get
11 sold on average for more than its book value. That we know.

12 Q And you are suggesting, I believe, that the Postal
13 Service should not be carrying its real estate at the
14 current book value but rather at market value?

15 A I don't think I testified as to that. I think I
16 said that that wasn't the subject of my testimony.

17 Q I think you suggested, however, that if the Postal
18 Service did either one or two of those things -- and I'm not
19 clear from your answer, the relationship between them, and
20 I'll get back to that.

21 But that if the Postal Service either sold real
22 estate or carried it at book value, that it would improve
23 its financial condition?

24 A I did say that.

25 Q But you said that without doing any analysis as to

1 what the actual pluses and minuses would be?

2 A Well, I think saying no analysis is a little bit
3 on the slim side. We do have what book values of Postal
4 Service properties, provided in the last rate case.

5 And LeEnfant Plaza is on the books. I don't have
6 the numbers sitting in front of me, but for somewhere less
7 than \$10 million, the Postal Service confirmed that the
8 appraisal value is \$68 million; that it's carried on the tax
9 books at \$68 million.

10 Q Do any other corporations or entities carry their
11 headquarters building or any other facilities on their book
12 at market value?

13 A I am told by my accounting firm, who I checked
14 with on this topic, that real estate is currently carried at
15 book value, but that it's a very big subject of controversy
16 in the accounting world.

17 And, recently, securities were repriced at market
18 value, rather than book value in the accounting world.

19 Q But speaking of real estate, there has been no
20 change in Generally Accepted Accounting Principles?

21 A There has been no change; that's correct.

22 Q Okay. If the Postal Service were to carry its
23 real estate at market value, that would result in a very
24 large increase in depreciation expense; would it not?

25 A That's not necessarily clear, because it's not

1 something that's done. Again, I spent a fair amount of time
2 talking to my accounting firm about how this would work.

3 If the increase in costs flowed through the income
4 statement for a year to get to the balance sheet, then there
5 would be a huge, huge increase in income that year, which
6 would offset the increase in depreciation.

7 Furthermore, in subsequent years, as long as the
8 market was going up, it's not clear that the increase in
9 depreciation would offset the increase in appreciation of
10 the real estate.

11 Q But you've done no analysis of that to know which
12 way it would work out for the Postal Service?

13 A As I pointed out in my interrogatory, I don't have
14 market values. We've asked the Postal Service for market
15 values. We don't have them.

16 Q Do you remember what the Postal Service said when
17 it was asked?

18 A I would be speculating, but I would guess that if
19 we went back and looked, they said they're not planning to
20 sell the real estate, and, therefore, there's no reason for
21 them to know what market value is.

22 Q I think the record shows what the Postal Service
23 actually said.

24 Could you look at your answer to our Question 12,
25 please?

1 [Pause.]

2 A I've got it.

3 Q You say there that reductions in craft labor,
4 ceterus parabus, will result in reductions in supervisory
5 labor; is that right?

6 A That's correct.

7 Q And ceterus parabus means other things being
8 equal; is that right?

9 A That's correct.

10 Q So let's hypothetically say that if everybody
11 working at the Postal Service ate their Wheaties every
12 morning and did twice as much work as they had done
13 previously, then you'd only need half the people, and the
14 number of supervisors could be reduced in that hypothetical;
15 would you agree with that?

16 A Sure.

17 Q Because all other things are equal?

18 A I don't think all other things are equal in that
19 example, but I would agree that if the amount of labor got
20 cut in half, the amount of supervisors would get cut in
21 half.

22 Q Why don't you agree that all other things are
23 equal?

24 A Well, I think you said that they all ate their
25 Wheaties in the morning, and they're not currently eating

1 their Wheaties in the morning, so something has changed.

2 Q That's the one thing that's changed, and we're
3 holding all else equal.

4 A Yes.

5 Q Okay. That's the hypothetical; that if there is
6 only one thing that changes, then you can conclude that the
7 other thing will change and hasn't been affected by some
8 outside influence, other than the one you're looking at.

9 That's the purpose of saying ceterus parabus;
10 isn't it?

11 A I --

12 [Pause.]

13 Q I mean, is that how you use the phrase in your
14 answer?

15 A Yes.

16 Q And your answer was talking about the introduction
17 of automation; is that correct?

18 A Yes. Actually, no; it was talking about anything
19 that would cause any of the cost reduction programs that
20 would cause costs, craft labor to decrease.

21 [Pause.]

22 Q That labor cost estimates, based on current labor
23 contracts, are less like to vary from actual future labor
24 costs than estimates that are based on assumptions about
25 future contracts?

1 A That seems to be a reasonable assumption, in
2 general.

3 MR. REITER: That's all I have. Thank you.

4 CHAIRMAN GLEIMAN: Is there any followup?

5 [No response.]

6 CHAIRMAN GLEIMAN: Questions from the Bench?
7 Commissioner LeBlanc?

8 COMMISSIONER LeBLANC: Mr. Buc, just clarify this
9 for me. In your colloquy with Mr. Reiter, it's your --
10 well, it's my understanding that your criticism of Witness
11 Tayman, is, in effect, there wasn't a lot of support for the
12 2.5, but then you don't go into a lot of detail, other than
13 the variances, as I remember.

14 That may be a mischaracterization, but what I'm
15 trying to get to is, what is your main basis for going from
16 2.5 to, say, one percent, if there is such?

17 THE WITNESS: I think that I have three bases for
18 doing that, Commissioner. I think that the variance
19 analysis shows that a smaller contingency is warranted.

20 And I think that when you look at the inflation
21 estimates, a smaller variance is warranted. And when you
22 look at the financial position of the Postal Service, a
23 smaller variance is warranted.

24 COMMISSIONER LeBLANC: What weight do you put on
25 the situation that everybody seems to be talking about in

1 the Postal press now about the demise of the volumes and how
2 that's going to affect the revenue and so forth?

3 THE WITNESS: I believe that the Postal Service
4 has taken account of their forecasted Postal volumes in
5 developing their cost estimates for the year, and for the
6 test year, so those are already accounted for.

7 Now, if the question is, there could be unexpected
8 declines in volume on top of that, there absolutely could
9 be, and I suspect that the variance of one percent is enough
10 to cover that.

11 Most people seem to think that as volume
12 disappears, it's not all going to be tomorrow and the day
13 after, but this is going to be a gradual thing.

14 COMMISSIONER LeBLANC: Thank you, Mr. Chairman.

15 CHAIRMAN GLEIMAN: Followup to questions from the
16 Bench?

17 [No response.]

18 CHAIRMAN GLEIMAN: There doesn't appear to be any.
19 Mr. Ackerly, would you like some time with your witness to
20 review whether you want to do redirect?

21 MR. ACKERLY: A brief moment, if I may, Mr.
22 Chairman.

23 CHAIRMAN GLEIMAN: Certainly.

24 [Pause.]

25 MR. ACKERLY: We have no redirect, Mr. Chairman.

1 CHAIRMAN GLEIMAN: That being the case, Mr. Buc,
2 that completes your testimony here today. We appreciate
3 your appearance and your contributions to the record. We
4 want to thank you, and you are excused.

5 [Witness Buc excused.]

6 CHAIRMAN GLEIMAN: Mr. Levy, I don't know if your
7 witness is here yet. We'll give you a moment.

8 MR. LEVY: Thank you.

9 CHAIRMAN GLEIMAN: We'll just take a short break
10 and stay here while Mr. Levy collects his witness.

11 [Recess.]

12 CHAIRMAN GLEIMAN: Mr. Levy, whenever you are
13 ready, you can introduce your witness.

14 MR. LEVY: Thank you, Mr. Chairman. Mr. Chairman,
15 the Alliance of Nonprofit Mailers presents its first
16 witness, Dr. John Haldi, ANM-T-1, and he has not testified
17 before in this case.

18 Whereupon,

19 JOHN HALDI,
20 a witness, having been called for examination and, having
21 been first duly sworn, was examined and testified as
22 follows:

23 DIRECT EXAMINATION

24 BY MR. LEVY:

25 Q Dr. Haldi, you have before you two sets of a

1 document marked --

2 MR. LEVY: I can never get it right.

3 CHAIRMAN GLEIMAN: Well, we had our sound system
4 fixed, and maybe they fixed it too much, I don't know.

5 BY MR. LEVY:

6 Q Dr. Haldi, you have before you two copies of a
7 document marked ANM-T-1. Do you recognize that as your
8 prepared testimony in this case?

9 A Yes, I do.

10 Q For the Alliance of Nonprofit Mailers. Was that
11 prepared by you or under your supervision?

12 A Yes, it was.

13 Q Do you have any changes you wish to make at this
14 time?

15 A Yes, there is one change, a slight change. Table
16 3.

17 Q On page?

18 A Page 17, the heading should read "1988 to 1999"
19 instead of "1968 to 1999."

20 MR. LEVY: And for the record, that change has
21 been marked on the two copies that will be given to the
22 reporter.

23 BY MR. LEVY:

24 Q With those two changes, do you adopt the document
25 as your testimony?

1 A Yes, I do.

2 MR. LEVY: And with that, Mr. Chairman, I will
3 hand the two copies to the reporter and ask that be
4 transcribed into the record and admitted into evidence.

5 CHAIRMAN GLEIMAN: Is there any objection?

6 [No response.]

7 CHAIRMAN GLEIMAN: Hearing none, Dr. Haldi's
8 testimony is admitted into evidence and is transcribed into
9 the record.

10 [Direct Testimony of John Haldi,
11 ANM-T-1, was received into evidence
12 and transcribed into the record.]

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ANM-T-1

BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, D.C. 20268-0001

Docket No. R2000-1

POSTAL RATES AND FEE CHANGES, 2000

DIRECT TESTIMONY OF

JOHN HALDI

CONCERNING

RATES FOR PERIODICALS MAIL

ON BEHALF OF

ALLIANCE OF NONPROFIT MAILERS

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May 22, 2000

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Autobiographical Sketch

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My name is John Haldi. I am President of Haldi Associates, Inc., an economic and management consulting firm with offices at 1370 Avenue of the Americas, New York, New York 10019. My consulting experience has covered a wide variety of areas for government, business and private organizations, including testimony before Congress and state legislatures.

In 1952, I received a Bachelor of Arts degree from Emory University, with a major in mathematics and a minor in economics. In 1957 and 1959, respectively, I received an M.A. and a Ph.D. in economics from Stanford University.

From 1958 to 1965, I was an assistant professor at the Stanford University Graduate School of Business. In 1966 and 1967, I was Chief of the Program Evaluation Staff, U.S. Bureau of the Budget. While there, I was responsible for overseeing implementation of the Planning-Programming-Budgeting (PPB) system in all non-defense agencies of the federal government. During 1966 I also served as Acting Director, Office of Planning, United States Post Office Department. I was responsible for establishing the Office of Planning under Postmaster General Lawrence O'Brien. I established an initial research program, and screened and hired the initial staff.

1 I have written numerous articles, published consulting studies,
2 and co-authored one book. Items included among those publications
3 that deal with postal and delivery economics are an article, "The Value of
4 Output of the Post Office Department," which appeared in *The Analysis*
5 *of Public Output* (1970); a book, *Postal Monopoly: An Assessment of the*
6 *Private Express Statutes*, published by the American Enterprise Institute
7 for Public Policy Research (1974); an article, "Measuring Performance in
8 Mail Delivery," in *Regulation and the Nature of Postal Delivery Services*
9 (1992); an article (with Leonard Merewitz), "Costs and Returns from
10 Delivery to Sparsely Settled Rural Areas," in *Managing Change in the*
11 *Postal and Delivery Industries* (1997); an article (with John Schmidt),
12 "Transaction Costs of Alternative Postage Payment and Evidencing Sys-
13 tems," in *Emerging Competition in Postal and Delivery Services* (1999); and
14 an article (with John Schmidt), "Controlling Postal Retail Transaction
15 Costs and Improving Customer Access to Postal Products," in *Current*
16 *Directions in Postal Reform* (2000).

17 I have testified as a witness before the Postal Rate Commission in
18 Docket Nos. R97-1, MC96-3, MC95-1, R94-1, SS91-1, R90-1, R87-1,
19 SS86-1, R84-1, R80-1, MC78-2 and R77-1. I also have submitted
20 comments in Docket No. RM91-1.

I. Summary and Purpose

Periodicals suffer an excessive amount of expensive manual sortation because of the Postal Service's admitted shortage of flat sorting machines. The Postal Service's growing amount of manual sortation of periodicals and other non-letters is reflected in the secular decline in Total Factor Productivity, which faces mailers of periodicals and other non-letter mail yet again with excessive increases in unit cost. The Base Year shortage of flat sorting capacity is the cumulative result of years of under-investment by the Postal Service.

The Postal Service has failed utterly to deliver on its mandate to provide mailers with economic and efficient management. Although it is not the Commission's responsibility to manage the Postal Service, neither should it rubber-stamp the revenue requirement, no matter how inefficient the underlying operating plan, and pass all resulting costs on to mailers. The appropriate remedy for the Commission is to disallow and exclude from the revenue requirement the extra costs resulting from inefficiency, not shift those costs to other mailers.

The purpose of this testimony is to explain the root source of the problem and why the proposed remedy is appropriate.

**II. Rising Costs and Falling Productivity Growth:
An Enduring Problem of Postal Ratemaking**

One central issue of postal ratemaking has been the persistence of increasing costs. In recent years, many large business enterprises in the United States and elsewhere in the industrialized world have achieved significant productivity gains and reduced their real (inflation-adjusted) operating costs by investing in computerized technology and downsizing their workforces.¹ By 1999, real private investment in equipment and software in the United States had risen to approximately 11 percent of real gross domestic product ("GDP").² Productivity growth in manufacturing averaged 4.2 percent per year between 1993 and the third quarter of 1999.³

The Postal Service's customers and competitors have participated fully in this trend. The 1997 report of the Postal Service's Blue Ribbon Committee noted:

Price increases are just not acceptable. Our customers won't allow it. In many of the products and services that we buy today, we're getting more value for money because of technology. Price increases have gone the way of cost-of-living increases and defined-benefit plans: all those standard ways of incrementing business costs have gone out the door.

Finding Common Ground: The Report of the Blue Ribbon Committee (1997), p. 25 (statement of Randy Lintecum, president, International

¹ See President's Council of Economic Advisors, *2000 Economic Report of the President* (Feb. 2000), pp. 28-30, 34-35, 97-128.

² *Id.* at 29.

³ *Id.* at 103.

1 Billing Services). *See also id.*, p. 36 (statement of Harry V. Quadracci,
2 president, Quad/Graphics, Inc.):

3 Automation is a key to cost control. Over the last 25 years,
4 since I started Quad/Graphics, the CPI has moved at a
5 compounded rate of 5.3 percent per year. Paper prices
6 actually have gone up 5.2 percent per year. First-class
7 postage went up 5.5 percent per year; second and third-class
8 somewhat higher. But print prices actually went down 1.1
9 percent per year over those 25 years, resulting each year in a
10 6.3 percent productivity increase by the printers, which,
11 passed on, is reflected in the prices all of you are paying for
12 it today.

13 If we hadn't made those investments in automation your
14 print prices today would be more than five times more than
15 what you're paying.
16

17 By contrast, Postal Service unit costs—especially for periodicals
18 and non-letter mail—have exceeded the rate of inflation by a wide mar-
19 gin. Moreover, rising costs have gone hand-in-hand with a long term
20 slowdown in productivity growth. Table 1 (on the following page) shows
21 the year-to-year change in the Postal Service's total factor productivity
22 ("TFP") for the years 1971-2000 (to date).⁴ The year-to-year fluctuations
23 should not obscure the underlying trend: long-term productivity growth

⁴ Total factor productivity equals total output divided by a weighted index of all inputs, not just labor or equipment.

1 has been slowing.⁵ Cumulative growth in total factor productivity has
 2 declined during each of the past three decades.⁶

3	1971-1980	6.9%
4	1981-1990	3.7%
5	1991-2000 (to date)	1.3%

⁵ This is illustrated by the period 1993-1999. The reorganization of 1992/93 reduced the complement dramatically, by approximately 48,000 employees in early FY 1993, and the immediate result was a 3.8 percent increase in TFP. In five out of the next six years, however, TFP was negative, and the sum of those negative years was -4.6 percent, as shown in Table 1.

⁶ In Table 1, the annual percentage changes are summed. Computing the long-term change by compounding (i.e., by multiplying the successive annual changes) leads to essentially the same result.

1	Table 1	
2	U.S. Postal Service	
3	Total Factor Productivity (TFP)	
4	FY 1971 - AP 5 FY 2000 YTD	
5		TFP: Percent
6	Fiscal	Change From
7	<u>Year</u>	<u>Previous Year</u>
8	1971	1.2%
9	1972	1.2%
10	1973	4.0%
11	1974	-1.7%
12	1975	-0.9%
13	1976	-0.5%
14	1977	2.0%
15	1978	3.3%
16	1979	-2.1%
17	1980	<u>0.4%</u>
18	Subtotal	6.9%
19	1981	0.2%
20	1982	-1.3%
21	1983	-0.6%
22	1984	0.3%
23	1985	-0.2%
24	1986	2.1%
25	1987	0.4%
26	1988	0.3%
27	1989	-0.5%
28	1990	<u>3.0%</u>
29	Subtotal	3.7%
30	1991	-1.7%
31	1992	0.4%
32	1993	3.8%
33	1994	-0.1%
34	1995	-1.8%
35	1996	-1.2%
36	1997	1.3%
37	1998	-1.2%
38	1999	-0.3%
39	2000 to date	<u>2.1%</u>
40	Subtotal	1.3%

41 Source: Attachment to Response of USPS witness Tayman to DMA/USPS-T9-31
 42 (2 Tr. 291).

1 These results are both discouraging and alarming. Over each
2 successive decade, the Postal Service's cumulative investment in mecha-
3 nization and automation has grown, yet TFP has responded in reverse.
4 As technological innovation has improved the speed and sophistication of
5 the equipment available on the market, productivity growth in the Postal
6 Service has slowed. Indeed, for the categories of mail incurring the
7 above-average increases in reported attributable costs, the productivity
8 changes implied by Postal Service cost data have been *negative*.

9 Larry Buc, Rita Cohen, Michael Nelson, Halstein Stralberg and
10 other intervenor witnesses explore in their testimony a variety of poten-
11 tial causes of this seeming paradox. My testimony focuses on perhaps
12 the most fundamental reason of all: the Postal Service's chronic under-
13 investment in up-to-date mail processing equipment, particularly for
14 non-letter mail. As I explain below, this underinvestment has inflated
15 the Postal Service's test year revenue requirement—and the costs attrib-
16 uted to processing non-letter mail—to levels far above those consistent
17 with economical and efficient management.

18 In raising this issue, I am mindful that the Postal Service's base
19 year accrued costs, and its operating plan for the period from base year
20 to test year, are conventionally assumed in postal rate cases to reflect
21 optimal management and operations. The Postal Service has gone even
22 further in recent rate cases, asserting that the efficiency of its actual
23 operations and accrued costs is completely irrelevant to postal rate-
24 making. In Docket No. R97-1, USPS witness Panzar stated:

25 [T]he efficiency of the Postal Service operating plan is not an
26 issue for the analyst. *As long as it is given that postal ser-*
27 *vices will be produced following Postal Service practices and*
28 *procedures, the relevant marginal and incremental costs for*
29 *pricing purposes are those calculated based on the Postal*
30 *Service' operating plan.*

1 USPS-T-11 (Docket No. R97-1) at 17 (emphasis in original).

2 The Postal Service has been equally assertive in this docket.

3 Invoking Dr. Panzar's testimony in Docket No. R97-1, the Service boasts
4 that "[n]o postal witness in this case has attempted to analyze whether
5 the Postal Service's operating plan is actually cost minimizing."⁷

6 In Docket No. R97-1, the Commission expressed skepticism that
7 economic efficiency could be dismissed so readily. Addressing Dr.
8 Panzar's testimony, the Commission noted that "the usual economic
9 definition of a cost function . . . derives the function $C(M, w)$ by selecting
10 labor and other inputs to *minimize* the cost of the vector of mail volumes,
11 (M) , at the given prices, (w) ."⁸

12 The Commission went on to analyze some of the consequences of
13 basing cost attributions on the costs of inefficient operations.⁹ For
14 example, without cost minimizing behavior, "the marginal cost of any
15 product becomes subject to the whims of the firm's management and
16 does not provide an accurate measure of the efficient cost of society's
17 resources to produce an additional unit of any of the firm's outputs."¹⁰
18 "Because the marginal costs of a firm not constrained to minimize total
19 production costs in producing its output is endogenous to its choice of
20 an operating plan, these marginal costs are of limited use in setting
21 rates."¹¹

⁷ Response to AAP/USPS-1 (21 Tr. 8611).

⁸ Docket No. R97-1, Opinion and Recommended Decision (May 11, 1998)
at ¶ 4032.

⁹ *Id.* at ¶¶ 4031 – 4052.

¹⁰ *Id.* at ¶ 4046.

¹¹ *Id.* at ¶ 4049.

1 The Commission's skepticism was well founded. In the face of the
 2 Postal Service's chronic failure to control its costs, further disregard for
 3 the Service's management efficiency has become an unaffordable luxury.
 4 The Postal Reorganization Act entitles the Postal Service only to those
 5 revenues needed to cover costs under "honest, economical and efficient
 6 management."¹² I am not a lawyer, and leave to others the legal interpretation of this phrase. As an economist, however, I find absurd the notion
 7 that the Postal Service and its Governors have a license to formulate and
 8 implement any operating plan whatsoever, no matter how inefficient,
 9 year after year, and pass on to mailers all the resulting costs.

11 A basic optimization problem faced by every firm is the selection of
 12 a cost-minimizing mix of inputs for producing a given quantity and
 13 quality of outputs at a given set of input prices. How much money, for
 14 example, should be budgeted for labor vs. machinery? How often should
 15 a firm replace older machinery with newer, more productive models?
 16 Every firm, large or small, continually faces variations of these questions.
 17 Firms that produce a given volume and quality of outputs with a cost-
 18 minimizing mix of inputs are said to be operating on the efficiency
 19 frontier or production-possibility frontier. Firms that adopt a more costly
 20 mix of inputs are said to be operating inefficiently.

21 In competitive markets, there is no need for any regulator to
 22 second-guess the management efficiency of the incumbent firms. The
 23 invisible hand of competition performs this task, rewarding efficiency and
 24 punishing its absence. All other things being equal, firms with efficient
 25 mixes of inputs are able to attain greater profitability than higher-cost
 26 rivals, or to attract more business by lowering prices. Firms that fail to
 27 maintain an efficient mix of inputs—including firms that underinvest in

¹² 39 U.S.C. § 3621.

1 maintenance, improvement and modernization of their physical plant—
 2 sooner or later improve their efficiency, or exit the market, or get ac-
 3 quired by other, more profitable firms.

4 Market power, however, tends to insulate incumbent firms from
 5 this competitive discipline. The greater the market power, the greater the
 6 inefficiency that can arise, and the longer the quiet life that allows it to
 7 persist. At the extreme is an organization like the Postal Service, which
 8 enjoys a legal monopoly over much of its business, and is the last re-
 9 maining nationwide monopoly. That this giant enterprise has not even
 10 “attempted to analyze whether [its] operating plan is actually cost mini-
 11 mizing” is evidence of great monopoly power indeed.¹³

12 When competition fails to provide a reliable check on the efficiency
 13 of regulated monopolies, government must replicate this safeguard
 14 through the ratesetting process. Hence, the legal directive to limit the
 15 Postal Service’s revenue to the levels justified by “honest, economical and
 16 efficient” management has only one sensible economic meaning: the
 17 Postal Service may recover costs from ratepayers only if efficiently
 18 incurred. Just as effective competition prevents firms from recovering
 19 the costs of suboptimal, uneconomic and inefficient management, so
 20 must the regulatory process disallow recovery of needlessly inflated costs
 21 by the Postal Service.

22 The standard here is not the perfection of 20/20 hindsight. Even
 23 the best managers must work with incomplete data and uncertain
 24 projections. Fairness entitles Postal Service management decisions to a
 25 certain amount of deference. But when management neglect generates
 26 massive excess costs, year after year, the standard of “honest, economi-

¹³ *Accord*, 2 Tr. 442-44 (Tayman) (“I am not aware if any [cost-benefit analysis] has” been performed to test the possibility that a larger amount of investment in flat-sorting equipment would have been beneficial).

1 cal and efficient management” does not allow the Commission simply to
2 rubber-stamp the excess as part of the Service’s revenue requirement.
3 The costs of such inefficiency must be excluded from the Service’s overall
4 revenue requirement, the attributable costs of individual classes or
5 categories of service, and the “relevant marginal and incremental costs
6 for pricing purposes.” Ignoring the possibility that Postal Service costs
7 have been inflated by inefficiency would abdicate the Commission’s
8 responsibility as a consumer protection agency.

9 In the context of the tradeoff between capital and labor, the stan-
10 dard of economical and efficient management requires that the Postal
11 Service invest adequately in capital assets, both in the aggregate and in
12 proportion to labor costs. When the cost of capital makes efficient the
13 substitution of capital for labor, the Postal Service should do so. Like-
14 wise, when replacing existing capital equipment with new equipment
15 (embodying the newest proven technology) appears profitable (in the
16 sense of generating cost savings or increased revenues that exceed a
17 reasonable hurdle rate), the Postal Service should replace the capital. In
18 other words, the Postal Service not only has the authority to borrow and
19 invest in its infrastructure, *it also has the responsibility to do so whenever*
20 *such moves becomes economic and efficient.*

21 As I show in the following sections, the Postal Service for many
22 years has steadfastly fallen far short of this standard.
23

1 **III. The Postal Service's Spending on Capital Investment** 2 **Has Been Grossly Inadequate**

3 The amount of money invested by the Postal Service for the last
4 decade, along with operating revenues, is summarized in Table 2 on the
5 following page. As shown in column 1 of the table, operating revenues
6 have grown each year, from approximately \$40 billion in 1990 to almost
7 \$63 billion in 1999, and are projected to grow to \$69 billion in 2001 on
8 an after rates basis.

9 Column 2 of Table 1 shows gross investment for each year, while
10 column 3 shows depreciation and amortization. Column 3 is a financial
11 measure of the "using up" or "wearing out" of capital equipment (e.g.,
12 vehicles). Over time, depreciation approximates consumption of fixed
13 capital. The Postal Service's reported depreciation expense has averaged
14 about 2.4 percent of revenues, far below the national average for nonfi-
15 nancial corporate businesses of about 11 percent.¹⁴

16 Net investment, shown in column 4, equals gross investment
17 spending minus depreciation and amortization. Beginning in 1993, net
18 investment declined precipitously, as the Postal Service's automation
19 program virtually ground to a halt for several years. The \$1.69 billion of
20 net investment in 1992 was higher than any subsequent year except
21 1999, when net investment finally recovered to \$2.1 billion. Considering
22 the inflation creep and volume increases that have occurred over the
23 intervening years, capital spending has experienced virtually no increase
24 whatsoever.

¹⁴ Council of Economic Advisors, *Economic Indicators: March, 2000*, p. 3. Many observers believe that the Postal Service's reported depreciation is overstated by the assumption of overly short asset service lives. If so, the Postal Service's actual consumption of capital is even smaller.

1 Column 5 of Table 2 helps put the Postal Service's net investment
2 spending into perspective. It shows net investment as a percentage of
3 the Postal Service's operating revenues. Between 1990 and 1992, the
4 percent of operating revenues spent on net investment grew from 3.0 to
5 3.7 percent, and then by 1995 the percentage of operating revenues
6 spent on investment dropped by two-thirds, to 1.2 percent—a dramatic
7 decline. On this basis, net investment in 1999, at only 3.4 percent of
8 gross revenues, did not reach the levels achieved in 1991 and 1992.
9 More startling, perhaps, the percentage is scheduled to decline sharply
10 during this year and the next, back down to 2.3 percent.

Table 2

U. S. Postal Service
Operating Revenues, Investment and Depreciation
1990 – 2001

	(1)	(2)	(3)	(4)	(5)
		Gross			
		Investment:			
		Purchase of	Depreciation	NET	Net
		Property &	and	INVEST-	Investment
		Equipment	Amortization	MENT	as Percent of
		(000)	(000)	(000)	Operating
	Fiscal	Revenues			Revenues
	Year				
1990	39,655	1,858	669	1,189	3.0%
1991	43,884	2,321	734	1,587	3.6%
1992	46,151	2,475	784	1,691	3.7%
1993	47,418	1,885	889	996	2.1%
1994	49,383	1,727	992	735	1.5%
1995	54,293	1,808	1,141	667	1.2%
1996	56,402	2,340	1,333	1,007	1.8%
1997	58,216	3,233	1,673	1,560	2.7%
1998	60,072	3,055	1,579	1,476	2.5%
1999	62,766	3,917	1,795	2,122	3.4%
2000	64,817	3,564	1,864	1,700	2.6%
2001	69,117	3,746	2,154	1,592	2.3%

Sources: 1990-1997, Annual Reports of the U.S. Postal Service.
1998-2001, col. 2, 3 & 4, response to ANM/USPS-T9-13 (2 Tr. 150).
Operating revenues for 2000-2001, USPS-9A; FY 2001 revenues
are After Rates.

Several factors indicate that these meager rates of net investment fall short of the levels needed to modernize the Service's plant, become more efficient, increase productivity, reduce costs and improve the service given to all classes of mail. I discuss these factors in turn.

1 **A. The Postal Service's Rate Of Net Investment Is Far Lower**
 2 **Than Achieved By Efficient Firms In Competitive Indus-**
 3 **tries.**

4 The Postal Service's recent rate of investment is far below the levels
 5 achieved by the best-managed postal authorities in other advanced
 6 Western economies, and other capital intensive firms in the United
 7 States.¹⁵ Indeed, Quad/Graphics, one of the participants in the Postal
 8 Service's own Blue Ribbon Committee, has spent approximately 20
 9 percent of its revenue on investment in automation over the past 25
 10 years.¹⁶

11 **B. The Postal Service's Rate of Net Investment Falls Consis-**
 12 **tently Short Of The Service's Own Capital Spending Tar-**
 13 **gets.**

14 The inadequacy of the capital spending portion of the Postal Ser-
 15 vice's Operating Plan is apparent even without considering the practices
 16 of other postal authorities and other businesses. Over the last 12 years
 17 the Postal Service has consistently failed to achieve even its own modest
 18 capital spending goals. Table 3 (on the following page) provides a sum-
 19 mary of the 12-year shortfall by major category.¹⁷ Of \$40.2 billion in
 20 planned commitments during this period, the Postal Service actually
 21 managed to commit only \$28.5 billion, a \$11.7 billion shortfall. In 6 of
 22 the last 8 years, the shortfall has exceeded \$1.1 billion (see Appendix,
 23 Table A-1). The largest category for planned commitments, mail process-
 24 ing equipment, had the largest shortfall: only 58.3 percent of planned

¹⁵ See p. 4, above.

¹⁶ *Finding Common Ground*, p. 36 (statement of Harry Quadracci).

¹⁷ For detail, see attachment to ANM/USPS-T10-47, as well as response thereto (2 Tr. 408-27).

1 commitments materialized. In 4 of the last 8 years, actual commitments
 2 were less than 50 percent of planned commitments (Appendix, Table A-
 3 2).

4
 5 **Table 3**

6 **U.S. Postal Service**
 7 **Capital Commitments**
 8 **1988-1999**
 9 **(\$, millions)**

	(1)	(2)	(3)	(4)
	Plan	Actual	Shortfall	Actual as
	(\$, 000)	(\$, 000)	(Plan -	Percent
			Actual)	of Plan
10 Category:				
11 Mail processing equipment	13,603	7,936	5,667	58.3%
12 Construction & building purchase	12,337	9,179	3,169	74.4%
13 Building improvements	5,374	5,049	325	94.0%
14 Vehicles	2,454	2,066	388	84.2%
15 Retail equipment	1,489	864	624	58.1%
16 Postal support equipment	4,916	3,381	1,534	68.8%
17				
18				
19				
20				
21				
22 TOTAL	40,173	28,476	11,697	70.9%

23 Source: Appendix A.
 24

25 **C. Chronic Underinvestment Has Led To A Severe**
 26 **Shortage of Mechanized and Automated Sorting**
 27 **Capacity For Periodical and Non-Letter Mail.**

28 An undeniable symptom of the Postal Service's underinvestment is
 29 a pervasive shortage of mechanized capacity to sort flats and small
 30 parcels. The shortage of adequate capacity to sort flats on a flat sorting
 31 machine ("FSM") and the consequent need to sort flats manually are
 32 discussed repeatedly by the Postal Service's operations expert, witness
 33 Kingsley, and also by witnesses O'Tormey and Unger. The testimony of
 34 these witnesses demonstrates that the Postal Service has for many years
 35 suffered a growing shortage of flat sorting capacity. For example:

- 1 • While it is envisioned that the AFSM 100 will ulti-
2 mately replace the FSM 881s, the first phase of deploy-
3 ment is primarily intended to supplement our existing
4 flat sorting equipment *by providing needed flats sorting*
5 *capacity*.¹⁸
- 6 • The FSM 1000 has helped reduce the volume of mail
7 that is processed in manual operations.¹⁹
- 8 • There are also heavy volume periods where our exist-
9 ing shortfall in flats sorting capacity results in some
10 flats... being processed in manual operations.²⁰
- 11 • The AFSM will help reduce the overall amount of mail
12 in manual operations *by providing needed additional*
13 *FSM capacity*.²¹
- 14 • FSM 881s will be relocated to smaller sites *that do not*
15 *have flats sorting equipment or lack sufficient flats*
16 *sorting capacity today*.²²
- 17 • Throughput of the AFSM 100 is approximately 2 to 3
18 times higher than that of the FSM 881... and *much of*
19 *the distribution that is being performed manually in*
20 *delivery units* will be automated in plants.²³
- 21 • The utilization [of barcodes] in incoming secondary
22 operations remains relatively low . . . and *it highlights*
23 *the need for additional flats sorting capacity*.²⁴

¹⁸ USPS-T-10 (Kingsley), page 11, lines 25-28 (emphasis added).

¹⁹ *Id.*, page 12, lines 20-21.

²⁰ *Id.*, pages 13-14.

²¹ *Id.*, page 14, lines 9-10 (emphasis added).

²² *Id.*, page 13, lines 9-11 (emphasis added).

²³ *Id.*, lines 14-17 (emphasis added).

²⁴ *Id.*, page 14, lines 24-26 (emphasis added).

- 1 • *As the flat mail volume grew throughout the 1990s, and*
2 *as we began incoming secondary and automated pro-*
3 *cessing, it was difficult to eliminate capacity con-*
4 *straints.*²⁵

- 5 • The main reason [why so many prebarcoded flats were
6 not processed in automated operations] *was due to not*
7 *enough flat sorting machine capacity*, which required
8 the flats to be sorted manually.²⁶

- 9 • Though some facilities may have the necessary flats
10 sorting capacity, others do not, and a shortage of FSM
11 capacity does exist, systemwide.²⁷

- 12 • [W]e have enough capacity in our letter mail system.
13 We have over 250 automated plants. We have plenty
14 of delivery bar code sorter capacity. Where the short-
15 age was [in the fall of 1998] is the significant shortage
16 of flat capacity, and that is what we had to deal with.
17 That hit us heavier and hit deeper²⁸

- 18 • [O]ne of the big contributors to flat processing costs is
19 a shortage of automation equipment capacity.²⁹

- 20 The Postal Service admits that it will require the additional capac-
21 ity of at least the first 175 AFSM 100s deployed. Since the capacity of
22 one AFSM 100 is equivalent to about 2.6 FSM 881s, this means that the

²⁵ Response of USPS witness O'Tormey to ANM/USPS-ST42-6 (21 Tr. 8303-05) (emphasis added).

²⁶ Response USPS witness Kingsley to MH/USPS-T10-8 (5 Tr. 1691-92) (emphasis added).

²⁷ Response of USPS witness Kingsley to MH/USPS-T19(b).

²⁸ 21 Tr. 8347 (O'Tormey).

²⁹ 21 Tr. 8393 (O'Tormey).

1 Service is short the equivalent of perhaps as many as 450 FSM 881s.³⁰
2 Such a shortage is inexcusable.

3 The first flat sorting machines, the FSM 775s were deployed in
4 1982, and the last one was installed in 1988.³¹ The FSM 775s were
5 converted to FSM 881s in 1990-92 by changing the configuration in a
6 way calculated to increase throughput. Thus, by 1986-88 the FSM
7 775/881s constituted an off-the-shelf, proven technology. Its cost and
8 capabilities were both well-known to the Postal Service.

9 The FSM775/881s were purchased to support expected volume
10 growth only through FY 1992.³² By 1992, however, when the Postal
11 Service should have been ordering additional flat sorting capacity, it
12 sharply cut commitments for new equipment to only 15 percent of Plan
13 (see Appendix, Table A-2). Under the circumstances, it is not surprising
14 that the Postal Service found itself progressively short of flat sorting
15 capacity after 1992. At the same time, the failure to plan and procure
16 additional FSMs so as to have adequate capacity during the years 1992-
17 2000 has deprived periodical mailers of the benefits of efficient and
18 economical management.³³

19 The average cost of the last FSM 881 machines purchased was
20 only \$230,000.³⁴ FSM 881s equipped with a barcode reader (BCR) and

³⁰ Response of USPS witness Kingsley to ANM/USPS-T10-21 and 39 (5 Tr. 1570, 1589).

³¹ Response of USPS witness Kingsley to ANM/USPS-T10-1 (5 Tr. 1551).

³² Response of USPS witness Kingsley to ANM/USPS-T10-39 (5 Tr. 1589).

³³ Response of USPS witness Kingsley to ANM/USPS-T10-1 (5 Tr. 1551).

³⁴ Response of USPS witness Kingsley to ANM/USPS-T10-29 (5 Tr. 1579).

1 an optical character reader (OCR) cost approximately \$290,000.³⁵ In the
 2 context of gross capital spending that ranged between \$1.7 and \$3.9
 3 billion (Table 1), additional flat sort capacity was clearly affordable.

4 Throughout the 1990s, the Postal Service has had ample borrowing
 5 authority that could have been used to purchase additional flat sorting
 6 capacity and build adequate-sized facilities.³⁶ In addition to, or instead
 7 of, acquiring more FSM 881s, the Postal Service could also have acquired
 8 more FSM 1000s, another off-the-shelf piece of equipment that was
 9 widely deployed in 1996-1998 at a cost of \$425,000 per machine.³⁷

10 The FSM 881 represents a more efficient and economical way to
 11 process flats than manual sortation, especially when equipped with a
 12 barcode reader. All FSM 881s were retrofitted with BCRs during the
 13 years 1992-1993.³⁸ Deployment of optical character readers to the FSM
 14 881s began in 1998, and all 812 FSM 881s will be equipped with BCRs
 15 by 2001.³⁹ The FSM 881 is capable of 94-100 separations, whereas the
 16 typical manual flats case has only 60 separations. Thus by any reckon-
 17 ing, the FSM 881 has for years represented a more economical and
 18 efficient alternative than manual sortation. Yet for years the Postal
 19 Service has been forced to undertake more and more manual sortation of
 20 flats because it has failed to invest in and deploy a sufficient number of

³⁵ Response of USPS witness Kingsley to ANM/USPS-T10-30 (5 Tr. 1580).

³⁶ Response of USPS witness Tayman to ANM/USPS-T9-30 (2 Tr. 177-78).

³⁷ USPS-T10 (Kingsley), page 11, lines 6-17; response of USPS witness Kingsley to ANM/USPS-T10-35 (5 Tr. 1585).

³⁸ Response of USPS witness Kingsley to ANM/USPS-T10-41 (5 Tr. 1592).

³⁹ Response of USPS witness Kingsley to ANM/USPS-T10-34 (5 Tr. 1584).

1 flat sorting machines.⁴⁰ Importantly, this is the course that would have
2 been followed by any firm that was motivated to reduce costs wherever it
3 had been proven to be economic and efficient to do so. There is no need
4 to speculate or second-guess. The FSM 881 and the FSM 1000 each
5 represent a fully-developed technology, with known cost, capabilities and
6 payoff.

7 The critical shortage of flat sorting capacity can rebound to the
8 particular disadvantage of those subclasses (such as nonprofit periodicals)
9 that do not present the Postal Service with sufficient volume to
10 constitute the most efficient utilization of the equipment. Witnesses
11 O'Tormey and Unger describe how Postal Service field managers have
12 striven to maximize utilization of the limited FSM capacity, and send all
13 flat-shaped mail which cannot be machine-processed to manual
14 sortation. No guidelines are in place to protect any subclass from the
15 discrimination that can result from efforts to meet the "bottom line
16 operational budget."

17 Witness Unger candidly states that "Based on my experience, I
18 believe it is possible that the objective of minimizing total costs does not
19 always translate into results that minimize every subset of costs." The
20 field managers who each day must struggle with how to optimize in the
21 face of such almost overwhelming space and equipment constraints
22 deserve empathy. They try do to the best with what they have, and are
23 not responsible for investment decisions that result in space and FSM

⁴⁰ In prior cases (Docket Numbers R94-1 and R97-1) witness Stralberg observed the extensive number of flats that were manually sorted and hypothesized that such labor represented "automation refugees." The Postal Service has denied the automation refugee hypothesis, and insisted that such manual sortation was necessary to meet service requirements. To the extent the Postal Service is correct, there has been a serious "automation shortfall."

1 capacity shortages.⁴¹ At the same time, in view of the critical space and
 2 capacity constraints acknowledged by every knowledgeable operations
 3 witness, the shortage of FSM capacity clearly discriminates against
 4 periodical mailers with comparatively small volumes that do not lend
 5 themselves to the most optimal use of scarce machine hours. Through
 6 no fault of their own, they are too often the ones whose mail is systemati-
 7 cally shunted to high-cost manual operations. This costly and inefficient
 8 triage, with its less-than-zero-sum consequences, would have been
 9 unnecessary if the Postal Service had made adequate investments in
 10 automated flat-sorting equipment.

11 **D. Chronic Under-Investment Has Led To A Wide-**
 12 **spread Shortage of Facility Space For Sorting**
 13 **Equipment For Non-Letter Mail.**

14 Another consequence of underinvestment is the emergence of too
 15 many cramped and overcrowded postal facilities, which contributes both
 16 to higher costs and the inconsistent quality of service received by the
 17 nonprofit subclasses, as well as other subclasses. Construction and
 18 building purchase represented the second largest category of shortfalls
 19 from planned commitments. During the 12-year period 1988-1999, only
 20 74.4 percent of planned commitments for construction and building
 21 purchase were actually made (see Table 3). The shortage of space at
 22 Postal Service plants and its effect on costs is candidly acknowledged by
 23 Postal Service witnesses on numerous occasions. For instance:

⁴¹ To the extent that space shortages and capacity limitations are the reason for the increase in wage-adjusted unit costs for periodicals, it should not be surprising that field managers cannot explain the increase in unit costs.

- 1 • Manual incoming secondary processing occurs pre-
2 dominantly at delivery units *due to space constraints at*
3 *plants . . .*⁴²
- 4 • There are two major reasons for not deploying feed
5 systems to all SPBSs: . . . (2) *Not enough space*—the
6 feed systems have a large footprint.⁴³
- 7 • When space is inadequate and all other less-disrup-
8 tive, less-costly alternatives have been exhausted, we
9 resort to an annex . . . There appears to be some form
10 of periodicals processing in these annexes . . . There
11 also are many other annexes that do not process peri-
12 odicals . . . I would expect that in most cases, addi-
13 tional handling and transportation costs could be
14 incurred with the use of annexes.⁴⁴
- 15 • However, during this period [1998] evaluating current
16 capacity needs was complicated by space limitations in
17 some facilities . . .⁴⁵

18 The Postal Service has failed, for one reason or another, to take
19 meaningful steps to set its own house in order. This continued and
20 persistent gross neglect of investment could be viewed as indicative of a
21 certain lack of confidence by the Postal Service in itself. The drive to
22 reclassify the various classes and subclasses of mail inadvertently may
23 have diverted attention from the critical issue of why the Postal Service
24 was cutting back on its automation program and doing so little to mod-
25 ernize the postal infrastructure. Whatever the reason, the Postal Service

⁴² Response of USPS witness Kingsley to MH/USPS-T10-1(e) (revised April 7, 2000) (5 Tr. 1676-78) (emphasis added).

⁴³ Response of USPS witness Kingsley to ANM/USPS-T10-13 (5 Tr. 1563) (emphasis added).

⁴⁴ Response of USPS witness Kingsley to MH/USPS-T10-7 (5 Tr. 1688-90).

⁴⁵ Response of USPS witness O'Tormey to ANM/USPS-ST42-6(e) (21 Tr. 8305).

1 has failed to use the authority granted under existing legislation to do
2 what needs to be done.

3 **E. Postal Service Spending on Research and Develop-**
4 **ment Has Also Been Inadequate.**

5 Another neglected area of the operating plan is research and
6 development. Spending on research and development is like seed corn.
7 It is a vital investment in the future, because it creates opportunities for
8 productive ways to invest capital. When directed properly, research and
9 development spending can be among the wisest investments of all.

10 Postal Service spending on research and development since 1990
11 is shown in Table 4. As can be easily seen, again starting in 1993,
12 research and development expenditures were curtailed sharply.⁴⁶ The
13 bottom was reached in 1994, but they have remained at a comparatively
14 low level since that time. In terms of operating revenues, the small
15 increases since 1994 have not been sufficient to lift R&D above the 1994
16 level (see Table 4, column 2).

17 The reduction in R&D seems extremely short-sighted for an organi-
18 zation that expects to generate over \$69 billion in revenues in 2001, has
19 almost 900,000 employees, and must move increasingly large mountains
20 of mail each year. Unless the necessary research and development takes
21 place today, future opportunities for investment opportunities and major
22 advances in modernization are likely to be delayed if not foregone en-
23 tirely.

⁴⁶ The internal reorganization in 1992/93 had a fairly dramatic impact in certain areas. One such area was research and development. The separate R&D Department was abolished and functionally reorganized as an office under the Engineering Department, which accounts for the radical reduction in R&D spending in 1993.

Modernization of the Postal Service infrastructure requires that a continuing stream of new developments be implemented to replace less efficient labor-intensive facilities with more efficient capital-intensive facilities. For so long as R&D and net capital spending continue at grossly inadequate levels, however, the Postal Service inevitably will continue to be a highly labor-intensive organization.

Table 4

**USPS Research & Development Expenditures
1990-1999
(\$ millions)**

		(1)	(2)
		Research &	Percent of
	Fiscal	Development	Operating
	<u>Year</u>	<u>Expenditures</u>	<u>Revenues</u>
17	1990	81	0.20%
18	1991	115	0.26
19	1992	168	0.36
20	1993	58	0.12
21	1994	50	0.10
22	1995	52	0.10
23	1996	56	0.10
24	1997	68	0.12
25	1998	77	0.13
26	1999	67	0.11

Source: USPS Annual Reports, 1990-1999, Auditor's Note 2.

F. The Postal Service's Failure To Invest More Is Unsupported By Cost Benefit Analysis.

The Postal Service has offered no cost-benefit analysis or other evidence indicating that its actual levels of investment in flat-sorting equipment have been efficient or adequate, and no such analysis appar-

1 ently was ever performed. To the contrary, the Service has made a point
 2 of pride out of its failure to "analyze whether the Postal Service's operat-
 3 ing plan is actually cost minimizing."⁴⁷

4 Moreover, the enormous returns predicted (and apparently
 5 achieved) by the Postal Service on its existing investment in sorting
 6 equipment for non-letter mail are powerful evidence that the Service has
 7 failed to exhaust all profitable opportunities for investment of this kind.
 8 Received microeconomic theory teaches that an economically and effi-
 9 ciently managed firm should expand investment in labor-saving, cost-
 10 reducing equipment to the point where the cost savings and increased
 11 revenue generated by the last dollar of investment produce a return
 12 equal the hurdle rate for the investment. Postal Service investments in
 13 sorting equipment for non-letter mail have not come close to this equilib-
 14 rium point.

15 Information submitted by senior Postal Service management to the
 16 Board of Governors on purchase and deployment of new flat sorting
 17 equipment since 1994 has projected returns on investment (ROI) far
 18 above the Postal Service's internal hurdle rate of 20 percent.⁴⁸

⁴⁷ Response to AAP/USPS-1 (21 Tr. 8611). USPS witness Tayman likewise admitted that "I am not aware if any [cost-benefit analysis] has" been performed to test the possibility that a larger amount of investment in flat-sorting equipment would have been beneficial. 2 Tr. 442-44 (Tayman). Mr. Tayman admitted that determining whether "a larger investment in capital of this kind . . . would have had incremental benefits that exceed the incremental costs" would have required a cost benefit analysis. *Id.* at 442 & 454, lines 16-22.

⁴⁸ Compare USPS Briefing Sheets for Board of Governors' Meetings, reproduced in Response of USPS witness O'Tormey to ANM/USPS-ST42-7, Attachment pp. 1, 4 and 5 (21 Tr. 8307) (projected returns on investment); 21 Tr. 8338-42 (O'Tormey) with 2 Tr. 463-64 (Tayman), Responses of USPS witness Tayman to ANM/USPS-T9-59 (2 Tr. 214), and ANM/USPS-T10-19 (2 Tr. 428) (20% hurdle rate). During cross-examination of Mr. O'Tormey, he speculated that the high returns projected for these investments were total returns over their expected life,
 (continued...)

	Date of <u>BOG Mtg</u>	Flat <u>Sorting Machine</u>	No. <u>Requested</u>	<u>ROI</u>
3	April 4-5, 1994	FSM 1000	102	69.4%
4	December 3, 1996	FSM 1000	240	37% to 66%
5	June 1-2, 1998	AFSM 100	175	30% to 45%

6 Although the Postal Service apparently has failed to conduct any
7 formal after-the-fact studies of the returns experienced on these specific
8 investments,⁴⁹ USPS witness O'Tormey has testified that these projected
9 returns have been borne out by experience.⁵⁰ By implication, additional
10 investment opportunities with likely returns above 20 percent remain
11 untapped. The "existence of a capacity shortfall implies that there are
12 . . . profitable opportunities for buying more equipment . . . profitable in
13 the sense that the expected returns are expected to exceed the hurdle
14 rate of the investment" (21 Tr. 8393 (USPS witness O'Tormey)).

15 Moreover, the Postal Service's hurdle rate of 20 percent appears to
16 be conservative. The Postal Service's cost of capital is tied to the U.S.
17 Treasury rate for borrowing, and hence is relatively low. Indeed, when

⁴⁸ (...continued)

not annualized returns. 21 Tr. 8339, lines 1-11. This conclusion is clearly mistaken: total returns at these levels over the multi-year projected lives of the investments would equate to annualized returns well below the 20 percent hurdle rate.

⁴⁹ Responses of USPS witness Tayman to ANM/USPS-T9-63-65 (2 Tr. 220-23); 2 Tr. 461-62 (Tayman).

⁵⁰ 21 Tr. 8341, lines 22-25; *id.* at 8342, lines 10-24 (O'Tormey). The Capital Investment Plan, FY 1998-2002, FY 2000 Update, states that since 1980 the USPS has invested \$5.6 billion in letter mail automation and the salary avoidance since that time amounts to about \$15 billion. This indicates quite a fairly spectacular return on investment, and witness Tayman assures that the cost avoidance figure is correct. Response of USPS witness Tayman to ANM/USPS-T9-8 and 51 (2 Tr. 122-45, 204-05).

1 former Postmaster General Runyon established the 20 percent value in
 2 1995, the the Postal Service's cost of capital was only 7.3 percent; the
 3 remaining 12.7 percentage points of the hurdle rate were intended as a
 4 risk premium, which is relatively high.⁵¹

5 The Postal Service's chronic neglect of these opportunities for
 6 profitable investment in flat-sorting equipment is consistent with the
 7 Service's myopic focus on short-run cash flow at the expense of long-run
 8 optimization. As USPS witness Tayman conceded, an investment is
 9 expected to be profitable if the discounted present value of its expected
 10 benefits exceeds the discounted present value of its expected cash
 11 outflows.⁵² The Board of Governors' high priority to conserving cash,
 12 however, can result in "disapproving of profitable investments because
 13 during some shorter period of years, the outflows are likely to exceed the
 14 inflows."⁵³

15 **G. Knowledgeable Outside Observers Have Confirmed**
 16 **The Inadequacy Of Postal Service Investment Lev-**
 17 **els**

18 Many participants in the Postal Service's Blue Ribbon Committee
 19 agreed in their 1997 report that the Postal Service's level of capital
 20 investment was grossly inadequate. Observed one participant, "I think
 21 the Postal Service is budgeting something like six to eight percent" of its
 22 revenue on capital investment. "That's not enough." *Finding Common*
 23 *Ground*, p. 36. "Automation . . . has to continue to grow," noted a direct-
 24 mail manager. *Id.*, p. 37. "The Postal Service should expand its invest-

⁵¹ Response of USPS witness Tayman to ANM/USPS-T10-19 (2 Tr. 428); 2 Tr. 463-64 (Tayman).

⁵² 2 Tr. 448-51 (Tayman).

⁵³ *Id.* at 452.

1 ment in technology to make the necessary measurements that a quality
2 program needs,” added a university mail manager. *Id.*

3 Based on the projections of future-Postmaster Henderson that the
4 Postal Service “would require a yearly investment of \$4 billion at a
5 minimum return-on-investment just to keep pace with current USPS
6 programmed labor cost increases,” the Blue Ribbon Committee recom-
7 mended an “expanded capital investment program.” *Id.*, p. 40. The
8 Committee also urged the Postal Service to establish a USPS task force to
9 make recommend “more appropriate capital spending targets,” and to
10 “identify specific opportunities within the Postal Service for additional
11 investment.” *Id.* at 44.

12 In Fiscal Year 2000, the Postal Service projects that its net invest-
13 ment as a percentage of operating revenue will be *lower* than in
14 1997—2.6 percent vs. 2.7 percent.⁵⁴

⁵⁴ See p. 15, above.

1 **IV. Excuses for USPS Under-investment**
 2 **Do Not Withstand Scrutiny**

3 **A. The Postal Service Has Substantial Unused Borrowing**
 4 **Capacity**

5 The Postal Service's total debt is subject to a statutory limit of \$15
 6 billion, and the annual net increase for capital investments is limited to
 7 \$2.0 billion.⁵⁵ These limits became effective in 1992 (before then, the
 8 limits were slightly lower).⁵⁶ Since the Postal Reorganization Act became
 9 effective, at no time has either of the two statutory ceilings restricted the
 10 actual level of capital investment by the Postal Service.

11 The actual outstanding long-term debt is revealing as an indicator
 12 of the Postal Service's ability to have undertaken greater net investment
 13 spending. Long-term debt is summarized in Table 5. The highest level of
 14 total debt ever incurred by the Postal Service, \$9.3 billion, was in 1993.
 15 During the subsequent years, 1994-1997, the Postal Service's outstand-
 16 ing long-term debt declined sharply, from \$9.2 to \$5.8 billion at the end
 17 of FY 1997. During 1998-1999, total debt increased, but only by \$552
 18 and \$504 million, respectively, far below the \$2 billion annual limit. At
 19 the end of FY 1999, the level of total debt was only 46 percent of the \$15
 20 billion statutory limit.⁵⁷

21 Had the Postal Service continued modernizing at the pace set in
 22 1993, debt might have increased in the short run. The Postal Service
 23 has offered no reason to conclude, however, that the statutory debt limits

⁵⁵ Response of USPS witness Tayman to ANM/USPS-T9-2 (2 Tr. 112).

⁵⁶ Response of USPS witness Tayman to ANM/USPS-T9-27 (2 Tr. 173-74).

⁵⁷ Response of USPS witness Tayman to ANM/USPS-T9-30 (2 Tr. 177-78).

contained in 39 U.S.C. § 2005 would have prevented a major ramp up in investment, even temporarily. Moreover, in the longer run, the cost savings and revenue growth permitted by the foregone investments would have allowed the Postal Service to carry more debt, or accelerate the payoff of existing debt.

The balance sheet may appear to have been strengthened by the reduction in debt between 1994-1997. It was obtained, however, as a result of the meager level of net investment and the concomitant failure of the infrastructure, especially mechanized flat sorting capacity, to keep up with the growth in volume.

Table 5

U.S. POSTAL SERVICE DEBT
1990-1999
(millions)

<u>End of</u> <u>Fiscal</u> <u>Year</u>	<u>Current</u> <u>Portion of</u> <u>Long-term</u> <u>Debt</u>	<u>Long-term</u> <u>Debt</u>	<u>Total Debt</u> <u>Subject to</u> <u>Statutory</u> <u>Limitation</u>
1990	303	6,668	6,971
1991	302	8,139	8,441
1992	750	9,173	9,923
1993	1,062	8,686	9,748
1994	1,261	7,727	8,988
1995	261	7,019	7,280
1996	2,010	3,909	5,919
1997	2,647	3,225	5,872
1998	3,633	2,788	6,421
1999	3,363	3,554	6,917

Source: USPS Annual Reports, 1990-1999.

1 **B. The Postal Service Has Ample Flexibility to Down-**
2 **size its Workforce.**

3 Every year since at least 1995, the number of career employees in
4 the Postal Service has climbed, sporadically but relentlessly, as shown in
5 Table 6 below. During a period when the labor force in many major firms
6 was being downsized, the Postal Service's has been upsized. Today, the
7 it has almost 800,000 career employees.⁵⁸ Including Postmaster Leave
8 Replacements, Rural Associates and Reliefs, and Non-bargaining Tempo-
9 raries, the Postal Service has almost 900,000 employees.⁵⁹

10 It is sometimes asserted that the Postal Service has trouble adjust-
11 ing and reducing the size of its labor force because contracts with its
12 labor unions specify that once career employees have six years of contin-
13 uous employment they are protected by a no-layoff provision.⁶⁰ Such
14 assertions, however, appear to be misplaced. As of accounting period 7,
15 FY 2000, 420,845 career employees had layoff protection. This means, of
16 course, that over 375,000 employees did not have any layoff protection,
17 which affords the Postal Service considerable flexibility with respect to
18 adjusting the size of its labor force.

19 Furthermore, if the Postal Service wanted to reduce the size of its
20 career labor force, it could also do so easily by taking advantage of the
21 ample turnover that results from retirements, voluntary separations and
22 other reasons. In less than five and one-half years almost 190,000
23 career employees, or over 25 percent of the number of career employees

⁵⁸ Since 1995 the career labor force has grown at a compound rate of 1.75 percent, even more than the 1.0 to 1.5 percent growth in deliverable addresses.

⁵⁹ Response of USPS witness Tayman to ANM/USPS-T9-60 (2 Tr. 215-16).

⁶⁰ Response of USPS witness Tayman to ANM/USPS-T9-66 (2 Tr. 224).

in 1995, were separated.⁶¹ The no-layoff provisions in the labor contracts do not provide any excuse for failing to procure an appropriate amount of flat sorting capacity and making the appropriate adjustments to the labor force.

Table 6

Career Employment in the Postal Service

Year	(1) Number of Employees	(2) Year-to-year Increase
1995	730,707	
1996	753,932	23,225
1997	760,750	6,818
1998	765,472	4,722
1999	794,064	28,592
2000	796,961	2,897

Source: USPS Financial & Operating Statements, A/P 1.

C. The Shortage of Experienced Supervisors Provides no Excuse for Inadequate Investment

Witness O'Tormey's testimony explains how the internal reorganization of 1992/93 stripped the Postal Service of one-fourth of its experienced supervisors.⁶² That internal reorganization, no matter how ill-

⁶¹ Response of USPS witness Tayman to ANM/USPS-T9-26 (2 Tr. 172).

⁶² USPS-ST-42 (O'Tormey); response of USPS witness O'Tormey to ANM/USPS-ST42-4 (21 Tr. 8300-01).

1 advised, provides a clear demonstration that the Postal Service does have
2 the flexibility to downsize its labor force.

3 The Postal Service's failure to recover fully from the internal
4 reorganization may be part of the explanation for the downward trend in
5 FSM operational productivity. That is no excuse, however, for failing to
6 invest in more mechanized/automated flat sorting capacity. The increase
7 in flat volumes throughout the 1990s was entirely foreseeable: the Postal
8 Service's expert, witness Tolley, predicted it in each rate case. In the face
9 of steadily increasing volumes, when the Postal Service deliberately chose
10 to eliminate one-fourth of its experienced field supervisors, it should
11 have redoubled its efforts to expand crowded facilities and provide
12 capacity sufficient to handle the growing volume. It would have been
13 entirely reasonable for the Postal Service to attempt to reduce its labor
14 force by substitution of capital through increased investment. Instead,
15 the Service reduced both the labor force and spending on capital invest-
16 ment, with disastrous consequences for mailers, especially periodicals
17 mailers.

18 **D. Availability of the AFSM in 2000 Provides No Excuse for**
19 **Previous Failure to Order Other FSMs.**

20 The shortage of FSM capacity did not occur overnight. Witness
21 Kingsley acknowledges that the FSM 775/881s were planned to handle
22 anticipated needs only through 1992.⁶³ Witness Kingsley notes that "a
23 production line [for the FSM 775/881] did not exist after FSM 775
24 deployment was completed in 1992 and considerable costs are incurred
25 to restart a production line."⁶⁴

⁶³ Response of USPS witness Kingsley to ANM/USPS-T10-39 (5 Tr. 1589).

⁶⁴ Response of USPS witness Kingsley to ANM/USPS-T10-40 (5 Tr. 1590-91).

1 That restarting a production line entails considerable fixed costs is
2 a well known fact of economic life that should have been obvious to
3 Postal Service management in 1988-1992. Moreover, since the Postal
4 Service knew full well that it was the only customer for flat sorting
5 machines, it has no excuse for not anticipating that the production line
6 would be closed down after the last FSM 775s were delivered. During
7 that same period, management should also have been aware that (i) there
8 were no plans to add FSM capacity to handle increased flats volume after
9 1992, and (ii) an improved, next-generation flat sorting machine was
10 nowhere close to availability. Before the first FSM 775s were purchased,
11 the Postal Service faced an obvious trade-off between ordering more
12 FSMs at that time, and thereby or subsequently (*e.g.*, within a few years,
13 and well before a critical shortage of capacity existed) paying the addi-
14 tional cost of restarting the production line, depending on which course
15 was more economic. But it did neither.

16 Witness Kingsley states that "The limited long-term value of the
17 FSM 775/881 is supported by the expected replacement of FSM
18 775/881s starting in FY 2001 with the AFSM Phase 2 deployment."⁶⁵
19 However, the advent of the AFSM 100 as a realistic alternative to earlier
20 machines by FY 1998-99 was no excuse for management inaction ex-
21 tending over a period as long as 10 years. Flats mailers, especially
22 periodicals mailers, are now asked to pay heavily for a long series of non-
23 economic, inefficient decisions — or "non-decisions" — whichever the
24 case may be.

⁶⁵ Response of USPS witness Kingsley to ANM/USPS-T10-40.

1 **E. Conclusion**

2 The main problem faced today by the Postal Service is its unwill-
3 ingness to invest in itself and its core mission as needed. The solution to
4 this problem can be achieved by the Postal Service acting alone.

5 Over the past three decades, the Postal Service has enjoyed a
6 remarkable growth in mail volume. Between 1978 and 1998 alone, total
7 volume more than doubled, from 96 to 198 billion pieces. Too many of
8 the existing postal facilities were not built to handle today's volume,
9 much less any future increases in volume. Considering the cramped and
10 over-crowded condition in which many postal employees must work, they
11 do an admirable job of getting the mail delivered. One can only marvel at
12 how well they do under such adverse circumstances. However, because
13 the Postal Service has struggled so long with an infrastructure than has
14 been inadequate for the growing volume of mail, it may have become
15 complacent about the fact that it perennially has so many undersized
16 and underequipped facilities. The infrastructure is what will determine
17 whether the Postal Service will be successful over the remainder of this
18 century.

V. Remedy

In this Docket, mailers of periodicals and other non-letter mail are again faced with excessive increases in unit costs because of the persistent failure of the Postal Service to make timely and adequate investments in needed flat sorting capacity and floor space.

What can the Commission do? It can—and should—adjust the unit cost of Periodicals downward to what that cost would be if the Postal Service had made anywhere near the appropriate investments in time for use during the test year.

The Postal Service's failure to produce (and, apparently, to create) the necessary data thwarts precise quantification of the full amount of the costs needlessly generated by the Service's underinvestment. Nevertheless, the costs clearly are large. Every Postal Service witness agrees that manual sortation of flats is undertaken as a last resort because it is more costly than when done on FSMs.⁶⁶ Manual flat sortation requires clerks with scheme knowledge, at pay level PS-05, while FSM in BCR or OCR mode only require clerks at pay level PS-04.⁶⁷ The FY 2001 projected national average labor rates for clerks, fully loaded with service wide costs are \$27.41 for PS-04, and \$31.41 for PS-04, or \$4.00 per hour more for clerks who sort manually.⁶⁸ Manual flats cost \$69.00 per thou-

⁶⁶ Responses to the following interrogatories provide information on productivity of FSMs: ANM/USPS-T10 16, 20 and 42-44.

⁶⁷ Response of USPS witness Kingsley to TW/USPS-T10-1 (revised 4/10/00) (5 Tr. 1840-42)

⁶⁸ Response to PostCom/USPS-T10-11.

1 sand to sort, while mechanized/automation flats cost on \$51.68 per
2 thousand.⁶⁹

3 Moreover, a conservative analysis does not require the Commission
4 to estimate by how much the efficient deployment of automated equip-
5 ment would have decreased the costs of mail processing costs: it suffi-
6 cient to know that inflation-adjusted unit costs would not have in-
7 creased. Barring war, revolution or other major dislocations, the stock of
8 technology and intellectual capital available for deployment in any
9 economy normally increases, or at a minimum remains constant. Stated
10 otherwise, the technological production possibility frontier does not
11 regress toward the origin; it either remains static or expands.

12 Hence, barring any drastic shift in the composition of a mail class,
13 or a significant change in its makeup that would make it more difficult or
14 costly to produce, there is no reason why the real (i.e., inflation-adjusted)
15 cost of processing the mail would increase under efficient management.
16 Accordingly, a conservative rule of thumb is that any persistent and
17 unreasonable increase in the inflation-adjusted unit cost of processing a
18 subclass of mail from one rate case to the next should be attributed to
19 internal inefficiency, unless the Postal Service demonstrates otherwise.

20 With respect to periodical mail, the Postal Service has made no
21 such showing. The two Postal Service witnesses tendered in response to
22 the Order No. 1289, Dennis Unger and Walter O'Tormey, candidly
23 admitted that they had no explanation for the significant and paradoxical
24 increase in such costs since 1993.

25 Mr. Unger's prefiled testimony (USPS-ST-43) recited a litany of mail
26 characteristics that supposedly make periodicals mail more expensive to
27 process than letters. On cross-examination, however, he was unable to

⁶⁹ Response to PostCom/USPS-T10-7 (5 Tr. 1827-28).

1 offer any evidence that these characteristics were more widespread or
 2 severe in 1998 than in 1993.⁷⁰ Indeed, he conceded that several alleg-
 3 edly significant mail-handling problems identified in his prepared testi-
 4 mony had *improved* over this period.⁷¹ And he conceded that he had not
 5 studied the cost-saving effects of the growth in destination entry,
 6 presorting, pre-barcoding, palletization and other improvements in mail
 7 preparation by periodical mailers during the 1993-98 period.⁷² "Why the
 8 costs for periodicals specifically has gone up, I can't answer," he con-
 9 cluded.⁷³

10 The testimony of USPS witness Walter O'Tormey was in the same
 11 vein. His prefiled testimony asserted that increased automation of non-
 12 letter mail processing has increased maintenance down time for the

⁷⁰ See 21 Tr. 8216-21 (cost-causing characteristics of *Wall Street Journal*); *id.* at 8222-23 (unaware whether physical handling characteristics of newspapers have worsened); *id.* at 8223-24 (unaware whether volume of broadsheet newspapers has increased as percentage of total periodical volume); *id.* at 8224-25 (unaware of percentage of periodicals mail that is polywrapped); *id.* at 8230-31 (unaware whether mail not pre-sequenced to line of travel has increased as a percentage of total periodical volume); *id.* at 8232, 8273-74 (unable to say whether percentage of periodical mail entered in skin sacks has increased); *id.* at 8232-33 ("[m]y personal opinion is that [the rate of flexible acceptance of periodicals] has stayed the same" during 1993-99); *id.* at 8233 ("I do not know if [the frequency of special handling for late-entered newspapers] has gone up or down and it is not a widespread thing"); *id.* at 8235 ("I have no idea" of the percentage of periodical volume that "receives hot pub treatment . . ." [I]t would be very low, but I don't know the specific percent . . . I do not know . . . the trend from '93 to '99."); *id.* at 8236 ("I do not know . . . whether service for periodicals today is as good as it was, say, in 1985").

⁷¹ See *id.* at 8225-28, 8273 (admitting that jam rate of polywrap has declined); *id.* at 8231 (as "a general statement, talking with the plant managers, from '93 to '99, I would say that the [bundle breakage] situation has improved"); *id.* at 8273 (same).

⁷² *Id.* at 8237-40, 8246-48, 8273 ("there is no doubt in my mind that machines [for processing periodicals mail] are saving money").

⁷³ *Id.* at 8279, 8282.

1 equipment. On cross-examination, however, he admitted that the
 2 benefits of the equipment in terms of faster or cheaper processing “far
 3 outweigh the cost that you are going to add for the maintenance.”⁷⁴
 4 Likewise, he admitted that the benefits of automated processing out-
 5 weighed the costs of the shorter runs required for some mail.⁷⁵ “You’re
 6 making an investment in this technology. You would expect to get the
 7 savings.”⁷⁶

8 As shown in Table 7, between 1993 and 1998 the wage-adjusted
 9 increase in the average unit costs of processing periodicals mail *in-*
 10 *creased* by approximately 1.13 to 1.30 cents per piece, while the average
 11 unit cost of processing single-piece First-Class Mail, where investment
 12 for automated letter sorting capacity has been less inadequate (and no
 13 major capacity shortfall is evident), *decreased* by 0.2 to over 0.5 cents
 14 per piece. As discussed previously, the Postal Service had all the finan-
 15 cial resources necessary to pursue automation of flats processing with as
 16 much vigor as it pursued automation of letter mail. Had it done so, it is
 17 reasonable to presume that, at a minium, wage-adjusted unit costs
 18 should not and would not have increased, and might even have de-
 19 creased.

20 A conservative estimate of the increase in the unit cost of periodi-
 21 cals brought about by the failure to make adequate investment for
 22 foreseeable needs is 1.2 cents. As shown in Table 8, Part B, this
 23 amounts to approximately \$94 million for all Regular Rate, Nonprofit and
 24 Classroom periodicals mail in the test year. In light of the Postal Ser-
 25 vice’s failure to provide any reasoned explanation for the runup in mail

⁷⁴ Compare USPS-T-42 at 14 (O’Tormey); 21 Tr. 8237 (O’Tormey).

⁷⁵ Compare USPS-T-42 at 14-15 (O’Tormey); 21 Tr. 8238-30 (O’Tormey).

⁷⁶ 21 Tr. 8330, 8335, 8391 (O’Tormey).

1 processing costs during this period, the entire amount should be disal-
2 lowed as inconsistent with economic and efficient management.

3 Finally, had net investment by the Postal Service been more
4 adequate over the last 8 years, this rate case could possibly have post-
5 poned for some time. To the extent that the Postal Service has filed this
6 rate case because it failed to make timely investment for foreseeable
7 events such as the growth in flats volume, it should not now be given a
8 large contingency for unforeseeable events.

1

2

Table 7

3

**Wage Adjusted Unit Cost of Single Piece
First-Class Letter and Regular Rate Periodicals
1993 and 1998
(cents)**

4

5

6

7

8

A. Mail Processing Costs

9

10

First-Class**Mail****Periodicals**

11

1993

6.81

4.98

12

1998

6.616.11

13

Increase (decrease)

-0.20

+1.13

14

B. Mail Processing and In-Office City Carrier Costs

15

16

First-Class**Mail****Periodicals**

17

1993

8.86

6.49

18

1998

8.307.79

19

Increase (decrease)

-0.56

+1.20

20

Source: Response of Postal Service witness Smith to POIR No. 4,
Attachment, pp. 1 (First-Class Mail) and 4 (Periodicals).

21

22

1

2

Table 8

3

**Computation of Reduction in Revenue Requirement
and Attributable Cost**

4

5

A. Periodical Volumes, GFY 1998 (from billing determinants)

6

7

8

9

10

			Page
Regular Rate and Science of Agriculture	7,195,165,978		E-1
Nonprofit	585,101,796		E-2
Classroom	<u>60,793,411</u>		E-4
TOTAL	7,841,061,185		

11

12

13

14

15

16

17

**B. Reduction in Attributable Costs and Revenue Requirements
(at 1.20 cents per piece)**

Regular Rate and Sc. of Agriculture	86,341,992
Nonprofit	7,021,224
Classroom	<u>729,521</u>
TOTAL	94,092,736

18

19

Source: Response of Postal Service witness Smith to POIR No. 4,
Attachment, pp. 1 (First-Class Mail) and 4 (Periodical Regular Rate).

20

1

APPENDIX

2

Postal Service Capital Commitments

3

Actual vs. Plan

4

1998-1999

5

This appendix shows Postal Service capital commitments, by major

6

category. All data are from the financial & Operation Statements, Ac-

7

counting Period 13 of each respective year. The appendix contains the

8

following tables:

9

A-1 Total Capital Commitments

10

A-2 Mail Processing Equipment

11

A-3 Construction and Building Purchase

12

A-4 Building Improvements

13

A-5 Vehicles

14

A-6 Retail Equipment

15

A-7 Postal Support Equipment

1					
2	Table A-1				
3	Total Capital Commitments				
4					
5	(1)	(2)	(3)	(4)	(5)
6	Postal			Shortfall	Actual as
7	Fiscal	Plan	Actual	(Plan -	Percent
8	<u>Year</u>	<u>(\$, 000)</u>	<u>(\$, 000)</u>	<u>Actual)</u>	<u>of Plan</u>
9					
10	1988	625.0	623.9	1.1	99.8%
11	1989	1,995.0	1,987.5	7.5	99.6%
12	1990	2,738.8	2,436.4	302.4	89.0%
13	1991	2,230.1	1,883.1	347.0	84.4%
14	1992	3,581.0	1,924.8	1,656.2	53.8%
15	1993	3,420.0	1,309.6	2,110.4	38.3%
16	1994	2,804.5	1,635.5	1,169.0	58.3%
17	1995	3,572.1	2,284.9	1,287.2	64.0%
18	1996	3,331.8	3,306.9	24.9	99.3%
19	1997	6,023.6	3,202.6	2,821.0	53.2%
20	1998	5,592.0	3,947.0	1,645.0	70.6%
21	1999	<u>3,998.5</u>	<u>3,817.3</u>	<u>181.2</u>	95.5%
22	SUM	39,912.4	28,359.5	11,552.9	71.1%
23					

1					
2	Table A-2				
3	Capital Commitments for Mail Processing Equipment				
4					
5	(1)	(2)	(3)	(4)	(5)
6	Postal	Plan	Actual	Shortfall	Actual as
7	Fiscal	(\$.000)	(\$.000)	(Plan -	Percent
8	Year			Actual)	of Plan
9					
10	1988	96.9	91.9	5.0	94.8%
11	1989	560.0	560.0	0.0	100.0%
12	1990	628.3	466.4	161.9	74.2%
13	1991	511.6	397.7	113.9	77.7%
14	1992	1,355.4	201.1	1,154.3	14.8%
15	1993	1,289.0	634.5	654.5	49.2%
16	1994	1,263.8	326.9	936.9	25.9%
17	1995	1,443.4	866.8	576.6	60.1%
18	1996	1,218.3	1,220.5	-2.2	100.2%
19	1997	2,440.7	808.2	1,632.5	33.1%
20	1998	1,682.6	1,204.1	478.5	71.6%
21	1999	<u>1,113.3</u>	<u>1,158.1</u>	<u>-44.8</u>	104.0%
22	SUM	13,603.3	7,936.2	5,667.1	58.3%
23					

1

2

Table A-3

3

Capital Commitments for Construction and Building Purchase

4

	(1)	(2)	(3)	(4)	(5)
	Postal Fiscal Year	Plan (\$, 000)	Actual (\$, 000)	Shortfall (Plan - Actual)	Actual as Percent of Plan
5					
6					
7					
8					
9					
10	1988	274.1	289.2	-15.1	105.5%
11	1989	1,002.0	1,037.7	-35.7	103.6%
12	1990	1,436.9	1,339.5	97.4	93.2%
13	1991	1,063.2	812.0	251.2	76.4%
14	1992	1,069.1	675.7	393.4	63.2%
15	1993	1,489.5	188.3	1,301.2	12.6%
16	1994	630.7	507.6	123.1	80.5%
17	1995	828.7	537.5	291.2	64.9%
18	1996	661.7	654.7	7.0	98.9%
19	1997	1,297.7	1,034.4	263.3	79.7%
20	1998	1,475.4	1,116.5	358.9	75.7%
21	1999	<u>1,108.0</u>	<u>985.4</u>	<u>122.6</u>	88.9%
22	SUM	12,337.0	9,178.5	3,158.5	74.4%
23					

1					
2	Table A-4				
3	Capital Commitments for Building Improvements				
4					
5	(1)	(2)	(3)	(4)	(5)
6	Postal	Plan	Actual	Shortfall	Actual as
7	Fiscal			(Plan -	Percent
8	Year	(\$, 000)	(\$, 000)	Actual)	of Plan
9					
10	1988	113.2	103.5	9.7	91.4%
11	1989	235.0	219.4	15.6	93.4%
12	1990	247.0	271.0	-24.0	109.7%
13	1991	272.5	306.5	-34.0	112.5%
14	1992	292.0	264.4	27.6	90.5%
15	1993	328.6	214.9	113.7	66.4%
16	1994	485.6	540.0	-54.4	111.2%
17	1995	588.3	513.0	55.3	90.3%
18	1996	620.6	542.1	78.5	87.4%
19	1997	753.0	651.1	101.9	86.5%
20	1998	745.5	704.0	41.5	94.4%
21	1999	<u>712.7</u>	<u>719.2</u>	<u>-6.5</u>	100.9%
22	SUM	5,374.0	5,049.1	324.9	94.0%
23					

Table A-5

Capital Commitments for Vehicles

	(1)	(2)	(3)	(4)	(5)
	Postal	Plan	Actual	Shortfall	Actual as
	Fiscal	(<u>\$, 000</u>)	(<u>\$, 000</u>)	(Plan -	Percent
	<u>Year</u>			<u>Actual</u>)	<u>of Plan</u>
1988	1988	10.5	10.0	0.5	95.2%
1989	1989	17.0	17.6	-0.6	103.5%
1990	1990	242.4	190.0	52.4	78.4%
1991	1991	147.1	143.6	3.5	97.6%
1992	1992	588.8	584.2	4.6	99.2%
1993	1993	36.5	66.3	-29.8	181.6%
1994	1994	154.1	23.5	130.6	15.2%
1995	1995	182.0	36.5	145.5	20.1%
1996	1996	374.7	330.1	44.6	88.1%
1997	1997	132.4	85.1	47.3	64.3%
1998	1998	302.4	294.2	8.2	97.3%
1999	1999	<u>266.3</u>	<u>284.8</u>	<u>-18.5</u>	106.9%
SUM	SUM	2,454.2	2,085.9	388.3	84.2%

1

2

Table A-6

3

Capital Commitments for Retail Equipment

4

	(1)	(2)	(3)	(4)	(5)
	Postal Fiscal Year	Plan (\$.000)	Actual (\$.000)	Shortfall (Plan - Actual)	Actual as Percent of Plan
5					
6					
7					
8					
9					
10	1988	64.9	64.1	0.8	98.8%
11	1989	39.0	33.7	5.3	86.4%
12	1990	42.4	15.6	26.8	36.8%
13	1991	64.3	44.1	20.2	68.6%
14	1992	217.7	157.7	60.0	72.4%
15	1993	25.5	11.1	14.4	43.5%
16	1994	121.5	26.0	95.5	21.4%
17	1995	156.0	7.6	148.4	4.9%
18	1996	79.6	219.6	-140.0	275.9%
19	1997	103.7	10.9	92.8	10.5%
20	1998	364.9	79.6	285.3	21.8%
21	1999	<u>209.3</u>	<u>194.4</u>	<u>14.9</u>	92.9%
22	SUM	1,488.8	864.4	624.4	58.1%
23					

1					
2	Table A-7				
3	Capital Commitments for Postal Support Equipment				
4					
5	(1)	(2)	(3)	(4)	(5)
6	Postal	Plan	Actual	Shortfall	Actual as
7	Fiscal			(Plan -	Percent
8	<u>Year</u>	<u>(\$, 000)</u>	<u>(\$, 000)</u>	<u>Actual)</u>	<u>of Plan</u>
9					
10	1988	66.2	65.2	1.0	98.5%
11	1989	142.0	119.1	22.9	83.9%
12	1990	141.8	153.9	-12.1	108.5%
13	1991	171.4	179.2	-7.8	104.6%
14	1992	217.7	157.7	60.0	72.4%
15	1993	250.9	194.5	56.4	77.5%
16	1994	248.8	211.5	37.3	85.0%
17	1995	393.7	323.5	70.2	82.2%
18	1996	376.8	339.9	36.9	90.2%
19	1997	1,296.1	612.9	683.2	47.3%
20	1998	1,021.2	548.6	472.6	53.7%
21	1999	<u>588.9</u>	<u>475.4</u>	<u>113.5</u>	80.7%
22	SUM	4,915.5	3,381.4	1,534.1	68.8%
23					

1 CHAIRMAN GLEIMAN: Dr. Haldi, have you had an
2 opportunity to examine the packet of designated written
3 cross-examination that was made available earlier today?

4 THE WITNESS: No, Your Honor, but I will quickly
5 check.

6 CHAIRMAN GLEIMAN: Only if you promise not to call
7 me "Your Honor."

8 MR. LEVY: That's my fault.

9 THE WITNESS: Yes, I have now, Mr. Chairman.

10 CHAIRMAN GLEIMAN: If these questions were asked
11 of you today, would your answers be the same as those you
12 previously provided in writing?

13 THE WITNESS: Yes, they would.

14 CHAIRMAN GLEIMAN: That being the case, counsel,
15 if you could please provide the two copies of the designated
16 written cross-examination of the witness to the court
17 reporter, I will direct that they be entered into evidence
18 and transcribed into the record.

19 [Designation of Written
20 Cross-Examination of John Haldi,
21 ANM-T-1, was received into evidence
22 and transcribed into the record.]

23
24
25

BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, DC 20268-0001

Postal Rate and Fee Changes, 2000

Docket No. R2000-1

DESIGNATION OF WRITTEN CROSS-EXAMINATION
OF ALLIANCE OF NONPROFIT MAILERS
WITNESS JOHN HALDI
(ANM-T-1)

Party

Newspaper Association of America

United States Postal Service

Interrogatories

USPS/ANM-T1-1-4

USPS/ANM-T1-5-7

Respectfully submitted,


Cyril J. Pittack
Acting Secretary

INTERROGATORY RESPONSES OF
ALLIANCE OF NONPROFIT MAILERS
WITNESS JOHN HALDI (T-1)
DESIGNATED AS WRITTEN CROSS-EXAMINATION

<u>Interrogatory</u>	<u>Designating Parties</u>
USPS/ANM-T1-1	NAA
USPS/ANM-T1-2	NAA
USPS/ANM-T1-3	NAA
USPS/ANM-T1-4	NAA
USPS/ANM-T1-5	USPS
USPS/ANM-T1-6	USPS
USPS/ANM-T1-7	USPS

ANM Witness John Haldi Response to Interrogatory of
United States Postal Service

USPS/ANM-T1-1. At page 5 of ANM-T-1 you state that "Postal Service unit costs — especially for periodicals and non-letter mail — have exceeded the rate of inflation by a wide margin."

- (a) Please confirm that the majority of the Postal Service's volume is letter mail. If you cannot confirm, explain your answer.
- (b) Please confirm that the Postal Service's unit costs for letter mail have risen by less than the rate of inflation. If you cannot confirm, please explain your answer.

Response:

- (a) Confirmed, but the volume of flats is hardly trivial. In 1999 the Postal Service handled about 61 billion flats, estimated as follows (in billions):

First-Class flats, at 12% of F-C volume	12
Periodicals	10
Standard A	39
TOTAL	61

- (b) For the 11-year period 1989-1999, the wage-adjusted data submitted by the Postal Service in response to POIR No. 4, Attachment, page 1, indicate that the unit mail processing plus in-office carrier costs for letters declined from 1989 (10.36 cents) through 1993 (8.86 cents), following which costs increased through 1998 (to 9.55 cents), then declined again through 1999 (to 8.30 cents). Over this entire 11-year period unit costs for letter mail have thus decreased, but neither uniformly nor in every year.

ANM Witness John Haldi Response to Interrogatory of
United States Postal Service

USPS/ANM-T1-2. With respect to the three decades that you have aggregated to display Total Factor Productivity (TFP) growth (Table 1 of ANM-T-1):

- (a) Please confirm that postal prices increased the least during the third decade (1991 through 2000 year to date). If you cannot confirm, please explain your answer.
- (b) Please confirm that postal prices increased the most during the first decade (1971 through 1980). If you cannot confirm, please explain your answer.
- (c) Please confirm that the Postal Service's service performance has been the highest during the third decade (1991 through 2000 year to date). If you cannot confirm, please explain your answer.

Response:

(a) and (b)

I am not certain what you mean by postal prices, but using the rate for the first ounce of single piece First-Class Mail as a proxy, LR-I-118 shows that the rate in 1971, 1980, 1990 and 1999 was, respectively, 8, 15, 25, and 33 cents. The percentage increases in these nominal prices (i.e., prices not adjusted for inflation) corresponding to those three decades were thus 87.5, 66.7, and 32.0 percent.

Adjusting the figures for inflation using the CPI – All Urban Consumers index, however, produces the following results:

ANM Witness John Haldi Response to Interrogatory of
United States Postal Service

Year	First-Class Rate for First Oz.	Percent Increase	CPI-U	Inflation- Adjusted Rate	Percent Increase
1971	\$ 0.08		40.5	\$ 0.1975	
1980	0.15	87.5%	82.4	0.1820	-7.84%
1990	0.25	66.7	130.7	0.1913	5.08
1999	0.33	32.0	166.6	0.1981	3.56

On this basis, the lowest inflation-adjusted percentage change was during the first decade – actually, a decrease – which corresponds to the decade with the highest increase in TFP. The inflation-adjusted change in the third decade is less than during the second decade. During the third decade, however, the Postal Service opted to keep down prices by incurring massive operating deficits, for which mailers are still paying.

- (c) The question as posed is essentially unanswerable. First, despite repeated promises to do so over the last three decades, the Postal Service has failed to develop any reliable end-to-end performance data for the Periodicals Subclass, the Standard A subclass, or the Standard B subclass (and for second, third, and fourth class mail which preceded the current classifications). Second, the Postal Service refuses to publish or release any Express Mail performance data. Third, the Postal Service has only recently implemented the Priority Mail end-to-end (“PETE”) performance system. The only data (of which I am aware) that could be used to respond to this question are (i) EXFC data, which were not in

ANM Witness John Haldi Response to Interrogatory of
United States Postal Service

existence for the three decades, and which are representative only of First-Class Mail, and (ii) ODIS data, which are not altogether reliable, especially prior to EXFC, when they were the only performance data being gathered.

ANM Witness John Haldi Response to Interrogatory of
United States Postal Service

USPS/ANM-T1-3. Do you agree that, from 1975 on, the Postal Service limited its ability to capture productivity gains through expanding the level and array of price incentives for worksharing? If not, please explain your answer.

Response:

No, I do not accept that worksharing has limited the Postal Service's ability to capture productivity gains in any material way. Worksharing has relieved the Postal Service of the need to hire tens, perhaps hundreds, of thousands of workers, and it has likewise relieved the Postal Service of the need for substantial investment in facilities and equipment that would be needed if it had to process mail that is currently workshared. This should have enabled the Postal Service even more to focus both its investment and its research and development efforts (before that group was abolished). The Postal Service can do many things to increase productivity, but it must realize that achieving such productivity gains is likely to require both skillful management and additional capital investment.

ANM Witness John Haldi Response to Interrogatory of
United States Postal Service

USPS/ANM-T1-4. During the three decades covered by Table 1 of ANM-T-1, how would you characterize combined Postal Service/Mailer(s) productivity? Would you say this combined productivity has increased more or less than Postal Service TFP? Please explain your answer fully.

Response:

I cannot accept a premise of the question: that the productivity of the Postal Service and its customers can meaningfully be "combined." Although the outputs of the Postal Service are inputs to its customers, the Postal Service and its customers are completely separate economic agents. Mailers have no ownership in or managerial control over the Service, and the Service has no ownership in or managerial control over its customers.

Moreover, the productivity performance of the Postal Service and its customers have been very different. Printing and preparation of mail in the private sector have been characterized by substantial capital expenditures for printing presses, computers, mail inserting and preparation equipment, and other productivity enhancing equipment as well. Following is the full quote from Harry Quadracci, in *Finding Common Ground*, referenced at page 16 of my testimony.

Q? What are the attributes necessary to insure a successful Postal Service?

Quadracci: Innovative. And in order to be innovative in today's world you've got to spend money. Automation is a key to cost control. Over the last 25 years, since I started Quad/Graphics, the CPI has moved at a compounded rate of 5.3 percent per year. Paper prices actually have gone up 5.2 percent per year. First-class postage went up 5.5 percent per year, second- and third-class somewhat higher. But print prices actually went down 1.1

ANM Witness John Haldi Response to Interrogatory of
United States Postal Service

percent per year over those 25 years, resulting each year in a 6.3 percent productivity increase by the printers, which, passed on, is reflected in the prices of all you are paying for it today.

If we hadn't made those investments in automation your print prices today would be more than five times more than what you're paying. How did we do that? We did it by spending a lot of money – 20 percent of our throughput per year.

I believe that Mr. Quadracci knows what he is talking about, and that productivity in the private sector has increased far more than the Postal Service TFP. Obviously, this means that the "combined" (i.e., averaged) productivity is up, but that is not because of any substantial productivity-enhancing investments made by the Postal Service during the last three decades. If the price of mailpieces had compounded at 5.5 percent for 25 years, those mailpieces would cost 3.8 times what they do today, and mail volume would be far lower than it is. The major "innovation" by the Postal Service has been worksharing, which provides incentive for *others* to make the necessary investments and do the work. As far as it goes, that is fine for large mailers who can take advantage of worksharing, but the Postal Service's continued failure to make economic investment results in shortchanging all those smaller mailers (which includes most nonprofits) who are more dependent on the Postal Service, and who must suffer the higher unit costs that results from the Service's continuing under-investment. Rather than making invidious comparisons with the productivity performance of its downstream customers, the Postal Service needs to focus on getting its own house in order by increasing the productivity of its own services.

ANM Witness John Haldi Response to Interrogatory of
United States Postal Service

USPS/ANM-T1-5. On page 13 of ANM-T-1 you state that the "Postal Service's reported depreciation expense has averaged 2.4 percent of revenues, far below the national average for nonfinancial corporate business of about 11 percent."

- (a) Please confirm, based on Table 2 of ANM-T-1, that the Postal Service's depreciation expense averages 2.8 percent of revenues for the time period 1997 through 1999. If you cannot confirm, please supply the corrected percentage.
- (b) Please confirm, based on United Parcel Service's 1999 Annual Report, that UPS' depreciation expense averaged 4.5 percent of revenues for the time period 1997 through 1999. If you cannot confirm, please supply the corrected percentage.
- (c) Also based on United Parcel Service's 1999 Annual Report, please confirm that about 25 percent of UPS' undepreciated assets are Aircraft (including aircraft under capitalized leases). If you cannot confirm, please supply the corrected percentage.
- (d) Please confirm that the Postal Service that [sic] none or essentially none of the Postal Service's assets are aircraft. If you cannot confirm, please identify the portion of the Postal Service's assets that you believe are aircraft.
- (e) Please confirm that the Postal Service contracts out virtually all of its inter-city surface transportation. If you cannot confirm, please identify what portion of the Postal Service's inter-city surface transportation you believe to be performed with Postal Service owned vehicles.

Response:

- (a) Confirmed.
- (b) Confirmed.
- (c) Confirmed.
- (d) Annual reports of the Postal Service do not provide a breakdown of assets by type, but it is my understanding that virtually none of the Postal

ANM Witness John Haldi Response to Interrogatory of
United States Postal Service

Service's capitalized assets consist of aircraft. It strikes me that the absence of any need to invest in a fleet of aircraft (and manage and operate such a fleet) should have facilitated, rather than retarded, the Postal Service's investment in modernizing the facilities and equipment for its core mission of processing the mail.

- (e) It is my understanding that the Postal Service contracts for a substantial portion of inter-city transportation, but I do not possess authoritative data that would enable me to confirm. It strikes me that the fact that the absence of any need to invest in a fleet of trucks for inter-city transportation (and manage and operate such a fleet) should have facilitated, rather than retarded, the Postal Service's investment in modernizing the facilities and equipment that are at the heart of its core mission, which is processing the mail.

ANM Witness John Haldi Response to Interrogatory of
United States Postal Service

USPS-ANM-T1-6. At page 16 of ANM-T-1 you state that Quad/Graphics "has spent approximately 20 percent of its revenue on investment in automation over the past 25 years. Do you agree that Quad/Graphics is a printer? If not, explain fully.

Response:

It is my understanding that over the past 25 years the primary business of Quad/Graphics has been printing.

ANM Witness John Haldi Response to Interrogatory of
United States Postal Service

USPS/ANM-T1-7. At page 17 of ANM-T-1, Table 3, you compare actual vs. planned Postal Service Capital Commitments for the period 1988 through 1999 (the reference to "1968" in the title is apparently a typographical error).

- (a) Do you agree that the Postal Service's actual capital commitments have trended upwards during this twelve-year period? If not, please explain.
- (b) Assume that commitment of funds for a major mail process [sic] facility was twice delayed, first to allow continued negotiations with local zoning officials concerning location and sites [sic] plans, and secondly to address the environmental issues. How would the shortfalls for this capital commitment be accounted for in your Table 3 and Appendix A?

Response:

- (a) As shown in my Appendix A, Table A-1, column 3, actual capital commitments have trended upward from the extremely low level of commitments over the 1988-1994 period. For those mailers who are faced with higher unit costs in this rate case because of past underinvestment (and the disruptive internal reorganization which is also blamed for the higher unit cost), it is little consolation to say that the underinvestment was even more severe in the past.
- (b) An occasional delay of the type described in the question, which extends beyond the end of the fiscal year,¹ is perhaps inevitable in a major construction and building purchase program, but such delays do not

¹ If the reasons for the delay were resolved within the fiscal year, the commitment presumably would be made, and there would be no difference between "plan" and "commitment."

ANM Witness John Haldi Response to Interrogatory of
United States Postal Service

begin to account for a total shortfall in the magnitude of \$11.6 billion (see my Appendix A, Table A-1, column 3). Nor do such delays account for any of the \$5.7 billion shortfall in mail processing equipment (41.7 percent of all planned commitments (see my Appendix A, Table A-2, column 5), or the \$1.5 billion shortfall in mail processing equipment (31.2 percent of all planned commitments (see my Appendix A, Table A-7, column 5).

1 CHAIRMAN GLEIMAN: Is there any additional written
2 cross-examination for the witness?

3 MR. REITER: Yes, Mr. Chairman. The Postal
4 Service would like to designate Dr. Haldi's responses to our
5 Questions 8 and 9.

6 CROSS-EXAMINATION

7 BY MR. REITER:

8 Q Good morning, Dr. Haldi.

9 A Good morning, Scott.

10 Q I have shown you copies of your answers to our
11 Interrogatories Number 8 and 9. If you were to testify
12 orally today, would your answers be the same as the written
13 answers?

14 A Yes, they would, with the slight amendment on page
15 3, just there was a double verb in there. The third line,
16 second -- the penultimate line on the page, in fact, it
17 says, "To avoid give the Service," the word "avoid" should
18 be struck. "To give the Service," so it reads that way.

19 MR. REITER: Mr. Chairman, with that, I would ask
20 that the questions be entered into the record as written
21 cross of the witness.

22 CHAIRMAN GLEIMAN: If you would please provide two
23 copies to the reporter, Mr. Reiter, I will direct that they
24 be received into evidence and transcribed into the record,
25 with the correction noted by Dr. Haldi.

1 [Designation of Written
2 Cross-Examination of John Haldi,
3 USPS/ANM-T1-8 and USPS/ANM-T1-9
4 were received into evidence and
5 transcribed into the record.]
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USPS/ANM-T1-8. Please refer to page 10 of your testimony, where you state that:

A basic optimization problem faced by every firm is the selection of a cost-minimizing mix of inputs for producing a given quantity and quality of outputs at a given set of input prices. . . . Firms that produce a given volume and quality of outputs with a cost-minimizing mix of inputs are said to be operating on the efficiency frontier or production-possibility frontier. Firms that adopt a more costly mix of inputs are said to be operating inefficiently.

a. Throughout your testimony, you are critical of what you term the Postal Service's "failure" to test for cost-minimization. In the real world, do you believe that there is any test or analysis the Postal Service could attempt which would ever offer any realistic prospects of proving to the satisfaction of participants in postal ratemaking (including yourself) that the Postal Service is actually operating on the efficiency frontier, as you have described that condition above? If so, please provide full details on what that test is, what data would be required, and how the test should be conducted.

b. Assume hypothetically that the Postal Service did conduct an analysis or test to determine whether its operating plan was actually cost minimizing, and such analysis or test indicated that the Postal Service was *not* operating on the efficiency frontier (i.e., was "operating inefficiently"). What would be the significance of this result for postal ratemaking, in light of your acknowledgment (pg. 11) that the "standard here is not the perfection of 20/20 hindsight," that even "the best managers must work with incomplete data and uncertain projections," and that "[f]airness entitles management decisions to a certain amount of deference"?

c. Please confirm that postal management, without resort to the formal results of a global test of whether the Postal Service's operating plan was or was not cost minimizing at any given historical point in time, can identify specific opportunities to improve efficiency going forward, can develop plans and commit resources to capture those cost savings, and can incorporate the effects of such cost reduction and productivity enhancing programs in the revenue requirement in postal rate cases submitted to the Postal Rate Commission. If you do not confirm, please explain fully.

Response:

a. The question misstates my position. I am not asking the Postal Service to perform any global test of economic efficiency, to prove that it is operating precisely at the margin of the efficiency frontier, or to disprove the existence of any of the myriad potential inefficiencies from which a firm may

Answer of ANM witness John Haldi
to USPS/ANM-T1-8

suffer. Determining whether a particular firm is operating at its efficiency frontier would require a precise specification of its production function. I doubt that the available data would ever permit an analyst to specify the exact production function of any real-world firm, let alone a firm as large and complex as the Postal Service. Even requiring the Postal Service to provide qualitative evidence of the absence of inefficiency in each facet of its operations would be asking the Service to disprove the existence of a needle in a \$69 billion-a-year haystack. Such a standard of perfection would be impossible to enforce or administer, and I do not propose that the Commission hold the Postal Service to it.

The efficiency analysis I propose is much more narrowly focused. Specifically, when another participant offers credible evidence that a particular aspect of the Postal Service's management or operations suffers from a significant inefficiency, the Service should have the burden of refuting this evidence. If the Postal Service fails to do so, the costs caused by the efficiency should be excluded from the Postal Service's revenue requirement, and should not be attributed to individual classes and subclasses of mail. This type of scrutiny is not dissimilar to the internal scrutiny routinely performed by well-managed businesses in the private sector, or the iterative process for improving Postal Service efficiency sketched out in part c of your question.

I also understand that other regulatory agencies have also applied a similar standard of scrutiny in enforcing the "honest, economical and efficiency" standard as embodied in other regulatory statutes for nearly a century. Under the existing regulatory standard, I understand that ratepayers and other intervenors bear the initial burden of coming forward with evidence of particular areas of inefficiency in the operation of the regulated monopoly. If they come

Answer of ANM witness John Haldi
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forward with such evidence, the regulated monopoly has an opportunity to defend itself and its practices. The standard thus demands credible evidence of inefficiency, and in no way holds the monopolist to a standard of perfection.

My testimony for ANM in this case identifies a significant area of inefficiency in the processing of flat-shaped mail. The unit costs of processing flat-shaped mail have risen in real terms for several years, as indicated by the inflation-adjusted unit cost data submitted in response to POIR No. 4. This trend alone is strong evidence of inefficiency: wage-adjusted unit costs should not increase for any product, especially an important product such as flats, for any prolonged period of time.¹ Moreover, the Postal Service's own witnesses and data have revealed several obvious explanations for this trend of rising costs: widespread shortages of space at Postal Service facilities (coupled with the extensive and prolonged utilization of annexes, with their admitted higher costs and inefficiencies), a widespread shortage of flat sorting capacity over a prolonged period of time, and massive reductions in the managerial ranks in tandem with reductions in the level of capital investment. With tell-tale data like

¹ The efficiency frontier depends upon the state of technology at any given time. Innovations tend to obsolete existing technology, and a characteristic of the efficiency frontier is that over time it either stays where it is (absent any technological change), or it expands. This means that the situation should remain unchanged or improve—certainly not get worse. To give a down-to-earth illustration of this somewhat theoretical discussion, if one looks back over the Postal Service's last 200 years, the efficiency frontier for transportation has undergone remarkable change, and the Postal Service has adapted (and continues to adapt) to such change. Horses and horse-drawn vehicles used for long-distance inter-city transportation of First-Class Mail were replaced with passenger trains during the latter half of the 19th century. In the 20th century, those passenger trains were replaced by trucks (for shorter hauls), along with airplanes (for longer hauls).

Answer of ANM witness John Haldi
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these, determining that the Postal Service has failed to engage in economical and efficient management hardly requires a cutting-edge econometric study.

b. The answer depends on the strength of the evidence of inefficiency. If the evidence of inefficiency is weak or equivocal, Postal Service management certainly should get the benefit of the doubt. Furthermore, as explained in preceding part a, I do not believe that the Commission should reduce the Postal Service's revenue requirement merely because the Service has failed to attain theoretical perfection. The inefficiency identified in my testimony, however, is neither ambiguous nor trivial nor merely theoretical. When the Postal Service persists in operating inefficiently in the face of clear signs that it is doing so (e.g., wage-adjusted unit costs that continue increasing), then the significance of this result for postal ratemaking should be—as it is in all other regulatory forums—for the Commission to reduce the revenue requirement by the amount of the established inefficiency. The practical results of such action will be (i) to relieve ratepayers of the burden of subsidizing the inefficiency, and (ii) to reduce the Postal Service's stated profits in Test Year which, through its EVA variable pay program, may reduce managerial bonuses, thereby holding management accountable for the results. The Postal Service will still have ample cash flow and borrowing authority to execute its operating plan.

c. Confirmed. And without resort to the formal results of a global test of whether the Postal Service's operating plan was or was not cost minimizing at any given historical point in time, management should also be able to measure unit costs, identify inefficiencies as they emerge, and take timely corrective actions going forward so as to recapture known levels of efficiency and bring inflation-adjusted unit costs back down to previous levels, so that such higher

Answer of ANM witness John Haldi
to USPS/ANM-T1-8

inflation-adjusted unit costs would not be incorporated into the revenue requirement in postal rate cases submitted to the Postal Rate Commission.

USPS/ANM-T1-9. With respect to your proposed "remedy" of a disallowance of 1.2 cents per unit of outside-county Periodicals mail:

a. Please clarify that this proposed amount is independent of any of the contested costing methodological issues in this proceeding, and that you would advocate its application regardless of the costing methodologies adopted by the Commission.

b. Please clarify which of the following most nearly describes your proposal:

(i) this amount constitutes what you believe the Commission should subtract from the unit costs, in addition to the cost savings (moving from the Base Year to the Test Year) already acknowledged by the Postal Service (either in its filing or in subsequent interrogatory responses), to reflect more fully the Postal Service's identified cost reduction programs, in order to arrive at a better estimate of what you believe *actual* Periodicals unit costs will be in the Test Year.

(ii) this amount constitutes what you believe the Commission should subtract from the unit costs, in addition to the cost savings (moving from the Base Year to the Test Year) already acknowledged by the Postal Service (either in its filing or in subsequent interrogatory responses), to reflect identified (by you or someone else) cost reduction programs (in addition to the cost reduction programs identified by the Postal Service), in order to arrive at a better estimate of what you believe *actual* Periodicals unit costs will be in the Test Year.

(iii) this amount constitutes what you believe the Commission should subtract from the unit costs, in addition to the cost savings (moving from the Base Year to the Test Year) already acknowledged by the Postal Service (either in its filing or in subsequent interrogatory responses), to reflect some as yet unidentified cost reduction programs (in addition to the cost reduction programs identified by the Postal Service), in order to arrive at a better estimate of what you believe *actual* Periodicals unit costs will be in the Test Year.

(iv) this amount constitutes what you believe the Commission should subtract from the unit costs, in addition to the cost savings (moving from the Base Year to the Test Year) already acknowledged by the Postal Service (either in its filing or in subsequent interrogatory responses) to reflect the Postal Service's identified cost reduction programs, in order to arrive at a better estimate of what you believe Periodicals unit costs hypothetically should be, regardless of what *actual* Periodicals unit costs will be in the Test Year.

c. Please confirm that the specific amount of the "remedy" (1.2 cents per unit) is based exclusively on your Tables 7 and 8, and its calculation is in no way related to any of the analysis you have presented in sections III or IV of your

Answer of ANM witness John Haldi
to USPS/ANM-T1-9

testimony. If you cannot confirm, please show mathematically exactly how any of the matters discussed in those sections affected the calculation of your "remedy."

Response:

a. First, I reemphasize that the wage-adjusted unit costs submitted in response to POIR No. 4 are the basis from which I developed my proposed remedy. I cannot attest to whether those costs were produced on a consistent methodological basis, but I would presume so. As such, the recorded increases in unit costs represent undeniable declines in productivity arising from the many problems discussed in my testimony.

Next, let me state that I draw a distinction between a "contested methodological" *issue* and a "contested methodological" *amount*. To my way of thinking, methodological issues include issues such as (i) the use of volume variable versus attributable costs, or (ii) the use of single subclass stop methodology for attributing city carrier street time. A contested *amount* would be a difference of opinion, for example, as to how much should be included in the Test Year for savings from the AFSM 100.

With these distinctions in mind, the answer is that my proposed remedy is independent of any of the contested methodological issues in this proceeding, as I am not concerned with reducing unit cost via some change in costing methodology. At the same time, however, it is not independent of some of the contested amounts (see my response to part b, *infra*, for further discussion on this point).

Answer of ANM witness John Haldi
to USPS/ANM-T1-9

b. Of the four choices proffered, your number (iv) comes closest to my proposal, which focuses on the standard of "honest, economical and efficient management"—i.e., what Periodicals unit costs ought to be under this standard, not what actual Periodicals unit costs will be in the Test Year. When the regulated monopolist can be shown to have failed to meet the above standard, it should not be allowed to recover the costs of inefficiency, even if actually incurred.

Let me clarify my position with respect to the question of what Periodicals unit costs ought to be in the Test Year. My response to USPS/ANM-T1-8 pointed out that the standard is not one of perfection. As shown in my testimony, Table 7, page 43, development of my remedy covered the years 1993 through Base Year 1998, while your question in (iv) raises the issue of cost savings from Base Year to Test Year. As pointed out in part a, supra, my proposed remedy is based on the decline in productivity and resulting increase in cost arising from failure of the Postal Service to meet the "honest, economical and efficient" standard. To the extent that the Postal Service has acknowledged its failings (either in its filing or in subsequent interrogatory responses) and has reflected cost reductions through its own increased productivity, it would amount to double counting to include my proposed remedy at the full amount along with these cost savings. Specifically, in Test Year the Postal Service is now belatedly installing additional flat sorting capacity to help overcome the accumulated shortfall since 1992. I suggest that all programmed cost savings for Periodicals from the AFSM 100s (some of which may also be included under "Equipment and Productivity Enhancement") be offset against my proposed remedy to ~~avoid~~ give the Service all benefit of doubt on this issue and avoid any possible double counting.

Answer of ANM witness John Haldi
to USPS/ANM-T1-9

c. The analysis in sections III and IV of my testimony show that the Postal Service has failed to meet the standard of "honest, economical and efficient" management, and that a remedy of the type which I propose is called for. The specific amount of my proposed remedy is developed in Table 7 and 8 of my testimony.

1 MR. LEVY: For the clarity of the record, the
2 correction was to page 3 of Question T1-9, or the answer to
3 that question.

4 [Feedback from microphone.]

5 CHAIRMAN GLEIMAN: That is the most meaningful
6 testimony we had so far in the case. But I am sure it is
7 going to get better. No offense to Mr. Buc or any of the
8 other witnesses.

9 Is there any other additional written --
10 designated written cross-examination for this witness?

11 [No response.]

12 CHAIRMAN GLEIMAN: If not, that brings us to oral
13 cross. The Postal Service is the only party that has
14 requested cross-examination of this witness.

15 Does anyone else wish to cross-examine the
16 witness?

17 [No response.]

18 CHAIRMAN GLEIMAN: If not, Mr. Reiter, it looks
19 like you have got the short straw again.

20 MR. REITER: Thank you, Mr. Chairman.

21 BY MR. REITER:

22 Q Dr. Haldi, page 11 of your testimony, would you
23 take a look at that, please? Specifically, line 11. You
24 refer there to monopoly power, is that correct?

25 A That is the phrase I used, yes, sir.

1 Q To what products does the Postal Service's
2 monopoly extend?

3 A It extends, my understanding, the monopoly, I am
4 not a lawyer, but my understanding is that it extends to all
5 address First Class mail and address Third Class mail.

6 Q In markets where the Postal Service has no
7 monopoly, does it have incentives to be efficient?

8 A One would hope so.

9 Q Does the Postal Service have a monopoly over
10 periodicals?

11 A Not to my knowledge, no.

12 Q If the Postal Service were inefficient in the
13 periodicals market, wouldn't there be competition?

14 A There was at one time, some budding competition,
15 but it, to my knowledge, doesn't exist any longer.

16 Q And if the Postal Service were inefficient in the
17 periodicals market, wouldn't there be an incentive for other
18 firms to enter that market?

19 A There definitely is an incentive.

20 Q But they haven't?

21 A To my knowledge they haven't as of yet.

22 THE REPORTER: Would you pull the mike a little
23 closer to you, Doctor. Thank you.

24 BY MR. REITER:

25 Q I would like to ask you some questions about flat

1 mail volume, specifically, non-carrier route presorted flat
2 mail volume. Could you tell me how predictable you believe
3 that that volume was during the 1990s?

4 A Forecastable, predictable, you mean year-to-year
5 basis?

6 Q Sure. Or over the entire period, either way.

7 A Well, I haven't examined Mr. Tolley's forecast to
8 see the level of error which was embodied in them, but I
9 believe it was about as predictable as many other subclasses
10 of mail.

11 Q So, you think --

12 A The periodicals component, I believe is
13 particularly predictable.

14 Q Yeah, I wasn't focusing just on periodicals.

15 A I understand that.

16 Q Yeah. I was talking about all flat mail.

17 A Yes.

18 Q So you think it was as predictable as anything
19 else?

20 A Yes.

21 Q Were there any changes in the classification and
22 rate structure during the '90s that had an effect on the
23 volume?

24 A Not to my knowledge.

25 Q What about the establishment of the letter-flat

1 differential in Docket Number R90, would that have affected
2 it?

3 A Only very modestly. It wasn't a very big
4 differential to start with.

5 Q Do you know whether it increased or decreased the
6 amount of non-carrier route flat volume?

7 A Offhand, I haven't reviewed those volumes lately.

8 Q Would you expect that it would have increased or
9 decreased the amount of uncertainty in trying to predict
10 that volume in the future once that change was implemented?

11 A I believe after the initial thrust it would settle
12 down and be as predictable as before.

13 Q During the '90s, did the establishment of the
14 enhanced carrier route subclass have any effect upon volume
15 trends?

16 A I believe the volume of the enhanced carrier route
17 subclass grew after its establishment.

18 Q Do you know whether the amount of non-carrier
19 route flat volume increased or increased?

20 A Offhand, I don't know.

21 Q And if I asked you the same questions about
22 saturation mail incentives or drop ship discounts, would
23 your answers be the same?

24 A In terms of the response to them, or the total
25 effect -- effect on total volume? I am not sure of the

1 question.

2 Q Well, whether -- well, I will ask them separately.
3 That's fair. Did the establishment of saturation mail price
4 incentives increase or decrease the amount of non-carrier
5 route flat volume?

6 A I am not offhand sure.

7 Q Would you expect that the introduction of such
8 incentives affected the uncertainty in trying to predict
9 those volumes at the time?

10 MR. LEVY: Mr. Chairman, I am going to object to
11 this line of questioning. This witness, in this testimony,
12 is not testifying about the contingency. The subject of his
13 testimony is an allegation of a long-term under-investment,
14 not short-term fluctuations.

15 MR. REITER: I am not asking about the
16 contingency, I am asking about facts and predictions that
17 are relevant to the witness' testimony on what investments
18 the Postal Service made or should have made in flat mail --
19 flat mail automation.

20 CHAIRMAN GLEIMAN: Why don't we let it go a little
21 while longer and see where the questioning is leading.

22 THE WITNESS: Can you repeat the question, please,
23 counselor?

24 BY MR. REITER:

25 Q My last question was with regard to saturation

1 mail price initiatives, and whether you thought that their
2 introduction would affect the uncertainty in trying to
3 predict non-carrier route flat mail volume in the future, in
4 the near future.

5 A I don't think it would have much impact because
6 the non-carrier route sort of serves a different market than
7 saturation, and I don't see a crossover between the two.

8 Q What about with regard to drop ship discounts?

9 A I don't see the drop ship discount affecting the
10 total volume. I think to the extent that non-carrier route
11 mail could take advantage of drop ship discounts, it would
12 do so. In fact, if anything, the drop ship discounts have
13 had the effect probably of increasing all volumes.

14 Q Going back to the letter/flat differential that
15 was introduced in R-90, do you recall what the Postal
16 Service predicted in terms of the letter/flat mix at that
17 time?

18 A No, I don't.

19 Q Do you know what actually happened?

20 A You means in terms of the --

21 Q The change in the mix?

22 A The change in the mix? No, I don't.

23 Q Would you look at your answer to our Question
24 Number 3, please?

25 [Pause.]

1 A All right.

2 Q I believe you said there that work-sharing has
3 relieved the Postal Service of the need for investment in
4 facilities and equipment; is that right?

5 A I believe, if there had not been work-sharing, and
6 the work-sharing that has occurred in the form of both
7 presortation and drop shipment had not occurred, the Postal
8 Service would have needed more facilities to process the
9 mail.

10 Q So it relieved the need for additional capital
11 investment then?

12 A I think, yes, it does.

13 Q As an economist, don't you normally associate
14 increases in efficiency with substituting capital for labor?

15 A Normally, that's what happens, yes.

16 Q Don't reduction in labor then reduce the
17 opportunity for increases in productivity?

18 A Not to my knowledge, no, not unless you reach some
19 extremely low level of employment.

20 Q Aren't the Postal Services key opportunities for
21 productivity increases in the area of mail distribution?

22 A I would imagine so.

23 Q So wouldn't opportunities for increases in
24 productivity be affected by the fact that more than half of
25 Standard Mail A is carrier route-presorted and avoids all

1 that distribution, a large percentage of First Class Mail
2 also?

3 A Could you say that again, please?

4 Q Yes, would the degree of that work-sharing that I
5 mentioned affect the Postal Service's opportunities for
6 increases in productivity in mail distribution?

7 A Only if you posit that there is some enormous
8 economies of scale, and that the amount of work-sharing
9 reduces the volume left to the point where they can't take
10 advantage of economies of scale, so that the investments
11 would not be economic, and I don't believe that to be the
12 case.

13 Q Well, I guess I wasn't asking if it eliminates
14 opportunity; simply whether it reduces them.

15 A It reduces the volume of mail that has to be
16 processed. I don't see that as reducing the opportunity to
17 process what's left more efficiently.

18 Q But if you're looking at mail volume overall, and
19 less of it is handled along the way, certainly as a
20 proportion, you'd have fewer opportunities there?

21 MR. LEVY: Objection, asked and answered.

22 CHAIRMAN GLEIMAN: Mr. Reiter, would you like to
23 try a different question?

24 MR. REITER: I don't think I asked that exact
25 question.

1 CHAIRMAN GLEIMAN: Well, I think you've asked Dr.
2 Haldi that question a couple of different ways, and I think
3 he's given you an answer.

4 BY MR. REITER:

5 Q Dr. Haldi, you used 1993 as a basis for your
6 productivity comparisons; is that right?

7 A That is correct.

8 Q Did anything unusual happen that year?

9 A Well, you got a new Postmaster General that year.

10 Q I believe it was the year before, but --

11 A Well, I believe he came in in the Summer of '92,
12 which was almost the beginning of Fiscal 1993.

13 Q That's true. And what else?

14 A What else unusual happened in 1993?

15 Q Yes.

16 A Well, they cut -- a lot of changes followed when
17 Mr. Runyon became Postmaster General. I'm not sure what
18 you're referring to.

19 Q Any that would be particularly relevant to your
20 productivity comparison?

21 A Well, the automation program was stopped, the R --
22 there was an internal reorganization of the Postal Service.
23 You have a reference to any specific thing?

24 Q Number of sub-employees?

25 A The management ranks were thinned considerably. I

1 think there was some thinning of the employees, a small
2 amount of thinning of the total employees.

3 Q A small amount?

4 A I don't know what the total effect was, but I know
5 the management ranks were rather decimated.

6 Q But you don't know what the amount of craft labor
7 reduction was?

8 A No.

9 Q Thank you.

10 MR. REITER: That's all I have.

11 THE WITNESS: It didn't last very long.

12 BY MR. REITER:

13 Q It didn't last long? why is that?

14 A Because they found they had to get the mail out,
15 and having cut back on investment, they had to add
16 employees.

17 Q In order to deliver the mail?

18 A In order to deliver the mail, correct.

19 MR. REITER: Thank you. That's all I have, Mr.
20 Chairman.

21 CHAIRMAN GLEIMAN: Is there any followup?

22 [No response.]

23 CHAIRMAN GLEIMAN: Questions from the Bench?
24 Commissioner LeBlanc?

25 COMMISSIONER LeBLANC: Dr. Haldi, just clarify for

1 me, if you will -- I feel like I've got a good grasp on it,
2 but just in your testimony where you say summary and purpose
3 of your testimony, at line 10 where you talk about the
4 Postal Service has failed utterly to delivery on its mandate
5 to provide mailers with economic and efficient management,
6 now having read that and then going through the whole
7 testimony, you seem to be focusing much more long-term than
8 in a short-term; am I right in that? Or, correct me if I'm
9 wrong in that.

10 THE WITNESS: Yes, sir, I view this as a continued
11 problem over a number of years, not just a one-time
12 happenstance event.

13 COMMISSIONER LeBLANC: But it's all tied in, as I
14 read your testimony, more to the automation side for the
15 flats, than anything else? Is that a fair characterization?

16 THE WITNESS: Yes, sir, I believe that's a fair
17 characterization.

18 COMMISSIONER LeBLANC: I just wanted to clarify
19 that. Thank you very much.

20 CHAIRMAN GLEIMAN: Commissioner Covington?

21 COMMISSIONER COVINGTON: Good morning, Dr. Haldi.
22 I'd like to follow up, primarily on what Commissioner
23 LeBlanc just asked you.

24 I notice that as the -- in a little background, as
25 things related to some of the testimony that you rendered

1 here in R97-1, that you were saying that from an efficiency
2 standpoint of view, your contention back then was that there
3 was probably an overall failure of proof on the part of USPS
4 that they were, I guess you would say, adequately managing
5 the financial resources that were being made available to
6 them at that time.

7 Would that probably still be your contention here
8 today, as it relates to Standard A, nonprofit mail possibly
9 being inflated and disproportionate to other classes of mail
10 in the system?

11 THE WITNESS: You're referring to the problems
12 with the costing system?

13 COMMISSIONER COVINGTON: Yes, the costing system.

14 THE WITNESS: Well, those problems run pretty
15 deep, yes, sir.

16 COMMISSIONER COVINGTON: Okay, and as Commissioner
17 LeBlanc stated earlier, where you mentioned inefficiency,
18 did you do any recent surveys of Alliance of Nonprofit
19 Mailer member organizations when it came to your actual
20 preparation and submission of your current testimony that
21 we're looking at today?

22 THE WITNESS: No, sir, we did not conduct any
23 formal surveys of our members.

24 COMMISSIONER COVINGTON: Okay, so primarily, I
25 guess what we have here is -- I guess when we look at the

1 testimony that you have submitted here to us today, that
2 this would pretty much reflect the opinions of the ANM
3 member organizations?

4 THE WITNESS: I believe so, yes, sir.

5 COMMISSIONER COVINGTON: Okay, thank you, Dr.
6 Haldi. That's all I have, Mr. Chairman.

7 CHAIRMAN GLEIMAN: Are there any followup
8 questions from the Bench?

9 [No response.]

10 CHAIRMAN GLEIMAN: If there are no followup to
11 questions from the Bench, Mr. Levy, that brings us to
12 redirect. Would you like some time with your witness?

13 MR. LEVY: If I may have a moment, Mr. Chairman?

14 CHAIRMAN GLEIMAN: Certainly.

15 [Recess.]

16 MR. LEVY: No questions.

17 CHAIRMAN GLEIMAN: That being the case, Dr. Haldi,
18 that completes your testimony here today. We appreciate
19 your appearance, your contributions to the record. You are
20 excused for today, and I suspect we will see you again
21 sometime over the next couple of weeks.

22 THE WITNESS: Thank you.

23 [Witness excused.]

24 CHAIRMAN GLEIMAN: What I would like to do at this
25 point is take a 10 minute break and then we are going to

1 come back and we are going to pick up the next two
2 witnesses, our OCA witnesses, and we will proceed with them.

3 [Recess.]

4 CHAIRMAN GLEIMAN: Ms. Dreifuss, it looks like all
5 the key people are here, so whenever you are ready, you can
6 introduce your witness.

7 MS. DREIFUSS: Thank you, Mr. Chairman. The OCA
8 presents its first witness, Robert E. Burns.

9 MR. BURNS: My name is Robert Edward Burns.

10 CHAIRMAN GLEIMAN: One moment, please.

11 MS. DREIFUSS: Oh, I guess I jumped ahead of you,
12 I am sorry.

13 CHAIRMAN GLEIMAN: That's okay. We want the
14 testimony to count.

15 MR. BURNS: Ah, very good.
16 Whereupon,

17 ROBERT EDWARD BURNS,
18 a witness, having been called for examination and, having
19 been first duly sworn, was examined and testified as
20 follows:

21 DIRECT EXAMINATION

22 BY MS. DREIFUSS:

23 Q Could you state your name again, please?

24 A Robert Edward Burns.

25 Q And your position?

1 A Senior research specialist at the National
2 Regulatory Research Institute of the Ohio State University

3 Q Mr. Burns, do you have before you two copies of a
4 document captioned "Direct Testimony of Robert E. Burns,
5 OCA-T-2"?

6 A Yes, I do.

7 Q Did you prepare this testimony or was it prepared
8 under your direct supervision?

9 A Yes, it was.

10 Q Do you adopt this as your testimony today?

11 A Yes, I do.

12 MS. DREIFUSS: In that case, I will hand two
13 copies to the reporter and ask that it be transcribed into
14 the record and entered into evidence, Mr. Chairman.

15 CHAIRMAN GLEIMAN: Is there any objection?

16 [No response.]

17 CHAIRMAN GLEIMAN: Hearing none, if counsel would
18 please provide the two copies, I will direct that the
19 reporter transcribe the material into the record, and it
20 will be admitted into evidence.

21 [Direct Testimony of Robert Edward
22 Burns, OCA-T-2, was received into
23 evidence and transcribed into the
24 record.]

25

**OCA-T-2
Docket No. R2000-1**

**DIRECT TESTIMONY
OF
ROBERT E. BURNS

ON BEHALF OF
THE OFFICE OF THE CONSUMER ADVOCATE**

MAY 22, 2000

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

Postal Rate and Fee Changes, 2000)

Docket No. R2000-1

DIRECT TESTIMONY
OF
ROBERT E. BURNS

1 I. STATEMENT OF QUALIFICATIONS

2 My name is Robert E. Burns. I am a Senior Research Specialist and one of two
3 attorneys at the National Regulatory Research Institute (NRRI), which is the research
4 and public service organization for the National Association of Regulatory Utility
5 Commissioners (NARUC). The Postal Rate Commission is a federal member of
6 NARUC and has been since 1971. The NRRI was established by NARUC at the Ohio
7 State University with the purpose of providing NARUC members, both state and federal,
8 with neutral and objective public policy research on matters such as ratemaking. In that
9 capacity, members of NRRI are occasionally retained by NARUC-member regulatory
10 agencies to present evidence in proceedings before those agencies. I am a Phi Beta
11 Kappa graduate of Marietta College, as well as a graduate of The Ohio State University
12 College of Law. I have over twenty-one years of public utility and public policy research
13 experience, with the last twenty being at the NRRI. I have written fifty major NRRI
14 reports, including studies dealing with average and marginal cost of service issues. I
15 am also the principal author of the NRRI report on *The Prudent Investment Test*, a

Docket No. R2000-1

OCA-T-2

1 report, which, among other things, deals with incentives for honest, efficient, and
2 economical management.

3 I have previously testified before the Federal Energy Regulatory Commission,
4 the Mississippi Public Service Commission, and, most recently before the Arizona
5 Corporation Commission as a staff witness, on July 16, 1998, In the Matter of the
6 Proposed Agreement Between the Arizona Public Service Company and the Salt River
7 Project. ACC Docket No. E-01345A-98-0245.

8 II. PURPOSE AND SCOPE OF TESTIMONY

9 My testimony will explore the purposes of "a reasonable provision for
10 contingencies" being included as a statutory item in the revenue requirement under the
11 Postal Reorganization Act, 39 U.S.C. §3621, so that the Postal Rate Commission might
12 judge for itself whether the contingency reserve proposed by the Postal Service
13 exceeds the amount that would be reasonable. In order to examine whether the
14 contingency is reasonable, I will explore the purpose of the Postal Service's
15 contingency reserve and will relate that to the purpose that a contingency rate reserve
16 serves in another industry where it is used, the insurance industry. I show that a
17 contingency reserve cannot be adjudged to be reasonable without some justification
18 stemming from an assessment and systematic analysis of the risks that the contingency
19 reserve is expected to protect the Postal Service against. Relying solely on
20 management discretion to pick the contingency reserve will not guarantee its
21 reasonableness. I also review the standards applied by the Postal Rate Commission in
22 reviewing contingency requests, and examine the adequacy of the reasons given for

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1 the 2.5 percent contingency, which amounts to \$1.68 billion in the test year, by the
2 Postal Service's witness on this subject, William P. Tayman. My colleague, Dr. Edwin
3 Rosenberg, will suggest an assessment and systematic analysis by which the
4 Commission can judge the reasonableness of the contingency reserve in this case.

5 III. THE CONTINGENCY MUST BE REASONABLY RELATED TO FUTURE
6 UNCONTROLLABLE EVENTS

7 The purpose of the contingency is to cover "expenses which could be neither
8 foreseen nor prevented through the exercise of honest, efficient, and economical
9 management. . ." PRC Op. R76-1 at 52. Stated another way, the purpose of a
10 contingency is to cover expense which are unexpected in their magnitude and are
11 uncontrollable, that is, beyond the control of management; or to cover expenses that
12 are unforeseen and unforeseeable and beyond the control of management. After all,
13 honest, efficient, and economical management will make every reasonable effort to
14 control those costs that are foreseen and foreseeable. Expected and foreseeable costs
15 are captured in the Postal Service's forecast of future costs. In particular, "[t]he
16 contingency allowance is . . . designed to offset the effects of misestimates in the test
17 year relating to revenue and costs." PRC Op. R77-1 at 29.

18 Contingency reserves are used by the insurance industry for the same purpose,
19 that is, to offset the effects of misestimates relating to revenue and costs. Here the
20 contingency reserve is generally referred to as a catastrophe reserve. The National
21 Association of Insurance Commissioners ("NAIC") recommends that a separate
22 component of insurance premiums cover catastrophic hazards, including unusual
23 floods, wind, or storm damage, and large fires, where the loss may exceed \$1 million.

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1 The position of the Financial Accounting Standards Board is that a contingency
2 reserve or catastrophic reserve for insurance is improper unless related to a current
3 obligation or liability of the reporting company, that is, insurance in force. If there is no
4 connection made between the future sacrifice (represented by the reserve) and some
5 past transaction or event (the risks actually insured for), the reserve is tantamount to
6 improperly attempting to smooth out irregularities or volatility in earnings. In other
7 words, for a contingency reserve to be proper and reasonable, it must be tied to a duty
8 to pay for events that have not occurred, but for which there is a projected probability of
9 occurrence. Indeed, California Insurance Regulations, Title 10, Section 2644.5, require
10 that any loading for catastrophic losses must be based on a multi-year, long-term
11 average of catastrophic claims with the number of relevant years set by the regulator.

12 In other words, in the insurance industry a contingency will permit the insurance
13 industry to collect monies for those years that a greater number of losses occur than
14 are forecasted. For example, for a year when a greater number than expected
15 hurricanes make landfall or for a year with a Hurricane Andrew. Otherwise, a
16 contingency reserve, if any is allowed, will be included in the profit allowance.

17 The Postal Rate Commission in endorsing variance analysis as a sound
18 analytical tool, does not rely solely on that tool to the exclusion of other factors. The
19 Commission will apply other pertinent factors to the variance analysis, "such as the
20 financial condition of the Postal Service, the state of the economy, the causes of the
21 variances, and such other relevant factors which may arise [that] must be considered in
22 arriving at a contingency provision." PRC Op. R 80-1, ¶0112 (citations omitted).

1 There has been for some time movement away from contingency reserves that
2 are not based on the likelihood of a future event. In the 1984 NAIC Study of Investment
3 Income, the NAIC Task Force stated, "Estimates of losses, expenses, and investment
4 income are used by insurers in combination with overall profit objectives to determine
5 the price at which its policy will be written. . . . The addition of a contingency provision
6 to a target return based upon . . . the relative risk is not necessary. . . ."¹

7 The implication that this has for the Postal Service and the Postal Rate
8 Commission is the contingency provision should, to the maximum extent possible, be
9 tied to the possibility that its expense and revenue forecasts contain misestimates.
10 These "variances, between estimated and actual results 'will occur as a result of errors
11 in assumptions underlying projections contained in the rate filing estimates arising from
12 unforeseen events and/or errors in forecasting techniques. . . .'" PRC Op. R80-1,
13 ¶0110. Indeed, the Postal Rate Commission has concluded that "historical variance
14 analysis supplemented by other pertinent factors is a proper and feasible procedure to
15 employ in establishing a reasonable contingency provision." PRC Op. R77-1 at 31.
16 And, the Commission has found "appropriate the utilization of variance analysis as a
17 starting point in evaluating the Postal Service's contingency request." *Id.* at 33.

18 The approach to a contingency reserve taken by the insurance industry also
19 indicates that, unless the Postal Service's proposed contingency reserve is related in
20 some fashion to future, uncontrollable events, it is merely a device to even out
21 controllable expenses. Under Financial Accounting Standards, such a device would be

¹ NAIC Study of Investment Income, Supplement to the NAIC Proceedings, vol. II, at 9 and 25 (1984).

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1 considered part of the profit allowance in the insurance industry. Of course, the Postal
2 Service is required to operate on a break-even basis, so such a profit would not be
3 allowed. This underscores the importance of the Postal Service relating its contingency
4 request to future, uncontrollable events.

5 Other experiences in regulated industries underscore the importance of tying a
6 contingency reserve to possible future, uncontrollable events. We can learn from the
7 utility regulatory experiences with fuel adjustment, purchased power adjustment, and
8 purchased gas adjustment clauses. Where managers are sheltered from the effects of
9 future events, they make less effort to take actions to control costs. In the case of
10 purchased fuel, purchased power, and purchased gas subject to automatic adjustment
11 clauses, public utilities tend to be mediocre negotiators of price, because any price that
12 they pay is passed through to the ratepayers. The automatic adjustment clauses thus
13 cushion the managers from the consequences of failing to control controllable costs.
14 Indeed, public utility managers of utilities with such automatic adjustment clauses have
15 tended not to hedge risks of purchased fuel, purchased power, and purchased gas,
16 even where futures and other hedging mechanisms exist, because there is no
17 advantage to be gained.

18 A larger than necessary contingency reserve creates a similar perverse
19 managerial incentive. Managers cushioned from the consequences of controlling costs
20 will tend not to act as aggressively to cut costs and waste. They become lax. This
21 could, and likely would, happen for Postal Service managers if the contingency reserve
22 were raised to a level that exceeds reasonable provision for future, uncontrollable

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1 events and thus acts to cushion managers from the consequences of failing to curb
2 controllable risks.

3 These general precepts are consistent with the Commission's approach to
4 reviewing the Postal Service's contingency request. From the outset, the Commission
5 has evaluated the contingency in light of prevailing national economic conditions and
6 the degree of economic stability present.² The Commission has long considered the
7 contingency to serve the dual role of providing a "cushion against unforeseeable
8 events,"³ including unfavorable financial events, and compensating for forecasting
9 errors.⁴ The Postal Service's contingency request must be supported by substantial
10 evidence, and Postal Service management's subjective perception of risks must be
11 reasonably articulated.⁵ In all cases, review of variance analysis serves as a tool to
12 guide the final decision.⁶ The Commission's prior decisions suggest that evaluation of
13 the Postal Service's contingency request rests upon (1) careful evaluation of the Postal
14 Service's explanation of subjective management judgment; (2) an objective review of
15 potential forecasting errors; and (3) consideration of external factors such as key
16 national economic indicators and economic stability. I will discuss the first of these
17 three areas, the Postal Service's subjective management judgment. My colleague, Dr.
18 Edwin Rosenberg, will address the review of potential forecasting errors through

² PRC Op. R76-1 at 56.

³ PRC Op. R80-1, ¶0109.

⁴ *Id.*, ¶ 0110.

⁵ PRC Op. R87-1, ¶¶ 2072-73.

⁶ PRC Op. R80-1, ¶¶ 0112, 0115.

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1 variance analysis and the consideration of external economic factors. Dr. Rosenberg
2 will also present a specific recommendation for the appropriate contingency to be
3 recommended in this case.

4 IV. THE POSTAL SERVICE HAS NOT ARTICULATED A REASONABLE BASIS
5 FOR ITS SUBJECTIVE JUDGMENT

6 It is clear from the history of Commission proceedings that the Postal Service
7 cannot justify a contingency reserve as being reasonable simply because management
8 deems it so. Yet that is what the Postal Service has done in this case. The testimony
9 of Postal Service witness Tayman makes various general observations on risks facing
10 the Postal Service, all of which witness Tayman frankly characterizes as subjective and
11 not based on specific evaluation of individual factors.⁷ Witness Tayman presents a
12 variance analysis "[i]n deference to the Commission's desire to evaluate forecast
13 errors,"⁸ but expressly disavows any reliance on such an analysis.⁹ Therefore, witness
14 Tayman's evidence must be judged as primarily being a subjective articulation of
15 management's perception of unforeseeable and uncontrollable risk. While such
16 evidence is permitted, "management's perception of those risks must be articulated to
17 a reasonable degree in order to satisfy the substantial evidence requirement." PRC
18 Op. R87-1, ¶2073.

⁷ Tr. 2/385-86 (witness Tayman's response to interrogatory OCA/USPS-T9-43), *id.* at 280 (response to interrogatory DMA/USPS-T9-15), and *id.* at 304 (response to interrogatory DMA/USPS-T9-47).

⁸ USPS-T-9 at 44.

⁹ "[M]anagement must be allowed to assume its responsibility to determine the amount of contingency most appropriate for achieving its goals." *Id.* at 45.

1 Review of witness Tayman's discussion shows that management's request has
2 not been sufficiently well-articulated to permit the Commission to place dispositive
3 reliance upon management's subjective judgment. Mr. Tayman devoted less than two
4 pages—and no supporting information, data, or studies—to justify the \$1.68 billion
5 annual revenue that the contingency represents.¹⁰ A review of Mr. Tayman's points
6 shows that the necessary substantial evidence is lacking.

7 *Recent financial performance.* Mr. Tayman states that recent financial
8 performance "has not been as favorable as in the mid 1990's," that FY 99 fell short of
9 plan, and that the Postal Service spent more than expected on Y2K remediation.¹¹ But
10 the Postal Service finished FY 99 in the black, with net revenue of \$363 million dollars.¹²
11 This was achieved despite spending \$88.6 million on Y2K resolution in FY 1998,
12 \$267.0 million in FY 1999, and an estimated \$42.6 million in FY 2000.¹³ This latter point
13 is a very good example of the sort of expense that a contingency can cope with. It was
14 known many years ago that the transition of computer systems to year 2000 would
15 present remediation problems, but due to the unique nature of the problem, the Postal
16 Service did not have a track record of reliable forecasting. Yet the Postal Service

¹⁰ See USPS-T-9 at 43-44.

¹¹ *Id.* at 43.

¹² 1999 Cost and Revenue Analysis, LR-I-275, filed April 4, 2000.

¹³ Tr. 2/278 (response of witness Tayman to interrogatory DMA/USPS-T9-13).

1 handled this future, largely uncontrollable event with the one percent contingency that it
2 requested and was granted in Docket No. R97-1.¹⁴

3 *Volume growth.* Mr. Tayman states that volume growth is below historical norms
4 and that the Postal Service plans a 1.5 percent workyear reduction in the test year.¹⁵
5 This is not an area outside of the Postal Service's control. To the contrary,
6 management is in a unique position to monitor and achieve the planned workyear
7 reduction.

8 *Other Uncertainties; salaries and benefits.* Witness Tayman next cites
9 unspecified "other uncertainties" and states that there "appear to be significant new
10 pressures on salary and benefit cost levels."¹⁶ Vague references to "other
11 uncertainties" does not provide the Commission with any evidence, much less
12 substantial evidence, on which to decide whether management has articulated that it
13 has made a rational, albeit subjective, choice. "New pressures" on salary and benefit
14 levels is not persuasive either. Management has input into the salary levels that will be
15 provided. Salary changes do not present the Postal Service with completely
16 uncontrollable risks.

¹⁴ Indeed, in requesting the one percent contingency in that docket, Mr. Tayman did not specify the uncertainty of the Y2K computer problem or, for that matter, any other potential risk then perceived by the Postal Service. Docket No. R97-1, USPS-T-9 at 38. To the contrary, Mr. Tayman there spoke only of recent financial success, current favorable economic climate, and management's concern about the effect of the contingency on rate levels. *Id.*

¹⁵ USPS-T-9 at 43-44.

¹⁶ *Id.* at 44.

1 *Health benefit costs.* Witness Tayman next cites health benefit cost increases at
2 "near double digit rates."¹⁷ Once again, indices and forecasts exist for such costs, and
3 they are not completely outside of management influence.

4 *Labor contracts.* The next point made by witness Tayman is that "labor contracts
5 which have become effective since the last rate filing are significantly more costly than
6 previous contracts."¹⁸ Of course, contracts that have become effective reflect known or
7 foreseeable costs that should be incorporated into the Postal Service's cost roll forward
8 to the test year. Only labor contracts not yet entered into for the test year present
9 uncertainty. Even here, however, the Postal Service has included an allowance for
10 increased costs, using available indices such as the Employment Cost Index. This
11 again is an area in which management at least has some input into the costs that result
12 from new contracts.

13 *Competition.* The final argument made by witness Tayman is that the Postal
14 Service operates in an "increasingly competitive environment," citing Internet diversion
15 of transaction, correspondence, and advertising mail; potential legislative limitations;
16 and foreign postal operations.¹⁹ With respect to the Internet, the Postal Service
17 presented detailed volume forecasts that took trends, including diversion of mail trends,
18 into account through the test year.²⁰ There is uncertainty about whether electronic

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ See, e.g., USPS-T-6 at 19 and 160-62.

1 diversion will accelerate in the future, but witness Tayman presented nothing more than
2 one sentence speculating that the Internet may "be making inroads" into mail volume.
3 More is required to articulate a rational choice of the level of the contingency.

4 Concerning legislative limitations, the Postal Service has endorsed pending
5 legislation that would change the nature of the rate-setting process significantly and
6 provide substantially more flexibility for the Postal Service to adapt to change. The
7 potential for a beneficial outcome appears to be at least as favorable as the potential of
8 a negative outcome. This hardly supports allowance of \$1.68 billion for adverse,
9 uncontrollable events. Finally, the incursion of foreign postal administrations is not
10 explained. The Commission cannot place decisional reliance on a bare and
11 unexplained assertion.

12 V. CONCLUSION

13 My review of the risk factors presented by witness Tayman lead me to conclude
14 that the Postal Service has failed to articulate a rational connection between potential
15 uncontrollable risks in the test year and the \$1.68 billion annual contingency request. I
16 concur with the recommendation of my colleague, Dr. Rosenberg, that the contingency
17 be kept at one percent.

1 CHAIRMAN GLEIMAN: Mr. Burns, have you had an
2 opportunity to examine the packet of designated written
3 cross-examination that was made available to you earlier
4 today?

5 THE WITNESS: Yes, I have.

6 CHAIRMAN GLEIMAN: And if these questions were
7 asked of you today, would your answers be the same as those
8 you previously provided in writing?

9 THE WITNESS: Yes, they would.

10 CHAIRMAN GLEIMAN: There are no corrections or
11 additions?

12 THE WITNESS: No.

13 CHAIRMAN GLEIMAN: That being the case, counsel,
14 if you would please provide two copies of the designated
15 written cross-examination of Witness Burns to the reporter,
16 I will direct that the material be received into evidence
17 and transcribed into the record.

18 [Designation of Written
19 Cross-Examination of Robert Edward
20 Burns, OCA-T-2, was received into
21 evidence and transcribed into the
22 record.]

23
24
25

BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, DC 20268-0001

Postal Rate and Fee Changes, 2000

Docket No. R2000-1

DESIGNATION OF WRITTEN CROSS-EXAMINATION
OF OFFICE OF THE CONSUMER ADVOCATE
WITNESS ROBERT E. BURNS
(OCA-T-2)

Party

Newspaper Association of America

United States Postal Service

Interrogatories

USPS/OCA-T2-1-6, 8-9

USPS/OCA-T2-1-9

Respectfully submitted,


Cyril J. Pittack
Acting Secretary

ANSWER OF OCA WITNESS ROBERT E. BURNS
TO INTERROGATORIES USPS/OCA-T2-1-9

USPS/OCA-T2-1. Please refer to your discussion of the insurance industry at pages 3-4 of your testimony.

- a. Are insurance companies and utilities are [sic] allowed to earn profits?
- b. Do those insurance companies that earn profits have positive equity?
- c. Does positive equity provides [sic] a cushion against unforeseen events?

RESPONSE TO USPS/OCA-T2-1:

a. Yes. Insurance companies and investor-owned utilities are allowed to earn profits; however, the allowed rate of return of each company, which includes its return on equity, that is, its profit, is regulated. It should be noted, however, that the vast majority of utilities in number are municipal utilities, cooperatively-owned utilities, and federal power authorities that are not-for-profit.

b. Usually yes. Most typically, an insurance company or any other company that earns a profit has positive equity; however, it is possible for an insurance company or any other company or entity to earn a profit in any individual year and yet have negative equity. The latter can happen whenever an insurance company's or any other entity's income exceeds its expenditures for the individual year, while its balance sheet is negative. However, an insurance company is expected to maintain a positive equity to maintain capital adequacy. The latter is necessary for a Standard & Poor's Rating of BBB or better.

c. Yes, positive equity provides a cushion against unforeseen events. This cushion is in addition to the initial cushion of a contingency reserve.

ANSWER OF OCA WITNESS ROBERT E. BURNS
TO INTERROGATORIES USPS/OCA-T2-1-9

USPS/OCA-T2-2. Please refer to page 2, lines 19-20, of your testimony, where you state: "Relying solely on management discretion to pick the contingency reserve will not guarantee its reasonableness." Also refer to the Postal Service responses to OCA Questions 1-3 on the Contingency filed on May 17, 2000.

- a. What approach to contingency selection will "guarantee" reasonableness?
- b. Is it your testimony that the Postal Service did no analysis and relied solely on management discretion in determining the size of the contingency? If your answer is yes, please explain fully.
- c. Do you believe any management discretion is appropriate in determining the size of the contingency? If your answer is no, please explain.

RESPONSE TO USPS/OCA-T2-2:

a. As the Postal Rate Commission has stated in the past, a reasonable result in establishing a contingency reserve is much more likely (that is, the reasonableness of the approach for picking the contingency reserve is better guaranteed) when the methodology begins with an objective analysis of the volatility of the forecasted cost variables contained in the proposed rates. Such an analysis was performed by Dr. Edwin Rosenberg in his testimony.

b. Since the Postal Service refused to provide the documents underlying the Tayman testimony, I am, therefore, unable to answer whether the Postal Service conducted an objective analysis of the volatility of its forecasted cost variables. I am also unable to answer whether the Postal Service relied at all on any objective analysis that they may or may not have performed. Thus, due to problems related to asymmetry of information, I am unable to state whether the Postal Service did any objective analysis and whether or not they relied solely on management discretion in determining the size of the proposed contingency. However, given the recommended contingency

ANSWER OF OCA WITNESS ROBERT E. BURNS
TO INTERROGATORIES USPS/OCA-T2-1-9

rate of 2.5 percent, the admitted lack of any set objective framework for reaching this contingency, and witness Tayman's statements that the determination of the contingency involves a subjective evaluation that is not based on specific evaluation of individual factors, it appears that the Postal Service relied very heavily, if not solely, on management discretion, that is, managerial gestalt, in determining the size of the proposed contingency.

c. Yes, management discretion can play a role in determining the size of a reasonable contingency reserve; but only after an objective analysis of the volatility of the forecasted cost variables has been completed. Again, Dr. Edwin Rosenberg has preformed such an objective analysis for the Postal Rate Commission, while Mr. Tayman's testimony contains no such analysis. Even so, to be useful, management's discretion must be clearly articulated and must either support a result consistent with the objective analysis or must clearly support (that is, support through clear and convincing evidence) why a reasoned contingency reserve should vary from the result indicated by the objective analysis. However, determinations that heavily or solely rely on management discretion, without having as a starting point an objective analysis of the variability of the future costs, can not be relied upon as being reasonable.

ANSWER OF OCA WITNESS ROBERT E. BURNS
TO INTERROGATORIES USPS/OCA-T2-1-9

USPS/OCA-T2-3. Please refer to page 3, lines 18-19, of your testimony where you state: "Contingency reserves are used by the insurance industry for the same purpose, that is, to offset the effects of misestimates relating to revenue and costs."

a. What percentage of total costs, including the amount to cover catastrophic hazards such as floods and storm damage, are typically used for contingency reserves in the insurance industry? Please provide the source of your answer.

b. Please confirm the fact that hurricanes and other catastrophes will occur in the future is known. If you do not confirm, please explain why.

c. Please confirm that the number and severity of such catastrophes that will occur in the future is unknown. If you do not confirm, please explain fully.

RESPONSE TO USPS/OCA-T2-3:

a. The question as phrased does not lend itself to a ready answer because there is no standard definition of total costs for the insurance industry. Keeping that in mind, if one were to presume that a property and casualty insurance company had a combined ratio of approximately 100 percent of premiums, which is about typical, then the typical loss ratio or loss reserve would be between 60% to 80% of premiums. That might be considered equivalent to 60% to 80% of total costs. See *Standard & Poor's Insurance Property Casualty Industry Survey* (New York: McGraw-Hill, 1999), 22. The contingency reserve is rolled in as a part of this loss ratio or loss reserve.

In a recent article, "Enhanced Criteria To Evaluate European Insurers' Capital Adequacy,"

<http://www.standardandpoors.com/ratings/criteria/insurance/enhanced/enhancedcrit.htm>, what I refer to as a contingency reserve is closely related to what is referred to in the article as a reserve risk. As defined in the article, reserve risk arises from the possibility that the actual cost of claims will vary from the expected cost reflected in the currently

ANSWER OF OCA WITNESS ROBERT E. BURNS
TO INTERROGATORIES USPS/OCA-T2-1-9

reported loss reserve. The reserve risk does not address the adequacy of current reserves. Rather, it measures the expected variability in reserve levels and the capital required to finance the reserve. These variations result from deviations from the expected level of frequency and severity of losses, which can be exacerbated by changes in economic, legal, and social conditions. According to the article, the reserve charges for property loss would be 22 percent of the loss reserves, net of reinsurance recoverable.

Putting these two articles together, the contingency reserve portion of the premiums would be approximately 13 percent to 18 percent of the total premiums. One must keep in mind, however, that the business of a property and casualty insurance company is insuring against risk. As such, one would expect a reasonable contingency reserve for an insurance company to be much larger than what would be a reasonable contingency reserve for the Postal Service.

My discussion of the contingency reserves established by the insurance industry was not for the purpose of saying that the *size* of insurance reserves was in any way analogous to the size of appropriate Postal Service reserves. Rather, I cited the insurance industry as a model of the *method* that the Postal Service should use to determine accurately the size of its needed contingency reserve. The uncertainties associated with any particular industry and its ability to control costs and revenues are unique to each industry.

It would be naive to imagine that the obligations of the insurance industry, which determine the size of the reserves they require, would be directly applicable to the

ANSWER OF OCA WITNESS ROBERT E. BURNS
TO INTERROGATORIES USPS/OCA-T2-1-9

Postal Service. The Postal Service has a number of safety nets that witness Rosenberg discusses in his testimony, e.g., the provision for recovery of prior years' losses and management's ability to control expenses, that are not available to the insurance industry. The latter point is important—the insurance industry has no control over the catastrophes for which it promises compensation to its policyholders. The Postal Service, on the other hand, has considerable control over its revenues and costs.

The point that I make in my testimony is that the insurance industry's method of estimating its future liability is far superior to that employed by the Postal Service, *i.e.*, a "connection [is] made between the future sacrifice (represented by the reserve) and some past transaction or event (the risks actually insured for)" and, further, there must be a "projected probability of occurrence." I also point out that "any loading for catastrophic losses must be based on a multi-year, long-term average of catastrophic claims with the number of relevant years set by the regulator." OCA-T-2 at 4. In my opinion, the Postal Service has failed to perform the type of probability analysis and quantitative assessment that the insurance industry performs and which I cite at page 4 of my testimony. I also note in my testimony that to the extent the Postal Service performs a variance analysis, it does not base its contingency proposal upon the analysis but disavows it.

b. Yes, it is known that Atlantic hurricanes and other natural catastrophes have occurred in the past and will occur in the future.

ANSWER OF OCA WITNESS ROBERT E. BURNS
TO INTERROGATORIES USPS/OCA-T2-1-9

c. While the number and severity of such catastrophes that will occur in the future is not exactly known, there are forecasting groups that forecast the number and severity of catastrophes such as Atlantic hurricanes, earthquakes, land/mudslides, and flood occurrences.

In the case of Atlantic hurricanes, the Colorado State University Hurricane Forecasting Team, led by Professor William Gray, has been issuing annual Atlantic hurricane predictions since 1994. Professor William Gray's most recent prediction for the 2000 Hurricane Season is for 12 named storms, 8 hurricanes, and 4 major hurricanes. The team is also predicting that the probability of one or more major hurricanes (Saffir-Simpson Category I, II, or III) coming ashore along the U.S. coastline is 71 percent. Thus, particularly within the last ten years, forecasting methods have been developed and put in place to better understand the variables that influence natural catastrophes, so that steps can be taken to mitigate the resultant damage and loss of life. My point here is this, during the last ten years, forecasting methods have also become available for the Postal Service to use to make an objective analysis of variables that could affect its future costs as well as to allow the Postal Service to bring those costs under control, through risk mitigation and/or prudent and efficient management. Before one can understand future costs, so that a reasonable contingency can be set at a level that mitigates uncontrollable risk while it provides management with an incentive to minimize costs, one must be able to conduct an objective analysis of the volatility of the forecasted cost variables. No such analysis is contained in the testimony of the Postal Service.

ANSWER OF OCA WITNESS ROBERT E. BURNS
TO INTERROGATORIES USPS/OCA-T2-1-9

USPS/OCA-T2-4. How much "profit allowance" is typically included in insurance rates? Please provide your sources.

RESPONSE TO USPS/OCA-T2-4:

Finding the "profit allowance" in insurance rates would require contacting each individual state insurance commission, an activity I did not undertake. Instead, I provide an estimate of the actual earned profit included in insurance rates. The actual earned profit included in insurance rates (insurance premiums) is typically very small, if not negative. My best property-casualty industry-wide estimate is between -3% and 4%. Here is how the calculation was done. *Best's Key Rating Guide, Property-Casualty* (Oldwick, NJ: A.M. Best, ed. 1999), inside cover, states that the pretax return on revenues (a measure of a company's operating profitability) is calculated as pretax operating income divided by net premiums earned. This figure is normally between 3% to 10%. However, to find an estimate of the actual profit that is included in insurance rates, it is necessary to net out the net investment yield. According to *Standard & Poor's Industry Survey, Casualty Insurance* (New York: McGraw-Hill, 1999), 19, the typical net investment yield for casualty insurance is 6%. After netting out the net investment yield, one is left with an estimated actual earned profits of -3% to 4% being included in insurance rates

ANSWER OF OCA WITNESS ROBERT E. BURNS
TO INTERROGATORIES USPS/OCA-T2-1-9

USPS/OCA-T2-5. Please refer to page 7, lines 10-11, of your testimony where you state: "Postal Service management's subjective perception of risks must be reasonably articulated." Please also refer to pages 43-46 of USPS-T-9.

a. Is it your testimony that Postal Service management's subjective perception of risks related to the contingency is not reasonably articulated in USPS T-9? If your answer is yes, please explain fully.

b. With reference to past contingency amounts proposed by the Postal Service and accepted by the Commission, please explain which ones were reasoned and which ones were not reasoned, and why.

c. For any previous contingency amounts considered by you to be reasoned, please explain how the support provided by the Postal Service for such contingency amounts differs from the support provided for the contingency in this docket which you say is not reasoned.

RESPONSE TO USPS/OCA-T2-5:

a. Yes. First, the Postal Service management's subjective perception of risks related to the contingency cannot be reasonably articulated unless it has some objective starting point. Without an objective analysis as a starting point, subjective perceptions of risk lack context. No such objective analysis of risk has been presented by the Postal Service witness. Second, where witness Tayman does present a variance analysis, he expressly disavows any reliance on the analysis, so that he relies totally on management's subjective judgment, which is not based on specific evaluation of individual factors. Third, the one formerly uncontrollable factor that witness Tayman cited, the Y2K remediation costs, did not prevent the Postal Service from finishing FY 99 in the black. As such, it is evidence that the current contingency is sufficient. Third, volume growth is not entirely out of the Postal Service's control. They can promote services. Fourth, management has input into salary levels, health care benefits, and

ANSWER OF OCA WITNESS ROBERT E. BURNS
TO INTERROGATORIES USPS/OCA-T2-1-9

labor contracts; and can project them fairly accurately into the future. Fifth, the one subjective perception of increased risk that Tayman articulated being an increasingly competitive environment was mostly taken into account by detailed volume forecasts. The uncertainty about electronic diversion in the future is supported by nothing more than one sentence speculating that the Internet may "be making inroads" into mail volume. More should be required to clearly articulate a subjective perception of uncontrollable risk. Certainly, there has been a failure to rationally connect potentially uncontrollable risks in the test year and the \$1.68 billion annual contingency request.

b. and c. The Postal Rate Commission has made clear that it expects the Postal Service to utilize increasingly sophisticated objective analysis of risks over time. Therefore, these questions are irrelevant to the current case; and, worse still, would ask the witness to engage in an anachronistic analysis, using today's tools, which were unavailable in the past, to measure the reasonableness of past decisions. Such an analysis violates logic and has been rejected by courts in other contexts.

ANSWER OF OCA WITNESS ROBERT E. BURNS
TO INTERROGATORIES USPS/OCA-T2-1-9

USPS/OCA-T2-6. Please refer specifically to USPS-T-15, Direct Testimony of Charles Holder in Docket No. R90-1.

a. Please confirm that the Postal Service determined that a contingency of 3.5% was necessary in Docket No. R90-1 and that this amount was recommended by the PRC. If you do not confirm, please explain why.

b. Do you consider that management's subjective perception of risks was reasonably articulated in Docket No. R90-1? If your answer is other than yes please explain why.

c. Please explain how management's subjective perception of risks related to the contingency in Docket No. R90-1 differs from its articulation of such risks in this Docket. If your answer is that one is more reasonably articulated than the other please explain by how much and how you arrived at your conclusion.

RESPONSE TO USPS/OCA-T2-6, parts a. – c.:

The Postal Rate Commission has stated its expectation that the Postal Service must study and learn about the risks that it faces over time and that develop and use increasingly sophisticated objective means of risk analysis. Objective risk analysis methods that were available ten years ago would be considered inadequate today. Any review of testimony from another case ten years ago would be an anachronistic (out-of-time) analysis that lacks relevance to today's case.

ANSWER OF OCA WITNESS ROBERT E. BURNS
TO INTERROGATORIES USPS/OCA-T2-1-9

USPS/OCA-T2-7. Please refer page 9, lines 3 and 4, of your testimony where you state that "Mr. Tayman devoted less than two pages—and no supporting information, data, or studies—to justify the \$1.68 billion annual revenue that the contingency represents." How many pages did Mr. Holder devote to this subject in Docket No. R90-1?

RESPONSE TO USPS/OCA-T2-7:

See my response to interrogatory USPS/OCA-T2-6.

ANSWER OF OCA WITNESS ROBERT E. BURNS
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USPS/OCA-T2-8. Please refer to page 10, line 3, of your testimony, where you state: "Mr. Tayman states that volume growth is below historical norms and that the Postal Service plans a 1.5 percent workyear reduction in the test year. This is not an area outside of the Postal Service's control." Is it your testimony that volume growth is controllable by the Postal Service? If your answer is other than no, please explain how volume growth can be controlled by the Postal Service and provide the source of your information.

RESPONSE TO USPS/OCA-T2-8:

First, the Postal Service controls the rate of workyear reduction. Further, the Postal Service can take measures to control volume. The Postal Service can influence volumes by improving service or promoting certain services. It can decrease volumes by withdrawing service or not advertising.

ANSWER OF OCA WITNESS ROBERT E. BURNS
TO INTERROGATORIES USPS/OCA-T2-1-9

USPS/OCA-T2-9. Please refer to page 11, line 1, of your testimony where you state that "witness Tayman next cites health benefit cost increases at 'near double digit rates.' Once again, indices and forecasts exist for such costs, and they are not completely outside of management influence." Please explain how Federal Employees Health Benefit Program premiums are within postal management's influence. Provide the source of your information.

RESPONSE TO USPS/OCA-T2-9:

The amount the Postal Service pays in health premiums is not entirely outside of the Postal Service's control, because the Postal Service controls the number of employees that it hires. For example, if a large number of additional workhours are required to process volumes, the Postal Service has two options. It can hire new workers or it can increase the overtime hours of its existing workforce. If it chooses the latter, health premium costs will not increase at as fast a rate because health premiums only vary with the number of employees, not the number of hours each employee works. Other increases in health care benefits can be forecasted and are already incorporated in the Postal Service's forecasts.

1 CHAIRMAN GLEIMAN: Is there any additional
2 designated written cross-examination?

3 MR. REITER: Yes, Mr. Chairman.

4 CHAIRMAN GLEIMAN: Mr. Reiter.

5 MR. REITER: The Postal Service would like to
6 designate the witness' response to our questions 10 through
7 18 which were filed today.

8 CHAIRMAN GLEIMAN: Please proceed.

9 CROSS-EXAMINATION

10 BY MR. REITER:

11 Q Good morning, Mr. Burns. I am Scott Reiter for
12 the Postal Service.

13 A Good morning.

14 Q I have shown you two copies of your answers filed
15 yesterday, is that correct?

16 A That's correct.

17 MS. DREIFUSS: Actually, they were filed this
18 morning.

19 BY MR. REITER:

20 Q This morning. To our questions 10 through 18.

21 A Yes.

22 Q And I will ask you if your answers would be the
23 same if I posed those questions to you orally today?

24 A Yes, they would.

25 MR. REITER: Mr. Chairman, I will hand those

1 copies to the reporter and ask that they entered into the
2 record as the witness' written cross.

3 CHAIRMAN GLEIMAN: I direct that the material be
4 received into evidence and transcribed into the record. You
5 are about to get two copies, Mr. Reporter.

6 [Additional Designation of Written
7 Cross-Examination of Robert Edward
8 Burns, USPS/OCA-T2-10 through
9 USPS/OCA-T2-18, were received into
10 evidence and transcribed into the
11 record.]
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UNITED STATES OF AMERICA
Before the
POSTAL RATE COMMISSION
WASHINGTON, D.C. 20268-0001


Postal Rate and Fee Changes, 2000)

Docket No. R2000-1

ANSWERS OF THE OFFICE OF THE CONSUMER ADVOCATE
TO INTERROGATORIES OF UNITED STATES POSTAL SERVICE
WITNESS: ROBERT E. BURNS (USPS/OCA-T2-10-18)
(July 6, 2000)

The Office of the Consumer Advocate hereby submits the answers of Robert E. Burns to interrogatories USPS/OCA-T2-10-18, dated June 27, 2000. Each interrogatory is stated verbatim and is followed by the response.

Respectfully submitted,


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ANSWER OF OCA WITNESS ROBERT E. BURNS
TO INTERROGATORIES USPS/OCA-T2-10-18

USPS/OCA-T2-10. Please refer to your response to USPS/OCA-T2-1(a), where you state: "It should be noted, however, that the vast majority of utilities in number are municipal utilities, cooperatively-owned utilities, and federal power authorities that are not-for-profit."

a. Please confirm that these utilities typically have positive equity. If you do not confirm, please explain.

b. What mechanisms, which are not available to the Postal Service, do not-for-profit utilities have to ensure their financial stability?

RESPONSE TO USPS/OCA-T2-10:

a. Municipally-owned and federal power authorities typically have proprietary capital, which is the equivalent to positive equity (although for purposes of ratemaking, it is considered to be the same as long-term debt). Sometimes, in the case of a municipally-owned utility, the proprietary capital is made up solely of retained earnings, with no investment by the municipality. In the case of cooperatively-owned utilities, the equivalent of positive equity would be memberships and patronage capital, provided by the cooperative owners, the users of the system.

b. Municipally-owned and cooperatively-owned utilities can issue tax-exempt bonds so long as the system is used for public purposes. The Postal Service can do the same. Municipally-owned utilities can also be subsidized from the municipal budget. However, I must point out that it is more common for municipally-owned utilities to have their retained earnings drawn upon by the municipality and applied to other municipal needs. Cooperatively-owned utilities can also create capital through membership and patronage capital, as well as obtain low-interest federal Rural Utility Service (formerly REA) loans. Federal power authorities also can issue low-interest,

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state-tax-exempt debt backed by the full faith and credit of the federal government, an
advantage shared by the Postal Service.

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TO INTERROGATORIES USPS/OCA-T2-10-18

USPS/OCA-T2-11. Please refer to your response to USPS/OCA-T2-3(a), where you state that "in my opinion, the Postal Service has failed to perform the type of probability analysis and quantitative assessment that the insurance industry performs and which I cite at page 4 of my testimony."

a. Please provide a citation for the authority requiring the Postal Service to support its contingency requirement with a probability analysis of the type performed in the insurance industry.

b. Please confirm that the insurance industry probability analyses of the type you describe deal with the prediction of the number and severity of catastrophes in the future. If you do not confirm, please explain.

c. Please confirm that catastrophes have occurred in the past and will certainly occur in the future, the only question being their number and severity. If you do not confirm, please explain.

d. Please confirm that, in determining the required level of contingency, the Postal Service must take into consideration events that are totally unknown, and other events for which there is no history, such as volume erosion due to the Internet. If you do not confirm, please explain why these types of unknowns do not have to be considered.

e. Please confirm that items for which a history exists, such as natural disasters, lend themselves to probability analysis much more readily than items for which no history exists. If you do not confirm, please explain, and include in your answer how the Postal Service should model unknown events and events for which there is no history. Please state whether you have done or have had done any probability analysis similar to the type done by the insurance industry to support your recommended 1% contingency. If you have, please provide copies of any probability analyses you performed to support a 1% contingency.

f. Please confirm that your determination that a 1% contingency is adequate was based on a subjective interpretation of the various information you have provided. If you do not confirm, please provide the specific calculations which resulted in a 1% contingency.

RESPONSE TO USPS/OCA-T2-11:

a. I believe that a proper construction of past Commission statements leads to the conclusion that the Commission would wish to see the types of probability

ANSWER OF OCA WITNESS ROBERT E. BURNS
TO INTERROGATORIES USPS/OCA-T2-10-18

analyses that are performed in the insurance industry. For example, in Docket No. R87-1, the Commission articulated the standard for assessing a Postal Service proposal for a contingency: "management's perception of . . . risks must be *articulated* to a *reasonable* degree in order to satisfy the substantial evidence requirement." PRC Op. R87-1, para. 2073 (emphasis added). In the current proceeding, the Postal Service has refused to provide any documents or analyses that underlie its contingency proposal. Therefore, I believe that I can state justifiably that management has failed to "articulate" its reasons for proposing the increased contingency. Furthermore, I believe that the scant, subjective statements that have been made are not a "reasonable" method for determining the size of the contingency. Probability analyses, which would break down costs into their many component parts, hypothesize various scenarios that would cause costs to deviate from the projections already made in the roll-forward of costs, and assign probabilities for these events to occur, would constitute a "reasonable articulation" of the factors leading to a particular contingency.

Moreover, the Commission also advised the Postal Service that there is a "need for a more objective and systematic approach to determining and evaluating the Postal Service's contingency needs." *Id.*, para. 2116. This need would be satisfied by thorough, well-designed probability analyses.

In PRC Op. R76-1 at 53-54, the Commission stated that "[t]he contingency provision could be accounted for by a suitable post-audit procedure showing how far the actual costs have departed from the estimates." In PRC Op. R77-1, the Commission stated, "Specifically, we believe that historical variance analysis will allow

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the Commission to project on a reliable basis the magnitude of adverse events befalling the Postal Service in any particular test year and thus provide a basis for the Commission to make allowance for these uncertainties Thus, we find appropriate the utilization of variance analysis as a starting point in evaluating the . . . contingency request." The probability analysis and quantitative assessment that the insurance industry performs to determine its contingency reserve is analogous to the variance analysis required of the Postal Service for known, but uncertain and uncontrollable future risks. To the extent the Postal Service performed a variance analysis in this case, it explicitly did not base its contingency proposal on its analysis, but instead disavows the analysis. Therefore, the Postal Service does not have an appropriate starting point for making its contingency request.

b. Yes, probability analyses, which are closely related to a variance analysis, are used to predict the likely number, severity, and location of future catastrophes. They are, therefore, analogous to the type of variance analysis of known, but uncontrollable, risks that the Commission requires as a part of, indeed as a starting point, for a contingency reserve analysis.

c. Yes, catastrophes that are insurable events have occurred in the past and will occur in the future, with the question being their number, severity, and location. They are therefore known but uncontrollable events. The use of a quantitative assessment analysis allows insurance companies to isolate the causes of these events and to better predict their probability of occurrence, their number, severity, and location; and, in some instances to take appropriate steps to mitigate the risks posed by those

ANSWER OF OCA WITNESS ROBERT E. BURNS
TO INTERROGATORIES USPS/OCA-T2-10-18

future events. The proper use of variance assessment as an analytical tool might allow the Postal Service to better predict and control what was once considered to be unforeseen and uncontrollable events. As the Commission has stated, "the relative magnitude of unforeseen events, including external events, over the long run will tend to display a degree of predictability, based upon historical results." A properly performed variance analysis would allow the Postal Service to identify patterns of expenditures and revenue incurrence that might allow it to avert cost/revenue inequalities. In turn this would allow for smaller contingency amounts that lead to lower rates and an enhanced competitive position.

d. While the Postal Service may be able to take into account events that are totally unknown, it is important to bear in mind that the Commission will consider events that are "substantially certain to be" but not those that are "clearly speculative." PRC Op. R84-1, para. 1055. Furthermore, in Docket No. 87-1, the Commission observed that "the relative magnitude of unforeseen events, including external events, over the long run will tend to display a degree of predictability, based upon historical events." PRC Op. R87-1, para. 2077. Therefore, there are reasonable limits to the types of unknown events or uncertainties that ought to be given weight in the contingency analysis.

The fact that volume erosion from the Internet can be identified means that it is not unforeseeable nor unknown. I also disagree with the statement that there is no history of volume erosion due to the Internet. Volume erosion from the Internet simply had a short history when the volume analysis for the test year was performed. Indeed,

ANSWER OF OCA WITNESS ROBERT E. BURNS
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Witness Tolley has taken such factors into consideration in his volume estimation procedure. See my testimony at 11, especially note 20.

While unforeseeable, unknown future risk must be accounted for in a contingency determination. Management's perception of those risks must be articulated to a reasonable degree in order to satisfy the substantial evidence requirement. To fulfill this requirement, the Commission suggested, in PRC Op. R87-1 at 36, that the Postal Service identify the set of events from which an intuitive sense of the risks might be drawn, consider the role of past experience in influencing the sensed magnitude and likelihood of the unforeseen risk, and indicate the importance of unforeseeable risks relative to recognized-but-unquantifiable risks. That analysis was not done.

e. I agree that items for which history exists lend themselves to probability and variance analysis more readily than for items for which no history exists. I also agree with the Commission, in Op. 87-1 at 37, that the relative magnitude of unforeseen events, including external events [and those that have no history], over the long run will tend to display a degree of predictability, based on historical events. The Postal Service should be able to identify with some degree of predictability the magnitude of unforeseen and external events. The variance analysis required by the Commission, in large part, fulfills this objective. Also, see my answer to interrogatory USPS/OCA-T2-12.

f. My determination that a 1% contingency is adequate is based in part on the objective variance analysis performed by Dr. Edwin Rosenberg. I used this as a

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TO INTERROGATORIES USPS/OCA-T2-10-18

starting point, then my analysis was influenced by the factors that Dr. Rosenberg cited: economic forecasts of continued vitality in the economy, low inflation, and low economic volatility. These point to keeping a low contingency of 1%. I rejected Witness Tayman's subjective analysis calling for more than a 1% contingency because it was unsubstantiated.

ANSWER OF OCA WITNESS ROBERT E. BURNS
TO INTERROGATORIES USPS/OCA-T2-10-18

USPS/OCA-T2-12. Please refer to your response to USPS/OCA-T2-3(c) where you state "my point here is this, during the last ten years, forecasting methods have also become available for the Postal Service to use to make an objective analysis of variables that could affect its future costs as well as to allow the Postal Service to bring those costs under control, through risk mitigation and/or prudent and efficient management." Have you utilized the "forecasting methods" to which you referred to calculate a 1% contingency? If so, please provide the name of the "forecasting method," a description of the methodology it employs, and the specific calculations yielding a 1% contingency.

RESPONSE TO USPS/OCA-T2-12:

No. It is the primary responsibility of the Postal Service to use the most up-to-date analytical tools and the data, which is in their possession, to make an objective analysis of future costs; to do so in a fashion that could identify when risk mitigation devices, such as hedging can be used; and to engage in prudent management practices that home in on ways to deliver postal service at the lowest cost.

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TO INTERROGATORIES USPS/OCA-T2-10-18

USPS-T2-13. Please refer to your response to USPS/OCA-T2-4, where you state that "to find an estimate of the actual profit that is included in insurance rates, it is necessary to net out the net investment yield."

a. Please confirm that the question asked you "how much 'profit allowance' is typically included in insurance rates. If you do not confirm, please explain.

b. Please confirm that you have attempted to provide a different amount, *i.e.*, "the actual earned profit included in insurance rates." If you do not confirm, please explain.

c. Please explain net investment yield and how it is used.

RESPONSE TO USPS/OCA-T2-13:

a. Yes, I confirm that was the question.

b. I do not confirm that I have given a different answer from the one the question sought. In the insurance industry, a profit allowance does not come from insurance rates if it is the result of net investment yield. Further, the profit is only potential and not earned until the events that were insured against did not occur during the premium period. Profit from net investment yield comes principally from the investments that the insurance company makes on its cash flow from the unearned insurance premiums, that is, the insurance premiums for which there is still a potential liability. Any effort to compare insurance rate profits to postal rate profits would be comparing apples to pineapples.

c. See my answer in USPS/OCA-T-13(b). Again, most of the profit in casualty insurance typically comes from the net investment yield rather than from insurance rates; and, for some companies, insurance rates provide negative earned profits.

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TO INTERROGATORIES USPS/OCA-T2-10-18

USPS/OCA-T2-14. Please refer to your response to USPS/OCA-T2-5(a), where you state that "the one formerly uncontrollable factor that witness Tayman cited, the Y2K remediation costs, did not prevent the Postal Service from finishing FY 99 in the black. As such, it is evidence that the current contingency is sufficient." Is it your testimony that because the Postal Service was able to fund FY 99 Y2K costs through cost cutting in other areas and a re-programming of priorities that "the current contingency is sufficient"? Please explain fully and include in your explanation a discussion of what limitations there may be on cost cutting and re-programming of funds to offset unplanned adversities in the test year.

RESPONSE TO USPS/OCA-T2-14:

I believe that the ability of the Postal Service to, through prudent management of its resources, meet its Y2K remediation costs within its current 1 percent contingency while finishing FY 99 in the black, is one piece of evidence that the current contingency level of 1 percent is adequate. That the Postal Service was able to cut costs and reprogram priorities without any adverse effect on service is an example of how a lower contingency reserve will tend to keep the Postal Service prudent and efficient and provide it with a continuing incentive to eliminate waste. The only limitation that there may be on cost cutting and reprogramming of funds to offset unplanned for adversities in the test year or beyond is if the cost cutting and reprogramming adversely affect service rather than eliminate waste. On balance, however, there is a greater moral hazard of creating an environment for lax and inefficient management through setting the contingency level too high, rather than keeping it where it currently is.

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TO INTERROGATORIES USPS/OCA-T2-10-18

USPS/OCA-T2-15. Please refer to your response to USPS/OCA-T2-5(a), where you state that "management has input into salary levels, health care benefits, and labor contracts; and can project them fairly accurately into the future." You also state that "the one subjective perception of increased risk that Tayman articulated being an increasingly competitive environment was mostly taken into account by detailed volume forecasts."

a. Please confirm that some previous Postal Service labor contracts have been determined by binding arbitration and that Postal Service health benefit premiums are determined by the Office of Personnel Management. If you do not confirm, please explain.

b. Please confirm that the magnitude and timing of the impact of the increasingly competitive environment on mail volume is in a state of flux and while recognized, remains uncertain. If you do not confirm, please explain how a precise quantification of the impact can be known with certainty and how you know this impact was reflected in Postal Service volume forecasts used for this filing.

RESPONSE TO USPS/OCA-T2-15:

a. Yes, I confirm that some previous Postal Service labor contracts have been determined by binding arbitration. It is also my general understanding that health benefit premiums are determined by the Office of Personnel Management. See my answer to interrogatory USPS/OCA-T2-18(c).

b. I am unable to confirm this statement. As I pointed out in my testimony at 11, the Postal Service's volume witness took factors such as these into account. Witness Tolley states at 18 of USPS-T-6 that "the real price of important nonpostal alternatives, which include both direct competitor (UPS) and indirect competitors (like the price of newspaper advertising)" are used to develop the volume estimates. Another important consideration is that the 2001 test year is not a period of time that is very far into the future. It will actually be underway at the time the Commission issues its decision. (The test year begins October 1, 2000, while the Commission should issue

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its decision some time around November 12, 2000). According to the Commission, "[t]he closer the proximity of the test year" to the time forecasts are made tends to support a lower contingency. PRC Op. R94-1, para. 2042.

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TO INTERROGATORIES USPS/OCA-T2-10-18

USPS/OCA-T2-16. Please refer to your response to USPS/OCA-T2-5(b) and (c) where you state:

The Postal Rate Commission has stated its expectation that the Postal Service must study and learn about the risks that it faces over time and develop and use increasingly sophisticated objective means of risk analysis. Therefore, these questions are irrelevant to the current case; and, worse still, would ask the witness to engage in an anachronistic analysis, using today's tools, which were unavailable in the past, to measure the reasonableness of past decisions. Such an analysis violates logic and has been rejected by courts in other contexts.

a. Please provide a specific quotation in and citation to each of the Commission's Opinions in the last three omnibus rate cases (Docket Nos. R90-1, R94-1, and R97-1), stating an expectation regarding the use of "increasingly sophisticated objective means of risk analysis."

b. Please explain what "today's tools" are, when "today's tools" became available for use, and how you have used "today's tools" to support a 1% contingency.

RESPONSE TO USPS/OCA-T2-16:

a. PRC Op. R97-1 contained little discussion of the contingency, perhaps because the Postal Service had initially proposed, and the Commission eventually recommended, a contingency of one percent. However, the Commission did reject the Postal Service's eleventh-hour justification of a 1.5 percent contingency by characterizing it as "arbitrary" and a "plug figure." *Id.*, at para. 2030-31.

PRC Op. R94-1 approved the Postal Service's request for a 2 percent contingency, stating that the Postal Service had "openly and clearly articulat[ed] the rationale for its requested contingency allowance. . . ." Also, according to the Commission, the Postal Service "has fully presented management's reasons. . . ." *Id.*, para. 2037. More importantly, the Commission was convinced that a policy of "rate restraint," intended to "cause the Service to control and even reduce its costs," was

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desirable. *Id.*, para. 2038. The Commission continued: "a policy of rate restraint will most likely enforce more efficient and economical management . . . [i]nasmuch as a limited provision for contingencies contributes to rate restraint. . . ." I heartily support such a policy and note that my testimony at 6-7 articulates essentially the same principles.

In Docket No. R90-1, the Commission was critical of Postal Service testimony that "does not describe in any detail how managerial judgement was exercised." Quoting from the witness' response to an OCA interrogatory that unknowns were "subjectively considered" and the contingency was determined "judgmentally," the Commission proceeded with its own analysis of the facts presented. PRC Op. R90-1, para. 2020. The Commission disagreed with the Postal Service's view that the Commission "must" accept postal management's judgment. Rather, the Commission insisted on independently examining the need for a contingency. *Id.*, at II-6, note 11. Of the facts put before the Commission, it was influenced by "projections offered by Postal Service witness Robertson . . . [of] weak economic growth" *Id.*, para. 2022. OCA Witness Rosenberg, on the other hand, cites economic forecasts of continued vitality in the economy, low inflation, and low economic volatility. These point to a low contingency.

b. Variance analysis and decision analysis techniques to name two have been available for at least a decade and need only be tailored to the Postal Service. Dr. Rosenberg used the objective variance analysis in his testimony to support a 1 percent contingency.

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TO INTERROGATORIES USPS/OCA-T2-10-18

USPS/OCA-T2-17. Please refer to your response to USPS/OCA-T2-8, where you state:

[T]he Postal Service can take measures to control volume. The Postal Service can influence volumes by improving service or promoting certain services. It can decrease volumes by withdrawing service or not advertising.

a. Please confirm that the variables you mention, *i.e.*, improving or promoting service, withdrawing service, and advertising are only a few of the many variables that influence volume. If you do not confirm, please explain.

b. Please confirm that other variables, such as competition and the economy, also affect volume and are, to a large extent, outside the direct control of the Postal Service. If you do not confirm, please explain how the Postal Service can control its competitors and the economy.

RESPONSE TO USPS/OCA-T2-17:

a. I confirm that these are only some of the variables that influence volume, but they are important variables because they are within the Postal Service's control.

b. I confirm that the economy affects volume and that the economy is largely out of the Postal Service's control. I also confirm that competition from competitors affects values. However, while the Postal Service cannot control its competitors, it can aggressively meet the competition through proper pricing and marketing of competitive services.

ANSWER OF OCA WITNESS ROBERT E. BURNS
TO INTERROGATORIES USPS/OCA-T2-10-18

USPS/OCA-T2-18. Please refer to your response to USPS/OCA-T2-9, where you state:

The amount the Postal Service pays in health premiums is not entirely outside of the Postal Service's control, because the Postal Service controls the number of employees that it hires. For example, if a large number of additional workhours are required to process volumes, the Postal Service has two options. It can hire new workers or it can increase the overtime hours of its existing workforce. If it chooses the latter, health premium costs will not increase at as fast a rate because health premiums only vary with the number of employees, not the number of hours each employee works.

a. Have you done any analysis comparing the cost of additional overtime to the cost of additional health benefits? If your answer is other than no, please provide your analysis.

b. Are you recommending that the Postal Service handle any increasing workload by using overtime to avoid additional health benefit costs? If your answer is yes, how much additional overtime should the Postal Service use before hiring additional employees? Please explain how you reached your conclusion.

c. Please confirm that the cost of health benefit premiums (*i.e.*, the cost incurred per employee) is managed by the Office of Personnel Management (OPM).

RESPONSE TO USPS/OCA-T2-18:

a. No. I expect the Postal Service would do this.

b. I am recommending that the Postal Service consider the cost of handling increased workload through the use of overtime versus the cost of hiring additional employees and should act in a cost effective manner. Such an analysis should look not only at costs, but productivity.

c. Although I cannot definitively state that health benefit premiums are managed by OPM, it is my general understanding that this is correct. I wish to add that I believe it is reasonable to assume that OPM develops its estimates of future health

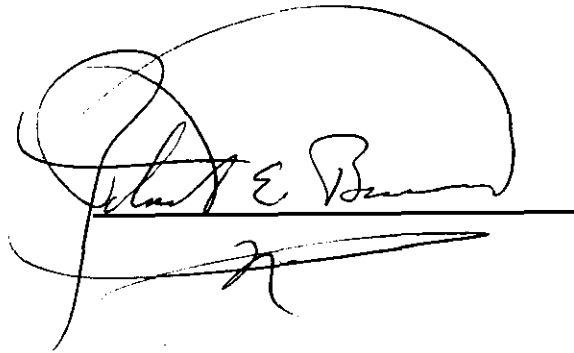
ANSWER OF OCA WITNESS ROBERT E. BURNS
TO INTERROGATORIES USPS/OCA-T2-10-18

benefit premiums with great care, very likely relying on relevant economic forecasts and indices of health care costs. The Washington Post (June 29, 2000, B2) recently published an article on a related topic – long-term care insurance – in which OPM officials were quoted as saying they “promise” that premiums for such insurance, scheduled to begin in late 2002, would be significantly lower than private companies’ premiums, and that the projection “is not ‘a made-up, pulled-out-of-the-air number.” Rather, “OPM checked with the Health and Human Services Department and a consultant before making its pledge of significantly lower premiums.” Therefore, health benefit premiums that are themselves founded upon careful analyses of costs should not be as liable to deviation from projected amounts as are estimates developed in a subjective, arbitrary, and judgmental manner.

DECLARATION

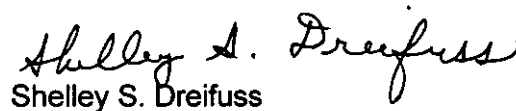
I, Robert E. Burns, declare under penalty of perjury that the answer to interrogatories USPS/OCA-T2-10-18 of the United States Postal Service, is true and correct, to the best of my knowledge, information and belief.

Executed 7/05/2000

A handwritten signature in dark ink, appearing to read "Robert E. Burns", is written over a horizontal line. The signature is stylized with a large, looping initial "R" and a long, sweeping horizontal stroke at the end.

CERTIFICATE OF SERVICE

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


Shelley S. Dreifuss

Washington, DC 20268-0001
July 6, 2000

1 CHAIRMAN GLEIMAN: Does anyone else have
2 designated written cross for this witness?

3 [No response.]

4 CHAIRMAN GLEIMAN: If not, that brings us to oral
5 cross-examination and, once again, the Postal Service is the
6 only party that has requested oral cross-examination.

7 Does anyone wish to cross-examine this witness?

8 [No response.]

9 CHAIRMAN GLEIMAN: If not, Mr. Reiter, when you
10 are ready, you may proceed.

11 MR. REITER: Thank you, Mr. Chairman.

12 BY MR. REITER:

13 Q Mr. Burns, would you look at your response to our
14 Question 2, part B, "B" as in "boy"?

15 A I am there, yes.

16 Q You say there, "I am unable to answer whether the
17 Postal Service conducted an objective analysis of the
18 volatility of its forecasted cost variables." Do you see
19 that?

20 A Yes, I do.

21 Q Did you review the Postal Service's written
22 answers to the OCA's questions on the contingency which the
23 Postal Service filed on May 17th?

24 A Those are Witness Tayman's, I believe?

25 Q No, these were from the Postal Service itself.

1 A I have reviewed a lot of testimony, yes, but I am
2 not certain whether that particular one was one of them. I
3 did see that there was a variance analysis by Witness Tayman
4 submitted.

5 Q I would be glad to show you the document and show
6 your counsel, and then perhaps you could answer.

7 A Okay.

8 MS. DREIFUSS: That is acceptable to us.

9 [Pause.]

10 THE WITNESS: Yes, I did review this one earlier.

11 BY MR. REITER:

12 Q Would you look in the answer to Question 2? In
13 the middle of the first paragraph it says, "Some of these
14 uncertainties are more identifiable than others. To the
15 extent they can be identified, an attempt is usually made to
16 evaluate the potential effects on future needs by some order
17 of magnitude, e.g., calculate the value of various
18 percentage changes in revenue, health benefits or wages."
19 Do you see that?

20 A Yes, I do.

21 Q Would you characterize that as an objective
22 analysis of the volatility of cost estimates?

23 MS. DREIFUSS: Mr. Chairman, I object to this
24 question. The OCA has not designated this material as
25 evidence. We found the answers to be entirely

1 unsatisfactory. The Postal Service did not provide any of
2 the underlying documentation that we asked for, and I think
3 it is improper to ask Mr. Burns to comment on this document.

4 MR. REITER: I think if the OCA wants to take the
5 position and not have me ask Mr. Burns whether he reviewed
6 this or what his opinion is of it, then he should withdraw
7 his statements that the Postal Service did not conduct such
8 an analysis.

9 MS. DREIFUSS: Mr. Chairman, I believe that the
10 Postal Service has not provided anything to the OCA which
11 would permit him to answer that question.

12 CHAIRMAN GLEIMAN: I am going to rule in favor of
13 the OCA on this one, Mr. Reiter. They did seek additional
14 information from the Postal Service and, to the best of my
15 recollection, it was not made available. And I think that
16 it would be improper now to present that evidence which --
17 that material which is not in evidence and ask the witness
18 to comment on it.

19 MR. REITER: I am not asking that the evidence --
20 that the matter be put into evidence. I am asking whether
21 the witness reviewed that in preparing his testimony. You
22 can review all kinds of things, they don't have to be
23 evidence.

24 MS. DREIFUSS: It is the OCA's position that there
25 is no way to corroborate the statements in this document,

1 because the Postal Service refused to provide the underlying
2 documents.

3 MR. REITER: The answers were provided as the
4 result of a negotiation between us and the OCA.

5 MS. DREIFUSS: I really need to add one more
6 comment, the OCA found these answers to be entirely
7 unsatisfactory. That is why we have not designated them as
8 evidence. Furthermore, we had to enter into an agreement
9 with the Postal Service that they would not use any
10 underlying documents in preparation of their rebuttal
11 testimony, that is also on file. So I do believe it is
12 improper to question this witness about any of the
13 statements made in this document.

14 CHAIRMAN GLEIMAN: Is indeed that agreement on
15 file and, if so, could you put your hands on a copy of it?

16 We will adjourn for about five minutes. I am
17 going to ask that you provide me a copy of the document, and
18 then I am going to rule, final.

19 MS. DREIFUSS: Yes, sir.

20 CHAIRMAN GLEIMAN: Okay.

21 [Recess.]

22 CHAIRMAN GLEIMAN: Ms. Dreifuss?

23 MS. DREIFUSS: Mr. Chairman, I am going to hand
24 you two documents that are involved in this dispute.

25 Let me just explain what it is you'll be looking

1 at: The OCA had originally asked for certain documentation
2 that underlies Witness Tayman's testimony, or may underlie
3 his testimony.

4 And the Postal Service objected to our questions.
5 And there are also some hearing questions involved.

6 The Postal Service didn't want to provide all of
7 that information to us, either.

8 As a way to amicably resolve the motion to compel
9 -- and then there was a motion to compel.

10 In an effort to resolve that, we engaged in a
11 series of informal discussions with the Postal Service, and
12 they eventually wound up filing the material that Mr. Reiter
13 wishes to cross examine Mr. Burns about this morning.

14 The OCA filed a notice on May 24th that we did not
15 believe that the matter was satisfactorily resolved.

16 And eventually the Postal Service entered into a
17 stipulation with the OCA that it would not rely on any of
18 the documents requested, but not provided in OCA questions
19 on the contingency.

20 And it's our view that it is now improper for the
21 Postal Service to try to --

22 CHAIRMAN GLEIMAN: Can I have the documents,
23 please?

24 MS. DREIFUSS: Certainly.

25 [Pause.]

1 CHAIRMAN GLEIMAN: You're obviously familiar with
2 the document that I'm looking at, that was submitted on May
3 the 31st.

4 MR. REITER: Yes.

5 CHAIRMAN GLEIMAN: It's got your signature on the
6 bottom of it. And I would like to hear from you one last
7 time as to why you think we should allow the questions to go
8 forward.

9 MR. REITER: I think that counsel has
10 mischaracterized the nature of my question. I'm not
11 attempting to delve into any of the material that we in the
12 OCA had a discovery dispute over.

13 In the effort to resolve that, the OCA submitted
14 some questions to us. One of them was Question Number 2,
15 which doesn't even ask for material.

16 It says did the Postal Service use any framework
17 for analysis to guide the process of developing the
18 contingency request? If so, please describe the framework
19 and its application, in detail, if not, why not?

20 We answered that question, describing whether we
21 used any framework and what it was. Mr. Burns is testifying
22 on that very issue.

23 And all I am asking him is not to get into
24 anything that we provided or didn't provide, but simply
25 whether he is aware of whether the Postal Service performed

1 the kind of objective analysis that his answer to our
2 interrogatory seems to say we didn't provide.

3 He goes on to say that it appears to him that the
4 contingency request is based purely on management gestalt.

5 CHAIRMAN GLEIMAN: I got it.

6 MR. REITER: And I think I have the right to ask
7 him what the basis of that opinion, and if he considered
8 this material, this particular answer, not any underlying
9 material.

10 MS. DREIFUSS: Mr. Chairman, may I reply to that?

11 CHAIRMAN GLEIMAN: No. I'm going to allow them to
12 go ahead with the question that was put to the witness. It
13 is based on material that was submitted, and there is a
14 limit.

15 I understand and have the stipulation in my hand
16 now, and we'll see where the Postal Service goes with its
17 questions, and where the witness goes with his answers.

18 The outstanding question essentially is, as I
19 understand it, are you familiar with material? Did you
20 review the material?

21 Is that your question?

22 MR. REITER: My first question was whether he
23 reviewed this answer that the Postal Service provided.

24 CHAIRMAN GLEIMAN: Right.

25 MR. REITER: And I believe he said he hadn't seen

1 it.

2 THE WITNESS: Yes, I have seen it.

3 CHAIRMAN GLEIMAN: I'm going to allow the Postal
4 Service to proceed. In the event that the Postal Service
5 crosses the line relative to this stipulation, or asks
6 questions based on material that is otherwise not in
7 evidence, then there's a question as to the predicate upon
8 which the questions would be based, and we would have to
9 take that up at that point in time.

10 MS. DREIFUSS: Mr. Chairman, if I may just make a
11 statement -- and I understand you to want to proceed -- the
12 OCA had difficulty accepting the premise of the question
13 because we were never permitted to see any documents to
14 corroborate what's presented in these responses.

15 CHAIRMAN GLEIMAN: The witness is in a position to
16 respond to what he saw and what he didn't see, and what he
17 based his decision on, what he based his statements on or
18 didn't base his statements on.

19 And I would like to proceed at this point.

20 MR. REITER: Thank you, Mr. Chairman.

21 BY MR. REITER:

22 Q I'll go back to the part of that answer that I
23 directed your attention to earlier, Mr. Burns, in the middle
24 of the first paragraph, where the Postal Service said:

25 To the extent they can be identified -- I'm sorry,

1 I should read the previous sentence:

2 Some of these uncertainties are more identifiable
3 than others. To the extent they can be identified, an
4 attempt is usually made to evaluate the potential effects on
5 future needs by some order of magnitude, e.g., calculate the
6 value of various percentage changes in revenue, health
7 benefits, or wages.

8 In light of that statement, do you have any
9 ability to state whether the Postal Service, according to
10 what it said, conducted an objective analysis of the
11 volatility of forecasted cost variables?

12 A Based on that statement, the Postal Service has
13 stated that it is looking at the volatility of cost
14 variables, but because I cannot look at the numbers and the
15 method behind it, I really cannot tell whether that's a
16 full, objective analysis.

17 And being able to actually go to the numbers and
18 the methodology behind it, would be necessary for me to say
19 and to answer conclusively that it was an objective analysis
20 of the volatility of the forecasted cost variables.

21 Q I understand that. If the Postal Service actually
22 did what it said, though, would you characterize that as
23 more than managerial gestalt?

24 A Well

25 MS. DREIFUSS:

1 BY MR. REITER:

2 Q And that's a quote from your answer.

3 A Yes, yes, it is.

4 Q I did cite that before.

5 A If the -- the reason that I refer to the
6 managerial -- that the setting of the contingency reserve
7 was managerial gestalt was that the Witness Tayman
8 specifically disavowed any variance analysis and any of the
9 objective analysis that he may have done.

10 Q Could you give me a citation for that?

11 A The actual citation --

12 MS. DREIFUSS: Could counsel be a little more
13 clear on what citation he's looking for at the moment?

14 MR. REITER: Witness Tayman's alleged disavowal of
15 any quantitative analysis.

16 THE WITNESS: Let me see if I can find it.

17 [Pause.]

18 Well, I don't have the citation directly in front
19 of me, but the statement that Witness Tayman made was that
20 the determination of a contingency involves a subjective
21 evaluation that is not based on specific evaluation of the
22 factors.

23 And that was his statement, and he actually did
24 submit the variance analysis for the Commission, because the
25 Commission was interested in it.

1 But he specifically stated that he was not relying
2 upon it.

3 BY MR. REITER:

4 Q That's the historical variance analysis; is that
5 correct?

6 A That's right.

7 Q Did he disavow analysis of future predictions --
8 predictions of future costs?

9 A The only testimony as to future costs was
10 statements that he made, specifically having to do with --
11 let's see if I can give you these categories.

12 [Pause.]

13 Recent financial performance, volume growth, other
14 uncertainties, salaries and benefits, labor contracts, and
15 competition and a referral to the possibility of the
16 Internet causing some volume erosion.

17 Q And most of those involve the future; is that not
18 correct?

19 A Those involve the future, yes.

20 Q Would you look at your answer to our Question
21 Number 6, please?

22 [Pause.]

23 You say there that any review of testimony from
24 another case ten years ago would be an anachronistic,
25 out-of-time analysis that lacks relevance to today's case;

1 do you see that?

2 A Yes, I do.

3 Q Is it your testimony that testimonies and
4 decisions related to the contingency provision in Docket
5 Number R90 or before are irrelevant to the issues in this
6 case?

7 A It's my testimony that the methods used at that
8 point in time would probably lack the sophistication that
9 the Commission would now require, and, indeed, the
10 Commission has stated that, over time, it would require
11 greater and greater sophistication as to risk analysis
12 measurements and methodologies.

13 And therefore, looking back at what was acceptable
14 ten years ago wouldn't give you any real guidance as to what
15 would be an acceptable measure of risk analysis today.

16 Q Do you recall where the Commission said that?

17 A We have -- going all the way back to Opinion
18 R77-1, at 37, we maintain our view, however, that
19 forecasting sources and that much can be learned by
20 systematically evaluating the behavior of those sources over
21 time.

22 We also adhere to our view that relative magnitude
23 of unseen events, including external events over the long
24 run, will tend to display a degree of predictability based
25 upon historic results.

1 They also say it's our view, over the long run,
2 the relative magnitude of unforeseen events will --
3 variances between estimates and actual results caused by
4 uncontrolled external events, will prospectively tend to
5 display a certain degree of predictability, albeit, not
6 precise, with historical results.

7 Specifically, we believe that the historical
8 variance analysis will allow the Commission to project on a
9 reliable basis, the magnitude of adverse events befalling
10 the Postal Commission in a particular test year, and thus
11 provide a basis to make allowances for these uncertainties
12 in the revenue requirement.

13 That -- these statements, taken with others that
14 the Commission has made, basically makes it clear that they
15 expect that variance analysis will be performed, that the
16 historic variance analysis will be done in such a way that
17 it looks to the future, tries to identify what would
18 otherwise be unforeseen.

19 And events that had occurred out of the historical
20 norms, to attempt to identify that. That certainly connotes
21 more and more sophistication in the methods over time.

22 That certainly the framework of analysis would
23 move with the experience of the Postal Service in using that
24 analysis, and that's what the Commission is urging, I
25 believe, and it goes back to '77.

1 Q And you said, I believe, that that connoted to you
2 a belief that analysis tools had become more sophisticated,
3 is that right?

4 A And indeed they have.

5 Q Let me ask you this. You are an expert on
6 insurance, is that correct?

7 A I am an expert on ratemaking and my major emphasis
8 actually is utilities, but I have been looking at insurance
9 in particular dealing with contingency reserves since that
10 is the area on which we are testifying, and that is where
11 the best analogies can be drawn.

12 Q Let me ask you an insurance hypothetical.

13 I have been driving a car, had a license for
14 almost 30 years, never did any damage to anybody's car or
15 property or person. Would you recommend that I cancel my
16 liability insurance?

17 A No.

18 Q Why not?

19 A Because there is always a chance that an
20 unforeseen event would occur whereby you might be held to be
21 liable. If you are in a -- and I am assuming you are not in
22 a no-fault state, there is a chance that something that is
23 again unforeseen or something out of the ordinary would
24 happen that that would cause an accident, and there is
25 always the potential of liability.

1 I don't advocate getting rid of the contingency
2 reserve either.

3 MR. REITER: Thank you. That is all I have Mr.
4 Chairman.

5 CHAIRMAN GLEIMAN: Is there any followup?
6 Questions from the bench? Commissioner LeBlanc.

7 COMMISSIONER LeBLANC: I am trying to understand.
8 I want to ask this question but you talk a lot about missed
9 estimates.

10 THE WITNESS: Yes.

11 COMMISSIONER LeBLANC: And it seems to me that
12 when I read your testimony and other things there seems to
13 be an indication that a missed estimate is a way of coming
14 back at -- you seem to allude to the fact -- I don't want to
15 put words in your mouth here and correct me if I am wrong,
16 but you seem to be alluding to the fact that this is just a
17 way to get extra funds to the Postal Service.

18 THE WITNESS: The contingency reserve is a way of
19 giving extra funds to the Postal Service to protect them
20 against both missed estimates and unforeseen, uncontrollable
21 events -- and those are the two categories.

22 COMMISSIONER LeBLANC: Are you familiar with prior
23 year losses?

24 THE WITNESS: Actually, somewhat, but I will tell
25 you that that is more of an area where my colleague Ed

1 Rosenberg can speak with greater authority.

2 COMMISSIONER LeBLANC: I may ask him a type of the
3 same question, but let me ask you -- if you are not familiar
4 with it enough to say so, please let me know.

5 In your opinion what is the difference between
6 being able to recapture what was lost in a year, whether a
7 contingency amount was not enough or is enough, and having a
8 contingency fund available for missed estimates?

9 THE WITNESS: Well, the difference is, and I think
10 this actually kind of goes to the heart of the entire
11 matter, is that if you are allowed to recover prior year
12 losses and you are allowed to do it by a rate -- a request
13 for a rate increase later that you will have already had an
14 incentive to be as efficient as possible and to live within
15 the contingency and the revenues that were allowed, and we
16 simply had a missed estimate, either as to cost or volumes
17 or otherwise, but there is every incentive on the part of
18 the Postal Service and its management to keep its costs down
19 and to act efficiently.

20 If you have a contingency reserve, that provides a
21 bigger buffer, and the bigger the buffer that you provide,
22 the less you -- you start to dampen the incentive to be
23 efficient, that actually you will create a moral hazard if
24 the contingency reserve is too large and you may actually
25 allow the management to become somewhat more lax than it

1 would be otherwise.

2 You are better off because of the direction that a
3 moral hazard goes in this case to keep the contingency
4 reserve relatively low but still again to have one.

5 COMMISSIONER LeBLANC: So the end justifies the
6 means in that case?

7 THE WITNESS: It is not so much the end justifies
8 the means. It is the matter of creating the right
9 incentives to keep the Postal Service as -- and its
10 management as efficient as possible.

11 I mean in the long-run if there is not waste by
12 the Postal Service there really isn't any great difference
13 between having a contingency reserve and being able to
14 collect the prior year's shortfalls that you have, but there
15 actually is a difference because of the incentives that it
16 creates.

17 COMMISSIONER LeBLANC: Now in your reserve account
18 that you call it where -- to have it set up, you talk also
19 about a reserve or catastrophic reserve.

20 THE WITNESS: Okay, with the insurance industry,
21 yes.

22 COMMISSIONER LeBLANC: With the insurance. Would
23 you envision the same thing here, a reserve as well as a
24 catastrophic reserve, or do you combine them and talk about
25 them as one entity here?

1 THE WITNESS: Well, what happens here is that the
2 Postal Service has already forecast that -- the increase in
3 costs that they expect during the test year. That in effect
4 is roughly analogous to a reserve.

5 I mean these industries are different but that is
6 what they expect the increased costs to be.

7 The catastrophic reserve is for missed estimates
8 and for unseen and uncontrollable events, the same as it is
9 for the Postal Service, so I would say that the catastrophic
10 reserve is the one that is the one that actually is more
11 analogous, and it is a smaller amount than the total reserve
12 in the insurance industry, and again the total reserve here
13 is more analogous to the projection that they have made and
14 already included in their general request, given the fact
15 that they have a future test year.

16 COMMISSIONER LeBLANC: Let me go back to a
17 question I've got that relates to the insurance industry.

18 It's always been my understanding that if you buy
19 whole life insurance with a cash value you are overpaying on
20 a premium and in fact a lot of the balance then goes to
21 build up your cash value over time.

22 Now if you are in the insurance industry, and if
23 you use that same analogy and try to relate it to the Postal
24 Service as an example, are you saying then that the rate
25 that is charged should be greater, that much greater to

1 cover not only losses but catastrophic and to provide for
2 the contingency, and that that should be taken over a
3 multiyear period, just as a clarification --

4 THE WITNESS: Well, there was a reason that I went
5 with the property damage and catastrophic loss category with
6 the insurance industry rather than life insurance and I
7 think you went right to it, and that is that you are
8 supposed to be building up some type of -- there is some
9 little provision in there that it is like a savings account
10 and that it increases in value.

11 The Postal Service is a nonprofit and its aim is
12 to break even, and I know that there is some concern about
13 having in time positive equity, but the fact is that that
14 can be taken care of in time and it is not -- the
15 contingency --

16 COMMISSIONER LeBLANC: Excuse me, what can be
17 taken care of in time?

18 THE WITNESS: Building up enough profits --

19 COMMISSIONER LeBLANC: Right.

20 THE WITNESS: -- in successive years so that the
21 equity goes positive again.

22 COMMISSIONER LeBLANC: Thank you very much, Mr.
23 Chairman. Thank you, Mr. Burns.

24 CHAIRMAN GLEIMAN: Commissioner Covington?

25 COMMISSIONER COVINGTON: Good morning, Mr. Burns.

1 I just have two questions that I wanted to ask
2 your input or receive your input on.

3 First, out of curiosity, I have noticed that in
4 your bio you say that you have previously testified before
5 the Mississippi Public Service Commission, and I am assuming
6 that that was down in Jackson, and I would like to know what
7 was the subject matter or what regulatory area were you
8 focusing on when you rendered that testimony.

9 THE WITNESS: The regulatory area was electric
10 utility deregulation and whether or not having open access
11 would be in the public interest for the citizens of the --
12 as they would say, the sovereign state of Mississippi.

13 COMMISSIONER COVINGTON: Okay, and I needed to get
14 some clarification. Earlier, when you were finishing
15 talking to -- I mean were responding to questions posed by
16 the USPS counsel, you did state that you were not advocating
17 abolishment of the contingency fund, is that correct?

18 THE WITNESS: That's correct. It's in the statute
19 that there would be a reasonable contingency reserve. The
20 question is really one of what should be the appropriate
21 level of that reserve.

22 COMMISSIONER COVINGTON: So it is fair to say that
23 you do agree that there should be contingency allowances
24 that's designed to offset the effects of missed estimates as
25 it relates to revenue and cost, be it USPS or whoever?

1 THE WITNESS: Both missed estimates and also
2 uncontrollable and unforeseen events, yes.

3 COMMISSIONER COVINGTON: Okay. Now if the USPS
4 were not -- I hate to use the term "forced" to move away
5 from contingency reserves, to follow up on what Commissioner
6 LeBlanc said, what cushion would they be compelled to rely
7 on in a situation like that?

8 You mentioned reserve and catastrophic in relation
9 to things over in the insurance industry. What could the
10 USPS do in a situation like that?

11 THE WITNESS: Well, what they could do is -- one
12 of the things they do do is they rely on the fact that they
13 can come back for future rate increases to make up their
14 past losses. In the short term between that they can rely
15 on the full faith and credit of the Government that they can
16 actually borrow money, and if they did have a positive
17 equity they could rely on that, although that was -- again,
18 the idea is that the Postal Service run at a break-even
19 level and that it is a nonprofit.

20 COMMISSIONER COVINGTON: Okay then, Mr. Burns, now
21 you state that they could come back and make up those
22 contingency shortfalls through a rate request.

23 What do you feel or do you feel that along those
24 lines that the frequency might be a little bit more often
25 than it is right now, correct?

1 THE WITNESS: Well, it certainly is the case that
2 if you were to have losses, successive years of losses, that
3 one of the right actions to take by the Postal Service would
4 be to come in for a rate increase if they were actually
5 experiencing losses that took them beyond any equity that
6 they had and beyond the contingency reserve.

7 The probably again with relying too much on a
8 large contingency reserve is that it creates a moral hazard
9 that could actually allow the management to become lax. You
10 are far better off to keep the contingency reserve around
11 but at a low level, certainly within the bounds of
12 historical variance analysis and again we, Professor
13 Rosenberg and I, suggested at 1 percent.

14 The level it is at now, which they have been able
15 to live with and actually deal with contingencies, such as
16 the Y2K remediation -- they were able to take care of that
17 within their current contingency reserve -- and still end up
18 with a net profit for the year, which again contributes to
19 our getting back into a positive equity situation.

20 COMMISSIONER COVINGTON: Okay. I understand, Mr.
21 Burns, so when you say the USPS could borrow money, that
22 wouldn't be synonymous to having a line of credit, would it,
23 because a lot of the time when people have access to capital
24 and cash they have a tendency to exceed their balance, so
25 what do you mean by borrowing money?

1 THE WITNESS: This is where again I probably
2 should defer somewhat to Professor Rosenberg, but it is my
3 understanding, and he can speak better to this than I can,
4 that the Postal Service can borrow from the Treasury and
5 that that money is of course expected to be made up over
6 time and I know that Professor Rosenberg knows more of the
7 details about that than I do, but you certainly don't want
8 them to stay without asking for a rate increase if they are
9 running deficits because that is -- there is that same
10 problem that you are pointing out.

11 You don't want someone to have years and years of
12 successive shortfalls without coming in.

13 COMMISSIONER COVINGTON: Okay, and one other
14 question. I think in your testimony, Mr. Burns, you stated
15 that one of your contingencies as it related to the
16 contingency allowance was that the Postal Service had failed
17 only one in four years as far as breaking even during the
18 test year. Is that correct?

19 Or what period were you looking at? What test
20 years were you talking about?

21 THE WITNESS: I think that is actually in
22 Professor Rosenberg's testimony.

23 COMMISSIONER COVINGTON: So you, actually, in
24 other words, you were alluding to something that --

25 THE WITNESS: Well, I think Professor Rosenberg

1 has that in his testimony. It is not actually -- I don't
2 believe that one is actually in mine. But, yeah, but I do
3 rely on Professor Rosenberg on some of the things he says
4 about it being adequate. And it is my -- yes, it is my
5 understanding that they have only -- that that is the case.

6 COMMISSIONER COVINGTON: Okay. Thanks, Mr. Burns.
7 That is all I have, Mr. Chairman.

8 CHAIRMAN GLEIMAN: Thank you. I just have a
9 couple of questions. I wanted to get back to automobile
10 insurance, since that is where counsel for the Postal
11 Service started, and my recollection is he said something to
12 the effect that, if I had a good driving record for the past
13 five years, might I be inclined to cancel my liability
14 insurance prospectively? And you indicated that, no, and
15 that you weren't advocating that the Postal Service cancel
16 its liability insurance, that is, its contingency.

17 THE WITNESS: I would say if you had 30 years,
18 though, of good driving, that you would have a lower rate
19 and that would actually, since the rate here is paid by the
20 users of the Postal Service, that it calls for a lower
21 contingency reserve. Actually, it is to everyone's
22 advantage.

23 CHAIRMAN GLEIMAN: Yes, I understand that. Let me
24 ask you another analogy, an automobile insurance analogy. I
25 know that every so often my insurance company sends me a

1 questionnaire and asks me how many miles I am driving to
2 work. And if I live three miles from work and drive every
3 day, I get one rate. If I live 17 miles from work, which I
4 happen to live, and drive every day, I get another rate, and
5 that rate is substantially higher. My understanding is that
6 the reason that I get a lower rate when I either live closer
7 or don't drive as many days of the week is because my
8 exposure potential for accidents is less, is that the
9 theory?

10 THE WITNESS: Well, first of all, I think you have
11 the same insurance company as I do. And it does deal with
12 exposure for accidents and, particularly, when accidents
13 occur the most, which is during rush hour, coming to and
14 from work. And yes, it has to do with the likelihood that
15 you would have an accident in those cases.

16 CHAIRMAN GLEIMAN: Less time in the car, so to
17 speak, equates with less chance of having an accident?

18 THE WITNESS: And less time in heavily congested
19 traffic where people may tend to become a little more
20 reckless.

21 CHAIRMAN GLEIMAN: Okay. Thank you. That was the
22 only question I had.

23 Is there any follow-up to questions from the
24 bench?

25 MR. REITER: Yes, Mr. Chairman, I have two

1 follow-ups.

2 FURTHER CROSS-EXAMINATION

3 BY MR. REITER:

4 Q If I could follow up on the Chairman's line, and I
5 believe Commissioner Covington asked you a similar one about
6 this insurance analogy, you told me earlier that you
7 wouldn't recommend canceling my insurance based on my
8 driving record because of what could happen. Would you
9 recommend lowering the amount of liability that I carry
10 based on my record?

11 A Actually, lowering the amount of liability, there
12 is a -- usually, there is -- the amount of liability that
13 you should be carrying for cases of auto insurance actually
14 has more to do with the amount of potential loss that you
15 would have, given whatever your net worth is. There is
16 usually some statutory minimum.

17 In the case of the Postal Service, I think it
18 really has to do with -- the better way of looking at this
19 has to do with what should the premium be, given the risk.
20 It is not the amount of liability that you should be
21 carrying so much as what type of premium you should be
22 carrying. And again, here we are trying to deal with the
23 risk of you having an accident, rather than the potential
24 that you may wipe out your entire net worth. Again, if you
25 were a millionaire, and, of course, I don't know, government

1 attorneys don't tend to be, but I would recommend much
2 higher levels of liability than I would than if you were a
3 government attorney.

4 Q Back to the Postal Service on this angle, though,
5 the Postal Service is essentially self-insuring, is it not?

6 A It essentially is.

7 Q So you would need to consider liability, the
8 liability side, which is what I asked you, as well as the
9 premium side that you were talking about, isn't that right?

10 A Yes, but the Postal Service has almost -- well,
11 for these cases, the reason that it is self-insuring is that
12 it has such a deep pocket, so to speak, as far as the number
13 of assets that it can fall back on, the amount of revenues
14 and everything else. It will affect -- those will affect
15 whether or not, of course, you end up with losses in a
16 particular year.

17 The real question, the question becomes one of,
18 again, what have you experienced historically and what can
19 you clearly articulate on subjective grounds as being an
20 uncontrollable and unforeseen risk that you think you might
21 be exposed to?

22 Q Thank you. I want to follow-up on an answer that
23 you gave to Commissioner Covington. I believe you mentioned
24 you mentioned the Y2K expenses in that answer. And you
25 also, in the interrogatory answer you filed today, said that

1 you believe that that didn't have any adverse effect on the
2 Postal Service.

3 MS. DREIFUSS: Excuse me just for a moment.
4 Counsel, could you cite the interrogatory, please.

5 BY MR. REITER:

6 Q I'm sorry. 14.

7 A Okay.

8 Q You cited the Y2K program there as an example
9 where the Postal Service was able to cut costs and redirect
10 priorities without any adverse effect on service. I
11 wondered if you had actually looked at whether the Postal
12 Service is meeting its service goals this year.

13 A No, I haven't. I have not viewed any of the
14 Postal Service's own documents as to whether or not they are
15 meeting their goals. I didn't -- let's put it this way,
16 this one might be more of the garden variety analysis.
17 Certainly, no one, none of the general people in the general
18 public have noticed any great adverse change in service as
19 far as the Postal Service is concerned.

20 Q Is that statement based on your own experience or
21 have you done some sort of research or survey?

22 A That is based on both my own experience and simply
23 reading the papers. It is more of a casual type of thing.
24 I haven't gone out to do formal research on that topic.

25 MR. REITER: Thank you.

1 That is all I have, Mr. Chairman.

2 CHAIRMAN GLEIMAN: Is there any further follow-up?
3 Questions from the bench?

4 If not, Ms. Dreifuss, would you like some time
5 with your witness?

6 COMMISSIONER GOLDWAY: I have a question.

7 CHAIRMAN GLEIMAN: I'm sorry. Commissioner
8 Goldway.

9 COMMISSIONER GOLDWAY: I just wanted to clarify on
10 this insurance parallel that we are developing here, which I
11 think is quite interesting. It is also true that the Postal
12 Service does carry insurance for major unforeseen incidents
13 with regard to damage to property, et cetera, other than the
14 contingency fund, is that true?

15 MR. REITER: I am sure Mr. Chairman would not let
16 me testify. Maybe the witness knows.

17 THE WITNESS: I was going to say, I would --

18 COMMISSIONER GOLDWAY: I don't know whether to ask
19 that of the witness or get additional information.

20 THE WITNESS: Yeah, I would have to say that I
21 don't know.

22 CHAIRMAN GLEIMAN: Let me try and solve the riddle
23 here. Do you know about our seven day rule, Mr. Reiter?

24 MR. REITER: I have heard of it.

25 CHAIRMAN GLEIMAN: Well, we are going to invoke

1 the seven day rule. Could you get back to the Commission or
2 have someone at the Postal Service get back to the
3 Commission in writing and let us know the extent to which
4 the Postal Service carries liability and other types of
5 insurance, other than self-insuring, for property and the
6 like?

7 MR. REITER: Would a pleading signed by counsel be
8 sufficient, or do you need something from a witness?

9 CHAIRMAN GLEIMAN: I suspect we could accept a
10 pleading signed by counsel at this stage, and then we will
11 take it from there.

12 MR. REITER: Well, if you want to simplify it
13 then, then you can -- would you like to accept an oral
14 statement from counsel?

15 CHAIRMAN GLEIMAN: I think since this is not
16 evidence yet, or won't be, we can accept an oral statement
17 at this point.

18 MR. REITER: The Postal Service does not carry
19 liability insurance or any other insurance, it is entirely
20 self-insured.

21 CHAIRMAN GLEIMAN: Thank you.

22 COMMISSIONER GOLDWAY: But is there a line item on
23 the budget for self-insurance?

24 CHAIRMAN GLEIMAN: I think we are going to cross
25 the line now and get into --

1 THE WITNESS: Well, on this, I mean to the extent
2 that something happens that is not expected or foreseen,
3 given the historical variance analysis, given the
4 projections that the -- well, I'm sorry, not expected or
5 foreseen given the projections of the increased cost that
6 the Postal Service has already worked into its rate case.
7 They try to pick that up in the contingency reserve as part
8 of the variance analysis.

9 Now, some of the things are historical already,
10 that they know that they expect, of course, a certain amount
11 of traffic accidents that involve Postal delivery cars and
12 things like that, and that is already probably in the cost
13 and already probably in the projections. The contingency
14 reserve is to deal with misestimates that are beyond the
15 control of the Postal Service and, also, again, unforeseen
16 and uncontrollable events that are beyond their control --
17 well, that are out there.

18 So, this is a type of -- it is more of a
19 catastrophic.

20 COMMISSIONER GOLDWAY: So, for instance, the cost
21 of a fire at a Postal Service center, you are saying that
22 the normal operating budget for property or property
23 maintenance would include in it some factor for repairing
24 from fires that have occurred over the past, they have a
25 sense of how many fires they have.

1 THE WITNESS: Right.

2 COMMISSIONER GOLDWAY: And what the cost for
3 repairs would be. And that is carried in their regular
4 budget?

5 THE WITNESS: What would be to some extent carried
6 within the regular budget and, also, to the extent that they
7 might feel that the variance might be larger than normal,
8 again, that would be picked up by the objective portion of
9 the contingency reserve that is based on the historic
10 variance. So, the idea that you might get hit with a
11 Hurricane Andrew once every 20-30 years is actually also
12 picked up in that.

13 COMMISSIONER GOLDWAY: In the contingency?

14 THE WITNESS: Yeah. Because that would be
15 something more, far more drastic than a single building.

16 COMMISSIONER GOLDWAY: Mr. Chairman, could we ask
17 perhaps that the Postal Service be asked to review this
18 discussion and, if it is not in fact accurate, to provide us
19 with additional information? If this information does, in
20 fact, cover the status quo, I am happy, but I can't be sure
21 that it does.

22 CHAIRMAN GLEIMAN: I suspect that if the Postal
23 Service, in reviewing the testimony of this witness,
24 concludes that there is something in there that is amiss in
25 a manner which would be detrimental to them, that we will

1 hear about it in rebuttal testimony.

2 There is no reason that the Postal Service can't
3 review this exchange that just took place and provide
4 comments on it if it thinks that they don't accurately
5 reflect how the Postal Service budget is put together.
6 Whether there are considerations in putting its budget
7 together, separate and apart from the contingency, which
8 look at historical events and take those events into
9 account, looking prospectively, fires, automobile accidents
10 and the like. So, perhaps the Postal Service can provide us
11 something. And since you were so quick to respond, we will
12 even give you an extra day, we will make it the eight day
13 rule this time.

14 MR. REITER: Just so I am clear, so you are asking
15 for a supplemental statement other than waiting for
16 rebuttal?

17 CHAIRMAN GLEIMAN: Yes. Because it is not clear
18 to me, if there is nothing that is adverse in the
19 commentary, I suspect you wouldn't be inclined to rebut it
20 and my colleague wishes to know whether it reflects
21 accurately what goes into making up a portion of the budget.
22 So I think that it would be helpful, certainly to my
23 colleague, and I am sure to the rest of us also, if we had a
24 better understanding. More knowledge is better than less.

25 MR. REITER: We shall do that.

1 CHAIRMAN GLEIMAN: Thank you, sir.

2 COMMISSIONER GOLDWAY: And then can I just clarify
3 with our witness then, it is your understanding that, as you
4 described it, the contingency that the Postal Service
5 carries includes those funds necessary for these unforeseen
6 Acts of God, et cetera?

7 THE WITNESS: That is correct.

8 COMMISSIONER GOLDWAY: And your testimony is that
9 the 1 percent would be adequate for all of that? And
10 whatever other costs that are in the contingency that you
11 have estimated.

12 THE WITNESS: The contingency reserve is, again,
13 for misestimates that are not in the control of the Postal
14 Service, and, also, for those unforeseen events that, again,
15 are beyond their control. And I would think that
16 catastrophic events such as that would end up being in that
17 second category. That at least is the purpose of the
18 contingency reserve.

19 COMMISSIONER GOLDWAY: And with your understanding
20 of that, you are still proposing that 1 percent?

21 THE WITNESS: We are still proposing 1 percent,
22 yes.

23 COMMISSIONER GOLDWAY: Okay. Thank you.

24 CHAIRMAN GLEIMAN: Is there any follow-up?

25 [No response.]

1 CHAIRMAN GLEIMAN: Ms. Dreifuss, would you like
2 some time with your witness to see whether you want to do
3 redirect?

4 MS. DREIFUSS: Mr. Chairman, I know that we want
5 to do redirect, and I think we would need at least 10
6 minutes to prepare.

7 THE WITNESS: Well, we will take a 10 minute break
8 then.

9 MS. DREIFUSS: Thank you.

10 [Recess.]

11 CHAIRMAN GLEIMAN: Ms. Dreifuss?

12 MS. DREIFUSS: Yes, Mr. Chairman, we are ready to
13 proceed with redirect.

14 REDIRECT EXAMINATION

15 BY MS. DREIFUSS:

16 Q Mr. Burns, the Postal Service counsel asked you if
17 you could provide a cite for Witness Tayman's disavowal of
18 the variance analysis.

19 Were you able to locate that cite during the
20 break?

21 A Yes. It's Tayman USPS-T-9 at page 45, Question, I
22 believe, 1, line 6 through 7:

23 I believe historical variance analysis should not
24 be the basis for determining the need for a contingency or
25 its size.

1 Q The statement you just made was a direct quote
2 from Mr. Tayman's testimony; was it not?

3 A Yes, it was.

4 Q Postal Service counsel asked you about a driver
5 with a very good driving record, during oral cross
6 examination; did he not?

7 A Yes, he did.

8 Q And I think he asked you if somebody with 30 years
9 of a good driving record, ought to reduce the amount of
10 their liability insurance; do you remember that exchange?

11 A I do remember that exchange.

12 Q Do you think that's an apt analogy to the size of
13 the contingency?

14 A No, I don't. What I think is the case is that we
15 -- well, what you need to look at is, of course, you want to
16 have the contingency reserve actually set to the total
17 estimated costs of the Postal Service.

18 So, actually, you would want it have -- be one
19 percent to the total estimated costs.

20 The fact that someone has a good driving record,
21 though, that actually, again, goes to the probability that
22 an accident would occur, and you could have a lower
23 insurance premium or a lower amount charged toward that
24 contingency reserve.

25 You still want to have it based on the total

1 estimated costs, though.

2 Q And you were not advocating applying the
3 contingency of one percent that you recommend, to anything
4 less than the total revenue requirement of the Postal
5 Service; is that correct?

6 A That's correct.

7 [Pause.]

8 Q Mr. Reiter also asked you a question about a
9 document that was filed on May 17th, and it was entitled
10 Responses of United States Postal Services to Questions of
11 the Office of the Consumer Advocate Regarding the Provision
12 for Contingencies.

13 He focused your attention on a Postal Service
14 response to Question Number 2. I'll give you a moment to
15 get to that place.

16 [Pause.]

17 If necessary, Mr. Burns, you and I can share the
18 same copy.

19 MS. DREIFUSS: Mr. Chairman, may I approach the
20 witness?

21 CHAIRMAN GLEIMAN: Certainly.

22 THE WITNESS: Is this it? I found it. Okay,
23 good.

24 BY MS. DREIFUSS:

25 Q He read you a statement, to the extent they can be

1 identified, an attempt is usually made to evaluate the
2 potential effects on future needs by some order of
3 magnitude. And he gave you some examples.

4 Have you seen any evidence in the record that
5 these effects have been identified, and particularly, have
6 they been quantified anywhere in the record?

7 A No, I have not seen any evidence to that effect.
8 In fact, with the response of Witness Tayman to the
9 interrogatories of the Office of Consumer Advocate, which is
10 OCA/USPS-T-9-43, in C, where it asks, please specifically
11 identify and explain each new or increased concern, risk, or
12 issue, or other criteria management considered when deciding
13 that the contingency should be increased in its docket from
14 the level requested in Docket Number R97-1, the statement
15 was made that the determination was largely subjective, and
16 there was a cross referral to the Direct Marketing
17 Association interrogatories and answers to that, which was
18 DMA/USPS-T9-15 and DMA/USPS-T9-47.

19 And in both of those, well, it was stated that the
20 determination was subjective and intuitive.

21 And in the one that's T9-47, Witness Tayman said:
22 I did not perform any studies relative to the greater risk
23 in this case than the last two.

24 And, again, the same type of non-response as far
25 as actually whether or not there is some type of a variance

1 analysis that goes off into the future and projects into the
2 future.

3 The statement is made again that there were no
4 specific studies to that effect.

5 Q Mr. Reiter seemed to try to make a distinction in
6 his questions concerning that sentence that I just read to
7 you a moment ago, that possibly Mr. Tayman had done some
8 kind of quantification of future risks.

9 Now, the OCA interrogatory that you've just cited,
10 that's a question about future risk; is it not?

11 A It is a question about future risk, yes.

12 Q And his answer is, if I understood you correctly,
13 that when he was estimating future risk, it was largely a
14 subjective determination; is that correct?

15 A That's correct; it's subjective and intuitive.

16 MS. DREIFUSS: I have no further questions, Mr.
17 Chairman.

18 CHAIRMAN GLEIMAN: Is there any recross?

19 MR. REITER: No, Mr. Chairman.

20 CHAIRMAN GLEIMAN: Mr. Burns, under ordinary
21 circumstances, this would complete your appearance before
22 the Commission, however, in recognition of the
23 interrelationship of your testimony and that of Witness
24 Rosenberg, OCA has volunteered to keep you available in the
25 hearing room today during the cross examination of witness

1 Rosenberg.

2 THE WITNESS: I wouldn't miss it anyway.

3 [Laughter.]

4 CHAIRMAN GLEIMAN: If Witness Rosenberg is asked a
5 question that he cannot answer because it is determined that
6 that is within your area of expertise, we may, indeed,
7 recall you to the stand.

8 I'm not sure whether you want to miss that or not.

9 [Laughter.]

10 CHAIRMAN GLEIMAN: But let me state for the
11 record, in the event that we don't recall you and I don't
12 have a chance to say so later, that we appreciate your
13 testimony. We appreciate OCA volunteering you for a few
14 more hours, perhaps, and with that caveat, you are excused.

15 [Witness Burns temporarily excused, subject to
16 recall.]

17 CHAIRMAN GLEIMAN: Counsel, you can call your next
18 witness whenever you're ready.

19 MS. DREIFUSS: The OCA calls Edwin A. Rosenberg to
20 the stand.

21 Whereupon,

22 EDWIN A. ROSENBERG,
23 a witness, having been called for examination, and, having
24 been first duly sworn, was examined and testified as
25 follows:

DIRECT EXAMINATION

BY MS. DREIFUSS:

Q Would you state your full name for the record, please?

A My name is Edwin A. Rosenberg.

Q And would you state your position, please?

A I'm an economist at the National Regulatory Research Institute, which is located at the Ohio State University in Columbus, Ohio.

Q Do you have before you, two copies of a document captioned Direct Testimony of Edwin A. Rosenberg, OCA-T-3?

A I do.

Q Were there any changes to this testimony, subsequent to the time it was originally filed?

A I believe there was one change to Table 5.

Q Yes, could you describe that change, please?

A I'll have to find it. In Table 5, which is located on page 14 of the testimony, there was a mistyping, and since I did the typing, I guess it was my mistyping.

In the column labeled 1986 -- or the row labeled 1986 to 1990, the second part of that, in the original page it showed that a 3.5 percent contingency was allowed, and had showed R84-1 rates being in effect from April '88 to February 1991.

And that should be R87-1 rates in effect from

1 April 1988 to February 1991, but everything else is correct,
2 and I understand we've entered that correction.

3 Q Right. It's your understanding of each of the two
4 copies you have before you include a revised page 14?

5 A That is correct.

6 Q Did you prepare this testimony, or was it prepared
7 under your direct supervision?

8 A Yes, I did; I prepared it.

9 Q Do you adopt this testimony today?

10 A I do.

11 MS. DREIFUSS: In that case, Mr. Chairman, I ask
12 that the testimony be entered into evidence and transcribed
13 into the record, and I will give the Reporter two copies.

14 CHAIRMAN GLEIMAN: If you would do that, counsel,
15 then I will direct that the testimony be transcribed into
16 the record and entered into evidence.

17 [Direct Written Testimony of Edwin
18 A. Rosenberg, OCA-T-3, was received
19 into evidence and transcribed into
20 the record.]

21
22
23
24
25

OCA-T-3
Docket No. R2000-1

DIRECT TESTIMONY
OF
EDWIN A. ROSENBERG

ON BEHALF OF
THE OFFICE OF THE CONSUMER ADVOCATE

MAY 22, 2000

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

Postal Rate and Fee Changes, 2000)

Docket No. R2000-1

DIRECT TESTIMONY
OF
EDWIN A. ROSENBERG

1 I. STATEMENT OF QUALIFICATIONS

2 My name is Edwin A. Rosenberg. I am an economist employed by The National
3 Regulatory Research Institute (henceforth, NRRI), which was established in 1976 by
4 the National Association of Regulatory Utility Commissioners (NARUC). The NRRI is
5 located at The Ohio State University in Columbus, Ohio, and its primary mission is to
6 provide research and advice to members of NARUC, such as the Postal Rate
7 Commission.

8 I have been at The NRRI since 1991. During that time I have authored or co-
9 authored a number of reports and papers concerning regulatory issues. In addition, in
10 1994, I offered testimony before the Public Utilities Commission of Ohio in Case No. 93-
11 487-TP-ALT. In that case, I, along with NRRI colleagues, evaluated a request by the
12 Ohio Bell Telephone Company to shift to from cost-of-service, or rate-of-return
13 regulation, to an alternative form of regulation – in this case, price-cap regulation. The
14 Staff of the Commission sponsored my testimony in that case.

1 Prior to joining The NRRI, I taught economics and statistics at the University of
2 North Carolina at Asheville and at North Carolina State University. Prior to that, I was
3 an economist on the Staff of the North Carolina Utilities Commission and the Public
4 Staff of that Commission. In that capacity I performed analyses and offered testimony
5 on a variety of issues concerning the regulation of electric, natural gas, and telephone
6 utilities in North Carolina.

7 I received a Bachelor of Arts degree in Economics from the University of North
8 Carolina at Asheville (1971), a Master of Economics degree (1973) and a Doctor of
9 Philosophy degree in economics (1985) from North Carolina State University.

10 II. PURPOSE AND SCOPE OF TESTIMONY

11 Robert Burns and I were asked by the Office of Consumer Advocate to consider
12 the reasonableness of the United States Postal Service's request for a contingency
13 provision in the amount of 2.5 percent of test-year revenues in this Docket. The
14 authority for such a contingency provision is found in 39 U.S.C. §3621, which states
15 that:

16 Postal rates and fees shall provide sufficient revenues so that the total
17 estimated income and appropriations to the Postal Service will equal as
18 nearly as practicable total estimated costs of the Postal Service. For
19 purposes of this section, "total estimated costs" shall include (without
20 limitation) operating expenses, depreciation on capital facilities and
21 equipment, debt service (including interest, amortization of debt discount
22 and expense, and provision for sinking funds or other retirements of
23 obligations to the extent that such provision exceeds applicable
24 depreciation charges), and *a reasonable provision for contingencies*.¹

¹ Emphasis added.

1 Thus, the question is not whether there should be a provision for contingencies but,
2 rather, whether the amount requested is reasonable.

3 III. RECOMMENDATION

4 I believe that an increase in the contingency provision from the existing level of
5 one percent of total estimated costs to 2.5 percent of total estimated costs is neither
6 necessary for the continued successful operation of the Postal Service nor in the public
7 interest. Such an increase would tend to raise rates charged for postal services above
8 reasonable levels given the costs incurred by the Postal Service. At this time, the
9 existing contingency provision of one percent of total estimated expenses should be
10 continued.

11 I have formed my opinion as a result of the application of a combination of sound
12 public policy and regulatory principles and evaluation of USPS Witness Tayman's
13 testimony and exhibits.²

14 The rates of the Postal Service are set using basic principles of cost-of-service
15 regulation. This principle is found in 39 U.S.C. §3621, which, as noted earlier, states
16 that

17 Postal rates and fees shall provide sufficient revenues so that the total
18 estimated income and appropriations to the Postal Service will equal as
19 nearly as practicable total estimated costs . . . and a reasonable provision
20 for contingencies.

² USPS-T-9.

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1 Thus, rates should be just sufficient to cover estimated expenses and allow for some
2 unforeseen or uncontrollable circumstances, but they should not be more than is
3 reasonably sufficient to do so.

4 The form of rate regulation applied to the Postal Service is a variant of a form of
5 regulation that has been applied in various public utility sectors in the United States for
6 many years. Though widely applied, cost-of-service regulation was subject to many
7 criticisms. These included its "cost plus" nature and lack of strong incentives for
8 regulated firms to minimize costs, the interaction of historical test years and regulatory
9 lag (causing rates to tend to lag costs during periods of rising costs), and prohibitions
10 against retroactive ratemaking (barring regulated firms from recovering economic
11 losses incurred when revenues did not cover total costs). Several of these
12 shortcomings in cost-of-service regulation are avoided in the specific application form to
13 the Postal Service.

14 First, in determining the level of test-year estimated expenses, revenues, and
15 revenue deficiency, the Postal Service is not required to use a strict historical test year.
16 Indeed, in estimating test-year revenues and expenses, the Postal Service is allowed to
17 begin with an historical base period and make many *pro forma* or "roll-forward"
18 adjustments to account for factors that are known or expected to occur outside the
19 historical base year. Thus, the estimated revenues and expenses for the test year,
20 especially on an "after rates" basis, represent the best available estimates or
21 projections of Postal Service management.

22 Second, in addition to allowing for *pro forma* adjustments to arrive at test-year
23 revenue and expense accounts, a reasonable provision for contingencies is added to

1 the forecast revenue requirement. This provision provides some safety margin should
2 the estimated revenues and expenses miss the mark due to unforeseen, unexpected,
3 and uncontrollable factors that adversely affect revenues and/or expenses.

4 Third, if the estimated revenues and expenses are way off target, and the
5 contingency provision should, therefore, turn out to be too small, the resulting operating
6 deficit can be recovered in the future on an amortized basis through the use of the
7 recovery of prior years' loss provision. Of course, reliance on recovery of prior years'
8 losses should be minimized, since this creates an inter-temporal transfer to the extent
9 that future customers are asked to pay costs that rightly belong to today's customers.
10 Nevertheless, the existence of this provision provides an additional level of protection
11 for the Postal Service.

12 Thus, the Postal Service has three different levels of protection that provide it
13 with a reasonable opportunity to meet its goals of breaking even financially while
14 providing good service to consumers at reasonable rates. Indeed, Mr. Tayman's
15 testimony and exhibits point this out. The Postal Service has posted positive net
16 incomes, or is projected to do so, in each year from 1995 through 2000.³

17 Although regulatory lag is often considered to be a deficiency, the existence of
18 regulatory lag can act to provide incentives for managers to minimize costs. The
19 process of resetting postal rates is time consuming, and there is a lag between the
20 projection or realization of the need for an increase in the general level of postal rates
21 and their implementation. During this period, managers are likely to find themselves in

³ USPS-T-9, p. 3-4.

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1 the position of having to make decisions to hold down costs so that the Postal Service
2 is able to come as close as possible to its break even target. This may be considered
3 to be a good thing, since managers *should* be in a position of having to seek ways of
4 controlling costs. Indeed, It is presumed that the Postal Service will exercise "honest,
5 efficient, and economical management."⁴

6 The allowance for a contingency provision in the revenue requirement is, in my
7 opinion, a form of insurance against unforeseen, unexpected, and uncontrollable
8 adverse fluctuations in revenues and/or expenses. The Postal Service is allowed to
9 adjust historical data to reflect known or projected changes in revenues and expenses;
10 nevertheless, there will almost certainly be some fluctuations that are not accounted for.
11 So the contingency provision serves as a cushion against occurrences that could not
12 reasonably be forecasted or foreseen. In addition, because of its cushioning effect, it
13 serves, implicitly, to lengthen the time between postal rate increases. A larger
14 contingency provision provides more of a cushion; a smaller contingency provision
15 provides less of a cushion. The essential question is: What is the optimum size of the
16 contingency?

17 A disciplined analysis of the optimum size of a contingency provision would
18 consider the following factors:

- 19 1) The magnitude and types of uncertainties that necessitate the existence of a
20 contingency provision. Of particular concern in this regard is the state of the
21 economy.

⁴ 39 U.S.C. § 3621.

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1 2) The historical experience of the Postal Service with respect to its contingency
2 provision. How has the Postal Service fared under various contingency
3 provisions?

4 3) The short-run and long-run effects of the contingency provision turning out to be
5 either too large or too small.

6 a) On the Postal Service and its managers

7 b) On the customers of the Postal Service

8 After considering these factors, the contingency provision may be set at a level that
9 considers existing circumstances and balances the various interests involved.

10 In my opinion, the requested increase in the contingency provision from one
11 percent to 2.5 percent of total expenses is not necessary at this time, and a
12 contingency provision of one percent of total estimated expenses should be allowed. I
13 have come to this opinion based on consideration of a number of factors.

14 IV. FACTORS CONSIDERED IN RECOMMENDATION

15 A. Economic Conditions Are Relatively Stable

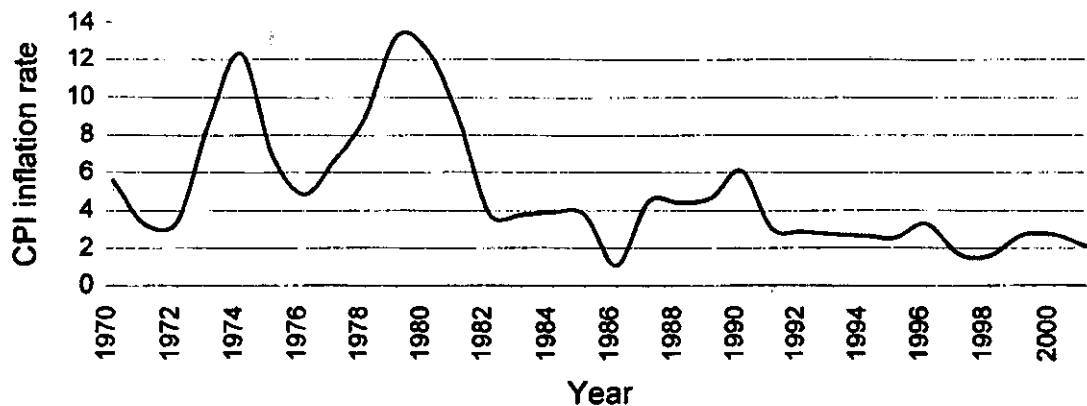
16 One major purpose of the contingency provision is to ensure against forecast
17 errors and unforeseen and uncontrollable events that have adverse consequences on
18 revenues and/or expenses. Other things being equal, relatively favorable and stable
19 economic conditions at present and forecasts of reasonable stability over the near-term
20 future can be expected to strengthen the ability of the Postal Service to forecast
21 revenues and expenses on a going forward basis, so the Postal Service's estimates
22 would be expected to be more reliable now than in more uncertain times. More

1 accurate forecasts or estimates would tend to allow for a relatively smaller provision for
2 contingencies.

3 At the present time, the United States is operating in a climate of relatively low
4 inflation, and the Federal Reserve Board, under Chairman Alan Greenspan, is
5 committed to hold inflation at moderate levels. Indeed, recent increases in the target
6 federal funds rate are pre-emptive strikes against nascent inflationary pressures.
7 Tables 1, 2, and 3 present excerpts from recent macroeconomic forecasts by the
8 Congressional Budget Office, Deutsche Banc Alex. Brown, and Standard and Poor's
9 DRI for 2000 and 2001. The historical path of consumer price inflation is shown in
10 Figure 1 and there is reasonable consensus that inflation is likely to continue to be
11 moderate through 2001. I have included DRI's April 2000 forecast of CPI inflation rates
12 for 2000 and 2001 taken from Table 3.

Figure 1
CPI Inflation 1970 - 2001

Historical Data from Table 4
Estimates for 2000 and 2001 from Table 3



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Table 1
Congressional Budget Office
Forecast for 2000 and 2001

Variable	Estimated	Forecasted	
	1999	2000	2001
Fourth Quarter to Fourth Quarter (Percentage change)			
Nominal GDP	5.3	4.6	4.7
Real GDP	3.9	2.9	3.0
GDP Price Index	1.4	1.7	1.6
Consumer Price Index	2.6	2.3	2.5
Consumer Price Index Excluding Food and Energy	2.1	2.3	2.5
Calendar Year Average (Percent)			
Real GDP	3.9	3.3	3.1
Unemployment Rate	4.2	4.1	4.2
Three-Month Treasury Bill Rate	4.6	5.4	5.6
Ten-Year Treasury Note Rate	5.6	6.3	6.4

Source: Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2001-2010*, released electronically on January 26, 2000.⁵

⁵ Accessed at <http://www.cbo.gov/showdoc.cfm?index=1824&sequence=0&from=7>, May 11, 2000.

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Table 2
Deutsche Banc Alex. Brown
Economic Forecast

Variable	2000	2001
Annual Percent Change		
CPI	2.7	2.0
Implicit Price Index	1.8	1.6
Real GDP	3.8	4.0
Unit Labor Costs (nonfarm)	0.8	1.8
Hourly Comp. (nonfarm)	4.4	4.7
Productivity (nonfarm)	3.5	2.8
Annual Average		
Unemployment Rate	3.9	3.7
3-Month Treasury Bills	6.0	6.2
10-Year Governments	6.2	6.1
Prime Rate	9.2	9.5

Source: Deutsche Banc Alex. Brown⁶

Table 3
DRI's Forecast for the U.S. Economy

Variable	1999	2000	2001
Annual Percent Rate of Change			
Real GDP	4.1	4.5	3.0
GDP Price Index	1.4	1.7	1.6
CPI (all urban consumers)	2.2	2.7	2.1
CPI excluding food And energy	2.1	2.3	2.3
Employment Cost Index	3.2	4.3	4.0
Output per Hour	3.0	3.0	1.8
Annual Average			
Unemployment Rate	4.2	3.9	4.0
Prime Rate	8.0	9.2	9.7
Thirty-Year Treasury Bond Yield	5.9	6.1	6.0
Treasury Bill Rate	4.6	5.9	6.1

Source: Standard & Poor's DRI, CONTROL0400 Forecast, April 2000

⁶ Dated May 5, 2000, <http://www.yardeni.com>, May 11, 2000.

1 The United States is currently enjoying the longest economic expansion in over
2 half a century. We continue to have robust economic growth combined with low and
3 relatively stable inflation. These conditions should allow the Postal Service to meet its
4 responsibilities with a minimum provision for contingencies.

5 B. The Recent Financial Success of the Postal Service

6 The recent experience of the Postal Service is that it has been able to achieve a
7 positive net income over the two most recent rate cycles with a contingency provision
8 less than the 2.5 percent requested. Nothing in the recent operating history of the
9 Postal Service suggests that the 2.5 percent request is necessary.

10 Unlike some situations that the Postal Service has experienced historically, there
11 is no chronic or growing deficit resulting from an over forecast of revenues and/or under
12 forecast of expenses. As shown in Mr. Tayman's Exhibit 9L,⁷ the Postal Service has
13 achieved a positive net income in every year since 1995 and is projected to do so
14 during FY 2000.

15 In fact, during the 1995 through 2000 period, the Postal Service generated a
16 cumulative net income of \$5.58 billion.⁸ The contingency provision was set at two
17 percent in Docket No. R94-1 and at one percent in Docket No. R97-1. In each year
18 since implementation of the rates approved in R94-1, the Postal Service has operated
19 quite successfully with a contingency provision less than the 2.5 percent it has
20 requested in this Docket.

⁷ USPS Exhibit 9L.

⁸ Calculated from USPS Exhibit 9L.

1 C. The Postal Service's Ability to Forecast is Improving

2 During the period immediately subsequent to the Postal Reorganization Act of
3 1970, the Postal Service entered a new environment. It has now had nearly thirty years
4 of experience operating in a more business-like manner. Thirty years of experience in
5 exercising honest, efficient, and economical management, by itself, justify a smaller
6 contingency provision than was necessary as the Postal Service sailed into uncharted
7 waters after its reorganization.

8 In addition, economic conditions – especially inflation rates – were much more
9 volatile and uncertain in the 1970s and 1980s than they are today. Inflation was, on
10 average, considerably higher then than it has been recently or than it is expected to be
11 over the near-term future. Historical inflation figures based on December-to-December
12 changes in the CPI for all urban consumers are shown in Table 4.

13 The rate of inflation is a major area of uncertainty that leads to the necessity of a
14 contingency provision. Other things being equal, higher rates of inflation may justify
15 relatively larger contingency provisions.

16 In addition to operating in a relatively stable economic climate, in Fiscal Year
17 1999 the Postal Service created a sixteen-person forecasting organization within its
18 Finance function. The goal of that group is to create more accurate and reliable
19 forecasts.⁹ More accurate and reliable forecasts would tend to reduce uncertainty and
20 allow for a smaller contingency provision.

⁹ Tr. 2/146.

Table 4
Consumer Price Index for All Urban Consumers:
All Items, 1982-84=100, Not Seasonally Adjusted

Year	December Value	Annual % Change	Year	December Value	Annual % Change
1969	37.7	n.a.	1985	109.3	3.80
1970	39.8	5.57	1986	110.5	1.10
1971	41.1	3.27	1987	115.4	4.43
1972	42.5	3.41	1988	120.5	4.42
1973	46.2	8.71	1989	126.1	4.65
1974	51.9	12.34	1990	133.8	6.11
1975	55.5	6.94	1991	137.9	3.06
1976	58.2	4.86	1992	141.9	2.90
1977	62.1	6.70	1993	145.8	2.75
1978	67.7	9.02	1994	149.7	2.67
1979	76.7	13.29	1995	153.5	2.54
1980	86.3	12.52	1996	158.6	3.32
1981	94.0	8.92	1997	161.3	1.70
1982	97.6	3.83	1998	163.9	1.61
1983	101.3	3.79	1999	168.3	2.68
1984	105.3	3.95	2000	n.a.	n.a.

Source: U.S. Department of Labor, Bureau of Labor Statistics¹⁰

- 1 Using the data shown in Table 4, I have calculated the simple averages of the
- 2 annual rates of change in the CPI for various periods. These simple or arithmetic
- 3 averages are shown in Table 5.

¹⁰ Accessed at <http://www.stls.frb.org/fred/data/cpi/cpiaucns> May 16, 2000.

Table 5
Arithmetic Averages of Annual CPI
Inflation Rates and Contingency Provision
(Inflation Data from Table 4)

Period	Arithmetic Average of Annual CPI Inflation Rates	Contingency Provision Recommended by the PRC	Case and Effective Dates
1970 - 1975	6.93%	n.a.	n.a.
1976 - 1980	9.28%	4%	R76-1, May 1978 to March 1981
1981 - 1985	4.86%	4%	R76-1, May 1978 to March 1981 R77-1, March 1981 to October 1981
		2.5% ¹¹	R80-1, November 1981 to February 1985
		3.5%	R84-1, February 1985 to April 1988
1986 - 1990	4.14%	3.5%	R84-1, February 1985 to April 1988
		3.5%	R87-1, April 1988 to February 1991
1991 - 1995	2.79%	3.5%	R90-1, February 1991 to December 1994
		2%	R94-1, January 1995 to January 1999
1996 - 1999	2.33%	2%	R94-1, January 1995 to January 1999
		1%	R97-1, January 1999 to present

- 1 Table 5 shows that the average rate of CPI inflation has generally been declining
2 since 1980. Table 5 also includes information on the time path of the contingency
3 provision recommended by the Postal Rate Commission during the various time

¹¹ The PRC recommended 2.5%, but the recommendation was appealed, and the effective contingency provision was 3%.

1 periods. As can readily be seen here and in Figure 1, above, the time path of inflation
2 has both trended lower and become less erratic in recent years. Both lower inflation
3 and less erratic inflation are factors that support a smaller contingency provision. This
4 is confirmed in the downward trend of the contingency provision over time. To increase
5 the contingency provision from the current one percent to 2.5 percent would certainly
6 deviate from the past trend illustrated in Table 5.

7 D. The Existence of Other Safety Net Provisions

8 Remember that the contingency provision is one of several built-in safety nets to
9 ensure the viability of the Postal Service, the others being the use of *pro forma*
10 estimates of revenues and expenses, the provision for recovery of prior years' losses,
11 management's ability to control expenses, and the Postal Service's ability to borrow.
12 Finally, I would note that the Postal Service is able to request new rates if it
13 experiences revenue shortfalls and/or expense increases that put it in jeopardy.

14 Although the recovery of prior years' losses provision and borrowing authority
15 should not be relied upon as substitutes for the contingency provision, the existence of
16 these additional safety nets may be taken into account when making a recommendation
17 as to the appropriate size of the contingency provision. If neither the recovery of prior
18 years' losses provision nor borrowing were available, the appropriate contingency
19 provision would be larger.

20 E. The Requested Increase in the Contingency Provision Is a Major
21 Component in the Revenue Deficiency and Should Be Justified

22 The increase in revenues necessary to move from a contingency provision of
23 one percent to a contingency provision of 2.5 percent is more than 27 percent of the

1 revenue requirement deficiency. Mr. Tayman states that "[t]he Test Year deficiency . . .
 2 will be approximately \$3.7 billion" ¹² On an "after rates" basis, the increase in the
 3 contingency reserve is, by itself, approximately \$1,007,859,510. ¹³ In fact, if calculated
 4 on an "after rates" basis, with an adjustment for cost savings, the increase is over 36
 5 percent of the total revenue increase. ¹⁴ An increase of the magnitude sought in this
 6 Docket should, I believe, require well reasoned justification; saying it is needed doesn't
 7 necessarily make it so.

8 F. Many Potential Sources of Expense and Revenue Variation are
 9 Accounted for in the Estimated Revenues and Expenses

10 In his discussion of the provision for contingencies, Mr. Tayman notes that

11 Volume growth is below historical norms and projections of Fiscal Year
 12 2000 require workyears be held at the Fiscal Year 1999 level while mail
 13 volume and the delivery network continue to grow. ¹⁵

14 Mr. Tayman also states that

15 Health benefit cost increases have now returned to near double digit
 16 rates. Also, the labor contracts which have become effective since the
 17 last rate filing are significantly more costly than previous contracts. ¹⁶

¹² USPS-T-9, p. 10.

¹³ USPS-T-9, p. 22, Table 15.

¹⁴ USPS-T-9, p. 52, Table 58.

¹⁵ USPS-T-9, pp. 43-44.

¹⁶ USPS-T-9, p. 44.

1 However, he admitted that

2 estimated volume and delivery network changes and changes in the level
3 of costs in employee benefits have been accounted for in the estimation
4 of test year revenues and expenses.¹⁷

5 Therefore, these factors cannot be adduced to justify the contingency provision,
6 and they certainly cannot be used to justify *increasing* the contingency provision by
7 more than \$1 billion. Moreover, Mr. Tayman stated that

8 The Postal Service's financial performance is under much greater
9 pressure and is subject to substantially greater risks than it was at the
10 time of the last two omnibus rate cases.¹⁸

11 However, he has also admitted that this statement is "subjective and intuitive" and that
12 he had performed no studies in this area.¹⁹ My colleague, Robert Burns, discusses in
13 greater detail the reasons for which Mr. Tayman's testimony is inadequate to support an
14 increase in the contingency provision.

15 V. THE REQUEST FOR A CONTINGENCY PROVISION OF 2.5 PERCENT IS
16 NOT SUPPORTED BY THE POSTAL SERVICE'S VARIANCE ANALYSIS

17 A. The Requested 2.5 Percent Lies Outside the Range of the Variance
18 Results

19 The variance analysis presented in Mr. Tayman's Exhibits²⁰ also fails to support
20 the necessity of a 2.5 percent contingency provision. The requested contingency
21 provision of 2.5 percent of total estimated costs lies *outside the range* of the results of

¹⁷ Tr. 2/280.

¹⁸ USPS-T-9, p. 45.

¹⁹ Tr. 2/304.

²⁰ USPS Exhibit 9J, pp. 5-8.

1 the variance analysis, which is from a positive 2.2% to a negative 2.3%. The mid-point
2 of the range of the four results is nearly zero (negative 0.05%). Moreover, even though,
3 as shown in Table 6, three of the scenarios presented assume lower than expected
4 revenues, the *total* of the four scenarios is negative, but it is less than one percent of
5 estimated test year costs. Furthermore, the *average* across the four scenarios is
6 negative, but it is less than one-quarter of one percent of estimated test year costs.

7 Mr. Tayman does not favor using the variance analysis to determine the size of
8 the contingency provision. He states

9 No matter what results an historical variance analysis produces, it is not
10 appropriate to use historical data to determine the size of the contingency
11 in lieu of management's judgment about the future.²¹

12 The Postal Service prefers, instead, to rely upon largely judgmental and
13 subjective guesstimates in determining the requested contingency provision. This
14 appears to be an attempt for the Postal Service to have their cake and eat it too:
15 recognizing that their *ex ante* forecasts may turn out to be wrong *ex post* – leading to
16 the necessity for the provision for contingencies – but asserting their ability to
17 accurately gauge the amount by which their forecasts are likely to be wrong.

²¹ USPS-T-9, p. 45.

Table 6
Results of Variance Analysis

Scenario	Net Effect	
	\$ 000's	%
Revenues .962% higher than expected; Expenses 1.177% lower than expected	\$1,455,557	2.2%
Revenues .9165% lower than expected; Expenses 1.119% lower than expected	\$118,279	0.2%
Revenues .1367% lower than expected; Expenses .9429% higher than expected	- \$728,039	- 1.1%
Revenues 1.23% lower than expected; Expenses .9878% higher than expected	- \$1,513,889	- 2.3%
Total	- \$668,092	
Total as a % of Test Year Estimated Cost	- 0.994%	
Average	- \$167,023	
Average as a % of Test Year Estimated Cost	- 0.2486%	

Source: USPS Exhibit 9J, pp. 5-8

1 If we consider the Postal Service's ability to forecast revenues and expenses on
2 an "after-rates" basis, using the figures contained in USPS Exhibit 9J, page 3 of 8, we
3 find that the total estimated "after-rates" revenues for the test years in the four previous
4 rate cases (Docket Nos. R87-1, R90-1, R94-1, and R97-1) were \$200,925.4 billion,²²
5 and actual after-rates revenues for the four years were \$200,650.8 billion. Thus, the
6 Postal Service's revenue forecast for the four years was a total of \$274.6 million, or
7 0.14 percent, high with two overestimates and two underestimates. On the expense
8 side, total expenses were estimated to be \$195,954.1 billion and actual total expenses

²² Using the "before-rates" estimated revenue for the test year in Docket No. R97-1, because the Docket No. R97-1 rates were not, in fact, implemented during the test year.

1 were \$198,805.7 billion. Thus, the Postal Service's expense forecast for the four years
2 was a total of \$2.8156 billion, or 1.46 percent, low, with one overestimate and three
3 underestimates. Over the four years, this amounts to an underestimate of net income
4 totaling \$3.1262 billion, or 1.57 percent, of total actual costs (or 1.6 percent of total
5 estimated costs). However, in only one of those years (FY1992) was there an actual
6 net loss. Thus the actual experience of the Postal Service after the last four rate cases
7 does not support increasing the contingency provision from one percent of estimated
8 total costs to 2.5 percent of estimated total costs.

9 B. Other Analytical Methods are Available

10 The Commission finds variance analysis to be a useful tool, but not the only
11 means to evaluate the reasonableness of a requested contingency provision. Other
12 analytical methods are available that might be useful. For example, in the electric utility
13 industry, a similar situation often arises. Electric utilities require some excess
14 generating capacity (a reserve margin), over and above their projected peak load, to
15 allow for unexpected weather-induced periods of high demand and/or for unplanned
16 outages of generation plants.

17 Electric utilities attempt to keep a reasonable amount of reserve capacity
18 available so that consumers are not faced with power brownouts or blackouts during
19 extreme weather – and consumers pay for the maintenance of this reserve capacity.
20 Greater reserve capacity decreases the probability that extreme weather or an
21 unplanned plant outage will result in the utility's inability to meet the demand placed on

1 its system (loss of load), but greater reserve capacity is costly, so the costs and benefits
2 of a greater or lesser amount of reserve capacity must be considered.

3 One commonly used way of determining whether a utility has sufficient, but not
4 excessive, reserve capacity is to use loss of load probability analyses (LOLP). These
5 probabilistic analyses simulate weather variation and allow for random unplanned plant
6 outages. Based on hundreds or thousands of Monte Carlo simulations of various
7 demand and plant availability conditions, the LOLP can be calculated for different plant
8 configurations. If the LOLP for a given mix of plants is at or just below some
9 predetermined value in terms of percent or days per year, the reserve capacity is
10 considered adequate, but not excessive. Another criterion sometimes used is that
11 there should be sufficient reserve capacity to meet projected peak loads when one, two,
12 or even three of the largest plants are forced out of service unexpectedly.

13 In addition, LOLP analyses are also considered in light of the possibility that a
14 utility facing internal supply constraints may be able to purchase power from utilities or
15 other power generators that have excess capacity at the time, and that the utility may
16 be able to control portions of its load by curtailing service to customers receiving power
17 under interruptible contracts or by engaging in other demand-side management
18 practices. Again, although the goal is to ensure sufficient capacity to meet customers'
19 needs, given the vagaries of weather and unplanned outages, consideration is given to
20 the relative costs and benefits of more versus fewer reserves.

21 Telephone companies and natural gas companies also face analogous
22 questions when making decisions related to network design or the amount of stored
23 reserves to have on hand, respectively. Similarly, there are analytical models that have

1 been developed to aid in the decision making process in these industries.

2 Although the situation facing the Postal Service is somewhat different, it would
3 be useful for the Postal Service to develop some form of more analytical approach to
4 determining the likely range of outcomes and assigning some likelihood or probability
5 weights to them.

6 VI. LARGER CONTINGENCY PROVISIONS ARE NOT PREFERABLE

7 The contingency provision must provide a cushion, but the cushion should not be
8 so thick as to be overly comfortable. Given the Postal Service's mandate to achieve
9 break-even results, it is presumed that managers will exercise diligent and efficient
10 practices in doing so. Nevertheless, if the allowed contingency provision is too large,
11 the cushion may result in a tendency toward slackness. This is a form of what
12 economists call moral hazard. This does not imply immoral behavior; rather, it means
13 that the structure of incentives and rewards may not lead to cost minimizing behavior.
14 The contingency provision is a form of insurance against unforeseen and uncontrollable
15 events.

16 Let me provide two examples. In the electric utility industry, a major source of
17 uncertainty or risk is the price of fossil fuel (coal, oil, natural gas). Regulators often
18 allow utilities to pass through to customers the changes in their cost of fuel in the form
19 of fuel cost adjustments. If, however, the utility is allowed to pass along 100 percent of
20 its fuel costs, it might not have sufficient incentive to hold costs down, so some
21 regulators have introduced provisions that require the utility and its shareholders to
22 bear some of the risk. Likewise, the use of deductibles in insurance policies tends to

1 give policyholders an incentive to minimize losses and claims. Such incentive would
2 not be present if policyholders were made whole for losses regardless of whether they
3 had taken care to prevent them.

4 If the contingency provision is too generous, managers can still meet their break-
5 even goal in the face of adverse circumstances without having to make tough
6 decisions. Mr. Tayman stated that the Board of Governors' policy is for "the Postal
7 Service [to] generate a net income equivalent to the recovery of prior year loss
8 provision amount included in the most recent rate filing and rates that are in place."²³ If
9 that goal is not being met, the Postal Service is directed to look for ways to generate
10 additional revenues or reduce expenses. Once those items are exhausted, the Postal
11 Service is to resort to filing for increased rates.²⁴ A contingency provision that is overly
12 generous can relieve Postal Service management of the pressure to manage
13 economically and efficiently.

14 VII. OTHER REASONS NOT TO INCREASE THE CONTINGENCY PROVISION

15 A. The Extra \$1 Billion Needed to Increase the Contingency Provision Is Not
16 Costless

17 The extra \$1 billion required to fund the requested increase in the contingency
18 provision from one percent to 2.5 percent of total estimated costs will not come out of
19 thin air. It will come out of the pockets of the customers of the Postal Service in the
20 form of higher rates and fees they must pay. The additional dollars paid to the Postal

²³ Tr. 2/557.

²⁴ *Id.* at 557-8.

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1 Service to increase the contingency provision are dollars that customers cannot allocate
2 to other things such as consumption, investment, and saving. Customers will suffer an
3 opportunity loss as a result, and there has been no analysis produced that takes these
4 costs into account.

5 The opportunity cost that customers bear as a result of funding a larger
6 contingency provision is not less than the rate of interest on U.S. Treasury securities,
7 and it is most likely considerably higher than that, since businesses routinely borrow at
8 rates well above Treasury rates; individuals carry credit-card balances, automobile
9 loans, or other consumer debt at higher rates; and businesses and individuals have
10 investment opportunities such as equity securities that have expected returns
11 considerably higher than Treasury rates.

12 It maybe argued that a larger contingency could give customers an indirect
13 benefit since it could tend to lengthen the rate cycle, so that postal rates and fees may
14 stay stable a bit longer. However, even if there were such an indirect benefit, it is not
15 the purpose of the contingency provision. Moreover, if the Postal Service decides to file
16 more frequent rate cases (as is discussed in the testimony of OCA witness Callow), the
17 contingency provision could be lower in light of the shorter period for which unforeseen
18 and uncontrollable events are being provided for.

19 B. Shortening the Rate Cycle Can Allow for a Smaller Contingency Provision

20 Postal Service rates are reset on a periodic basis as necessary for its continued
21 operations. A major reason for the existence of the contingency provision is to provide
22 some protection against unforeseen, unexpected, and uncontrollable factors that

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1 adversely affect revenues and/or expenses. The Postal Service forecasts or estimates
2 the effects of all reasonably foreseeable events on the horizon. Nevertheless, there will
3 be some unforeseen events – some positive and some negative – that change
4 revenues and/or expenses from their estimated values. The farther into the future we
5 attempt to see, the greater the likelihood that forecasts or estimates will err. Thus, by
6 shifting from a rate cycle based on the presumption that rates will remain in effect for
7 three to four years – as was the case from 1981 through 1998 – the size of the
8 contingency provision can be lowered, since the near-term future is likely to be more
9 predictable than the longer term.

10 This is similar to the notion that the more often a business plans to restock its
11 inventory, the smaller its inventories can be and the lower its carrying costs. The
12 contingency provision may be likened to business inventories in that they both provide
13 a buffer against uncertain fluctuations.

14 The Docket Nos. R84-1 and R87-1 rates were each in effect for slightly less than
15 three years, and the R90-1 and R94-1 rates were in effect for about four years.
16 Assuming that the Docket No. R2000-1 rates are effective January 1, 2001, the Docket
17 No. R97-1 rates will have been in effect for slightly less than two years. Moreover,
18 Deputy Postmaster General Nolan noted projections that the Postal Service could file
19 for new rates in 2003, 2005, and 2007.²⁵ A two-year rate cycle can allow for a smaller
20 contingency provision.

²⁵ *PostCom Bulletin*, May 5, 2000, p. 2, and Alliance for Nonprofit Mailers, *Alliance Report*, May 10, 2000, p. 2.

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1 The cost and time involved in requesting and implementing new postal rates (or
2 restocking inventories) must be considered. It would not be wise to attempt to revise
3 them too often, but if the Postal Service initiates regular and more frequent reviews it
4 could provide benefits to certain mailers by providing smaller, more predictable changes
5 in their postage costs, and the overall level of rates could be lower due to a smaller
6 contingency provision. At the same time, as discussed by OCA witness Callow, there
7 are techniques available that could permit the Postal Service to increase convenience
8 to household users of the mail by changing single-piece rates every two rate cases.

9 In addition, more frequent reviews could allow rates to match costs more
10 accurately over time. Moving to a somewhat shorter rate cycle would have the effect of
11 smoothing the path of postal rates and lowering their average level by reducing the
12 relative size of the contingency provision. Although there are costs associated with a
13 shorter rate cycle, they are likely to be small compared to the cost savings that would
14 flow to customers as a result of a smaller contingency provision.

15 C. The Contingency Provision Should Not Be Used to Restore The Equity
16 Account

17 Compare what happens if the contingency provision turns out to be too small
18 versus too large. If the contingency provision turns out to be insufficient, the Postal
19 Service can take actions to increase revenue and/or cut costs, and it can file for another
20 rate increase. Admittedly, rate cases take time to file and for new rates to become
21 effective. However, even if it prefers not to do so, the Postal Service has the ability to
22 borrow from the Federal Financing Bank. Such borrowing is generally on
23 advantageous terms, since no private borrower can borrow on terms equivalent to the

1 U.S. Treasury's cost of money plus 1/8 percent. At September 30, 1999, the Postal
2 Service had received direct loans from the FFB of \$6.279 billion.²⁶ It is currently limited
3 to an annual increase in debt of \$1.0 billion for operating purposes and \$2.0 billion for
4 capital investments, with an overall debt ceiling of \$15 billion.²⁷ At the end of FY 1999,
5 the Postal Service had a debt level of \$6.9 billion.²⁸

6 Suppose, however, that the Postal Service's revenue and expense projections
7 turn out to be on target and that the 2.5 percent contingency provision is approved. If
8 that happens, the funds flowing from the recovery of prior years' losses (\$268.257
9 million)²⁹ and the contingency provision (\$1.680 billion)³⁰ will flow to net income and be
10 credited to the equity account. The total amount of \$1.948 billion would then be
11 credited to equity, leaving nearly \$1.568 billion in equity.³¹ Although this would restore
12 the equity account nearly to its original level, this is not the intended method of doing
13 so.

14 Indeed, with a contingency provision of one percent of estimated costs, if the
15 Postal Service's estimates are on target, \$940.163 million will flow into the equity

²⁶ *Federal Financing Bank: Financial Statements As of September 30, 1999 and 1998 Together With Auditors' Report* (Arthur Anderson, LLP, January 4, 2000), p. 8. Acrobat PDF file downloaded from http://www.treas.gov/ffb/financials/1999_statements/1999_statements.html May 3, 2000.

²⁷ 39 U.S.C. § 2005 and Tr. 2/112, 173.

²⁸ Tr. 2/177.

²⁹ USPS-T-9, Table 53, p. 48.

³⁰ 2.5 percent of the Total Cost figure shown in USPS Exhibit 9J.

³¹ Adding the \$1.948 billion net income to FY 2000 net equity of (\$380.389 million) from USPS-T-9, Table 59, p. 53.

1 account, which will show a positive balance of approximately \$560 million, which will be
2 the first positive balance since 1987.³²

3 This could happen. Indeed, the recent success achieved by the Postal Service
4 in meeting or exceeding its breakeven goal has taken some pressure off rates and fees,
5 because the annual charge for recovery of prior years' losses has decreased.
6 However, just as the recovery of prior years' loss allowance should not be seen as a
7 substitute for an adequate contingency provision, the contingency provision should not
8 be used as a substitute mechanism for recovery of prior years' losses. It would not be
9 proper to use the contingency provision, even implicitly, as a mechanism of equity
10 restoration. If the Postal Service wants to accelerate its rate of equity recovery, it can
11 request a shorter amortization period for recovery of prior years' losses rather than
12 using a back-door approach.

13 D. Increasing the Contingency Provision May Be Counterproductive

14 In addition, it may be counterproductive for the Postal Service to increase its
15 rates by an additional \$1 billion to fund a larger contingency provision, given the
16 "increasingly competitive environment in which the Postal Service operates."³³ The
17 increase in rates necessary to support the enlarged contingency provision cannot help
18 the competitive position of the Postal Service relative to its existing and emerging
19 competitors. If competition is, indeed, increasing, the Postal Service could exacerbate

³² One percent of Total Costs from USPS Exhibit 9J plus allowance for recovery of prior years' losses.

³³ USPS-T-9, p. 44.

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1 the problem by raising rates by more than is absolutely necessary. It is possible to
2 envision a "vicious cycle" in which rising postal rates create more headroom for
3 competitors, which would result in lower revenues and a call for further rate increases,
4 further encouraging competitors.

5 VIII. CONCLUSION

6 The Postal Service has several layers that protect its viability, the contingency
7 provision being one. First, the Postal Service uses *pro forma* estimates of revenues
8 and expenses, so that anything that can be forecasted can be adjusted for. Second,
9 the contingency provision provides some protection against unforeseen, unexpected,
10 and uncontrollable factors that adversely affect revenues and/or expenses. Third,
11 Postal Service management can take actions to increase revenues and/or reduce
12 costs. Fourth, the Postal Service can borrow for operations if it becomes necessary to
13 do so. Fifth, the Postal Service can recover prior years' losses from future rates.
14 Finally, the Postal Service can file for new rates as necessary. Each of these tools is
15 important and has a part to play in maintaining the health of the Postal Service. Given
16 the historical experience of the Postal Service and the relative stability of current
17 economic conditions the Postal Service can continue to meet its objectives and
18 continue the presently allowed contingency provision of one percent of total estimated
19 costs. The increase in the contingency provision from one percent to 2.5 percent of
20 total estimated costs is not necessary at this time.

1 CHAIRMAN GLEIMAN: Mr. Rosenberg, have you had an
2 opportunity to examine the packet of Written Cross
3 Examination that was made available earlier today?

4 THE WITNESS: Yes, Mr. Chairman, I have.

5 CHAIRMAN GLEIMAN: And if those questions were put
6 to you today, would your answers be the same as those you
7 previously provided in writing?

8 THE WITNESS: They would.

9 CHAIRMAN GLEIMAN: That being the case, if counsel
10 would please provide two copies of the Designated Written
11 Cross Examination of Witness Rosenberg to the Reporter, I'll
12 direct that the material be received into evidence and
13 transcribed into the record.

14 [Designated Written Cross
15 Examination of Edwin A. Rosenberg
16 was received into evidence and
17 transcribed into the record.]

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BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, DC 20268-0001

Postal Rate and Fee Changes, 2000

Docket No. R2000-1

DESIGNATION OF WRITTEN CROSS-EXAMINATION
OF OFFICE OF THE CONSUMER ADVOCATE
WITNESS EDWIN A. ROSENBERG
(OCA-T-3)

Party

United States Postal Service

Interrogatories

USPS/OCA-T3-1-17

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Cyril J. Pittack", written in a cursive style.

Cyril J. Pittack
Acting Secretary

INTERROGATORY RESPONSES OF
OFFICE OF THE CONSUMER ADVOCATE
WITNESS EDWIN A. ROSENBERG (T-3)
DESIGNATED AS WRITTEN CROSS-EXAMINATION

<u>Interrogatory</u>	<u>Designating Parties</u>
USPS/OCA-T3-1	USPS
USPS/OCA-T3-2	USPS
USPS/OCA-T3-3	USPS
USPS/OCA-T3-4	USPS
USPS/OCA-T3-5	USPS
USPS/OCA-T3-6	USPS
USPS/OCA-T3-7	USPS
USPS/OCA-T3-8	USPS
USPS/OCA-T3-9	USPS
USPS/OCA-T3-10	USPS
USPS/OCA-T3-11	USPS
USPS/OCA-T3-12	USPS
USPS/OCA-T3-13	USPS
USPS/OCA-T3-14	USPS
USPS/OCA-T3-15	USPS
USPS/OCA-T3-16	USPS
USPS/OCA-T3-17	USPS

ANSWERS OF OCA WITNESS EDWIN A. ROSENBERG
TO INTERROGATORIES USPS/OCA-T3-1-17

USPS/OCA-T3-1. Please refer to page 8, line 3, of your testimony where you state:

At the present time, the United States is operating in a climate of relatively low inflation, and the Federal Reserve Board, under Chairman Alan Greenspan, is committed to hold inflation at moderate levels. Indeed, recent increases in the target federal funds rate are pre-emptive strikes against nascent inflationary pressures.

(a) Please confirm that increases in the federal funds rate are intended to slow economic growth. If you do not confirm, please explain your answer fully.

(b) Please confirm that Postal Service mail volume and revenue could be adversely affected as a result of slower economic growth. If you do not confirm, please explain your answer fully.

RESPONSE TO USPS/OCA-T3-1:

(a) Confirmed. The intended result of the increases in the federal funds rate is to slow the economy's rate of growth to a sustainable level, thereby reducing potential inflationary pressure.

(b) To the extent that the rates of growth of mail volume and revenue are positively related to the rate of growth of economic activity, rates of growth of mail volumes and revenue will slow as the rate of growth of economic activity slows. However, whether this can be characterized as "adverse" depends on whether the slower rate of economic growth is less than the assumed rate of growth built into the Postal Service's volume and revenue projections.

In addition, because of variable or volume-sensitive components of cost, slower growth of mail volume is also likely to result in slower growth of total cost. Finally, slower economic growth may result in a lower rate of inflation than would be the case if economic growth were more rapid, and lower inflation also tends to reduce upward pressure on Postal Service costs.

ANSWERS OF OCA WITNESS EDWIN A. ROSENBERG
TO INTERROGATORIES USPS/OCA-T3-1-17

USPS/OCA-T3-2. Please refer to page 11, line 8, of your testimony, where you state:

"Nothing in the recent operating history of the Postal Service suggests that the 2.5 percent request is necessary."

(a) Do you consider yourself an expert on recent and historical Postal Service operations? If your answer is yes, please explain what experience and/or information has enabled you to become an expert.

(b) How long have you been studying Postal Service operations?

RESPONSE TO USPS/OCA-T3-2:

(a) and (b) I have not offered testimony about Postal Service operations. The section of my testimony from which the quote is taken discusses the recent financial success of the Postal Service. I testified that the Postal Service has operated successfully (in terms of financial results) with a contingency provision less than the 2.5 percent it has requested in this Docket. That statement was based on the Postal Service's positive net income figures for each year in the 1995 through 2000 period as shown in USPS Exhibit 9L. During that period Postal Service operations generated a cumulative net income of \$5.58 billion. Furthermore, since the contingency provision was set at two percent in Docket No. R94-1 and at one percent in Docket No. R97- 1, the Postal Service was able to achieve those financial results while operating with a contingency provision lower than the 2.5 percent requested in this case.

ANSWERS OF OCA WITNESS EDWIN A. ROSENBERG
TO INTERROGATORIES USPS/OCA-T3-1-17

USPS/OCA-T3-3. Please refer to page 11, line 10, of your testimony, where you state:

Unlike some situations that the Postal Service has experienced historically, there is no chronic or growing deficit resulting from an over forecast of revenues and/or under forecast of expenses. As shown in Mr. Tayman's Exhibit 9L, the Postal Service has achieved a positive net income in every year since 1995 and is projected to do so during FY 2000.

Please confirm that net income has declined in every year during the period in question from \$1.8 billion in FY 95 to less than \$100 million projected for FY 2000. If you do not confirm, please explain why.

RESPONSE TO USPS/OCA-T3-3:

As shown in USPS Exhibit 9L, net income has declined over the FY 1995 to FY 2000 period. Note, however, that the Postal Service has earned a positive net income in each of those years, so it was able to meet its breakeven goal. In fact, during that period the Postal Service generated a cumulative net income of \$5.58 billion.

Moreover, part of the decline may be related to the Postal Rate Commission's R97-1 decision, which reduced the provision for recovery of prior years' losses and the contingency provision from the levels approved in R94-1. As shown in Appendix A of the R94-1 Opinion, the Commission recommended a contingency provision of \$1.050607 billion and an allowance for recovery of prior years' losses of \$936.226 million for a total of \$1.986833 billion. As shown in Volume 2, Appendix C of the R97-1 Opinion, the Commission recommended a contingency provision of \$598.956 million and an allowance for recovery of prior years' losses of \$377.063 million for a total of \$976.019 million. Other things being equal, those changes would reduce net income by \$1.010814 billion per year.

ANSWERS OF OCA WITNESS EDWIN A. ROSENBERG
TO INTERROGATORIES USPS/OCA-T3-1-17

The trend is not necessarily continuing or worsening. The Postal Service reported net losses in FY 2000 Accounting Periods 5, 6, and 9, but it had net incomes in Accounting Periods 1, 2, 3, 4, 7, and 8. The Accounting Period 9 loss put year-to-date net income (\$906.5 million) behind the net income for the same period of FY 1999 (\$1.0625 billion). However, year-to-date net income through FY 2000 Accounting Period 8 (\$1.0695 billion) was ahead of net income for the same period of FY 1999 (\$1.033 billion). Moreover, for five of the first nine Accounting Periods of FY 2000, reported net income was higher than it was in the same periods of FY 1999.

ANSWERS OF OCA WITNESS EDWIN A. ROSENBERG
TO INTERROGATORIES USPS/OCA-T3-1-17

USPS/OCA-T3-4. Please refer to page 11, line 15, of your testimony, where you state:

In fact, during the 1995 through 2000 period, the Postal Service generated a cumulative net income of \$5.58 billion. The contingency provision was set at two percent in Docket No. R94-1 and at one percent in Docket No. R97-1. In each year since implementation of the rates approved in R94-1, the Postal Service has operated quite successfully with a contingency provision less than the 2.5 percent it has requested in this Docket.

(a) Please confirm that the period covered by these results was covered by the contingency levels determined by Postal management to be necessary (i.e., the contingency amounts reflected in the rates that were in effect during this period were not adjusted by the Commission). If you do not confirm, please explain and provide your sources.

(b) Would you say that actual results during this period indicate that Postal management's judgment related to the selection of the contingency in Dockets R94-1 and R97-1 amounts was good? Please explain any negative answer fully.

RESPONSE TO USPS/OCA-T3-4:

(a) In R94-1, the contingency provision was set at two percent of estimated costs. In R97-1, the contingency provision was set at one percent. Those were the amounts requested. However, in R97-1, Postal Service witness Porras testified that, if the Commission reduced the revenue requirement by using updated (lower) actual cost figures rather than the original estimates of costs, the contingency should be set at 1.5 percent rather than the one percent originally requested. The Commission rejected that suggestion in its Opinion and Recommended Decision.

(b) In his testimony in R94-1, Postal Service witness Ward expressed concern that the two percent contingency might provide a smaller margin than would normally be prudent. That concern proved to be overstated, since the Postal Service was able to meet its breakeven goal during each year the R94-1 rates were in effect, generating over \$5 billion in net income during the period from 1995 to 1998.

ANSWERS OF OCA WITNESS EDWIN A. ROSENBERG
TO INTERROGATORIES USPS/OCA-T3-1-17

In his testimony in R97-1, Postal Service witness Tayman argued that the one-percent contingency request was based on the Postal Service's financial success, the favorable economic climate, and management's concern about the effect of the contingency on rate levels. Moreover, the one-percent contingency requested in that case has proved to be sufficient, since the Postal Service has generated positive net income since the R97-1 rates went into effect.

Postal Service management's judgment and concern for the effect of the contingency on rate levels in R97-1 are commendable. Although Mr. Tayman testified in R97-1 that the Postal Service was leaving the door open to a larger contingency if circumstances were to change, it is not clear from his testimony in this case what circumstances have changed to alter management's judgment, reduce their concern about the effect of the contingency on rates, and necessitate a one hundred fifty percent increase in the requested contingency provision (from one percent to 2.5 percent), especially given the history of successful operation with lower contingency levels.

ANSWERS OF OCA WITNESS EDWIN A. ROSENBERG
TO INTERROGATORIES USPS/OCA-T3-1-17

USPS/OCA-T3-5. Please refer to page 8, lines 17-20, of your testimony, where you state:

A disciplined analysis of the optimum size of a contingency provision would consider the following factors:

- 1) The magnitude and types of uncertainties that necessitate the existence of a contingency provision. Of particular concern in this regard is the state of the economy.
- 2) The historical experience of the Postal Service with respect to its contingency provision. How has the Postal Service fared under various provisions?
- 3) The short-run and long run effects of the contingency provision turning out to be either too large or too small.
 - a) On the Postal Service and its managers
 - b) On the customers of the Postal Service

(a) Please confirm that one of the factors which should be considered in determining the size of the contingency, which you have not included on your list, is the adverse impact of future events that are totally unknown. If you do not confirm, please explain fully why you believe the contingency is not intended to protect against totally unknown adverse events.

(b) How does one determine the magnitude of totally unknown events? Please explain your answer.

RESPONSE TO USPS/OCA-T3-5:

(a) In my use of the term "uncertainties," I include the impact of both forecasting errors and future events that are totally unknown.

(b) One cannot determine the magnitude of totally unknown events. However, one can do hypothetical scenario analyses and attempt to estimate the impact of events that are unknown but conceivable. Some catastrophic or cataclysmic events (a large meteor hitting earth, nuclear war, for example) would have a huge impact, but they have a low probability of occurring. Other events (a recession or an oil embargo, for example) could have a large impact and a have higher probability of occurring than the catastrophes mentioned earlier. The contingency provision is intended to provide a

ANSWERS OF OCA WITNESS EDWIN A. ROSENBERG
TO INTERROGATORIES USPS/OCA-T3-1-17

buffer for adverse events, but some unknown events could have beneficial effects (collapse of the oil cartel, a significant technological breakthrough, for example).

Although it is extremely difficult, if not impossible, to forecast the occurrence of such events, it is possible to develop scenario analyses for adverse events and attempt, however imperfectly, to estimate their impact and have contingency plans in place for dealing with them. Admittedly, the further outside the range of historic experience an event is, the more difficult it is to estimate its impact and develop a plan for reacting. Random events do, however, occur from time to time, and the ability of the Postal Service to react to and survive various events is reflected in its record of successful operation. Moreover, although the contingency provision is intended to provide a buffer against uncontrollable or unknowable adverse events, it need not be large enough to provide a buffer against all unknowable adverse events.

ANSWERS OF OCA WITNESS EDWIN A. ROSENBERG
TO INTERROGATORIES USPS/OCA-T3-1-17

USPS/OCA-T3-6. Please refer to Chapter IV C. in your testimony entitled "The Postal Service's Ability to Forecast is Improving." In your opinion, has the Postal Service's ability to forecast improved? Please reconcile any negative answer to the above citation.

RESPONSE TO USPS/OCA-T3-6:

The section of my testimony referenced above lists several reasons why I believe that the Postal Service's ability to forecast has improved when compared with earlier periods. My reasons include the Postal Service's nearly thirty years operating in a business-like manner, inflation rates that are both relatively low and less volatile than they were in the 1970s and 1980s, and the creation of a forecasting organization with the purpose of creating more accurate and reliable forecasts. For all these reasons, I believe that the Postal Service's ability to forecast has improved compared with some earlier periods.

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TO INTERROGATORIES USPS/OCA-T3-1-17

USPS/OCA-T3-7.

(a) Please refer to page 2 of the A/P 8 Financial and Operating Statements (FOS) and confirm that the Postal Service is currently \$333.1 million below its planned net income through A/P 8 PFY 2000. If you do not confirm, please explain fully.

(b) Please also refer to the FOS for A/P 9 (which will be released before the due date for this question) and confirm the Postal Service incurred a loss of \$154 million in A/P 9 and the year-to-date plan shortfall grew to \$420.4.

(c) Please confirm that, even if the Postal Service can reverse this trend of below-plan results and achieve its plan for the remainder of the year, it will suffer a plan shortfall and incur a loss for FY 00, instead of the planned net income of \$100 million reflected in the response to ANM/USPS-T9-41.

RESPONSE TO USPS/OCA-T3-7:

(a) I confirm that for year-to-date through FY 2000 Accounting Period 8 the Postal Service reported that its net income was \$333.1 million below plan. I note, however, that for the same period of PFY 1999, the Postal Service was \$342.1 million below plan, yet, as shown in USPS Exhibit 9L, it was able to generate \$363.4 million in net income for 1999. This income figure was greater than the \$200 million planned for 1999 as shown in the response to ANM/USPS-T9-41.

(b) I confirm that the Postal Service reported a net loss of \$154.2 million for FY 2000 Accounting Period 9 and that the Postal Service reported that its year-to-date net income through FY 2000 Accounting Period 9 was \$420.4 million below its plan. As I noted in my answer to USPS/OCA-T3-3, the Postal Service reported net losses in FY 2000 Accounting Periods 5, 6, and 9 and net incomes in Accounting Periods 1, 2, 3, 4, 7, and 8.

(c) According to the U.S. Postal Service FY 2000 Operating Plan (filed in response to OCA/USPS-T9-27 and OCA/USPS-81), the Postal Service plans to incur losses of \$217.5 million, \$237.5 million, \$281 million, and \$348 million in FY 2000

ANSWERS OF OCA WITNESS EDWIN A. ROSENBERG
TO INTERROGATORIES USPS/OCA-T3-1-17

Accounting Periods 10, 11, 12, and 13, respectively. Thus, if the Postal Service operates according to its plan, the total loss for the remainder of FY 2000 will be \$1.084 billion. If net losses for the rest of FY 2000 run according to the plan, the Postal Service will incur a net loss of \$177.5 million for FY 2000, given reported year-to-date net income of \$906.5 million through FY 2000 Accounting Period 9. The response to ANM/USPS-T-9-41 indicates that the Postal Service's FY 2000 plan was for net income to be \$100 million.

However, the scenario just described may not come to pass. It is typical for the Postal Service to report net losses in Accounting Periods 10 through 13, and Postal Service plans for FY 1999 and FY 2000 reflect that tendency. In FY 1999, the Postal Service did, in fact, report net losses in each of Accounting Periods 10 through 13, but the actual net loss in each period was less than the net loss assumed in the Postal Service's FY 1999 plan. This is illustrated at page 4 of the Postal Service's Financial and Operating Statements for Accounting Period 13, PFY 1999. It is possible that the Postal Service's FY 2000 plan for Accounting Periods 10 through 13 may also prove to be overly pessimistic. I note that the actual results in FY 2000 Accounting Periods 1, 2, 3, 4, and 7 were better than the actual results for the same periods in FY 1999, and actual results in FY 2000 Accounting Periods 1, 4, and 7 were better than the results assumed in the FY 2000 plan. Moreover, I hope that management is taking steps to enhance revenues and control expenses so that a loss will not be realized in FY 2000.

ANSWERS OF OCA WITNESS EDWIN A. ROSENBERG
TO INTERROGATORIES USPS/OCA-T3-1-17

USPS/OCA-T3-8. Please refer to Board of Governors Resolution No. 95-9 (policy statement on equity restoration) and the report on equity restoration prepared by Price Waterhouse LLP for the BOG. (Docket No. MC96-3, LR SSR-112). In your opinion, is the restoration of equity important to the Postal Service and its customers? Please explain any negative answer.

RESPONSE TO USPS/OCA-T3-8:

Restoration of equity by the Postal Service is an important goal that would have benefits for the Postal Service. Restoration of equity does provide benefits for customers, but whether it provides customers with net benefits depends on whether they prefer lower postal rates in the near term or in the longer term. This is because restoring equity requires higher postal rates in the near term. As equity is restored, Postal Service debt and interest expense should decline over time, as should the provision for recovery of prior years' losses, both of which tend to lower rates. Thus, equity recovery requires higher rates near term and provides the benefit of lower rates over the longer term.

Since 1995, when the above referenced Resolution and Price Waterhouse report were prepared, the Postal Service has improved its equity position considerably. At the end of 1994, as shown in USPS Exhibit 9L, the Postal Service had negative equity of \$5.96 billion. At the end of 1994, the Postal Service was at its nadir with respect to its equity position and had suffered net losses in eight of the previous ten years. In contrast, it has enjoyed positive net incomes in every year since 1994. The equity deficit that existed at the end of 1994 was created over a number of years, and it would not have been prudent to attempt to correct the equity deficit too quickly. Thus, the provision for recovery of prior years' losses uses a nine-year recovery period, which does not unnecessarily increase rates paid by postal customers in any single year.

ANSWERS OF OCA WITNESS EDWIN A. ROSENBERG
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As of May 19, 2000, the Postal Service had positive equity of \$213 million, as shown in the Postal Service's Financial and Operating Statements for Accounting Period 9 of PFY 2000. Thus, over the past six years, the Postal Service has been able to increase its equity by \$6.17 billion, and it has done so while operating with a contingency provision far less than the 2.5 percent requested in this case.

ANSWERS OF OCA WITNESS EDWIN A. ROSENBERG
TO INTERROGATORIES USPS/OCA-T3-1-17

USPS/OCA-T3-9.

(a) Based on your training and experience, how much of a variance between actual results and the Postal Service's test year estimates of revenue and expense could occur for the estimate to be considered accurate? Please explain your answer.

(b) Would you consider a test year estimate that is within 1 percent to be accurate? Why or why not?

(c) Would you consider an estimate that is within 2 percent to be accurate? Why or why not?

RESPONSE TO USPS/OCA-T3-9:

(a), (b), and (c) The Postal Service has a breakeven obligation or goal. Thus, an estimate is sufficiently accurate, if, when combined with the contingency provision and the allowance for recovery of prior years' losses, it allows the Postal Service to meet or exceed that goal. In the present case, estimates of test year revenue and expense would be sufficiently accurate if the combined error is no more than approximately \$940 million in an adverse direction (revenue less than estimate, and expense greater than estimate). This assumes a one-percent contingency provision (\$672 million) and an allowance for recovery of prior years' losses of \$268 million, which together total approximately 1.4% of after rates, test year total cost segments as shown in Table 15 of Mr. Tayman's testimony (USPS T-9, p. 22).

ANSWERS OF OCA WITNESS EDWIN A. ROSENBERG
TO INTERROGATORIES USPS/OCA-T3-1-17

USPS/OCA-T3-10. Please refer to page 15 of your testimony, where you discuss what you refer to as built-in safety nets available to the Postal Service which you say support a contingency lower than 2.5%.

(a) Please confirm that all of the items you have referred to as safety nets were available to the Postal Service in the prior six Dockets R76-1 through R90-1. If you do not confirm, please explain and provide your sources.

(b) Please refer to Table 5 in your testimony and confirm that the contingency of 2.5% currently estimated by the Postal Service is lower than the contingency requested in the six Dockets R76-1 through R90-1. If you do not confirm, please explain.

RESPONSE TO USPS/OCA-T3-10:

(a) Confirmed.

(b) Confirmed. Note that, as shown in Table 5 of my testimony, inflation rates were higher when those cases were heard, and when the rates set in those cases were in effect, than they have been more recently and that the Postal Service has achieved considerable financial success since the R94-1 and R97-1 rates went into effect. The Postal Service experienced net losses in eleven of the seventeen years from 1978 through 1994, when the rates set in Dockets R76-1 through R90-1 were in effect, and it was allowed a contingency provision at or above the 2.5 percent requested in this case. In contrast, the Postal Service has had net profits in each year from 1995 forward when allowed a contingency provision less than the 2.5 percent requested in this case.

ANSWERS OF OCA WITNESS EDWIN A. ROSENBERG
TO INTERROGATORIES USPS/OCA-T3-1-17

USPS/OCA-T3-11. Please confirm that, if all other things are equal, the smaller the contingency the more likely that a test year loss will be incurred. If you do not confirm, please explain how a smaller contingency would not increase the odds of incurring a loss in the test year.

RESPONSE TO USPS/OCA-T3-11:

Other things equal, a smaller contingency provision increases the likelihood that there will be a loss in the test year. Conversely, a larger contingency provision reduces the likelihood of a net loss. However, other things are rarely equal, and the size of the contingency provision is only one factor that determines whether or not the Postal Service will operate at a profit or a loss. The state of the economy, including the rate of inflation and the rate of economic growth, and Postal Service management's actions to control costs and enhance revenue also determine whether a profit or a loss will be realized. Moreover, although a larger contingency provision will generally reduce the likelihood of the Postal Service's incurring a net loss, there may be some point beyond which raising the contingency provision actually decreases the Postal Service's ability to break even.

As noted in my answer to USPS/OCA-T3-10, the Postal Service experienced net losses in eleven of seventeen years (1978 through 1994), during which time it was allowed a contingency provision as large or larger than the one requested in this case. In 1985, 1988, and 1991, the years the R84-1, R87-1, and R90-1 rates went into effect, respectively, the Postal Service reported losses, even though a contingency provision of 3.5 percent was allowed in each of those cases. In contrast, the Postal Service has reported net profits in each of the past six years (1995 through 2000, including projected

ANSWERS OF OCA WITNESS EDWIN A. ROSENBERG
TO INTERROGATORIES USPS/OCA-T3-1-17

2000 results) while operating with a contingency provision smaller than the 2.5 percent requested in this case.

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USPS/OCA-T3-12. Please refer to page 16 of your testimony, where Section F is entitled: "Many Potential Sources of Expense and Revenue Variation are Accounted for In the Estimated Revenues and Expenses."

(a) Please confirm that you are referring to estimates of changes in revenue and expense based on events that are assumed to occur, such as wage increases and the price of fuel. If you do not confirm, please explain fully.

(b) Please confirm that estimates similar in nature were reflected in all previous rate filings. If you do not confirm, please explain fully.

(c) Please confirm that there is uncertainty regarding the actual outcome of these events (e.g., the labor contract may be more costly than estimated and the price of fuel may be higher than estimated) and that this type of uncertainty is not accounted in the Postal Service's estimates of revenues and expenses other than through the contingency. If you do not confirm, please explain fully.

RESPONSE TO USPS/OCA-T3-12:

(a) Confirmed. I also assume that the after-rates test year estimates include projections of inflation, economic growth, and the effect of changes in postal rates on volume, revenues, and expenses.

(b) Confirmed. However, as I note at page 12, lines 8 through 20, of my testimony, some of those estimates were made during periods when the rate of inflation was both higher and more volatile than it has been recently or than it is projected to be in the near-term future. The relatively stable economic climate we are enjoying at the present time allows greater confidence in the accuracy and reliability of the estimates and allows a smaller contingency provision than would be the case in more volatile periods.

(c) Various items could turn out to be higher or lower than the estimates built into the after-rates, test year revenue and expense figures. In the four previous cases (R87-1, R90-1, R94-1, and R97-1), the Postal Service's revenue estimates were too

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high twice and too low twice, and its expense estimates were too high once and too low three times. Note that the test year will be in progress by the time the Commission issues its decision, so some expense and revenue elements may be less uncertain at that time than they were when the original estimates were developed. Furthermore, in addition to the contingency provision, management's ability and duty to control cost and enhance revenue is an important factor in determining whether the bottom-line results are positive or negative.

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USPS/OCA-T3-13. Please refer to page 18, lines 14 -18, where you state:

"This appears to be an attempt for the Postal Service to have their cake and eat it too: recognizing that their ex ante forecasts may turn out to be wrong ex post – leading to the necessity for the provision for contingencies – but asserting their ability to accurately gauge the amount by which their forecasts are likely to be wrong."

Please provide the basis (including sources) of your statement that the Postal Service asserts that it can "accurately gauge the amount by which their forecasts are likely to be wrong."

RESPONSE TO USPS/OCA-T3-13:

In each case, the Postal Service requests a contingency provision that reflects management's judgment concerning the size of the contingency they feel necessary to provide an adequate cushion against the effects of unforeseen, unexpected, and uncontrollable adverse events that are not reflected in the test-year estimates. I have made the inference that the size of the contingency request is based on Postal Service management's judgment as to the accuracy and reliability of their forecasts or estimates of test-year revenue and expense and the degree of uncertainty they face.

In R94-1, the Postal Service requested and was allowed a two-percent contingency. In R97-1 the Postal Service requested and was allowed a one-percent contingency. Those contingency amounts proved to be adequate as evidenced in the fact that the Postal Service has generated over \$5 billion in net income since 1994. In this case, the Postal Service has requested a one hundred fifty percent increase in the allowed contingency provision (from one percent to 2.5 percent). From this I infer that Postal Service management believes that its estimates for the 2000 test year are likely to be less accurate than the estimates for the two prior years proved to be. I also infer

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that the size of the increase in the contingency request reflects the amount by which they believe their forecasts or estimates may be in error.

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TO INTERROGATORIES USPS/OCA-T3-1-17

USPS/OCA-T3-14. Please refer to page 20, line 16, of your testimony, where you state that "electric utilities attempt to keep a reasonable amount of reserve capacity available so that consumers are not faced with power brownouts or blackouts during extreme weather - and consumers pay for the maintenance of this reserve capacity."

(a) What percent of reserve capacity is typically kept by electric utilities?

(b) What is the maximum amount of reserve capacity kept by a utility of which you are aware and what is the minimum? Please provide the source of your answer.

RESPONSE TO USPS/OCA-T3-14:

(a) Given the changes taking place in the electric utility industry, I'm not sure that there is a "typical" reserve margin anymore. The electric utility industry has begun to rely on regional interconnection, wholesale transactions between utilities, power purchased from independent power producers and non-utility generators, and interruptible power contracts to meet or control peak loads.

For the investor-owned electric utility industry as a whole, the approximate capacity margin (the percent of capacity not needed at peak load) was 14.9 percent in 1996 and 13.4 percent in 1997. I calculated these figures from electric utility industry data in *The Value Line Investment Survey, Edition 1*, March 10, 2000, p. 156.

Capacity margins are also published on a regional basis. In part, this recognizes the robust wholesale market now taking place in electricity. It also recognizes the interconnected nature of the electric utility industry.

Here are the summer 1999 capacity margins for the various U.S. regions (Figures from the North American Electric Reliability Council's *Reliability Assessment 1999-2008*, March 2000, p. 14.):

ECAR (East Central Area Coordination Agreement), 12.5%;

ERCOT (Electricity Reliability Council of Texas), 15.9%;

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FRCC (Florida Reliability Coordinating Council), 13.0%;
MAAC (Mid-Atlantic Area Council), 14.2%;
MAIN (Mid-America Interconnected Network), 13.6%;
MAPP-US (Mid-Continent Area Power Pool -- U.S.), 14.4%;
NPCC-U.S. (Northeast Power Coordinating Council -- US), 14.4%;
SERC (Southeastern Electric Reliability Council), 12.8%;
SPP (Southwest Power Pool), 14.5%;
WSCC--U.S. (Western Systems Coordinating Council -- US), 17.5%;
Overall United States, 14.3%.

(b) There may be utilities with reserve or capacity margins as high as 40 percent, or more. Those utilities rely on sales to other utilities to absorb their excess capacity. Other utilities have negative reserve or capacity margins, meaning that they do not own sufficient generating capacity to serve their customers' peak loads. Those utilities rely on power purchased in the wholesale market to meet their customers' needs.

My discussion of capacity or reserve margins in the electric utility industry was in no way predicated on a belief that the Postal Service requires a contingency reserve of similar magnitude. Rather, I discussed loss of load probability models and Monte Carlo analyses as examples of analytical processes and state (at page 22, lines 2 through 4, of my testimony) that it would be useful for the Postal Service to develop some form of more analytical approach to determining the likely range of outcomes and assigning some likelihood or probability weights to them. I believe the application of such techniques would provide a more objective basis for determining the adequacy of a

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contingency provision than the judgmental, subjective, and intuitive approach currently taken by Postal Service management.

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USPS/OCA-T3-15.

(a) Have you studied the economic and other adverse consequences to the Postal Service and its customers that would result from the Postal Service incurring a loss in the test year? If so, please provide the results. If not please explain why.

(b) Please confirm that a test year loss would have adverse consequences for both the Postal Service and its customers. If you do not confirm, please explain why.

RESPONSE TO USPS/OCA-T3-15:

(a) and (b) This is discussed at page 26, lines 17 through 22, of my testimony.

If the Postal Service incurs a loss in the test year, the future path of postal rates would tend to be raised. This is so because the allowance for recovery of prior years' losses would increase in future rate cases, as would interest expense on funds borrowed as a result of the loss incurred. A loss in the test year may result in the Postal Service filing its next rate case sooner than otherwise planned, and it is possible that the specter of a test-year loss could result in some degradation of service levels, depending on the specific actions taken by management to control costs and enhance revenues. To the extent that a loss results from postal rates being set too low for the Postal Service to meet its breakeven goal given honest, efficient, and economical management, postal customers enjoy lower current rates and experience higher future rates.

These are potential costs or adverse effects that must be considered. Nevertheless, these potential adverse effects must be weighed against the adverse effects in terms of the very real opportunity cost or value postal customers place on the consumption, savings, and investment they have to forego to provide an extra \$1 billion to fund a contingency provision that is excessive in light of current economic conditions and the recent success of the Postal Service operating under a contingency provision far smaller than that requested in this case. I discuss the opportunity cost of money

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used to fund used an increase in the contingency provision at page 24, lines 5 through 11, of my testimony.

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USPS/OCA-T3-16. Please refer to page 26, line 19, of your testimony, where you begin to state:

"Admittedly, rate cases take time to file and for new rates to become effective. However, even if it prefers not to do so, the Postal Service has the ability to borrow from the Federal Financing Bank. Such borrowing is generally on advantageous terms, since no private borrower can borrow on terms equivalent to the U.S. Treasury's cost of money plus 1/8 percent."

(a) Are you advocating that the Postal Service borrow money to fund losses instead of raising rates? Please explain your answer.

(b) If the Postal Service were to borrow to fund operations, please confirm that ratepayers will ultimately pay for the additional interest cost of borrowing. If you do not confirm, please explain who will bear this cost and explain fully.

RESPONSE TO USPS/OCA-T3-16:

(a) I have not advocated that the Postal Service borrow to fund losses rather than raise rates. At page 15, lines 8 through 19, of my testimony, I discuss the Postal Service's ability to borrow through the Federal Financing Bank, if it becomes necessary to do so, as being one of several safety nets provided to ensure the viability of the Postal Service.

(b) Borrowing by the Postal Service, whether for operations or for capital investment, results in interest costs that become part of total recoverable expenses. Thus, increased borrowing tends to raise future expenses and future rates. Postal customers will bear this cost. However, the possible cost resulting from borrowing, should the Postal Service operate at a loss, must be weighed against the definite opportunity cost in terms of the value of consumption, savings, and investment forgone by postal customers, if they are asked to fund a contingency provision that is larger than necessary. That opportunity cost is discussed at page 24, lines 5 through 11, of my testimony.

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Moreover, I would note that debt is commonly used by utilities, including those that are not investor-owned, as a normal component of their capital structures. Moreover, at September 30, 1999, the Postal Service's long-term debt of \$3.544 billion was only 6.36 percent of total liabilities and equity, and total debt (including the current portion of long-term debt) was \$6.92 billion or 12.4 percent of total liabilities and equity. Furthermore, the Postal Service's use of debt has been decreasing. As of May 19, 2000, long-term debt had declined to \$2.553 billion, or 4.41 percent of total liabilities and equity, and total debt (including the current portion of long-term debt) stood at \$4.492 billion or 7.77 percent of total liabilities and equity.

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USPS/OCA-T3-17. Please refer to page 28, lines 7-12, of your testimony, where you state:

the contingency provision should not be used as a substitute mechanism for recovery of prior years' losses. It would not be proper to use the contingency provision, even implicitly, as a mechanism of equity restoration. If the Postal Service wants to accelerate its rate of equity recovery, it can request a shorter amortization period for recovery of prior years' losses rather than using a back-door approach.

Is it your testimony that the Postal Service selected a 2.5% contingency in this case in order to restore equity? If your answer is yes, please provide all evidence supporting this allegation.

RESPONSE TO USPS/OCA-T3-17:

If the Postal Service is allowed to include a larger contingency provision in its revenue requirement, net income will be larger than if it is allowed a smaller contingency provision. Thus, an implicit effect of a larger contingency provision is to accelerate the Postal Service's rate of equity restoration. I am not in a position to know whether Postal Service management chose to request a larger contingency provision with the intent of accelerating the rate of equity restoration. Nevertheless, if the requested increase in the contingency provision is allowed, all other things being equal, the effect will be to accelerate equity restoration.

1 CHAIRMAN GLEIMAN: Is there any additional written
2 cross examination for this witness?

3 MR. REITER: Yes, Mr. Chairman. The Postal
4 Service would like to designate his responses to our
5 Questions 18 and 19.

6 CROSS EXAMINATION

7 BY MR. REITER:

8 Q Mr. Rosenberg, I have handed you the two copies of
9 those answers that your counsel provided to me earlier
10 today. If I were to ask you those questions orally, would
11 your answers be the same?

12 A They would, sir.

13 Q Thank you.

14 MR. REITER: Mr. Chairman, I'll ask that those
15 answers be entered into the record.

16 CHAIRMAN GLEIMAN: If you would please provide the
17 two copies to the Court Reporter, I'll direct that they be
18 entered into evidence and transcribed into the record.

19 [Additional Designated Written
20 Cross Examination of Edwin A.
21 Rosenberg, USPS/OCA-T3-18 and
22 USPS/OCA-T3-19 were received into
23 evidence and transcribed into the
24 record.]

25

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


Postal Rate and Fee Changes, 2000)

Docket No. R2000-1

ANSWERS OF THE OFFICE OF THE CONSUMER ADVOCATE
TO INTERROGATORIES OF UNITED STATES POSTAL SERVICE
WITNESS: EDWIN A. ROSENBERG (USPS/OCA-T3-18-19)
(July 6, 2000)

The Office of the Consumer Advocate hereby submits the answers of Edwin A. Rosenberg to interrogatories USPS/OCA-T3-18-19, dated June 29, 2000. Each interrogatory is stated verbatim and is followed by the response.

Respectfully submitted,


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ANSWERS OF OCA WITNESS EDWIN A. ROSENBERG
TO INTERROGATORIES USPS/OCA-T3-18-19

USPS/OCA-T3-18. Please refer to your response to OCA/USPS-T3-5, where you state "it is possible to develop scenario analyses for adverse events and attempt, however imperfectly, to estimate their impact and have contingency plans in place for dealing with them." Have you done any scenario analysis or estimates of adverse events, other than a subjective interpretation of how the material you have presented relates to the size of the contingency? If your answer is other than no, please provide the specific amounts and detailed calculations of adverse events you made. Please include an explanation of the methodology used and references.

RESPONSE TO USPS/OCA-T3-18:

I have performed no scenario analysis with respect to events that might affect the Postal Service adversely. I disagree with the characterization that I have done a "subjective interpretation." In my testimony, I reviewed both the variance analysis contained in Mr. Tayman's testimony and the experience of the Postal Service in forecasting actual test-year revenue and expenses in the four most recent rate cases. The 2.5 percent contingency requested in this Docket lies outside the range of the results of the variance analysis, and it is larger than the average difference between estimated and actual net income in the four most recent test years. Moreover, the Postal Service failed to meet its breakeven goal in only one of the four most recent test years, and it was allowed a 3.5 percent contingency at that time.

My response to OCA/USPS-T3-5 was intended to suggest that more objective analytical approaches are available that might be used instead of the largely subjective and intuitive approach currently used by Postal Service management.

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USPS/OCA-T3-19. Please refer to your response to OCA/USPS-T3-10 where you state:

The Postal Service experienced net losses in eleven of the seventeen years from 1978 through 1994, when the rates set in Dockets R76-1 through R90-1 were in effect, and it was allowed a contingency provision at or above the 2.5 percent requested in this case. In contrast, the Postal Service has had net profits in each year from 1995 forward when allowed a contingency provision less than the 2.5 percent requested in this case.

- (a) Please confirm that the effective contingency for Dockets R76-1 through R90-1 was never as low as 2.5% as you have stated but actually ranged from 3.0%-4.0%. If you do not confirm, please explain.
- (b) Is it your testimony that contingencies "at or above 2.5%" result in net losses and contingencies less than 2.5% result in net incomes? If your answer is yes, please explain how you reached this conclusion. If your answer is no, please explain the purpose of the above statement.

RESPONSE TO USPS/OCA-T3-19:

- (a) Confirmed. As shown in Table 5 of my testimony, including footnote number 11, the effective contingency during the 1978 through 1994 period was never lower than 3.0 percent, although in R80-1 the Commission recommended a contingency of 2.5 percent.
- (b) It was not and is not my testimony that "contingencies 'at or above 2.5%' result in net losses and contingencies less than 2.5% result in net incomes."

In my response to USPS/OCA-T2-11, I state: "Other things equal, a smaller contingency provision increases the likelihood that there will be a loss in the test year. Conversely, a larger contingency provision reduces the likelihood of a net loss. However, other things are rarely equal, and the size of the contingency provision is only one factor that determines whether or not the Postal Service will operate at a profit or a loss. The state of the economy, including the rate of inflation and the rate of economic

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growth, and Postal Service management's actions to control costs and enhance revenue also determine whether a profit or a loss will be realized. Moreover, although a larger contingency provision will generally reduce the likelihood of the Postal Service's incurring a net loss, there may be some point beyond which raising the contingency provision actually decreases the Postal Service's ability to break even."

DECLARATION

I, Edwin A. Rosenberg, declare under penalty of perjury that the answers to interrogatories USPS/OCA-T3-18-19 of the United States Postal Service are true and correct, to the best of my knowledge, information and belief.

Executed 5 July 2000

Edwin A. Rosenberg

CERTIFICATE OF SERVICE

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

Shelley S. Dreifuss
Shelley S. Dreifuss

Washington, DC 20268-0001
July 6, 2000

1 CHAIRMAN GLEIMAN: Does anyone else have any
2 Designated Written Cross Examination for this witness?

3 [No response.]

4 CHAIRMAN GLEIMAN: If not, that brings us to oral
5 cross. Once again, the Postal Service is the only part that
6 has requested oral cross examination of this witness. Does
7 anyone else wish to cross examine this witness?

8 [No response.]

9 CHAIRMAN GLEIMAN: If not, Mr. Reiter?

10 CROSS EXAMINATION [Resuming]

11 BY MR. REITER:

12 Q Good morning, Mr. Rosenberg.

13 A Good morning, sir.

14 Q Would you look at your response to our Question
15 Number 3 please?

16 A I have it before me.

17 Q You say there that the Commission's R97 decision
18 reduced the provision for recovery of prior losses and the
19 contingency provision from the levels approved in R94.

20 What do you mean by "reduced," in that sentence?

21 A Well, I mean reduced.

22 Q And how would you define that?

23 A Well, built into the revenue requirement in R94-1,
24 as I understand it, was a provision for \$936 million for
25 recovery of prior year losses, and the contingency provision

1 of slightly over \$1 billion, which was two percent of total
2 estimated costs.

3 In the R97 case, the revenue requirement included
4 \$377 million in recovery of prior year loss allowance, and a
5 contingency provision of \$598, almost \$599 million for --
6 which was one percent of the estimated costs at that time.

7 So, because those two items are the main source,
8 as I understand it, of whatever income results for the
9 Postal Service, in effect, the income allowance, if you
10 will, was reduced by about \$1 billion a year, lowered.

11 I'm not sure what is unclear about that statement,
12 sir.

13 Q Well, why don't you tell me why those amounts were
14 reduced?

15 A Well, they were reduced for --

16 Q Excuse me a second. Just so it's clear for you
17 and me, why don't we do them separately, first prior losses,
18 and then the contingency?

19 A Okay. The prior year losses were reduced because
20 during the period leading up to the R97 case, the Postal
21 Service had earned a considerable amount of net income
22 during that period.

23 Now -- and therefore the accumulated prior year
24 losses, the cumulative prior year losses that existed when
25 the R97 decision was made, were lower than they had been

1 when the R94 decision was made, and therefore necessitated a
2 lower recovery of prior year loss allowance.

3 Q Before we go on to contingency, let me follow up
4 on that separately. So when you say that the Commission
5 reduced that, what you mean is, as you explained, is that
6 the Postal Service had reduced its accumulated net deficit
7 and therefore the Commission, using the same methodology,
8 ended up with a smaller number for recover of prior year
9 losses; is that accurate?

10 A That's accurate.

11 Q Okay, now, I'll let you go on to the contingency.

12 A In the R94 case, the Postal Service has requested
13 a two-percent contingency provision.

14 In the R97 case, the Postal Service requested a
15 one-percent contingency provision, which, to my
16 understanding, that was granted.

17 And so the net effect of those was to lower, in a
18 sense, income, those two things in combination.

19 Q Would you look your response to our Question 4(b),
20 please?

21 A I have it before me, sir.

22 Q Okay. You say there, "Although Mr. Tayman
23 testified in R97-1 that the Postal Service was leaving the
24 door open to a larger contingency if circumstances were to
25 change, it is not clear from his testimony in this case what

1 circumstances have changed to alter management's judgment."

2 Do you see that?

3 A I do see that. Yes, sir.

4 Q Thank you. Do you have Witness Tayman's testimony
5 with you by any chance?

6 A I do.

7 Q Could you look at page 43, please, beginning at
8 line 25.

9 A I see it, sir.

10 Q Are you there? He lists mail volume growth below
11 historic norms and requirements to hold level and even
12 reduce work years while workload continues to grow. Do you
13 see that?

14 A I do see that. I believe that should be accounted
15 for in the Postal Service estimates of revenue, expenses and
16 volumes for the test year.

17 If the fact that the Postal Service believes its
18 volume is going to be growing more slowly that should be
19 accounted for.

20 Q And you wouldn't characterize them as
21 circumstances that have changed since last time to affect
22 management's judgment?

23 A I would not characterize them as anything that
24 would affect the necessity or the size of the contingency
25 provision.

1 Q On page 44, would you look at that, beginning at
2 line 5?

3 He refers to increases in health benefit costs
4 which previously had been decreasing, and then beginning at
5 line 18 he adds "uncertainties related to electronic volume
6 erosion, the pursuit of adverse initiatives by competitors
7 and increased competition from foreign competitors."

8 Do you see those?

9 A I have seen those.

10 Q And are those not circumstances which could be
11 characterized as having changed from the past?

12 A They might have changed from the past. There's
13 been no attempt that I have seen to quantify the effect of
14 those or estimate the impact of each of those individually
15 or the likelihood of the timing of those impacts.

16 Certainly volume erosion due to electronic message
17 delivery systems of various kinds may happen, but it is not
18 happening at least right now. Postal Service volume as I
19 have seen it is actually still increasing year to year.

20 It is projected to increase during the test year
21 and I don't see that as something that is easily
22 quantifiable in a contingency allowance.

23 Q I think that is -- my question was whether that
24 was the circumstances -- a circumstance which has changed
25 since the last time that would affect management's judgments

1 about the uncertainties related to those issues.

2 A Those circumstances, to the extent that Postal
3 Service has built projections of health cost increases,
4 benefit increases, wage increases, volume increases, volume
5 diversions, slowing rate of growth of volume into its
6 estimates those are already accounted for in test year
7 estimates of revenue/expenses, as I understand it.

8 Q The effects of those are already known, is that
9 what you are saying?

10 A They are not known. They are estimated. They
11 certainly are not known with certainty but they are
12 estimated so only the parts of them that are likely to
13 result in adverse shock should be accounted for in the
14 contingency provision.

15 Q And which of those do not fall into that category
16 in your opinion?

17 A There may be parts of each of them but there has
18 been no attempt to quantify the effect of them that I see.

19 Q Have you attempted to do so?

20 A I have not.

21 Q So an attempt at quantification of those is not
22 the basis for your recommendation of a 1 percent
23 contingency, is that correct?

24 A No, the 1 percent contingency that I have
25 recommended is sort of a maintenance of the existing

1 contingency based on the success of the Postal Service in
2 operating with 1 percent contingency.

3 Going back to 1995 the Postal Service in the R94
4 case actually got well ahead during the period those rates
5 were in effect, 1995 through 1998, got well ahead of its
6 equity recovery plan. It actually was running about \$1.4
7 billion ahead at the end of 1998.

8 In 1999 --

9 Q And that was because it was able to retain the
10 amount that was included for recovery of prior year's
11 losses, is that correct?

12 A But that effectively means since the Postal
13 Service as I understand it has sort of two targets -- one is
14 a break even target and certainly does not want to lose
15 money in any given year -- but also has a target of
16 recovering at least the recovery of the prior year loss
17 amount that was allowed in the previous rate case, I believe
18 those are the income targets, so judged on that basis the
19 Postal Service over-recovered, recovered more dollars from
20 Postal customers than was necessary during the 1995 to 1998
21 period, it recovered approximately in 1999, the approximate
22 recovery of prior year loss allowance that was accepted in
23 the R97 case, you know, so to that extent the Postal Service
24 has done quite well.

25 It has restored its equity and as of Accounting

1 Period 9 of this year the equity actually is a positive
2 number. The economy is still relatively stable even though
3 growth appears to be slowing due to Federal Reserve policy
4 attempting to curtail inflation pressures, so I don't see
5 inflation accelerating.

6 The economy appears to be growing. The Postal
7 Service is in relatively good financial health compared with
8 any recent period and all those -- and it has operated well
9 for the past two years with the 2 percent -- 1 percent
10 contingency, excuse me, and all those factored into my
11 judgment that the 1 percent could be continued without
12 unreasonably burdening the Postal Service.

13 Q When you talk about "continued" do you know if the
14 net income that the Postal Service had in FY 1999 included
15 or totalled to the amount for the recovery of prior year
16 losses plus the contingency?

17 A It did not, but the Postal Service's own target
18 income level does not include the contingency.

19 Q I understand that but when you talk about existing
20 contingency, the contingency was gone.

21 A But the contingency was in a sense eaten up. The
22 Postal Service net result was very close to the recovery of
23 prior year loss amount, just slightly short, and the raise
24 went into effect somewhat later. They didn't go into effect
25 until 1999. No, it just appears that the Postal Service

1 operated what I would deem successfully during that period.

2 Q But now the Postal Service is requesting rates for
3 the future and is trying to establish a contingency and
4 recovery of prior year's losses based on the current
5 situation, is that correct?

6 A That is correct. The Postal Service in this
7 particular matter we are discussing has requested a 150
8 percent increase in the size of the contingency.

9 Q Based on the last case?

10 A No, sir.

11 Q Your comparison of --

12 A Well, 150 percent. It had 1 percent. It
13 requested an allowance of 2.5 percent. That is a 150
14 percent increase in the relative size of the allowance.

15 Q When is the period it actually had 1 percent that
16 you are referring to?

17 A It is not -- well, only since the R97 rates went
18 into effect.

19 Q And we just agreed that we didn't have the entire
20 amount in fiscal year 1999? Is that correct?

21 A That's correct.

22 Q Would you look at again your answer to 4(b)?

23 The question we actually asked was, "Would you say
24 that actual results during this period indicate that postal
25 management's judgment related to the selection of the

1 contingency in Dockets Number R94-1 and R97-1 amounts was
2 good?"

3 I don't think you actually answered that question
4 and I would like you to.

5 A The Postal Service in R94-1 requested and was
6 allowed a contingency provision of 2 percent. Mr. Ward's
7 testimony at that time was that he was concerned that that
8 might not be sufficient.

9 However, if you look at the effect of the R94-1
10 rates during the period 1995 through 1998, when they were in
11 effect, the Postal Service not only met its equity
12 restoration goals of targets, as stated in the Board of
13 Governors' resolution, it actually exceeded those targets
14 cumulatively about \$1.4 billion over that period of time,
15 which means that the Postal Service in effect collected too
16 many dollars from ratepayers that time.

17 Now it did result in somewhat lower rates going
18 into effect in the R97 case than might otherwise have been
19 the case, but is that necessarily good judgment?

20 I would say that they were overly pessimistic and
21 could have been a little more sanguine with respect to the
22 contingency provision in 1994.

23 Looking at that \$1.4 billion on an annual basis
24 was about two-thirds of a percent of the estimated expenses
25 that were calculated in the R94 case, so, you know, I don't

1 know that -- you know, is that good judgment?

2 Q So you might say it should have been one and
3 one-third percent?

4 A Well, had it been one and a third percent allowed,
5 just sort of a ball park figure, that would have been
6 sufficient for the Postal Service to be on target for its
7 equity recovery or equity restoration plan.

8 Q Would you look at your answer to Question 7,
9 please? You say there that it is possible that the Postal
10 Service's FY 2000 plan for accounting periods 10 through 13
11 may also prove to be overly pessimistic. And I would ask
12 you also to look at your answer to Number 6, where you say
13 that I believe -- I'm sorry -- I believe that the Postal
14 Service's ability to forecast has improved compared with
15 some earlier periods. Why, in light of that statement,
16 would you expect the Postal Service's current plan to be
17 inaccurate?

18 A Well, the Postal Service has -- its month-to-month
19 forecasts, if you look at the -- I was looking at the
20 charts, I haven't done a calculation, but sometimes the
21 actual results are close to the plan. Sometimes they miss
22 the mark, sometimes the plan is too high or too low relative
23 to actual. The ability of the Postal Service to forecast in
24 a relatively stable economic environment ought to be, in my
25 opinion, better than it would be in a less stable economic

1 environment. Also, with inflation relatively low and
2 stable, I think that increases the ability to forecast
3 certain expenses.

4 But, you know, I think -- and, also, the Postal
5 Service has indicated that they are trying to improve their
6 forecasts. They have a forecasting section that is -- with
7 the intent of improving the accuracy and reliability of
8 their forecasts. All of those things, I think, to me,
9 indicate the Postal Service's ability to forecast should be
10 improving.

11 Now, whether this plan, the financial plan of the
12 Postal Service is derived directly from those forecasts, I
13 don't know.

14 Q But yet it is your opinion that it is overly
15 pessimistic?

16 A Well, in 1999, I am just simply stating that the
17 Postal Service underestimated its net income in each of the
18 accounting periods 10 through 13, or -- yes, 10 through 13.
19 And that was just showing, comparing the actual results to
20 the plan.

21 Now, I am not necessarily saying that that will
22 occur this year. I am saying it is not beyond the realm of
23 possibility, or probability, that something similar might
24 happen.

25 Q Has inflation accelerated or decelerated since the

1 Postal Service filed its case?

2 A Well, the rate of inflation on a month-to-month
3 basis has been pretty variable, but I think it has gone up
4 just a little bit

5 Q It has accelerated?

6 A I believe it has increased. It is still below
7 what it was, below -- approximately the rate it was in the
8 R97 case. It is -- and the Federal Reserve system is taking
9 action to try to rein that acceleration in.

10 Q Do you know if it is higher or lower than what we
11 estimated when we filed the case?

12 A I think, it is my recollection, I haven't looked
13 at this, that the Postal Service, at least in part of the
14 testimony used the data resources, November 1999 estimates,
15 is that correct? I would have to ask. It seems like I saw
16 that. So it might be a little higher than it was then.

17 Q And do you know how that compares to the situation
18 in the last case, in R97?

19 A I have not looked at that comparison.

20 Q Would you look at your response to our Question
21 10, please? And there you refer to your Table 5 and say
22 inflation rates were higher when those cases were heard than
23 they have been more recently.

24 A I see that. That is --

25 Q And I want to ask you about your Table 5, if you

1 have that.

2 A I do have that.

3 Q Your reference there, or your figures in Table 5
4 are limited to the Consumer Price Index, is that correct?

5 A Yes.

6 Q And that is a measure of prices paid by consumers?

7 A Yes.

8 Q Do you believe that is -- that the CPI is an
9 accurate measure of inflation in Postal Service services?

10 A Well, it would be one measure. There are other
11 measures, the Employment Cost Index is another measure the
12 Postal Service has used. I didn't put it in here, it is
13 contained in some of the forecasts that I included in my
14 testimony.

15 Q So was your answer yes or no? I'm sorry.

16 A I think most price indices are fairly well
17 correlated. Whether that is an accurate indication of the
18 increases in costs of the Postal Service, I am not prepared
19 to say.

20 Q Have you looked at the correlation of CPI with
21 Postal Service expenses over the Postal Service's existence?

22 A I have not.

23 Q Do you consider the economy more or less stable
24 now that it was when the Postal Service filed this case?

25 A I think the case was filed last fall.

1 Q It was filed in January.

2 A This year, January this year. Some of the data
3 was from the fall. I made no attempt to study that, but I
4 think the economy clearly is more stable now than it was at
5 some other times in the past when the Postal Service had
6 cases before the Commission and was requesting and receiving
7 higher contingency provisions.

8 I think there is some instability right now. You
9 know, there clearly are always uncertainties in the macro
10 economy.

11 Q Would you say that, referring to past cases, would
12 you say that the economy is more or less stable today than
13 it was during the test period for the last case, which was
14 fiscal year 1998?

15 A I have not made that comparison.

16 Q And have you also not made a comparison with the
17 previous case or cases?

18 A Well, based on past -- just my simple experience,
19 having lived through the 1970s and '80s, I know that at some
20 of the periods when the Postal Service had cases before the
21 Commission, the economy was much for stable, inflation was
22 much higher, unemployment was higher. We have had several
23 recessions. You know, now we are in, I guess, the longest
24 post-war period of economic growth. And we have had no
25 recession since 1991, well, I guess it ended in '92.

1 MR. REITER: That's all I have, Mr. Chairman.

2 CHAIRMAN GLEIMAN: Is there any follow-up?

3 Questions from the bench?

4 COMMISSIONER LeBLANC: Yes, sir.

5 CHAIRMAN GLEIMAN: Commissioner LeBlanc.

6 COMMISSIONER LeBLANC: Dr. Eisenberg, I mean to
7 ask this, I guess I should have asked it possibly to your
8 compadre over there, but when you looked at the contingency,
9 did you all also look at things like overruns -- I say
10 overruns, a surplus that the Postal Service gets back in
11 things like workmen's comp and so forth, that happened in
12 the late '80s, early '90s timeframe that I remember? I
13 can't quote you exact figures, but I know that there were
14 surpluses that weren't used and so forth. Did you take any
15 look into that at all in your determinations?

16 THE WITNESS: Commissioner LeBlanc, I was not
17 aware of that, I did not use that. I can't speak for Mr.
18 Burns. But we didn't consider that, nor did we have that
19 information at our disposal.

20 COMMISSIONER LeBLANC: So you did not look, in
21 effect, on a line item basis and say, well, if there were
22 overages, shortages or whatever, when you came up with your
23 analytical approach to this? ●

24 THE WITNESS: No, sir, we made no attempt to, on a
25 line item by line item basis, look at the cost variances or

1 differences between estimates and forecasts that might have
2 resulted.

3 COMMISSIONER LeBLANC: Okay. As an economist,
4 when you look at quote-unquote "reasonable amount," by law
5 we are required, to paraphrase, to give a reason able for a
6 contingency. Keeping in mind the PYL, the recouping of any
7 losses that take place, what is your definition then of
8 "reasonable"?

9 THE WITNESS: Well, I think that in terms of being
10 reasonable, if rates are set at a level that allows the
11 Postal Service, assuming economical and efficient
12 management, to meet its income target, to meet -- at least
13 recover is prior year loss amount, and certainly not to
14 suffer a net loss, if it gives it a reasonable opportunity
15 to do that, then rates are reasonable.

16 I think it's very difficult for the Commission to
17 guarantee the Postal Service will, in fact, meet its income
18 target or even earn a profit, and that could be seen from a
19 long history of losses. It's sometimes very difficult to
20 make a -- to guarantee.

21 One can only go back to the 1970s and 80s and look
22 at some of those loss figures and say, well, what would
23 rates have to have been in order to ensure the Postal
24 Service didn't operate at a loss?

25 So, my definition of reasonable is that the Postal

1 Service would at least break even, and preferably would
2 recover it's prior year losses.

3 That allows -- if you look at those amounts, the
4 one-percent contingency that we've suggested should be
5 continued, plus the recovery of prior year losses, it
6 results in about a 1.4 percent margin over estimated costs.

7 COMMISSIONER LeBLANC: You said 1.4?

8 THE WITNESS: Well, that includes the recovery of
9 prior year loss amounts that are included. Those two items
10 amount to about 1.4 percent of total estimated costs added
11 over and above that, over and above the estimated costs.

12 You know, the Postal Service would have to incur
13 net adverse effects, uncontrollable effects that overwhelm
14 that amount before it would suffer and absolute loss.

15 COMMISSIONER LeBLANC: In this business we hear a
16 lot about stability and flexibility over time.

17 Did you and Mr. Burns ever consider maybe even
18 raising the contingency and doing away with the PYL, or did
19 you look at how much flexibility it gives you versus
20 stability by lowering the contingency?

21 THE WITNESS: Well, I cannot speak for Mr. Burns,
22 but I know that I didn't consider in discussing the
23 contingency provision, anything about doing away with the
24 recovery of prior year loss allowance.

25 I think those have somewhat different impacts, and

1 different reasons for being in existence. If there were no
2 recovery of prior year losses -- and I've stated so in my
3 testimony -- if the Postal Service did not have the
4 provision that it could recover prior year losses, if it had
5 no borrowing authority, if it did not use estimated future
6 test year revenues and expenses, then I think the
7 contingency provision should be considerably higher or be
8 somewhat higher.

9 COMMISSIONER LeBLANC: What do you mean by
10 "somewhat," in this particular case?

11 THE WITNESS: Well, I've made no study, but each
12 of those is a factor that I think contributes to the
13 viability of the Postal Service.

14 That's what we're all concerned with, is ensuring
15 the viability of the Postal Service, giving -- and if those
16 other provisions were not in existence, then I think the
17 contingency provision, whether you called it a contingency
18 provision or not, would have to be somewhat larger in order
19 to ensure the Postal Service didn't continually operate at a
20 loss.

21 COMMISSIONER LeBLANC: Okay. A minute ago, you
22 talked about adverse shock. I believe that's the word you
23 used that I wrote down here.

24 And you were talking about it, I believe, in the
25 context of what happens if it's not there; that it being the

1 contingency. Maybe that's a mischaracterization on my part.

2 I'm not trying to put words in your mouth, but
3 could you explain to me and this Commission, what adverse
4 shock would mean?

5 THE WITNESS: Well, it's my understanding that the
6 definition of an adverse shock is one that's unforeseeable,
7 unforecastable, uncontrollable, beyond the limits of Postal
8 Service management to adjust for, that has an adverse impact
9 on the net income, either revenues or expenses of the Postal
10 Service, and makes it difficult for it to at least break
11 even or meet its income target and threatens its long-term
12 viability.

13 There can also be positive shocks. I mean,
14 sometimes good things happen, sometimes bad things.

15 I think clearly the contingency provision is
16 designed to provide a buffer against the net effect of
17 adverse shocks.

18 COMMISSIONER LeBLANC: Again, I don't want to
19 mischaracterize what you say; I'm just trying to clarify it
20 here for me and for the record, possibly.

21 But a minute ago in your colloquy with counsel for
22 the Postal Service, you were talking about -- if I put this
23 down right -- the Postal Services plan and how it relates to
24 the contingency and so forth.

25 Is it your testimony that the contingency drives

1 the plan, or does the plan drive the contingency?

2 THE WITNESS: I really have trouble answering
3 that, sir, and let me explain why: I think when the Postal
4 Service comes in for a rate case, it suggests a contingency,
5 then given factors, it develops an operating plan.

6 I don't exactly know the linkage between the
7 estimates, the forecasts, and so forth that are built into,
8 say, the test year numbers, and an operating plan on a
9 month-by-month basis for the Postal Service.

10 I know that the Postal Service, you know, does
11 have a plan, a projection of revenues and so forth and
12 expenses for each month.

13 The Postal Service, for instance in 1999, in its
14 plan, has a net income of \$200 million. It exceeded that.

15 Its plan for this year is to earn net income of
16 \$100 million. Now, the \$200 million is a different number
17 than the Board of Governors' resolution, which calls for the
18 Postal Service to have a net income while rates are in
19 effect, cumulatively equal to the cumulative recovery of
20 prior year loss allowed.

21 So the Postal Service's plan for 1999 was for an
22 income level that was somewhat below the Board of Governors'
23 target level.

24 Now, it, in fact, exceeded that by about \$160 some
25 odd million dollars.

1 So I'm just not -- don't know the linkage between
2 the way the contingency request is determined, and the plan
3 of the Postal Service.

4 COMMISSIONER LeBLANC: Thank you very much. Thank
5 you, Mr. Chairman.

6 CHAIRMAN GLEIMAN: Commissioner Goldway?

7 COMMISSIONER GOLDWAY: I just had a question. As
8 an economist having some sense of what the future economic
9 situations will be, you did have some discussion about the
10 current rate of inflation.

11 But I was struck yesterday with the announcement
12 that the budget surplus over the next ten years is going to
13 be \$1,000,873,000,000 or something like that, and that just
14 four months ago, the expectation was that the surplus would
15 be \$700 and some odd billion.

16 Do you think those kinds of figures have an impact
17 on what we can expect inflation rates will be in the near
18 term?

19 THE WITNESS: Well, the economy in the last little
20 bit, couple years, I guess, really has been growing somewhat
21 faster than almost anyone projected it to grow.

22 And at least according to Chairman Greenspan of
23 the Federal Reserve Board, the Board of Governors of the
24 Federal Reserve, that's an unsustainable rate of growth.

25 And so that might set off inflationary pressures.

1 At least part of the growth in budget surpluses, I believe,
2 has come because economic growth has stayed more rapid than
3 anyone really projected.

4 It wasn't too long ago that people were worried
5 about deficits as far as the eye could see. Now people are
6 worried about surpluses as far as the eye can see, and what
7 to do with them.

8 That's a much more pleasant prospect, you know,
9 but does it affect the rate of inflation?

10 Well, clearly if economic growth continues, given
11 that the unemployment rate is down around four percent or
12 slightly above four percent, we're kind of towards the
13 bottom of what would be a reasonable unemployment rate
14 without setting off wage and price pressure.

15 You know, if the Federal Reserve is successful in
16 achieving a soft landing, as I think it did about five years
17 ago, and it's not too bumpy, we might -- inflationary
18 pressures might be cooled off. But I don't do macro
19 economic forecasting, and --

20 COMMISSIONER GOLDWAY: Thanks.

21 CHAIRMAN GLEIMAN: Commission Covington?

22 COMMISSIONER COVINGTON: Good afternoon, Mr.
23 Rosenberg. I wanted to follow up on a question I had asked
24 your colleague, Mr. Burns, prior to you taking the witness
25 stand.

1 And it dealt with frequency of rates in the event
2 USPS found itself having to have to move around with this
3 contingency allowance.

4 Now, in your testimony, you specifically stated or
5 you specifically advocated shortening the rate cycle. I
6 think you alluded to the fact that two years was a
7 possibility; is that correct?

8 THE WITNESS: Well, the R97 rates will have been
9 in effect about two years at the time that the new rates go
10 into effect, presumably. That is somewhat of a shortening
11 of the cycle.

12 I was not specifically advocating a shortened
13 cycle. I was saying that one effect of shortening the
14 cycle, the planned cycle, might be to allow for a smaller
15 contingency.

16 The Postal Service, in one document that I have
17 seen from about five years ago, said that they had sort of a
18 rate cycle -- a three-year rate cycle presumption, and they
19 planned to make significant income the first year, break
20 even in the second year, and lose money in the third year
21 before new rates went into effect.

22 I think, you know, that could be changed a little
23 bit.

24 COMMISSIONER COVINGTON: Okay, as far as the rate
25 cycle is concerned, but when you look at it in the overall

1 scheme of things -- and I think Deputy Postmaster General
2 Nolan has even alluded to the possibility of a shortened
3 rate cycle, but what do you think that would do the rate
4 process overall as far as deciding what revenue the Service
5 would need to be viable and to even satisfy the break-even
6 requirement, given the fact that it takes us ten months to
7 sit here and listen to testimony as we're doing today?

8 THE WITNESS: I understand the time consumed in
9 going through a rate case. Shortening the rate cycle, I
10 think, would be one factor that might allow for a somewhat
11 smaller contingency than if the rate cycle were, say,
12 presumably three or four or five years.

13 If you knew that you were setting rates that had
14 to be in effect for -- let's just hypothetically say five
15 years or four years.

16 Then the uncertainties on that time horizon are
17 somewhat larger; not that there are not uncertainties or
18 unforecastable events even out a year. But I think the
19 horizon looks a little closer if you're looking at just a
20 few years.

21 However, the purpose of the contingency provision,
22 as I understand it, is to allow the Postal Service at least
23 to break even or hit its income target during the test year,
24 as it actually materializes.

25 And so if you start trying to look too far out in

1 the future, I think you do run the risk of setting rates
2 maybe higher than they need to be at present, and then sort
3 of building up a reserve and drawing it down over time.

4 And now one way, I think -- it's my understanding
5 that Mr. Callow's testimony makes the suggestion that
6 certain rates, specifically, I guess, single-piece First
7 Class rates, will be adjusted only every other rate case to
8 allow stability for those users, and then have other users,
9 the bulk mailers and so forth, would do -- could more easily
10 adapt to changes, more frequent changes, their rates would
11 be adjusted at every rate case.

12 One of our colleagues at the National Regulatory
13 Research Institute testified before one of the Committees of
14 Congress a few years ago on the possible efficacy of
15 applying price cap regulation to the Postal Service.

16 In many utility settings right now, the rates are
17 allowed to increase at an annual rate equal to the rate of
18 inflation, minus some productivity factor, so that you just
19 simply assume that there will be some adjustment, although a
20 decrease in the real price of a utility's services,
21 telephone service, principally, over time.

22 COMMISSIONER COVINGTON: Mr. Rosenberg, in your
23 professional opinion, and given your economic background,
24 what would you say constitutes a too-large or a too-small
25 contingency request? Would that be putting the rope around

1 your neck and kicking the stool out from under you?

2 THE WITNESS: Well, as I indicated in my
3 testimony, there are costs and benefits from being too large
4 or too small.

5 You know, if the contingency request turns out to
6 be too large, that means consumers today have paid dollars
7 they didn't need to pay and that may mean they have lower
8 rates in the future.

9 On the other hand, if the contingency request
10 turns out to be too small, consumers today pay, may pay less
11 than the true cost of receiving service and they -- but they
12 have to pay higher rates in the future.

13 Now -- so there is a fine line that needs to be
14 drawn. I think while I have advocated continuation of the 1
15 percent, it's been based on the experience of the Postal
16 Service in successful operation or successful financial
17 results over the last two years with the 1 percent
18 contingency.

19 COMMISSIONER COVINGTON: Now which -- you know,
20 which leads me to my final question. In the event that that
21 occurs and you -- you know, at the United States Postal
22 Service, the end result of that is a loss even though they
23 may be being as efficient, as honest, and probably managed
24 as economically good as they can, I think in your testimony
25 you say that under those type circumstances customers would

1 enjoy lower current rates and experience higher future
2 rates, which means pay me now or pay me later, correct, when
3 you start talking about, you know, from the consumer's side
4 of things, which all things being considered, I think that
5 is one of the reasons why we are here also.

6 THE WITNESS: That's correct, sir. I think the
7 consumers can pay early or pay late but they will pay.

8 COMMISSIONER COVINGTON: In some shape, form or
9 fashion.

10 THE WITNESS: Yes, sir.

11 COMMISSIONER COVINGTON: Thank you, Mr. Rosenberg.
12 That's all I have, Mr. Chairman.

13 CHAIRMAN GLEIMAN: Is there any followup to
14 questions from the bench?

15 If not, that brings us to redirect.

16 Would you like some time with your witness?

17 MS. DREIFUSS: I think just a minute would be
18 enough.

19 CHAIRMAN GLEIMAN: Certainly.

20 And while counsel is talking to the witness, just
21 let me mention that we are going to try and do one more
22 witness before we break for lunch. I understand that the
23 next witness we have scheduled, Mr. Buckel, is not -- we
24 have had no requests for oral cross examination, and to the
25 best of my knowledge there are no questions from the bench.

1 If all that holds, we will see if we can't get Mr.
2 Buckel's testimony in the record before we break for lunch.

3 MS. DREIFUSS: The OCA has no redirect, Mr.
4 Chairman.

5 CHAIRMAN GLEIMAN: Since the OCA has no redirect,
6 Mr. Rosenberg, that completes your testimony here today.

7 We appreciate your appearance and your
8 contributions to the record. We want to thank you and you
9 are excused.

10 THE WITNESS: Thank you, Mr. Chairman.

11 [Witness excused.]

12 CHAIRMAN GLEIMAN: Mr. McLaughlin, if you are
13 prepared to call your witness.

14 MR. McLAUGHLIN: Mr. Chairman, the Saturation Mail
15 Coalition calls as its witness Harry J. Buckel.

16 CHAIRMAN GLEIMAN: Mr. Bucket, if I could ask you
17 to stand for a moment and raise your right hand.
18 Whereupon,

19 HARRY J. BUCKEL,
20 a witness, was called for examination by counsel for the
21 Saturation Mail Coalition and, having been first duly sworn,
22 was examined and testified as follows:

23 CHAIRMAN GLEIMAN: Please be seated.

24 DIRECT EXAMINATION

25 BY MR. McLAUGHLIN:

1 Q Mr. Buckel, I am handing you two copies of a
2 document captioned Direct Testimony of Harry J. Buckel on
3 behalf of the Saturation Mail Coalition, identified as
4 SMC-T-1.

5 Was that testimony prepared by you or under your
6 direction and supervision?

7 A It was.

8 Q Is it true and correct, to the best of your
9 knowledge and belief?

10 A It is.

11 MR. McLAUGHLIN: Mr. Chairman, with that I would
12 ask that it, testimony SMC-T-1, be received into evidence
13 and transcribed into the record, and I will hand the copies
14 to the Reporter.

15 CHAIRMAN GLEIMAN: Is there any objection?
16 Hearing none, counsel, if as promised you will provide the
17 two copies to the Court Reporter I will direct that the
18 direct testimony of Witness Buckel will be transcribed into
19 the record and received into evidence.

20 [Direct Testimony and Exhibits of
21 Harry J. Buckel, SMC-T-1, was
22 received into evidence and
23 transcribed into the record.]

24

25

SMC-T-1

BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, D. C.

POSTAL RATE AND FEE CHANGES, 1997

Docket No. R2000-1

DIRECT TESTIMONY OF
HARRY J. BUCKEL
ON BEHALF OF THE
SATURATION MAIL COALITION

Communications with respect to this document should be sent to:

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May 22, 2000

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Autobiographical Sketch

1 My name is Harry J. Buckel. I have been involved in publishing community
2 newspapers and advertising shoppers industry for 29 years, and have maintained
3 an active interest in postal matters.

4 From 1972 to 1978, I held several positions for the Panex Corporation
5 involving the publication of various community newspapers including the Community
6 News of Suburban Detroit (100,000 circulation): Group Vice President, South East
7 Michigan Newspapers, and Vice President, Publisher of the Miami Beach Sun
8 Reporter.

9 In 1978, I joined Harte-Hanks Communications. I served in the following
10 positions: President and Publisher, San Francisco Progress, President and
11 Publisher, Ypsilanti Press, President and Publisher Gloucester County Times,
12 President and Publisher Journal Publishing Company, Hamilton, Ohio.

13 In 1982, I became Publisher of the PennySaver, a position I held until 1996
14 when I left the company to form the Newport Media Group. Newport Media was
15 formed in 1996 to acquire several existing mail and home-delivered saturation
16 shoppers in the Long Island area. During my ownership, the combined circulation
17 of the Newport Media group grew to exceed 2.5 million households and included a
18 private carrier delivered paper, the Marketeer, that delivered our largest, heaviest
19 paper and other shopper publications that were delivered by the Postal Service at
20 Standard A Enhanced Carrier Route (ECR) saturation rates.

21 In February 1999, I sold the Newport Media Group to Times Mirror. The
22 acquisition included an agreement for me to become the CEO of the Newport Media
23 subsidiary and a plan to do acquisitions to build up a network of shoppers along the
24 East Coast. In March, 1999 I suffered a stroke that changed my plans and that of my
25 employer.

- 2 -

1 I have maintained an interest in this industry and currently serve as a
2 consultant for Times Mirror. I am on the Board of Directors of Trinity Publishing, a
3 company with paid and free weekly papers in the Pittsburgh market. Trinity has
4 publications in the mail as well as private carrier.

5 This is my fourth appearance before the Postal Rate Commission. I
6 presented testimony on behalf of Harte-Hanks Shoppers in Dockets R90-1 and
7 R94-1, and for the Saturation Mail Coalition in R97-1. I have belonged to and actively
8 participated in numerous trade and industry associations relating to postal and
9 publishing matters. Some highlights: In 1989 I served as industry co-chairman of
10 the Postmaster General's Worksharing Task Force; I was Executive Vice Chairman
11 of the Third Class Mail Association from 1989 to 1991 and chaired that association
12 from 1991 through 1993; and in 1997, I helped form and have remained active in the
13 Saturation Mail Coalition.

Purpose of Testimony

14 I am testifying for the Saturation Mail Coalition because I believe that
15 maintaining reasonable rates and reducing the current pound rate are essential for
16 the Postal Service to retain the business of saturation mailers. The purposes of my
17 testimony are:

- 18 • Describe the Saturation Mail Coalition and the different types of mail
19 programs operated by saturation mailers;
- 20 • Describe the customers served by the saturation mail industry; particularly,
21 the many individuals and small businesses that use and depend on
22 saturation mail programs;
- 23 • Describe the highly competitive nature of our business and the growing
24 erosion of our customer base due to nonpostal competition;
- 25 • Describe the major problem with the present pound rate and how this
26 artificially contrived rate structure is prodding successful saturation mailers to
27 explore forming private delivery options. When saturation mailers switch to
28 private delivery, the Postal Service both loses saturation mail volumes and
29 finds itself facing an able competitor seeking to take more ad mail business
30 from it.

- 3 -

A. The SMC And The Saturation Mail Industry

1 The SMC is a coalition of businesses that operate cooperative
2 advertising programs that are distributed by saturation mail. Formed in 1997, we
3 now have approximately 50 members that share a common interest in postal issues
4 relating to service and postal rates. The Coalition's membership reflects the
5 breadth of the industry. It includes publishers of free weekly newspapers, free
6 advertising and shopper publications, shared mail programs, cooperative coupon
7 envelope companies, and publishers of coupon magazines and booklets. Some of
8 our members also prepare solo saturation mailings and conduct "total market
9 coverage" (TMC) mailings for newspapers. All of our members are users of ECR
10 saturation mail and some distribute portions of their circulation via private delivery.
11 SMC members include the nation's largest shared mailers, ADVO, Inc. and Harte-
12 Hanks Shoppers, with combined weekly circulation of approximately 70 million
13 homes. The majority of our members, however, are local or regional mailers that
14 mail on a regular weekly, monthly or other periodic schedule to specific geographic
15 markets ranging from 10,000 to a million households. Many of our members are
16 small mailers or publishers like Money-Saver Advertising, Inc. in New York, with
17 weekly circulation of less than 15,000 homes.

18 One of the reasons I was active in forming the Saturation Mail Coalition was to
19 provide a forum for these varied mailing businesses, that often compete against
20 each other in the market place, to come together and work on issues of common
21 concern, like postal matters, and to address misperceptions about our industry.

22 When I was with Harte-Hanks, I became aware that many Washington
23 leaders, and even top Postal Service officials, erroneously believed that the
24 saturation mail industry consisted of only a few large mailers and primarily served
25 "big business." This is far from true. With the exception of a few, national concerns,
26 most saturation mailers are very local and cover a limited market area. Although

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1 saturation mail customers include national retailers, franchises, and chains, our
2 core customers are small local businesses, individual entrepreneurs, and
3 consumers.

4 The saturation mail industry has three basic product lines. The one with
5 which I am the most familiar is the free community paper or "shopper segment."
6 There are more than a thousand local and regional free community papers or
7 shoppers in United States. Roughly half the circulation of these papers is
8 distributed by mail at ECR rates. Some shoppers contain 100% advertising while
9 others contain local and community news and other editorial matter. Free papers
10 are typically printed in a newspaper tabloid or booklet format. Most shoppers zone
11 individual editions of their paper to reflect the shopping and traffic patterns of the
12 communities they serve. My last paper, Newport Media, divided its market into over
13 190 zones that each served approximately 13,000 households. A separate and
14 unique edition was printed for each zone each week. Shoppers also try to sell the
15 delivery of preprinted advertising circulars, known as preprints or inserts. Inserts
16 may be printed by the shopper or be free standing inserts that are printed by the
17 advertiser for insertion and delivery with the paper.

18 The "shared mail" segment of the industry includes shared mail programs
19 that cover 100% of all households in a geographic area and TMC programs. These
20 programs generally combine the insert advertising of several retailers in a single
21 package with a common piece, or wrap, on the outside. TMC programs integrate the
22 paid circulation list of a weekly or daily paper with a household mailing list. For
23 retailers who want their advertising delivered to all households in a given
24 geographic area, the TMC program allows the retailer to reach a household that
25 subscribes to the paper by getting its insert in the paper. Nonsubscriber
26 households receive the retailer's preprint (together with other advertiser's circulars)
27 as part of a shared mail package or a package of advertising delivered to the home

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1 by private carrier or by mail at the Standard A high density rate. In response to
2 advertiser demands, many daily newspapers have acquired mail operations, or
3 entered into TMC agreements with shared mailers, to provide advertising delivery
4 services to nonsubscribers.¹

5 One of the growth areas for the USPS, and the shared mail industry, has been
6 the development of shared mail programs in smaller, more rural markets. These
7 programs combine preprinted inserts from advertisers with advertising designed
8 and printed for customers by the shared mail company, and are typically mailed
9 monthly or bimonthly to the smaller, more rural markets where there may be few, if
10 any, other advertising alternatives.

11 A third type of shared mail program is the cooperative "coupon" segment. The
12 most well-recognized mailers of this segment are the coupons in envelope national
13 franchises operated by Val-Pak, Money Mailer, Super Coups, United and others. The
14 franchised coupon envelope companies involve individual entrepreneurs or dealers
15 that find and sell local businesses coupon advertising targeted to zones of, typically,
16 10,000 homes. The printing, preparation and mailing of the coupon envelopes are
17 handled by the national franchisor. There are also hundreds of shared mail coupon
18 businesses that sell coupons by mail in a booklet, in a tabloid or magazine format,
19 or in an envelope.

20 In spite of the breadth and diversity of these shared mailers and mail
21 programs, saturation mailers share many common market characteristics:

- 22 • Saturation mail programs are used for mass media advertising by
23 retailers and service businesses that offer products and services
24 appealing to a broad customer base.
- 25 • Saturation mail programs are targeted to local, geographically defined
26 markets.

¹ TMC programs may be handled by a newspaper's own private carrier force, a hand delivery company, shared mail company or letter shop. Some SMC members operate TMC programs for newspapers.

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- 1 • The primary customers of saturation mailers are local retailers, service
2 businesses and other advertisers who need a way to reach all
3 consumers who reside near their stores or businesses. A typical
4 shopping radius for a traditional retail business is two to five miles,
5 and even smaller for many small businesses with only a single
6 business location.
- 7 • Saturation mail programs are mailed on a regular, predictable
8 schedule, typically weekly or monthly.
- 9 • Postage is the highest, "uncontrollable," cost for most saturation
10 mailers. For a shared mailer, postage may exceed 50% of its gross
11 revenues. For free papers and shoppers, postage is typically the
12 second highest cost, following only labor, running 25% to 30% of gross
13 revenues. Because postage costs are so high, most saturation
14 mailers take advantage of every worksharing opportunity available to
15 them from the Postal Service.

16 The market condition most saturation mailers experience involves selling in a
17 tough competitive environment to advertising customers that are tremendously cost
18 conscious. As a mass media, saturation mail services are often measured in cost
19 per thousand. Our customers are constantly weighing and reevaluating the cost-
20 benefit equation of our services against those of our competitors. With the exception
21 of small markets and rural areas, where advertisers may have few choices, most
22 saturation mailers operate in a fiercely competitive market, competing with each
23 other, with daily and weekly newspapers, private delivery companies, electronic
24 media, and the burgeoning growth of new media ranging from everything from
25 internet advertising to specialty publications given away on store counters and racks.

B. Saturation Mailers And Their Customers

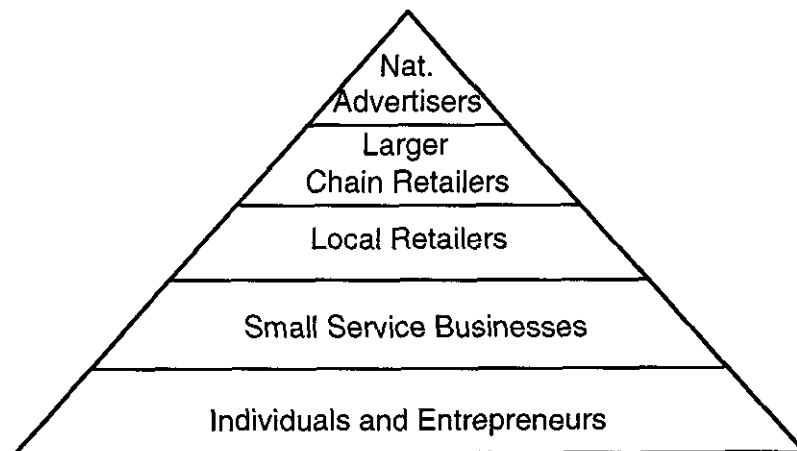
26 Most saturation mailers depend on a blend of different sized
27 customers to survive. Although the mix of advertisers will vary from one saturation
28 mailer to another, most mailers need to maintain some large customers to keep
29 their programs in business.

30 From a mailer's perspective, larger customers are important because they go
31 to most or all of the zones the mailer covers on a regular basis. These major

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1 players provide a base of business that the mailer needs to commit to mailing on a
2 fixed schedule. It is these large mailers, however, who are the most price sensitive
3 and cost conscious. They treat saturation mail services as a commodity and will
4 freely switch from mail to other distribution media if the price is right. A typical large
5 advertiser may be a grocer or mass merchandiser who views all consumers in a
6 major metropolitan area as potential customers.

7 From the advertiser's perspective, the chief benefit of a saturation mail
8 program is its ability to reliably reach all households in the defined area desired by
9 the advertiser. Larger advertisers have more alternatives when it comes to mass
10 media methods to reach consumers. For the small business, however,
11 geographically targeted saturation mail may be the only cost effective choice.



12 If viewed as a pyramid, the base of business for most saturation mailers is
13 our small business customer. Individual advertisers, service providers, tradesmen,
14 and home-based businesses comprise 70% to 80% of our customers. This
15 category includes employment, real estate, auto, personal and classified ads placed
16 by individuals, and is where the self-employed, building, home improvement and
17 other trade and service persons go to market their goods and services.

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1 Next on the pyramid is the small service business that may buy a larger
2 classified specialty section, or partial page display ad. The local optician, dentist,
3 chiropractor, hair stylist, drycleaner, house and carpet cleaners, lawn and garden
4 services are among these typical customers.

5 Local retailers are important display ad customers. For a one or two location
6 store, the targeted shared mail program provides a way to remind customers that
7 the store is in their neighborhood and has something worthwhile to offer. The family
8 restaurant, the tire and auto repair shop, the furniture store, the neighborhood deli
9 and ethnic grocery all need a forum to let consumers comparison shop their goods
10 against those of their big store competitors.

11 For most shared mailers our corporate mission is focused on meeting the
12 needs of our individual and small business customer. Free papers, coupon mailers
13 and shared mailers all pursue the small advertiser and offer more than just print
14 distribution services. To capture and serve the needs of small business, we offer a
15 turnkey advertising service to help the littlest of customers make the greatest impact
16 with their advertising message.

17 Shared mail programs provide valued and needed service to small
18 businesses by acting as their public relations, advertising and marketing
19 department. Shared mailers help small businesses understand and define their
20 market area. We look at prior sales to determine where a business gets its
21 customers. We may recommend ways of getting additional sales data, by reviewing
22 credit card receipts or asking customers for zipcode information, to improve and
23 target marketing efforts in the future. We use maps and demographic data by zone
24 to identify our advertisers' best market.

25 Most shared mail providers have a trained sales force with expertise on the
26 needs of small business. We help each customer design a program that will fit its
27 needs and budget. The new business or professional with a freshly hung shingle

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1 might need a special offer to lure customers in the door. For an auto service store
2 we might suggest a grand opening promotion with a free car wash with every
3 service. For the new dentist in town we might recommend offering a free cleaning or
4 free x-rays to help build a patient base. New category and product information is
5 available to help us, and our customers, on the types of ads and offers that work
6 best by business category. For food stores, industry research shows a BOGO "buy
7 one, get one free" offer may drive the best customer response. For the house
8 painter or home remodeling contractor who suffers from low sales in the winter
9 months, we may recommend offering a limited time savings of 20% for interior work.
10 When business rebounds, leads may be generated by a smaller discount of 10%.

11 With our small business customers, we are not just competing with other
12 media. We are also competing with the other demands on their limited resources.
13 For many of our customers, their pocket book and the business check book are the
14 same. Where should they spend their money this month? Rent? Groceries? Or
15 Advertising? Although advertising may be essential for the success of their
16 business, it is one of the few expenses that is discretionary. This is one of the
17 reasons that shared mailers are so sensitive to cost increases. When our costs go
18 up, whether for postage, newsprint or labor, our small business customers are
19 reluctant to pay more. In the face of a price increase, a small business is likely to
20 respond "I won't run an ad this month" or "can't you just make my ad smaller?"

21 Other shared mail advertisers include larger chain retailers, franchises and
22 national advertisers. National advertisers, like food and consumer product
23 manufacturers, and check and label printers and other direct response advertisers,
24 may use the mail to distribute coupons and drive a response to a 1-800 phone
25 number or the internet. This category probably makes up less than 1% of all
26 saturation advertisers.

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1 As stated earlier, most shared mailers depend on maintaining a mix of large
2 and small customers to have a viable share mail program. This mix is important
3 both from the standpoint of revenues needed to cover postage and printing and to
4 provide consumer household and readers with the mix of large and small local
5 business and service information they want. Shared mailers get the best response,
6 in terms of patronage of their advertisers and response to reader surveys, when
7 consumers have the opportunity to comparison shop and find good values in one
8 convenient place. For shared mailers to have a "win, win, win" solution for our
9 business, our advertisers, and consumers we need to offer cost-effective advertising
10 services for small, medium and large businesses alike.

C. Saturation Mail Competition

11 Although individual and small business advertisers are the primary
12 customers we serve, the long term viability of the shared mail industry depends on
13 the extent to which we can compete for retail advertising preprints of the medium to
14 large store customer. The competition for these larger, highly sought retail
15 advertisers is intense. Since I last appeared before the Postal Rate Commission, I
16 believe the competitive scale has tipped against shared mailers and in favor of hand
17 delivery options.

18 Focusing on two markets with which I am familiar, the New York and
19 Philadelphia markets, almost every major retail preprint advertiser has switched
20 from mail delivery to private carrier or a combination thereof. Why? Pricing. The
21 equation is like a teeter totter. Retailers are concerned about two factors when it
22 comes to the delivery of preprint advertising: credibility of the delivery versus cost.
23 Historically, mail has been the most credible form of delivery. But it has always been
24 the most costly. Private carrier, or alternate delivery has always been the least
25 costly, but lacked credibility.

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1 Rising costs for saturation mail, combined with the artificially contrived,
2 excessive pound rate, have tipped the teeter totter to favor hand delivery. In major
3 metropolitan areas, where retailers have competitive choices, the major preprint
4 advertisers are not using shared mail services. Daily newspapers, non-postal
5 TMCs, and private carrier companies are dominating the delivery of retailers'
6 preprints.

7 The unwillingness of the big advertisers to pay the high distribution costs for
8 mail has forced many shared mail companies to take a hard look at switching part
9 or all of their distribution system to alternate delivery.

10 I realize skeptics on the Commission and staff may ask "Haven't we heard
11 this before" or "Shouldn't we wait until there is hard evidence of shared mailers
12 leaving the USPS before we take action?" From the standpoint of the long term
13 viability of the shared mail industry, and the dependence of the Postal Service on this
14 business for predictable revenue and volumes, I certainly hope the Commission
15 takes action now.

D. The Need For A Lower, More Reasonable Pound Rate

16 Hand delivery, in newspapers, in TMCs, and by private carrier forces, is
17 gaining an ever increasing portion of the distribution market for retail preprints. As
18 retailers leave shared mail programs, this has a domino effect forcing mailers to
19 consider switching all or part of their circulations to private delivery.

20 Although I am no postal costing expert, I have owned and operated a shared
21 mail and private carrier paper and I know what happened to my costs as weight
22 increased. Under current rates for saturation ECR mail, the postage rate for pieces
23 above the breakpoint increases on an almost one-to-one ratio with weight. This
24 makes shared mail noncompetitive for the delivery of heavier preprint inserts. It also
25 forces mailers with a successful paper or shared mail program to take a hard look
26 at establishing their own private carrier force.

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1 This was my experience at Newport Media. Our lighter papers were
2 customers of the Postal Service. Our biggest paper, and the one carrying the most
3 retail preprints, was delivered by our own carriers. The ability of our private carrier
4 paper to generate incremental profits by selling additional pieces at heavier weights
5 was substantial. We could deliver our basic paper for 50% of the cost of mail.
6 Additional inserts could be sold into the paper at a very low distribution cost to us
7 and produced significant profits.

8 Our private delivery paper didn't just compete for business that might have
9 gone into other shared mail programs or daily newspapers. We were also able to
10 compete against the Postal Service and draw advertisers out of the mail and into the
11 pages of our hand delivered paper.

12 The current high pound rate is causing many shared mailers to think twice
13 about becoming postal service competitors. Major retailers and franchises are
14 increasingly receptive to hand delivery as a credible distribution method for print
15 advertising.² At the moment, the "teeter totter" is tilted strongly in favor of hand
16 delivery for the distribution of retail preprints. The modest reduction in the pound
17 rate proposed by the Postal Service will not substantially change this balance.
18 However, it will help shared mailers retain some of the business we need from

2 One of the reasons hand delivery is now perceived as a more credible method of distribution is the increasing number of recognized businesses that offer private carrier delivery as an option. The days when most private carrier companies were perceived as underemployed "vagrants" or "door-to-door winos" are gone. Consolidation among media companies, falling newspaper subscriptions, and retailer demands, have led many large, credible businesses to go into the private delivery business. Many large newspaper companies now have a private delivery subsidiary, or subcontractor, that is a reliable hand delivery provider. Circulation and delivery audit companies provide services to measure the reliability of hand delivery and ratings confirm delivery of 90% or more. Few mailers today sell against hand delivery by questioning the reliability or credibility of its delivery. Indeed, the only selling point that many mailers now have against hand delivery is the fact that many consumers, particularly in areas where there is snow, do not welcome advertising material hung on their door that announces to the world that they are not home or in their drive way where it may clog the snow blower.

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1 medium to large customers and be more competitive for the distribution of lighter
2 weight preprint pieces.

3 The lower pound rate will help the Postal Service preserve, and perhaps build,
4 saturation mail volumes. Because saturation mailers can become significant
5 competitors of the Postal Service when they leave the mail, it is enlightened self-
6 interest for the Postal Service to establish a rate structure that does not artificially
7 drive mailers out of the business and into competition with the Postal Service.

8 The chief reasons, however, for lowering the pound rate are that it is totally
9 unrelated to the incremental cost of piece delivery and is inconsistent with how other
10 businesses that compete for the delivery of print advertising charge. Shared
11 mailers, suburban and community newspapers, and other media companies
12 across the country are looking at ways to expand their advertising delivery market.
13 From the standpoint of the Postal Service, this is a logical source of core business
14 that could provide revenue to support its overhead and delivery point network.

15 Advertisers need and want a way to get shopping news into the hands of
16 customers near their stores. Consumers want and value this information. The
17 market will find a way to link advertisers and consumers together. Members of the
18 Saturation Mail Coalition have been trying to provide this service for small and large
19 customers alike through saturation shared mail programs. The current,
20 noncompetitive, non-market based pound rate is making this task more difficult and
21 is forcing many mailers to reevaluate and weigh our long-term future, either as
22 Postal Service customers or competitors.

1 CHAIRMAN GLEIMAN: There is no designated written
2 cross examination for Witness Buckel of which I am aware,
3 does anyone have any that we weren't aware of before today?

4 MR. BAKER: Bill Baker for the Newspaper
5 Association of America.

6 Since Mr. Buckel has made the trip, I will have
7 one question that was received after the conventional period
8 for this would be.

9 CROSS EXAMINATION

10 BY MR. BAKER:

11 Q So Mr. Buckel, I am going to hand you two copies
12 of your response to NAA/SMC-T-1-2 and would ask if we would
13 ask this today, would your answer be the same?

14 A Thank you. I would like to clarify my response to
15 NAA-T-1-2. The impact of the answer really centered around
16 the diversion of volume, advertising mail volume from the
17 mail to TMC programs and it would be, the specific issue is
18 it should be a great concern to all of us in this economy to
19 have advertising mail volumes declining with the most robust
20 ever advertising economy in probably 40 years, so that is a
21 significant concern, and the TMC programs are able to blend
22 their lower cost hand delivery with the mail and arrive at a
23 lower pricing structure than a pure saturation mailer.

24 I would thank you for the question. I feared
25 becoming the Harold Stassen of postal rate cases.

1 Q Well, then, with that, would your answer be the
2 same or different?

3 [Laughter.]

4 THE WITNESS: I would have clarified it more but
5 it is the same, the same answer.

6 MR. BAKER: Well, with that I suppose I will go
7 ahead and move it into the record, Mr. Chairman.

8 [Laughter.]

9 CHAIRMAN GLEIMAN: If you would provide the copies
10 to the Court Reporter and we will ask that they be
11 transcribed into the record and received into evidence along
12 with Mr. Buckel's additional explanation.

13 [Designation of Written
14 Cross-Examination of Harry J.
15 Buckel, NAA/SMC-T1-2, was received
16 into evidence and transcribed into
17 the record.]

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RESPONSE OF SMC WITNESS BUCKEL TO NAA INTERROGATORIES

NAA/SMC-T1-2. Of the three categories of saturation mail that you describe ("shopper segment", "shared mail", and "cooperative coupon"), please provide your best estimate of the proportion each comprises of total saturation commercial ECR mail.

I do not have specific information. Shoppers predominate in terms of total number of saturation mailers, with many serving relatively small market areas. In terms of saturation volumes, my best guess is that shoppers account for 35-40%, shared mail accounts for 40-45%, and cooperative coupons account for 20-25%.

There is another important segment of the saturation market discussed in my testimony that is not included in the "saturation commercial ECR mail" category that you ask about -- namely, newspaper nonsubscriber total market coverage (TMC) programs typically mailed at the ECR "high density" rate, used in conjunction with newspaper insert distribution to subscribers to achieve saturation coverage. Many of the nation's largest newspapers who are members of NAA -- like the *Washington Post*, *Chicago Tribune*, *Los Angeles Times*, *Boston Globe*, *Providence Journal*, *Baltimore Sun*, *Atlanta Constitution Journal*, *Miami Herald*, *Palm Beach Post*, *Orlando Sentinel*, *Dallas Morning News*, *Houston Chronicle*, and *Kansas City Star*-- offer mailed TMC programs. In addition, many smaller newspapers who are members of the National Newspaper Association have TMC programs mailed at the ECR high density rate, as well as free community newspapers mailed at the ECR saturation rate.

The mail volumes of these newspaper TMC programs are substantial. I am told that, according to Postal Service billing determinant data, the volume of ECR high density flats (most of which is likely TMC) is about 16% of the volume of ECR saturation flats (most of which is likely shoppers and shared mail), a proportion that is growing. High density flats also have a higher average weight than saturation flats

RESPONSE OF SMC WITNESS BUCKEL TO NAA INTERROGATORIES

and a substantially greater proportion of volume over the 3.3 ounce breakpoint. About 44% of high density flats pay the pound rate compared to 28% of saturation flats. Moreover, the USPS data indicate that the volume of high density flats paying the pound rate grew about 18% from 1998 to 1999, whereas the volume of saturation flats paying the pound rate declined by about 11%.

I would also note that under the Postal Service's proposed rates, newspaper TMC programs using ECR high density rates would receive smaller rate increases than shoppers and shared mail programs using ECR saturation rates, and would benefit from the proposed reduction in the ECR pound rate.

1 CHAIRMAN GLEIMAN: Is there any other designated
2 written cross? Counsel? They weren't kidding when they
3 said you were going to make an appearance soon, eh?

4 MR. MOORE: Absolutely. The Postal Service would
5 like to designate Mr. Buckel's response to AAPS-T1-1.

6 THE REPORTER: Would you identify yourself?

7 MR. MOORE: Joseph Moore.

8 THE REPORTER: Thank you.

9 CROSS EXAMINATION

10 BY MR. MOORE:

11 Q Mr. Buckel, did you prepare or supervise the
12 preparation of those interrogatory responses?

13 A I did, but again I would like to clarify.

14 We had a hypothetical response in our response
15 talking about costing of one of our delivery packages in the
16 mail versus private delivery and I have brought a real
17 world, specific example to share. This was delivered last
18 week in Brooklyn. It is an example of a pure private
19 delivery package, weighs 9 and a half ounces.

20 It would cost \$321 per thousand to deliver under
21 today's rates, \$295 under proposed rates, and the cost of
22 private delivery is somewhere around \$100 to \$125 a
23 thousand, so there's a significant, three time cost
24 structure built into the pound rate, in my opinion
25 artificially high pound rate, that it doesn't match the

1 reality of the true cost, in my opinion, of delivering that
2 package.

3 The proposed reduction of pound rate for the post
4 office would not divert this package to the mail but it
5 would certainly make lighter weight pieces more competitive
6 for the mail practiced and allow saturation mailers to offer
7 more options to advertisers, but the specifics -- so we went
8 from the hypothetical response to a specific example of how
9 the differing cost structures and prices work in private
10 delivery versus the current pound rate.

11 Q So taking into account the changes that you just
12 noted, if you were to give your testimony orally today,
13 would your answers be the same?

14 A They would with the addition of the specific
15 examples.

16 MR. MOORE: With that, Mr. Chairman, the Postal
17 Service moves that the response be admitted into evidence.

18 MR. STRAUS: I object to the oral presentation by
19 Mr. Buckel. It was not a clarification of a response. It
20 was additional direct testimony that should have been filed
21 with the direct testimony.

22 If it was an update to an interrogatory response,
23 it should have been filed prior to his live appearance here
24 today.

25 We have had no opportunity to examine the material

1 he waved in front of the Commission. We have no opportunity
2 to find out who it is that allegedly delivers this piece at
3 the price he said. This is clearly additional direct
4 testimony and very untimely.

5 You know, we do permit friendly cross examination
6 in the form of written cross, but this is really taking it
7 to an extreme.

8 MR. McLAUGHLIN: Mr. Chairman, if you look at the
9 witness's response, he does describe 'a 12-ounce Shopper
10 example, and he indicates a price in the mail at the current
11 pound rate and a price in the mail of the proposed pound
12 rate, and he compares that to a price in private delivery.

13 In his paragraph they are talking about a private
14 delivery company called Delivery Services of America. This
15 is just a specific example.

16 CHAIRMAN GLEIMAN: I understand, Mr. McLaughlin,
17 what transpired in the information that was, the additional
18 information that was provided.

19 The problem is, and perhaps I should have been
20 stricter in my application of the rules on the initial
21 request for the designation by NAA, in stopping Mr. Buckel
22 from doing other than making corrections to his previous
23 written response, and I was derelict in my responsibilities
24 I think then, but did not see any specific harm and there
25 was no objection at that point.

1 There is an objection standing now, and I think it
2 is a proper objection.

3 The information is in the record because it's been
4 spoken out here. I am loathe to strike anything from the
5 record but I think that Mr. Straus made his point and the
6 Commission will, when it reviews the transcript of this
7 hearing, Mr. Buckel's testimony, give proper weight to a
8 statement that was made that embellished, did not correct
9 but embellished quite a bit on a previously provided
10 interrogatory response, so I am not going to ask that it be
11 stricken but we'll take appropriate notice of it.

12 If counsel wishes to provide two copies of the
13 designated written cross-examination which was the subject
14 matter of his original request of the witness to the Court
15 Reporter, I will direct that that material be transcribed
16 into the record and received in evidence.

17 I was sitting up here, quite frankly, thinking as
18 Mr. Buckel was speaking of saying something that is too cute
19 by half, like I think your counsel just waived his right to
20 redirect, but obviously that is, as I said, too cute by
21 half, so I wouldn't say that, other than in jest.

22 [Designation of Written Cross
23 Examination of Harry J. Buckel,
24 AAPS/SMC-T1-1 and Witness Buckel's
25 response were received into

evidence and transcribed into the
record.]

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RESPONSE OF SMC WITNESS BUCKEL TO AAPS INTERROGATORIES

AAPS/SMC-T1-1. You state at page 10, lines 18-20, that preprint advertisers have switched from mail to private carrier or to a combination of mail and private carrier, and at page 11, lines 1 and 2, you blame "rising costs for saturation mail" and an allegedly excessive pound rate.

- a. Please identify the advertisers to which you are referring and state when they made the switch that you suggest. (If the list contains more than twenty names, you may provide only the largest twenty.)
- b. For each advertiser identified in part (a), identify the private carrier to which the switch was made.
- c. Is it your contention that the costs of saturation mail have risen in the past three years?
- d. When is the last time that the postage for a saturation ECR mail piece weighing 6 ounces was increased, and what was the percentage increase?
- e. When is the last time that the saturation ECR pound rate was increased, and what was the percentage increase?

a-b. I do not have a list of advertisers or dates, but in the New York market every major preprint circular is now carried in private delivery or newspapers. The major private delivery operation in that area is Delivery Services of America. Their program is so filled with preprints, particularly heavier preprints weighing one to three ounces, that their packages frequently exceed 16 ounces in total weight. Shared mail is not competitive in this market, and mailed shoppers are basically confined to carrying very light weight preprints and single-sheet inserts. The cost disadvantage is significant. For a 12-ounce shopper including inserts, postage is \$406 per thousand (\$366 at the proposed rates), compared to a private delivery cost of around \$125 per thousand. This loss to private delivery has occurred over the last five or so years, and is due to the fact that the high pound rate makes saturation mail non-competitive except for light-weight pieces. Although we made efforts to entice several major retailers back into the mail, we were told that our rates were not close to those offered in private delivery.

In the Philadelphia market, preprints have been shifted out of the mail and into Advo's private delivery operations. Although most of this occurred several years ago,

- 2 -

Advo has within just the last six months started a substantial new private delivery operation in northern New Jersey, converting mailed preprints to private delivery. Advo has also converted preprints from mail to private delivery in the Cincinnati market in 1997. It is my understanding that these private delivery operations, which encompass about 2 million homes weekly, were undertaken primarily because of the high pound rate.

I would emphasize that the moderate reduction in the pound rate proposed by the Postal Service will not cause a major shift in the marketplace. Saturation mail would still be non-competitive for mid-size and heavier preprints. However, the lower pound rate would help at the margin to retain and compete for lighter weight preprints and also to encourage saturation mailers to stay in the mail.

c. Total costs have gone up. Although postage rates have not risen, I do not consider that to be a "stable" situation because the high pound rate is still as much out of sync with the marketplace as it was before, and will only encourage further shifts to non-postal delivery. I am not a cost expert but I believe the pound rate is also out of sync with costs. The rate for a 7-ounce saturation mailing is effectively double that for a 3.5-ounce mailing. In private delivery, the weight/cost relationship is only a fraction of that, and I cannot imagine that postal costs would be that much different.

d. 14.7 percent in 1995.

e. 14.5 percent in 1995.

DRAFT

Dear Chairman Dyhrkopp:

This is to review generally the Postal Service's position on the contingency element of the revenue requirement. This issue is currently being addressed specifically in the pending omnibus rate case within the context of the Postal Service's request for recommendations on postal rates and fees. The Postal Rate Commission will consider the evidence compiled on the record of the case in connection with its Recommended Decision. In the meantime, there has been considerable discussion about the contingency in various trade press publications. The following is not intended to comment on the evidence in the case or to supplement it, but to outline the Postal Service's traditional position on what constitutes an appropriate contingency.

It is worth noting at the outset that the Postal Reorganization Act *requires* that the expenses encompassed by the revenue requirement in a rate case include "a reasonable provision for contingencies." Since 1971, the Postal Service's understanding of this requirement has been that Congress intended that a contingency be included as a cushion against unknown and unforeseen events that might jeopardize the Postal Service's financial situation in the future. This need arises in part out of Congress's mandate under the Act that the Postal Service break even over time. For-profit enterprises can use profits or retained earnings to absorb adverse financial events. Similarly, in other regulatory systems, the same function can be fulfilled by an amount for return on investment, which is typically allowed to be incorporated in the regulated firm's revenue requirement. Without a contingency amount built into postal rates, the Postal Service would not have a comparable mechanism to help ensure financial and rate stability.

Over the years, with one notable exception mentioned below, the Postal Rate Commission has not disagreed with this basic interpretation. In fact, for the most part, the Commission has usually recommended the contingency proposed by the Postal Service, in the form of a percentage of estimated expenses. There has been some disagreement, however, on what it takes to demonstrate that a contingency amount is "reasonable." Mailers very frequently have tended to second-guess the Board of Governors' judgment on what size contingency is justifiable. In this respect, the dispute in the current rate case is not at all unusual. In fact, disagreement over the size of the contingency has been perhaps the most common issue raised in connection with the revenue requirement in rate cases.

Furthermore, in evaluating the contingency, the Postal Service and the Commission have tended to have different perspectives, influenced in large part by the different functions performed by the Commission and the Board in the statutory scheme. Because it functions primarily as a fact-finder in conducting its

hearings, the Commission tends to look on reasonableness of the contingency as a function of objective fact. In other words, the Commission and many parties have often expressed the view that the need for a particular contingency should be demonstrated by pointing to specific recent historical experience or *predictable* future events that can establish whether the contingency is justified. By contrast, the Board of Governors has been entrusted by Congress with determining financial policy for the Postal Service. From this perspective, the contingency is a policy call, rather than an objective fact. As a means to deal with future uncertainty, the contingency represents the level of risk that the Governors determine, as a matter of policy, the Postal Service should assume in establishing a revenue requirement. Since the purpose of the contingency is to prepare for unknown and unknowable events, the recent past or probable future events, while relevant, are not explicit guides to determining the contingency. Nor is the overall level of *increases* in expenses predicted for the test year. While the contingency will be available in the event those predictions do not turn out to be accurate, the unknown, unpredictable need for additional revenue is not necessarily a function of the size of the increases that can reasonably be forecast.

This fundamental difference in outlook lies at the center of the current dispute over the contingency. Several parties argue that, because the Postal Service proposed relatively low contingencies in the two most recent rate cases, and the Postal Service has been financially healthy during the past several years, a low contingency is all that is justified. Conversely, the Postal Service maintains that the low contingencies in the recent cases represent specific policy trade-offs in the special circumstances of those cases. In any event, the purpose of the contingency is to safeguard the Postal Service's financial health against the unknown. Adopting a low contingency would be no more prudent than a driver deciding not to carry automobile insurance because he has a good driving record.

The legislative history of the Postal Reorganization Act suggests that Congress had in mind a range of three to five percent as a zone of reasonableness for a contingency. Historically, contingencies in this range have been proposed by the Postal Service and recommended by the Commission in the majority of rate cases. In only one instance in the past has the Commission decided to challenge the Board's policy judgment by eliminating the contingency altogether. The Commission did this in order to force upon the Postal Service the Commission's own financial policy views as to when rate changes should be made. That decision was challenged by the Postal Service in court, and the court of appeals in effect overturned the Commission. In reaching this result, the court affirmed the policy role of the Governors in determining the appropriate level of contingency.

In the current rate case, the Postal Service has presented evidence justifying the Board's election of a contingency equal to 2.5 percent of total

estimated expenses in the test year. This determination represents the Board's judgment that, in current circumstances, for an organization with overall expenses exceeding \$60 billion, 2.5 percent is not an unreasonable cushion to protect against the unknown in the test year and beyond. Many historical examples could be given of possible future events that could create a combined need for as much or more revenue. Whether that need can be supported by the recent past, by specific probable events, or even by any particular level of estimated expense increases in the test year are not dispositive in evaluating the Board's judgment as to the appropriate level of protection needed by the Postal Service, as a matter of sound financial policy. In any event, because of the requirement and the Governors' commitment that the Postal Service break even over time, even if the contingency turns out not to be needed in the test year to break even, the mailers will benefit from the revenues, since they will be available to meet future expenses of any kind. Unused contingency will simply contribute to the Postal Service's ability to keep rates stable by delaying the next round of rate increases.

1 CHAIRMAN GLEIMAN: There was no request for oral
2 cross examination. I don't know whether there is now a
3 request for oral cross examination. I don't see anybody
4 jumping up. I didn't see anybody jump up to tell me they
5 had additional designated written cross either. I don't
6 know whether there are questions from the bench now. I
7 didn't think there were before.

8 There are still no questions from the bench. You
9 are safe, and that being the case, you don't have to waive
10 redirect.

11 There is no redirect, so Mr. Buckel, we want to
12 thank you.

13 That completes your testimony here today. We
14 appreciate your appearance and your contributions to the
15 record, and you are excused.

16 [Witness excused.]

17 THE WITNESS: Thank you.

18 CHAIRMAN GLEIMAN: We are going to break for lunch
19 now. We will come back, to make it easy, on the hour at
20 2:00 and pick up there. Thank you.

21 [Whereupon, at 12:54 p.m., the hearing was
22 recessed, to reconvene at 2:00 p.m., this same day.]

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1 A F T E R N O O N S E S S I O N

2 [2:00 p.m.]

3 CHAIRMAN GLEIMAN: Mr. Straus, I believe you have
4 the next witness.

5 MR. STRAUS: Yes. The Association of Alternate
6 Postal Systems calls John White to the stand.
7 Whereupon,

8 JOHN WHITE,
9 a witness, having been called for examination and, having
10 been first duly sworn, was examined and testified as
11 follows:

12 DIRECT EXAMINATION

13 BY MR. STRAUS:

14 Q Mr. White, I am about to hand you two copies of a
15 document entitled "Direct Testimony of John White on Behalf
16 of Association of Alternate Postal Systems," also marked
17 AAPS-T-1, and ask you if this testimony was prepared by you
18 or under your supervision?

19 A Yes, it was.

20 MR. STRAUS: Mr. Chairman, I would ask that the
21 testimony be copied into the record and admitted into
22 evidence.

23 CHAIRMAN GLEIMAN: Is there any objection?

24 [No response.]

25 CHAIRMAN GLEIMAN: Hearing none, I will direct

1 counsel to provide the reporter with two copies of the
2 testimony of Witness John White. That testimony will be
3 transcribed into the record and received into evidence.

4 [Direct Testimony of John White,
5 AAPS-T-1, was received into
6 evidence and transcribed into the
7 record.]

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AAPS-T-1

BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, D.C. 20268-0001

POSTAL RATE AND FEE CHANGES, 2000

Docket No. R2000-1

DIRECT TESTIMONY
OF
JOHN WHITE
ON BEHALF OF
ASSOCIATION OF ALTERNATE POSTAL SYSTEMS

AAPS-T-1

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2
3 **DIRECT TESTIMONY OF**
4 **JOHN WHITE**
5 **ON BEHALF OF**
6 **ASSOCIATION OF ALTERNATE POSTAL SYSTEMS**
7
8

9 **I. Introduction**

10 My name is John White, and I am General Manager of Distribution Systems of
11 Oklahoma. Since January 1, 1999, I have served as the Executive Director of the
12 Association of Alternate Postal Systems. I have been a member of AAPS since 1991
13 and served on the Board of Directors for three years, with one year as President.

14 I recognize that replacing Ken Bradstreet (who is now an elected member of the
15 Michigan State Legislature) as the representative of our association before this
16 Commission is a Herculean task. I closely followed Ken's participation in prior cases
17 and have studied his testimony. Because much of that testimony addresses the history
18 of the relationship between the alternate delivery industry and the Postal Service and
19 the anticompetitive bent of the Postal Service, it is as valid and important today and in
20 this proceeding as it was in prior proceedings. Because my attorney tells me that every
21 case has to be decided on the basis of the record in that case, I will go over a little bit of
22 that ground again.

23 I believe that I am qualified to do so, based upon my experience in the industry.
24 My company, Distribution Systems of Oklahoma (DSO), provides a delivery alternative

1 to the Postal Service for businesses in central Oklahoma, principally the Oklahoma City
2 metro area.

3 Weekly deliveries to approximately 282,000 houses typically consist of
4 commercial publications delivered by individual carrier route. Mostly, these publications
5 would qualify as Standard mail saturation advertising pieces, or are phone books,
6 packaged product samples, address specific newspapers, and doorhangers (coupon
7 cards that are specifically hole punched to fit door handles).

8 We produce detailed route information along with an accurate, flexible, and
9 audited delivery service to our clients. Because of this, we can usually provide effective
10 competition for the Postal Service for heavier weight shared mail packages, in
11 particular.

12 I have long been an advocate of preserving free enterprise and fair competition,
13 having had a father that owned his own feed store and a grandfather who owned a
14 battery store. Business and consumers (to both of which I belong) ultimately benefit
15 from wider selection and better quality, not to mention lower prices.

16 I volunteered to serve on the Postal Committee of AAPS in 1996, after my
17 business was dealt a severe blow following the postal reclassification case in 1995-96.
18 The reduction in rates for densely distributed periodicals destroyed our profitable
19 magazine delivery business, and the reduction in price for lightweight ECR pieces
20 eliminated much of that portion of our business. And now, with the request for a lower
21 pound rate, resulting in a rate reduction for most of the remaining, heavier weight

1 material for which we compete, the Post Office and shared mail partners are poised to
2 do even greater harm than what our industry and my business endured from the loss of
3 lighter pieces of periodical and related advertising business following the reclassification
4 case.

5 But it wasn't just magazines and catalogs that our industry lost in 1996. It was
6 far more than that. It was our credibility. The one fragile thing that keeps banks, auto
7 dealers, politicians and alternate delivery in business, any business, new or old, for that
8 matter is credibility.

9 And who would know that better than a veteran businessman like then
10 Postmaster General (a.k.a. CEO) Marvin Runyon.

11 "Kill the body and the head will die," was legendary boxer Smoking Joe Frazier's
12 account of how relentless punches to the abdomen of Muhammad Ali would take their
13 toll. Well, Mr. Runyon must have been in Smokin' Joe's corner, because with
14 magazines embodying the bulk of deliveries for new alternate delivery companies
15 springing to life, the Postal Service proposal under Mr. Runyon in the MC95-1 punched
16 relentlessly where it hurt the most when it proposed very large reductions in postage for
17 the mass circulation magazines that were most susceptible to diversion to alternate
18 delivery. Although the Rate Commission rejected the Postal Service's reclassification
19 proposal for periodicals, it gave the Postal Service half a loaf by reducing the postage
20 rates for the most densely delivered magazines. That half loaf was enough to threaten
21 many of our businesses.

1 Prior to that decision, at DSO we delivered more than 175,000 magazines each
2 month into 17 central Oklahoma communities. Annual revenue from the magazines
3 alone was more than \$400,000 and projected to grow. The fact that we delivered
4 magazines with household names such as *Better Homes and Gardens*, *Parenting*,
5 *Mirabella*, *Redbook*, *Field & Stream*, to name a few, was priceless in terms of the
6 credibility of our company and the service we performed.

7 When our magazine revenue and our lighter weight piece revenue went away, so
8 did five sales jobs, two secretary positions, over 20 warehouse jobs, and a lot of extra
9 money that my carriers depended on from the delivery of those magazines and inserts.
10 I have over \$40,000 in mobile magazine storage racks sitting idly, and thousands of
11 dollars in promotion geared to magazine insert delivery in our market was wiped out
12 instantly.

13 I was also forced to explain to scores of clients for months to come that it wasn't
14 anything we had done to cause us to lose the magazines back to the mail, but that, in
15 fact, we were powerless to stop it. It was very nearly a lethal blow to our business and
16 others like us, and especially to our *credibility*. To many, it was the end.

17 Now, here we are. It's 2000, and once again our business is beginning to grow
18 at the heavier weight levels due to our hard work and our ability to be competitive for
19 this material. Standard mailers, package goods manufacturers, yellow pages
20 publishers, couponers and the like have in many cases managed to find alternate
21 delivery as an answer to some of their delivery needs, although ours remains an

1 industry with low profitability. Volumes are growing modestly, and credibility has
2 returned.

3 All to the chagrin of the Post Office and shared mail. The question is, can we
4 survive another round of body punches?

5 There's clearly no doubt the Postal Service has a great deal of work ahead of it
6 as it continues to retool, reposition and reinvent itself to be more competitive with
7 private enterprise and keep abreast of technology. Hey, I feel for them; we've been
8 doing that after every rate case. Sometimes I wonder when it's our turn to file one!

9 But, as reported, I've seen first hand and continue to wear the scars of how
10 private enterprise fared in the predicament the Postal Service found itself back in 1996.

11 As for shared mail packages, in our market, the Postal Service competes
12 vigorously with alternate delivery for business. Their claimed advantages are lower
13 prices, better delivery timing and placement in the mail receptacle. All pretty darn good
14 ones.

15 Lowering the pound rate would further damage alternate delivery's ability to
16 compete, not only against lack of access to the mailbox but with prices that could allow
17 shared mail packages to arbitrarily price below our costs, forcing alternate delivery
18 companies out of business. As a general proposition, our industry is forced to use
19 Postal Service prices as a guide to setting ours, so a rate reduction would certainly
20 create significant problems for alternate delivery companies.

1 **II. Purpose of Testimony**

2 My testimony, like testimony submitted by AAPS in prior cases, will not be
3 technical, because I am not an expert in postal costing. I don't know the details of the
4 in-office costing system, and I don't know a MODS pool from a swimming pool. But I do
5 know about how the Postal Service, in addition to its prior history with respect to
6 periodicals, seems to keep finding ways to justify a reduction in the saturation pound
7 rate against which we compete while raising rates for captive mailers, including those
8 small businesses who wish to target their mailed advertisements. And I know that the
9 Postal Reorganization Act requires that when rates are set, both the Postal Service and
10 the Postal Rate Commission are required to consider the impact of rate changes on
11 competitors as well as on mailers. In past cases, it has been shown that the Rate
12 Commission has taken this requirement seriously, while the Postal Service has paid it
13 lip service at best. I will show that in keeping with its sorry tradition, the Postal Service
14 has once again considered its competitors for saturation advertising only as prey, not
15 as worthy of any real consideration as to impact.

16 To the extent I am able as a layperson (when it comes to the complex
17 development of postal rates), I will also suggest that the Postal Service proposal to
18 reduce the pound rate is unsound, at least insofar as it fails to address all of the
19 relevant factors such as the difference in cost between flats and letters, the added costs
20 of handling loose pieces put together in a set, and the true effect of weight on costs.

III. The Association of Alternate Postal Systems

1
2 The Association of Alternate Postal Systems is a trade association of
3 approximately 110 private, door-to-door delivery companies located in 33 states. Many
4 of these member companies are solely private postal systems; that is, they are
5 independently owned and are not an affiliate of any particular publication. A number of
6 member companies are owned and operated by publishers of shopping guides or
7 "penny-savers." Others are owned by newspapers.

8 Because of the Postal Service's strained definition of "letter," which prevents us
9 from delivering selectively addressed advertisements, by far the majority of items
10 delivered by AAPS members would qualify as saturation or near saturation Standard A
11 flats. Therefore, AAPS members, all of whom compete with the USPS for the delivery
12 of Standard ECR saturation or high density advertising, are vitally concerned with any
13 USPS proposal like the one in this case that affects Standard A ECR rates.

14 AAPS members are mainly engaged in the delivery of weekly TMC shopping
15 guides, saturation shopping guides and accompanying preprinted inserts. In addition,
16 most AAPS members distribute community and telephone directories and product
17 samples. The USPS proposal would significantly harm these businesses, especially in
18 competing for heavier weight items and those items that are lighter weight but are sent
19 by mailers willing to combine them with other material in a heavier shared mail set.
20 Historically, some AAPS members also distributed magazines and periodicals to

1 specific addresses, although, as I pointed out in the introduction, that business has
2 virtually disappeared in the past couple of years.

3 **IV. The Postal Service's Advantages as a Governmental Monopoly**

4 My company, like all other AAPS members and most businesses in the private
5 sector, is free to set its own rates, pays taxes and fees, and can either turn a large profit
6 or, like some of our members over the years, fail and go out of business. We have no
7 monopoly, statutory or otherwise, to protect any segment of our revenues. If we make
8 bad decisions, we pay for it in lost business.

9 The Postal Service is quite different. It has tens of billions of dollars in monopoly
10 revenue, and I think it is unique in that it is allowed to establish the limits of its own
11 monopoly, something it did years ago when it decided that an addressed advertising
12 brochure, no matter how impersonal, is a "letter" subject to its monopoly. It does not
13 pay taxes and is required only to break even over time, so that unlike a private
14 business, it need not provide a return to its investors.

15 These advantages must be offset by rate regulation that to the extent possible
16 prevents abuse and protects competitors. The Postal Service's recent history shows
17 that it is more than willing to take advantage of its privileges and advantages in order to
18 invade and conquer small competitors in the private sector. Therefore, those of us who
19 feel the brunt of its efforts in all likelihood owe our continued existence, and the tens of
20 thousands of jobs for which we are responsible, to the vigilance of the Postal Rate
21 Commission. The Commission has been willing to take seriously Congress's concern

1 that a huge postal monopoly not use its size and insulation from most competition and
2 risk as a weapon against those who manage to maintain what is in comparison a tiny
3 market share.

4 The Postal Service, of course and naturally, does not like having its rates
5 regulated and would like to set prices as if it were a private business. Its thus far
6 unsuccessful efforts to convince what appears to be a skeptical Congress to pass
7 postal "reform" is an ongoing example of that posture. Likewise, its favored treatment
8 of its largest saturation mail customers, compared with its captive advertising
9 customers, and its focus on reducing advertising rates to drive out competition show
10 that, in this sense at least, the Postal Service wants to act "like a business." But it isn't
11 a business. It has no shareholders, pay no taxes, and is immune from antitrust and
12 other laws. It's not a business, it's a government agency with a public service mission
13 and a huge monopoly. Its latest effort in this case to reduce rates for its most
14 competitive advertising product should once again be rejected.

15 I understand that a lot of factors well beyond my expertise go into the
16 development of postal rates, but the proof, or at least some of it, can be found in the
17 pudding even if you don't know all of the details of the recipe. Over time, where there is
18 no competition, USPS proposed rate increases have been larger than where there is
19 competition. The key competitive rate when it comes to saturation advertising and our
20 membership is the pound rate, because the shopping guides and the free publications
21 that make up the backbone of the business for most of our members make their
22 delivery choices with reliance almost exclusively on the pound rate, not the piece rate.

1 This is because the typical publication weighs between 3 and 6 ounces.
2 However, publishers, like shared mail companies, sell the delivery of preprinted inserts
3 to advertisers. With one or more regular inserts, the combined weight of the publication
4 and its inserts is in the 4 to 10 ounce range, and often higher. The cost of the
5 incremental weight is a major consideration on the part of publishers whether to use the
6 Postal Service, to use an alternate delivery provider, or perhaps even whether to start a
7 delivery system of their own. The cost of weight determines, to a large extent, the cost
8 of handling preprinted inserts.

9 The Postal Service is certainly aware of this key rate, as it showed most recently
10 in its proposals in MC95-1, R97-1 and again here. The lowest proposed pound rate for
11 ECR saturation mail of 45 cents (for DDU entry) is only 25% higher than the 36 cent
12 rate paid by saturation advertisers in 1978 through 1980, which shows just how
13 protected this rate has been. I understand that requirements imposed on mailers also
14 changed over time, but the fact remains that we must compete with the Postal Service's
15 lowest rate.

16 As I've already stated, the history of such favored treatment would have been
17 much worse if the Rate Commission were the rubber stamp that the Postal Service no
18 doubt wishes it were. In R90-1, the USPS proposed to reduce the lowest saturation
19 rate from \$0.101 to \$0.091 per piece, a 10% reduction. The Commission
20 recommended instead that the low rate be \$0.105 for saturation flats, an increase of
21 only 4%, but an increase. In the 1995 reclassification case, the USPS proposed a
22 pound rate for saturation advertising of as little as 39.9 cents per pound. The

1 Commission recommended instead a rate of 55.2 cents and above. In R97-1, the
2 Postal Service requested a decrease in the ECR base pound rate from 66.3 cents to
3 53 cents, but the Commission recommended that it stay where it was. Here, the Postal
4 Service is trying the "half a loaf" approach that worked so well for periodicals, seeking a
5 reduction from 66.3 cents to 58.4 cents in the basic ECR pound rate and reductions of
6 8.3 cents, 8.7 cents and 8.7 cents for BMC, SCF and DDU entry (along with an
7 increase in the piece rate). We believe that the PRC should once again refuse to lower
8 the rate.

9 The result of the proposed changes for saturation advertising mail would be an
10 overall *reduction* in the effective rate starting at five ounces. The rate for a six ounce
11 piece will decrease by 3.56% with SCF entry and by 3.73% with delivery unit entry. The
12 percentage rate change grows steadily with weight, rising to negative 7.49% (SCF) and
13 negative 7.85% (delivery unit) at nine ounces, and to negative 9.47% (SCF) and
14 negative 9.92% (delivery unit) at twelve ounces. At the heaviest weights, there would
15 be double-digit percentage decreases.

16 In our highly competitive world, I wonder how we can survive if our competition is
17 permitted to reduce rates by these amounts starting a year from now and continuing at
18 least a couple of years beyond that, especially if the recent rise in gasoline prices,
19 which along with other cost increases significantly affects our business, leads to an
20 increase in the overall rate of inflation and drives up our costs still further over that
21 three-year period. Even if gasoline prices return to last year's levels, we can expect

1 some cost inflation in the next few years. But we will see no increase in the postal rates
2 against which we compete.

3 **V. The Postal Service as a Competitor**

4 The Postal Service's approach to rates for saturation advertising speaks for itself
5 in establishing that the Postal Service is focused on, if not obsessed with, increasing its
6 business with little concern for the consequences. It finally realizes, however, that it
7 should try to shove its intentions under the rug. In Docket R97-1 it made the "mistake"
8 of admitting in witness Moeller's testimony in that case (T-36 at 26) that the proposal to
9 reduce the pound rate was based in part upon the fact that ECR mail "is in a
10 competitive market and is susceptible to diversion to alternate media." In his latest
11 testimony, Mr. Moeller makes no such reference, and in response to an NAA
12 interrogatory (Tr. 3881), claims that, this time, "the pound rate proposal is not based on
13 an effort to stem diversion to alternate media." I don't want to make any inappropriate
14 accusations, but given that the market is no less competitive now than it was in 1997,
15 and given that the Postal Service continues to contract with SAI to study our business, I
16 find that claim difficult to reconcile with the proposed reduction. In fact, SAI prepared
17 reports on the alternate delivery industry in 1993, 1994, 1995, 1996, 1997, and 1998.
18 Ironically, while I have been preparing this testimony in the past two months, and while
19 the Postal Service has refused to let me see or us use information on our industry in
20 prior SAI reports, I have had two phone calls from SAI seeking to interview me about
21 our business. Other members of our association have as well. Perhaps the question to
22 Mr. Moeller could have been asked differently, because it may be that the proposal is

1 not designed "to stem diversion to alternate media" but to create diversion *from*
2 alternate media.

3 Such a purpose and goal would be consistent with recent Postal Service history,
4 and it is worth retelling here a bit of that history that Mr. Bradstreet recited in his R97-1
5 testimony when he discussed a speech made by Postmaster General Marvin Runyon
6 shortly after the results of the MC95-1 case were in. In that case, the Postal Service
7 made it abundantly clear that among its prime targets were alternate delivery
8 companies that through the early 1990s were gaining a small foothold in the delivery of
9 subscriber magazines.

10 Time Warner had started a company named Publishers Express (PubEx) to
11 organize the private delivery of subscription magazines. My company, DSO, was a
12 licensee of Publishers Express, as were a number of other AAPS members. Another
13 company, Alternate Postal Delivery (APD) of Grand Rapids, Michigan, had already
14 demonstrated the feasibility of delivering subscription magazines, and had developed
15 delivery capability in a number of major markets. With the addition of Publishers
16 Express, by 1994 more than 80 markets were being served by either APD or PubEx
17 affiliates, most of which were members of AAPS. The fact that the volumes delivered
18 outside the mail were extremely small by Postal Service standards did not stop the
19 Postal Service's search and destroy mission.

20 Thus, the USPS proposal in MC95-1 would have split regular rate periodicals
21 into two subclasses, producing rate reductions for favored large magazine publishers

1 (those whose density made them prospects for APD and PubEx and thus for us) at the
2 expense of large rate increases for small magazines that did not produce the density to
3 make alternate delivery viable for them. Although the Rate Commission rejected this
4 aspect of reclassification, it did order rate decreases for the mass circulation
5 periodicals, leading to the practical abandonment of alternate delivery by magazine
6 publishers. As a result, Publishers Express announced in mid-February, 1996, that it
7 would cease operations, the result of which killed a significant portion of alternate
8 delivery.

9 Just days later, on February 20, Postmaster General Marvin Runyon, in a
10 speech to the NAPUS Leadership Conference in Washington, DC addressed the
11 demise of Publishers Express with what Mr. Bradstreet aptly described as
12 "unmistakable glee":

13 I would like to close with a story that tells it all. Remember the
14 alternate delivery company called Publishers Express? They came
15 on the scene a few years back with a lot of fanfare and tough talk.
16 They said they were going to deliver magazines and advertisements
17 faster and cheaper than us. Eleven days ago, they quietly went out
18 of business. They said that they were no longer needed. They had
19 no more customers. We ran them out of business, by improving
20 service and keeping costs low!

21

1 After the demise of Publishers Express we became a licensee of APD, looking to
2 salvage what magazine revenue and credibility we could. In March, 1997, we were
3 informed by APD that it was forced to shut down that portion of its business; a sad day
4 for the company that had pioneered the concept of magazine delivery by private carrier.

5 The former Postmaster General voiced no concern for those whose jobs he "ran
6 out," or about the investment by small companies in magazine delivery that the Postal
7 Service wiped out. While we have no knowledge of equivalent statements by current
8 postal management, we do have tangible evidence of its continuing intent: the
9 proposed rate reductions for much of the very product for which our members compete.

10 We also have a very mixed and therefore suspicious message from the Postal
11 Service about the extent to which it focused on its competitive position in proposing the
12 ECR rates here, clearly a relevant consideration given the language of statutory
13 Criterion 4 *requiring* consideration of the impact of rate changes on competitors. On
14 the one hand, as I've already noted, witness Moeller conveniently omitted his prior
15 reference to competition as a justification for reducing the pound rate and now claims
16 incongruously that it was not a consideration. I say "incongruously" not only because
17 the competitive situation has not changed, but also because the Postal Service
18 continues to pay an outside contractor to study the alternate delivery business, even if
19 its witnesses (but perhaps not those giving the orders) studiously avoid looking at any
20 of these studies.

1 Indeed, Postal management and Postal Service witnesses appear to be playing
2 "hide and seek" with its studies of alternate delivery. I would have thought that, after
3 the past two cases, the Postal Service would have proven that it really does consider
4 Criterion 4 by *insisting* that its rate setters and witnesses actually take a look at the
5 studies it pays for year after year. However, in response to an AAPS interrogatory
6 (Tr. 4196), witness Mayes answers a simple "no" when asked if she had reviewed the
7 initial SAI study, a question that should have been anticipated, since she claims to be
8 testifying about the effect of the proposed rates on competitors. In her answer to a later
9 interrogatory (Tr. 4197), the witness responded to a question about the impact of rates
10 on competitors, but professed a less than complete ability to do so because "other
11 providers of delivery services are not required to reveal cost structures, rates, pricing
12 and other practices." Perhaps she should have looked at the SAI studies. Although we
13 are not permitted to reveal much about the latest study (and I have neither seen them
14 nor been advised of their contents beyond what is in this testimony), we have been
15 permitted to state that it contained a redacted section entitled "Threat to USPS" and a
16 redacted market forecast for 1999-2005. Most of the current market analysis was also
17 redacted. It seems, therefore, that the Postal Service does collect information of the
18 type Ms. Mayes deems relevant, but she chooses not even to look at it because she
19 can't be convinced of its accuracy and because, she says (Tr. 4206), the report (that
20 she still hasn't read) is "anecdotal." But I wonder why the Postal Service continues to
21 study our industry if such studies are irrelevant, anecdotal and not relevant to the Postal
22 Service's own pricing.

1 Witness Moeller remained similarly isolated from the very information that should
2 have been crucial to his testimony, if in fact he really sought to examine the impact of
3 rates on competitors. He recalls (Tr. 3834) controversy surrounding the earlier SAI
4 study in MC95-1, but he has not since seen it or any updates. He was asked in AAPS
5 interrogatory T35-9 if there had been any updates, and the Postal Service objected.

6 The objection itself revealed that, in fact, the study had been updated in 1998
7 and that there was a 1999 "assessment" by SAI of an unidentified, multi-market
8 alternate delivery company. In response to follow-up interrogatories, Mr. Moeller stated
9 (Tr. 3836) that he was not even aware of the 1998 revised SAI study and (Tr. 3838) that
10 he was not aware of, had not read prior to his testimony and still had not read the 1999
11 "assessment." He also admitted (Tr. 4019) that he considered nothing beyond his
12 virtually silent written testimony concerning the impact on alternate delivery companies,
13 that he made no inquiry and did no research on our industry (Tr. 4020) and that he did
14 no analysis of the impact of MC95-1 on our industry. Yet this is a witness to whom is
15 entrusted the Postal Service's legal obligation to consider the impact of rates on
16 competitors! I simply cannot understand why, even if I believe that, the Postal Service
17 would commission these clearly relevant studies, and then its witnesses on the subject
18 would not only fail to read them, but they don't even know about them and make no
19 effort to obtain any relevant information.

20 The latest "SAI studies" and the curious avoidance of such studies by Postal
21 Service witnesses must be set in the historical context of the extent to which the Postal
22 Service has claimed that it did, or did not, consider competition from companies such as

1 the members of AAPS and Criterion 4. For example, in Docket R94-1, USPS witnesses
2 admitted that they made no effort to study the alternate delivery industry (Tr. 1251,
3 Docket R84-1) and that they did not even discuss private delivery among themselves in
4 preparing the rate proposal (Tr. 2004-05, Docket R84-1).

5 Docket R87-1 was much the same. In his initial testimony, USPS witness Lyons
6 suggested that the proposal considered "the continued competitiveness of newspapers
7 and private delivery firms." When questioned about that consideration, Lyons referred
8 to an article he had read in *Advertising Age* which did mention newspapers but did not
9 mention private delivery (see Tr. 3844, Docket R87-1).

10 In R90-1, witness Lyons proposed a rather novel interpretation of Criterion 4. It
11 was apparently his testimony that Criterion 4 was automatically satisfied as long as
12 Criterion 3 was satisfied. The new doctrine was that as long as rates covered their
13 direct cost (direct testimony at 39 and 41), and as long as rates are not specifically
14 designed to hurt competitors (Tr. 4293-94), then that amounted to due consideration of
15 competitors and satisfied Criterion 4. That testimony was similar to the testimony of
16 witness Donald J. O'Hara's in Docket R97-1, who concluded: "Given the very high cost
17 coverage of the ECR sub-class, this rate increase [*decrease?*] does not result in unfair
18 competition for its competitors." Testimony, page 35. I note that the same theme is
19 repeated here by witness Mayes, who stresses (at page 8 of T-32) that the rates were
20 not designed "with the specific goal of harming a competitor or group of competitors," as
21 if that's all that matters. The fact is that the pound rate at the levels relevant to us
22 hasn't risen in years and, under this proposal, would go down.

1 In Docket MC95-1 the Postal Service changed direction, proposing rates under
2 new classification headings that it freely admitted were developed for competitive
3 reasons. Its “consideration” of competitors was apparently a consideration of how to
4 put them out of business. It was to some extent successful, as the Mr. Runyon’s
5 speech concerning Publishers Express cited above demonstrates.

6 In R97-1, the Postal Service may have been confused about its motives. Its
7 witness Moeller, as stated above, referred to competition as one of the reasons for
8 proposing a reduction in the pound rate, yet in an objection to an interrogatory in that
9 case (AAPS/USPS-6) asking about any updates to the SAI study of alternate delivery,
10 the Postal Service stated: “Nowhere in the Postal Service’s testimony is there a claim
11 that the existence of a ‘competitive threat’ from alternative delivery forms the basis for
12 any of the rate and classification proposals in this docket.”

13 That claim of no competitive consideration appears to be repeated here, yet it is
14 not credible. Just as the USPS fought hard in Docket R97-1 to avoid releasing the
15 complete new SAI study done after the study revealed in Docket MC95-1, it has
16 revealed in discovery responses (but not in the testimony of its witnesses) that it has
17 once again contracted for yet two more SAI studies. As in Docket R97-1, the studies
18 were apparently so controversial – and perhaps inconsistent with the testimony of its
19 witnesses – that the Postal Service didn’t even let the witnesses that testified about
20 impact on competition and competitors see them or learn of their existence! In that
21 docket, witness O’Hara was asked to “describe what efforts the Postal Service made to
22 determine whether the rate decreases proposed will have an adverse impact on

1 competitors or on competition." He responded, "...a quantitative assessment of the
2 effects on competitors would require information on competitors' costs, prices, and
3 volumes, and as far as I am aware this information is not available... ." Tr. 116.
4 Unbeknownst to Mr. O'Hara, this type of information was indeed available. The powers
5 that be just decided not to tell him.

6 Similarly in Docket R97-1, witness Moeller, who was charged with the rate
7 design for the highly competitive ECR rates, was obviously not aware of the SAI study
8 either. He acknowledged that he had not reviewed competitors' rates for two and a half
9 years. He thought he might have logged onto some web sites for information, but
10 couldn't remember seeing any rate information. He had acknowledged studying
11 competitive rates, however, in preparation for MC95-1. And now witness Mayes claims
12 that comparative information is not available from competitors, but she hasn't bothered
13 to look at the Postal Service's own studies. Do we see a pattern here?

14 With this history, the Commission should not believe that competition, which was
15 a serious USPS consideration in MC95-1 and may have been considered in R97-1 is no
16 longer a consideration for the reduced pound rate in this case. The Postal Service
17 cannot be permitted to blind itself, or at least its witnesses, to the facts when it
18 proposes large rate reductions for its most competitive advertising mail. It continues to
19 this day to retain SAI to study our industry and apparently obtains strategic advice. The
20 1999 SAI "assessment" contains a redacted page entitled "Opportunities for USPS." Is
21 one of those "opportunities" a pound rate reduction? Why?

1 With this history, and with the little we have been permitted to learn about the
2 details of the latest and past SAI studies, it is easy to conclude that despite the
3 professed ignorance of its key witnesses, the Postal Service knows exactly what it is
4 doing, and to whom.

5 **VI. Flaws in the Postal Service Case**

6 Although I will again admit that I am not an expert in postal ratemaking, I believe
7 that I do know enough about the process and about how costs are incurred in delivering
8 material to homes to provide useful comments on the proposal for ECR rates here. The
9 first matter about which I wish to comment is one that AAPS has been raising for many
10 years—the Postal Service's over-reliance on the concept of "cost coverage" to justify
11 various rate relationships and, especially, the relationship between First-Class and
12 Standard A rates without adequate (or in this case any) consideration of the unit
13 contribution. USPS witness Mayes concedes (Tr. 4210 and Tr. 4493) that unit
14 contribution was considered only with respect to the overall breakeven obligation, not
15 as a way to compare classes' and subclasses' relative contribution to institutional costs.
16 This is wrong.

17 AAPS has been critical of the Postal Service's over-reliance on percentage cost
18 coverage since it began participating in these rate cases. For example, as we stated at
19 page 33 of our initial brief in R90-1, the saturation mailers will argue that the rates for
20 saturation mail "are too high because the 'attributable cost coverage' is higher for that
21 particular type of mail than for other particular types of mail." I expect that again.

1 It was AAPS's position then, and it is AAPS's position now, that the USPS's
2 embrace of percentage cost coverage (whether attributable, incremental or volume
3 variable) has "elevated a convenient but misleading tool of comparison into the
4 exclusive rate making tool." In fact, in the words used by AAPS witness Bradstreet
5 while testifying in R90-1 (Tr. 18490), the percentage attributable cost coverage concept
6 has "evolved into a rigged system where first-class mailers are forced to pay a hugely
7 disproportionate share of institutional costs, whereas third-class mailers pay a meager
8 share of the total."

9 In his dissent in R84-1, Commissioner Crutcher (at page 3) was critical of a
10 "strict adherence to percentage markups" which, he said, "ignores absolute unit cost
11 contribution to institutional costs." Mr. Crutcher was simply reiterating what the
12 Commission found in R80-1. There it explained (at page 455, footnote 1) that use of
13 percentage cost coverage "can misrepresent" institutional cost burdens where there are
14 substantial differences in attributable costs and that, consequently, the Commission
15 "must be guided more by the per piece cost contributions than by percentage cost
16 coverage" in comparing first-class letters and third-class bulk mail.

17 To its credit, the Commission recognized this important concept in evaluating the
18 Postal Service's proposals in recent rate cases, and, as a result, has tempered the
19 First-Class increases and rejected USPS attempts to impose either small or negative
20 rate increases on Third Class/Standard ECR saturation mailers. The Commission
21 should consider the disproportionately low burden now being borne by Standard ECR in

1 assessing the USPS's proposal to reduce even further the rate for many saturation
2 flats.

3 As AAPS has contended in previous cases, the shortcomings of the percentage
4 markup analysis become more pronounced as mailers bypass attributable costs and,
5 therefore, attempt to free themselves from institutional costs burdens as well. I repeat
6 below footnote 16 from page 36 of the AAPS initial brief in Docket No. R90-1:

7 In earlier cases, the Coalition of Non-Postal Media had
8 hypothesized a class of mail handed to the letter carrier on the way
9 out the door, in which the attributable costs are to be extremely low
10 and which would, therefore, be 'assigned' a very low percentage of
11 institutional carrier street time, contrary to all logic. The Postal
12 Service's deep discounts in this case for walk-sequenced, delivery
13 office mail show that our earlier hypothetical analogy is becoming
14 frightfully real.

15

16 Most recently, the Rate Commission's decision in R97-1, for example at
17 page 259, recognizes the need to examine unit contributions to institutional costs,
18 especially when it comes to classes like ECR, where the mail heavily uses postal
19 functions whose costs are classified as institutional. The Commission said there that in
20 future cases it will consider the adequacy of contributions from these classes,
21 presumably from the perspective of per piece as well as percentage. It should do so
22 here, even if the Postal Service refuses.

23 At the proposed rates, the unit contribution to institutional costs will continue to
24 show a much more severe burden on First Class than on Standard mail pieces. Under
25 the USPS proposal, each piece of First Class letter mail will make a contribution of

1 16 cents toward institutional costs (Tr. 4502). Standard ECR, which on average weighs
2 much more, will contribute only 8.19 cents per piece (Tr. 4391, 4627).

3 Another issue raised for years by AAPS is the Postal Service's refusal to
4 recognize fully the effect of weight on costs. This is a subject about which Mr.
5 Bradstreet testified extensively in R97-1 and that the Commission discussed in its
6 Recommended Decision at pages 392-93 and 399-403. The Commission concluded,
7 as it should once again, that the Postal Service has failed to produce a reliable
8 cost/weight study, because once again the Postal Service has failed to study and
9 measure the impact of weight on out-of-office costs. It has conducted no new studies
10 since that case (Tr. 1157).

11 For example, witness Daniel admitted (Tr. 1158) that city carrier street Route and
12 Access costs were "assumed" to vary only with pieces, not with weight. Access and
13 route costs continue to be allocated "strictly on the basis of pieces." (Tr. 1160).
14 Witness Daniel also conceded that route costs "*may vary*" (emphasis hers) depending
15 upon the weight of the piece and, while the Postal Service allocated route costs as if
16 they will not vary with weight, the allocation of elemental load costs in proportion to
17 weight "could compensate" for that error. (Tr. 1162). Two wrongs must make a right.
18 In addition, to the extent that weight is not given enough weight, then Support Costs will
19 also be affected, because they are distributed as if they vary with all other city carrier
20 costs. (Tr. 1162).

1 I run a delivery business. I know that weight has a substantial impact on the
2 amount of time it takes and the cost to make deliveries—the “out-of-office” time. It is
3 preposterous to assume that there is very little difference between the “street time”
4 costs for a carrier to deliver 500 half-ounce pieces (in FY 1999, the average city
5 delivery route had 496.3 pieces) that weigh a total of 15.6 pounds and 500 three-ounce
6 pieces that weigh a total of 93.75 pounds, or that there are not substantial cost
7 increases if there are 500 twelve-ounce pieces that weigh a total of 375 pounds versus
8 500 six-ounce pieces that weight half as much. This is especially true, of course, for a
9 carrier on a walking route that can carry only about 30-35 pounds of mail at a time. In
10 FY 1999, 47.6% of the city routes were door delivery. Yet the Postal Service would
11 price the half-ounce piece and the three-ounce piece the same.

12 In the past year, we had a TMC product that had increased on average by a half
13 ounce, from 7½ to 8 ounces. Based on delivery of the product over a 52 week period
14 and figuring the average households per carrier route, DSO carriers packed an extra 26
15 pounds *every week*. The fact that the dimensions (bulk) of the product alone precluded
16 them from putting more that 30 to 35 papers in their bags, the additional weight added
17 two additional trips back to their vehicle to restock bags. This caused an extra half to
18 one mile of walking based on how far away each carrier had to park (these are address
19 specific products, so not every household was delivered, requiring greater distances
20 between carrier and car). This translated into 50 miles of additional walking over a one
21 year period, a fact that did not escape our carriers’ notice and for which we increased
22 the delivery charge to the customer.

1 Now, I can't say what the effect of weight on costs actually is, just as I don't know
2 the precise effect of loose as opposed to bound matter (for which the Postal Service
3 charges the same price), but I know that there is a difference. On that point, witness
4 Daniel recognizes (Tr. 1157) that the degree to which mail is loose or bound "could
5 conceivably affect costs," but no study of such costs has been conducted. Of course
6 not. If it were, or if the Postal Service differentiated in its rates to reflect the differences
7 in costs between pound-rated Standard A letters and flats, the shared mail sets of the
8 nation's largest mailer might be required to pay more postage. And the Postal Service
9 has long sought to lower, rather than raise, the postage of shared mailers.

10 It does appear certain that the Postal Service has once again measured only
11 what it chooses to measure, not what it should measure, in order to justify its continuing
12 effort to reduce the price it charges for the mail for which our members and other
13 competitors compete. It hasn't attempted to measure diversion from solo piece to
14 shared mail (Tr. 3835, 4132-34), nor did witnesses Tolley and Thress make separate
15 elasticity forecasts for piece and pound-rated pieces (or separate volume forecasts) (Tr.
16 3632 and Tr. 3766). According to witness Tolley, the Postal Service didn't ask him to.

17 Despite ups and downs, small delivery companies have been successful over
18 the past decade or so in building business volumes on weekly newspapers, TMC
19 advertisements, phone books, and product samples. USPS volume and profit figures
20 demonstrate that these privately delivered materials have not negatively impacted the
21 USPS. There is more advertising mail volume than ever. Certainly a reduction of as
22 much as 11% per piece for this type of mail would have a severe impact on the private

1 delivery of these heavier pieces. I do not want our company or any of our members to
2 be the next USPS victim for which a postmaster general takes credit.

3 **VII. Conclusion**

4 Let's face it, the Post Office just cannot escape from the fact that its every
5 attempt to manipulate rates is yet another veiled effort to keep competitors from the
6 private sector at bay.

7 It would prefer to have us all think that competitors of the Post Office lie in wait
8 and pounce only on the weaknesses that it is powerless to change, unless given the
9 latitude by the Postal Rate Commission.

10 Alternate delivery's strengths are not solely predicated on USPS weaknesses,
11 but on our strengths also. Tough competition, as I said in my opening, is good for all of
12 us. Deliberately pricing postal rates in order to drive our industry into the ground is not.

13 The road back for alternate delivery since 1996 has been a particularly long and
14 winding one. We ask that we not go down it again. The pound rate should not be
15 reduced.

1 CHAIRMAN GLEIMAN: Mr. White, have you had an
2 opportunity to examine the packet of designated written
3 cross-examination that was made available to you earlier
4 today?

5 THE WITNESS: Yes, sir.

6 CHAIRMAN GLEIMAN: If those questions were asked
7 of you today, would your answers be the same as those you
8 previously provided in writing?

9 THE WITNESS: All but with two minor corrections.

10 CHAIRMAN GLEIMAN: And what are those, sir?

11 THE WITNESS: In the USPS/AAPS-T1-9, there is,
12 under the Response B, second line, there is the word
13 "their," t-h-e-i-r, and it should be t-h-e-r-e, just a
14 little grammatical change.

15 MR. STRAUS: Mr. Chairman, would you like me to
16 mark these changes on the copies that go to the reporter or
17 not?

18 CHAIRMAN GLEIMAN: I think that would probably be
19 a real good idea.

20 THE WITNESS: Yes, that one is so tough to find,
21 we didn't find it.

22 And on USPS/AAPS-T1-22, on the third line of that,
23 at the end of the line, it is the last three words, "a piece
24 plus", and then on the next line "pound rate," those five
25 words, I just want to strike those words.

1 CHAIRMAN GLEIMAN: Counsel, I am going to give you
2 a moment to make the corrections. And then if I could get
3 you to give those copies, two copies to the court reporter.

4 MR. TODD: Mr. Chairman.

5 CHAIRMAN GLEIMAN: Yes.

6 MR. TODD: This is a minor matter. David Todd on
7 behalf of MOAA. This a minor matter, but I did file a
8 correction in Interrogatory MOAA/AAPS-T1-1, and in
9 particular, part C of that, in which a random upper case B
10 appeared in the second line. Perhaps to avoid some future
11 confusion, I had refiled that taking out the upper case B.
12 And it strikes me that it might be helpful to simply strike
13 this in the copies that are transcribed into the record.

14 CHAIRMAN GLEIMAN: I appreciate that, Mr. Todd,
15 and we will attempt --

16 MR. STRAUS: I thought we took it out before we --

17 MR. TODD: You didn't take it out of the ones you
18 served on me.

19 [Discussion off the record.]

20 CHAIRMAN GLEIMAN: One more correction and then
21 those copies will be returned to the reporter, at which
22 point the reporter will have them transcribed into the
23 record and they will be as evidence.

24 [Designation of Written
25 Cross-Examination of John White,

1 AAPS-T-1, was received into
2 evidence and transcribed into the
3 record.]
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BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, DC 20268-0001

Postal Rate and Fee Changes, 2000

Docket No. R2000-1

DESIGNATION OF WRITTEN CROSS-EXAMINATION
OF ASSOCIATION OF ALTERNATE POSTAL SYSTEMS
WITNESS JOHN WHITE
(AAPS-T-1)

Party

Interrogatories

Advo, Inc.

ADVO/AAPS-T1-1-7, 9-10, 12-18

MOAA/AAPS-T1-1-3, 6-9

USPS/AAPS-T1-1-4, 6, 9

Mail Order Association of America

MOAA/AAPS-T1-1-9

USPS/AAPS-T1-1-12

Newspaper Association of America

MOAA/AAPS-T1-1, 4, 6-9

USPS/AAPS-T1-1-3, 5-12

United States Postal Service

ADVO/AAPS-T1-7, 12, 14-15

MOAA/AAPS-T1-1-3, 5-9

USPS/AAPS-T1-1-5, 7-17, 21-25

Respectfully submitted,


Cyril J. Pittack
Acting Secretary

INTERROGATORY RESPONSES OF
ASSOCIATION OF ALTERNATE POSTAL SYSTEMS
WITNESS JOHN WHITE (T-1)
DESIGNATED AS WRITTEN CROSS-EXAMINATION

<u>Interrogatory</u>	<u>Designating Parties</u>
ADVO/AAPS-T1-1	Advo
ADVO/AAPS-T1-2	Advo
ADVO/AAPS-T1-3	Advo
ADVO/AAPS-T1-4	Advo
ADVO/AAPS-T1-5	Advo
ADVO/AAPS-T1-6	Advo
ADVO/AAPS-T1-7	Advo, USPS
ADVO/AAPS-T1-9	Advo
ADVO/AAPS-T1-10	Advo
ADVO/AAPS-T1-12	Advo, USPS
ADVO/AAPS-T1-13	Advo
ADVO/AAPS-T1-14	Advo, USPS
ADVO/AAPS-T1-15	Advo, USPS
ADVO/AAPS-T1-16	Advo
ADVO/AAPS-T1-17	Advo
ADVO/AAPS-T1-18	Advo
MOAA/AAPS-T1-1	Advo, MOAA, NAA, USPS
MOAA/AAPS-T1-2	Advo, MOAA, USPS
MOAA/AAPS-T1-3	Advo, MOAA, USPS
MOAA/AAPS-T1-4	MOAA, NAA
MOAA/AAPS-T1-5	MOAA, USPS
MOAA/AAPS-T1-6	Advo, MOAA, NAA, USPS
MOAA/AAPS-T1-7	Advo, MOAA, NAA, USPS
MOAA/AAPS-T1-8	Advo, MOAA, NAA, USPS
MOAA/AAPS-T1-9	Advo, MOAA, NAA, USPS
USPS/AAPS-T1-1	Advo, MOAA, NAA, USPS
USPS/AAPS-T1-2	Advo, MOAA, NAA, USPS
USPS/AAPS-T1-3	Advo, MOAA, NAA, USPS
USPS/AAPS-T1-4	Advo, MOAA, USPS
USPS/AAPS-T1-5	MOAA, NAA, USPS
USPS/AAPS-T1-6	Advo, MOAA, NAA
USPS/AAPS-T1-7	MOAA, NAA, USPS
USPS/AAPS-T1-8	MOAA, NAA, USPS

USPS/AAPS-T1-9	Advo, MOAA, NAA, USPS
USPS/AAPS-T1-10	MOAA, NAA, USPS
USPS/AAPS-T1-11	MOAA, NAA, USPS
USPS/AAPS-T1-12	MOAA, NAA, USPS
USPS/AAPS-T1-13	USPS
USPS/AAPS-T1-14	USPS
USPS/AAPS-T1-15	USPS
USPS/AAPS-T1-16	USPS
USPS/AAPS-T1-17	USPS
USPS/AAPS-T1-21	USPS
USPS/AAPS-T1-22	USPS
USPS/AAPS-T1-23	USPS
USPS/AAPS-T1-24	USPS
USPS/AAPS-T1-25	USPS

**RESPONSE OF ASSOCIATION OF ALTERNATE POSTAL
SYSTEMS WITNESS WHITE TO INTERROGATORIES OF
ADVO, INC.**

ADVO/AAPS-T1-1. Please confirm that Distribution Systems of Oklahoma is a division of *The Oklahoma Publishing Company*, publisher of Oklahoma's largest newspapers, *The Daily and Sunday Oklahoman*. If you cannot confirm, please describe specifically the legal and corporate relationships between Distribution Systems of Oklahoma and both *The Oklahoma Publishing Company* and *The Daily and Sunday Oklahoman*.

Response

Confirmed. I will add that DSO is established as a separate, independent division with a separate location, employee base, carriers, general accounting ledger, sales department and management. I also note that ownership by another media company is hardly unique in this case. I understand that *The Flyer*, published by AISOP witness Baro, is owned by Harte Hanks, and that both Carol Wright and ValPak are owned by Cox Target Media, the parent of which, Cox Enterprises, owns sixteen daily newspapers, including the *Atlanta Journal-Constitution*.

**RESPONSE OF ASSOCIATION OF ALTERNATE POSTAL
SYSTEMS WITNESS WHITE TO INTERROGATORIES OF
ADVO, INC.**

ADVO/AAPS-T1-2. Please confirm that The Daily and Sunday Oklahoman is the only daily local newspaper in the Oklahoma City metropolitan MSA area (excluding college newspapers). If you cannot confirm, please identify each other daily local newspaper in the MSA area, and provide its estimated daily circulation.

Response

Not confirmed. The daily local newspapers in the Oklahoma City SMA include: The Edmond Sun (20,000), The Norman Transcript (25,000), The Shawnee News-Star (20,000), The Chickasha Evening Star (15,000), and The Oklahoma City Journal Record (20,000).

**RESPONSE OF ASSOCIATION OF ALTERNATE POSTAL
SYSTEMS WITNESS WHITE TO INTERROGATORIES OF
ADVO, INC.**

ADVO/AAPS-T1-3. Please confirm that Distribution Systems of Oklahoma provides weekly Wednesday delivery of The Express Line, the total market coverage (TMC) product of The Daily Oklahoman.

Response

Confirmed.

**RESPONSE OF ASSOCIATION OF ALTERNATE POSTAL
SYSTEMS WITNESS WHITE TO INTERROGATORIES OF
ADVO, INC.**

ADVO/AAPS-T1-4. Please describe DSO's distribution and circulation of The Express Line TMC product, including the following:

- (a) Is The Express Line distributed by DSO only to nonsubscribers of The Daily Oklahoman newspaper, or is it also distributed to subscribers?
- (b) Please provide the weekly nonsubscriber circulation of The Express Line distributed by DSO.
- (c) Please provide the weekly subscriber circulation of The Express Line distributed by DSO.
- (d) Please provide the total subscriber circulation of The Daily Oklahoman in the areas or zones where DSO distributes The Express Line.
- (e) Please provide the total household count in the areas or zones where DSO distributes The Express Line.
- (f) In areas or zones where DSO distributes The Express Line, does DSO make deliveries to all households or just to those that are to receive The Express Line?

Response

- a) Non-subscribers only
- b) 210,000
- c) See answer to T1-4 (a)
- d) Objection filed
- e) Objection filed
- f) Sometimes we make deliveries to nearly all households, and sometimes only to those that receive Expressline. It depends on the needs of DSO clients at the time.

**RESPONSE OF ASSOCIATION OF ALTERNATE POSTAL
SYSTEMS WITNESS WHITE TO INTERROGATORIES OF
ADVO, INC.**

ADVO/AAPS-T1-5. Please provide the following information for both Distribution Systems of Oklahoma and The Daily and Sunday Oklahoman.

- (a) For each year from 1987 to the present, please provide the total annual volume of preprint circulars distributed by (i) The Daily and Sunday Oklahoman, and (ii) Distribution Systems of Oklahoma.
- (b) For each year, of the total volume of preprints distributed by DSO, how many were distributed only to nonsubscribers of The Daily Oklahoman?
- (c) In addition to the Express Line and preprints, has DSO delivered other publications such as shoppers or buyers guides? If so, please provide the annual volumes of such publications distributed by DSO from 1987 to the present.

Response

- a) Objection filed.
- b) Objection filed. Without waiving that objection, however, I am willing to state that, for DSO, a rough estimate would be a little more than half are distributed to non-subscribers.
- c) Yes. Objection filed to the second part of the question.

**RESPONSE OF ASSOCIATION OF ALTERNATE POSTAL
SYSTEMS WITNESS WHITE TO INTERROGATORIES OF
ADVO, INC.**

ADVO/AAPS-T1-6. Does DSO offer its distribution services to independent shopper or buyers guide publications (i.e., publications not affiliated with the Oklahoman newspaper)? If so,

- (a) Please provide the rates offered or charged for such distribution services.
- (b) Does DSO accept preprint inserts that accompany a shopper publication? If so, please provide the rates offered or charged for preprints accompanying such a publication.

Response

Yes.

- a) Vary by publication and are individually negotiated. Specific rates range from 7.3¢ per piece to 13.8¢ per piece or more if necessary.
- b) Yes. No separate rates if inserted within the publication.

**RESPONSE OF ASSOCIATION OF ALTERNATE POSTAL
SYSTEMS WITNESS WHITE TO INTERROGATORIES OF
ADVO, INC.**

ADVO/AAPS-T1-7. Please identify (by estimated annual preprints distributed in the Oklahoma City metro area MSA market) the five largest multi-page preprint distribution competitors of Distribution Systems of Oklahoma and The Daily and Sunday Oklahoman. For each competitor, please

- (a) indicate its primary method of preprint distribution (i.e., privately delivered newspaper inserts, mailed newspaper inserts, privately delivered shopper publication inserts, mailed shopper publication inserts, or saturation shared mail).
- (b) provide an estimate of its annual volume of preprints distributed in the Oklahoma City MSA market.

Response

- a) I cannot answer for The Daily and Sunday Oklahoman, although probably anyone who competes with DSO for insert distribution also competes with all of the local weekly & daily newspapers, including The Daily Oklahoman. DSO's largest competitors are The Daily and Sunday Oklahoman (newspaper inserts, mailed inserts, product samples); Buyers Guide/Advo (saturation shared mail); Central Oklahoma Newspaper Group (privately delivered & mailed newspaper inserts); USPS Saturation Mail (mailed saturation of stand alone inserts, product samples); VAL PAK/Carol Wright Coupons (saturation shared mail inserts).
- b) I don't know. It's not a common business practice for competitors to share proprietary information with DSO.

**RESPONSE OF ASSOCIATION OF ALTERNATE POSTAL
SYSTEMS WITNESS WHITE TO INTERROGATORIES OF
ADVO, INC.**

ADVO/AAPS-T1-8. Please provide the following market share information. If precise data are not available, please provide DSO/The Daily and Sunday Oklahoman's best estimate of its market share, and explain the basis for the estimate.

- (a) What is the market share of multi-page preprint circulars held by DSO/The Daily and Sunday Oklahoman in the Oklahoma City metro MSA area?
- (b) What is the market share of single-sheet (8" x 10" or larger) preprint circulars held by DSO/The Daily and Sunday Oklahoman in the Oklahoma City metro MSA area?
- (c) If information on the breakout of multiple-page v. single-sheet preprints is not available, what is the market share of total preprint circulars held by DSO/The Daily and Sunday Oklahoman in the Oklahoma City metro MSA area?

Response

- a) Objection filed.
- b) Objection filed.
- c) Objection filed.

**RESPONSE OF ASSOCIATION OF ALTERNATE POSTAL
SYSTEMS WITNESS WHITE TO INTERROGATORIES OF
ADVO, INC.**

ADVO/AAPS-T1-9. Please provide copies of the last two issues of The Express Line, the TMC product of The Daily Oklahoman that is delivered by DSO, including inserts and other materials distributed along with it.

Response

The requested copies have been filed as Library Reference AAPS-LR-2.

**RESPONSE OF ASSOCIATION OF ALTERNATE POSTAL
SYSTEMS WITNESS WHITE TO INTERROGATORIES OF
ADVO, INC.**

ADVO/AAPS-T1-10.

- (a) What is the average weight, and weight range, of The Express Line product distributed by DSO?
- (b) What is the average weight, and weight range, of The Express Line product including preprint inserts?
- (c) What is the average number of preprint inserts carried in The Express Line, and the average weight and weight range of those individual preprint inserts?

Response

- a) 2 to 3 ozs.
- b) 8.1 ozs.; 7.23 to 11 ozs.
- c) The typical number and average weight range of individual preprint inserts are much the same as the Expressline examples provided in response to T1-9.

**RESPONSE OF ASSOCIATION OF ALTERNATE POSTAL
SYSTEMS WITNESS WHITE TO INTERROGATORIES OF
ADVO, INC.**

ADVO/AAPS-T1-11. Please provide the current retail rate card (or booklet) of The Daily and Sunday Oklahoman newspaper, including rates for distribution of preprint inserts. If the rate cards do not show specific rates for preprint inserts, please provide the rates charged for preprint inserts, including rates by weight or pages, and volume and frequency discounts.

Response

Objection filed.

**RESPONSE OF ASSOCIATION OF ALTERNATE POSTAL
SYSTEMS WITNESS WHITE TO INTERROGATORIES OF
ADVO, INC.**

ADVO/AAPS-T1-12. Please provide the current retail rate card (or booklet) of Distribution Systems of Oklahoma, including rates for distribution of preprint inserts. If the rate cards do not show specific rates for preprint inserts or other publications, please provide the rates charged for preprint inserts and other publications, including rates by weight or pages, and volume and frequency discounts.

Response

See the attached.

DSO CUSTOMIZED SATURATION DELIVERY OPTIONS

SATURATION BY UPSCALE NEIGHBORHOODS

NORTHWEST OKLAHOMA CITY

Subdivision	Total HH	Subdivision	Total HH
Blue Stem	243	Mesta Park	552
Bluff Creek	525	Nichols Hills	2,023
Briar Creek	336	Putnam Heights	440
Camelot/Bel Aire/Stonegate	1,726	Quail Creek	2,191
Cobblestone	96	Rumsey Road	597
Edgewater	765	Ski Island	359
Greens	806	Summerfield East	518
Gun Club	517	Summerfield West	231
Harvest Hills N.	330	Summit Place	818
Harvest Hills S.	423	Surrey Hills	787
Heritage Park	435	Val Verde	293
Hefner Middle School	421	Warwick	381
Lakehurst	345	Warwick V	336
Lansbrook	409	Willow Creek	526
Westbury South	685		
Kingsgate	135		
		Total	18,249

EDMOND

Arrowhead Hills	61	Huntwick	134
Arrowhead Valley	99	Kickingbird	230
Blue Quail Ridge/Silver Creek	395	Kingston	187
Brasswood	159	N. Brook/Olde Town	433
Cedar Ridge	196	Northwood	411
Cheyenne Ridge/Wellington	468	Oaks I & IV/Fox Hollow	286
Chimney Hill	455	Spring Hill	204
Copperfield	420	Tall Oaks IV	67
Dunthorpe Farms	213	Timber Ridge	285
Eagle Crest	213	Timberdale	307
Frimond Oaks	107	Trails North/Pine Valley	452
Faircloud	395	Turtle Creek/	
Fairway Est/N. Creek	128	Walnut Cove/Woodlands	90
Fox Lake	204		
Glen Eagles	200		
		Total	6,799

SOUTH OKLAHOMA CITY

Greenbriar/Kingspark/		Ranchwood	660
Lake Ridge Run	855	Village Green/Rivendell	462
Greenbriar Kingsridge	570		
		Total	2,547

NORMAN

Bar Harbor	430	Hall Park	380
Barry Estates	461	Rustic Hills	426
Brookhaven	1,946	Trails	417
Cambridge	621	Westbrook	291
		Total	4,972

GRAND TOTAL: 32,567

SATURATION AREAS BY INCOME

Based on U.S. Census Block Group Data

Area*	Total DSO Residential and Apartment Coverage	Greater Than \$40,000 HHI	Greater Than \$50,000 HHI	Greater Than \$60,000 HHI
1	26,720	5,050	4,535	0
2	26,036	18,363	14,697	4,731
3	27,441	12,344	9,910	2,079
4	30,632	2,691	2,303	424
5	21,181	0	0	0
6	27,377	869	869	0
7	32,773	5,704	3,907	0
8	38,232	8,261	6,202	2,060
9	27,123	5,115	3,873	2,084
10	24,939	13,515	9,575	1,613
Totals	282,454	71,942	55,871	12,991

*Can be split into specific Zips upon request

TOTAL DSO RESIDENTIAL & APARTMENT COVERAGE

Zip	Covered by DSO Routes	Zip	Covered by DSO Routes	Zip	Covered by DSO Routes
73003	8,155	73107	12,160	73129	5,684
73008	8,018	73109	7,590	73130	3,993
73013	7,117	73110	13,422	73131	285
73034	6,043	73111	5,574	73132	10,295
73064	2,793	73112	15,217	73135	5,574
73069	8,793	73114	5,841	73139	6,915
73071	8,759	73115	8,691	73142	2,680
73072	9,571	73116	4,812	73145	664
73078	236	73117	1,131	73149	1,937
73084	304	73118	7,498	73150	125
73099	12,204	73119	11,654	73159	11,040
73103	2,215	73120	15,561	73160	14,182
73105	2,231	73122	5,663	73162	8,970
73106	6,299	73127	6,463	73170	6,095
		Total	282,454		

*Includes all residential and apartment deliveries within DSO routes

*Counts available by routes within each Zip Code

DISTRIBUTION SYSTEMS OF OKLAHOMA

100 N. E. 5th
Oklahoma City, OK 73104
(405) 231-3111 FAX: (405) 231-3199



Private Postal Delivery

Rate Card

SATURATION DELIVERY

- Delivery will be made as an outsert with ExpressLine and delivered solo or with other items to all other households.
- Special requests may require additional charges.
- Customized delivery areas according to geographic or demographic needs.

Quantity	Cost Per Piece
Under 25,000	10.8¢ each
25,001-50,000	9.4¢ each
50,001-150,000	8.3¢ each
Over 150,000	7.3¢ each

EXPRESSLINE OUTSERTS

- All deliveries are placed inside the bag on the outside of ExpressLine.
- Customized delivery areas according to geographic or demographic needs to selected households.

Quantity	Cost Per Piece
Under 25,000	4.5¢ each
25,001-50,000	4.2¢ each
50,001-150,000	3.9¢ each
Over 150,000	3.6¢ each

SPECIFIC ADDRESS DELIVERY

- Customer or demographic list delivery to specifically addressed households.
- Customer can provide list or use available DSO demographic lists.
- All addresses must be within DSO routings for delivery. DSO can provide mail labels for areas outside our delivery area.
- Delivered items must meet certain postal restrictions to qualify.

Quantity	Cost Per Piece
Under 25,000	12.5¢ each
25,001-50,000	11.5¢ each
Over 50,000	10.5¢ each

DISCOUNTS

- Annual discounts can be quoted based on frequency and/or quantities.

ADVANTAGES OF DSO DELIVERY OVER MAILING SERVICES AND THE POST OFFICE

1. MUCH LOWER COSTS

- No label or handling charges.
- Lower per piece delivery charge.
- Accurate delivery counts allow savings on printing overages.

2. SUPERIOR DELIVERY

- DSO is audited by the Audit Bureau of Circulations (A.B.C.), the same company that independently audits every major newspaper in the United States.
- All DSO routes are manager verified for delivery and written documentation on each and every route is filed.

3. UPDATED ROUTING/ACCURATE DELIVERY COUNTS

- All DSO routes are updated weekly (in the Oklahoma City metro area) by The Oklahoma Publishing Company.

4. EXCLUSIVE DELIVERY

- Front door delivery insures your publication the ultimate impact of standing out. No bills, catalogs or gimmick mail to compete with.

5. CONVENIENT DEADLINES

- Publications can arrive on Friday prior to the Wednesday delivery day. On an emergency basis however, Monday morning could be arranged.

Visit our website at: www.dsok.com



A Division of
OPUBCO

member
aaps
Association of Alternate
Postal Systems, Inc.

RECEIVING INSTRUCTIONS

Warehouse Address: 100 N.E. 5th
Oklahoma City, OK 73104
(Southside receiving doors)
Attn: Warehouse Manager

Packaging: • On skids - Shrink wrapped or boxed (preferred)
• Turns of 50 (preferred)
• Skid Tag showing quantity delivered and number of skids

Mailing Address: P.O. Box 25125
Oklahoma City, OK 73125

Dock Hours: Monday-Friday, 8:30-5:00 p.m.
(Central time)

Questions (?): Warehouse Manager
Business: (405) 231-3135
Fax: (405) 231-3199

GENERAL INFORMATION

QUANTITIES:

All quantities are based on number of deliveries on a weekly basis.

SIZE & WEIGHT:

All publications and product samples must be no larger than 8 1/2 x 11 folded size, and can weigh up to 5 oz. without extra charge.

PRINTING AND DESIGN:

Assistance with design, composition and printing is available with any DSO delivery.

ADVERTISING AGENCIES:

All recognized Advertising Agencies will receive a standard 15% commission on any scheduled delivery. Some restrictions may apply on saturation delivery.

INQUIRIES ABOUT A COMPLETED DELIVERY:

If you have a question about delivery to a specific area or even a specific address, DSO can provide a detailed list of documented addresses receiving delivery in that area.

DELIVERY DAYS/DEADLINES

- Most DSO deliveries are made each Wednesday. Some routes are completed on Thursday. Delivery is available on other days for an additional charge.
- All delivery items should arrive by the Friday prior to the Wednesday delivery date. DSO cannot guarantee delivery quantities if items arrive late.

WHO WE ARE

Established in 1991 by the Oklahoma Publishing Company (OPUBCO), Distribution Systems of Oklahoma (DSO), is a division of The Daily and Sunday Oklahoman, the state's largest newspaper.

**RESPONSE OF ASSOCIATION OF ALTERNATE POSTAL
SYSTEMS WITNESS WHITE TO INTERROGATORIES OF
ADVO, INC.**

ADVO/AAPS-T1-13. At page 2 of your testimony, you state that:

"Weekly deliveries to approximately 282,000 homes typically consist of commercial publications delivered by individual carrier route. Mostly, these publications would qualify as Standard mail saturation advertising pieces, or are phone books, packaged product samples, address specific newspapers, and doorhangers (coupon cards that are specifically hole punched to fit door handles)."

- (a) Please identify, by newspaper title and publisher, the "address specific newspapers" delivered by DSO. Please identify which, if any, of these newspapers are not owned or affiliated with The Oklahoma Publishing Company and The Daily and Sunday Oklahoman newspaper.
- (b) Please identify, by publication title and publisher, the "commercial publications" delivered by DSO. Please identify which, if any, of these commercial publications are not owned or affiliated with The Oklahoma Publishing Company and The Daily and Sunday Oklahoman newspaper.

Response

- a) The Expressline (Oklahoma Publishing Co.)
 - On Air Magazine (PSI, Grand Rapids, MI)
 - OSU Spirit (OSU Alumni Association, Stillwater, OK)
 - Auto Trader (Trader Publications, Oklahoma City, OK)
 - Boat Trader (Trader Publications, Oklahoma City, OK)
 - South Oklahoma City Leader (S. OKC Leader Publications, Oklahoma City)
- b) Horizons (Oklahoma City Community College)
 - Vo-Technology (Francis Tuttle Vo-Tech)
 - Newschannel 4 Extra (KFOR-TV)
 - Feist Publications (Yellow pages, Coupon books)
 - The Real Estate Book (Real Estate Book Publications)
 - The Remington Post (Remington Park Race Track)
 - Holiday Shopper (Holiday Shopper Publications)
 - Nichols Hills News (Nichols Hills Publishing)
 - Quail Creek News (Quail Creek Publishing)
 - The Shoppers Edge (The Shoppers Edge)

This is only a partial list. The entire list would be too numerous.

**RESPONSE OF ASSOCIATION OF ALTERNATE POSTAL
SYSTEMS WITNESS WHITE TO INTERROGATORIES OF
ADVO, INC.**

ADVO/AAPS-T1-14. At page 5 of your testimony, you state: "As for shared mail packages, in our market, the Postal Service competes vigorously with alternate delivery for business." Please identify the companies that, on a regular basis (monthly or more frequently), offer shared mail programs in your market.

Response

The major ones are: Buyers Guide/Advo; VAL PAK; Central Oklahoma Newspaper Group.

**RESPONSE OF ASSOCIATION OF ALTERNATE POSTAL
SYSTEMS WITNESS WHITE TO INTERROGATORIES OF
ADVO, INC.**

ADVO/AAPS-T1-15. At page 7 of your testimony, you state that some of the members of AAPS are owned by newspapers. Please identify each of the members of AAPS that is owned, controlled, or affiliated with a newspaper; and for each, identify the newspaper name and the parent company.

Response

I don't have all of the specific information or detail you want. The AAPS Directory (submitted as library reference AAPA-LR-1) lists parent company information for some but not all members. There are a few on the roster that are easily recognizable daily newspapers such as:

- CIPS Marketing Group (Los Angeles Times)
- Custom Distribution (Sacramento Bee)
- Herald Direct (Miami Herald)
- Central Indiana Alternate Delivery (Thomson Newspapers)
- Delivery Plus System (Indianapolis Newspapers)
- Gateway Consumer Services (St Louis Post Dispatch)
- Star Precision Delivery (Kansas City Star)
- Distribution Systems of Oklahoma (Oklahoma Publishing)
- R-J ADService (Las Vegas Review-Journal)
- Distribution Systems of America (Newsday)
- Times Distribution (Seattle Times)

From the information in the Membership Directory, there appear to be approximately 15 more that are associated in some way with a daily newspaper, which would total about 30, or about 25% of our members.

**RESPONSE OF ASSOCIATION OF ALTERNATE POSTAL
SYSTEMS WITNESS WHITE TO INTERROGATORIES OF
ADVO, INC.**

ADVO/AAPS-T1-16. In your response to USPS/AAPS-T1-9, you state that "We have already been driven out of the light weight market."

- (a) Please define what you mean by "the light weight market."
- (b) For the period from 1991 to the present, please provide the annual volumes of *preprint inserts and other materials distributed by DSO that (i) fall within your definition of "the light weight market," and (ii) fall outside that definition.*

Response

- a) I had no bright line in mind. Clearly, pieces of 2 ounces or less are considered to be light weight, and I suppose that, in general, anything up to the 3.3 ounce breakpoint would be as well.
- b) (i) and (ii) I don't have specific records containing the data you request, but I would estimate about 2 to 3 million pieces per year from 1992-1996. We had a substantial amount of light weight pieces that were distributed with magazine titles as inserts in the early to mid 90's. All are now gone.

**RESPONSE OF ASSOCIATION OF ALTERNATE POSTAL
SYSTEMS WITNESS WHITE TO INTERROGATORIES OF
ADVO, INC.**

ADVO/AAPS-T1-17. Please refer to the example you cite at page 25 of your testimony concerning the effect on your costs of an increase in weight of a TMC product from 7-1/2 ounces to 8 ounces. With respect to this example, please provide the following:

- (a) Please provide all calculations and state all assumptions used in concluding that this change required your carriers to make two additional restocking trips and to walk an extra half-to-one-mile each delivery day.
- (b) What was the average number of total deliveries per route for DSO carriers prior to this weight change?
- (c) What was the average number of walking "loops" per route for DSO carriers prior to this weight change?
- (d) What was the average number of deliveries per walking loop for DSO carriers prior to this weight change?
- (e) What was the average satchel weight per loop (the weight of delivery materials in the satchel at the start of the loop) for DSO carriers prior to this weight change?
- (f) Explain how, and by how much, each of (b)-(e) above changed as a result of the example you cite?

Response

- a) Depending on an Expressline weight that varies from 7 to 11 ozs., DSO carriers carry between 20-40 Expressline products in their bag, even less if there are other delivery items that day. On average these weigh 15-25 lbs. They also carry plastic bags (saddled on a hook), manifests (route cards), the thick canvas bag itself, maps, and personal needs. A bag typically slung from the shoulder weighs in the range of 25 to 30 lbs. Based on the additional average weight increase of a 1/2 oz., the typical contractor (carrier) on average will carry two less Expresslines per "loop" from his vehicle. It is not important to focus on the 1/2 oz. average increase for purpose of this example. The additional weight a contractor carried over the course of 1999 was 7%. The additional bulk of the Expressline most weeks forced contractors to lessen the amount of product in their bags. Some neighborhoods require the carrier to go to 70% of the households with Expressline and some 30%. The average used to compute this example was 50% with 700 Expressline households per route and 1400 total households over the route. A contractor parks and restocks about 20 to 30 times each delivery day. A difference of just

**RESPONSE OF ASSOCIATION OF ALTERNATE POSTAL
SYSTEMS WITNESS WHITE TO INTERROGATORIES OF
ADVO, INC.**

two Expresslines less (if an average were used) requires the carrier to increase by two his restocking stops and loops. With an average delivery of 2 to 3 per block face, a full bag can cover 40 to 100 households. This computes to 8 to 12 city blocks up and then back. A total round trip is 16 to 24 city blocks, and since this happens twice (on average), a total of 32 to 48 city blocks. Based on 12 city blocks as an accepted distance for a mile, the DSO contractor (carrier) actually has as much as an additional 4 miles to negotiate, which renders my original conclusion on Page 25 of my testimony considerably conservative. If a carrier can arrange his or her loop into square block areas, he or she could conceivably cut the distance down. However, geography and topography of the areas dictate the chances for that. Overall, the additional weight added a minimum of 104 miles of walking for the year and a maximum of 208 miles.

- b) 700
 - c) No finite average available, 18 to 35 loops.
 - d) No finite average available, weight of product increases or decreases deliveries per loop from 20 ~ 40.
 - e) 25 to 30 lbs.
 - f) (b) did not change (c) increased annual distance walked by 7% (d) increased the total amount of loops (e) did not change
- All estimates (b) through (e) vary by contractor (carrier) based on physical ability, geography, topography and additional delivery items in the course of a day.

**RESPONSE OF ASSOCIATION OF ALTERNATE POSTAL
SYSTEMS WITNESS WHITE TO INTERROGATORIES OF
ADVO, INC.**

ADVO/AAPS-T1-18. Please refer to the example you cite at page 25 of your testimony concerning the effect on your costs of an increase in weight of a TMC product from 7-1/2 ounces to 8 ounces. You state that the TMC delivery in question was "address specific products, so not every household was delivered." You also state that "we increased the delivery charge to the customer."

- (a) Please identify, by TMC product name and publisher, the TMC product in question.
- (b) What was the delivery charge to the customer on a per piece basis before, and after, this change?

Response

- a) The Expressline, TMC product of The Daily Oklahoman
- b) Objection filed. Our specific per piece charges are commercially sensitive and confidential at the request of DSO clients. I am willing to state, however, that on a percentage basis, rates were raised 4.2%.

**RESPONSE OF ASSOCIATION OF ALTERNATE POSTAL SYSTEMS WITNESS WHITE
TO INTERROGATORIES OF MAIL ORDER ASSOCIATION OF AMERICA**

MOAA/AAPS-T-1-1. You claim that the Postal Service proposal will "do even greater harm" to "our industry" for the "heavier weight material for which we compete" (at 2, 3).

a. Please provide the annual volumes for 1995-1999 of materials carried by Distribution Systems of Oklahoma (DSO) that "would qualify as Standard Mail Saturation advertising pieces" (at 2).

b. Please provide the annual volumes for 1995-1999 of materials carried by DSO that are phone books and the percentage of those phone books that weight more than sixteen ounces.

c. Please provide the annual volumes of materials carried by DSO for the years 1995-1999 that would qualify as Standard Mail A ECR pieces only at the basic ~~2~~ (rather than the Saturation or High Density levels).

d. Please provide a copy of the rate schedule (or schedules) that reflect the current rates charged by DSO, including the effect of the weight of a piece upon rates.

Response

a.	1995	11,504,000
	1996	11,463,000
	1997	14,985,000
	1998	15,401,000
	1999	15,924,000

b.	1995	54,000 (>16 oz. is 100%)
	1996	54,000 (>16 oz. is 100%)
	1997	101,000 (>16 oz. is 100%)
	1998	77,000 (>16 oz. is 100%)
	1999	722,000 (>16 oz. is 95%)

c. zero

d.	<u>Quantity</u>	<u>Cost Per Piece</u>
	<25,000	10.8¢ to 13.8¢ ea.
	25,001 – 50,000	9.4¢ to 12.4¢ ea.
	50,001 – 150,000	8.3¢ to 11.3¢ ea.
	>150,000	7.3¢ to 10.3¢ ea.

- Size & weight: All publications and product samples must be no larger than 8 ½ X 11 folded size, and can weigh up to 5 oz. without extra charge.
- Rates based on customized delivery areas according to geographic or demographic needs.

**RESPONSE OF ASSOCIATION OF ALTERNATE POSTAL SYSTEMS WITNESS WHITE
TO INTERROGATORIES OF MAIL ORDER ASSOCIATION OF AMERICA**

- All quantities and rates are based on a one-day delivery basis.

High Density (Per Piece)

No published rate schedule. Rates are based on weight, geography, of delivery area, dimensions of product, frequency of the delivery and, which is often the case, special needs or requests.

**RESPONSE OF ASSOCIATION OF ALTERNATE POSTAL SYSTEMS WITNESS WHITE
TO INTERROGATORIES OF MAIL ORDER ASSOCIATION OF AMERICA**

MOAA/AAPS-T-1-2. In preparing your testimony, were you provided with rate information by members of the Association of Alternate Postal Systems?

- a. If so, please provide copies of all such rate information.
- b. If not, is it your contention that the rates charged by members of the Association are irrelevant to the Commission's evaluation of your testimony?

Response

- (a) No.
- (b) No.

**RESPONSE OF ASSOCIATION OF ALTERNATE POSTAL SYSTEMS WITNESS WHITE
TO INTERROGATORIES OF MAIL ORDER ASSOCIATION OF AMERICA**

MOAA/AAPS-T-1-3. In preparing your testimony did you request data from members of your Association about the effect of weight upon the rates charged by those members?

- a. If so, please provide copies of all such rate information.
- b. If not, is it your contention that the effect of weight upon rates of the members is irrelevant in the Commission's evaluation of your testimony?

Response

(a) No.

(b) No.

**RESPONSE OF ASSOCIATION OF ALTERNATE POSTAL SYSTEMS WITNESS WHITE
TO INTERROGATORIES OF MAIL ORDER ASSOCIATION OF AMERICA**

MOAA/AAPS-T-1-4. Is it your position that the revenue loss that you claim resulted from "reducing the postage rates for the most densely delivered magazines" (at 3) is relevant to the Commission's consideration of Standard Mail A rates?

Response

The specific amount of the revenue loss is less relevant than the fact that companies in our industry, and their success or failure, are directly affected by postal rates. What happened with Periodicals can happen with Standard A material.

**RESPONSE OF ASSOCIATION OF ALTERNATE POSTAL SYSTEMS WITNESS WHITE
TO INTERROGATORIES OF MAIL ORDER ASSOCIATION OF AMERICA**

MOAA/AAPS-T-1-5. Is it your position that the existing or USPS proposed rates for magazines and periodicals are too low?

Response

I have taken no position on the existing Periodicals rates, which are higher than the rates that resulted from Docket MC95-1, and I have taken no position on the proposed Periodical rates. Please see my response to USPS/AAPS-T1-10 for a further explanation.

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MOAA/AAPS-T-1-6. Is it your position that the rates for Standard Mail A should be established without regard to costs?

Response

No.

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MOAA/AAPS-T-1-7. Please explain fully your statement that "our industry is forced to use Postal Service prices as a guide to setting ours . . ." (at 5).

Response

The Postal Service is our main competitor. Although not every mailer would have a viable alternative in alternate delivery, virtually every alternate delivery customer has a viable alternative in the mail. Therefore, it follows that our rates must take into account, or use as a "guide," the rates charged by the Postal Service.

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MOAA/AAPS-T-1-8. What percentage of (a) DSO's, and (b) your Association member's volumes consist of "shared mail set[s]" (at 7)?

Response

(a) 73%

(b) I don't know.

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MOAA/AAPS-T-1-9. What percentage of (a) DSO's, and (b) your Association member's volumes consist of "heavier weight items" that are not part of a "shared mail set"?

Response

(a) 20%

(b) I don't know.

**RESPONSE OF ASSOCIATION OF ALTERNATE POSTAL SYSTEMS WITNESS WHITE
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USPS/AAPS-T1-1. On page 2 lines 9-11 of your testimony, you state, "we can usually provide effective competition for the Postal Service for heavier weight shared mail packages, in particular."

- a) Define "effective competition."
- b) Is your statement about "effective competition" intended to convey that alternate delivery rates are below the rates that would be charged by the Postal Service?
- c) Provide a chart comparing, for each ounce increment starting at 4 ounces through 16 ounces, USPS proposed Standard Mail (A) postage rates and figures showing the average rate (based on the most accurate and comprehensive information available to you) for carriage of flat-sized articles by alternate delivery. Identify the source of the alternate delivery rates and explain how they were derived.
- d) Is it fair to say that, on average for the alternate delivery industry, rates for pound rated flats (i.e., in excess of 3.3 ounces up to 16 ounces) carried by alternate delivery are below those for equivalent articles sent via Standard Mail (A) ECR flat-rate postage?

Response

(a) I mean a level of competition where we can obtain a fair and appropriate share of the product, based on price, service and related considerations, and where a government monopoly is not exploited.

(b) Sometimes they are, and sometimes they aren't. It depends upon the company and the product. Although I do not know what is contained in the SAI reports commissioned by the Postal Service annually for the past few years, you may find relevant information there.

(c) You have the requested information on the Postal Service's proposed rates, but, unfortunately, I have no information on the "average rate" charged by alternate delivery companies. Although I do not know what is contained in the SAI reports commissioned by the Postal Service annually for the past few years, you may find relevant information there.

(d) No, I cannot confirm that it is fair to say that, because I do not have information available that would either support or refute that statement. As I said, I do not have information on the "average" rate charged by alternate delivery companies. Based upon my knowledge of the industry, however, it is fair to say that rates offered by alternate delivery companies are often but not always below those charged by the Postal Service. You might check your SAI reports for this information.

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USPS/AAPS-T1-2. On page 9 lines 19 lines 19-22 of your testimony, you state: "the shopping guides and the free publications that make up the backbone of the business for most of our members make their delivery choices with reliance almost exclusively on the pound rate, not the piece rate."

- a) What proportion of alternate delivery industry revenue is comprised of carriage of "shopping guides and free publications"?
- b) To what pound and piece rates are you referring in this passage? Identify by rate category and rate.
- c) Does your statement imply that shopping guides and free publications do not consider the prices charged by alternate delivery in making delivery choices? Please explain your response.

Response

(a) I can only make a guess. I would estimate that about two thirds of our industry's revenue is derived from shopping guides and free publications, with the assumption that newspaper TMC products are included in the definition, but it varies widely by company. Although I do not know what is contained in the SAI reports commissioned by the Postal Service annually for the past few years you may find relevant information there.

(b) Primarily the ECR Saturation rate.

(c) Of course they do. Like any customer, they consider price, service quality, the "prestige" of being able to use the mailbox, and other factors.

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USPS/AAPS-T1-3. On page 9 lines 17-19 of your testimony, you state "[o]ver time, where there is no competition, USPS proposed rate increases have been larger than where there is competition."

- a) At the time you drew this conclusion, what mail categories did you understand to be provided where "there is no competition"?
- b) At the time you drew this conclusion, what mail categories did you understand to be provided where "there is competition"?
- c) Over what time period is your statement intended to refer?
- d) For each category in subparts (a) and (b), provide the USPS proposed rate increases to which your statement is intended to refer for the time period identified in (c).

Response

(a) I don't know that I had a precise and complete list in mind, but I certainly was thinking about First-Class mail and the non-saturation portion of Standard A, the address specific material that the Postal Service will not permit us to deliver (unless we pay the postage).

(b) I again did not have a precise or complete list in mind, but I was thinking primarily about ECR saturation mail. I have noticed as well that, now that it has eliminated the competition for the delivery of magazines following the MC95-1 rate changes, the Postal Service is seeking a large rate increase for Periodicals.

(c) Basically, I was thinking about the same time period addressed in detail in Ken Bradstreet's testimony in R97-1, with the addition of the past couple of years. Please see his testimony at pages 9-12.

(d) Please see Ken Bradstreet's testimony in R97-1, upon which I relied for my conclusion as to cases prior to this one.

**RESPONSE OF ASSOCIATION OF ALTERNATE POSTAL SYSTEMS WITNESS WHITE
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USPS/AAPS-T1-4. On page 10 line 1 of your testimony, you state that the "typical publication weighs between 3 and 6 ounces." On lines 3-4, you state "[w]ith one or more regular inserts, the combined weight of the publication and its inserts is in the 4 to 10 ounce range, and often higher."

- a) Is the "typical publication" in this passage intended to refer to publications carried by alternate delivery or by the Postal Service or both?
- b) Is it fair to conclude from your statements that the typical flat-sized article carried by alternate delivery is in the 4 to 10 ounce range?
- c) What figure, in your opinion, best represents the average weight (with inserts) of a flat-sized article carried by alternate delivery? Use the best and most accurate and comprehensive source(s) of information available to you, and identify the sources and show the derivation of the final result.
- d) Provide a chart showing, for each ounce increment from 3 ounces to 16 ounces, the percentage of flat-sized volume in each ounce increment carried by alternate delivery as a proportion of the total flat-sized volume carried by alternate delivery in this weight range, i.e., 3 oz. to 16 oz. Use the best and most comprehensive information available to you, and identify the source(s) of your information.

Response

(a) Alternate delivery.

(b) Depending upon what you mean by "article," the answer is probably "yes." That is, the 4-10 ounce "piece," like a shared mail set, can be said to contain a number of "articles."

(c) I don't have that information. Based upon my experience in the industry, however, I would say that the typical piece (if piece means a set containing inserts) weighs roughly 7-9 ounces, but the average weight for any particular company varies by the market. Although I do not know what is contained in the SAI reports commissioned by the Postal Service annually for the past few years, you may find relevant information there.

(d) I do not have the information necessary to respond to this question. Although I do not know what is contained in the SAI reports commissioned by the Postal Service annually for the past few years, you may find relevant information there.

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USPS/AAPS-T1-5. On page 10 lines 7 to 8 of your testimony, you state, "[t]he cost of weight determines, to a large extent, the cost of handling preprinted inserts."

- a) To what does the term of "cost of weight" refer?
- b) To what does the term "cost of handling preprinted inserts" refer?
- c) Is your statement intended to convey that the cost to the alternate (i.e., non-USPS) delivery agent to handle incremental weight determines, to a large extent, the price of inserts? If not, please explain your response.
- d) Which is the more commonly used determinant of the price of carriage of a flat-sized piece by alternate delivery – number of pages, or weight? Please explain.
- e) Explain how prices for inserts are quoted to customers of alternate delivery.
- f) Are prices quoted in terms of pages of an insert?
- g) Do alternate delivery providers typically assess a pound rate on inserts?
- h) Do alternate delivery providers typically use a combined piece and pound rate structure for inserts?

Response

- (a) The cost of handling the weight of the product.
- (b) The cost of all of the steps that we, or the Postal Service, go through to deliver a product.
- (c) No. It is intended to convey that weight drives costs. I haven't there addressed pricing, although weight is also a driver of prices.
- (d) I don't know which is more common, although I would guess that weight and/or bulk of the item are the most common determinants of price. Page count might also used, but page count is frequently a proxy for weight and bulk. Although I do not know what is contained in the SAI reports commissioned by the Postal Service annually for the past few years, you may find relevant information there.
- (e) It will differ from company to company. In the case of my company, they are based on quantity, weight and dimensions.
- (f) It's possible, but I don't know of any companies that price strictly on the basis of pages.
- (g) I'm not sure what's typical, although I would guess that a strict pound rate is far less common than alternatives.
- (h) I don't believe so.

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USPS/AAPS-T1-6. On page 10 lines 14-15 of your testimony, you state that "the fact remains that we must compete with the Postal Service's lowest rate."

- a. Is your statement intended to convey that the customers that perceive there to be a choice between ECR saturation rates and alternate delivery are those that make use of DDU ECR saturation rates? Please explain.
- b. Do you believe that postal customers that enter mail upstream from destination delivery units also perceive there to be a choice between ECR postage and alternate delivery? Please explain.
- c. Identify, based on parameters of subclass, rate category, weight, and content, the customer base you believe has a choice between delivery by USPS and alternate delivery.

Response

(a) I don't intend to convey the thought that *all* customers that perceive that choice use the DDU rate, but many and probably most of our potential customers would likely use that rate.

(b) Sometimes, and those customers would typically be weighing the rate for SCF entry against alternate delivery costs.

(c) Anyone sending saturation Standard A material in theory has a choice between alternate delivery and USPS delivery, but as a practical matter, in the absence of a national alternate delivery network (for this type of material), the typical customer base would be choosing between alternate delivery and Standard A ECR entered at a DDU or SCF. Again in theory, ECR mailers at any weight level could choose alternate delivery, but we really can't compete for the lighter weights unless the piece can be delivered as part of a heavier weight set. We would also be a logical alternative to those mailing product samples, which typically weigh several ounces or more, especially those subject to the surcharge, and to those seeking delivery of phone books and similar saturation directories that would otherwise be mailed at the Bound Printed matter rate. Although I do not know what is contained in the SAI reports commissioned by the Postal Service annually for the past few years, you may find relevant information there.

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USPS/AAPS-T1-7. On page 12 line 14 of your testimony, you state that "the market is no less competitive now than it was in 1997"

- a) Identify the parameters of the market to which you are referring in terms of weight, content, size, point of entry and market coverage (e.g., saturation).
- b) Identify all of the facts and the sources of these facts that you considered before or at the time you drew this conclusion.

Response

(a) I was referring to the market for material that can be mailed at the ECR saturation rate with DDU or SCF entry weighing five ounces and above. Of course, if the pound rate is lowered, this market will become less competitive, as the market for lighter weight pieces became less competitive after the reclassification case.

(b) My statement isn't based upon "facts" that can be listed. It is based upon my years of experience running an alternate delivery company that competes with the Postal Service.

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USPS/AAPS-T1-8. On page 18 line 1 of your testimony, is your reference to R94-1 intended to be to Docket No. R84-1? If not, please explain.

Response

Yes.

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USPS/AAPS-T1-9. On page 18 lines 21-22 of your testimony, you state "[t]he fact is that the pound rate at the levels relevant to us hasn't risen in years and, under this proposal, would go down."

- a) Identify the parameters of the "levels" to which your statement refers in terms of weight, content, size, point of entry and market coverage (e.g., saturation).
- b) Identify, by category, all of the pound rates that are "relevant" to the alternate delivery industry.
- c) Identify, by category, all of the pound rates that are not "relevant" to the alternate delivery industry.

Response

- (a) I am referring to the rate applied to saturation ECR material at 5-6 ounces and above, entered at the DDU.
- b) I don't discuss relevant pound rates; I discuss relevant levels, and by that I meant weight levels of pieces for which ~~there~~ is effective competition—mostly 5-6 ounces and above. We have already been driven out of the light weight market.
- (c) See my response to part (b). *there*

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USPS/AAPS-T1-10. Please refer to page 3 lines 13 to 21 of your testimony. You state:

[w]ith magazines embodying the bulk of deliveries for new alternate delivery companies springing to life, the Postal Service proposal under Mr. Runyon in the MC95-1 [case] punched relentlessly where it hurt the most when it proposed very large reductions in postage for the mass circulation magazines that were most susceptible to diversion to alternate delivery. Although the Rate Commission rejected the Postal Service's reclassification proposal for periodicals, it gave the Postal Service half a loaf by reducing the postage rates for the most densely delivered magazines. That half loaf was enough to threaten many of our businesses.

- a) Is it your testimony that the Commission's recommended rates for Periodicals in Docket No. MC95-1 "threatened" alternate delivery?
- b) In what way was alternate delivery "threatened"?
- c) Would AAPS members prefer that Periodicals rates be set higher than they are currently for "the most densely delivered magazines"? If not confirmed, please explain.
- d) Does AAPS believe that the Commission should consider the effect on alternate delivery when evaluating criterion (b)(4) with respect to the proposed rates for Periodicals Mail in this docket? Why or why not? Please explain your response.
- e) Does AAPS support a higher or lower cost coverage for Periodicals Mail in this docket than proposed by the Postal Service? Please explain your response.
- f) Does AAPS support higher or lower rates for carrier route Periodicals Mail in this docket than proposed by the Postal Service? Please explain your response.
- g) What consequence would a higher markup on Periodicals than proposed by the USPS have on alternate delivery?
- h) What consequence would higher carrier route Periodicals rates than proposed by the USPS have on alternate delivery?

Response

(a) Yes. They more than threatened the alternate delivery of periodicals, they effectively terminated it.

(b) As stated in my testimony, the rate reduction for densely distributed magazines caused both of the national periodical alternate delivery companies to end their involvement in the distribution of periodicals, which was a serious threat to the financial well being of a number of alternate delivery companies.

(c) As a general matter, we would of course always "prefer" that postage rates for material for which we compete be higher, rather than lower. That statement would undoubtedly apply to every business in a competitive market, including the Postal Service. But the fact that we would prefer rates to be higher doesn't necessarily mean that they should be higher, and I would also note that, with respect to periodicals in particular, the rate was raised in R97-1 and a large increase is proposed here, and I don't see anyone taking steps to resurrect alternate delivery of

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periodicals. It may be, therefore, that the concept is dead, at least for a good while. As I said in my testimony, credibility of alternate delivery is crucial, and I'm afraid that we've lost credibility when it comes to periodicals. I'm also afraid that potential market entrants are discouraged because they see how easy it would be for the Postal Service to repeat the 1995 experience, especially if postal "reform" is passed. The costs of setting up this type of selective delivery business are quite high.

(d) The Commission should consider every criterion with respect to every rate, because, as I understand it, that's what the law requires. However, since there really is no competition at this time for periodical delivery, and none appears to be on the horizon, I'm not sure that this criterion is particularly relevant any longer with respect to periodicals.

(e) AAPS takes no position in this docket on any rate other than ECR rates. See also my response to part (c).

(f) See my response to part (e).

(g) It depends upon how high. As I explained in response to subpart (c), now that there are no viable national competitors to the Postal Service for the delivery of periodicals, it seems unlikely that within any reasonable range of markups there would be any effect at all on alternate delivery. If the markup were to go to 100%, would a competitor appear? I don't know. Perhaps that question could be directed to Time Warner, which founded Publishers Express.

(h) My answer would be the same as my answer to part (g).

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USPS/AAPS-T1-11. On page 22 lines 17-19 of your testimony, you state, "[t]o its credit, the Commission recognized this important concept in evaluating the Postal Service's proposals in recent rate cases, and, as a result, has tempered the First-Class increases and rejected USPS attempts to impose either small or negative rate increases on Third Class/Standard ECR saturation mailers."

- a) For First-Class, identify the rates, rate categories, rate increase percentages (USPS proposed vs. PRC recommended), and rate cases to which your statement refers.
- b) For Third Class/Standard ECR saturation, identify the rates, rate categories, rate increase percentages (USPS proposed vs. PRC recommended), and rate cases to which your statement refers.

Response

(a) My statement is not based upon an analysis of specific First-Class rate requests and decisions but on my impression that the Commission, by recommending higher Standard A rates than requested, has spared First-Class mailers some costs. I am sure that you have ready access to the details of what was proposed and recommended for every rate category in prior cases.

(b) I am certainly referring to R97-1, in which the Postal Service's request for a reduction in the pound rate was rejected by the Commission, and to MC95-1, where the recommended minimum pound rate (55.2 cents) was considerably higher than the requested rate (39.9 cents). As for prior cases, it is again my general understanding that that the Commission has recommended higher rates for what is now saturation ECR than were recommended by the Postal Service. You would have ready access to that information and I'm sure you can show that I'm wrong, if I am.

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USPS/AAPS-T1-12. You refer to the "disproportionately low burden now being borne by Standard ECR" on page 22 line 21 of your testimony.

- a) To what subclass figure(s) is your statement regarding "low burden" intended to refer?
- b) Does your statement apply to the percentage cost coverage of ECR?
- c) Does your statement apply to the unit contribution of Standard Mail ECR?
- d) Confirm that your statement that the cost coverage is "disproportionately low" suggests that other subclasses are shouldering a "burden" that should be borne by Standard Mail ECR. If confirmed, identify all subclasses that are shouldering such a burden.

Response

(a) I'm not sure that I understand the question. I think that the answer is that my statement refers to the institutional cost responsibility of ECR mail.

(b) Yes, but it applies more to the per-piece contribution.

(c) Yes.

(d) Confirmed. Without analyzing every class of mail, which I have neither the time nor the expertise to do, I cannot tell you where the burden falls. It appears that First-Class mailers and OCA believe that First-Class mail shoulders too heavy a burden, compared with Standard A mail.

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USPS/AAPS-T1-13. Who, or what entity, owns Distribution Systems of Oklahoma?

Response

The Oklahoma Publishing Company.

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USPS/AAPS-T1-14. Please provide a list of the members of AAPS.

Response

A copy of the AAPS membership directory is being filed as Library Reference
AAPS-LR-1.

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USPS/AAPS-T1-15. Please provide the per-piece rates that would be charged by Distribution Systems of Oklahoma for the following distributions:

- a. Delivery of a 4-ounce advertising piece (that would qualify for saturation Standard Mail (A)) to all 282,000 houses in your service area.
- b. Delivery of a 5-ounce advertising piece (that would qualify for saturation Standard Mail (A)) to all 282,000 houses in your service area.
- c. Delivery of a 6-ounce advertising piece (that would qualify for saturation Standard Mail (A)) to all 282,000 houses in your service area.
- d. Delivery of a 4-ounce advertising piece (that would qualify for saturation Standard Mail (A)) to 10,000 houses in your service area.
- e. Delivery of a 5-ounce advertising piece (that would qualify for saturation Standard Mail (A)) to 10,000 houses in your service area.
- f. Delivery of a 6-ounce advertising piece (that would qualify for saturation Standard Mail (A)) to 10,000 houses in your service area.

Response

I assume that you mean a flat (not bulky) item that is or is folded to 8 ½ X 11 or smaller.

- a) 7.3¢ per piece
- b) 8.5¢ to 9¢ per piece
- c) 9¢ to 11¢ per piece
- d) 10.8¢ in some areas, up to 13.8¢ in specially requested areas
- e) 12¢ in some areas, up to 15¢ in specially requested areas
- f) 13.5¢ in some areas, up to 17¢ in specially requested areas

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USPS/AAPS-T1-16. For each rate identified in USPS/AAPS-T1-15 (a) through (f), state whether or not the rate can be negotiated with customers, or whether the rate is uniform for all customers. If rates for any categories are not uniform, provide the range of rates for each category.

Response

The rate is negotiated with customers based on weight and upon the identifiable physical limitations of the delivery area due to the geography, topography, the area's lot sizes, and DSO penetration in that area. The range of rates for (b) through (f) are noted in Response T1-15.

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USPS/AAPS-T1-17. Please see your testimony at page 25, line 21, where you mention your "carriers".

- a. Please explain the nature of the relationship between Distribution Systems of Oklahoma and the carriers. For example, are they employees, or subcontractors, or both? If both, what percentage, roughly, of pieces are delivered by employees of DSO?
- b. How are the carriers compensated? For example, are they paid an hourly wage? If so, provide the average hourly wage paid. Or are they paid on a per-piece basis? If so, provide the per-piece compensation they receive for the delivery of i) saturation advertising pieces, ii) phone books, iii) address specific newspapers, and iv) doorhangers.
- c. State whether and how compensation to carriers varies according to the weight of the piece delivered.

Response

- a) They are independent contractors.
- b) Per piece delivered, based upon size, weight and delivery type for each piece. (i) saturation pieces are paid at 5¢ to 13¢ per piece (ii) phone books vary greatly by weight and are paid from 10¢ to 30¢ per book (iii) from 6¢ to 30¢ per piece (iv) 3¢ to 9¢ per piece.
- c) No actual formula is really applicable. Compensation is based on a piece by piece basis, with weight below 5 ounces or above 5 ounces being a break point (for contract purposes) along with the actual dimensions of product itself. Our pay per piece is relative to our overhead in our market. Our overhead is relative to the local real estate costs, salaries, etc.

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USPS/AAPS-T1-21. USPS Please see your response to USPS/AAPS-T1-3(b). Is it your belief that the proposed rate increase for Periodicals, which is based on a markup of less than 2%, is an effort by the Postal Service to exact an inappropriate amount of revenue from mail for which competition has been "eliminated"? Please explain your response.

Response

No. I understand, however, that Periodicals mailers believe that the claimed attributable costs are too high, so that in their view the requested markup is actually higher than 2%.

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USPS/AAPS-T1-22. Please see your response to USPS/AAPS-T1-5(g). Define the "alternatives" to a "strict pound rate."

Response

There is a wide range of possible alternatives to a rate based exclusively on weight, which is what I meant by a "strict pound rate." If by "define" you mean "list," I cannot of course list every conceivable approach, but some that come to mind are ~~a piece plus pound rate~~, a rate based upon pages (which is something of a proxy for weight), a rate based upon a combination of weight and bulk and a rate based upon a combination of weight and volume/frequency.

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USPS/AAPS-T1-23. Please see your response to USPS/AAPS-T1-7(a) where you state that the market will become "less competitive" if the pound rate is lowered. In your opinion, what would happen to the level of competitiveness if the pound rate were increased?

Response

From our perspective, it would become more competitive, by which of course I mean that we could compete more successfully, assuming that the increase is meaningful. Please note, however, that AAPS has not proposed an increase.

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USPS/AAPS-T1-24. Please see your response to USPS/AAPS-T1-9(b) where you state that you have been driven out of the light weight market.

- a. Would a higher per-piece rate increase the level of competition for lighter-weight pieces? Why or why not?
- b. Please confirm that, all else equal, a lower pound rate leads to a higher per-piece rate. If you cannot confirm, please explain.

Response

- a. Yes, assuming that the increase is big enough. As for why, it should be obvious that if our competitor's rate increases, our ability to compete increases as well (as long as the ultimate rate is one that permits competition).
- b. I assume that you are not suggesting that "all else equal" includes net revenues from the pound rate, because if that were held equal a lower pound rate should not affect the piece rate. I suppose that if you hold everything else equal as you suggest, including the volume of pound rated mail and the total revenues from ERC mail, what you suggest follows mathematically.

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USPS/AAPS-T1-25. Please see your response to USPS/AAPS-T1-10(d), where you state your doubt as to whether criterion (b)(4) is relevant in Periodicals since there is "really no competition at this time for periodical delivery..." If delivery of advertising were to become similarly lacking in competition, would it then be appropriate for the Commission to recommend a lower cost coverage for ECR? Please explain your response.

Response

I have not testified about cost coverage and do not claim to understand the interrelationships of the statutory criteria sufficiently to give a strong opinion on the appropriate cost coverage for ECR. To use your "everything else equal" assumption from question 24, it does seem to me that if as I believe criterion 4 might justify a higher coverage than might otherwise be applied, in the absence of any competition there could be a reason to lower the coverage, but I can certainly not say by how much. I can say, however, that if we are driven from our remaining markets as we were driven from the periodicals market, I really won't care what the cost coverage is and my opinion will not be offered in a rate case, because I'll have to be in another line of work.

1 CHAIRMAN GLEIMAN: Thank you, Mr. Straus and thank
2 you, Mr. Todd.

3 Is there any other designated written
4 cross-examination for this witness? Mr. Baker.

5 MR. BAKER: Mr. Chairman, Bill Baker for the NAA,
6 and I am going to hand the witness two copies of his answers
7 to USPS/AAPS-T1-19 and 20 and ask him if we were to ask him
8 those question today, would his answers be the same.

9 THE WITNESS: I believe they would.

10 MR. BAKER: With that, Mr. Chairman, I would ask
11 that the witness' unembellished and unclarified answers be
12 added into the record.

13 CHAIRMAN GLEIMAN: Unembellished, unclarified,
14 with no words struck and with no errant upper case or lower
15 case Bs floating around it. Those Bs come around in the
16 summertime like that sometimes. We have problems all the
17 time here at the Commission.

18 In any event, the two copies having been handed to
19 the court reporter, I will direct that they be transcribed
20 into the record and received into evidence.

21 [Additional Designation of Written
22 Cross-Examination of John White,
23 USPS/AAPS-T1-19 and 20, were
24 received into evidence and
25 transcribed into the record.]

**RESPONSE OF ASSOCIATION OF ALTERNATE POSTAL
SYSTEMS WITNESS WHITE TO INTERROGATORIES OF
UNITED STATES POSTAL SERVICE**

USPS/AAPS-T1-19. Please see your testimony at page 26, lines 1-3 where you state that "you can't say what the effect of weight on costs actually is..."

- a. Are you referring to the costs the Postal Service incurs as weight increases?
- b. What is the effect of weight increases on your costs? What studies and analyses support your conclusion? Please identify the studies by title, author, and date and provide copies.

Response

- a) Yes.
- b) We have to pay our contractors more per piece, as increasing weight requires additional time to restock their bags and deliver their routes and increases their transportation costs. As independent contractors, their automobile costs (gasoline) have nearly doubled for them in the past year, which raises the question, has any consideration been given to skyrocketing fuel costs since the recommendation to lower pound rates in the USPS was submitted in January, 2000?

No formal studies have been funded, nor are they necessary. Apt business practices based on years of delivery experience in each AAPS member's market supports the concept to charge more if it weighs more than your weight limit. Please see my response to Advo/AAPS-T1-19 for the results of an informal study I performed.

**RESPONSE OF ASSOCIATION OF ALTERNATE POSTAL
SYSTEMS WITNESS WHITE TO INTERROGATORIES OF
UNITED STATES POSTAL SERVICE**

USPS/AAPS-T1-20. Please see your response to USPS/AAPS-T1-1(a).

- a) What is a "fair and appropriate share of the product" that you should be able to obtain?
- b) Of what market share information are you privy with regard to products competing with Standard Mail (A)? Please identify such information by title, author, and date.
- c) Provide a copy of each document identified in subpart (b).

Response

- a) I can't quantify it, and I'm afraid that my response might be a bit circular. But the best answer I can give is that a fair and appropriate market share for us is that share that we would obtain when we operate efficiently and the Postal Service's rates against which we compete are in compliance with the law.
- b) My only market share "information" is that alternative delivery has roughly 2-3% of the market for the primary materials we are permitted to and strive to deliver. There is no title author or date for this conclusion. It results from my efforts about a year ago to estimate our market share.
- c) There are none.

1 CHAIRMAN GLEIMAN: Anyone else?

2 [No response.]

3 CHAIRMAN GLEIMAN: If not, that brings us to oral
4 cross-examination, and I guess we are going to break the
5 mold a little bit here. Three parties have requested oral
6 cross-examination of this witness, Advo, Inc., Mail Order
7 Association of America and the United States Postal Service.
8 Is there any other party that wishes to cross-examine this
9 witness?

10 [No response.]

11 CHAIRMAN GLEIMAN: If not, Mr. McLaughlin, unless
12 there is some agreement that changes the order, you are up.

13 CROSS-EXAMINATION

14 BY MR. McLAUGHLIN:

15 Q Good afternoon, Mr. White. I would like to start
16 first just with sort of a general understanding of your
17 operations in the market that you operate in. Now, Delivery
18 Systems of Oklahoma, I guess we can call that DSO, is
19 that the --

20 A Distribution Systems of Oklahoma, DSO.

21 Q Okay. DSO. DSO is a division of the Oklahoman
22 Publishing Company which owns the Daily Oklahoman and Sunday
23 Oklahoman in Oklahoma City, is that correct?

24 A That's correct.

25 Q Okay. And that is the largest newspaper in

1 Oklahoma City?

2 A That is correct.

3 Q Now, on your response to Advo Interrogatory Number
4 2, you identified a couple of other newspapers that are also
5 in the Oklahoma City MSA area, and you list some
6 circulations for them. Can you give us, by comparison, what
7 the circulation is for the Daily Oklahoman and the Sunday
8 Oklahoman?

9 A Not really. I don't work for the Sunday or the
10 Daily Oklahoman, I don't really -- I could probably guess.
11 The publish the amount of circulation on the front of the
12 Sunday paper occasionally.

13 Q Well, if the --

14 A What is it, I might get -- what is it, one -- so
15 what are you saying, the percentage of how those compare to
16 the newspaper there in Oklahoma City?

17 Q Yes.

18 A Well, those are all suburban newspapers, and I
19 believe, if I read the question correctly, that was -- we
20 are not talking about -- okay. Well, I would assume that
21 those are all probably around 10 percent as large, or maybe
22 -- as the daily, I don't know.

23 Q Now, I would like to refer you to your response to
24 MOAA Number 1, which concerns some volume figures that you
25 gave. There you indicated that in 1999, DSO delivered about

1 15.9 million copies of materials that would qualify as
2 saturation mail. Do you see that?

3 A That is correct.

4 Q Does that include copies of -- well, let me back
5 up, first of all, let's just clarify for the record the term
6 Total Market Coverage, or TMC. A TMC is a program whereby a
7 newspaper is able to deliver advertising preprints to
8 subscribers in its newspaper and then uses another vehicle,
9 whether private delivery or mail, to deliver that same
10 advertising to non-subscribers, is that correct?

11 A That's correct.

12 Q And basically, what you provide for the Daily
13 Oklahoman is the non-subscriber TMC distribution for their
14 TMC product, their TMC advertising product?

15 A For the Oklahoman, yes.

16 Q And so you carry inserts to non-subscribers that
17 also are delivered to subscribers inside the newspaper?

18 A There are inserts inside the TMC piece, yes.

19 Q Now, in the case of those inserts that go to --
20 that are carried in the newspaper to subscribers, you carry
21 only to non-subscribers, right? Those don't also go by you
22 to subscribers?

23 A No, sir, just non-subscribers.

24 Q Now, back to the MOAA Interrogatory 1 where you
25 list volumes here of 15.9 million, that was for the entire

1 year?

2 A Yes.

3 Q Now, if I divide that by 52 weeks a year, that
4 averages about 300,000 per week?

5 A That's correct.

6 Q And your circulation is 200,000 to 300,000?

7 A Our circulation --

8 Q Your DSO, what is your saturation circulation?

9 A We do about 300,000 pieces a week, whether it be
10 saturation pieces or TMC pieces, or various things like
11 that.

12 Q Okay. So the 15 million volume figure on an
13 annual basis means one piece per week on average?

14 A No, there could be a number of pieces, if I
15 understand you correctly. It is not just the TMC that I am
16 doing 300,000 of a week.

17 Q Well, now I am somewhat confused. The question
18 asked you for the annual volumes of materials carried by DSO
19 that would qualify as standard mail saturation advertising
20 pieces.

21 A Well, are you saying that TMC doesn't qualify as
22 standard mail saturation?

23 Q No, I am trying to figure out what the figure
24 represents.

25 A That figure represents every -- any time we have a

1 customer who asks us to do a saturation delivery, whether it
2 is 10,000 pieces, 50,000 pieces, or 100,000 pieces, then
3 that is basically all part of that volume. That is our
4 volume for the year, the amount of saturations that we have
5 done, whether they are high density saturation, or whatever
6 else.

7 Q Well, let me ask you this: Does that figure
8 include preprint inserts that are inside the TMC product?

9 A They do not. That is the newspapers. They sell
10 that; we don't.

11 Q Okay, so --

12 A -- on the distribution end.

13 Q Okay, so you interpret materials there as meaning
14 packages that encompass inserts, as opposed to counting each
15 individual piece separately?

16 A A goodly portion of that are packages that have
17 multiple inserts in them. If I were to count every insert
18 in each package, it would likely end up being more than
19 that, yes.

20 Q Can you tell us the volume of inserts that you
21 carry to nonsubscribers that are inside the TMC product?

22 A No, I cannot. That is the -- our client is the
23 Daily Oklahoman and the Sunday Oklahoman for the TMC
24 product.

25 That is proprietary information of theirs and they

1 don't share it with us.

2 MR. STRAUS: Mr. Chairman, the AAPS was asked that
3 question and filed an objection to that question, which at
4 this point has not been -- there's been no motion.

5 [Pause.]

6 BY MR. McLAUGHLIN:

7 Q So what is the average weight of the TMC product
8 that you carry for the Daily Oklahoman?

9 A The average weight on the year is about 8.1
10 ounces, something along those lines, average weight over a
11 52-week period.

12 Q And how much of that is inserts? All but about
13 2.2 ounces?

14 A If you're asking me the average weight of the
15 jacket that the Oklahoman puts on the inserts, I think it
16 ordinarily weighs two to three ounces.

17 I think I might have answered a question along
18 those lines elsewhere in this also. I don't know who asked
19 it, unless you have a copy of it.

20 Q I think that may, have been --

21 MR. STRAUS: ADVO-10.

22 BY MR. McLAUGHLIN:

23 Q Yes, ADVO-10.

24 A Okay.

25 Q Now, in response to ADVO Interrogatory Number 8 --

1 A Eight?

2 Q Yes, ADVO Number 8.

3 A Okay.

4 Q You were asked about the market share of multipage
5 preprints that are carried by DSO and the Oklahoman
6 newspapers, and you objected to that on the grounds that
7 that was proprietary -- I guess, on the grounds that that
8 was proprietary, confidential information.

9 And you were also asked about information about
10 what you're competitors were doing in the marketplace.

11 You mentioned, for example, the Buyers Guide/ADVO.

12 A Where is that?

13 Q ADVO Interrogatory Number 7.

14 A Okay.

15 Q Are you aware of any preprints that are carried by
16 Shoppers or shared mailers in the Oklahoma City market that
17 weigh in excess of one ounce?

18 A Preprints?

19 Q That are carried by Shoppers or shared mailers in
20 Oklahoma City?

21 A No, not really. I couldn't say I'd be a great
22 source for you, but no.

23 Q Are you aware of any preprints in excess of one
24 ounce carried by DSO that are part of the Daily Oklahoman
25 TMC program?

1 A There are inserts in Express Line that are in
2 excess of one ounce.

3 Q Now, your response to the UPS Interrogatory Number
4 20.

5 MR. STRAUS: Excuse me?

6 MR. McLAUGHLIN: USPS Number 20, excuse me.

7 MR. STRAUS: They reach far and wide, but not this
8 far.

9 MR. McLAUGHLIN: Yes.

10 THE WITNESS: Number 20, USPS?

11 MR. McLAUGHLIN: I always worry about
12 spell-checking my briefs for that term, for fear I won't
13 catch that one.

14 BY MR. McLAUGHLIN:

15 Q You were asked about the market share of private
16 delivery, and there you give an estimate that alternate
17 delivery has roughly a two- to three-percent market for the
18 primary materials we are permitted to carry.

19 Are you familiar at all with the Shoppers
20 publication industry?

21 A Somewhat. I mean, not deeply.

22 Q What percent of Shopper publications are privately
23 delivered?

24 A I have no idea.

25 Q You have no idea?

1 A [No response.]

2 Q Was this two- to three-percent estimate for the
3 market of ultimate delivery; was that your estimate?

4 A Yes, sir.

5 Q Did you consider the share of the market of
6 Shopper publications when you made that estimate?

7 A That two to three percent was basically just going
8 through the AAPS members that listed the amount of
9 households that they deliver, un-duplicated, in a week, just
10 some quick math.

11 And I took those total households and compared
12 that figure to the amount of households in the country. I
13 don't even remember what that figure was. I'm sure I asked
14 somebody in the marketing department.

15 And that's basically a figure I arrived at. There
16 is no scientific basis on it at all, other than the fact
17 that I was trying to be as agreeable as possible and give
18 you something.

19 Q But by market share, you're talking about how only
20 two or three percent of households in the country receive
21 privately-delivered products?

22 [Pause.]

23 A I'm sorry, I still don't understand your question.
24 Are you saying as far as how many households in America?

25 Q I thought you explained that your two to three

1 percent share was based on a count of the number of
2 households or circulation of AAPS members compared to the
3 total households; is that what you said?

4 A I took what saw in the AAPS, what they listed,
5 and, you know, I should say that they can say what they want
6 to say.

7 That is, there's no study that's been done,
8 there's no proof of how many households they actually do.
9 That's just what they list at the time when they join the
10 Association.

11 Q So it's your estimate that only two to three
12 percent of the households in the country receive private
13 delivered material?

14 A No, just AAPS households.

15 Q Just AAPS members' households?

16 A That's all I could probably -- and, once again, we
17 don't fund any studies or do anything of that nature to
18 ascertain that information.

19 Q Is ADVO a member of AAPS?

20 A AISOP; is that what you said?

21 Q Is ADVO a member of AAPS?

22 A Oh, ADVO. No, not the corporate ADVO. I think we
23 have one company in Kentucky, the Door Store, that --

24 Q And is the Door Store owned by ADVO?

25 A I believe they are.

1 Q Do you have any idea of what percentage of ADVO's
2 total shared mail packages are delivered by private
3 delivery?

4 A No, I have no idea.

5 Q So you wouldn't know whether it's more than the
6 two to three percent that you list here as the total market
7 for AAPS members?

8 A No, I would not know that.

9 Q What is, by these same criteria, what is DSO's
10 market share in Oklahoma City?

11 A Market share compared to what?

12 Q Share of the market?

13 A No. We deliver 282,000, we can deliver 282,000
14 unduplicated households.

15 Whatever percentage that is I am not sure. We
16 don't always do that. Depends on if we have clients who
17 want to deliver to that many households.

18 We are capable of delivering 282,000 households in
19 Oklahoma City.

20 Q And 210,000 of those are nonsubscriber households?

21 A The Express Line on average in the years about
22 210,000.

23 Q Okay, so then there are about 72,000 subscriber,
24 presumably subscriber that are not included in the 210,000?

25 A I believe there's probably close to 400,000

1 households in Oklahoma City metro area, 385,000 or something
2 like that.

3 I would have to get my hands on that information.
4 You may have it. I am talking about the Oklahoma City metro
5 area, SMSA.

6 Q Well, maybe I am a little confused here. You did
7 not deliver to the entire metropolitan area. You have just
8 portions of the area that you deliver to, is that correct?

9 A Well, that's correct. There are some areas that
10 are less desirable than others and we don't have requests
11 for, so we don't -- we have not developed delivery into some
12 areas for Oklahoma City.

13 Q You have a standing distribution of roughly
14 210,000 that is used for the --

15 A We have routes designed.

16 Q -- the newspaper TMC product that goes to
17 nonsubscribers?

18 A Yes.

19 Q Does the 282,000 figure that you gave, does that
20 include that same geography as the 210,000 nonsubscriber
21 distribution? That is what I am asking you.

22 A No. There are some areas, some rural areas that
23 receive TMC also -- well, you are saying -- okay -- of the
24 282,000 households that we cover there are some areas
25 outside of Oklahoma City that receive The Oklahoman or the

1 TMC product via our circulation department -- excuse me,
2 Daily Oklahoman circulation department.

3 Our is the distribution department.

4 Q Okay. Let me just understand this. You do
5 deliver sometimes to both subscriber and nonsubscriber
6 households, or do you never deliver to subscriber
7 households?

8 A Yes, we will -- if there is a subscriber in that
9 household, we will deliver to them if we have a client who
10 wants to go to that household.

11 Q But that client would not be the newspaper TMC
12 program?

13 A That is correct.

14 Q Okay. Turn to Advo-5, please.

15 The question asked you, the total volume of
16 preprints delivered by DSO, how many were distributed only
17 to nonsubscribers of the Daily Oklahoman newspaper, and an
18 objection was filed but you did give an answer that a rough
19 estimate would be a little more than half are distributed to
20 nonsubscribers.

21 Were you there talking about preprints?

22 A Are you talking about (a)?

23 Q No. Question (b).

24 A (b) -- okay. I believe I understood that question
25 to say how many of the total volume that we deliver how

1 much -- in saturation, how much of that is Total Market
2 Coverage products for the Oklahoman?

3 Q Well, the question asked about the total volume of
4 preprints distributed by DSO.

5 A Well, once again I don't know that and I don't
6 have privy, I am not privy to that information. I don't
7 know the preprints -- the preprints that are delivered by
8 DSO are inside the Express Line, which is the TMC product
9 sold by the Daily Oklahoman.

10 Q And you have no idea what the number of those
11 preprints is?

12 A No.

13 Q Well, what is this answer that you gave to what I
14 thought was the question concerning preprints? It obviously
15 doesn't relate to preprints. What does it relate to?

16 A I basically -- just the volume of our saturation
17 deliveries that we make in the period of a year,
18 approximately a little more than half of them are, would be
19 Total Market Coverage, probably I am going to say 60, an
20 even 60 percent.

21 Q Now when you say saturation deliveries, is that
22 distinct from the weeks where all you deliver is to
23 nonsubscribers?

24 A Yes. There's hardly a week goes by when we don't
25 do some type of saturation deliver in some portions of the

1 city. Obviously if we do 300,000 we have to when there is
2 only 210,000 on average.

3 Q I would like to refer you to your response to Advo
4 Number 12 where you have a rate card. You have an
5 attachment there to Advo-12 and I am looking at the second
6 page of the attachment.

7 A I don't have a copy of that rate card.

8 Q There was an attachment to your interrogatory
9 response, unless I got it by accident.

10 A I had one in my file -- this one, okay. Okay, I
11 have it now.

12 Q Okay. Really I just want to make sure I
13 Understand what it says here. Up in the very top left there
14 is a block that says Saturation Delivery.

15 A Okay.

16 Q And it says that this is for delivery along with
17 the Express Line publication and delivered solo to other
18 households, so in other words this is where you would
19 deliver to all households, part of it being along with the
20 TMC product, is that correct?

21 A That is just to make it clear to any advertiser
22 that does business with distribution systems that there are
23 other things going to be going to the door along with their
24 saturation piece.

25 Q Okay.

1 A Yes.

2 Q And you show a rate for larger circulation of 7.3
3 cents per piece. Do you see that?

4 A Over 150,000 pieces, right.

5 Q Right. Now that is a rate that applies if it is
6 going by your company or by DSO, excuse me --

7 A By DSO.

8 Q By DSO --

9 A This is our rate card --

10 Q -- to all --

11 THE REPORTER: This is our rate card?

12 THE WITNESS: What's what I said. This is DSO's
13 rate card and ours alone.

14 BY MR. McLAUGHLIN:

15 Q Now the preprints that appear inside the TMC
16 product, they don't pay this rate, do they?

17 A No.

18 Q Do you know if their rate is lower than that rate?

19 A Well, the TMC portion that we deliver? It's not,
20 it's not based on per piece inside the newspaper's jacket
21 there. It is based on the package itself, so it is a per
22 delivery based on the TMC alone.

23 These rates right here are saturation rates based
24 on whether it is an individual insert or individual piece,
25 could be --

1 Q So if you had a half ounce piece that wanted to be
2 delivered by you, it would go at the \$73 per thousand rate?

3 A If there were 150,000 or more of them, yes.

4 Q And if they wanted to go to the newspaper and have
5 the newspaper carry the subscriber portion and you carry
6 just the non-subscriber portion it would not be this rate
7 that they would pay?

8 A That's correct.

9 Q Do you have any idea whether the rates they would
10 pay for that kind of distribution through the newspaper
11 would be substantially lower than these rates?

12 A I don't have the newspaper's rate card to be able
13 to answer that.

14 Q Okay. I would now like to refer you to the
15 Library Reference you filed. It was AAPS Library Reference
16 Number 2, which were two copies of the Express Line TMC
17 publication that you deliver.

18 Do you happen to have copies of those?

19 A I don't have the actual copies.

20 Q Okay.

21 A I have the information you provided to Mr. Straus
22 regarding this.

23 MR. McLAUGHLIN: Mr. Chairman, I am going to be
24 handing the witness a cross-examination exhibit that I
25 provided to Mr. Straus, I believe it was yesterday. And

1 this is just a description of the contents that are inside
2 the Express Line Total Market Coverage product.

3 I have marked this as Advo Cross-Examination
4 Exhibit Advo/AAPS-XE-1.

5 [Cross Examination Exhibit No.
6 Advo/AAPS-XE-1 was marked for
7 identification.]

8 MR. McLAUGHLIN: Basically, this exhibit has --
9 first, Mr. Chairman, I would ask that this be included in
10 the transcript so that people can follow it. I do intend to
11 request that it be received into evidence. I don't know
12 whether it is appropriate to do that now or after I ask a
13 few questions about it.

14 CHAIRMAN GLEIMAN: I will direct that it be
15 transcribed now. It is up to you when you ask --

16 [Cross Examination Exhibit No.
17 Advo/AAPS-XE-1 was transcribed into
18 the record.]

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Contents of "Express Line" Issues in AAPS-LR-2

<u>June 14, 2000 Version</u>		
	<u>Weight</u>	
Total package	9.1 oz.	
Express Line	2.2 oz.	
Total Inserts	6.9 oz.	
<u>Individual Inserts *</u>	<u>Weight</u>	<u>Pages</u>
Buy For Less	0.7 oz.	8
Southwestern Bell	0.3 oz.	1
Papa John's	0.2 oz.	1
Mardel	0.7 oz.	8
Walgreens	1.5 oz.	20
Mayfair Market	0.7 oz.	4
Wards	0.7 oz.	4
Michaels	0.6 oz.	4
Albertsons	0.5 oz.	4
Homeland	1.4 oz.	12
Total All Inserts *	7.3 oz.	
Total # of Inserts	10	
Average Insert	0.7 oz.	6.6

<u>June 21-22, 2000 Version</u>		
	<u>Weight</u>	
Total package	3.8 oz.	
Express Line	2.2 oz.	
Total Inserts	1.6 oz.	
<u>Individual Inserts *</u>	<u>Weight</u>	<u>Pages</u>
Cross Road Chrysler Plymouth	0.2 oz.	1
Little Caesars Pizza	0.2 oz.	1
Albertsons	0.6 oz.	4
Homeland	0.7 oz.	8
Total All Inserts *	1.7 oz.	
Total # of Inserts	4	
Average Insert	0.4 oz.	3.5

* Note: Weights are rounded up to the nearest 0.1 ounce. Totals may not equal due to rounding.

1 MR. McLAUGHLIN: Okay. This was --

2 THE REPORTER: Do you have two copies?

3 MR. McLAUGHLIN: Oh, I am sorry.

4 BY MR. McLAUGHLIN:

5 Q Basically, what I did is took the Library
6 Reference that you filed and weighed them on my Postal scale
7 which obviously may not be entirely accurate, and I believe
8 Postal scales typically weigh up to the next tenth of an
9 ounce, as opposed to rounding down, unfortunately. So, if
10 you look at the total weights I show there, and then you
11 look at the individual insert weights, when you add them all
12 up, there is a difference which I believe is probably due to
13 rounding.

14 Have you had a chance to look at this exhibit
15 which identifies the packages by total package weight and
16 the insert weight, and the individual inserts and their
17 weights?

18 A I have looked at this exhibit, yes, and I was the
19 one that sent the packages in that you had requested for
20 those two particular dates in June.

21 Q Does this look accurate to you? Is there anything
22 that looks inaccurate in terms of the figures that are shown
23 there?

24 A I would clarify one thing, the particular package,
25 I should state that the particular packages, we, on our TMC

1 product that we deliver, there are 50 to 100 versions of the
2 package itself, they are microzoned. If there is 50 or 75
3 or a hundred versions that week, it is quite possible they
4 could weigh 3.8 ounces, which is the total weight you have
5 there for the June 21-22 version. It could -- there were
6 packages that day, I called back to Oklahoma this morning
7 just to verify it, there were packages that day that weighed
8 almost seven ounces in various parts of the city, and
9 six-and-a-half, and overall, in fact, the individual I was
10 talking to said you couldn't have went out to your warehouse
11 and picked a worse example. If you were looking for
12 something, you wanted it to be a little heavier. And I said
13 I didn't really know and care at the time, I just wanted to
14 give you the example of the date that you wanted.

15 Q Yeah. No, I don't have any problem. It did occur
16 to me that the June 21-22 version was substantially below
17 your average weight, is that correct? The average weight --

18 A In fact, almost all in June generally will be,
19 June is a particularly light month

20 Q Okay. But the June 14th is a more typical issue,
21 I take it?

22 A Yeah, and I would guess that is because it is a
23 mid-month issue like that on a pay period.

24 Q Now, I take it that the various pieces that are
25 shown here, the individual inserts, most of those are less

1 than one ounce, is that correct? There are some over one
2 ounce.

3 A Yeah, there are only two on the June 14 that are
4 over an ounce.

5 Q Okay. And there are also a number of -- well, I
6 shouldn't say number, there are several single page sheets
7 such as Papa John's Pizza, a circular that is just a single
8 page printed on both sides, is that correct?

9 A Uh-huh.

10 Q And that is -- by my scale it weighed two-tenths
11 of an ounce, but that could be 1.1 -- I have got .11 ounces.

12 A We don't weight them individually, so I couldn't
13 tell you. I will take your word for it.

14 Q And none of these pieces would pay the \$73 per
15 thousand rate that you charge for -- that you show on your
16 rate card, is that right?

17 A Not as long as they are in that TMC product. They
18 would if they weren't.

19 Q All of these are based on the newspaper rates, is
20 that correct?

21 A Whatever the newspaper sells those for and inserts
22 those into the TMC package, that's correct.

23 Q Do you have any idea of the range of rates that
24 they charge?

25 A No, sir.

1 Q Do you know whether they could charge as little as
2 \$20 per thousand or two cents for this kind of an
3 advertisement, the Papa John's single page flyer?

4 A I don't know what they charge for it. I would
5 think it is probably -- I think ordinarily in the industry,
6 I see, because, obviously, -- let's face it, the Oklahoman
7 is one of our largest, if not our largest competitor in our
8 market, and so it is helpful to know what they charge. My
9 guess is something like that is going to run probably
10 \$25-\$30 a thousand.

11 Q You mentioned the Oklahoman as your competitor.
12 The owner of the Oklahoman, you are division of, is that
13 correct?

14 A That's correct.

15 Q Are you familiar with a company called
16 Albertson's, it is a grocery store?

17 A Yes, sir.

18 Q Albertson's is a customer of the newspaper, isn't
19 it?

20 A That is correct.

21 Q They are a preprint insert customer of the
22 newspaper?

23 A Yes, sir.

24 Q Do you go to that customer and offer them a lower
25 rate to be distributed in DSO than the rate that the

1 newspaper charges their customer?

2 A I would in a Washington, D.C. minute if I had a
3 lower rate to give them.

4 Q You simply can't beat their rate, is that what you
5 are saying?

6 A No. I can't beat Advo's for those either.

7 Q But you carry the Albertson in your distribution,
8 is that right?

9 A If it is in the TMC package that we deliver that
10 particular week, and as I see here, both those weeks it is.
11 I assume that they must be on some type of a frequency
12 agreement and they are in there regularly. I don't
13 ordinarily go through and look at which inserts are there
14 that particular week.

15 Q Well, the fact is is that you do carry lightweight
16 preprint inserts in the package that you deliver, is that
17 right?

18 A There are lightweight inserts in that package,
19 yes. It is sold by the Oklahoman and not by us.

20 Q I have some questions now on page 25 of your
21 testimony in response to Advo Number 17 where you discuss
22 the effect of weight.

23 MR. STRAUS: Wait a minute. There was a reference
24 to the testimony?

25 MR. McLAUGHLIN: Page 25, and to Advo-17. It

1 might be easiest to just turn directly to Advo-17, since
2 that's where I have my questions.

3 BY MR. McLAUGHLIN:

4 Q Basically, the example that you gave of an
5 increased cost due to weight, was an instance where the
6 weight of the product you were carrying went from 7.5 to
7 eight ounces; is that correct?

8 A That's on average for the year, yes.

9 Q Okay. And we then ask you for some information
10 about your route system. And you indicated that a route, on
11 average, has 700 households that you deliver to?

12 A That were capable of delivering to. We may not go
13 to every household on that particular route that week,
14 unless we're asked to by saturation advertisers.

15 Q Well, I didn't quite understand it that way. If
16 you look at your response to Number A, down toward the
17 bottom of that first page of your response, you say the
18 average used to compute this example was 50 percent, meaning
19 that was the penetration.

20 A I might have confused you just with the answer I
21 gave you here live. I don't know.

22 What you're asking here, I believe, was the -- or
23 the example that I used here was for Express Line only, one
24 product, one item, based on that, not all the products we
25 deliver.

1 I just took one item that I knew that I had the
2 weight of for 52 weeks.

3 Q Okay.

4 And for that Express Line product, the average
5 carrier route that you have has 700 households that receive
6 the Express Line product?

7 A Approximately half of them, as a rule of thumb.
8 There are 700 households -- wait a minute.

9 I'm sorry, there are 1400 households, you're
10 right; 700 Express Line households out of 1400.

11 Q Okay.

12 A I'm looking at that total, and yes, there is a
13 total of 1400 households on there, excuse me.

14 Q Okay. So you make deliveries -- a carrier makes
15 deliveries on that route to 700 households?

16 A At a minimum.

17 Q But in your example, it was 700?

18 A Yes.

19 Q And you indicate that on average, the carrier
20 parks and restocks about 20-30 times each delivery day.

21 Now, by parking and restocking, is that like what
22 the Postal Service would call a loop? You have 20-30 loops
23 per day?

24 A Yes, but we don't call them loops. I don't know
25 -- we don't really have a term for them, but I use loops,

1 just to try to be able to compare and give you some
2 apples-to-apples.

3 Q Right, and basically a loop can be different
4 things: It can be walking up one side of the street and
5 then coming back down the other side; it could be going
6 around the block or --

7 A Straight down a street and straight all the way
8 back.

9 Q And usually the idea is that you start at the
10 vehicle, you make deliveries all the way around, and
11 eventually make deliveries all the way back to the vehicle
12 again; is that correct?

13 A That is correct.

14 Q Okay. Now, if you have 20-30 loops per day,
15 that's an average of about 25 loops per day or per route,
16 midway between 20 and 30?

17 A Okay.

18 Q Now, if you have 700 deliveries per route and 25
19 loops, I calculate that as about 28 deliveries per loop. Is
20 that --

21 A I believe, from what my distribution manager tells
22 me, when we took a look at this and take a look at it
23 ordinarily from time to time, there's about 30 to 35 Express
24 Line households that a carrier can deliver.

25 Q Okay, well, I did my calculations on 28. I

1 suppose I could try to do them on 30 as well. Let's just
2 use 30 here.

3 A Are you talking about the 20-30 loops; is that
4 what you're talking about?

5 Q You have 20-30 loops, and at an average of 25
6 loops, that works out to about, you said, it would average
7 out to 28 deliveries per loop, and you just mentioned that
8 that could be 30 to 35 deliveries per loop; is that correct?

9 A I actually, on my answer, state that the carriers
10 carry between 20 and 40 Express Line products in their bag,
11 and it's going to depend solely on the weight and dimension
12 of the Express Line that week. I can't say --

13 Tom, that would be an average for the year that
14 you're wanting to work with here.

15 Q I understand that.

16 A Okay.

17 Q Now, 30 deliveries per loop at 7.5 ounces, I
18 calculate it to be -- actually, I did it on eight ounces.
19 Let me just redo that here.

20 [Pause.]

21 I calculate that to be about 14 pounds; does that
22 sound right?

23 A If the product weighed 7.5 ounces, more than
24 likely they would probably be 30-40 in a bag.

25 Q Well, the figure I just gave you was based on 30.

1 A It depends on the physical characteristics and
2 makeup of the carrier.

3 Q Okay. I'm just using the figures you gave for
4 your example.

5 A That's right, but I'm trying to say that in my
6 answer there I used the actual weight over the year and
7 divided it by 52.

8 So, if you hold it literal at 7.5 ounces and eight
9 ounces, then we won't be talking about the same thing.

10 Q Well, but if you're talking about on average over
11 the year, having 30 deliveries per loop, that would give us,
12 at a 7.5-ounce piece, that would be 14 pounds and an
13 eight-ounce piece would be 15 pounds; is that correct for
14 that loop?

15 A If it were a 7.5-ounce piece, and there were 30 in
16 the bag, that would be about 15 pounds.

17 Q That would be -- well, in fact, that would be 14
18 pounds. If you had eight ounces, at 30, would be 15 pounds.

19 A Okay.

20 Q The difference is one pound; is that correct, or
21 two eight-ounce TMC products?

22 A I say that, on average, these weigh 15 to 25
23 pounds in there, so that's -- you're hitting what I said
24 right there.

25 Q Okay, so what you're talking about is the

1 difference per loop is one additional pound when you added
2 that weight; is that correct?

3 A [No response.]

4 Q Going from 14 pounds per loop to 15 pounds per
5 loop?

6 A Ordinarily, to jump that half ounce over the
7 period of 52 -- and you're talking millions of pieces here
8 over a period of 52 weeks -- ordinarily that half ounce,
9 there's going to be some weeks when the product got a great
10 deal larger than it was the weeks before, maybe in that same
11 period of the year.

12 Over the entire year, weight went up seven
13 percent. It may be, Tom, that they walked three or four
14 miles more one week, and no more, maybe a mile less the next
15 week than they did before.

16 We don't do studies like that.

17 Q Well, but you will confirm that, on average,
18 you're talking about one additional pound per loop going
19 from 14 to 15 pounds; is that correct?

20 A [No response.]

21 Q That's what the figures come out to, right?

22 A I can't substantiate that without sitting here and
23 doing more math than you're allowing me to do right now.

24 Q Well, I've tried to be very careful going through
25 these, using your own figures here.

1 A satchel will hold 25 to 30 pounds; won't it?

2 A Ordinarily, the bag weighs 25 to 30 pounds, that
3 is what I've answered.

4 Q So you're talking about a situation where that
5 extra half ounce is one pound increase in weight?

6 A The total weight on there for the year, but if it
7 -- that's -- if that's one pound per loop; is that what
8 you're saying?

9 Q Yes.

10 A That's, I guess -- let's say yes and move on,
11 okay?

12 Q Let's assume -- I assume we could argue about how
13 often that one extra pound is going to be right at the very
14 30-pound limit that causes you to not be able to accommodate
15 two additional copies into that satchel, so that he has to
16 make some extra movements.

17 But I don't think there's any need debating that
18 here.

19 Let's just take the example where maybe the
20 carrier satchel is right at 29.5 pounds, and you get this
21 extra one pound that throws it over to 30.5 pounds, and he
22 can't carry those last two pieces out on that loop; do you
23 follow me?

24 A I see what you're saying, but I don't think it's
25 going to be that perfect a situation.

1 Q Well, okay.

2 A You're asking for an ideal situation, and I'm sure
3 it's from the point you're wanting to make.

4 Q Well, when the carrier then -- let's say he cannot
5 carry those extra two pieces on his loop.

6 If he goes out on his loop and delivers all the
7 rest, won't he be virtually back at this vehicle when he
8 finally runs out of product and has just two extra pieces to
9 deliver at that point?

10 A Ordinarily he's going to -- if it's just two
11 pieces you're talking about, ordinarily he's probably going
12 to try to stuff them in there any way he can, and the extra
13 pound is not going to preclude him from getting around
14 there.

15 When the piece is four or five ounces more and
16 you're talking about a carrier ordinarily gets 30 in his
17 bag, and now all of a sudden, he's talking about 120 more
18 ounces divided by 16, it's five or six pounds, and it's a
19 5'2" female, she is not going to be able to carry that
20 additional weight.

21 Now --

22 Q That's a different hypothetical, though, isn't it?

23 A That's my hypothetical.

24 MR. McLAUGHLIN: I have no further questions.

25 CHAIRMAN GLEIMAN: Mr. Todd?

1 MR. McLAUGHLIN: How can I carry all this stuff?

2 MR. STRAUS: You just wanted a free copy to read,
3 that's all.

4 CHAIRMAN GLEIMAN: It is that extra half ounce
5 that makes it so tough on you, Mr. McLaughlin.

6 [Laughter.]

7 MR. COSTICH: He has to drop his briefcase on the
8 way out the door.

9 CHAIRMAN GLEIMAN: How much does that satchel
10 weigh that you just picked up?

11 THE WITNESS: You look plenty strong enough, Tom,
12 to carry for us, by the way. I think so.

13 CROSS EXAMINATION

14 BY MR. TODD:

15 Q Good afternoon, Mr. White. I am David Todd,
16 posing some questions to you on behalf of the Mail Order
17 Association of America.

18 With respect to your response to MOAA/AAPS-T1-1, I
19 have used and you in turn have used the terms "basic,"
20 "saturation" and "high density" -- just to clarify, are we
21 using those terms in the same manner that the Postal Service
22 uses them?

23 A I would say -- not remembering an exact total --
24 but yes, we generally try to relate it to if we are making
25 between -- obviously a saturation is 100 percent of the

1 households that we go to in that particular area or maybe on
2 that route. We may have a route, yes, that has 100 percent
3 saturation on it. It may be that there's some addresses on
4 that route may be closed, locked out, things like that that
5 we can't get into and so you cannot tell an advertiser you
6 are saturating when you can't get into every address on that
7 route so we will call that high density.

8 As far as it being an exact definition that the
9 post office's is, no, we don't relate it to a postal
10 definition.

11 Q So your use of the term "saturation" means that
12 you would deliver to every address on a given route?

13 A If it is a saturation and we can go to every
14 address on that route, if every address on that route is
15 deliverable, and we have about 1100 routes, if on some of
16 those routes we can go to every address then it is a
17 saturation.

18 Q However, if you are saying that even if one
19 address you couldn't deliver to you would not then call it a
20 saturation?

21 A We would probably term it a saturation but we
22 would certainly inform the advertiser and we are well aware
23 of what areas we cannot go into on any routes, so there
24 might be, you know, a few addresses that for one reason or
25 another we cannot get into, and those are identified to our

1 advertisers.

2 Q Well, if you would refer to your response to Part
3 (c) of that Question 1, you stated that you had zero at the
4 basic rate, and I was using basic rate there as it is used
5 by the Postal Service, what -- I think we should clarify --
6 what is your understanding of my question there?

7 What did you answer zero to?

8 A I answered zero to the fact that we -- I am
9 making the assumption there on that question that what we
10 were delivering would not qualify as something that was a
11 complete saturation or a near saturation, which would be the
12 high density. We don't have an pieces that we deliver that
13 go to smaller numbers than that, and so that was what I am
14 assuming you were asking.

15 Is it not what you were asking?

16 Q If I were to represent to you that you could
17 qualify for the ECR rate with as few as 10 pieces per
18 carrier route at the basic level, would it be your answer
19 that you would not deliver any pieces if there were only 10
20 pieces per route?

21 A No. We ordinarily stick to what we hope to be
22 saturations are pretty much the majority on each route.

23 In other words, if somebody came to us and said I
24 want to deliver 100 to these different routes we wouldn't do
25 that. We don't do that. That is why I am zero.

1 Q Even if they said we are going to deliver five
2 more than 100, but if there were only 10 to 15 pieces per
3 route, you wouldn't be interested in the business?

4 A No, sir.

5 Q Are you aware of what percentage of enhanced
6 carrier route as defined by the Postal Service consists of
7 saturation pieces? What percentage of the ECR mail stream
8 consists of saturation business?

9 A Of the postal routes, of a postal route?

10 Q No. What percentage of the total ECR mail volumes
11 consists of saturation mail as defined by the Postal
12 Service?

13 A No. No, I am not aware of that.

14 Q You are not aware of that? If I were to represent
15 to you that it was only about 50 percent of total ECR, would
16 you agree then that you're only competing for -- against
17 about 50 percent of the mail carried by the Postal Service
18 at ECR rates?

19 A I don't know. I don't have any research on that
20 to agree with you one way or the other and I can't really
21 say. I'm willing to take your word for it, but I am not
22 sure what you are asking me.

23 Q I am asking you to assume that 50 percent of ECR
24 mail is not saturation mail as you have defined it --

25 A Okay. So you are saying high density and

1 saturation is -- does not -- of mail does not make, those
2 two classes of ECR do not make up --

3 Q -- the totality of ECR volumes?

4 A If you have that information and that is the
5 correct information, then I would say yes.

6 Q All right, thank you. In response to that same
7 Question, Part (d), you gave a series of rates based purely
8 on volume and I gather from your first bullet under (d) that
9 that rate would be the same if the piece weighed one ounce
10 or weighed five ounces, is that correct?

11 A Up to five ounces, 4.9. Five or more would be
12 more.

13 Q All right, up to 4.999.

14 A Yes.

15 Q All right. You haven't given any information
16 about your rates for mail at 5 ounces and above, which I
17 believe was encompassed by the question.

18 Do you have data that would provide that you could
19 give to the record about --

20 A I believe I have but I believe it is in response
21 to USPS Interrogatories or somebody's. They had a specific
22 set of questions on various weights, some over 5 ounces,
23 some under 5 ounces and I gave answers to those.

24 MR. STRAUS: Postal Service 15.

25 BY MR. TODD:

1 Q Well, as I read Postal Service 15, we are still
2 only going to 6 ounces.

3 A Okay.

4 Q I ask information -- that's not your maximum
5 weight that you'll carry, is it?

6 A No, we'll carry any amount that is necessary and
7 we will price it accordingly.

8 MR. TODD: Well, I will renew to counsel for Mr.
9 White a complete response to MOAA/AAPS-T1-1.

10 MR. STRAUS: I believe he got a complete response.
11 He got the rate schedule. We provided the rate schedule to
12 Advo. There is no rate schedule for pieces above 5 ounces.

13 Those rates are determined on a case by case basis
14 and so there is nothing else to provide.

15 You did not -- what you asked for was rate
16 schedules.

17 THE WITNESS: Actually, the weight on there says
18 size and weight. All publication product samples must be
19 ordered and can weigh up to 5 ounces without extra charge.
20 After that we pretty much have to price it accordingly.

21 BY MR. TODD:

22 Q So you will meet any price you have to meet in
23 order to satisfy the customer?

24 A We would like to satisfy the customer, if he is
25 accepting of the price, yes, but I don't know what that

1 price is.

2 If you want to give me some examples perhaps --

3 Q No, actually I would like some examples from you.

4 We have a fact that at 150,000 pieces you have
5 given certain rate levels --

6 A That is correct.

7 Q -- which vary fairly substantially.

8 A You would like to know why they perhaps -- you ask
9 the question. I'll answer it. I am not going to ask it.

10 Q Well, let me ask it in two parts.

11 First of all, you give a rate range --

12 A Yes, sir.

13 Q -- of 7.3 to 10.3 cents even though a quantity is
14 presumably identical.

15 What determines the weight range within a given
16 quantity?

17 A The rate range or the weight range, did you say?

18 Q The rate range.

19 A The rate range? The 7.3 to 10.3, since you are
20 using that as the example, there's two bullets, actually
21 there's three bullets below that. The second bullet, rates
22 based on customized delivery areas according to geographic
23 and demographic needs, and to give you an example, in each
24 market and alternate, and I would like to point out that we
25 haven't talked much about the industry of alternate delivery

1 today but we have talked a lot about Oklahoma City and DSO,
2 but the actual, each market is customized basically
3 according to the needs of that market.

4 In Oklahoma City we are the second largest land
5 mass of any city in the country. We are very spread out.
6 When we have advertisers come to us and want us to do a
7 saturation what I can do at 7.3 over here may be 10.3 in
8 this area, 9.5 there. We may have to blend a rate up for
9 them, so you asked for a range. I gave you a range -- 7.3
10 to 10.3 is an ordinary range for 150,000 pieces.

11 It might fall at it's 9.2 cents, 9.3, 9.1, 8.6 --
12 whatever. It depends on where it is going to go in Oklahoma
13 City because our carriers obviously if it is one acre lots
14 or if they are small row houses, it really depends on that.

15 That 7.3 will get you row houses all day long,
16 where all we have to do is pop in and out.

17 Q So you simply, you deal with each of your
18 customers on an individual basis?

19 A We roll all our costs into it. We put on a
20 profit, what we feel like we need to make on it, and then --

21 Q You give each customer the best price you can give
22 them that will get the business? -- I'm sorry.

23 A Okay. We basically take all the costs that we
24 have, whether applied in our market, real estate, utilities,
25 everything, go in all our costs, and then we put on, yes, a

1 profit that we need to make on that particular delivery that
2 makes it worthwhile for us, and then we come out with the
3 rate per piece and that is what the advertiser will get.

4 That is ordinarily how it is done.

5 Q Would the desirability of keeping a given customer
6 happy who is a long-time customer, would that enter into
7 your final rate decision for someone?

8 A We have stated on our rate card that we will offer
9 a frequency discount if someone wants to do delivery with us
10 monthly. If someone came to me and wanted to do the same
11 delivery in the same area over and over every week,
12 certainly we could accommodate something for them. That's
13 pretty basic.

14 Q So you are able to meet customers' needs as long
15 as you can cover costs and make a profit?

16 A That's correct.

17 Q In response to both Questions 2 and 3, you stated
18 that you neither have nor requested any rate information
19 from members of the association.

20 In some earlier questions today you did look over
21 their volumes. You were able to give some volume estimates
22 for other members of the association but I take it no rates?

23 A They don't publish rates in our membership
24 directory nor do we any study. There is no one -- there is
25 no one entry into the association to be able to buy several

1 markets.

2 In fact, many of our members are competitive with
3 each other. In Chicago alone our biggest competitors are
4 each other. We have got five alternate delivery companies in
5 Chicago that are all members of AAPS. There are several in
6 Minnesota in the Minneapolis area, so they are not
7 inclined -- in other words, they are just not inclined to
8 share information with us because they have their own
9 competitors in our association.

10 I stated earlier today that Advo, there is an Advo
11 company that is owned by Advo in our association also.

12 Q Do you believe that the rates that you charge are
13 representative and typical of what is being charged by other
14 association members?

15 A The rates that I charge in Oklahoma City?

16 Q Yes.

17 A I have heard higher rates than mine and I have
18 heard lower rates than mine.

19 Q Referring your attention to MOAA-7, the final
20 sentence you state, "Therefore, it follows that our rates
21 must take into account or use as a guide the rates charged
22 by the Postal Service." Do you think the same is true of
23 the Postal Service?

24 A What, that they into account our rates?

25 Q Or that they should if they are going to be

1 competing in that market?

2 A I am going to say that through -- you know, just
3 recently I was contacted by SAI, Strategic Analysis, they
4 have done a study on alternate delivery that has been
5 sponsored by the Postal Service for several years running.
6 I would say if you are privy to that information, which I
7 have not ever been allowed to, that you might check that and
8 that would probably give you a lot of information.

9 Q That really wasn't my question. My question is,
10 you state that as a matter of business reality, paraphrasing
11 your answer, you have to take into account the rates charged
12 by the Postal Service, is that an accurate paraphrase?

13 A I have to. I am forced to because my customers
14 tell me what the Postal rate -- what the Post Office
15 charges. So, yes, they confront me every day with this is
16 what I am paying in the Post Office. Can you do it for
17 this, or this or this?

18 Q And you regard the Postal Service as a competitor?

19 A Certainly.

20 Q And doesn't it follow, therefore, that the Postal
21 Service as a competitor must take into account the rates
22 that you and other similarly situated alternate delivery
23 companies charge?

24 A I believe they are, yes.

25 Q On what do you base that belief?

1 A On the fact that they have studied the alternate
2 delivery business since 1994, year after year, with study
3 after study. And that information, I believe, is in some
4 other testimony. I don't know if I can put my finger right
5 on it as far as the fact that they have actually studied the
6 effects of the Postal rates basically on alternate delivery,
7 and looking for -- wait a minute, what was it, the
8 advantages or what? I don't know.

9 Q Assume that they have done that, is there anything
10 inappropriate about that?

11 A Is there anything inappropriate about it?

12 Q Inappropriate, yes.

13 A I believe there is, yes. I believe we are in a
14 very competitive situation here, and we are dealing with the
15 Postal Service that has inherent advantages built in all
16 over it. I don't know if we are going to take up the
17 Commission's time and everybody else's today by going into
18 all of those. But with the fact that the mail box is one
19 advantage, and the monopoly in some areas is one advantage,
20 and the fact that there is statutes out there that preclude
21 us from delivering 82 percent of what is in the Postal
22 stream is a heck of an advantage.

23 There are a lot of advantages that the Post Office
24 has. And the effects on alternate delivery in our industry
25 are borne out in the fact that many times, we have been hurt

1 by changes in things that have happened at the Postal
2 Service that have bettered them.

3 One that I point out all over my testimony is
4 magazines. That used to be an alternate delivery, and they
5 are no longer because of the rates being lowered for the
6 larger distributed magazines. So, yeah.

7 Q That really wasn't my question, Mr. White.

8 A Okay. I'm sorry.

9 Q Mr. White, we can all discuss, and perhaps you can
10 discuss, even though it wasn't the question, what advantages
11 or disadvantages the Postal Service may have. I suppose one
12 competitive disadvantage is their rates are, of course, open
13 to the world, including you. Wouldn't you agree that that
14 was a competitive advantage to you?

15 A I don't particularly concede that their rates
16 being out there are just a huge advantage, but it is
17 helpful. How would it not be helpful to not know what your
18 competitor is charging? I think that is an advantage.
19 Okay.

20 Q To you and other alternative delivery, they know
21 what they are charged. You know what the Postal Service
22 charges. There isn't any mystery about it, is there? You
23 don't have to do any industrial espionage, it is all part of
24 a public document, is that correct?

25 A You have to do some math, but, yes, correct.

1 Q I am asking you, therefore, is it your position
2 that, because of what you consider to be certain advantages
3 the Postal Service has, that it should ignore the
4 competitive realities that it faces?

5 A I don't believe I have taken a position on that in
6 any of the questions I have been asked. If I have to answer
7 that question, say yes or no, I am going to say that we have
8 some advantages. Just like any sales and competitive
9 situation, we try to look for our advantages. And if we
10 know that a competitor is charging X amount, and generally
11 that X amount comes not from our math or anything. I don't
12 have a Postal rate card, I don't refer to that. My rates
13 are posted out there, too. The Post Office, all they have
14 to do is call me and they get a rate card, they can see my
15 rates. Is that not an advantage for them? I don't know.

16 Q Well, Mr. White, it really wasn't my question.

17 A Okay.

18 Q My question was, without necessarily agreeing with
19 you as to the competitive advantages that you have in an
20 earlier response listed as belonging to the Postal Service,
21 but even if we simply take as an assumption your belief that
22 these are competitive advantages, does it flow from that
23 that the Postal Service should ignore competitive realities
24 in pricing its product? Is that your position?

25 A They cannot -- basically, what they can't ignore

1 is the effect on businesses like mine of what they -- how
2 they price, because of those advantages that are built in.
3 Okay. So the answer is we don't have any particular
4 advantages that go beyond the advantages that they have. If
5 I get to see their price and I know what their price is, I
6 can use that to my advantage, and I will, and that is all I
7 am saying.

8 Q And as far as your testimony is concerned, all we
9 have today about product prices is your company's, that is
10 all you have offered in your testimony, is that correct?

11 A As I say, it is not posted. We are not in a
12 situation where we have any studies or any need to study the
13 average rate or the rates. You can't come into the -- AAPS
14 is an association. You can't go to me and buy 50 markets.

15 Q So the answer is yes, the only data that you have
16 provided in your testimony concerns DSO in terms of prices,
17 is that correct?

18 A That is correct. And those were all the questions
19 I was asked, yes, so I answered as regarding DSO.

20 Q Why do you have a flat rate for pieces up to five
21 ounces?

22 A Why do we have a flat rate for pieces up to five
23 ounces? Basically, we have to -- our carriers are
24 independent contractors, and we have to show them -- we have
25 to basically set up by contract for our carriers, number

1 one, first and foremost, we have to give them -- we have to
2 draw a line somewhere for them, so if weight does begin
3 going up, and they do know they are going to be carrying
4 heavier products, then they need to be compensated more for
5 them because it is going to take them more time to deliver
6 them.

7 Q But your costs aren't uniform between one or five
8 ounces, or are they?

9 A If it up to 4.999 ounces, then the costs are what
10 is on our rate card. And then again, once again, our rate
11 card is based on the geography, the demographics, all the
12 other things go into it.

13 Q Just, I may have asked this inartfully, I am not
14 talking about the rate you charge the customer, I am talking
15 about DSO costs. Are DSO's costs essentially uniform
16 between zero and five ounces?

17 A Oh, does it cost me any more to deliver it if it
18 is two ounces or four?

19 Q How much does it cost you?

20 A On a weight basis, no. On a dimension basis, it
21 possibly could. We may charge more if it is a larger
22 dimension. Dimension has as much to do with weight as
23 anything else, as far as being how many carrier can -- yeah,
24 if it is a roll of toilet paper, obviously, it is lighter
25 than something that is -- laundry detergent. There might be

1 some laundry detergent you can carry more of. Maybe they
2 are a little heavier, but you can carry more of them, they
3 are smaller. So, the dimensions have a lot to do with it.

4 So, you know, when I am rolling through this, I am
5 not trying to be, you know, vague to you. What I am saying
6 is there is no one thing we can say, gee, that is 7.3 or
7 whatever else. It is, once again, we have to see the
8 product. We have to be able to determine how much it is
9 going to cost us, then we add our profit to it, and then we
10 deliver it.

11 Q Well, let's go back to this. Let's keep the basic
12 shape of your pieces uniform for the purpose of this
13 question, so that we are not talking about rolls of toilet
14 paper and perhaps flat pieces.

15 A Okay. Okay.

16 Q And I am not talking about the rates you charge
17 your customers, I am talking about DSO costs. And my
18 question is, is it your testimony that between zero and five
19 ounces, your costs do not significantly vary by weight?
20 Your costs, not your prices.

21 A Okay. I am going to clarify something and I think
22 I can answer your question. If it is, say, and 8-1/2 by 11
23 12 page piece and an 8-1/2 by 11 18 page piece, one weighs
24 two ounces, one ways three ounces. Those are going to cost
25 us about the same to deliver.

1 Q And that would be true between zero and five
2 ounces also, right? Again, same shape, same piece, same
3 basic appearance, a different weight.

4 A If there were going -- I'm sorry, if they were
5 going to the same place. If they were going to the exact
6 same place. If they were going to be delivered in the
7 different areas of Oklahoma City, the cost to me would
8 change, I would pay more to the carriers.

9 Q But again, same place, same route, no significant
10 difference in cost to do so?

11 A That's correct.

12 Q Thank you.

13 Could you please refer to USPS Question 2?

14 [Pause.]

15 I'm sorry, wrong reference, Question 3.

16 [Pause.]

17 Are you aware that there are -- this is
18 specifically your Part A, the Question Part A of the
19 Question and your response to Part A.

20 [Pause.]

21 You were thinking of non-saturation portion of
22 Standard A, the address-specific material that the Postal
23 Service will not permit us to deliver unless we pay the
24 postage.

25 Are you aware that much material in Standard Mail

1 ECR consists of catalogs, and do you know what the
2 definition of a catalog is?

3 A Twenty-two pages, bound and a minimum of 24 pages,
4 a minimum.

5 Q That's awfully close to the definition. Are you
6 aware that those catalogs may be delivered outside of the
7 Postal Service without payment of postage?

8 A On an address-specific basis?

9 Q Yes.

10 A As long as they're over 24 pages, that was always
11 the Postal statute that we abided by. We delivered catalogs
12 before they were taken away from us, like magazines were.

13 Q And they were taken away from you, not because you
14 can't deliver them, right? You can deliver them without
15 paying postage?

16 A Catalogs came through the companies that went
17 under when magazines went under. We didn't get catalogs
18 straight from Lillian Vernon.

19 But we did Lillian Vernon catalogs, and they went
20 through Publishers Express or APD. I can't remember.

21 But, yes, we delivered catalogs that were over 24
22 pages, and we were allowed to deliver them, whether they
23 were standard, whether they were periodical class. We would
24 deliver them.

25 But when the magazines dried up, the catalogs

1 dried up.

2 Q Would you be able to deliver catalogs at your rate
3 schedules, let's say, a four-ounce catalog where at least
4 150,000 pieces were offered, but there were only ten
5 catalogs per your carrier route?

6 A I do address-specific catalogs over 24 pages, and
7 my address-specific rates are on my rate card, the rate card
8 that's on file there.

9 And those rates are listed there. Actually,
10 they're going up. My advertisers don't know, but I'm having
11 a rate increase this year. But don't tell anybody.

12 Q Referring your attention to USPS 15 and 16 --

13 [Pause.]

14 Would you agree that your ability to negotiate
15 prices with individual customers without any regulatory or
16 any other restraint, other than your need to make a profit,
17 represents a competitive advantage?

18 A It seems like that's an advantage to me, so I
19 would represent it as an advantage. I have to have some.

20 [Pause.]

21 Q Finally, going back to MOAA-1 --

22 [Pause.]

23 Again, Part D of your response, you have fairly
24 striking differences in rate ranges, depending upon quantity
25 offered.

1 Does this represent the fact that your costs are
2 less, or that you need to do this in order to meet a
3 competitive situation?

4 A Our costs are not less. I guess they're less or
5 they're more.

6 You said -- you used a good word there, fairly
7 striking differences. We have fairly striking differences
8 in geography that causes our costs to go up or down.

9 Q Well, I understand that, but as I understand your
10 answer, at 150,000 pieces and up, the range is between 7.3
11 and 10.3 cents, which is significantly less than for 25,000
12 pieces or less.

13 And my question is, do those rate ranges represent
14 a difference in DSO's costs as a result of quantity, or does
15 it represent something other than that?

16 A I pay a carrier more -- on the small saturations
17 we do, I do pay carriers more than on the larger saturations
18 we do, yes, by contract.

19 So, yes, our costs are more to deliver smaller
20 saturations than they are larger saturations as we contract
21 with our carriers.

22 So it's not a competitive advantage to be able to
23 drop the rate this or that to get the business, if that's
24 what you're asking.

25 Q Well, let's explore that for a moment.

1 A Okay.

2 Q You have obviously, as you have described, fairly
3 wide ranges of density of households.

4 A That's correct.

5 Q But if it's a saturation per route, and you're
6 using saturation as all or nearly all of the addresses on a
7 particular route, as I understand it; is that correct?

8 A Yes, I think so, yes.

9 Q All right. What difference does it make to a
10 given carrier, whether -- why would your costs differ if the
11 carrier has enough work to perform that carrier's full day,
12 as it were?

13 A If it's a regular customer, something of a
14 frequency nature here, if it's a regular customer, that that
15 carrier is maybe doing a saturation for each and every week,
16 then he may get a nickel or six cents or seven cents or
17 whatever it is to deliver it.

18 If it's what we call an unscheduled saturation,
19 which on our contract to our carriers, we have scheduled
20 saturations which are regular customers that are identified
21 on an ongoing basis, so our carriers, when they show up on
22 Tuesday to pick up product, they're not really surprised by,
23 hey, by the way, you're going go to twice as many households
24 this week as you did last week.

25 They pretty much know before they come, and by

1 knowing, then they can plot their day, plan their day and
2 plan their time.

3 So it's a scheduled saturation. We pay less for
4 that because it's a regular, ongoing saturation, and
5 sometimes we compress.

6 If they have a regular saturation customer that
7 they're delivering for, we might make their territory a
8 little bit smaller -- excuse me, their route a little bit
9 smaller.

10 So, in other words, they are able to cover all
11 those households in a particular day.

12 But by contract we give them more money if it's an
13 unscheduled saturation. If somebody comes to me and says I
14 want to do 10,000 in North Oklahoma City, then we pay that
15 more than we do if they were doing 10,000 every week in that
16 same area.

17 Q Well, what I'm still unclear about, Mr. White, is
18 it doesn't seem to explain the differences in rates between
19 25,000 and 150,000, which appear to be based not on
20 regularity or anything else, but simply on numbers.

21 A Well, that's a quantity discount.

22 Q That's a quantity discount?

23 A Of course.

24 Q Which is, of course, because that's the way
25 business is done?

1 A Ordinarily, yes.

2 MR. TODD: Thank you, Mr. White. Thank you, Mr.
3 Chairman. I have no further questions.

4 CHAIRMAN GLEIMAN: Well, we've been at it for a
5 little more than an hour and a half, and I think we will
6 take a very short break before we pick up with the Postal
7 Service. No cross examination from the Postal Service?

8 Well, then maybe we just ought to try and plow
9 through till we come to redirect, if you're okay?

10 THE WITNESS: I'm fine.

11 CHAIRMAN GLEIMAN: Okay. We'll let it ride for a
12 couple more minutes then.

13 Followup?

14 [No response.]

15 CHAIRMAN GLEIMAN: Any followup questions?

16 [No response.]

17 CHAIRMAN GLEIMAN: Questions from the Bench?
18 Commissioner Omas?

19 COMMISSIONER OMAS: I just have a couple of quick
20 questions: Mr. White, how frequently do you deliver to the
21 various areas in your distribution area? I think you
22 mentioned you had 1100 distribution -- 1100 routes?

23 THE WITNESS: We deliver -- Wednesday is our
24 delivery day. We deliver one day a week.

25 COMMISSIONER OMAS: You deliver one day a week.

1 What role does frequency play as far as private delivery of
2 mail? I mean, is --

3 THE WITNESS: I believe, if you're asking -- and
4 I'm going to speak for DSO. Frequency, obviously, if it's a
5 regular customer, if they are on a weekly basis or a monthly
6 basis.

7 I have customers that are going to be quarterly.
8 If they are going to do it four times a year with me, we'll
9 contract with them in order that we know that we're going to
10 have that volume of business in those particular months.

11 It's very helpful for us to know that, where that
12 volume of business is going to be, because I think
13 everybody, probably, in this room, if they have 300 and some
14 odd people working for them, or with them or through them
15 like I do, we need to know how many people we're going to
16 have on that particular month.

17 So, frequency pays big dividends, frequency
18 discounts, to be able to keep customers on a regular basis,
19 so we know what kind of staffing we need.

20 COMMISSIONER OMAS: All right, thank you.

21 CHAIRMAN GLEIMAN: Commissioner LeBlanc?

22 COMMISSIONER LeBLANC: Mr. White, just to clarify
23 your colloquy with counsel for MOAA, these contracts that
24 you talk about, are they given prior to any scheduling or
25 prior to any size known?

1 In other words, do you set up a contract with a
2 particular individual and say, okay, you will cover this
3 area, based on the numbers, period?

4 Does it change, per demographic, if you will, or
5 do you have a rural versus a suburban area? I mean, how
6 does that change?

7 Is it pre-given, in effect?

8 THE WITNESS: Are you talking about our clients,
9 contracting with our clients, or contracting with our
10 carriers, which are independent contractors?

11 COMMISSIONER LeBLANC: Both.

12 THE WITNESS: The --

13 COMMISSIONER LeBLANC: What I'm trying to do is
14 relate it back to the cost, the total cost. And I would
15 tend to -- and correct me if I'm wrong here, but I would
16 tend to think that both of those go into your costs, your
17 total costs.

18 THE WITNESS: Well, what we have to pay the
19 contractor, per piece, obviously goes into the cost of it.

20 COMMISSIONER LeBLANC: Correct.

21 THE WITNESS: And that is annotated on our
22 contract to the particular carrier, as far as what type of
23 delivery it is, whether it's address-specific or saturation
24 or anything like that.

25 So that carrier, when he signs that contract, he

1 knows that we're going to pay him X amount for whatever we
2 ask of his services.

3 COMMISSIONER LeBLANC: I guess what I'm getting at
4 is -- I'm really not making myself clear.

5 If you have a contact with both the delivery side
6 as well as --

7 THE WITNESS: The client.

8 COMMISSIONER LeBLANC: -- the client, that
9 contract is based on a maybe seasonal -- so you know this is
10 going to happen every year at certain times; this is going
11 to be done.

12 Now, does that change? What causes a change in
13 that particular cost or contract? Is it that something
14 comes up and somebody says -- or if you get a new account or
15 if you get an account away from a competitor or what happens
16 to that contract? Is everything based on that same thing
17 that you set up before, or does it change?

18 THE WITNESS: Well, these things change on both
19 sides of that.

20 We raise the per piece we are going to pay the
21 carrier from time to time, which in other words will change
22 the provisions of the contract that we are going to pay
23 more.

24 With a customer when we sign a contract whether it
25 is quarterly or monthly or weekly, annual, whatever, the

1 costs are stipulated on the contract or what we are going to
2 do that for, we will basically --

3 COMMISSIONER LeBLANC: So you are locked into that
4 though?

5 THE WITNESS: We are locked into it for the terms
6 of the contract.

7 COMMISSIONER LeBLANC: Okay.

8 THE WITNESS: That is correct.

9 COMMISSIONER LeBLANC: Good. Thank you very much.

10 CHAIRMAN GLEIMAN: Do you know whether the Postal
11 Service has any rates that have break points related to
12 volume like you have to have a certain number of pieces --
13 if you have 500 pieces you get -- over 500 pieces you can
14 get a certain rate, if you do a certain type of work below
15 500 pieces if you did the same work you wouldn't get a break
16 on your rate?

17 THE WITNESS: I don't know if they spell it out
18 that specifically, but I was under the assumption here that,
19 and correct me if I'm wrong, but I was under the assumption
20 under -- between basic and high density and saturation that
21 was based on "x" amount of pieces in those particular
22 categories, and for that there is a sliding scale for how
23 many pieces they enter into those categories.

24 CHAIRMAN GLEIMAN: When you talk about North
25 Oklahoma City, are you talking about Edmond? Do you go up

1 that far?

2 THE WITNESS: You're familiar with Edmond?

3 Uh-huh.

4 CHAIRMAN GLEIMAN: And you go over to Midwest
5 City, Del City?

6 THE WITNESS: Midwest City and Del City, yes.

7 CHAIRMAN GLEIMAN: Do you go out to Pond Creek,
8 Moore?

9 THE WITNESS: I actually go to Norman.

10 CHAIRMAN GLEIMAN: All the way down? Okay. Just
11 kind of curious.

12 THE WITNESS: And Yukon, home of Garth Brooks,
13 which is on the west.

14 CHAIRMAN GLEIMAN: I am aware of what is west of
15 there. You don't go all the way out to Kingfisher or
16 Anadarko?

17 THE WITNESS: No, sir.

18 CHAIRMAN GLEIMAN: Cordell -- and I know you don't
19 go to Boise City. Nobody goes to Boise City.

20 [Laughter.]

21 THE WITNESS: Where are you from anyway?

22 CHAIRMAN GLEIMAN: I have been to Oklahoma a
23 little bit. I just kind of was curious about, you know,
24 what territory you covered.

25 Are there any other questions on the bench?

1 Followup questions from the bench?

2 [No response.]

3 CHAIRMAN GLEIMAN: Would you like some time with
4 your witness?

5 MR. STRAUS: Yes, I would.

6 CHAIRMAN GLEIMAN: Five? Ten?

7 MR. STRAUS: Five minutes is fine.

8 CHAIRMAN GLEIMAN: Okay. We will take a
9 five-minute break then.

10 [Recess.]

11 CHAIRMAN GLEIMAN: Mr. Straus?

12 MR. STRAUS: The wind comes right behind the rain.

13 CHAIRMAN GLEIMAN: No, that isn't it.

14 THE WITNESS: I can sing if you like.

15 COMMISSIONER LeBLANC: No, you can't.

16 [Laughter.]

17 CHAIRMAN GLEIMAN: I think the folks who were
18 cross examining you before wanted you to sing. I am not
19 sure you sang the right tune though.

20 MR. STRAUS: I do have a couple of questions on
21 redirect for Mr. White.

22 REDIRECT EXAMINATION

23 BY MR. STRAUS:

24 Q Mr. White, Mr. Todd got you to admit that the
25 Postal Service's rates are actually public and that gives

1 you some advantage. Do you recall that?

2 A Yes.

3 Q You also compete in other alternate delivery
4 companies, also compete against Advo, do you not?

5 A That's correct.

6 Q Now the rates that Advo pays the Postal Service
7 would be public, but are the rates that Advo charges to
8 advertisers public, to your knowledge?

9 A Not to my knowledge, no.

10 Q Next question is there was, it appeared to me at
11 least some confusion on this two to three percent number and
12 the number of households and the number of pieces. Do you
13 recall that discussion?

14 A Vividly.

15 Q I thought that you said that you think that
16 alternate delivery serves two to three percent of the
17 households in the country, whereas I thought that your
18 answer to the interrogatory was talking about a rough
19 estimate that you serve about two to three percent of the
20 volumes.

21 Which one is it?

22 A If I was saying household I was unaware of it, and
23 I think that was early in the testimony. It was definitely
24 volume, two to three percent, and that is a rough,
25 seat-of-the-pants opinion of the volume for alternate

1 delivery per year.

2 MR. STRAUS: Thank you. That is all the redirect
3 I have.

4 CHAIRMAN GLEIMAN: Is there any recross? Mr.
5 McLaughlin.

6 RECROSS EXAMINATION

7 BY MR. McLAUGHLIN:

8 Q On that two to three percent figure, is this some
9 estimate that you did yourself?

10 A Yes.

11 Q What share did you assume that the newspaper
12 industry has of the relevant market?

13 A What share? I don't know. I did that based on
14 AAPS members. I don't know about -- the AAPS members are,
15 the majority of them are not newspaper.

16 Q Well, I am still confused as to -- it is two to
17 three percent of volumes but what are you comparing volumes
18 to? What volumes?

19 A The volume of pieces delivered by alternate
20 delivery companies in AAPS. I am figuring, a rough guess,
21 very rough guess, of two to three percent.

22 Q Of what?

23 A Of Standard A delivery -- the private delivery of
24 Standard A that is available that we deliver is about two to
25 three percent of the entire market that is delivered.

1 Q It is two to three percent of what? Standard A
2 mail?

3 A If we had two, three percent of it, the post
4 office has 97 percent of it, Standard A mail.

5 Q You are talking about Standard A mail.

6 A Yes, sir.

7 Q Is it Standard A ECR mail or all of Standard A
8 mail?

9 A ECR.

10 Q Standard A ECR saturation mail or does it include
11 nonsaturation mail

12 A I base that more than likely on saturation and,
13 like I say, it was so rough, I tried to put something out
14 there, probably could look at the question again, but at the
15 same time I tried to put something out there that I could
16 just base that on.

17 Once again, we have a very, very small percentage
18 of the market. Two or three may even be high. I don't
19 know.

20 Q But you indicated you don't know what share
21 private delivery has of the shopper distribution market?
22 Shoppers are distributed at --

23 A No, I just meant saturation. I am talking about
24 any pieces that are saturated, not just shoppers.

25 Q Okay, but you don't know what percentage of

1 shoppers are distributed by private delivery versus mail?

2 A No, sir.

3 Q You don't know whether that might be very, very,
4 very much larger than two or three percent, like on the
5 order of 50 percent?

6 A I don't know. I don't have any numbers that I can
7 give you on that.

8 Q Okay, and I believe you also indicated that
9 previously you don't know what proportion just one of your
10 members, Advo, has of its volume in private delivery --

11 MR. STRAUS: I object to this question. We are
12 getting well beyond the redirect that just clarified volumes
13 versus households and now we are getting not only beyond it
14 but we are getting exactly the same questions asked now as
15 were asked before, and Mr. White did not learn during that
16 break any of the information that he didn't have before.

17 MR. McLAUGHLIN: Well, Mr. Chairman, I think I
18 have asked all the questions I need to ask on this, so I
19 will have no further questions.

20 CHAIRMAN GLEIMAN: That's good. Saves me from
21 having to rule.

22 Is there any further recross? Any re-redirect?

23 MR. STRAUS: Absolutely not.

24 CHAIRMAN GLEIMAN: That being the case, Mr. White,
25 that completes your testimony here today and we sure do

1 appreciate your appearance.

2 I want to thank you and you are excused.

3 THE WITNESS: If you are going to do that, I am
4 going to say "yee-haw."

5 [Laughter.]

6 [Witness excused.]

7 CHAIRMAN GLEIMAN: Mr. Costich, whenever you are
8 ready to introduce our next witness today.

9 MR. COSTICH: Thank you, Mr. Chairman. The OCA
10 calls James F. Callow.
11 Whereupon,

12 JAMES F. CALLOW,
13 a witness, having been called for examination and, having
14 been first duly sworn, was examined and testified as
15 follows:

16 DIRECT EXAMINATION

17 BY MR. COSTICH:

18 Q Mr. Callow, do you have before you two copies of a
19 document identified as OCA-T-6?

20 A Yes, I do.

21 Q Could you identify that document?

22 A It is the Direct Testimony of James F. Callow on
23 Behalf of the Office of Consumer Advocate.

24 Q Was that document prepared by you or under your
25 supervision?

1 A Yes, it was.

2 Q Do you have any corrections to make to that
3 document?

4 A Just one. On page 24, line 9, the figure 1.352
5 should be changed to 1.353. This change would make the
6 figure, the new figure consistent with the response given to
7 DMA/OCA-T6-9(b), and the changes are in the copy that will
8 be handed to the reporter.

9 Q If you were to testify orally today, would this be
10 your testimony?

11 A Yes, it would.

12 MR. COSTICH: Mr. Chairman, I will hand two copies
13 of the document to the reporter and ask that it be admitted
14 into evidence.

15 CHAIRMAN GLEIMAN: Is there any objection?

16 [No response.]

17 CHAIRMAN GLEIMAN: Hearing none, I will direct
18 counsel to provide those two copies as promised to the
19 reporter and the testimony of Witness Callow will be
20 transcribed into the record and received into evidence.

21 [Direct Testimony of James F.
22 Callow, OCA-T-6, was received into
23 evidence and transcribed into the
24 record.]

25

OCA-T-6
Docket No. R2000-1

DIRECT TESTIMONY
OF
JAMES F. CALLOW

ON BEHALF OF
THE OFFICE OF THE CONSUMER ADVOCATE

MAY 22, 2000

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

Postal Rate and Fee Changes, 2000)

Docket No. R2000-1

DIRECT TESTIMONY
OF
JAMES F. CALLOW

1 I. STATEMENT OF QUALIFICATIONS

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

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

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

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

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

13 I am an accountant by training. In 1985, I earned an MS degree in accounting
14 from Georgetown University. My course work included cost accounting and auditing. In
15 1977, I obtained my BA degree from the University of Michigan-Dearborn with a double
16 major in political science and history and a minor in economics.

1 II. PURPOSE AND SCOPE OF TESTIMONY

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

6 In Part I, I propose that the current rate for First-Class Letters be maintained at
7 33 cents in order to mitigate the growing institutional cost burden on First-Class Letter
8 Mail. During the past 12 years, First-Class Letter Mail has been carrying an increasing
9 burden of the institutional costs of the Postal Service, and that burden has become
10 more prominent in recent years. This conclusion is based upon an analysis of Postal
11 Service data using several common measures of institutional cost. Moreover, the
12 growth in institutional costs has occurred as the cost of First-Class Letter Mail has
13 declined. Similarly, the institutional cost burden on First-Class Letter Mail has
14 increased relative to the institutional cost burden on Standard (A) Regular Mail.

15 The institutional cost burden on First-Class Letter Mail has also grown relative to
16 the institutional cost burden intended by the Commission, as expressed in several
17 recent recommended decisions. As a result, First-Class Letter Mail has contributed
18 \$6.2 billion more than intended by the Commission to the institutional costs of the
19 Postal Service since FY1988, and this additional revenue is expected to reach \$11.2
20 billion through the test year. Mitigation of the institutional cost burden on First-Class
21 Letter Mail should involve consideration of the additional contribution to institutional
22 costs above that intended by the Commission.

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

8 Under my proposal, the single-piece First-Class ("SPFC") rate would be
9 determined without regard to the "integer constraint." The rate paid by households, by
10 contrast, would be set at a whole cent, as in the past. The SPFC integer rate would be
11 set so that sufficient revenues would accumulate in a "reserve account" to permit the
12 single-piece rate to remain the same for a period of two rate proceedings, a duration of
13 approximately four years. In effect, the SPFC rate would be changed every other rate
14 proceeding, with revenue generated during the first rate period covering any revenue
15 deficiency in the second rate period. In this manner, household mailers would enjoy
16 greater rate stability, while allowing business mailers smaller, more frequent and
17 predictable rate adjustments.

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

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

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

1

PART I2 I. THE INSTITUTIONAL COST BURDEN ON FIRST-CLASS LETTER MAIL IS
3 INCREASING

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

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

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

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

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

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

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

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

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

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

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

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

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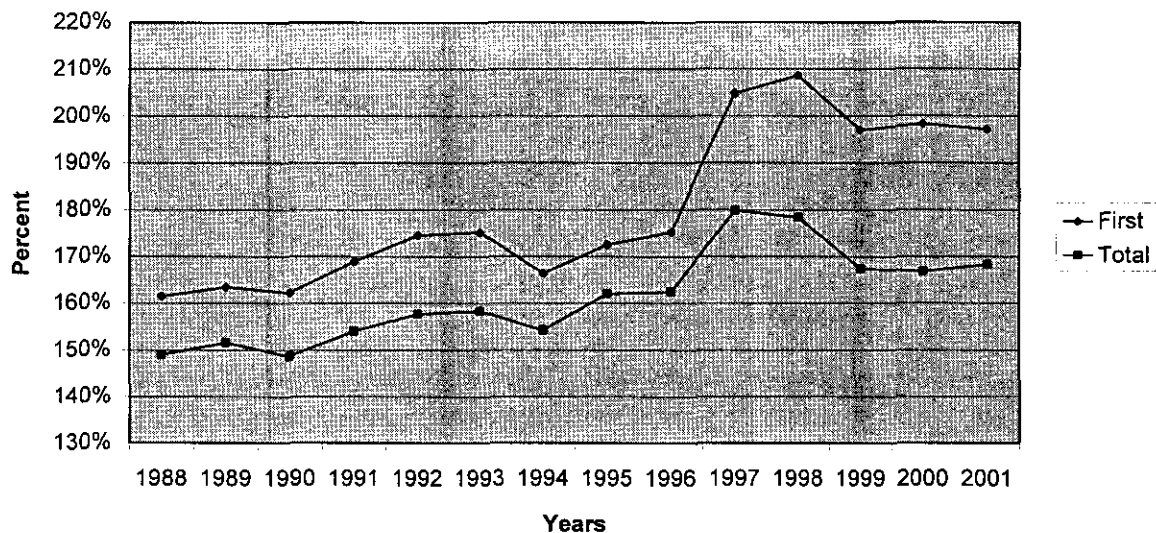
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- 1 the cost coverage into perspective, from FY 1988 to FY 1996 the cost coverage rose
 2 gradually from 162 percent to 175 percent. The First-Class cost coverage is expected
 3 to remain in the upper 190's through the test year.

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

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

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



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

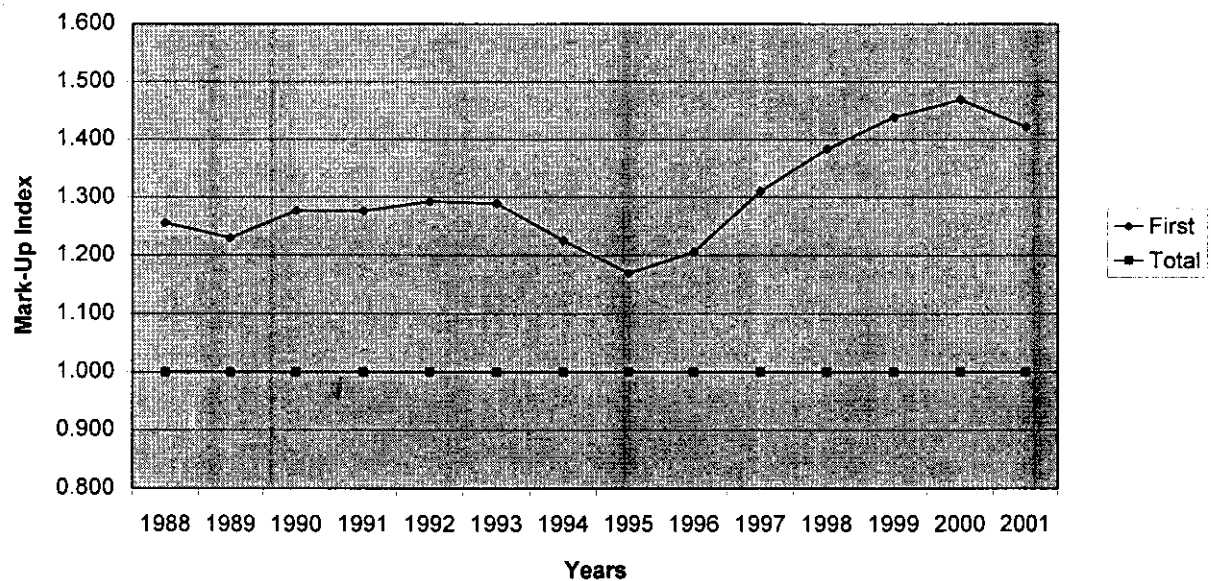
- 6 The mark-up index places the rising institutional cost burden on First-Class
 7 Letter Mail on a more comparable basis from year-to-year.⁶ Table 2 and accompanying

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

1 Figure 2 show the First-Class Letter mark-up index. As revealed in Table 2, the mark-
 2 up index for First-Class Letters rose from 1.256 to 1.439 during the 12 year period FY
 3 1988 through FY 1999. In more recent years, the mark-up index shows a more rapid
 4 rise in the institutional cost burden on First-Class Letter Mail. During the five year
 5 period beginning in FY 1995, the mark-up index increased from 1.169 to a high of
 6 1.439. The First-Class Letter mark-up index is expected increase still higher in FY
 7 2000.

Table 2 FIRST-CLASS LETTER MARK-UP INDEX													
Mark-Up Index	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
First	1.256	1.230	1.277	1.276	1.293	1.289	1.226	1.169	1.206	1.311	1.384	1.439	1.469
Total	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000

Figure 2: First-Class Letter Mark-Up Index



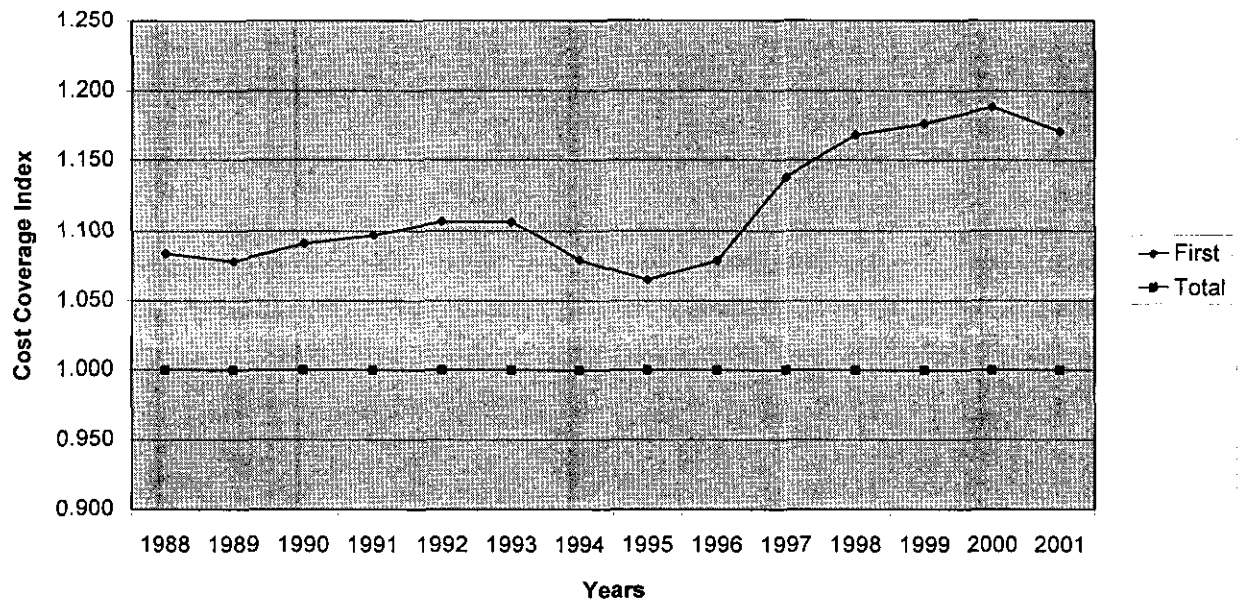
1 3. The cost coverage index also shows an increase in the institutional
2 cost burden on First-Class Letters

3 The cost coverage index shows the rising First-Class Letter institutional cost
4 burden on a different yet comparable basis.⁷ Table 3 and Figure 3 present the First-
5 Class Letter cost coverage index. The cost coverage index shows, like the mark-up
6 index, a similar increase in the institutional cost burden on First-Class Letter Mail.
7 Based upon reported data, the cost coverage index for First-Class Letters grew from
8 1.084 in FY 1988 to 1.177 in FY 1999, and is expected to rise still higher in FY 2000.
9 As with the mark-up index, the First-Class Letter cost coverage index shows a steady
10 rise from 1.065 to 1.177 beginning with FY 1995 through FY 1999.

⁷ See note 4, *supra*.

Table 3														
FIRST-CLASS LETTER COST COVERAGE INDEX														
Cost Coverage Index	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
First	1.084	1.078	1.091	1.097	1.107	1.107	1.079	1.065	1.079	1.138	1.169	1.177	1.198	1.171
Total	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000

Figure 3: First-Class Letter Cost Coverage Index



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

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

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

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

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

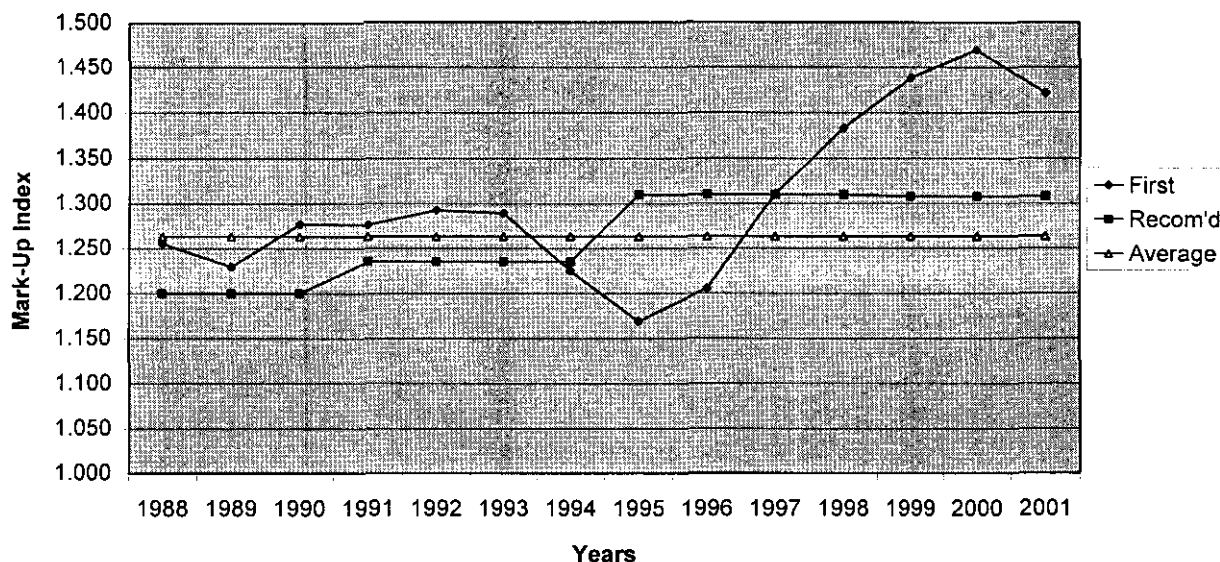
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Table 4
COMPARISON OF FIRST-CLASS LETTER MARK-UP INDEX TO RECOMMENDED AND AVERAGE MARK-UP INDICES

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

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



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

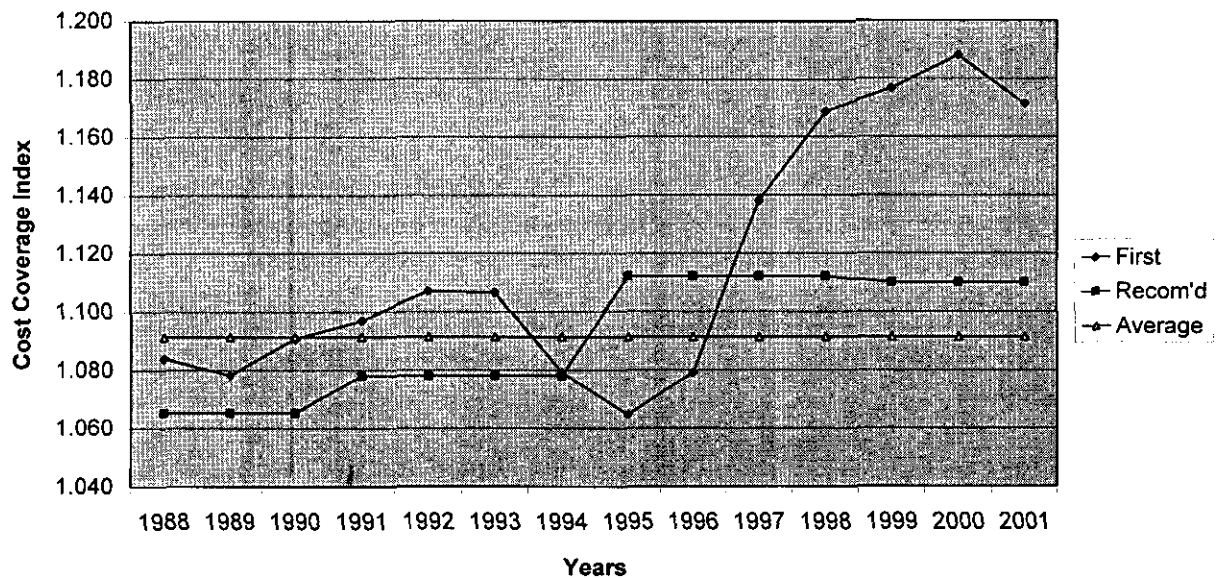
8 During the 12 year period, FY 1988 through FY 1999, the actual First-Class
 9 Letter cost coverage index is above the recommended index for all but two years. If the
 10 recommended First-Class Letter cost coverage index from Docket No. R97-1 is

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

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

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

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



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

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

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

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

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

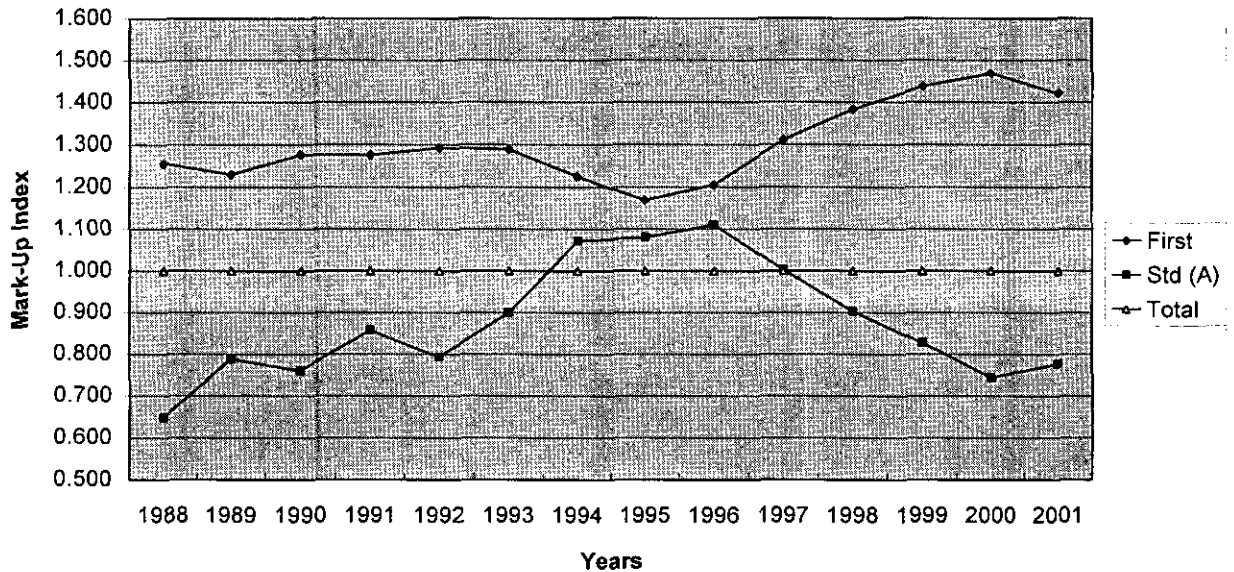
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Table 6
COMPARISON OF FIRST-CLASS LETTERS AND STANDARD (A) REGULAR MARK-UP INDICES

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

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



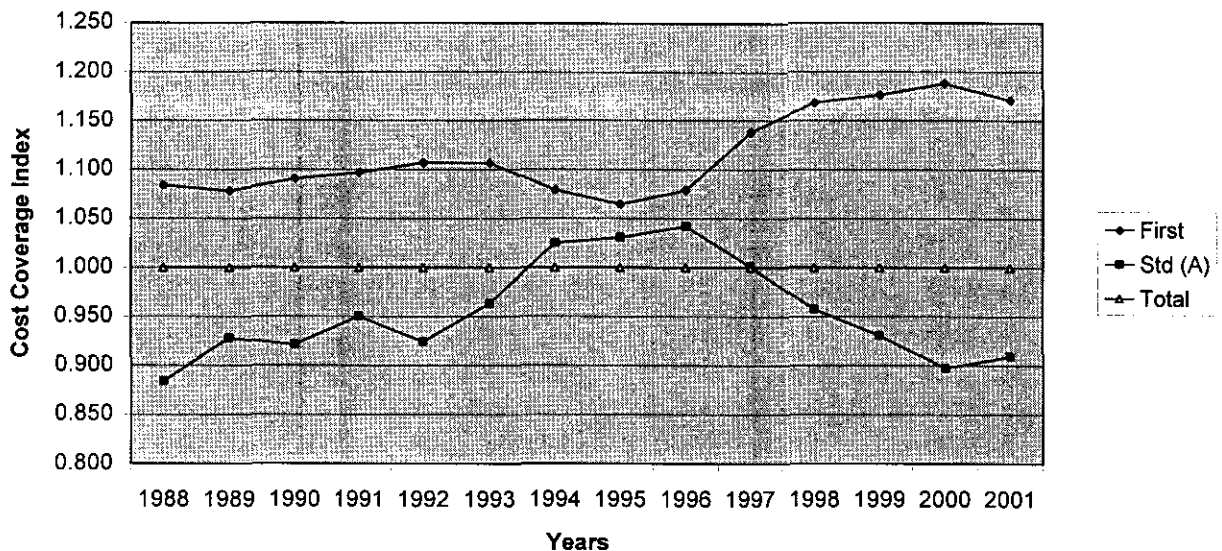
1 Table 7 and Figure 7 compare the First-Class Letter and Standard (A) Regular
2 cost coverage indices to the cost coverage index for all mail. Comparing cost coverage
3 indices for First-Class Letters and Standard (A) Regular shows a pattern similar to that
4 of the mark-up indices—a widening gap in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

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

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

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

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



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

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

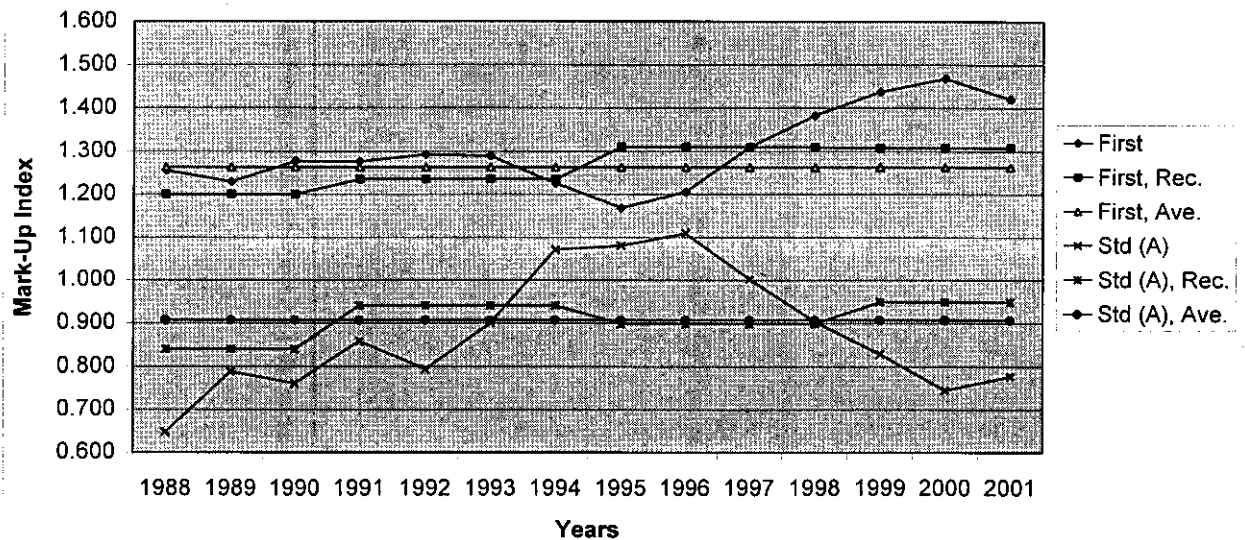
1 indices reveals a widening gap in the relative contributions by First-Class Letters and
2 Standard (A) Regular mail.

3 Table 8 and accompanying Figure 8 compare the actual First-Class Letter and
4 Standard (A) Regular mark-up indices to the Commission's recommended mark-up
5 index for each subclass, and the average recommended index calculated for the four
6 Commission opinions issued during the period covered by this analysis. The analysis
7 for Table 8 for First-Class Letters is the same as presented with respect to Table 4.
8 The actual First-Class Letter mark-up index roughly tracks, albeit somewhat higher, the
9 recommended index until FY 1994, falling below the recommended index for three
10 years. From FY 1995 through FY 1999, the actual First-Class Letter mark-up index
11 increases, rising above the recommended index during the last three fiscal years. The
12 actual First-Class Letter mark-up index follows a similar pattern vis-a-vis the average
13 mark-up index. By contrast, the actual Standard (A) Regular mark-up index remains
14 below the recommended index for all but five years, FY 1994 through FY 1998, and
15 then returns below the recommended index in FY 1999. The actual Standard (A)
16 Regular mark-up index follows the same pattern by comparison to the average mark-up
17 index.

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

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

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



1 Table 9 and Figure 9 compare the actual First-Class Letter and Standard (A)

2 Regular cost coverage indices against the Commission's recommended cost coverage

3 index, and the average recommended index calculated for the four Commission

4 opinions. The analysis of Table 9 for First-Class Letters is the same with respect to

5 Table 5. Table 9 shows the actual First-Class Letter cost coverage index falls below

6 the recommended index in only two years, FY 1995 and FY 1996, during the 12 years

7 from FY 1988 through FY 1999. From FY 1995, it increases, rising above the

8 recommended index during the last three years. The actual First-Class Letter cost

9 coverage index is above the average index during six of the 12 year period, FY 1988

10 through FY 1999, and rises high above the average in the last three years. By contrast,

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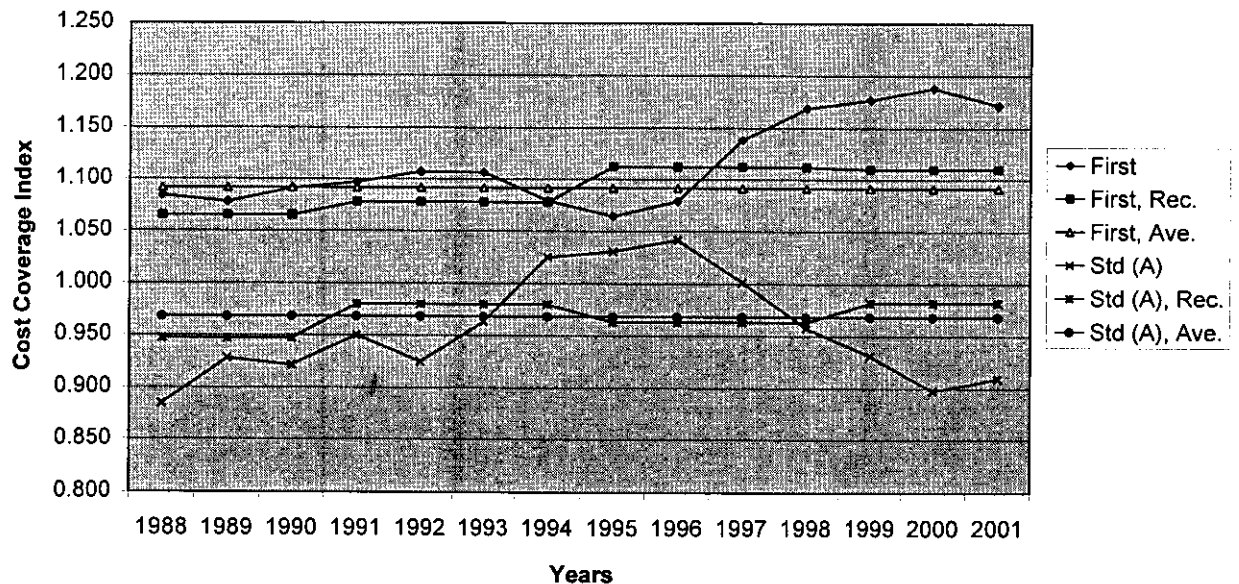
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1 Table 9 shows the actual Standard (A) Regular cost coverage index below the
 2 recommended index for all but four years from FY 1988 through FY 1999. The
 3 Standard (A) Regular cost coverage index follows the same pattern when compared to
 4 the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

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

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

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



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

4 That the institutional cost burden on First-Class Letter Mail has risen from FY
 5 1988 through FY 1999, and at an accelerating rate in recent years, has produced
 6 substantial additional revenues for the Postal Service. More significantly, the additional
 7 revenue contributed by First-Class Letter Mail to the Postal Service's institutional costs
 8 has exceeded the revenue contribution intended by the Commission.

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

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

⁹ PRC Op. R94-1, ¶4041. See also PRC Op. MC95-1, ¶1019.

¹⁰ *Id.*, ¶4043.

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

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

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

3 Rather than measuring the excess revenues using the systemwide average cost
 4 coverage, a more conservative approach might consider the First-Class Letters cost
 5 coverage recommended by the Commission as "reasonably near" the systemwide
 6 average. For purposes of measuring the change in revenue, I calculate an average
 7 mark-up using the First-Class Letters mark-up index figures in Table 10. The
 8 conversion of the First-Class Letters cost coverage to a mark-up index is shown in the
 9 last line of Table 10.¹¹ Averaging the First-Class Letters mark-up index for all four rate
 10 cases (PRC Ops. R87-1 through R97-1) results in an average mark-up index of 1.263.

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

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

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

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

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

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

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

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

4 The Commission should mitigate the increasing institutional cost burden on First-
5 Class Letter Mail by maintaining the single-piece First-Class rate at 33 cents.
6 Maintaining the current single-piece First-Class rate will reduce the institutional cost
7 burden on First-Class Letter Mail,¹³ and directly benefit consumers, as revenues
8 contributed by single-piece letters will decline by approximately \$607 million.¹⁴ Even
9 with a 33 cent First-Class rate, the mark-up index will be approximately 1.353.¹⁵

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

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

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

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

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

¹⁵ Attachment USPS-32A (revised 4-21-00), adjusted for OCA costs.

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

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

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

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

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

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

1 Table 12 and accompanying Figure 10 compare the attributable and institutional
2 costs for First-Class Letters as a percent of total postal costs. Table 12 reveals that the
3 First-Class Letter Mail attributable costs as a percentage of the total have declined from
4 52.98 percent to 45.71 percent during the 12 year period from FY 1988 through FY
5 1999. First-Class Letter attributable costs are expected to decline still further, to 44.99
6 percent in the test year. Moreover, the decline in First-Class Letter attributable costs is
7 most apparent in recent years. Since FY 1995, First-Class Letter Mail costs have
8 declined continuously from 53 percent and are expected to be 44.99 percent of total
9 postal costs in the test year.

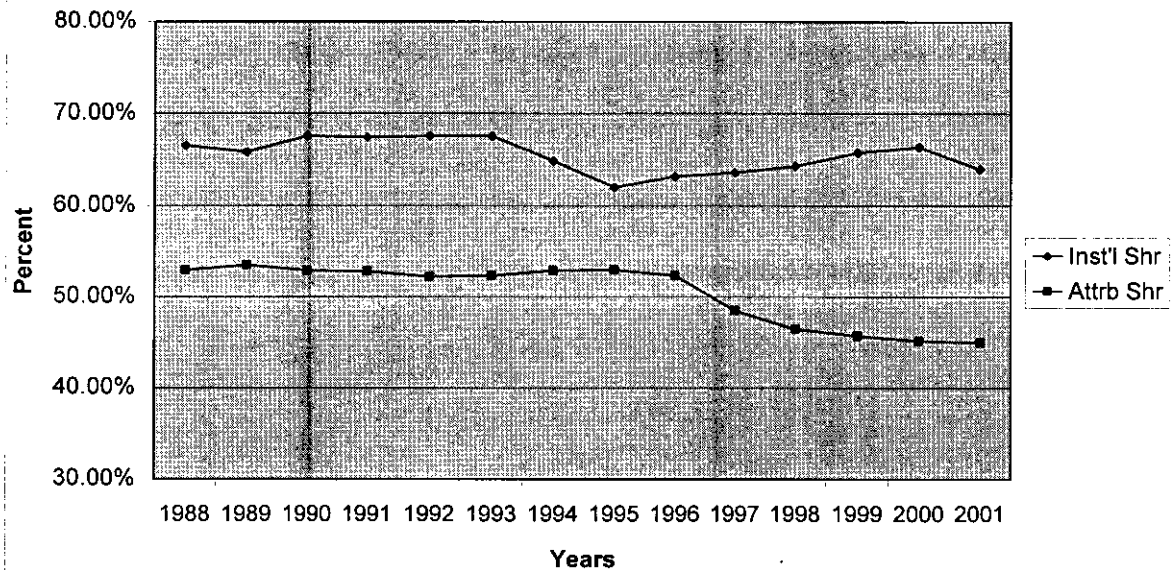
10 By contrast, First-Class Letter Mail institutional costs have remained nearly
11 constant as a percent of the total institutional costs of the Postal Service. As Table 12
12 shows, First-Class Letter Mail institutional costs have declined slightly from 66.52
13 percent to 65.76 percent during the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

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

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

First-Class Letters	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Inst'l Shr	66.52%	65.63%	67.58%	67.44%	67.57%	67.57%	64.88%	61.98%	63.15%	63.60%	64.30%	65.76%	66.36%	63.96%
Attrb Shr	52.98%	53.53%	52.91%	52.84%	52.27%	52.40%	52.94%	53.00%	52.37%	48.52%	46.47%	45.71%	45.17%	44.99%

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



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

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

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

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

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

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

1 IV. CONCLUSION

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

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

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

1

PART II2 I. HOUSEHOLDS AND BUSINESS MAILERS HAVE DIFFERENT INTERESTS
3 WITH RESPECT TO CHANGES IN THE FIRST-CLASS RATE

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

8 Households rely on First-Class Mail more so than any other class of mail.
9 Virtually all pieces mailed by households are mailed at single-piece rates. The average
10 household mails approximately twelve First-Class Mail pieces per month.¹⁷ In
11 percentage terms, however, households mailed only 16.1 percent of the 101.4 billion
12 pieces of First-Class Mail in 1999.¹⁸

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

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

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

¹⁸ USPS-T-6 (Tolley) at 25-26.

¹⁹ *Id.*, at 25.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

15 2. More predictable rate increases facilitate business planning

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

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

3 In response to the desires of business mailers, the Postal Service is planning
4 future rate adjustments on a more frequent and predictable basis—approximately every
5 two years. Recently, it was reported that Deputy Postmaster General John Nolan, in a
6 speech to the Direct Marketing Association, stated that postal management is
7 beginning to plan for the 2003 and 2005 rate cases.²³ Previously, in estimating volumes
8 in response to a request of the General Accounting Office (GAO), the Postal Service
9 assumed rate increases would become effective beginning in January 2001, and every
10 two years thereafter, e.g., January 2003, 2005 and 2007.²⁴ Moreover, if recommended
11 by the Commission, implementation of the proposed rate changes from this proceeding
12 in January 2001 would be consistent with a two-year rate cycle, as the increases
13 resulting from Docket No. R97-1 took effect in January 1999.

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

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

²⁴ See LR-I-179, p. 5.

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

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

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

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

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

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

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

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

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

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

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

²⁸ See PRC Op. R94-1 at ¶5005.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

PART B: CALCULATED SINGLE-PIECE NON-INTEGER RATE											
Calculated Non-Integer Rate	Year 2000		Year 2001		Year 2002		Year 2003		Year 2004		2001-2004
	Rate	Volume	Rate	Volume	Rate	Volume	Rate	Volume	Rate	Volume	Total
Single-Piece	\$0.33	53,378	\$0.330	53,378	\$0.330	52,651	\$0.348	51,898	\$0.348	49,238	207,164
Workshare	\$0.27	45,253	\$0.270	45,253	\$0.270	47,320	\$0.288	46,529	\$0.288	45,887	184,990

PART C: CHANGE IN VOLUME AND PERCENT BETWEEN SPFC AND WORKSHARE												
	Year 2000		Year 2001		Year 2002		Year 2003		Year 2004		2001-2004	
	Volume	Percent	Volume	Percent	Volume	Percent	Volume	Percent	Volume	Percent	Volume	Percent
SPFC			(1,651)	-3.2%	(1,628)	-3.2%	948	1.8%	899	1.8%	(1,431)	-0.70%
Workshare			1,629	3.5%	1,704	3.5%	(1,002)	-2.2%	(989)	-2.2%	1,342	0.72%
Net Change			(21)		75		(54)		(89)		(89)	

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

6 As shown in Table 15, the largest shifts in volume could reach +6.3 percent for
7 SPFC mail and -7.2 percent for workshare mail when the calculated single-piece rate is
8 2 cents greater than the SPFC rate. As noted above, a difference of this size or larger
9 becomes more likely in an inflationary environment. Such a difference could produce a
10 larger deficit in the SPFC Reserve Account at the end of the two rate case cycle
11 compared to a low inflationary period. Moreover, while total First-Class volume would
12 not change to any significant degree, a larger decrease in workshare volume could
13 create greater difficulties for presort and pre-barcode mailers.

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

1 III. CONCLUSION

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

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

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

1

PART III2 I. THE NONSTANDARD SURCHARGE IS NO LONGER WARRANTED FOR LOW
3 ASPECT RATIO NONSTANDARD LETTER MAIL

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

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

³⁰ PRC Op. MC73-1 at 26.

³¹ *Id.*, at 27.

³² PRC Op. R78-1 at 1.

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

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

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

3 Nonstandard mailpieces are defined by reference to several physical
4 measurements.³⁵ Currently, any piece of First-Class Mail weighing one ounce or less is
5 subject to the applicable nonstandard surcharge if it has³⁶

6 ▷ a thickness exceeding 0.25 inches, or

7 ▷ a height exceeding 6.125 inches, or

8 ▷ a length exceeding 11.50 inches.

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

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

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

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

³⁶ See DMM § C100.4.0.

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

1 These four defining limits of nonstandard mail have not changed since
2 establishment of the classification in Docket No MC73-1.³⁸

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

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

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

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

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

³⁹ PRC Op. R78-1 at 36.

⁴⁰ *Id.*, citations omitted.

⁴¹ PRC Op. MC73-1 at 26.

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

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

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

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

⁴² *Id.*, at 28.

⁴³ *Id.*

⁴⁴ PRC Op. R97-1, para. 5227.

⁴⁵ USPS-T-10 (Kingsley) at 3-4.

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

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

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

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

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

⁴⁷ Tr. 5/2078.

⁴⁸ USPS-T-24 (Miller) at 20.

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

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

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

⁵⁰ PRC Op. R97-1, ¶5226.

⁵¹ *Id.*, ¶5227.

⁵² *Id.*, ¶5228.

⁵³ *Id.*, ¶5230.

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

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

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

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

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

⁵⁴ USPS-T-24 (Miller) at 19.

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

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

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

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

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

⁵⁵ *Id.*, at 20-21.

⁵⁶ *Id.*, at 22, emphasis added.

⁵⁷ *Id.*, citation omitted.

⁵⁸ *Id.*

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

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

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

⁵⁹ *Id.*

⁶⁰ Tr. 7/3225.

⁶¹ USPS-T-24 at 21.

⁶² *Id.*, at 21.

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

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

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

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

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

⁶³ *Id.*, at 21-22.

⁶⁴ Tr. 5/2082.

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

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

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

⁶⁵ Tr. 7/3132 (OCA/USPS-T24-5(f)). See also USPS-T-24 at 21.

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

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

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

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

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

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

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

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

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

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

⁶⁸ See USPS-T-24, Appendix 1.

⁶⁹ USPS-T-24, Appendix I at I-35.

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

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

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

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

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

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

5 In the case of letters that are square in shape, where only 50 percent are
6 presented to automated equipment, the model mail processing unit cost is 21.644
7 cents. The assumption of 50 percent presented for automated processing and
8 acceptance rates adjusted by 50 percent is reasonable, and represents a "worst case"
9 for the automated processing of square letter mail. This unit cost figure is less than the
10 Postal Service's model mail processing unit cost, where 100 percent manual processing
11 is assumed, of 23.941 cents.⁷² Moreover, the 21.664 cents model unit cost is only
12 2.056 cents more than the average test year mail processing unit cost for letters
13 weighing less than or equal to 1 ounce.⁷³ As a "worst case," the unit cost figure is only
14 9.348 cents (21.644 - 12.296) greater than the average test year CRA mail processing
15 unit cost.

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

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

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

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

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

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

4 The nonstandard surcharge for low aspect ratio letter mail should be eliminated.

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

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

14 Eliminating the 11 cent nonstandard surcharge for low aspect ratio letter mail
15 would slightly reduce First-Class Mail revenues to the Postal Service. In the test year
16 after rates (TYAR), the total volume of nonstandard single-piece First-Class mailpieces
17 is 360,307,000.⁷⁴ Assuming all nonstandard mailpieces were low aspect ratio letters,
18 the total estimated reduction in revenue in the test year after rates would be
19 \$39,634,000.⁷⁵

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

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

⁷⁵ *Id.*

1 17.41 percent of the total nonstandard single-piece First-Class volume.⁷⁶ In the test
2 year after rates, nonstandard letter-shaped volume would equal 62,718,000
3 (360,307,000 * 0.174068). However, the volume of letter-shaped pieces that are low
4 aspect ratio letters is unknown. Assuming all 62,718,000 nonstandard letter-shaped
5 pieces were low aspect ratio letters, the estimated revenue loss would be \$6,899,000
6 (62,718,000 * \$0.11).

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

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

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

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

1 In the test year after rates, the combined rate for low aspect ratio nonstandard
2 letter mail would amount to 45 cents (34 cents + 11 cents). This amount far exceeds
3 the test year after rates average cost per piece of 25.2 cents (\$13,326,042 /
4 52,877,657) for all single-piece First-Class Letters.⁷⁷ In fact, under the "worst case"
5 assumptions presented above, a test year single-piece rate of 34 cents is
6 approximately one-half cent less than the total estimated cost to process low aspect
7 ratio letter mail of 34.548 cents (25.20 cents + 9.348). Moreover, the effect of
8 eliminating the surcharge on First-Class revenues would be negligible, and would not
9 materially affect the cost coverage of single-piece First-Class Mail.

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

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

1 IV. CONCLUSION

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

1 CHAIRMAN GLEIMAN: Mr. Callow, have you had an
2 opportunity to examine the packet of designated written
3 cross-examination that was made available earlier today?

4 THE WITNESS: Yes, I have.

5 CHAIRMAN GLEIMAN: And if those questions were
6 asked of you today, would your answers be the same as those
7 you previously provided in writing?

8 THE WITNESS: They would, Mr. Chairman, with the
9 addition -- two of the responses I have substituted, for
10 clarity, some of the graphs were not clear and, also, the
11 copies did not incorporate changes made to my responses --
12 revisions made to my responses on June 29. And those
13 changes are made in the copies that will be handed to the
14 reporter.

15 For the record, the changes are made in
16 DMA/OCA-T6-2, the second and third page of that response.
17 It should be marked revised 6/29/2000. And the other
18 change, primarily for clarity, was all of MMA's response --
19 all of MMA's interrogatories, MMA/OCA-T6-1-5, and that, by
20 replacing all five graphs, I captured the revision to the
21 fourth question dated June 29, 2000.

22 CHAIRMAN GLEIMAN: And all those changes, you have
23 got the revised up-to-date copies in the packet that you are
24 looking at now?

25 THE WITNESS: Yes, I do, Mr. Chairman.

1 CHAIRMAN GLEIMAN: All right. Counsel, if you
2 would please provide those copies to the court reporter, I
3 will direct that they be received into evidence and
4 transcribed into the record.

5 [Designation of Written
6 Cross-Examination of James F.
7 Callow, OCA-T-6, was received into
8 evidence and transcribed into the
9 record.]

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BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, DC 20268-0001

Postal Rate and Fee Changes, 2000

Docket No. R2000-1

DESIGNATION OF WRITTEN CROSS-EXAMINATION
OF OFFICE OF THE CONSUMER ADVOCATE
WITNESS JAMES F. CALLOW
(OCA-T-6)

Party

Interrogatories

Association for Postal Commerce

DMA/OCA-T6-1, 5, 8
DMA/OCA-T1-1, 3, 5 redirected to T6
PostCom/OCA-T6-2-5

Major Mailers Association

MMA/OCA-T6-1-5

Newspaper Association of America

DMA/OCA-T6-2, 4-5, 8-9
PostCom/OCA-T6-1, 3

United States Postal Service

DMA/OCA-T6-1, 3, 7-9
DMA/OCA-T1-1-2 redirected to T6
PostCom/OCA-T6-4-5
USPS/OCA-T6-1-7, 9-13, 15-16, 20
USPS/OCA-T1-11-12 redirected to T6

Respectfully submitted,


Cyril J. Pittack
Acting Secretary

INTERROGATORY RESPONSES OF
OFFICE OF THE CONSUMER ADVOCATE
WITNESS JAMES F. CALLOW (T-6)
DESIGNATED AS WRITTEN CROSS-EXAMINATION

<u>Interrogatory</u>	<u>Designating Parties</u>
DMA/OCA-T6-1	PostCom, USPS
DMA/OCA-T6-2	NAA
DMA/OCA-T6-3	USPS
DMA/OCA-T6-4	NAA
DMA/OCA-T6-5	NAA, PostCom
DMA/OCA-T6-7	USPS
DMA/OCA-T6-8	NAA, PostCom, USPS
DMA/OCA-T6-9	NAA, USPS
DMA/OCA-T1-1 redirected to T6	PostCom, USPS
DMA/OCA-T1-2 redirected to T6	USPS
DMA/OCA-T1-3 redirected to T6	PostCom
DMA/OCA-T1-5 redirected to T6	PostCom
MMA/OCA-T6-1	MMA
MMA/OCA-T6-2	MMA
MMA/OCA-T6-3	MMA
MMA/OCA-T6-4	MMA
MMA/OCA-T6-5	MMA
PostCom/OCA-T6-1	NAA
PostCom/OCA-T6-2	PostCom
PostCom/OCA-T6-3	NAA, PostCom
PostCom/OCA-T6-4	PostCom, USPS
PostCom/OCA-T6-5	PostCom, USPS
USPS/OCA-T6-1	USPS
USPS/OCA-T6-2	USPS
USPS/OCA-T6-3	USPS
USPS/OCA-T6-4	USPS
USPS/OCA-T6-5	USPS
USPS/OCA-T6-6	USPS
USPS/OCA-T6-7	USPS
USPS/OCA-T6-9	USPS
USPS/OCA-T6-10	USPS
USPS/OCA-T6-11	USPS
USPS/OCA-T6-12	USPS

USPS/OCA-T6-13	USPS
USPS/OCA-T6-15	USPS
USPS/OCA-T6-16	USPS
USPS/OCA-T6-20	USPS
USPS/OCA-T1-11 redirected to T6	USPS
USPS/OCA-T1-12 redirected to T6	USPS

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES DMA/OCA-T6-1-9

DMA/OCA-T6-1. Please refer to your testimony at page 22, where you compute an "average mark-up index" for First Class Letters in the amount of 1.263. Please also refer to your testimony on page 23 at lines 5-7, where you discuss the annual contribution of First-Class letter mail to USPS institutional costs "... intended by the Commission, based upon the average First-Class Letters mark-up index benchmark."

- a. Would you agree that the expressions of intent by the Postal Rate Commission concerning institutional cost contribution of any class of mail, including First-Class Letter mail, are limited to the respective proceeding in question; are based upon the evidence in each respective proceeding; and are limited to the test year utilized in the respective proceeding? Please explain fully any answer other than an unqualified "yes."
- b. Please identify, with as much specificity as possible, any and all expressions of Commission intent with respect to contributions to institutional costs by specific classes or subclasses of mail in years other than the test years utilized in each respective proceeding.
- c. In your opinion, has the Commission ever expressed an intent concerning contribution to institutional costs with reference to averages based upon multi-year periods? If so, please identify all such expressions with as much specificity as possible.

RESPONSE TO DMA/OCA-T6-1.

(a) No. For purposes of my analysis, I interpret the test year as a period that is intended to be typical or representative of (i.e., an average for) the period that recommended rates are in effect. Thus, the contribution recommended by the Commission for the test year should equal the average contribution per year during the period in which the rates are in effect.

(b) - (c) See my response to part (a), above.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES DMA/OCA-T6-1-9

DMA/OCA-T6-2. Please refer to your testimony on page 23, line 1, where you state, "This excess contribution has accelerated in recent years."

- a. Please confirm that the First-Class Letters mark-up index reflected in the Commission's recommendations in the two most recent omnibus rate proceedings, as shown in your Table 10 (1.310 and 1.308, respectively) are both in excess of your computed "average mark-up index" of 1.263. If you do not confirm, please explain fully.
- b. Would you agree that the "acceleration" in the purported "excess contribution" is a direct result of express PRC choices that were made in Dockets R94-1 and R97-1, and that were based on the evidence of record in those proceedings? Please explain fully any answer other than an unqualified "yes."
- c. Please refer to your Table 11. If the annual contributions to institutional costs made by First-Class Letter mail are a result of specific Commission recommendations, is it not erroneous to consider these contributions, especially those in the years 1997 through 2001, to be "excess?" Please explain fully any answer other than an unqualified "yes."

RESPONSE TO DMA/OCA-T6-2.

(a) Confirmed.

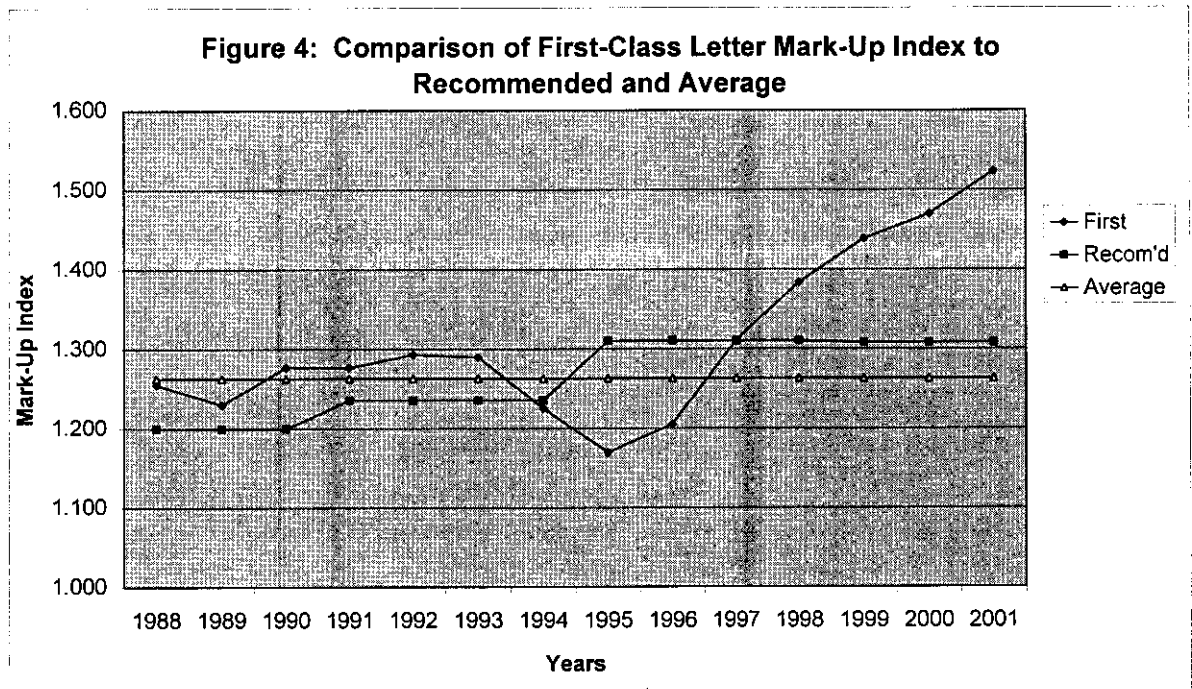
(b) No. The notion that the "'acceleration' in the purported 'excess contribution' is a direct result of express PRC choices" is not borne out by an analysis of actual revenue and cost data. Below, I have reproduced Figure 4 from my testimony, OCA-T-6, Part I, at 13, with one change. That change calculates the First-Class Letters mark-up index using the R97-1 rates for FY 2001.

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ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES DMA/OCA-T6-1-9

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

Mark-Up Index	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
First	1.256	1.230	1.277	1.276	1.293	1.289	1.226	1.189	1.206	1.311	1.384	1.439	1.469	1.524
Recom'd	1.200	1.200	1.200	1.235	1.235	1.235	1.235	1.310	1.310	1.310	1.310	1.308	1.308	1.308
Average	1.263	1.263	1.263	1.263	1.263	1.263	1.263	1.263	1.263	1.263	1.263	1.263	1.263	1.263



Source: For FY 2001, Exhibit USPS-32A (revised 4-21-00) at 1.

Beginning in FY 1995, the actual markup index for First-Class Letters rises rapidly through FY 1999. Moreover, using R97-1 rates, the estimated mark-up index continues rising through FY 2001, to 1.524 $((16,631.177 / 24,627.081) / (18,459.138 / 41,647.946))$. During this same period, the Commission-recommended index is essentially constant at about 0.05 above the four-rate-case average. If one calculates the excess First-Class Letter Mail contribution relative to the recommended contribution over the two most recent rate cases, one finds a smaller excess. But the

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ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES DMA/OCA-T6-1-9

annual excess increases every year. Thus, the acceleration in the amount of the excess in recent years remains even after accounting for the Commission's recent higher recommended mark-up indexes.

(c) No. The table below is an excerpt from Table 11 showing the period FY 1995 through FY 2001. This excerpt displays the excess contribution made by First-Class Letter Mail calculated using the Commission's recommended mark-up indexes—1.310 for FY 1995 through FY 1998, and 1.308 for FY 1999 through FY 2001. The excess rises rapidly.

EXCERPT FROM TABLE 11 IN OCA-T-6

1995	1996	1997	1998	1999	2000	2001
(\$1,221)	(\$841)	\$117	\$1,292	\$1,505	\$2,229	\$1,210

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES DMA/OCA-T6-1-9

DMA/OCA-T6-3. Please refer to your testimony at page 27, line 3 through page 28, line 5. In this passage you refer to the first pricing criterion of section 3622(b) ("fairness and equity") and state that "Simple fairness suggests that the institutional cost burden for First-Class Letter Mail be mitigated." Please refer also to your testimony on page 28, lines 18-19, where you state, "The trend of a higher institutional cost burden borne by First-Class Letter Mail in excess of that intended by the Commission, on balance, requires mitigation."

- a. Please confirm that, with the exception of a brief reference to pricing criterion 9 ("which permits the Commission to consider such other factors as it deems appropriate.") (page 28, lines 22-23), your testimony omits reference to any other of the pricing criteria set forth in section 3622(b) of the Postal Reorganization Act.
- b. Please explain in as much detail as possible the extent to which you considered pricing criteria 2 through 8 in connection with your recommendation to maintain the single-piece First-Class rate at 33 cents.
- c. Please present an analysis of the evidence of record in this case relevant to pricing criteria 2 through 8 and describe the extent to which this testimony supports or undermines your proposal.

RESPONSE TO DMA/OCA-T6-3.

(a) Confirmed.

(b) - (c) The 33 cent single-piece First-Class rate that I propose is the same rate recommended by the Commission and approved by the Governors in Docket No. R97-1. Consequently, since I propose no change in the lawful current single-piece rate, I did not consider it necessary to analyze any of the criteria in Section 3622(b). Moreover, I am not aware that anyone has contested the consistency of the current single-piece rate with the criteria of Section 3622(b).

My proposal to provide some degree of mitigation of the high and rising institutional cost burden on First-Class Letter Mail can be achieved simply by retaining

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES DMA/OCA-T6-1-9

the current single-piece rate, thereby enhancing fairness and equity for individual and smaller mailers.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES DMA/OCA-T6-1-9

DMA/OCA-T6-4. Assuming, arguendo, that the Commission agrees with you that the cost coverage for First-Class letters should be moderated, please provide as complete an explanation as possible as to why the Commission should recommend a cost coverage and mark-up index for First-Class letters at the levels implied in the OCA 33-cent SPFC proposal.

- a. Did you consider during the preparation of your testimony, or can you now suggest, a modification in the USPS proposals that would benefit consumers and small businesses and that would "moderate" First-Class letter cost coverage, but to an extent lesser than that implied by the OCA 33-cent SPFC?
- b. If so, please describe such modification as fully as possible.

RESPONSE TO DMA/OCA-T6-4.

Maintaining the 33 cent single-piece rate would reduce the high institutional cost burden on First-Class Letter Mail in a manner providing the most benefit to consumers. That the First-Class Letter Mail institutional cost burden has become more prominent in recent years, and will remain high through the test year, seems indisputable. See OCA-T-6, Part I, Figures 1 and 2, at 8 and 9, respectively. Moreover, it is clear the institutional cost burden has exceeded that intended by the Commission, on balance, during the years FY 1988 through FY 1999. Similarly, considering only the test year in Docket No. R97-1, the institutional cost burden on First-Class Letter Mail has far exceeded that intended by the Commission, based upon the Commission's recommended mark-up index. See OCA-T-6, Part I, Figure 4, at 13. The conclusion is inescapable that mailers of First-Class Letters are carrying an increasing institutional cost burden of the Postal Service, and to a much greater extent than intended by the Commission, and that simple fairness suggests that this burden be mitigated. For that

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES DMA/OCA-T6-1-9

reason, I propose maintaining the 33 cent single-piece rate.

(a) - (b) Yes. Other options for reducing the institutional cost burden on First-Class Letter Mail might include reducing the extra ounce rate, or increasing the "passthroughs" for presort mail. However, these options would be less beneficial for consumers than maintaining the current 33-cent First-Class rate.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES DMA/OCA-T6-1-9

DMA/OCA-T6-5. Please refer to your testimony on page 30, lines 8-17.

- a. Please provide an estimate of the postage costs that would be saved by First-Class mailers in the test year if the OCA 33-cent SPFC proposal were implemented, as compared with the First-Class rates proposed by the Postal Service.
- b. Please provide an estimate of the portion of the estimated savings identified in question 5.a., above, that would be saved by consumers.
- c. Please provide an estimate of the portion of the estimated savings identified in question 5.a., above, that would be saved by business mailers.

RESPONSE TO DMA/OCA-T6-5.

(a) I estimate total postage savings to mailers of First-Class Letters at \$1.076 billion. See my response to PostCom/OCA-T6-4(a).

(b) According to the Postal Service, a reasonable approximation of the volume of First-Class Mail generated by households in 1998 is 14.9 billion. Tr. 12/4766 (OCA/USPS-T33-1(a)). Thus, using this volume figure as a proxy for mail entered by consumers, I estimate consumers would save approximately \$149 million.

(c) I estimate the savings for business mailers to be \$927 million (\$1,076 - \$149).

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES DMA/OCA-T6-1-9

DMA/OCA-T6-7. Please refer to your testimony at page 37, lines 9-12, where you state that "... rates for First Class Letters ... would be set without regard to the 'integer constraint.'" You continue by stating, *"The rate actually paid by households, by contrast, would be set at a whole cent."*

- a. Is it your proposal that the SPFC "integer rate" would not be available to business mailers? If so, how do you propose that the Postal Service enforce the requirement that business mailers pay a rate other than the integer rate?
- b. Are you proposing that there would be a difference in the SPFC rate depending upon whether a stamp, a postage meter or some other method of paying postage were used? Please explain fully.
- c. Do you have any data or estimates on the number of household mailers that have access to means of paying postage other than by applying stamps? If so, please provide such data and/or estimates in as much detail as possible.

RESPONSE TO DMA/OCA-T6-7.

(a) - (b) No. Under SPFC rate stability proposal, any mailer, business or otherwise, entering single-piece First-Class letter mail, e.g., mail other than presorted or prebarcoded, would pay the single-piece First-Class rate, and could benefit from the longer period of stable rates intended by this proposal.

(c) No.

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ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES DMA/OCA-T6-1-9

DMA/OCA-T6-8. Please refer to your testimony at page 37, line 20 through page 38, line 5.

- a. Would the 33-cent SPFC stamp you propose produce a "positive balance" in the "SPFC Reserve Account" that you propose, in the test year?
- b. If so, how large do you estimate the reserve would be at the end of test year?
- c. On pages 21 through 23 of your testimony, you argue that First-Class letter mail has contributed an excess of revenues over the past twelve years. Is it your testimony that, in effect, there is already a "positive balance" to the "credit" of SPFC mail that should cause the Commission to recommend SPFC rate stability in this proceeding by maintaining the 33-cent rate recommended in R97-1?
- d. Have you made an analysis as to whether similar "excess contributions" have been made by other classes or subclasses of mail that should be used to maintain rate stability for those classes, as well? If so, please describe such analyses in detail.

RESPONSE TO DMA/OCA-T6-8

(a) - (b). In this proceeding, if the Commission maintains the current First-Class rate at 33 cent, rate stability will effectively be provided through two rate case periods, Docket Nos. R97-1 and R2000-1. Under these circumstances, I would not expect the Commission to recommend my rate stability proposal in this proceeding; it would be more appropriate to recommend this proposal in the next rate proceeding. Please note that to illustrate the operation of my proposal, I assumed a 34 cent SPFC rate and a "calculated" non-integer single-piece rate of 33 cents, the rate from which workshare discounts are set. Under these illustrative assumptions, which could be recommended by the Commission in this proceeding, I estimate that the SPFC Reserve Account would accumulate \$517 million in the test year. See OCA-T-6, part II, Table 13, at 40.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES DMA/OCA-T6-1-9

(c) No. I consider my proposal to mitigate the high institutional cost burden on First-Class Letter Mail by maintaining the current 33 cent First-Class rate, discussed in Part I of my testimony, separate from the SPFC rate stability proposal, discussed in Part II of my testimony. The high institutional cost burden on First-Class Letter Mail should be reduced whether or not the Commission decides to recommend the SPFC rate stability proposal. Similarly, the Commission could recommend a "calculated" non-integer single-piece rate that results in the same cost coverage as proposed by the Postal Service, and then set the SPFC rate to fund the SPFC Reserve Account.

(d) No. However, an analysis of the institutional cost contribution of Standard (A) Regular mail reveals not "excess contributions," but contributions less than intended by the Commission, based upon the Commission's recommended mark-up index for Standard (A) Regular. See OCA-T-6, Part I, Figure 8, at 19.

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ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES DMA/OCA-T6-1-9

DMA/OCA-T6-9. What are the cost coverage and mark-up index for First-Class letters implied by the OCA 33-cent SPFC proposal in the Test Year both (1) using Test Year costs proposed by the Postal Service and (2) using Test Year costs as estimated by OCA witness Thompson. See OCA-T-9.

RESPONSE TO DMA/OCA-T6-9

With respect to (1) Test Year costs proposed by the Postal Service, the cost coverage and mark-up index for a 33 cent single-piece First-Class rate would be 190.1 percent and 1.369, respectively.

With respect to (2) Test Year costs estimated by OCA witness Thompson, the cost coverage and mark-up index for a 33 cent single-piece First-Class rate would be 180.4 percent and 1.353, respectively.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES DMA/OCA-T1-1-6

DMA/OCA-T1-1. Please refer to your testimony, OCA-T-1, at page 5.

- a. Have you made a legal analysis of the consistency between your "single-piece first-class rate stability proposal" and the provisions of the Postal Reorganization Act of 1970?
- b. If so, please describe the results of your analysis in as much detail as possible.
- c. Please describe in as much detail as possible your opinion, if any, as to whether your First-Class rate stability proposal is consistent with the requirement that postal rates implemented pursuant to a particular PRC proceeding be supported by the record created in that proceeding.
- d. Please describe in as much detail as possible your opinion, if any, as to whether your first-class rate stability proposal is consistent with USPS management prerogatives relating to the timing of the filing of omnibus postal rate proceedings and the timing of implementation of postal rate changes.

RESPONSE TO DMA/OCA-T1-1.

(a) - (b) No. I am not a lawyer and, therefore, have not made a legal analysis of the type you describe. However, I would note that my proposal is designed so that single-piece First-Class Mail will "break-even" over two rate case periods in which the same single-piece First-Class rate is in effect. It is also intended that, if adopted, single-piece First-Class Mail would continue to bear its related direct and indirect costs, so as not to adversely affect other classes of mail.

(c) Since I am not a lawyer, I cannot give a legal opinion to this question. That said, however, under my proposal, the "calculated" single-piece non-integer rate would be determined in each rate proceeding, and in the same manner as past proceedings, including compliance with the test year break-even requirement. It would also preserve the right of every participant to litigate any issue in every case, including the single-

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES DMA/OCA-T1-1-6

piece First-Class ("SPFC") rate. Consequently, I would expect the record to have sufficient evidence to permit the Commission to determine the SPFC integer rate, including maintaining the SPFC rate in the next rate case after the SPFC rate has been established under this approach.

(d) My proposal does not affect postal management's prerogatives with respect to the timing of the filing of omnibus postal rate cases and the timing of implementation of postal rate changes. See OCA-T-6, at 4 and 47. Under my proposal, postal management is able to file omnibus rate proceedings, and to select the implementation date of rate changes, at its discretion. However, given that postal management is evidently planning to initiate future rate proceedings approximately every two years, see OCA-T-6, Part II, at pages 34-35, my proposal would accommodate the differing interests of household and business mailers with respect to such rate adjustments.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES DMA/OCA-T1-1-6

DMA/OCA-T1-2. Please refer to your testimony on page 5, lines 22-23, where you state: "The SPFC rate stability proposal is intended to provide greater convenience to consumers. . . ."

- a. In addition to the asserted "greater convenience to consumers," are there any other valid purposes that would be served by your proposal and that may provide additional reasons for the Commission to recommend your proposal? If so, please describe any and all such purposes in as much detail as possible.
- b. During the course of developing this proposal, did you consider the relative usage of single-piece First Class Mail by various types of mailers? If so, please describe in as much detail as possible what these considerations were and the data concerning SPFC usage that was available to you at that time.
- c. Do you currently have data concerning the relative usage of SPFC mail by households, "small businesses" and large businesses over the last five years? If so, please provide this data in tabular form.

RESPONSE TO DMA/OCA-T1-2.

(a) Yes. The SPFC rate stability proposal would accommodate the differing interests of household and business mailers with respect to the amount and timing of rate changes related to First-Class Mail. See OCA-T-6, Part II, at 30-35. Moreover, my proposal proposes that workshare discounts be determined by reference to a "calculated" non-integer single-piece rate, rather than the single-piece integer rate used now. In so doing, rates for workshare mail would more accurately reflect costs. See OCA-T-6, Part II, at 38-39.

The SPFC rate stability proposal could have some public relations value for the Postal Service. To the extent households find frequent rate changes inconvenient, maintaining the single-piece First-Class rate for longer periods would be viewed favorably, and redound to the benefit of the Postal Service.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES DMA/OCA-T1-1-6

The SPFC rate stability proposal is expected to increase workshare volumes and presort mailer revenues, at least during the first rate case period. The additional revenues could permit some presort mailers to invest in new capital equipment, thereby increasing efficiency. See OCA-T-6, Part II, at 45.

(b) - (c) See OCA-T-6, Part II, at 30.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES DMA/OCA-T1-1-6

DMA/OCA-T1-3. Please refer to your testimony at page 6, lines 11-13, where you state that "The Postal Service would track the excess or deficient revenues from single-piece mail over time in a reserve account."

- a. Please describe in as much detail as possible the manner in which this "reserve account" would be established and maintained.
- b. Would it be a separate account in which cash would be accumulated initially and then drawn down? If so, please explain in as much detail as possible what would happen when the assets in the account become fully depleted and additional charges to the account are made.
- c. Is the "reserve account" intended merely to be an accounting convenience?
- d. Whether the "reserve account" is an accounting convenience or an actual account in which assets are held, please describe in as much detail as possible the computations that would be made leading to the debiting or crediting of amounts to the account. Please address separately how the relevant costs would be computed in the test year, in the year following the test year, and in the years following implementation of a subsequent rate change.

RESPONSE TO DMA/OCA-T1-3.

(a) - (c) The SPFC Reserve Account is intended to be an entry in the book of accounts of the Postal Service for the purpose of recording the accumulation and reduction in revenues resulting from selecting (and then maintaining) the SPFC integer rate. See OCA-T-6, Part II, at 37-38. The amounts recorded in the SPFC Reserve Account represent the difference between the "calculated" non-integer rate and the SPFC rate multiplied by the volume of SPFC letters.

(d) I expect the balance in the SPFC Reserve Account to be determined each accounting period. Consequently, the amounts credited and debited in the SPFC Reserve Account would be the single-piece letter volume each accounting period

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES DMA/OCA-T1-1-6

multiplied by the difference between the "calculated" non-integer rate and the SPFC rate. This calculation would take place each accounting period beginning with the accounting period in which the new SPFC rate established under this proposal is made effective.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES DMA/OCA-T1-1-6

DMA/OCA-T1-5. Please refer to your testimony at page 6, lines 10-11.

- a. Please describe in as much detail as possible your conclusion that, under your rate stability proposal, "the single-piece rate category would 'break even' over two rate case periods."
- b. Does your proposal assume that the SPFC "deficit" created by keeping the SPFC rate "stable" in the second proceeding would be equal to the "surplus" created during the effectiveness of the rates implemented pursuant to the first case?
- c. What would be the result, under your proposal, if the deficit that needed to be filled in the second case were twice the size of the surplus that had been accumulated under the first case?
- d. Under the scenario hypothesized in question 5.c. above, would the SPFC rate be "rounded up" again, permitting the "surplus" to continue to grow, or would the SPFC rate be rounded down, creating a deficit that would require higher rates in the third proceeding?
- e. Assuming that the surplus created pursuant to the first case is not exactly equal to the deficit created through rate stability in the second case, would you agree that your proposal amounts to nothing more than an accounting convention creating a "slush fund" that could be used in any rate case to justify rounding up or rounding down the SPFC rate from a "target" fractional rate to a rate with an even integer? If you do not agree, please explain fully.
- f. Given the significant number of judgmental factors that the Commission must consider in setting all postal rates, including the SPFC rate, please explain your views as to the relative importance of your proposed "reserve account" in relation to the other pricing factors.

RESPONSE TO DMA/OCA-T1-5.

(a) The entire sentence is

The difference would be that the single-piece First-Class rates for letters and cards would be set in one case at a level that would permit the rate to remain unchanged during the second rate case period, such that the single-piece rate category would "break even" over two rate case periods.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES DMA/OCA-T1-1-6

This concept is also described in my testimony, OCA-T-6, Part II, at 37 and 38, lines 20-22, and 1-3, respectively. The intent expressed in both passages is that the SPFC rate would be selected so that sufficient revenues would be generated during the effective period of rates established at the time of the first rate case to permit the SPFC rate to be maintained through the following rate case period.

(b) That would be the intent when selecting the SPFC rate.

(c) - (d) My proposal anticipates the possibility that revenue generated during the first rate period may be insufficient to cover the likely revenue deficiency during the second rate period. If, at the time of the second rate proceeding, the SPFC Reserve Account is expected to have a revenue deficiency that is very large, such that the "calculated" non-integer rate is expected to increase by more than 1.5 cents above the existing SPFC integer rate, I propose that the Commission recommend a new SPFC integer rate at the time of the second rate proceeding to cover the estimated deficiency and generate additional revenues to build a positive balance in the SPFC Reserve Account to permit maintenance of the new SPFC rate through two rate cases. See OCA-T-6, Part II, at 45-46.

(e) No. My proposal is an effort to accommodate the interests of households for greater rate stability, while allowing business mailers smaller, more frequent and predictable rate adjustments. To do so, the SPFC integer rate would be set so that sufficient revenues would be generated to permit the single-piece rate paid by consumers to remain the same for two rate case periods, a duration of approximately

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ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES DMA/OCA-T1-1-6

four years. The SPFC Reserve Account, an accounting convention, is the mechanism by which the accumulation and reduction in revenues during the two rate case periods are recorded. Please see my response to DMA/OCA-T1-3(a)-(c).

(f) Please see my response to DMA/OCA-T6-3(b)-(c).

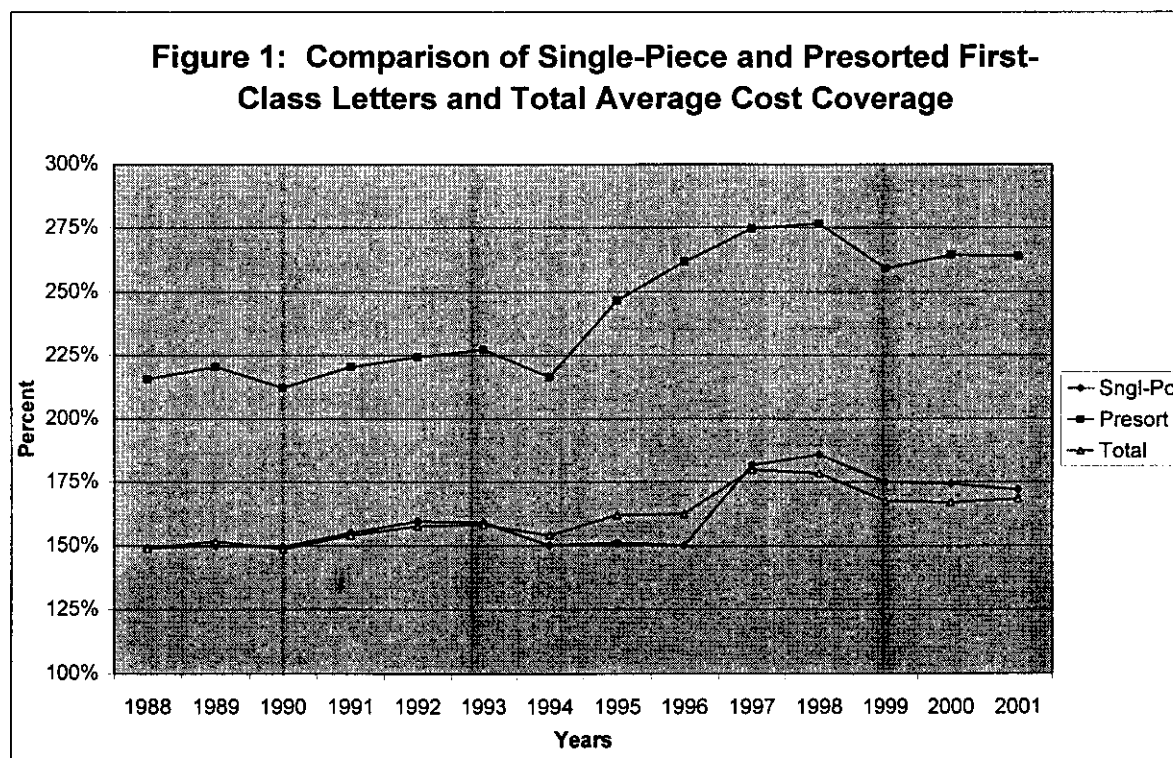
ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES MMA/OCA-T6-1-5

MMA/OCA-T6-1 Please refer to page 8 of your prepared testimony, specifically Table 1 and the graph identified as Figure 1, both entitled "Comparison Of First Class Letters And Total Average Cost Coverage." Please provide a similar table and graph showing, for the same time periods, the implicit cost coverages (separately) for First-Class Single Piece and First-Class Presorted Letters and the average total cost coverage.

RESPONSE TO MMA/OCA-T6-1

Table 1
COMPARISON OF SINGLE-PIECE AND PRESORTED FIRST-CLASS LETTER AND TOTAL AVERAGE COST COVERAGE

Cost Coverage	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Sngl-Pc	149%	150%	150%	155%	160%	159%	150%	151%	150%	182%	186%	175%	174%	172%
Presort	216%	220%	212%	220%	224%	227%	216%	247%	262%	275%	277%	259%	265%	264%
Total	149%	152%	149%	154%	158%	158%	154%	162%	162%	180%	178%	167%	167%	168%



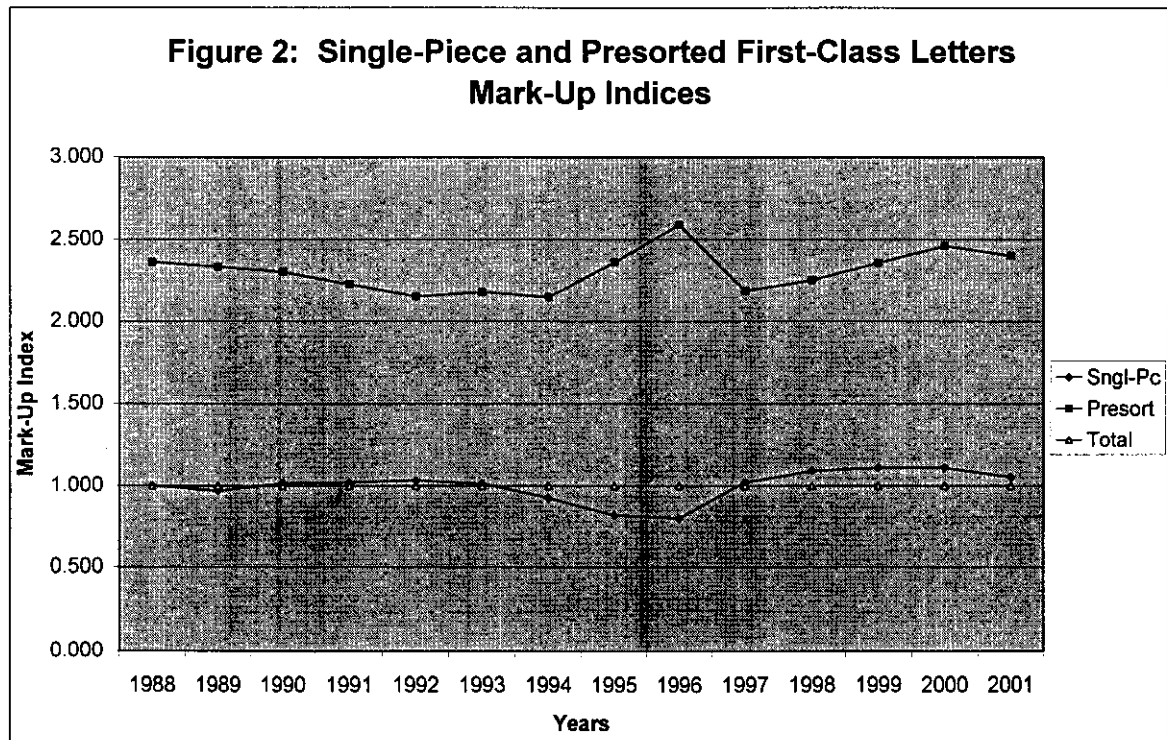
ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES MMA/OCA-T6-1-5

MMA/OCA-T6-2 Please refer to page 9 of your prepared testimony, specifically Table 2 and the graph identified as Figure 2, both entitled "First Class Letter Mark-Up Index." Please provide a similar table and graph showing, for the same time periods, the implicit mark up indices (separately) for First-Class Single Piece and First-Class Presorted Letters.

RESPONSE TO MMA/OCA-T6-2

Table 2
SINGLE-PIECE AND PRESORTED FIRST-CLASS LETTERS MARK-UP INDICES

Mark-Up Index	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Sngl-Pc	1.001	0.969	1.016	1.020	1.033	1.015	0.927	0.823	0.801	1.021	1.093	1.112	1.112	1.053
Presort	2.362	2.333	2.303	2.227	2.153	2.181	2.149	2.361	2.590	2.186	2.252	2.357	2.461	2.401
Total	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000

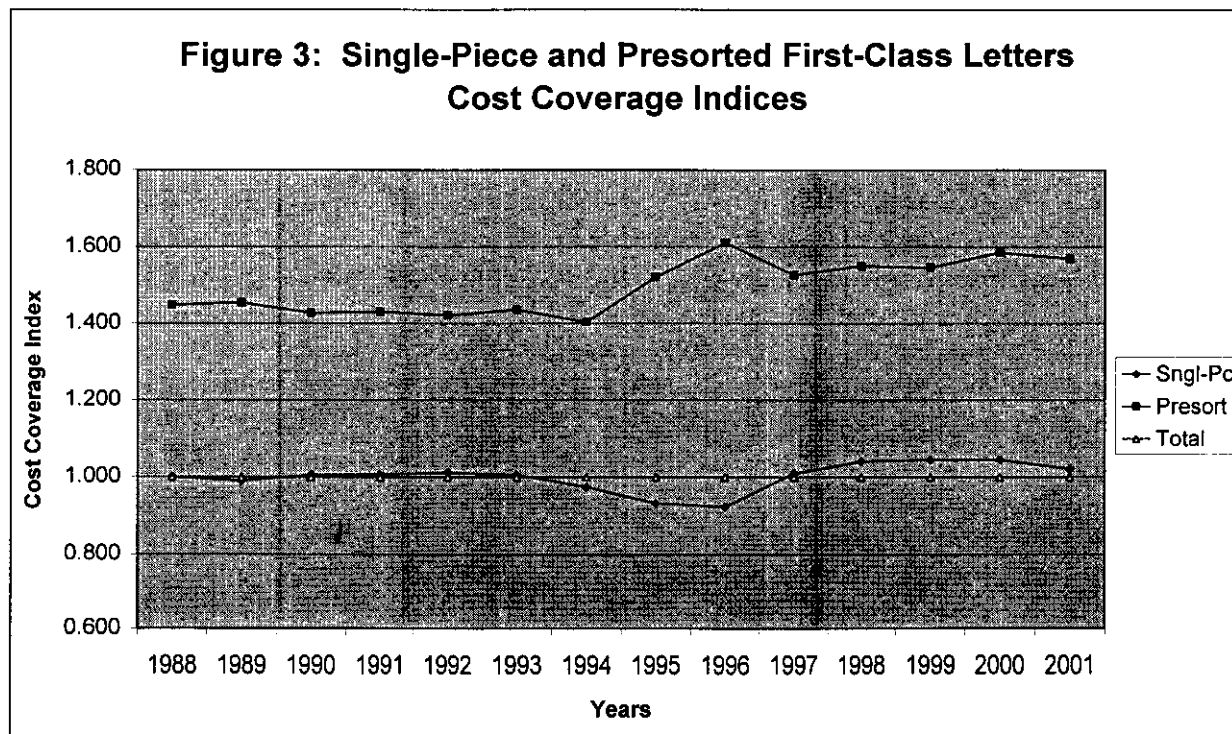


ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES MMA/OCA-T6-1-5

MMA/OCA-T6-3 Please refer to page 11 of your prepared testimony, specifically Table 3 and the graphs identified as Figure 3, both entitled "First-Class Letter Cost Coverage Index." Please provide a similar table and graph showing, for the same time periods, the implicit cost coverage indices (separately) for First-Class Single Piece and First-Class Presorted Letters.

RESPONSE TO MMA/OCA-T6-3

Table 3														
SINGLE-PIECE AND PRESORTED FIRST-CLASS LETTERS COST COVERAGE INDICES														
Cost Coverage Index	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Sngl-Pc	1.000	0.989	1.005	1.007	1.012	1.005	0.974	0.932	0.924	1.009	1.041	1.045	1.045	1.022
Presort	1.448	1.454	1.427	1.431	1.422	1.435	1.404	1.521	1.611	1.527	1.550	1.547	1.585	1.569
Total	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000



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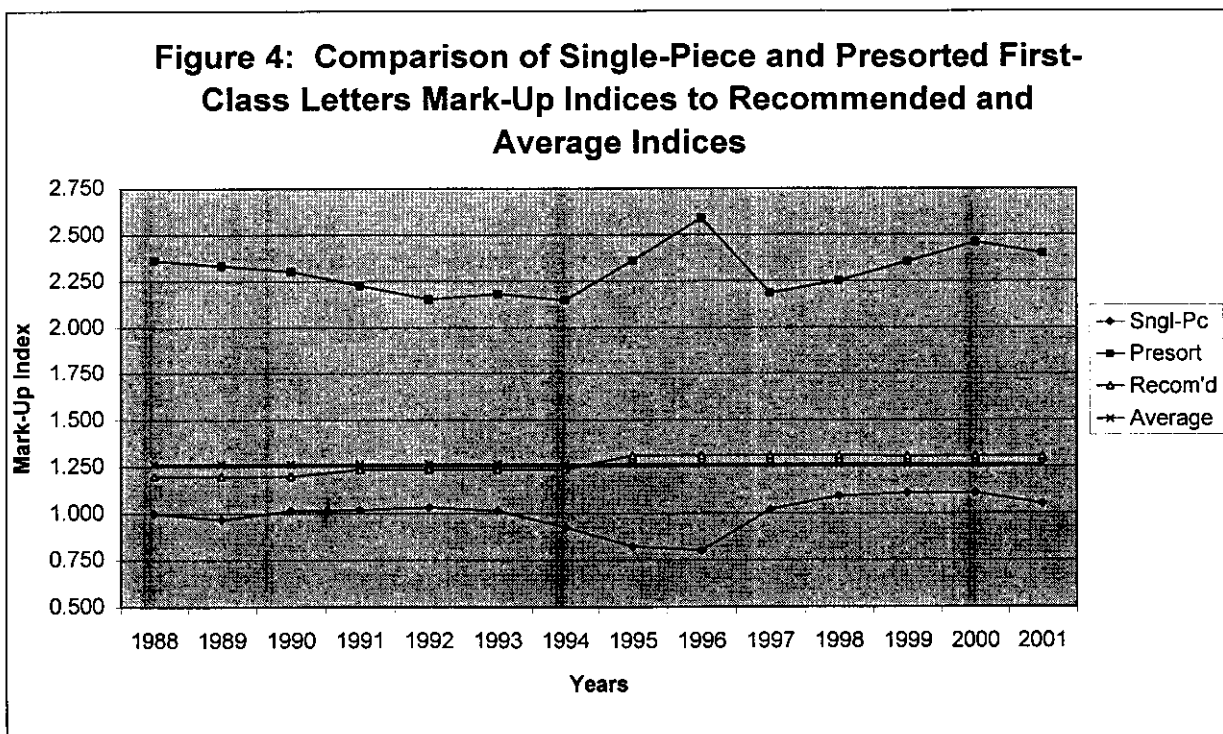
ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES MMA/OCA-T6-1-5

MMA/OCA-T6-4 Please refer to page 13 of your prepared testimony, specifically Table 4 and the graph identified as Figure 4, entitled respectively "Comparison Of First-Class Letter Mark-Up Index To Average And Recommended Mark-Up Indices" and "Comparison Of First-Class Letter Mark-Up Index To Average And Recommended." Please provide a similar table and graph showing, for the same time periods, the implicit mark-up indices (separately) for First-Class Single Piece and First-Class Presorted Letters, compared to the average and recommended mark-up indices.

RESPONSE TO MMA/OCA-T6-4

Table 4
COMPARISON OF SINGLE-PIECE AND PRESORTED FIRST-CLASS LETTERS MARK-UP INDICES TO RECOMMENDED AND AVERAGE MARK-UP INDICES

Mark-Up Index	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Sngl-Pc	1.001	0.989	1.016	1.020	1.033	1.015	0.927	0.823	0.801	1.021	1.093	1.112	1.112	1.053
Presort	2.362	2.333	2.303	2.227	2.153	2.181	2.149	2.361	2.590	2.186	2.252	2.357	2.481	2.401
Recom'd	1.200	1.200	1.200	1.235	1.235	1.235	1.235	1.310	1.310	1.310	1.310	1.308	1.308	1.308
Average	1.263	1.263	1.263	1.263	1.263	1.263	1.263	1.263	1.263	1.263	1.263	1.263	1.263	1.263



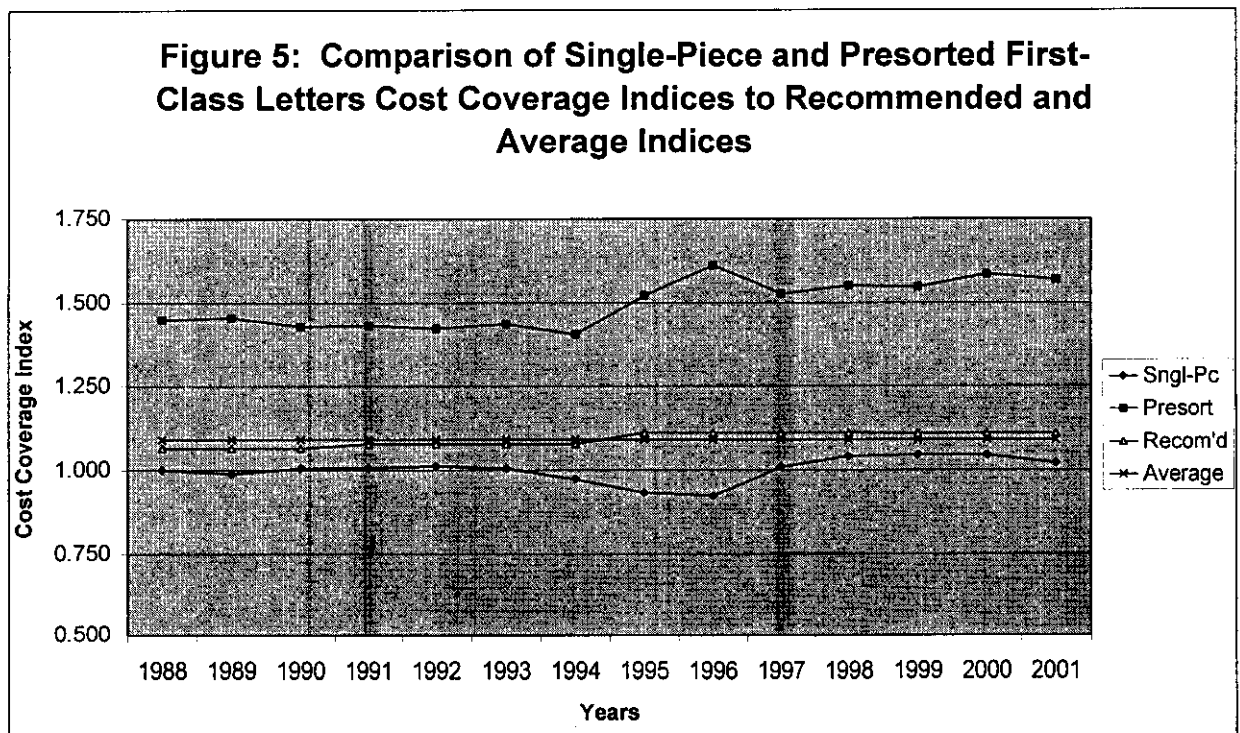
ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES MMA/OCA-T6-1-5

MMA/OCA-T6-5 Please refer to page 14 of your testimony, specifically Table 5 and the graph identified as Figure 5, entitled respectively "Comparison Of First-Class Letter Cost Coverage Index To Average And Recommended Indices" and "Comparison Of First-Class Letter Cost Coverage Index To Average And Recommended.". Please provide a similar table and graph showing, for the same time periods, the implicit cost coverage indices (separately) for First-Class Single Piece and First-Class Presorted Letters, compared to the average and recommended cost coverage indices.

RESPONSE TO MMA/OCA-T6-5

Table 5
COMPARISON OF SINGLE-PIECE AND PRESORTED FIRST-CLASS LETTERS COST COVERAGE INDICES TO RECOMMENDED AND AVERAGE INDICES

Cost Coverage Index	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Sngl-Pc	1.000	0.989	1.005	1.007	1.012	1.005	0.974	0.932	0.924	1.009	1.041	1.045	1.045	1.022
Presort	1.448	1.454	1.427	1.431	1.422	1.435	1.404	1.521	1.611	1.527	1.550	1.547	1.585	1.569
Recom'd	1.065	1.065	1.065	1.078	1.078	1.078	1.078	1.112	1.112	1.112	1.112	1.110	1.110	1.110
Average	1.091	1.091	1.091	1.091	1.091	1.091	1.091	1.091	1.091	1.091	1.091	1.091	1.091	1.091



ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES PostCom/OCA-T6-1-5

PostCom/OCA-T6-1. Should the parenthetical in the second line of note 3 at page 6 of your testimony read "(percentage by which the revenues exceed attributable cost)" with the emphasized word added?

RESPONSE TO PostCom/OCA-T6-1.

Yes. An appropriate errata will be filed.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES PostCom/OCA-T6-1-5

PostCom/OCA-T6-2. Which of the measures of "relative institutional cost[] burden" (at T6, 6, line 14) do you believe [are] most accurately reflective of the phenomenon to be measured and why?

RESPONSE TO PostCom/OCA-T6-2.

In analyzing the relative institutional cost burden, I purposely did not choose between the cost coverage, mark-up index, or cost coverage index for the purpose of measuring the institutional cost burden on First-Class Letter Mail. Rather, I presented all three measures because of their familiarity and, with respect to cost coverage and mark-up index, their use by the Commission. Moreover, in preparing my testimony, I did not separately study the cost coverage, mark-up index, or cost coverage index and their relative merits, or lack thereof, as measures of institutional cost burden since there is a remarkable consistency among all three measures with respect to the increasing institutional cost burden on First-Class Letter Mail.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES PostCom/OCA-T6-1-5

PostCom/OCA-T6-3. In your comparisons of the relative institutional cost burdens of First-Class letter mail and Standard (A) regular mail, how do you account for the creation of the Standard (A) ECR subclass?

RESPONSE TO PostCom/OCA-T6-3.

For revenues, I used the "Total Bulk Rate Regular" amount from the annual RPW, which includes the Carrier Presort rate category through PFY 1996, and the Standard (A) ECR subclass for years after PFY 1996. For costs, I used the "Total Regular" amount, which includes the Carrier Presort rate category through FY 1996, and the "Total Commercial" amount for years after FY 1996, which includes the Standard (A) ECR subclass, from the annual Cost Segments and Components. This permits a consistent measure of revenues and costs for commercial mail e.g., mail other than nonprofit and single-piece, as a whole during the entire period of my analysis.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES PostCom/OCA-T6-1-5

PostCom/OCA-T6-4. Your proposal for First-Class rates in part 1 (iii) of your testimony appears to affect only single-piece First-Class letters. [a] Is this correct? [b] Please confirm that your analysis of cost burdens in part 1 (i) is based upon all First-Class letter mail, not solely single-piece First-Class letter mail. If you do confirm, please explain why you believe that the remedy you propose is justified by the proof you advance for it. If you do not confirm, please explain.

RESPONSE TO PostCom/OCA-T6-4.

(a) No. My proposal to maintain the single-piece First-Class rate would also affect the rates for workshare mail. I do not take a position on the proper discounts for workshare mail. I assume, for purpose of analysis, that the discounts from the single-piece rate would not change. As a result, my proposal would affect the rates for workshare mail.

In the body of my testimony, for purposes of illustration, I estimate the direct benefit to mailers of maintaining the single-piece rate at approximately \$607 million. See OCA-T-6, Part I, at 24. In Footnote 14, I present the total reduction in revenues for the entire First-Class Letter Mail subclass, an estimated \$1.076 billion.

(b) Confirmed. See my response to part (a) above.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES PostCom/OCA-T6-1-5

PostCom/OCA-T6-5. At OCA-T6, 38, lines 12-14 you say:

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

- (a) Please explain how the SPFC reserve account balance "would be taken into account."
- (b) Do you envision any other changes in the factors taken into account at present in omnibus rate cases in setting SPFC rates?

RESPONSE TO PostCom/OCA-T6-5.

(a) At the time of the third rate proceeding, I would expect the "calculated" non-integer single-piece rate to be determined in the same manner as in any rate proceeding. See OCA-T-6, Part II, at 37, lines 7-11. However, when the single-piece First-Class integer rate (paid by consumers) is set by the Commission, the balance in the SPFC Reserve Account would be considered. If the balance in the SPFC Reserve Account was positive and sufficiently large, there might not need to be a change in the integer rate paid by consumers, or the increase might be smaller than would otherwise be the case. Alternatively, if the balance was negative by a large amount, the integer rate paid by consumers would be increased to cover the negative balance and generate additional revenues to build a positive balance in the SPFC Reserve Account to permit maintenance of the new SPFC rate through the fourth rate case.

- (b) No.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T6-1-13

USPS/OCA-T6-1

In Part II, Section I.A of your testimony, you state that "Households Prefer Longer Periods of a Stable Single-Piece First-Class Rate." Please elaborate upon any studies that support this contention. In particular:

- a. Is this section of testimony based on any surveys or other studies of household mailers that indicate preference for these "longer periods of stable rates"? If so, please provide documentation for these studies.
- b. Is this section of your testimony based on any focus group studies that indicate preference for the longer periods of stable single-piece First-Class Rates? If so, please provide notes, transcripts, etc., documenting these focus group studies.

RESPONSE TO USPS/OCA-T6-1

(a) - (b) No. OCA attempted to elicit this information from the Postal Service, to no avail. See Tr. 21/9090. Response of the United States Postal Service to Interrogatory of the Office of the Consumer Advocate, OCA/USPS-54.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T6-1-13

USPS/OCA-T6-2

What percent of the household single-piece First-Class mailers prefer the larger rate increases every other rate case? Please provide the data source and backup documentation for this figure. If you do not have data necessary, so state, and please state what you believe to be a rough order of magnitude (ex., 10-20 percent) for this figure.

RESPONSE TO USPS/OCA-T6-2

To my knowledge, there is no data available to answer this question. See my response to USPS/OCA-T6-1(a) - (b). Any information on the preferences of consumers is based upon correspondence from consumers, or phone conversations.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T6-1-13

USPS/OCA-T6-3

Part II, Section I.A.2, is titled "Longer periods of rate stability minimize confusion to household mailers."

- a. What is the proportion of households for which the primary mailers of the household are generally confused due to a rate increase? Please explain how you arrive at this figure. If you have no data on which to rely for this response so state and please state what you believe to be a rough order of magnitude (ex., 10-20 percent) for this figure.
- b. Do you have any data to indicate how these confused household mailers cope with non-postal price increases (for example, gasoline prices)? Do any of these non-postal price increases occur with greater frequency than general postal rate increases?

RESPONSE TO USPS/OCA-T6-3

(a) I have not seen any data of the type requested that would permit computation of the proportion of households confused by postal rate changes. Nevertheless, as a practical matter, it seems that any rate change, either positive or negative, could cause a period of confusion for some consumers. This is likely where households possess several different First-Class stamps, such as current single-piece stamps, "make-up" rate First-Class stamps, and non-denominated or letter-denominated stamps marked "First-Class." An indication of the magnitude of this situation is the 239 million pieces of "short-paid" single-piece letters. See Tr. 21/9166. Response of the United States Postal Service to Interrogatory of the Office of the Consumer Advocate, OCA/USPS-106.

(b) No. Yes, I believe prices for gasoline change more frequently than postal rates. With respect to confusion over changes in non-postal prices for consumer

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T6-1-13

goods. such as gasoline, the price is known by the consumer at the time of purchase.
and there is no need for the consumer to remember the price or re-value the item at the
time of use.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T6-1-13

USPS/OCA-T6-4

Consider the household mailers who are generally confused by, say, a one-cent increase every three years in the single-piece First-Class rate.

- a. What is the approximate size of this group of household mailers?
- b. Were you able to determine what proportion of this group would be less confused if they would sometimes receive a rate increase and sometimes not at the conclusion of an omnibus rate case? Please explain and provide any relevant data and studies supporting your response.

RESPONSE TO USPS/OCA-T6-4

(a) - (b) See my response to USPS/OCA-T6-3(a) - (b).

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T6-1-13

USPS/OCA-T6-5

Please refer to Part II, Section I.A.2 of your testimony which is titled "Longer periods of rate stability minimize confusion to household mailers." In this section you assert that longer periods between rate increases would decrease confusion for household mailers.

- a. Suppose that rates would never again be increased for single-piece First-Class rates. Would this lead to less or more confusion for those household mailers who are confused by rate increases? Please explain.
- b. Please define the use of the word "minimize" in the context of the title of Part II, section I.A.2 of your testimony.

RESPONSE TO USPS/OCA-T6-5

(a) I am not aware of data on "confused" households. Not changing the single-piece First-Class rate would seem to minimize confusion. See my response to USPS/OCA-T6-3(a) - (b).

(b) I use the term "minimize" to indicate that households become more familiar with postal rates over time and that changing such rates could create a period of confusion.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T6-1-13

USPS/OCA-T6-6

On page 4[9] lines 13-14 of your testimony you state, "Advances in the technology of mail processing since implementation of the surcharge have made the surcharge obsolete with respect to low aspect ratio mail..." Separately list each technological advance to which you are referring and state how each advance specifically affects low aspect ratio mail piece costs such that the nonstandard surcharge would be "obsolete."

RESPONSE TO USPS/OCA-T6-6

The statement concerning "[a]dvances in the technology of mail processing since implementation of the surcharge" in my testimony refers to advances in technology generally, and over time. Since implementation of the surcharge, mail processing technology has progressed from manual processing, through Letter Sorting Machines (LSMs), to the present, where almost all letter mail is now processed on automated mail processing equipment. It is this advance in technology that permits the Commission to conclude: "It is well-accepted that the Service's processing equipment is now far more sophisticated than when the surcharge was introduced." See PRC Op. R97-1, para. 5227.

Moreover, the Postal Service's automated mail processing equipment is not designed to cull-out nonstandard mailpieces based upon aspect ratio. Tr. 5/2078 (Kingsley). The operating manuals for the current generation of OCRs and BCSs do not list aspect ratio as a limitation of the equipment. Tr. 7/3221 (Miller). Consequently, it might be fair to deduce that the Postal Service's automated mail processing equipment has some toleration for mailpieces that are nonstandard by virtue of their aspect ratio.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T6-1-13

USPS/OCA-T6-7

On page 5[7] lines 15-16 of your testimony you state that "The Postal Service does not 'fully understand' how the aspect ratio affects mail processing operations." Please confirm that the OCA does not "fully understand" how low aspect ratios affect mail processing operations. If not confirmed, please explain.

RESPONSE TO USPS/OCA-T6-7

The statement quoted at page 57 of my testimony captures the meaning of Postal Service witness Miller's testimony (USPS-T-24) with respect to the Postal Service's understanding of the effect of aspect ratio on mail processing operations. See USPS-T-24, at 21, lines 27-29. Moreover, it is clear the Postal Service has no intent to remedy its limited understanding by studying mail processing operations as they relate to aspect ratio. *Id.* at 21-22. Consequently, OCA's understanding as to how aspect ratio affects mail processing operations involving low aspect ratio letter mail is necessarily limited by the Postal Service's unwillingness to "fully understand" such affects.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T6-1-13

USPS/OCA-T6-9

On page 5[3] lines [5-7] of your testimony you state, "The increasing sophistication of automated equipment permits certain nonstandard letter mail, previously unsuited for mechanized processing, to be processed on the automated equipment."

Please describe the "certain nonstandard letter mail" to which you are referring. Also describe in specific, technical detail the "increasing sophistication" of automated equipment and the manner in which each specific increase in sophistication ensures that mail "previously unsuited for mechanized processing" can now be "processed on the automated equipment."

RESPONSE TO USPS/OCA-T6-9

The statement quoted at page 53 of my testimony is the first sentence of a paragraph, and represents a general statement. The remainder of the paragraph discusses the processing of low aspect ratio letter mail. With respect to the increasing sophistication of automated mail processing equipment, please see my response to USPS/OCA-T6-6.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T6-1-13

USPS/OCA-T6-10

On page 5[3] lines [11-13] you state:

"In fact, it has been shown that some seasonal greetings that are square in shape (aspect ratio 1:1) are processed either partially, or entirely, on automated equipment." This comment refers to an analysis performed by witness Haldi (NDMS-T-1) in Docket No. R97-1.

- a. Please confirm that this analysis consisted of a sample size of 10 5"x5" Christmas cards (Docket No. R97-1, NDMS-T-1, page 11). If not confirmed, please explain.
- b. Do you consider an analysis that involves a sample size of 10 to be statistically valid? If so, please explain. If not, please explain how this analysis has "shown" (as you put it) anything.
- c. Please confirm that 1 of the 10 envelopes was damaged during processing (Docket No. R97-1, NDMS-T-1, page 12). If not confirmed, please explain.
- d. Do you consider a damage rate of 10% to be acceptable? If you do, please explain why. If you do not, what would you consider to be an acceptable damage rate?
- e. Please confirm that, of the remaining nine undamaged cards, one card was never received (Docket No. R97-1, NDMS-T-1, page 11, footnote 8). If not confirmed, please explain.
- f. Is it possible that the mail piece described in (e) was also damaged during processing such that the mail piece was destroyed and could not be delivered? If your answer is no, please explain.
- g. Please confirm that the presence of a barcode on a mail piece does not necessarily mean that this mail piece was successfully processed on automation through the entire postal automation mail processing network. If not confirmed, please explain.
- h. Please confirm that witness Haldi's study did not prove that any of the 10 nonstandard mail pieces were successfully processed through the entire postal automation mail processing network. If not confirmed, please explain.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T6-1-13

RESPONSE TO USPS/OCA-T6-10

(a) Confirmed.

(b) No. Both the Commission and witness Haldi characterized the mailing of 10 Christmas cards with envelopes that were square in shape (aspect ratio of 1:1) as an "experiment," and a "small-scale experiment," respectively. As is evident in witness Haldi's library reference, LR-NDMS-1, from Docket No. R97-1, nine were received with cancellation and barcodes, evidencing some automated mail processing. It is this "experiment" that shows, and permits the Commission to conclude, that "automation capabilities have expanded, at least for low aspect ratio mail pieces." See PRC Op. R97-1, para. 5227. It also shows that witness Miller's assumption that "all nonstandard letters are processed manually," see USPS-T-24, at 22, is not realistic, and should be replaced.

(c) Confirmed.

(d) No. Since I do not consider a mailing of 10 low aspect ratio letters statistically valid, I would not consider one damaged envelope out of 10 to be a statistically valid measure of the rate of damage of low aspect ratio letter mail.

(e) Confirmed.

(f) There are many other possibilities as well, including the possibility, as explained by witness Haldi, that the Christmas card never received was never actually mailed. See Docket No. R97-1, NDMS-T-1, at 11, note 8. So is the possibility that the card in question was lost at the point of collection. Similarly, there is the possibility that

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T6-1-13

the card in question was never delivered by the carrier during the busy holiday season. The number of possibilities would seem limitless, and there appears no way to determine the true cause of the missing card.

(g) Confirmed. What the presence of a barcode does show, however, is that the Postal Service's assumption of 100 percent manual processing for low aspect ratio letter mail is not realistic.

(h) Confirmed. What witness Haldi's "small-scale experiment" does show is that there is some automated processing of low aspect ratio letter mail and, as a result, the Postal Service's assumption of 100 percent manual processing for such mail is unrealistic.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T6-1-13

USPS/OCA-T6-11

In Table 17 on page 6[3] you calculate several mail processing unit costs for low aspect ratio letters given a variety of inputs.

- a. Please confirm that every mail processing unit cost value listed in Table 17 is greater than the average single-piece letter mail processing unit cost of 12.296 cents that you reference on page 6[4] line [1]. If not confirmed, please explain.
- b. Please confirm that the cost cells in Table 17 indicate that nonstandard letters with low aspect ratios do indeed incur additional mail processing costs. If not confirmed, please explain.
- c. Given the results shown in Table 17, how can you justify eliminating the nonstandard surcharge for low aspect ratio letters when the results clearly indicate that these mail pieces incur additional costs?

RESPONSE TO USPS/OCA-T6-11

(a) Confirmed.

(b) Confirmed. The amount of the addition to the unit cost of processing standard letter mail caused by the low aspect ratio characteristic is the difference between each unit cost shown in Table 17 and 12.296 cents.

(c) While every amount in Table 17 is greater than the cost of processing standard-size mail, it is also true that every amount is far below the Postal Service's proposed test year single-piece rate of 34 cents. Consequently, low aspect ratio nonstandard letter mail would still provide a substantial per unit contribution to institutional costs, without materially affecting the cost coverage of single-piece First-Class Mail. Moreover, the estimated maximum revenue loss to the Postal Service from eliminating the 11 cent surcharge would be negligible, at \$6,899,000.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T6-1-13

USPS/OCA-T6-12

In Table 17, an input to your cost analysis is the probability that a mail piece would be faced properly. You use a range from 0.5 to 1.0.

- a. Please confirm that these percentages are not based on any "real world" studies conducted at postal facilities. If not confirmed, please explain.
- b. Please confirm that the use of percentages lower than 0.5 would increase the costs found in columns [3], [4], and [5]. If not confirmed, please explain.
- c. Please confirm that your use of 0.5 as a starting point does not consider mail piece characteristics such as: the distribution of envelope weight, the distribution of mail piece weight within the envelope, the weight of stamps and ink on the mail piece, etc. If not confirmed, please explain.
- d. Please confirm that your use of 0.5 as a starting point does not consider the fact that a given mail piece processed on AFCS's and other postal equipment must pass through multiple systems before reaching the sortation bins. If not confirmed, please explain.

RESPONSE TO USPS/OCA-T6-12

(a) Confirmed. See my testimony, OCA-T-6, Part III, at 58-59, for the origin of the figure of 50 percent, and the range of 50 to 100 percent.

(b) Confirmed.

(c) Confirmed. However, it should be noted that the importance, if any, of the distribution of envelope weight, the distribution of mailpiece weight within the envelope, the weight of stamps and ink on the mailpieces in question—low aspect ratio nonstandard letters weighing one ounce or less—is unknown, since the Postal Service has no information on the relationship between the weight of a mailpiece (or the distribution of weight within a given mailpiece) and its aspect ratio. See Response of

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T6-1-13

the United States Postal Service to Interrogatory of the Office of the Consumer Advocate, OCA/USPS-134.

(d) Not confirmed. I account for the fact that low aspect ratio letter mail initially sorted by the AFCS may nevertheless be rejected during subsequent automated processing operations by increasing the reject rate in each automated operation. See OCA-LR-I-3, Part III, at page I-39.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T6-1-13

USPS/OCA-T6-13

Have you conducted any research to determine the extent to which your proposal would affect the volume of low aspect ratio nonstandard size letters that would be entered as collection mail into Postal Service facilities? If not, why not?

RESPONSE TO USPS/OCA-T6-13

No. I have not conducted any research on the question posed. However, the additional volume of low aspect ratio nonstandard size letters entered as collection mail is likely to be small. In the test year, the volume of nonstandard single-piece First-Class letter-shaped mailpieces is 62,718,000. See OCA-T-6, Part III, at 67. Consequently, 62,718,000 would appear to be a reasonable maximum number of low aspect ratio nonstandard letters, since not all nonstandard single-piece First-Class letter-shaped mailpieces are low aspect ratio letters. Moreover, to the extent that individual mailers are unaware of the nonstandard surcharge, they have no incentive to increase the volume of low aspect ratio nonstandard letters entered as collection mail. And, it would appear that individual mailers who unknowingly enter low aspect ratio nonstandard letters may never be informed that such letters are nonstandard. See Docket No. R97-1, NDMS-T-1 (Haldi), at 12, where witness Haldi states that none of the Christmas cards mailed in his experiment were received with the marking "postage due."

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T6-14-17 and 19-21(b)

USPS/OCA-T6-15

Please refer to your testimony at page 32, lines 1-4. Please identify and provide all information which would form a basis for quantifying the "hidden cost . . . imposed on households when 'left over' stamps of older denominations go unused."

RESPONSE TO USPS/OCA-T6-15

The hidden cost to households is the cost of carrying unused First-Class stamp "inventories." However, information to quantify this cost is not available from the Postal Service. According to the Postal Service, while it "estimates postage in the hands of the public in the aggregate, it does not distinguish among denominations of postage nor isolate the portion of such postage associated with a rate change." See Tr. 21/9069. Response of the U.S. Postal Service to Interrogatories of the Office of the Consumer Advocate, OCA/USPS-48.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T6-14-17, and 19-21(b)

USPS/OCA-T6-16

Please refer to your testimony at page 32, lines 8-11. Please identify and provide all information which would form a basis for quantifying the percentage of "left over" non-denominated stamps.

RESPONSE TO USPS/OCA-T6-16

Information on the percentage of "left over" non-denominated stamps unused by households is not available from the Postal Service. In fact, there appears to be only limited information on the number of F-, G-, and H-rate non-denominated stamps *printed and sold*. See Tr. 21/9068, Response of the U.S. Postal Service to Interrogatories of the Office of the Consumer Advocate, OCA/USPS-47.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T6-14-17, and 19-21(b)

USPS/OCA-T6-20

Table 15 of your testimony presents the illustrative effect of a change in the SPFC rate on the shift in estimated single-piece and workshare volumes.

- (a) How were the levels of workshare volume change at the differing levels of discount calculated? Please describe the calculations or provide a workpaper or testimony reference.
- (b) What specific workshare discount is being measured, for example, basic automation from the single-piece rate?

RESPONSE TO USPS/OCA-T6-20

(a) See OCA-LR-I-3, Part II, Table A (and the notes thereto), at page 3, which provides the data used in Table 15.

(b) Yes. I have assumed for purpose of illustration a discount for workshare mail of \$0.06, the amount of the discount for Automation Basic. See OCA-T-6, Part II, at 41, lines 9-12. See also OCA-LR-I-3, Part II, Table 14 (and the notes thereto), at page 2.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T1-11-12

USPS/OCA-T1-11

On page 6 of your testimony at lines 14-16 you state that, "Moreover, as proposed by the OCA, there would be a 'safety valve' that would permit the SPFC rate to be increased in two consecutive rate cases if a failure to do so would create a severe shortfall in the reserve account, or cause excessive shifting of First-Class Mail between single-piece and workshare categories."

- (a) Please define "severe shortfall" as used in this sentence.
- (b) Please define "excessive shifting" as used in this sentence.
- (c) Who would decide when circumstances justified using the "safety valve"?
- (d) On page 6 at lines 24 of your testimony, you state, "The Postal Service would continue to decide when to file rate cases and what rates to propose for each rate class and category." On page 6 at lines 1-2 of your testimony, you state, "It [reserve account proposal] is designed to safeguard the prerogatives of the Postal Service. . . ." Does this mean that, under your proposal, the Postal Service would decide when it is necessary to use the "safety valve"? Please explain.

RESPONSE TO USPS/OCA-T1-11.

(a) Although I do not use the phrase "severe shortfall," this concept is also described in my testimony, OCA-T-6, Part II, at 45-46, lines 22-23, and 1-3, respectively. The reference in witness Gerarden's testimony is to circumstances causing the "calculated" non-integer rate to be established at a level at which, without a change in the SPFC integer rate, the SPFC Reserve Account would accrue a large expected deficiency (e.g., more than the revenue generated in the first rate case period) during the second rate case period. Consequently, I define a "severe shortfall" as a negative balance in the SPFC Reserve Account estimated for the end of the second rate case period such that waiting until the third rate case to increase the SPFC

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T1-11-12

integer rate would produce "rate shock."

(b) Although I do not use the phrase "excessive shifting," this concept is also described in my testimony, OCA-T-6, Part II, at 46, lines 3-8 and 19-23. I define "excessive shifting" as a circumstance where the volume shifting between single-piece and workshare mail would be greater than approximately 5 percent. This is likely to occur at the point where the "calculated" non-integer single-piece rate is 1.5 cents above the SPFC integer rate.

(c) - (d) Although I do not use the phrase "safety valve," this concept is also described in my testimony, OCA-T-6, Part II, at 45-46. In the first instance, the Postal Service could invoke the "safety valve" in its request at the time of the second rate proceeding. The Postal Service would estimate the volume of single-piece First-Class mail through the test year based upon its model of First-Class volumes. I would also expect the Postal Service to know the balance in the SPFC Reserve Account at the time of the filing and to estimate the balance through the duration of the first rate case period. This information would in turn permit an estimate of the amount of revenue to be "drawn" from the SPFC Reserve Account during the second rate case period, and a determination as to whether the requested increase in the "calculated" non-integer single-piece rate is such that there should be an increase in the SPFC integer rate to avoid a negative balance in the SPFC Reserve Account at the end of the second rate case period. Of course, estimates, projections, and all other factors involved in establishing the "calculated" non-integer single-piece rate and the SPFC integer rate

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T1-11-12

would be subject to litigation by all parties. I would expect the Commission to review the estimates and information submitted by the Postal Service, as it does now, and to make an independent recommendation as to whether there should be any changes in the SPFC integer rate. Ultimately, however, this would be a policy decision of the Board of Governors acting upon the Commission's recommended decision.

Moreover, I would hope the Postal Service and the Commission would collectively be able to agree on the circumstances under which an increase in the SPFC integer rate would be warranted. As I suggest in my testimony, in circumstances where the "calculated" single-piece non-integer rate in the second rate proceeding is expected to increase by more than 1.5 cents above the existing SPFC integer rate, a change in the SPFC rate could be warranted. See OCA-T-6, Part II, at 46.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T1-11-12

USPS/OCA-T1-12

In the initial implementation of the proposed reserve account, is the intention of the OCA to build up a surplus in the early years that would then be drawn down in the later years as the second rate case period ends?

- (a) If so, have you evaluated, either quantitatively or qualitatively, how consumers feel about the tradeoff between essentially overpaying postage for approximately two years in return for possible rate stability in later years? Please explain and provide any documentation and supporting information.
- (b) Do you see any conflict between this proposal and the statutory requirements under which the Postal Service operates, for example, that it breakeven and cover its costs?

RESPONSE TO USPS/OCA-T1-12.

More precisely, the intent is to generate sufficient revenues to produce a positive reported balance in the SPFC Reserve Account in the first rate case period to permit the SPFC integer rate to be maintained through the second rate case period. During the second rate case period, where maintenance of the same SPFC integer rate would likely cause a revenue "deficiency," the existing positive balance in the SPFC Reserve Account from the first rate case would be used to make up this deficiency. See OCA-T-6, Part II, at 38.

(a) No. See my response to USPS/OCA-T6-2.

(b) I am not a lawyer. Consequently, I cannot give a legal opinion to the extent this question seeks one. That said, however, my proposal would not preclude or otherwise interfere with Postal Service's obligations to meet the "breakeven" requirement or cover the costs of postal services. As envisioned here, my proposal

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T1-11-12

would simply permit a longer period of stability for the single-piece First-Class rate by generating sufficient revenues in the first rate case period in order to maintain the SPFC integer rate through two rate case periods. The intent is that single-piece First-Class mail "breakeven" over the two rate case periods in which the same SPFC integer rate is in effect.

1 CHAIRMAN GLEIMAN: Is there any additional written
2 cross-examination for Witness Callow? Mr. Tidwell.

3 CROSS-EXAMINATION

4 BY MR. TIDWELL:

5 Q Good afternoon, Mr. Callow. I have just handed
6 you two copies of your responses to Postal Service
7 Interrogatories 22, 24 and 26. Were those responses
8 prepared by you or under your supervision?

9 A Yes, they were.

10 Q And if you were to give those responses again
11 today orally, would the answers be the same?

12 A Yes, they would.

13 MR. TIDWELL: Mr. Chairman, with that, I would
14 then move that the responses be entered into the evidentiary
15 record.

16 CHAIRMAN GLEIMAN: They will be received into
17 evidence and transcribed into the record. If you would be
18 kind enough to provide the two copies to the reporter.
19 Thank you, Mr. Tidwell.

20 [Additional Designation of Written
21 Cross-Examination of James F.
22 Callow, USPS/OCA-T6-22,
23 USPS/OCA-T6-24 and USPS/OCA-T6-26,
24 were received into evidence and
25 transcribed into the record.]

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T6-22-27

USPS/OCA-T6-22. Please refer to page 4, lines 8-13, of your testimony, where you state:

Under my proposal, the single-piece First-Class ("SPFC") rate would be determined without regard to the "integer constraint." The rate paid by households, by contrast, would be set at a whole cent, as in the past. The SPFC integer rate would be set so that sufficient revenues would accumulate in a "reserve account" to permit the single-piece rate to remain the same for a period of two rate proceedings, a duration of approximately four years. In effect, the SPFC rate would be changed every other rate proceeding, with revenue generated during the first rate period covering any revenue deficiency in the second rate period.

- (a) Please explain how you would determine how much above the "unconstrained" rate the whole cent rate would be set in order to be "sufficient," and how much of a reserve would be appropriate to generate over the period of the first rate case. For example if the unconstrained rate were 33.8 cents, would the whole cent rate be set at 34 cents, 35 cents, or some other amount, and how much of a reserve should be generated? Please explain your answer fully.
- (b) Please confirm that the amount of difference between the unconstrained rate and the integer rate is limited to amounts equal to the difference between the unconstrained rate and the next higher cent and amounts equal to that difference plus some number of whole cents (for example if the unconstrained rate is 33.8 cents the difference between it and the actual rate paid by users would be limited to 0.2 cent, 1.2 cents, 2.2 cents and so on). If you do not confirm, please explain fully.

RESPONSE TO USPS/OCA-T6-22

(a) An illustration of the relationship between the "calculated" non-integer single-piece rate and the SPFC integer rate is shown in Table 13. See OCA-T-6, Part II, at 40. The amount of revenue generated in the first rate case period is the positive difference between the "calculated" non-integer single-piece rate and the SPFC integer rate multiplied by the volume of SPFC letters. In Table 13, the positive difference is 1 cent. This amount, multiplied by the volume of SPFC letters, generates \$1.027 billion in

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T6-22-27

the SPFC Reserve Account during the first rate case period, assumed in this illustration to be FY 2001 and FY 2002. Of course, a larger or smaller difference than 1 cent would generate more revenue, or less revenue, respectively. The intent when selecting the SPFC rate would be to have the revenue generated during the first rate case period cover the expected revenue deficiency during the second rate case period. This would be accomplished by setting the SPFC rate so that the positive difference between the "calculated" non-integer single-piece rate and the SPFC integer rate in the first rate case was approximately equal to the negative difference between the "calculated" non-integer single-piece rate and the existing SPFC integer rate in the second rate case.

For the hypothetical posed in the question, where the "calculated" non-integer rate is 33.8 cents, a SPFC integer rate of 34 cents would be sufficient where the "calculated" non-integer rate in the second rate case would likely be 34.2 cents, or 0.2 cents more than the SPFC rate of 34 cents. The positive difference of 0.2 cents (34 cents - 33.8 cents) generates approximately \$209 million in the first rate case period, and offsets the expected revenue deficiency of approximately \$204 million produced by the negative difference of 0.2 cents (34 cents - 34.2 cents) in the second rate case period.

It should be noted that, in this hypothetical, the change in the "calculated" non-integer rate between the first and second rate case is only 0.4 cents (34.2 cents - 33.8 cents). To the extent postal costs are rising, or are expected to rise, more than 0.4 cents (assuming the same cost coverage) for single-piece First-Class letters during the

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T6-22-27

two rate case periods, a 35 cent SPFC integer rate might be necessary in the first rate case to ensure sufficient revenues to cover the expected deficiency during the second rate case period.

(b) Confirmed, by definition, so that the SPFC rate can be set at a whole cent, or integer.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T6-22-27

USPS/OCA-T6-24. Please confirm that under your proposal, where the single-piece First-Class ("SPFC") rate is determined without regard to the "integer constraint," the rates of all other categories of mail would be higher by that amount required to make up the difference between the unconstrained SPFC rate and the rounded SPFC rate. If you do not confirm, please explain your answer.

RESPONSE TO USPS/OCA-T6-24

Not confirmed. There would be no shift in revenue from First-Class Letters to other mail classes or subclasses. As proposed, rates for workshare mail would be set by reference to the "calculated" non-integer single-piece rate, which would be determined based upon the litigated cost coverage for First-Class Letter Mail. See OCA-T-6, Part II, at 39. The SPFC integer rate would be selected so as to generate revenues greater than the "calculated" non-integer rate in order to permit the single-piece rate (paid by single-piece First-Class mailers) to remain the same for a period of two rate cases. A SPFC integer rate so selected would permit single-piece First-Class Mail to "break-even" over the two rate case periods using revenue generated during the first rate period to cover the expected revenue deficiency in the second rate period. Consequently, if adopted as intended, single-piece First-Class Mail would continue to bear its costs and appropriate mark-up, so as not to adversely affect other classes of mail. Moreover, rates for all other classes and subclasses of mail would be set in the same manner as in past proceedings.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T6-22-27

USPS/OCA-T6-26. Please refer to page 46, lines 17-19, of your testimony, where you state: "I propose that in circumstances where the calculated single-piece rate in the second rate case is expected to increase by more than 1.5 cents above the existing SPFC integer rate, a change in SPFC rate would be warranted."

- (a) Please confirm that if the calculated single-piece rate in the second rate case is expected to increase by 1.4 cents or less, the existing SPFC integer rate would not be changed. If you do not confirm please explain.
- (b) If the calculated rate is 1.4 cents greater than the existing SPFC integer rate, how [] much revenue and net income would the Postal Service lose over the course of the second rate case period versus the amount that would be realized if the SPFC rate were increased by the indicated amount? If you are unable to quantify the amount of loss, please provide your best rough approximation and explain how it was calculated.
- (c) Would the pursuit of the Board's policy on equity restoration and the statute's breakeven requirement remain viable under such a scenario? Please explain your answer fully.

RESPONSE TO USPS/OCA-T6-26

(a) Partially confirmed. I proposed that the SPFC integer rate be changed in the second rate case (rather than maintaining the SPFC rate set in the first rate case) where the "calculated" non-integer rate was expected to increase by more than 1.5 cents above the existing SPFC rate as a suggestion, in part, to limit the volume shift between single-piece and workshare mail to approximately 5 percent. An increase in the "calculated" non-integer rate of 1.4 cents or less would also limit the volume shift between single-piece and workshare mail to approximately 5 percent. For that reason, an increase of 1.5 cent above the SPFC integer rate should be viewed as a suggestion. To the extent a volume shift between single-piece and workshare mail of more than 5 percent is not viewed as problematic, an increase in the "calculated" non-integer rate of

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T6-22-27

more than 1.5 cents above the SPFC integer rate might be acceptable. Conversely, if a shift in volume of 5 percent (or less) is considered "too much," that suggests a "calculated" non-integer rate of less than 1.5 cents above the SPFC integer rate should be the limit. Ultimately, I would hope that the Postal Service and the Commission would collectively be able to agree on the circumstances under which an increase in the SPFC integer rate would be warranted for the second rate case.

(b) The size of the expected revenue deficiency in the second rate case period has meaning only in relation to the revenue generated during the first rate case period. The revenue generated in the first rate case period is intended to cover the expected revenue deficiency in the second rate case period. Consequently, another way to look at this question is to consider the size of the balance, positive or negative, in the SPFC Reserve Account at the end of the second rate case period. In the first rate case period, the SPFC integer rate might be 1.4 cents above the "calculated" non-integer rate (i.e., the difference is positive), producing a balance in the SPFC Reserve Account at the end of the first rate case period of approximately \$1.413 billion. In the second rate case period, the relationship might reverse, with the "calculated" non-integer rate now 1.4 cents more than the SPFC integer rate (i.e., the difference is negative). The balance in the SPFC Reserve Account at the end of the second rate case period would then be approximately -\$26 million (\$1.413 - \$1.439).

Alternatively, in the first rate case period, the SPFC integer rate might be set at 1.0 cent more than the "calculated" non-integer rate (i.e., the difference is positive).

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T6-22-27

The balance in the SPFC Reserve Account at the end of the first rate case period would be approximately \$1.027 billion. If, in the second rate case period, the "calculated" non-integer rate is again 1.4 cents greater than the SPFC integer rate (i.e., the difference is negative), the balance in the SPFC Reserve Account at the end of the second rate case period would be approximately -\$431 million (\$1.027 - \$1.458). Of course, where the positive difference between the SPFC integer rate and the "calculated" non-integer rate is near 1.4 cents, more revenue is generated in the first rate case period and would cover more of the expected revenue deficiency in the second, resulting in a smaller negative balance. Conversely, as the positive difference between the SPFC integer rate and the "calculated" non-integer rate is much smaller than 1.4 cents, the result is a larger negative balance at the end of the second rate case period.

In my testimony, I proposed that the SPFC integer rate be changed at the time of the second rate case in circumstances where the "calculated" non-integer rate is expected to increase by more than 1.5 cents above the existing SPFC integer rate as a suggestion. Using 1.4 cents as the maximum (rather than 1.5 cents), changing the SPFC integer rate at the time of the second rate case would result in a positive balance of approximately \$622 million at the end of the second rate case period.

(c) Yes. Although I am not a lawyer, it is my understanding that the Postal Service views the Postal Reorganization Act's "breakeven" requirement as a long-run objective to be achieved over a number of years. As proposed in my testimony, the rates for First-Class Letter Mail are intended to generate sufficient revenues to "break

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T6-22-27

even" over two rate case cycles, a period of approximately four years, assuming the Postal Service adjusts rates every two years. To the extent the expected revenue deficiency in the second rate period is greater than the revenue generated during the first rate case period (i.e., there is a negative balance in the SPFC Reserve Account), the deficit would be of short-term duration, less than two years, as any positive balance in the SPFC Reserve Account would partially offset the expected revenue deficiency until the new SPFC integer rate is selected at the time of the third rate case. To the extent circumstances warrant a change in the SPFC integer rate at the time of the second rate case, there would be a positive balance in the SPFC Reserve Account at the end of the second rate case period—the Postal Service would not experience a deficit at all.

Similarly, in my view, the rate stability proposal can be pursued in conjunction with the Board's policy statement on restoration of equity. A copy of the Board's policy statement is attached. The second paragraph of the Board's policy statement contemplates the possibility that circumstances will be such that equity restoration may not be achieved. My proposal considers a similar situation with respect to the SPFC Reserve Account; that is, the possibility that the revenue generated in the first rate case period is insufficient to cover the expected revenue deficiency in the second rate case period. Where the expected revenue deficiency in the second rate case period is large relative to the revenue generated in the first rate case period (i.e., there is a large negative balance in the SPFC Reserve Account), such that an increase in the

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T6-22-27

"calculated" non-integer rate of more than 1.5 cents above the existing SPFC integer rate is likely, I propose that the SPFC integer rate be changed at the time of the second rate case proceeding. In effect, this would increase revenues, consistent with the Board's policy statement in paragraph two. Where the negative balance in the SPFC Reserve Account at the end of the second rate case period is smaller, the negative balance could be covered by a change in the SPFC Reserve Account at the time of the third rate case proceeding.

RESOLUTION OF THE BOARD OF GOVERNORS
OF THE
UNITED STATES POSTAL SERVICE
Resolution No. 95-9
Restoration of Equity and
Recovery of Prior Years' Losses

RESOLVED:

The Board of Governors hereby adopts the following Policy Statement affirming the Postal Service's commitment to the goals of breaking even over time and taking actions to improve its equity position. The Board intends to re-examine this Policy Statement on an annual basis.

POLICY STATEMENT ON RESTORATION OF EQUITY
AND RECOVERY OF PRIOR YEARS' LOSSES

- The Postal Service will plan for cumulative net income, in the period since implementation of the rates adopted in the most recent omnibus rate proceeding, *to equal or exceed the cumulative prior years' loss recovery target* for the same period. The cumulative prior years' loss recovery target is calculated by multiplying the test year amount for recovery of prior years' losses included in current rates by the number of years that will have elapsed since those rates were implemented.
- Whenever it is projected that the goal specified in the section above will not be met, the Board of Governors and Postal Service management, to the extent consistent with this policy objective and other pertinent policy considerations, will take actions which reduce costs and/or increase revenues.
- In the event that equity is projected to deteriorate due to the imposition of costs such as those imposed in prior *Omnibus Budget Reconciliation Acts*, the Board will determine whether to modify the goal specified above in order to prevent further deterioration of equity.

The foregoing resolution was adopted by the Board of Governors on July 10, 1995.


Secretary

1 CHAIRMAN GLEIMAN: Mr. Baker.

2 MR. BAKER: Mr. Chairman, I will hand the witness
3 his answers to two -- our interrogatories, answers to which
4 we received after the filing of the written designation
5 notice.

6 CROSS-EXAMINATION

7 BY MR. BAKER:

8 Q And I will be handing the witness his responses to
9 NAA/OCA's T6 Number 1 and Number 3, and him to review them
10 and would his answers be the same today.

11 A Yes, they are.

12 MR. BAKER: And with that, Mr. Chairman, I would
13 move their admission into the record as cross-examination.

14 CHAIRMAN GLEIMAN: It is so ordered. I also
15 direct that they be transcribed. If you would please
16 provide two copies to the reporter, Mr. Baker.

17 [Additional Designation of Written
18 Cross-Examination of James F.
19 Callow, NAA/OCA-T6-1 and
20 NAA/OCA-T6-3, were received into
21 evidence and transcribed into the
22 record.]

23

24

25

TO INTERROGATORIES NAA/OCA-T6-1-3

NAA/OCA-T6-1. Your testimony compares the institutional cost contributions of First Class Mail and Standard A Mail on the basis of cost coverage, markup indices, and cost coverage indices. Please confirm that the Commission has also relied on unit institutional cost contributions when evaluating institutional cost contributions, such as in [the] Commission's Opinion and Recommended Decision in Docket No. R97-1 at page 259, paragraph 4085-4086.

RESPONSE TO NAA/OCA-T6-1

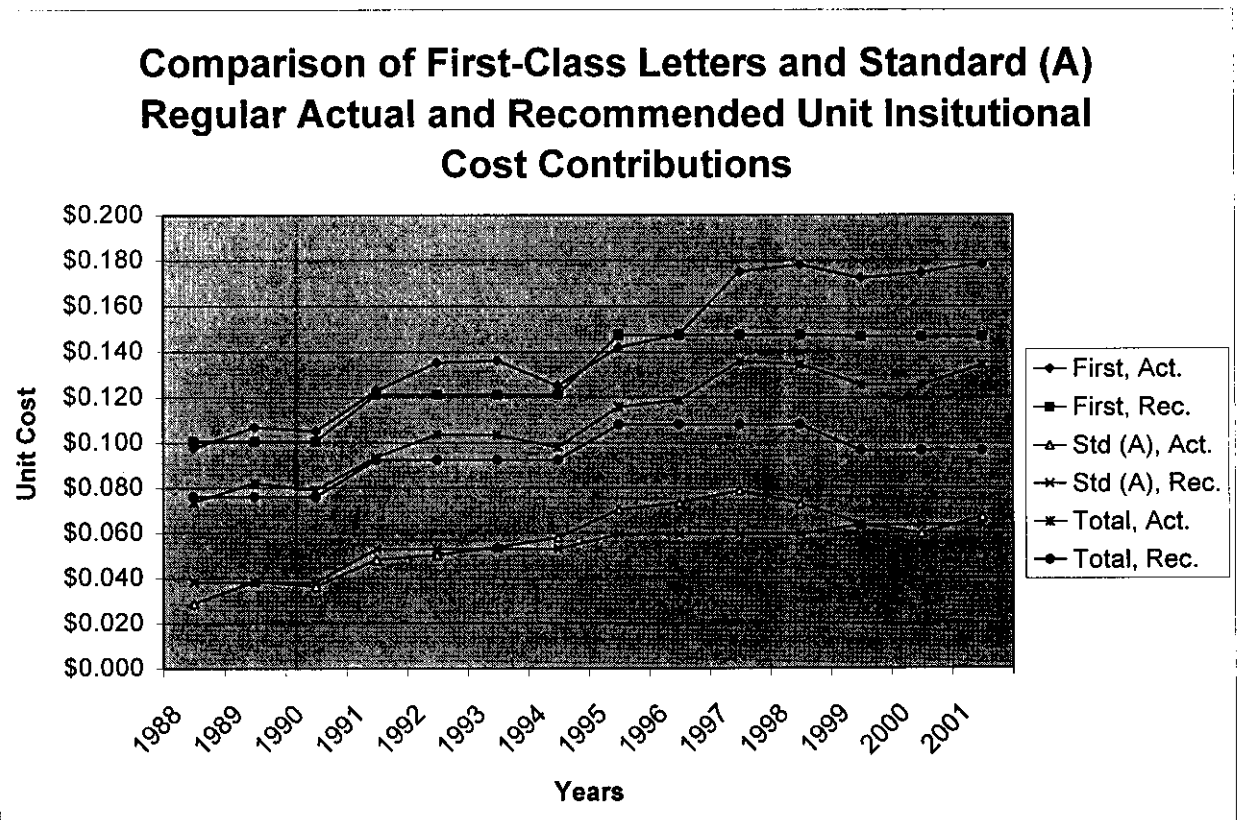
Confirmed. Accordingly, "[t]he Commission has carefully reviewed whether . . . the relative markup and unit contribution for this [ECR] subclass . . . seem adequate to reflect fairly the noncost factors of the Act." PRC Op. R97-1, para. 4086.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES NAA/OCA-T6-1-3

NAA/OCA-T6-3. Please provide a table comparing the actual unit contributions of First Class Mail and commercial third class/Standard A subclasses to the average unit contributions at recommended rates for the same period as covered by Figure 6 of your testimony.

RESPONSE TO NAA/OCA-T6-3

COMPARISON OF FIRST-CLASS LETTERS AND STANDARD (A) REGULAR ACTUAL AND RECOMMENDED														
UNIT INSTITUTIONAL COST CONTRIBUTIONS														
	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
First, Act.	\$0.09762	\$0.10690	\$0.10519	\$0.12296	\$0.13526	\$0.13624	\$0.12502	\$0.14193	\$0.14747	\$0.17491	\$0.17790	\$0.17217	\$0.17449	\$0.17846
First, Rec.	\$0.10070	\$0.10070	\$0.10070	\$0.12123	\$0.12123	\$0.12123	\$0.12123	\$0.14738	\$0.14738	\$0.14738	\$0.14738	\$0.14670	\$0.14670	\$0.14670
Std (A), Act.	\$0.02886	\$0.03861	\$0.03642	\$0.04822	\$0.05017	\$0.05362	\$0.05799	\$0.07022	\$0.07329	\$0.07872	\$0.07284	\$0.06377	\$0.05976	\$0.06687
Std (A), Rec.	\$0.03817	\$0.03817	\$0.03817	\$0.05288	\$0.05288	\$0.05288	\$0.05288	\$0.05952	\$0.05952	\$0.05952	\$0.05952	\$0.06354	\$0.06354	\$0.06354
Total, Act.	\$0.07347	\$0.08205	\$0.07898	\$0.09361	\$0.10367	\$0.10347	\$0.09803	\$0.11574	\$0.11865	\$0.13587	\$0.13440	\$0.12553	\$0.12542	\$0.13420
Total, Rec.	\$0.07604	\$0.07604	\$0.07604	\$0.09240	\$0.09240	\$0.09240	\$0.09240	\$0.10800	\$0.10800	\$0.10800	\$0.10800	\$0.09664	\$0.09664	\$0.09664



1 MR. BAKER: I will and let me just express a
2 little appreciation to counsel for OCA who provided me, as
3 new, as fresh as he could, a copy of the chart that is
4 NAA-3, and I am hopeful that when it is transcribed, it will
5 be clear, as clear as we can get it in the transcript.

6 CHAIRMAN GLEIMAN: We sure hope so. I am sure it
7 will be as clear as they can get it. No clearer, no less.

8 Anyone else?

9 [No response.]

10 CHAIRMAN GLEIMAN: That brings us to oral cross.
11 We have had two parties indicate that they wish to have oral
12 cross-examination, the Association for Postal Commerce and
13 the United States Postal Service.

14 Is there anyone that wishes to cross?

15 [No response.]

16 CHAIRMAN GLEIMAN: Am I correct that APC and the
17 Postal Service have no cross today?

18 MR. WIGGINS: Not quite right.

19 CHAIRMAN GLEIMAN: Mr. Wiggins.

20 MR. WIGGINS: But it will be short.

21 CROSS-EXAMINATION

22 BY MR. WIGGINS:

23 Q Mr. Callow, I am Frank Wiggins for the Association
24 for Postal Commerce.

25 A Good afternoon.

1 Q Take a look with me, if you would, please, at your
2 answer to DMA Interrogatory 8 to you, that is T6-8.

3 A I have it.

4 Q Is it a fair summary or recapitulation of your
5 answer to A and B that you are here sort of melding together
6 two proposals made in your testimony, or showing how those
7 two proposals are coordinated, and saying that if the Rate
8 Commission to adopt your freeze of the 33 cent rate level
9 for the first ounce, First Class stamp, that it should not
10 also adopt another proposal that you have advanced, the
11 proposal that would have rates for single piece First Class
12 mail established to prevail over two rate cases, rather than
13 being up for relitigation every rate case? Does that catch
14 it? You should do one or the other, but not both of those
15 things?

16 A No. And the reason is that we viewed these -- I
17 viewed these two proposals separately. I guess what I, in
18 part A and B, what I was expressing was that you could
19 achieve rate stability by holding or maintaining the 33 cent
20 rate in this docket. In effect, you would have two periods
21 of rate stability.

22 However, it doesn't necessarily follow that you
23 couldn't do both proposals in this docket, and that I think
24 was made clear in part C.

25 Q In part C, you say that you consider the two

1 things separate, I appreciate that.

2 A That's correct.

3 Q If the Commission were to recommend a 33 cent
4 First Class, first ounce rate, --

5 A Right.

6 Q -- would there be enough money available to carry
7 that rate through two rate cases, not to have an adjustment
8 whenever the next rate case comes up? Could you go for four
9 years, adopting your assumption of two year rate case
10 cycles, with a 33 cent rate?

11 A I guess this is -- I think we are blending two
12 proposals now. The reason for a 33 cent rate was to address
13 the high cost coverage. The proposal to maintain a single
14 piece First Class rate, be it 33 or 34, was to provide two
15 rate periods' worth of rate stability.

16 Q I understand that. My question is a little bit
17 different.

18 A Okay.

19 Q Suppose that you have persuaded the Commission,
20 and it says, boy, that is a smart idea, Mr. Callow, we are
21 going to hold the First Class, first ounce rate at 33 cents.
22 Would it be prudent for the Commission also, having taken
23 that step, okay, that is behind it, also to endorse your
24 second proposal? Would you recommend that the Commission do
25 that? At 33 cents for the first ounce, First Class rate.

1 A It could, sure.

2 Q Would you recommend it?

3 A Would I recommend it?

4 Q Yeah.

5 A I believe you could do it, yes.

6 Q Is that what your testimony is recommending to the
7 Commission, that they do both of those things in this rate
8 case?

9 A I had, as I say, I had -- let me, let me back up
10 for a second. I guess the answer is no. If they recommend
11 a 33 cent rate in this docket then we have achieved two
12 periods of rate stability.

13 That said, there would be no reason to do the
14 single piece, First Class proposal that we have advanced in
15 Part 2 of my testimony.

16 Q And if the Commission were to decide not to
17 endorse your 33 cent first ounce, First Class rate, what
18 rate -- but did decide that it wanted to endorse your rate
19 stability proposal, what rate are you recommending that the
20 Commission adopt for that first ounce First Class stamp?

21 A 34 cents.

22 Q And how do you know that that is the just right
23 number? I mean does your testimony purport to show that to
24 me, that that is the just right number?

25 A I think my testimony illustrates using the 34 cent

1 rate. It makes an assumption about what we call a
2 calculated noninteger rate and the difference between the
3 two provides, if you will, or generates the revenue that
4 would permit the single piece First Class proposal or the
5 single piece First Class rate to be maintained over two
6 periods.

7 Q And your illustrations of the way that that rolls
8 out you think are accurate predictions of what volumes and
9 costs are going to be over the next four-year period, is
10 that right?

11 A I tried to make that, based upon the information I
12 had --

13 Q Sure.

14 A -- and it is in my Library Reference I used, the
15 data that the Postal Service had provided to the General
16 Accounting Office. I used the elasticities that the Postal
17 Service provided in this docket. So I did my best effort
18 based upon the information there was to get as close as I
19 could.

20 Q And you effectively did a four-year roll forward
21 of the best take that you could get on costs and volumes, is
22 that right?

23 A Not on costs, no. My -- the information I used
24 from GAO were the revenue and volume data.

25 Q That's sort of what I thought, but what about

1 costs. What are you assuming about costs in your look
2 forward?

3 A I didn't make projections on costs.

4 Q So we don't really know with any degree of
5 confidence that the 34 cents with the accounting conventions
6 that you recommend to go along with it will be adequate over
7 that four-year period to defray all of the costs that the
8 Postal Service incurs in providing single piece First Class
9 service?

10 A I don't -- I didn't -- I don't have specific cost
11 information so I --

12 Q I am just asking. I am not being accusatory.

13 A No, no, I understand. I don't have -- my effort
14 was on the revenue on the volume side.

15 Q Sure.

16 A And I had to make, I made an assumption about the
17 costs.

18 Q Right. Look at your answer to DMA-1, to Mr.
19 Gerarden, T1-1, which was referred to you for an answer and
20 particularly at subpart (d) as in "dog" --

21 A I have it.

22 Q You say my proposal and you are talking about the
23 rate stability proposal here, correct?

24 A That is correct.

25 Q Yes. You say your proposal does not affect postal

1 management's prerogatives with respect to the timing of the
2 filing of omnibus postal rate cases.

3 Isn't it right that your analysis does assume that
4 there will be rate case, there will be another rate case
5 filed two years following the close of this one and then
6 still another rate case filed two years after the close of
7 that case?

8 A That's correct.

9 Q Okay.

10 A That is my assumption based upon what we have
11 heard from postal management, what they have said to the
12 General Accounting Office, my understanding what they have
13 said to mailers and mailers have said back to the Postal
14 Service -- we like your policy.

15 Q But your assumption about the rate stability
16 proposal and how it would work depends on that timing,
17 doesn't it?

18 A It doesn't depend on any particular timing. It
19 does depend on a two-year cycle.

20 My illustration is based on that.

21 Q Sure.

22 A But you could conceivably have a single piece
23 First Class rate, the one paid by single piece mailers, that
24 could accommodate maybe a three-year cycle.

25 Q That rate would have to be higher, would it not?

1 A It would.

2 Q And you haven't sought to calculate how much
3 higher that would have to be?

4 A I have not.

5 Q So that if the Commission wants to endorse your
6 proposal and the 34 cent rate that you use to illustrate
7 your proposal, it would effectively be requiring the Postal
8 Service to file rate cases each two years, wouldn't it?

9 A Again, I did this for illustrative purposes. It
10 does not per se -- obviously the Commission can decide what
11 it wants to decide and the Board of Governors have the
12 option thereafter to decide what they want, so I have not --
13 I don't view it as tying the Board of Governors' hands in
14 this respect.

15 For illustrative purposes I used two years, in
16 part because -- not in part, because the Postal Service said
17 that is how we look at the future.

18 Q If the Postal Service changed its vision of the
19 future some time between now and four years from now, and
20 decided that it wanted to switch over to three year rate
21 case cycles, to the dismay of all the lawyers in this room,
22 you would have to look forward not just four years, but six
23 years, correct, to make sure you were setting the rate at
24 the level that was going to be fully compensatory over that
25 entire period?

1 A Well, you would of course, you would want to look
2 at that. I don't view it as -- it is not -- I don't view it
3 as necessary because, remember, between -- in the interim,
4 say at year four, there would be -- or in year three leading
5 to year four there would be another rate case, so the
6 assumptions on which the single piece First Class rate were
7 set in the first rate case could be reviewed in the second
8 rate case.

9 Q And you expressly recognize such a safety valve
10 and talk about it in your answer to DMA/OCA-T1-5, do you
11 not, and particularly the answers to Parts (c) and (d)?

12 A Did you say DMA/OCA-T1-5?

13 Q Yes. The response under (c) and (d). That is
14 your safety valve provision, is it not?

15 A Yes.

16 Q Take a look -- I'd like to try to understand a
17 little bit more closely just how the accounting feature of
18 your rate stability proposal works, and to do that I would
19 like for you to look with me at DMA/OCA-T1-3.

20 A Okay.

21 Q Is that a reasonable place to look to try to get a
22 handle on the accounting feature, or at least to start
23 looking?

24 A Yes.

25 Q Now, just walk me through how the accounting

1 calculation will be made? I have a certain volume of
2 single-piece First Class mail for an accounting period?

3 You're going to do this, accounting period by
4 accounting period; are you not?

5 A Correct.

6 Q Okay, so I know what my volume is for an
7 accounting period-by-accounting period, and what do I do?
8 What do I do with the volume to meld it with your notion of
9 how this system is to work?

10 A If I could direct you to Table 13 in my testimony,
11 it's on page 40.

12 Q Sure.

13 A This table is done on an annual basis, but you
14 could take, you know, the line 4, the volume figure, and
15 chop it up into 13 -- I'm sorry, into accounting periods.

16 And the volume for each counting period times the
17 difference, line 3, would give you the increment or the
18 accounting -- the amount that would flow into the reserve
19 account.

20 It would be recorded in the reserve account?

21 Q And the difference is the difference between the
22 .33 under Year 2000 and the .34 under 2001; is that correct?

23 That's where you get that .01?

24 A Yes. It's the difference between -- the
25 difference between --

1 Let me back up. The difference, line 3, is one
2 cent, which is the difference between line 1 and line 2, or
3 line 2 and line 1.

4 Q Correct.

5 A In year 2001.

6 Q Correct. Now, just say for me, what each of those
7 numbers is meant to represent. What does the .33 represent?

8 A That is the calculated single-piece rate; that's
9 the rate that the -- you could look at it several ways.

10 That's the rate that on which the Commission would
11 recommend, would go through all the statutory criteria,
12 costing, pricing, volume, and make its recommended decision
13 under the law.

14 And then --

15 Q Let me ask you to pause just for a moment there,
16 Mr. Callow.

17 A Sure.

18 Q That's also the rate, is it not, on which
19 work-sharing discounts will be calculated?

20 A Yes, and that was the way -- that's why I said you
21 could look at it in several different ways; that's correct.
22 That's the rate the work-share discounts will be calculated
23 on.

24 Q And how do you characterize the .34 number?

25 A That's the rate the single-piece mailers would

1 pay.

2 Q And how is the Commission to figure out how to get
3 to that second -- it gets to the first number the way it's
4 always calculated rates, correct?

5 A Correct.

6 Q Yes. So the Commission knows how to do that.

7 A Right.

8 Q But that second number, the .34 number, how is the
9 Commission supposed to derive that?

10 A Well, as I envision the proposal, single-piece
11 mailers pay an integer rate. So this is intended to be the
12 integer rate paid by single-piece mailers.

13 It would be an integer rate. You would -- in my
14 example, the difference, the single-piece rate is higher
15 than the calculated single-piece rate, non-integer rate.

16 And that's where the revenue would be generated.
17 That difference, again, is used times the volume and gives
18 you the amount in the reserve account.

19 Q Right. I understand how that works. I'm just
20 trying to figure out what this Commission needs to look at.

21 It's going to have to look at something different
22 from what it has done in the past.

23 A Right.

24 Q Because the .33 is what it has done in the past.

25 A Right.

1 Q So it's going to have to have a different shape of
2 some sort in its sights in order to get the correct number
3 for that .34.

4 And I'm just trying to get your view on
5 analytically how this Commission should carry out that
6 process, if it decides to endorse your proposal.

7 A The proposal is intended to generate revenues to
8 permit the single-piece rate that's selected to be carried
9 over for two periods.

10 So, obviously, it would want to look at how much
11 revenue would be generated, how much revenue above the
12 calculated single-piece rate would be generated. That would
13 be one.

14 And probably it would be the most important
15 factor. So that you would generate enough revenues to carry
16 -- to permit the single-piece rate to be carried through two
17 rate periods.

18 Q But shouldn't the Commission do another thing, a
19 thing that you didn't do, you just told me; and that is,
20 shouldn't the Commission look at costs as well?

21 Revenues are wonderful things, but they have to be
22 mated up against costs; don't they?

23 A Except the costs are already taken into account
24 when you set the 33 cent rate.

25 Q Well, costs are taken into account at a point in

1 time, correct?

2 A Correct, right.

3 Q But those costs might change over a four-year
4 interval, might they not?

5 A That's correct.

6 Q And shouldn't the Commission try to look forward
7 and see where those costs are going to be in Years 2, 3, and
8 4?

9 A I expect they would, just out -- if not out of
10 curiosity, but certainly to try and understand.

11 I guess what I'm saying is that in a stable
12 inflationary, Postal inflationary environment, it might not
13 -- it might not be as critical to do so, again, in part,
14 because the time of the second rate case, they would have an
15 opportunity to do that again.

16 Q I appreciate that. We talked about your safety
17 valve.

18 A Right.

19 Q So that will always be there, you know, as an
20 escape hatch for you if things get really ugly.

21 But if you have to use the escape hatch with any
22 regularity, your proposal hasn't really accomplished what it
23 set out to do; has it?

24 A No. If every rate case, the single-piece rate
25 changes, then it hasn't accomplished it.

1 Q Sure. You haven't improved anything.

2 So that in order to be more confident that the
3 benefits of your proposal would actually be realized, that
4 you wouldn't be doing that escape hatch in the interim rate
5 case, the Commission would have to look at costs; would it
6 not?

7 A I believe they would, yes.

8 Q Sure.

9 And they would have to be looking at costs four
10 years out into the future?

11 A If that were the duration of the rate cycles, yes.

12 Q Sure, or, if, as I hypothetically suggested, the
13 Postal Service changed its mind and decided that it liked
14 three-year rate cycles instead of two-year rate cycles, then
15 the Commission would have the chore of looking at costs six
16 years down the road; would it not?

17 A Yes.

18 Q Would your confidence in anybody's power to
19 predict costs six years down the road be as secure as your
20 confidence that you could make that prediction four years
21 down the road, or is the six-year projection more difficult,
22 less certain?

23 A Obviously, the further out you go in time, it
24 becomes less certain.

25 Q Sure, four years is harder than three years, is

1 harder than two years, is easier than six years?

2 A Yes.

3 Q OCA Library Reference 3 is our workpaper; isn't
4 it?

5 A Correct.

6 Q Take a look at Part 1, page 15 of 20, with me, if
7 you would, please.

8 I'm now sort of shifting gears and looking at not
9 your rate stability proposal, but some of the argumentation
10 in favor of your First Class rate relief proposal.

11 A I have it.

12 Q That's what you're showing me in that calculation
13 in Table B; you're showing me how you derived the amounts of
14 overpayment, if you would, by First Class Mail, over the
15 period 1988 through 1999; are you not?

16 A Correct.

17 Q And that's the number in Row 1 at the top of that
18 presentation; is it not?

19 A Correct.

20 Q And you get, if you look at page 16 of 20, which
21 has got the footnotes telling you how all these numbers came
22 into being --

23 A Correct.

24 Q You tell me that Row 1 equals Row 8 minus Row 4,
25 right?

1 A [No response.]

2 Q Those are two revenue numbers aren't they, Mr.
3 Callow, 8 and 4?

4 A Yes, they are.

5 Q Can you characterize how each of those was
6 calculated in a non-technical way?

7 Because that's the key number, right? That's the
8 number on which the logic of your argument hinges?

9 A Yes. Row 8 is the revenue reported for First
10 Class letter subclass reported in the RPW.

11 Q Those are real hard, historical RPW numbers?

12 A Correct.

13 Q So that we can repose about as much confidence in
14 those numbers as we can in any of the myriad of numbers that
15 surround rate cases, correct? That is as good as it gets?

16 A Those are the numbers, yeah, that we rely on.

17 Q Right. Exactly. Okay. So we got 8 and we are
18 highly confident that is 8 as about as accurate as this game
19 gets. Now, take me up to Number 4 and explain that one to
20 me. Row 4.

21 If you look on the next page, let me focus the
22 question just a little bit more for you. That was pretty
23 nebulous. Look at page 16.

24 A I have it.

25 Q And I am looking at the formula for Note 2.

1 A Correct.

2 Q And it says you multiply 1.263. Can you tell the
3 Commissioners what that number represents?

4 A Yes, I can. If you go to page 17 of 20, Table E.

5 Q Right.

6 A The last number, First Class letters.

7 Q Right.

8 A 1.263, which is the average for -- the average
9 Commission recommended mark-up.

10 Q Over the period --

11 A R-87. R-87, the four rate cases, R-87, --

12 Q Right. R-87 through --

13 A -- R-90, R-94, R-97.

14 Q So, help me out a little bit conceptually here,
15 Mr. Callow. I have got a real number in Row 8, and I am
16 comparing that with a number that is calculated by using the
17 average of rates recommended by the Commission over a 10
18 year period of time, correct?

19 A Correct.

20 Q Why is that a thing that I want to be doing? Why
21 does that make sense?

22 A Because the Commission has made a number of
23 statements about the recommended cost coverage mark-up index
24 that the -- it is a goal or preference that the mark-up for
25 First Class and Standard A move toward equalization at the

1 system-wide average. And I interpreted that in my testimony
2 on page 22. I interpreted that, took the average to be
3 reasonably near the system-wide average.

4 Q Well, but this is the average -- this isn't
5 system-wide average, you don't contend that this is
6 system-wide average, do you?

7 A No.

8 Q This is --

9 A First Class.

10 Q First Class.

11 A Right.

12 Q The average of the mark-ups that the Commission
13 has recommended in each of the last four cases, correct?

14 A Correct.

15 Q And I am just trying to conceptually understand,
16 Mr. Callow. I have got this real hard number down here in
17 Row 8, and I am comparing that with the number in Row 4,
18 correct?

19 A Right.

20 Q I mean that is what this exercise is. That is
21 what drives your argument?

22 A Correct.

23 Q So, I have got this real hard actual number, and I
24 am comparing it with a number that has very, very different
25 characteristics. It is some senses an imaginary number.

1 A I wouldn't call it imaginary.

2 Q Not in mathematical terms. But it never lived in
3 the world, this number.

4 A No, it lived -- it was my attempt to put numerical
5 meaning to the views of the Commission as I saw them. It
6 was my attempt to put numerical meaning to my interpretation
7 of the Commission's statements in several recommended
8 opinions and recommended decisions.

9 Q Sure. For each of the years that you show here in
10 Table B at page 15 of 20 in part 1 of OCA LR-3, there was a
11 real number that could have been used in Row 4, wasn't
12 there, the number from the most recent rate case that the
13 Commission had actually decided, rather than an average of
14 those decided numbers over time? You could have done that,
15 couldn't you?

16 A In fact, I did in response to DMA, DMA-2.

17 MR. WIGGINS: Correct. Thank you, Mr. Chairman
18 and thank you, Mr. Callow. I have nothing further.

19 CHAIRMAN GLEIMAN: Mr. Tidwell.

20 MR. TIDWELL: Good afternoon, Mr. Chairman.

21 CROSS-EXAMINATION

22 BY MR. TIDWELL:

23 Q Good afternoon, Mr. Callow. Michael Tidwell on
24 behalf of the United States Postal Service. I would like to
25 start by directing your attention to your response to DMA

1 Interrogatory T6-1(a). Do you have that?

2 A Yes.

3 Q There you indicate that for purposes of your
4 analysis, you interpret the test period as a period intended
5 to be typical or representative of, or an average for the
6 period the recommended rates were to be in effect. And then
7 you go on to say that the contribution recommended by the
8 Commission for the test year should be equal to the average
9 contribution per year during the period in which rates are
10 to be in effect. Is this the way the Commission has
11 typically viewed the test year for purposes of rate-making?

12 A Not as a legal matter, no. As an analyst, though,
13 I treated the test year as the period that is intended to be
14 representative of the period during which the recommended
15 rates are in effect. I mean you might -- I guess legally,
16 you could interpret the test year as a single year, but the
17 concept of a test year seems to make little sense if it is
18 not representative of the period in which the rates are in
19 effect.

20 Q And what sort of test year does the Commission
21 typically use? What, and how does the Commission typically
22 define a test year?

23 A My understanding is it picks -- I'm sorry. My
24 understanding is that the Postal Service proposes a test
25 year a year or so out from the time the rate case is filed.

1 Q And the test year is defined in what terms? I
2 mean if the Postal Service gets to select a test year, are
3 there some limitations on the test year that the Postal
4 Service gets to select?

5 A I am not certain, I guess I am not certain what
6 you are asking. I mean I understand there are some
7 requirements in the Commission's rules about test year. I
8 am not familiar with those.

9 Q And so you couldn't tell whether your test period
10 is consistent with those requirements?

11 A No, I mean I didn't look at it as -- I didn't go
12 to the Commission's rules and say I am going to create a
13 test year. You know, from an analyst's standpoint, I
14 interpreted the test year as the period in which --
15 representative of the period in which the rate are in
16 effect. I did not look at it, if you will, from, I guess,
17 how a lawyer might look at it. You know, does it have all
18 the requirements, the features that the Commission expects
19 when a filing is made?

20 Q Well, you keep referencing how lawyers would look
21 at it, but are there other witnesses in this case who are
22 not lawyers who take a look at the Commission's requirements
23 and try to define test years on that basis?

24 A Well, I mean I -- hmm. Maybe you should rephrase
25 that before I answer or give me another chance at it.

1 Q Give it another shot.

2 A I guess I am telling you what I did, which
3 apparently is different from what other folks have done,
4 apparently different from what a lawyer might interpret
5 should be done.

6 Q And is it different from what the Commission
7 traditionally does?

8 A I believe it is.

9 Q Earlier in your conversation with Mr. Wiggins you
10 talked about the two-year rate cycle and you described it as
11 representing the Postal Service's approach to how it looks
12 at the future.

13 You made reference to a document Postal Service
14 submitted to the GAO. Do you recall from that document
15 whether the Postal Service described the two-year rate cycle
16 that it used for purposes of the exercise reflected in that
17 document as a hypothetical construct or as a statement of
18 the Postal Service's policy and intentions for the future?

19 A My recollection is that the material in response
20 to the institutional interrogatory that produced the GAO
21 estimates for this record and in the document itself, there
22 were all kinds of caveats about this not being, you know,
23 Postal Service policy.

24 Q Let's take a look then at page 34 of your
25 testimony.

1 If the two year rate cycle is not Postal Service
2 policy then how do you reconcile that with your statement
3 that the Postal Service is planning -- at the top of page 34
4 you have Postal Service is planning future rate adjustments
5 approximately every two years.

6 I mean that seems to me to be a statement that it
7 is in fact Postal Service policy to establish a two year
8 rate cycle.

9 A I guess what you have is statements from postal
10 management saying that the Postal Service is operating on a
11 two year cycle, that mailers have commented that more
12 frequent and predictable rate increases are considered to be
13 postal policy.

14 Q By the mailers or by the Postal Service?

15 A By the mailers and apparently -- and there is a
16 fairly broad understanding in the public that that is how
17 the Postal Service is operating presently.

18 Q Based on mailers' statements that that is the way
19 it is or based on some policy statements issued by the
20 Postal Service?

21 A Well, we have the statement of Postmaster General,
22 Deputy Postmaster General Nolan in a speech saying that he
23 is beginning to plan for rate cases in 2003 and 2005.

24 Q And in reference to that particular statement the
25 Postal Service received an interrogatory from the OCA,

1 Interrogatory OCA/USPS-136, and the response to which was
2 filed I guess a week or so after your testimony was filed,
3 and I -- well, have you had a chance -- are you familiar
4 with that interrogatory response, Postal Service
5 Interrogatory or OCA Interrogatory 136?

6 MR. COSTICH: Mr. Chairman, I will object at this
7 point. Counsel is trying to do the same thing that counsel
8 this morning did, namely get a self-serving interrogatory
9 response into the record that no one has designated and no
10 one has had an opportunity to cross examine a Postal Service
11 witness concerning.

12 MR. TIDWELL: The Postal Service has yet to try to
13 move anything into evidence at this point.

14 MR. COSTICH: And I don't want them trying either.
15 This interrogatory response has not been designated by
16 anyone. It is the Postal Service's own self-serving
17 response.

18 MR. TIDWELL: The witness has --

19 CHAIRMAN GLEIMAN: Can you please give me the
20 Interrogatory number again?

21 MR. TIDWELL: It is OCA/USPS-136.

22 CHAIRMAN GLEIMAN: Okay.

23 MR. TIDWELL: If it would be helpful, I could
24 distribute it.

25 CHAIRMAN GLEIMAN: It is an interrogatory that OCA

1 sent to a Postal Service witness?

2 MR. TIDWELL: To the Postal Service.

3 CHAIRMAN GLEIMAN: And the Postal Service answered
4 it?

5 MR. TIDWELL: Correct.

6 CHAIRMAN GLEIMAN: Okay -- and it is not
7 designated written cross examination?

8 MR. TIDWELL: That's correct.

9 CHAIRMAN GLEIMAN: I think that -- my recollection
10 of the rules are that when you are doing cross examination
11 it is supposed to be in reference to the witness's
12 testimony, not the testimony of the Postal Service.

13 MR. TIDWELL: And the witness has just testified
14 about the statement by Mr. Nolan, which is the subject
15 matter of the interrogatory response.

16 MR. COSTICH: The interrogatory response is not a
17 response of Mr. Nolan. It is not attested to by anyone. It
18 is not accompanied by an affidavit. It is not admitted into
19 evidence. It has not been designated --

20 CHAIRMAN GLEIMAN: Do you have copies of Mr.
21 Nolan's speech available that you can ask questions about?

22 MR. TIDWELL: There are none that I am aware of.

23 CHAIRMAN GLEIMAN: No copies of Mr. Nolan's speech
24 or no copies of reports of Mr. Nolan's speech?

25 MR. TIDWELL: I believe that there -- the response

1 to the interrogatory indicates there is no written version
2 of the speech and there is no written transcription of it.

3 CHAIRMAN GLEIMAN: I'm afraid I am going to have
4 to side with the OCA on this one, Mr. Tidwell.

5 If the interrogatory had been designated at the
6 end of the first round of hearings as an institutional
7 response by someone then it would be in the record and we
8 could have some cross on it, but I think that Mr. Costich is
9 correct in his position.

10 Q Let's move on to page 30 of your testimony.

11 [Pause.]

12 There you describe differences you perceive
13 between the interests of business and household users of
14 First Class Mail.

15 And at lines 15-17, you state that one of the
16 differences between household mailers and business mailers
17 that causes them to have different interests related to the
18 amount and timing of First Class Mail rate changes is that
19 for many businesses, the rate paid First Class Mail
20 represents a major item of costs, and as a result, occupies
21 considerable management attention.

22 Now, is it your opinion that, generally speaking,
23 First Class Mail postage is less likely to be a major item
24 of cost for households?

25 A I believe that if you look in the paragraph above,

1 we -- the data shows that there is approximately 12 First
2 Class mail pieces per month. So at a 33-cent rate, that
3 would not, for most folks, not be a lot of money.

4 Q Okay. Generally speaking, would you agree that
5 business users of First Class Mail are more adept than
6 household mailers at dealing with changes in Postal rates?

7 A Yes, I believe they are. The rate schedule is set
8 up in tenths of a cent, so the rates would be more
9 complicated, I assume, to take account of the fact that they
10 devote more resources to managing the rates.

11 Q I direct your attention to page 32 of your
12 testimony, and focus on the paragraph that is between lines
13 5 and 15.

14 And there you differentiate between household
15 mailers and business mailers, and when differentiating
16 between household mailers and business mailers, you testify
17 about how a higher level of frequency of rate changes can
18 create confusion for household mailers.

19 Am I capturing the essence of your testimony
20 there?

21 A Yes.

22 Q And I guess it's the frequency with which
23 household mailers would have to deal with -- I think that at
24 one point you characterize them as leftover First Class Mail
25 basic stamps and makeup stamps and nondenominational First

1 Class basic stamps; that that whole exercise is confusing
2 for households, and that that confusion could be minimized
3 if they had to endure that exercise with less frequency than
4 they currently do?

5 A Well, the confusion is limited, certainly to a
6 time after implementation. This isn't something that I
7 would expect would go on for a long time.

8 Q But it relates to the fact that they've got to mix
9 different stamps so that -- or different combinations of
10 stamps to pay their basic First Class Mail?

11 A Or that they would have separate inventories, if
12 you will, and then with a rate change, they would have
13 another separate inventory, another First Class stamp with a
14 different denomination.

15 The end results is that consumers, single-piece
16 mailers, household mailers, might underpay.

17 Q And did you think that this sort of confusion
18 could be exacerbated if for First Class Mail, household
19 mailers had to deal with two basic First Class Mail rate
20 stamps?

21 A Are you referring to CEM?

22 Q I suppose that falls into the universe.

23 A No. That would be -- if the Postal Service were
24 to offer a CEM rate, that would be offering consumers a
25 choice. If consumers felt confused by having a CEM rate and

1 a First Class rate, they wouldn't take advantage of it.

2 Q I'm just focusing right now on the rate
3 implementation period, right after a change in rates is
4 announced, and the -- let's say the basic First Class rate
5 is going up by a penny or two cents, and the CEM rate is
6 going up by a penny or two cents, and the household mailer
7 is sitting there with his or her leftover First Class basic
8 stamps and their leftover CEM stamps, and then they've got
9 makeup stamps and they've got nondenominational stamps to
10 deal with for the new rate.

11 Would it be more confusing? Would that scenario
12 be more confusing than an alternative scenario where they
13 only had one basic First Class rate to deal with?

14 Granted that maybe over time, the confusion would
15 diminish, but at least during the transition, would it be
16 more confusing to have to deal with two basic rate stamps?

17 A In the time period after implementation? Yes,
18 there would be. The confusion is associated with the
19 change, so to the extent that you had two First Class basic
20 rate stamps that were changing, you'd have, you know,
21 potential for more confusion, but it's related to the
22 change.

23 Q Okay. I'd like to change topics now, and move on
24 to your non-standard surcharge proposal, and direct your
25 attention to your response to Postal Service Interrogatory

1 T6-13.

2 A I have that.

3 Q Now in your response you acknowledge that you
4 haven't conducted any research on how your proposal to
5 eliminate nonstandard surcharge on low aspect ratio letters
6 would affect the volume of these letters, is that correct?

7 A I'm sorry, I missed the first part of your
8 question.

9 Q In I guess it is the beginning of the first line
10 of your response you indicate that you haven't conducted any
11 research to determine how your proposal would affect the
12 volume of nonstandard surcharge -- or of low aspect ratio
13 letters.

14 A Correct.

15 Q And you go on to say in your response that the
16 current number of total nonstandard letters would probably
17 serve as a reasonable maximum number of low aspect ratio
18 letters if the low aspect ratio boundary were eliminated as
19 a rate differential.

20 A Correct, for low aspect ratio mail.

21 Q And I am just trying to explore some of the
22 reasoning behind or what goes behind your analysis there.

23 Your response doesn't mention anything about
24 businesses and other organizations that, like greeting card
25 companies, that design mail pieces, isn't that correct?

1 A Correct.

2 Q And do you think that the existence of a
3 nonstandard surcharge influences mail piece design?

4 Do you think that greeting card companies and
5 other envelope manufacturers make efforts to design mail
6 pieces so that the purchasers of their products can avoid
7 having to pay a nonstandard surcharge?

8 A I guess my answer is some do, some don't -- I mean
9 I think --

10 Q Do you think it is a 50/50 split?

11 A I don't know. I don't have any information on it,
12 just personal experience. I have seen, you know, square
13 cards in card stores and stuff like that, but I don't have
14 any information on that.

15 Q I would like for you to take a look at your
16 response to Postal Service Interrogatory T6-6.

17 A I have it.

18 Q And I guess toward the bottom of the first
19 paragraph of your response you quote the Commission's
20 recommended decision in R97. There is a quote, "It is well
21 accepted that the Service's processing equipment is now far
22 more sophisticated than when the surcharge was introduced."

23 You quote, I guess it is paragraph 52-27 of the
24 R97 decision.

25 Now would you agree subject to check that the

1 nonstandard surcharge was first introduced in 1978?

2 A Yes.

3 Q When you were reviewing the Commission's opinion,
4 R97 opinion and the record in R97 in reference to this
5 particular interrogatory response, were you able to identify
6 any specific changes in the transport systems that guide low
7 aspect ratio letter mail pieces through letter mail
8 processing equipment so as to better preserve their
9 orientation than was the case 20 years ago?

10 Are you familiar with the changes in mail
11 processing equipment that have improved the capacity of
12 letter mail processing equipment to preserve the orientation
13 of square nonstandard sized letters?

14 A If you are asking me can I point to specific, you
15 know, specific features of specific machines, no.

16 What I can say is that over time the -- at the
17 time the surcharge was introduced in 50 percent, 56 percent
18 standard size letters were manually processed and then mail
19 processing became mechanized and then moved to automation,
20 but I can't point to specific features of, say, automated
21 machines that preserve, if you will, the orientation of low
22 aspect ratio mail.

23 MR. TIDWELL: That's all we have, Mr. Chairman.

24 CHAIRMAN GLEIMAN: Is there any follow-up?

25 Questions from the bench?

1 COMMISSIONER COVINGTON: I have two.

2 CHAIRMAN GLEIMAN: Commissioner Covington.

3 COMMISSIONER COVINGTON: Good afternoon, Mr.

4 Callow.

5 THE WITNESS: Good afternoon, Commissioner.

6 COMMISSIONER COVINGTON: Thank you, Mr. Chairman.

7 I have just two quick questions. I guess,
8 primarily, Mr. Callow, it would be more for clarification
9 purposes. The first one deals with your response to PostCom
10 OCA-T6-4, it was an interrogatory that asked you to provide
11 a response which deal with the dealt with the single piece
12 First Class rate and the effect that it would have on work
13 shared mail. And what I am wondering, Jim, is I read that
14 and I still don't know what impact a single piece First
15 Class rate would have on work shared mail if we went with
16 keeping the current 33 cents price in effect.

17 THE WITNESS: In my proposal, I made an assumption
18 about the work share discount, that it would be -- I assumed
19 the automatic basic discount of six cents from, in this
20 case, in the rate stability proposal, six cents less than
21 the calculated rate, which was 33 cents.

22 COMMISSIONER COVINGTON: Okay.

23 THE WITNESS: What happens with -- it is a six
24 cent difference from the calculated rate, but a seven cent
25 different from the single piece rate, which was the integer

1 rate, which was 34 cents. So, the effect on work share
2 would have been, if you will, a larger discount and more
3 work share mail in the first rate period.

4 COMMISSIONER COVINGTON: Okay. And then --

5 THE WITNESS: I have answered your question.

6 COMMISSIONER COVINGTON: All right. And then I
7 think that when you, in your analyses and your studies, I
8 noticed where you looked at cases going from R87-1 up until
9 R97, and am I correct, I think that somewhere I noted where
10 the average mark-up index was going to be 1.263, which your
11 contention was that that, as a result of that \$6.8 billion
12 had been contributed or had been moved over to institutional
13 costs as far as the United States Postal Service was
14 concerned. Do those figures sound about right?

15 THE WITNESS: Yes.

16 COMMISSIONER COVINGTON: Okay. And with regard,
17 and this is the last thing I have, Mr. Chairman, with regard
18 to the low aspect ratio analyses, your contention is that it
19 is somewhat outdated right now?

20 THE WITNESS: Yes. I think in my conclusion that
21 the assumptions that the Postal Service -- the assumption
22 that the Postal Service uses, 100 percent manual processing,
23 is not realistic. That there have been advances in the
24 technology of mail processing and automated processing that
25 render that assumption obsolete, and that that assumption is

1 used to develop costs which are used for rates that are not
2 correct

3 COMMISSIONER COVINGTON: So, in other words, you
4 are saying that that non-standard surcharge should no longer
5 be warranted because mail processing is so advanced now, and
6 the fact that you have got cards, or Christmas greetings and
7 so forth, and invitations, that that within itself makes
8 that pretty much a non-player?

9 THE WITNESS: For low aspect ratio mail. For the
10 square, if you will, the square or nearly square pieces.

11 COMMISSIONER COVINGTON: Envelope. Okay. Well,
12 does anybody know, or did you take into account, or have you
13 looked at where could we find out how much savings a mailer
14 can realize, or what would this cost the United States
15 Postal Service if we dealt with your low aspect ratio
16 analysis?

17 THE WITNESS: Yes, Commissioner Covington, in my
18 testimony, --

19 COMMISSIONER COVINGTON: Is it in something?

20 THE WITNESS: Yes, I was going to just briefly
21 point it out. On page 67, I make a calculation about the
22 revenue lost to the Postal Service if you eliminated the 11
23 cent non-standard surcharge on the low aspect ratio mail.
24 It is line 5 of page 67. It is about \$6.9 million.

25 COMMISSIONER COVINGTON: Million and not billion?

1 THE WITNESS: Right, with an "M."

2 COMMISSIONER COVINGTON: Okay, \$6.9 million. I
3 must have missed that page. All right. That just about
4 cleared up what I had, Mr. Callow.

5 Thanks a lot, Mr. Chairman.

6 CHAIRMAN GLEIMAN: It doesn't appear there are any
7 other questions from the bench. Is there follow-up
8 questions from the bench?

9 MR. WIGGINS: Very briefly, Mr. Chairman.

10 CHAIRMAN GLEIMAN: Okay. Mr. Wiggins.

11 MR. WIGGINS: Thank you.

12 CROSS-EXAMINATION

13 BY MR. WIGGINS:

14 Q Mr. Callow, you talked with Commissioner Covington
15 about the phenomenon described in your testimony as the
16 increasing institutional costs of First Class mail.

17 A Yes.

18 Q It is right, isn't it, that there is not a single
19 mark-up, effective mark-up for different categories of First
20 Class mail? Some First Class mail contributes more than
21 others, does it not? Isn't some First Class mail more
22 profitable to the Postal Service than other First Class
23 mail?

24 A Are you talking about implicit cost coverage?

25 Q Implicit cost coverage, precisely. Right.

1 A Yes.

2 Q There are different implicit cost coverages within
3 the universe of First Class mail?

4 A Yes.

5 Q So, another way to talk about -- let me ask you,
6 is another way to talk and think about the fact that the
7 institutional cost coverage for First Class mail has gone
8 up, is another way to think about that, that there is more,
9 more profitable First Class mail today than there was at
10 points in the past? Is that another way to say the same
11 thing?

12 A I didn't look at the implicit cost coverages. I
13 mean I don't have -- I didn't look at the implicit cost
14 coverages to know what has happened.

15 Q Is it a possible explanation at least, even though
16 an unexamined one in the case of you?

17 A It could be.

18 MR. WIGGINS: Thank you.

19 CHAIRMAN GLEIMAN: Any further follow-up?

20 [No response.]

21 CHAIRMAN GLEIMAN: If not, Mr. Costich, would you
22 like some time with your witness for redirect?

23 MR. COSTICH: Yes, Mr. Chairman. Could we have 10
24 minutes?

25 CHAIRMAN GLEIMAN: You bet.

1 [Recess.]

2 CHAIRMAN GLEIMAN: Mr. Costich, we are ready
3 whenever you are.

4 MR. COSTICH: Thank you, Mr. Chairman.

5 REDIRECT EXAMINATION

6 BY MR. COSTICH:

7 Q Mr. Callow, you had a conversation with
8 Commissioner Covington, in which he had referred you to a
9 PostCom interrogatory; do you recall that?

10 A Yes, I do.

11 Q Did you understand the question?

12 A I think I misunderstood the question, and the
13 question concerns whether my testimony affects only the
14 single-piece First Class letters. And this in the context
15 of maintaining the 33-cent rate.

16 What my response should have been in proposing to
17 retain the 33-cent rate is, I'm also proposing to retain all
18 other rates in the First Class subclass; that is, the
19 work-share discounts would not change.

20 But, of course, those workshare rates would differ
21 from those of the Postal Service, so I hope that clarifies
22 it.

23 I momentarily almost was confused.

24 Q Counsel for PostCom asked you some questions about
25 how difficult it might be to project costs under your rate

1 stability proposal; do you recall that?

2 A Yes, I do.

3 Q Just how difficult and just how important is it to
4 project costs out beyond the expected duration of the rates
5 to be set in the first rate case?

6 A Well, as I mentioned, as you go out, of course, it
7 is more difficult to project costs, but it's not -- it would
8 be relevant, but it's not necessary.

9 It wouldn't be necessary at the time of the first
10 rate case, and in the context of the rate stability
11 proposal, you know, setting the single-piece rate does not
12 have to be a precise exercise.

13 It's -- because the reserve account is intended to
14 serve as a buffer to hold, to absorb changes in the revenues
15 caused by holding the single-piece rate constant over the
16 two periods.

17 MR. COSTICH: Thank you. I have no further
18 questions, Mr. Chairman.

19 CHAIRMAN GLEIMAN: Is there any recross?

20 MR. WIGGINS: I do have a question, Mr. Chairman.

21 RE CROSS EXAMINATION

22 BY MR. WIGGINS:

23 Q Tell me how the buffer that you just testified
24 about is going to work, if the costs of First Class Mail
25 prove out to be in the second year or the third year or the

1 fourth year, given your hypothetical, they prove out to be
2 considerably greater than one could have guessed?

3 How does the buffer work?

4 A Well, in the third -- in effect, in the first
5 year, you're going to have revenues -- in the first rate
6 period, you're going to have revenues generated because of
7 the difference between the calculated rate and the
8 single-piece rate, the single-piece First Class rate paid by
9 single-piece mailers.

10 So there would be revenues generated, reported to
11 the reserve account.

12 If costs turn out to be higher, and the calculated
13 rate is much higher, and as I indicated in my testimony, if
14 it's over 1.5 cents, that, of course, would -- I had
15 anticipated or would expect the Commission to change the
16 single-piece rate at that time because of the difference.

17 But if the change, if the difference in the second
18 rate case period or at the time of the second rate
19 proceeding was not that -- was larger than, say, or caused a
20 reduction in revenues greater than the revenue generated in
21 the first period, that could be accommodated, it seems to
22 me, in the third rate case, if you will, at the time the
23 single-piece rate paid by single-piece mailers was changed
24 again.

25 You might have a period of time where, accounting

1 periods where you might have a loss, but that could be then
2 accommodated in the third rate case period.

3 Q And how do you count that the Postal Service would
4 fund its operations if, for example, in Year 3, the costs
5 are substantially higher than projected, and therefore there
6 is not enough money in the reserve account to draw -- you
7 have drawn down below zero in the reserve account.

8 A Well, it seems to me it's unlikely to happen in
9 the third year.

10 Q Okay, the fourth year, and you're down below zero.

11 A It seems --

12 Q How do you pay your bills?

13 A It seems to me that that's something that happens
14 now, that they find themselves in a situation where the
15 revenue is not coming in as fast, and they have to come in
16 and request new rates.

17 Q But that wouldn't be possible under your proposal;
18 would it?

19 A No, it would, because in the third -- if we're
20 talking Year 4 and we're assuming a two-year rate cycle, in
21 Year 5 or at the time there would be new rates at Year 5 --

22 Q But they wouldn't be permitted to come in earlier,
23 if they recognized that things were going South on them?
24 That's what your proposal is all about.

25 A Well, sure, we're talking about a two-year rate

1 cycle.

2 MR. WIGGINS: Thank you.

3 CHAIRMAN GLEIMAN: Is there any re-redirect?

4 MR. COSTICH: Yes, Mr. Chairman.

5 FURTHER REDIRECT EXAMINATION

6 BY MR. COSTICH:

7 Q Mr. Callow, counsel just asked you if under your
8 proposal it would be impossible for the Postal Service to
9 request a rate increase prior to the fourth year.

10 Do you recall that?

11 A Yes.

12 Q Is that in fact part of your proposal, that the
13 Postal Service is absolutely locked into the timing of its
14 rate requests?

15 A No. My -- I have illustrated it on a two-year
16 cycle but there is nothing that requires the Postal Service
17 to adopt a two-year cycle and this proposal would -- it
18 would only work if the Governors wanted it to work.

19 MR. COSTICH: Thank you. No further questions,
20 Mr. Chairman.

21 CHAIRMAN GLEIMAN: I have to ask. Is there any
22 re-recross?

23 MR. WIGGINS: I think not, Mr. Chairman.

24 CHAIRMAN GLEIMAN: That being the case, I think we
25 have come to the end of our rope today.

1 Mr. Callow, that completes your testimony here
2 today. We appreciate your appearance and your contributions
3 to the record. I thank you. We thank you and you are
4 excused.

5 [Witness excused.]

6 CHAIRMAN GLEIMAN: That concludes today's hearing.

7 We will reconvene tomorrow, July the 7th, at 9:30.

8 We have a host of witnesses scheduled for
9 tomorrow: Witnesses Heselton, Kuhr, Lawton, Martin,
10 Heisler, Buc, Willette, Karls, Glick, and Thompson.

11 In addition to all that, we may be treated to a
12 fire drill tomorrow morning sometime between 9:15 and 10:00
13 a.m. -- they may set the alarm off but I am told that it is
14 to check another part of the building, so we won't have to
15 leave if we hear the fire alarm go off and it is a test.

16 I am not sure if there is a real fire and they set
17 off the alarm how we are supposed to determine the
18 difference. Hopefully someone will run in and tell us to
19 get the devil out of the building.

20 In any event, have a lovely evening. Enjoy what
21 is left of what I understand was a nice day.

22 [Whereupon, at 5:27 p.m., the hearing was
23 recessed, to reconvene at 9:30 a.m., Friday, July 7, 2000.]

24
25

The number 10287 was not used.

Transcript Volume 23 starts with 10288.

