OCA-RT-1
Docket No. R2000-1

REBUTTAL TESTIMONY

OF

JAMES F. CALLOW

ON BEHALF OF

THE OFFICE OF THE CONSUMER ADVOCATE

JULY 27, 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

REBUTTAL TESTIMONY
OF
JAMES F. CALLOW

I. STATEMENT OF QUALIFICATIONS

My name is James F. Callow. I am a Postal Rate and Classification Specialist. I have been employed by the Postal Rate Commission since June 1993, and since February 1995 in the Office of the Consumer Advocate (OCA). A more complete statement of qualifications is provided in my testimony, OCA-T-6, submitted earlier in this proceeding.[1]

[1] *See* Tr. 22/10099-10100.

II. PURPOSE AND SCOPE OF TESTIMONY

This testimony addresses Postal Service forecasting of the number of additional ounces per piece for single-piece First-Class Letter Mail in the test year. In this proceeding, the Postal Service has proposed two methodologies for forecasting the number of additional ounces per piece: the "as-filed" methodology, presented at the time of its original request, and the "revised" methodology, introduced several months thereafter. The "as-filed" methodology results in a forecast showing an increase in the number of additional ounces per piece between the base year and the test year, consistent with the long-term trend of an increase in the number of additional ounces per piece. The "revised" methodology produces a forecast showing that the number of additional ounces per piece remains the same between the base year and the test year.

I propose that the Commission adopt the "as-filed" methodology for forecasting the number of additional ounces per piece in the test year. The "revised" methodology fails to reflect the historical trend of an increasing number of additional ounces per piece, an average weight per piece, for single-piece First-Class Letter Mail.

The "revised" methodology appeared at the same time the Postal Service made a necessary correction to account for the omission of the net overpayment of First-Class postage in its revenue calculation. Correcting that error increased total net revenue for single-piece First-Class Letter Mail by $192.3 million. By contrast, the "revised" methodology reduced net revenue for single-piece First-Class Letter Mail by $172.2 million. The "revised" methodology thus served to offset nearly all of the increase in net revenue of single-piece letters from the error correction.

Assuming the Commission adopts the "as-filed" methodology, I also propose that the $192.3 million in net revenue from postage overpayment be used for the benefit of single-piece mailers, as most of this net revenue is the result of postage overpayments by single-piece mailers. This error correction is further justification for maintaining the single-piece First-Class Letter rate at 33 cents, as proposed in the direct case of the Office of Consumer Advocate.

III. THE COMMISSION SHOULD RELY ON THE "AS-FILED" METHODOLOGY TO FORECAST THE NUMBER OF ADDITIONAL OUNCES OF SINGLE-PIECE LETTER MAIL

In this proceeding, the Postal Service has presented two conflicting methodologies to forecast the number of additional ounces associated with single-piece First-Class Letter Mail in the test year. The first (herein, the "as-filed") methodology recognizes the decade-long trend of an increasing number of additional ounces per piece for single-piece First-Class Letters as the basis for forecasting additional ounces.[2] The second (herein, "revised") methodology considers a short recent period showing a small change in the number of additional ounces per piece as indicative of a reversal of the long-term trend, and the basis for forecasting no increase in the number of additional ounces in the test year.

The "revised" methodology appeared in response to an institutional discovery request seeking clarification as to the inclusion, or lack thereof, of the net overpayment of First-Class postage in the Postal Service's test year revenue requirement.[3] In that response, the Postal Service acknowledged that it had failed to include the net overpayment of First-Class postage in its revenue calculation. Correcting that error increased total net revenue for First-Class Mail by $219.4 million.[4] However, the "revised" methodology, introduced at the same time, reduced net revenue for single-

[2] See the testimony of witness Thress, USPS-T-7, Workpaper 4, and USPS-LR-I-122.

[3] Tr. 21/9178. Response of the U.S. Postal Service to OCA/USPS-106(d).

[4] *See* Notice of Inquiry, No. 3, First-Class Revenue Adjustment Factor (RAF) and Additional Ounce Method Change, June 30, 2000, Table 1, at 2. Of the total increase in the net revenue for First-Class Mail of $219.4 million, $192.3 million is related to single-piece letters. *Id.*

piece First-Class Letter Mail by $172.2 million. In effect, introduction of the "revised" methodology served to offset all but $47.2 million of the revenue resulting from the error correction. The Postal Service proposes to add the $47.2 million to the net revenues of First-Class Mail in the test year.[5]

The Commission should adopt the "as-filed" methodology for forecasting of number of additional ounces per piece in the test year. The "revised" methodology fails to recognize the long-term trend showing an increasing number of additional ounces per piece, and average weight per piece, for single-piece First-Class Letter Mail.

A. The "As-Filed" Methodology Properly Reflects the Increasing Long-Term Trend in the Number of Additional Ounces per Piece, and Average Weight per Piece, for Single-Piece Letters

The "as-filed" methodology recognizes the long-standing trend of the increasing number of additional ounces, and average weight per piece, in forecasting additional ounces.[6] The "as-filed" methodology results in a forecast showing an increase in the number of additional ounces per piece between the base year and the test year, and is obtained in a three step process. First, the base year ratio of additional ounces per piece for both presort letters and the First-Class Letters subclass as a whole is calculated. Next, the base year ratios are applied to the test year volumes of presort

[5] *Id.*

[6] Witness Fronk characterizes the "as-filed" methodology as "a departure from the method the Commission itself has used in past rate cases." *See* Tr. 34/16533-34. According to witness Fronk, it is the "revised" methodology that represents a return to the traditional approach used by the Commission in the past five rate cases. *See* Tr. 34/16566. An exception noted by witness Fronk, however, is the Commission's opinion and recommended decision Docket No. MC95-1, where the Commission used a method for forecasting the number of additional ounces similar to the "as-filed" methodology. *See* Tr. 34/16537.

letters and total First-Class Letter Mail. Finally, the number of additional ounces per piece for single-piece letters is calculated for the test year as the difference between total additional ounces and presort additional ounces.[7]

1. The long-term trend for single-piece letters reveals an increase in the number of additional ounces per piece

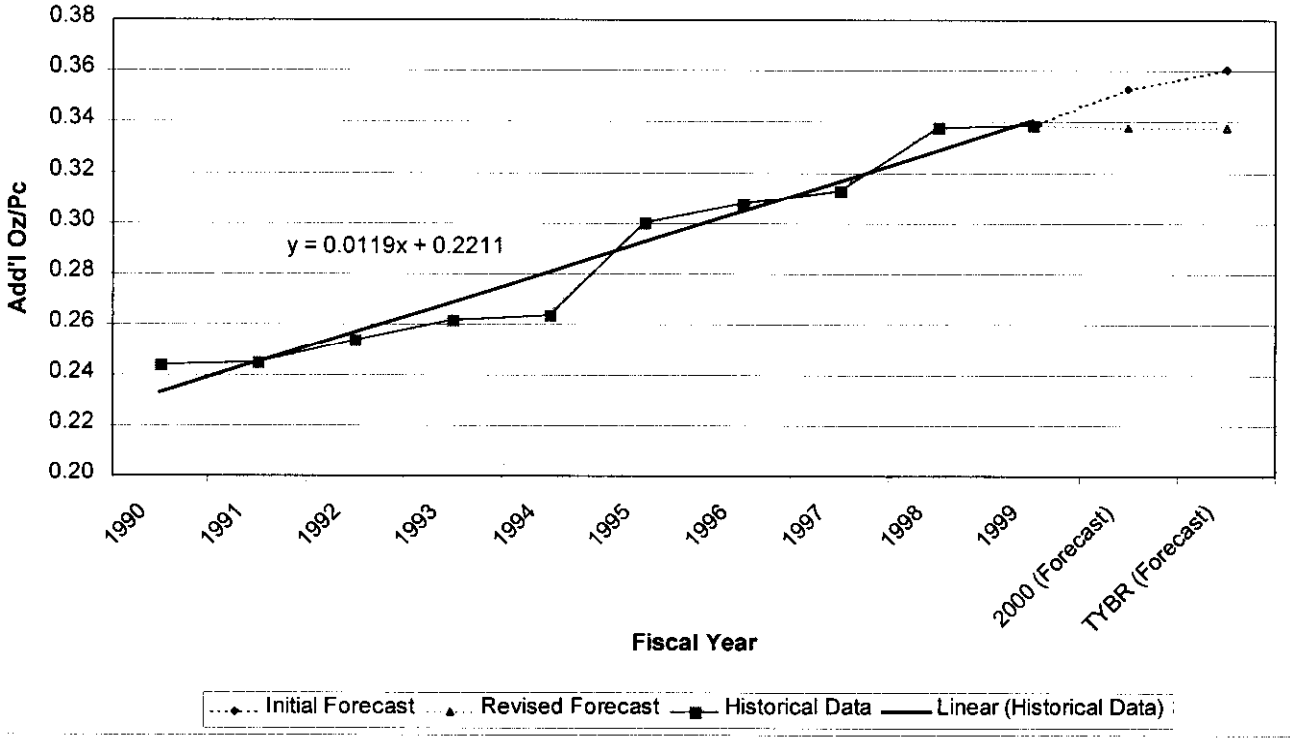
The number of additional ounces per piece for single-piece letters has increased continually during the past 10 years. Figure 1 presents the historical data for the number of additional ounces per piece for single-piece letters during the period FY 1990 thorough FY 1999, and the "as-filed" and "revised" forecasts of the Postal Service through the test year.[8] A linear trend line is drawn through the historical data.

In every year during the 10 year period of analysis, the number of additional ounces per piece has increased. Consequently, the trend in the number of additional ounces per piece is rising. This rising trend in the number of additional ounces per piece is properly reflected in the "as-filed" forecast of the Postal Service, shown in Figure 1.

[7] For a presentation of the Postal Service's "as-filed" methodology, *See* USPS-T-7, Workpaper 4, and LR-I-122.

[8] Figure 1 duplicates Attachment 4 in the Commission's Notice Of Inquiry No. 3, with the addition of a linear trend line through the historical data.

Figure 1. Additional Ounces per Piece
First-Class Single-Piece, 0-11 Ounces



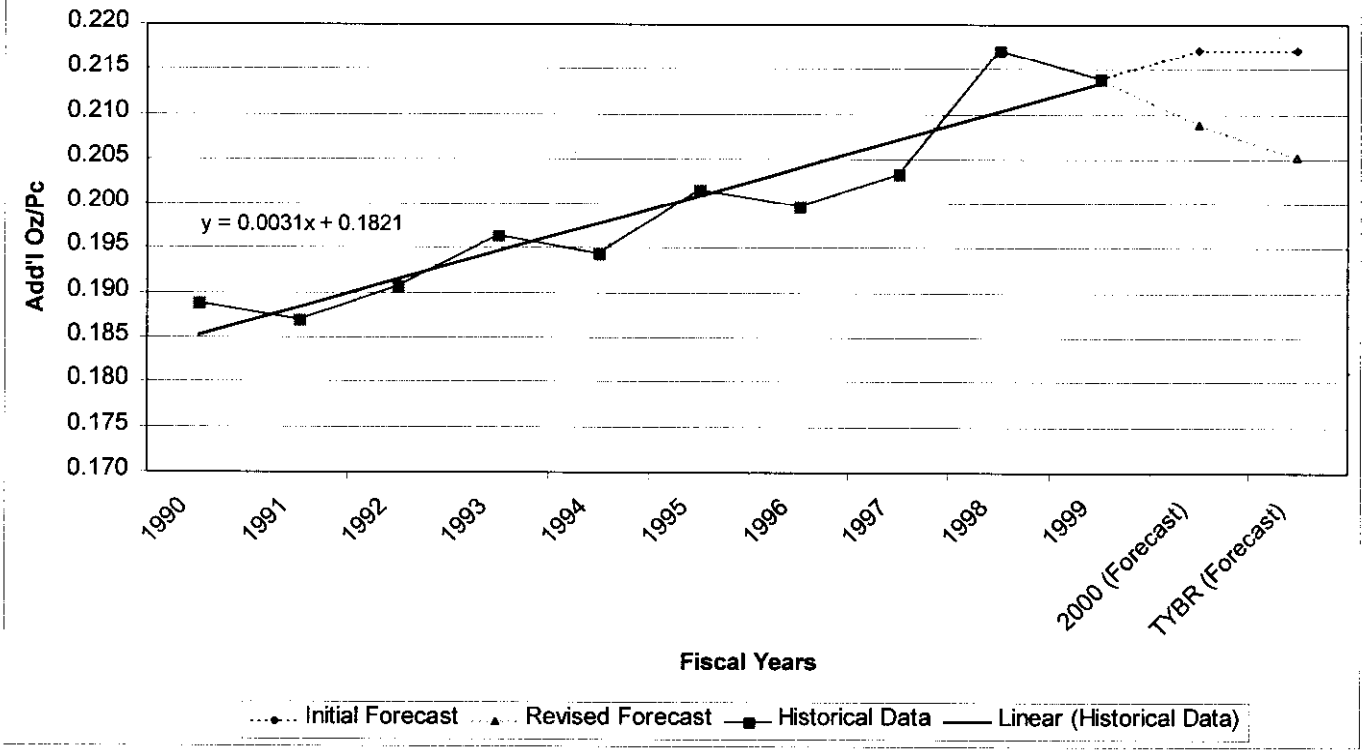
A similar trend is apparent for total First-Class Letter Mail. Figure 2 presents the historical data for the number of additional ounces per piece for total First-Class Letter Mail during the same 10 year period, FY 1990 thorough FY 1999.[9] The "as-filed" and "revised" forecasts of the Postal Service through the test year are also presented. Again, a linear trend line is drawn through the historical data.

The number of additional ounces per piece for total First-Class Letter Mail has increased over the past 10 years, despite several years during which the number of additional ounces per piece declined. This increase during the entire period is revealed

[9] Figure 2 duplicates Attachment 5 in the Commission's Notice Of Inquiry No. 3, with the addition of a linear trend line through the historical data.

in the linear trend line through the historical data shown in Figure 2. The Postal Service's "as-filed" forecast also properly reflects this rising trend.

Figure 2. Additional Ounces per Piece
Total First-Class Letters, 0-11 Ounces

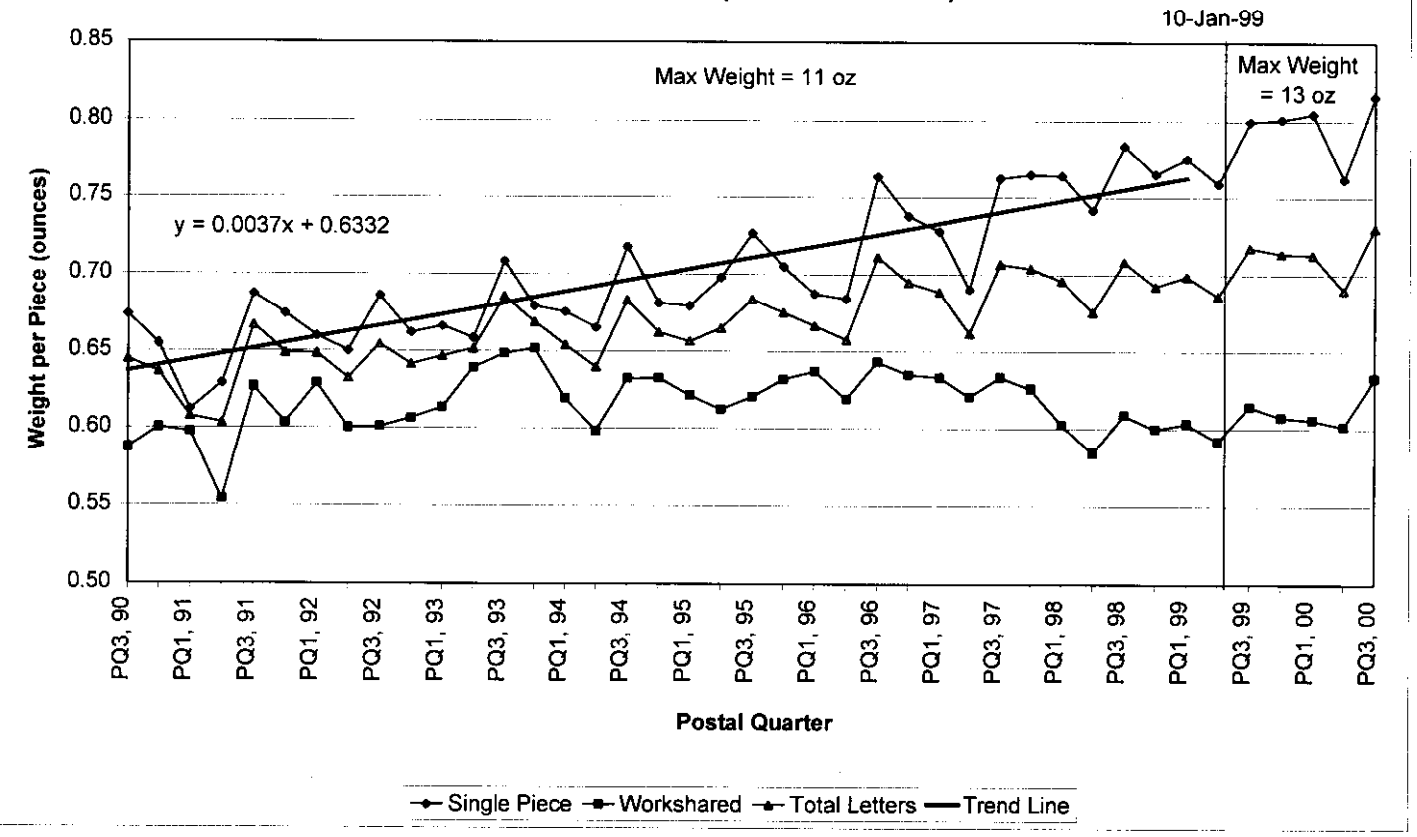


2. The long-term trend for single-piece letters reveals an increasing average weight per piece

The increasing long-term trend in the number of additional ounces per piece is consistent with the increase in the average weight per piece for single-piece letters during the past 10 years. Figure 3 shows the average weight per piece for single-piece, workshared and total letters from postal quarter (PQ) 3 of 1990 through postal quarter 3

of 2000.[10] A linear trend line is drawn through the data for single-piece letters for the period PQ3, 1990 through PQ1, 1999. This trend line corresponds to the period when the maximum weight for single-piece letters was 11 ounces. The historical trend of an increasing average weight per piece for single-piece letters is apparent from a visual inspection of single-piece letters, where the values for PQ3 in all but two years are higher than the preceding years. The trend is also evident from the slope of the linear trend line in Figure 3.

Figure 3. Quarterly Weight per Piece
First-Class Letters (with Trend Line)



[10] Figure 3 was entered into evidence as OCA cross-examination exhibit, OCA-XE-NOI3-1. *See* Tr. 34/16594. Figure 3 duplicates Attachment 2 in the Commission's Notice Of Inquiry No. 3, with the addition of a linear trend line through the data for single-piece letters.

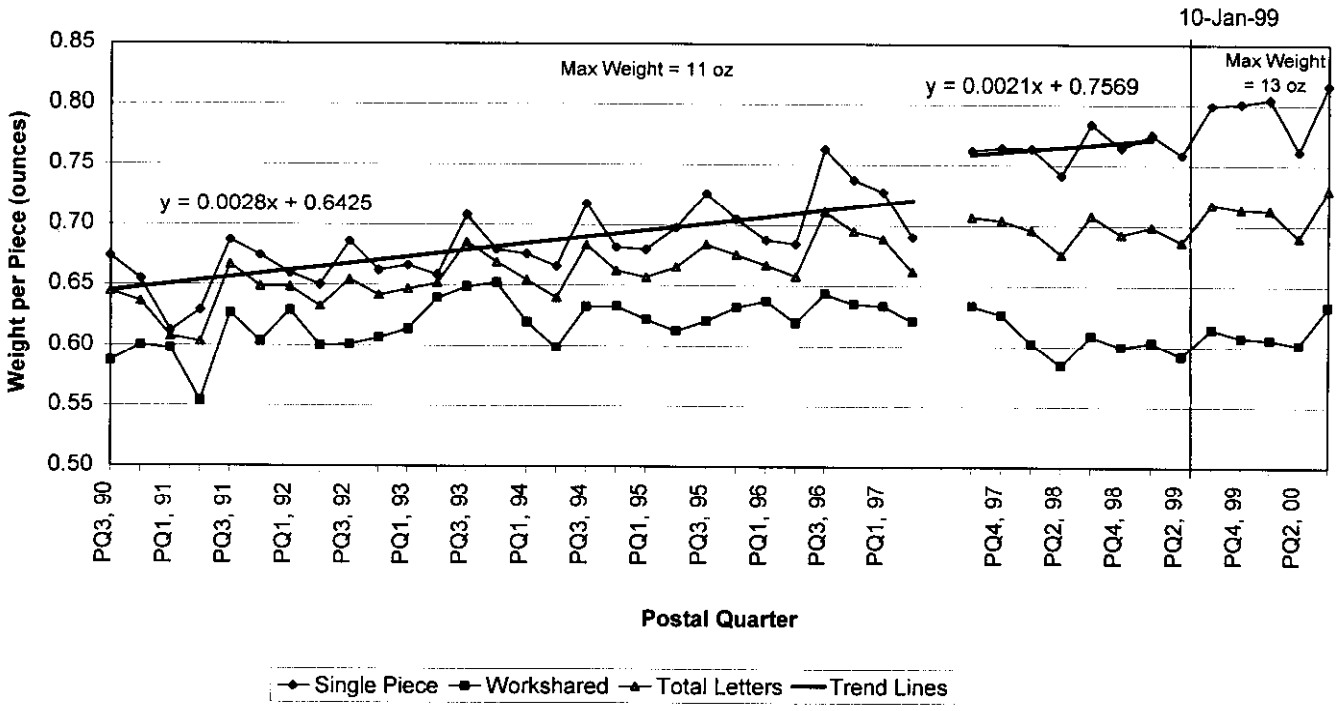
Figure 4 displays the same data presented in Figure 3.[11] However, the weight per piece data are segregated into two groups, with data in PQ3, 1990 through PQ2, 1997 in one group and data in PQ3, 1997 through PQ1, 1999 in a second group. Separating the data between PQ2 and PQ3—the midpoint of 1997—recognizes the fairly sharp increase in the number of additional ounces per piece between 1997 and 1998,[12] and permits a comparable analysis of the weight per piece data with the number of additional ounces per piece.

Figure 4 shows that, while the trend in the average weight per piece for single-piece letters rises more rapidly in the period prior to PQ3, 1997, there nevertheless continues to be a positive, but smaller, increase from PQ3, 1997 through PQ1, 1999. The change in the trend is revealed by the change in the equation of the slope of the trend line.

[11] Figure 4 is changed slightly from the graph entered into evidence as OCA cross-examination exhibit, OCA-XE-NOI3-2. *See* Tr. 34/16598. The cross-examination exhibit separates the data between PQ2 and PQ3 of 1996 to recognize the sharp increase in the average weight per piece in PQ3.

[12] *See* Notice of Inquiry, No. 3, First-Class Revenue Adjustment Factor (RAF) and Additional Ounce Method Change, June 30, 2000, Attachment 4.

Figure 4. Quarterly Weight per Piece
First-Class Letters (with Trend Lines)



3. An increasing average weight per piece for single-piece letters creates an increase in the number of additional ounces per piece for single-piece letters

In his response to Notice of Inquiry No. 3, witness Fronk states that "it is the trend in additional ounces per piece . . . rather than average weight per piece, that is more directly related to revenue."[13] Witness Fronk supports his statement by example:[14]

[13] *Id.*

[14] *Id.*

> . . . for a given volume, the average weight of single-piece mail weighing less than 1 ounce could hypothetically increase from 0.5 ounces to 0.7 ounces and the average weight of pieces weighing between 1 and 2 ounces could increase from 1.6 to 1.9 ounces. This would increase the average weight of the single-piece mail stream, but leave revenue unchanged since a first-ounce stamp would still cover the postage for a 0.7 ounce piece and an additional ounce stamp would still core the postage of the second ounce.

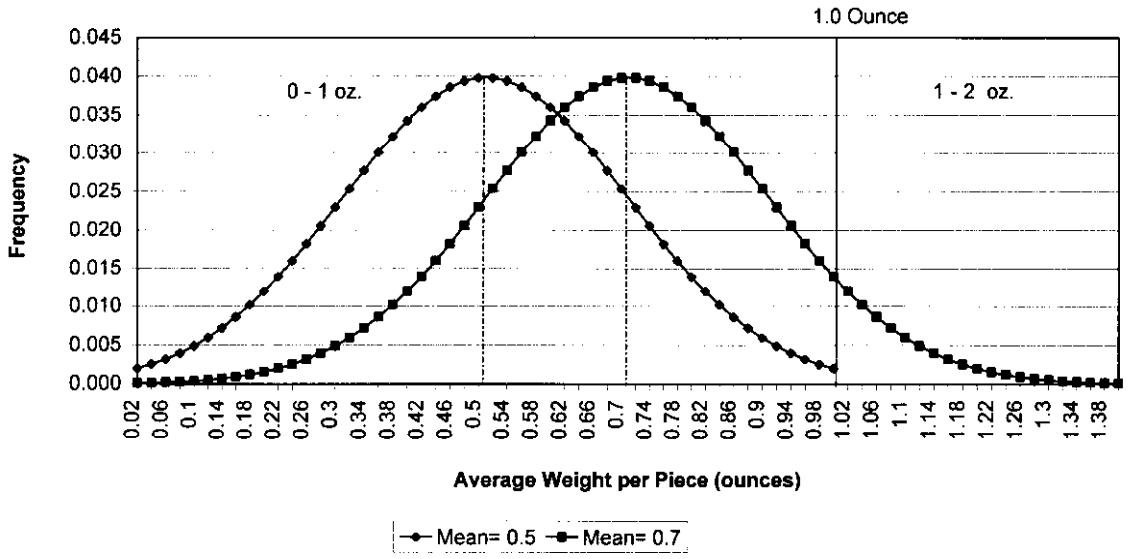
Witness Fronk's statement, while true, attempts to separate the relationship between an increase in the average weight per piece and an increase in the number of additional ounces per piece. His example, hypothesizing an increase in the average weight of pieces within the same weight step, ignores the fact that an increase in the average weight per piece in one weight step can just as well increase the number of additional ounce pieces in next weight step. Another example, presented below, illustrates a different relationship between the average weight per piece and number of additional ounces per piece.

For a given volume of single-piece letter mail, the average weight per piece within any given weight step is the sum of the weight of each piece divided by the number of pieces in that weight step. To derive the average weight per piece, there is, in effect, a distribution of pieces by weight around the average. As the average weight per piece increases, the distribution of pieces around the average shifts to the right, resulting in an increasing number of pieces crossing into the next higher weight step.

Figure 5 visually displays hypothetical data based on the example of witness Fronk. It shows the effect on the number of additional ounces per piece in the first and second ounce weight step when the average weight per piece in the first ounce is increased from 0.5 to 0.7 ounces. The increase in the number of additional ounces in

1 the second ounce weight step is indicated by the area under the graph, "Mean=0.7," to
2 the right of the "1.0 Ounce" line shown in Figure 5.

Figure 5. Increasing Average Weight per Piece Creates New Additional Ounces



3 Consequently, all other things being equal, an increase in the average weight per piece
4 increases the number of additional ounces in the next higher weight step, resulting in
5 additional revenue.

6 B. The "Revised" Methodology Ignores the Increasing Long-Term Trend in
7 Additional Ounces and Results in an Unrealistic Forecast

8 The "revised" methodology, like the "as-filed" methodology, is based upon an
9 assumption about the future trend of the number of additional ounces per piece. Under
10 the "revised" methodology, however, it is assumed that the number of additional ounces
11 per piece in the historical 0-11 ounce weight range for single-piece letters will remain

the same between the base year and the test year. In forecasting the number of additional ounces, the ratio of the number of additional ounces per piece for single-piece letters in the base year is applied to the test year single-piece letter volume.

This approach ignores the long-term trend of an increase in the number of additional ounces, and the average weight per piece, for single-piece letter mail. It also ignores the continuing, but smaller, rise in the number of additional ounces per piece in more recent years.

1. The forecast for the number of additional ounces through the test year is not supported by the long-term trend

Witness Fronk acknowledges that the "as-filed" methodology "may appear to be more consistent with the long-term trend in additional ounces."[15] Nevertheless, it is claimed that the "revised" methodology should be adopted because "newly available 1999 data . . . indicate that the additional ounces per piece in th[e] 0-11 ounce weight range have remained almost constant between 1998 and 1999."[16]

As noted previously, the number of additional ounces per piece for single-piece letter mail has exhibited positive growth every year since 1990. Witness Fronk's "revised" methodology incorporates negative growth for 2000, and zero growth for 2001. Not only is this inconsistent with the historical trend of the past 10 years, but it ignores the witness Fronk's own finding of positive, but smaller, growth in the number of

[15] Tr. 34/16533. Response of US Postal Service Witness Fronk to Notice of Inquiry No. 3, July 17, 2000.

[16] Tr. 21/9180-81. Witness Fronk, in his response to NOI No. 3, maintains that "data in 1999 *and* 2000 confirm that no change in the long-standing traditional method [e.g., the "revised" methodology] is necessary or appropriate." Tr. 34/16537 (emphasis added).

additional ounces per piece in 1999, and in the "hybrid" year 1999/2000. Table 1 shows the continuing growth in the number of additional ounces per piece as determined by witness Fronk.[17]

Table 2

ADDITIONAL OUNCES PER PIECE, 1998, 1999, AND COMBINED 1999/2000			
	1998	1999	1999/2000
Single-Piece Letters	0.3378	0.3387	0.3396

This continuing positive, but smaller, growth in the number of additional ounces per piece is consistent with the historical trend, which shows periods of smaller positive growth followed by periods of more substantial growth.[18]

Moreover, with respect to total First-Class Letters, witness Fronk's use of the "revised" methodology results in a forecast of two years of negative growth in the number of additional ounces per piece. Since 1990, there have never been two consecutive years during which growth has been negative.

2. The more recent data on the number of additional ounce per piece are insufficient to predict a reversal of the long-term trend

It is premature to predict a reversal (or leveling-off) of the decade-long trend toward an increasing number of additional ounces per piece for single-piece First-Class

[17] Tr. 34/16538-39. Response of US Postal Service Witness Fronk to Notice of Inquiry No. 3, July 17, 2000. It should be noted that the positive, but smaller, growth in the number of additional ounces per piece occurs using data that reflects only "physical" additional ounces. *See* Tr. 34/16537.

[18] For example, between 1990 and 1991, the annual percentage change in the number of additional ounces per piece was 0.2 percent. A similar change of 0.6 percent occurred between 1993 and 1994. *See* Notice of Inquiry, No. 3, First-Class Revenue Adjustment Factor (RAF) and Additional Ounce Method Change, June 30, 2000, Attachment 3.

Letter Mail. Witness Fronk maintains that the additional ounce data for 1998, 1999 and three quarters in 2000 lend support for use of the "revised" methodology for forecasting the number of additional ounces per piece. However, the two years of 1998 and 1999 is much too limited a time period to claim an end of the long-term trend, particularly while the additional ounce data for 2000 is incomplete. Moreover, estimates of the number of additional ounces per piece are derived from sampling.[19] The recent lower rate of growth in the number of additional ounces per piece may be nothing more than sampling error. For these reasons, the absence of a clear break from the long-term trend over a sufficient period of time makes the "revised" methodology a departure from the empirical reality of the past decade.

[19] Tr. 34/16582.

IV. THE "REVISED" METHODOLOGY SHOULD BE CONSIDERED ON ITS OWN MERITS, SEPARATE FROM THE NECESSARY CORRECTION OF REVENUES TO ACCOUNT FOR OVERPAYMENT OF POSTAGE

The question of whether to use the "as-filed" methodology or the "revised" methodology for forecasting the number of additional ounces per piece in the test year is independent of witness Fronk's error correction, involving application of the revenue adjustment factors "inadvertently omitted" from his test year revenue calculations.[20] Application of the revenue adjustment factors is a necessary change to reconcile revenues obtained from the billing determinants with postage revenue from the Revenue, Pieces, and Weight report; that is, to account for the net overpayment of single-piece First-Class postage.

Witness Fronk considers the correction to include the net overpayment of First-Class postage in the revenue calculation, and the change in the forecasting methodology, to be "inseparable," going so far as to describe both as "errors."[21] I disagree. Unlike application of the revenue adjustment factors, the "revised" methodology does more than rectify an omission or make a simple error correction. Rather, it represents a new methodology, introduced late in the course of this proceeding, that the Postal Service believes is "better" than the methodology proposed in its original filing. There is no necessary connection between correction of the net

[20] Tr. 34/16535. Response of US Postal Service Witness Fronk to Notice of Inquiry No. 3, July 17, 2000.

[21] Tr. 34/16557.

overpayment of postage and the change in the forecasting methodology now proposed by the Postal Service.[22]

Witness Fronk's introduction of the "revised" methodology for forecasting the number of additional ounces per piece for single-piece letter mail, without the Postal Service withdrawing or repudiating the "as-filed" methodology, presents the Commission with a choice. Consequently, the Commission should evaluate both methodologies on their merits, to determine the one that most accurately reflects the underlying reality of changes in the number of additional ounces. For the reasons given previously, the "as-filed" methodology reflects the long-term trend of an increase in the number of additional ounces per piece, and is the appropriate method for forecasting the number of additional ounces per piece in the test year.

V. THE SINGLE-PIECE REVENUE RESULTING FROM APPLICATION OF THE REVENUE ADJUSTMENT FACTORS, AND THE "AS-FILED" METHODOLOGY, SHOULD BE USED FOR THE BENEFIT OF SINGLE-PIECE MAILERS

The Postal Service's introduction of the "revised" methodology reduces the net revenue of single-piece First-Class Letter Mail by $172.2 million in the test year. Witness Fronk's error correction increases the net revenue of single-piece First-Class Letter Mail by $192.3 million.[23] As discussed previously, the "revised" methodology

[22] The Postal Service contends that the "revised" methodology "is likely to do a better job . . . [of] reflect[ing] the empirical reality of nearly three years (1998 through PQ3 2000) immediately preceding 2001" than the "as-filed" methodology. Tr. 34/16533. Response of US Postal Service Witness Fronk to Notice of Inquiry No. 3, July 17, 2000. For the reasons discussed earlier, this is not the case. The clear, longer-term trend is the more rational basis for forecasting the number of additional ounces in the test year.

[23] *See* Notice of Inquiry, No. 3, First-Class Revenue Adjustment Factor (RAF) and Additional Ounce Method Change, June 30, 2000, Table 1, at 2.

thus served to offset nearly all of the identified increase in net revenue of single-piece letters occasioned by witness Fronk's error correction.

Assuming that the Commission adopts the "as-filed" methodology, the resulting $192.3 million increase in the net revenue of single-piece letters should be used for the benefit of single-piece mailers. The identified increase in net revenue is a consequence of the behavior of single-piece mailers. According to witness Fronk, much of the unexplained revenue is "most likely explained by single-piece mailers using first-ounce stamps for additional ounce postage."[24]

The net revenue resulting from the error correction therefore should be used for the benefit of mailers paying single-piece First-Class Mail rates. The high and rising cost coverage for First-Class Letter Mail will be exacerbated if no rate adjustment is made. And the effect of the postage overpayment on reducing single-piece rates would be significant. It amounts to more than 0.36 cents per piece, a figure exceeding one-third of the rate increase sought for the first-ounce of First-Class Letter Mail.[25] Maintaining the single-piece First-Class Letter rate at 33 cents is such rate adjustment proposed in the direct case of the Office of Consumer Advocate that would benefit single-piece mailers.

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[24] Tr. 34/16536. Response of US Postal Service Witness Fronk to Notice of Inquiry No. 3, July 17, 2000.

[25] Based upon the Postal Service's single-piece letter volume in the test year after rates ($192.3 million / 52,877.658 million). *See* USPS-T-6 (Tolley), Table 1, at 2.

VI. CONCLUSION

The "as-filed" methodology properly reflects the decade-long trend of an increase in the number of additional ounces per piece for single-piece letter mail. Consequently, the Commission should adopt the "as-filed" methodology for forecasting the number of additional ounces per piece in the test year. By contrast, the "revised" methodology ignores the increasing long-term trend in the number of additional ounces per piece and results in an unrealistic forecast in the test year.

The increase in net revenue for single-piece First-Class Letter Mail resulting from the necessary correction in the net overpayment of postage, in conjunction with the "as-filed" methodology, should be used for the benefit of single-piece mailers.