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POSTAL RATE COMMISSION
OFFICE OF THE SECRETARY

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

POSTAL RATE AND FEE CHANGES, 2000)

Docket No. R2000-1

Rebuttal Testimony of

DR. JOHN HALDI

Concerning

PARCEL POST RATES

on Behalf of

AMAZON.COM, INC.

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Counsel for Amazon.com, Inc.

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1

AUTOBIOGRAPHICAL SKETCH

2

For a copy of my autobiographical sketch, see APMU-T-1 in this

3

docket.

4

I. PURPOSE OF TESTIMONY

5

The purpose of this testimony is to rebut certain testimony of

6

United Parcel Service ("UPS") witnesses pertaining to Parcel Post,

7

especially witness David E.M. Sappington (UPS-T-6) and witness Ralph L.

8

Luciani (UPS-T-5).¹

9

II. INTRODUCTION

10

UPS witness Sappington is the rate level witness for UPS. For

11

Parcel Post, he recommends an increase in rates designed to increase

12

revenues by 24.9 percent. See UPS-T-6, p. 39 (revised 6/22/00). Tr.

13

31/15260, l. 5.

14

Witness Luciani is the UPS witness who addresses rate design

15

issues for Parcel Post. He does not, however, offer a complete set of rates

16

for Parcel Post that would implement witness Sappington's recommended

¹ Tr. 31/15219-15267 and Tr. 25/11770-11823, respectively.

1 24.9 percent revenue increase. Instead, he limits his recommendations
2 to the DDU and DSCF rates.

3 The arguments of witness Sappington and Luciani are flawed, for
4 reasons explained below.

5 **III. WITNESS SAPPINGTON'S PROPOSED MARKUP**
6 **FOR PARCEL POST**

7 Witness Sappington bases his recommendation for Parcel Post on
8 arguments in the following categories:

- 9 • Increased total attributable costs
- 10 • Volume and revenue growth
- 11 • Revenue below cost
- 12 • Higher-value services

13 **A. The Increase in Total Attributable Costs Relied on by Witness**
14 **Sappington Is Not a Relevant Consideration When Determining**
15 **Rates for Parcel Post**

16 Witness Sappington's direct testimony, UPS-T-6, recommending
17 dramatically higher Parcel Post rates, refers only to changes in **total**
18 attributable cost for Parcel Post, not changes in **unit** attributable cost.
19 Although witness Sappington discusses changes in the volume of Parcel
20 Post elsewhere in his testimony, he makes no effort to relate changes in
21 total attributable cost to changes in volume.

1 The “illogic” of witness Sappington’s argument to base unit rate
2 increases on increases in total costs can be viewed in bold relief by
3 applying it to any industry characterized by lower unit costs and rapidly
4 expanding volume. For example, the leading producer of microchips is
5 Intel. Over the four-year period 1996-1999,² Intel’s cost of sales
6 increased by 29 percent, from \$9.164 to \$11.836 billion. Application of
7 witness Sappington’s pricing rationale would argue that the substantial
8 increase in Intel’s costs since 1996 necessitates a substantial, perhaps
9 roughly comparable, increase in the price of chips to ensure that
10 revenues exceed costs. However, since the unit cost of producing chips
11 declined over the four-year period, this prescription would make no
12 sense at all. As everyone knows, the price of microchips has declined
13 during the period, in tandem with the declining unit cost of producing
14 chips, to the benefit of both Intel and its customers, and totally contrary
15 to the pricing rationale expounded in witness Sappington’s direct
16 testimony.³

² See Intel’s 1999 Annual Report. A four-year period was selected here to correspond with the four years encompassed by the years 1998 (the Test Year in Docket No. R97-1 and the Base Year for this docket) to 2001.

³ Witness Sappington does acknowledge that it is appropriate to consider unit cost when setting rates. Tr. 31/15293-4. Nevertheless, he somehow considers increases in total attributable costs to be equally relevant. Tr. 31/15510.

1 Percentage changes in **total** attributable cost is not an appropriate
2 basis for determining percentage changes in postal rates. The rate
3 reflects the **unit** price, and it should be evaluated against the **unit**
4 attributable cost, as the Commission has always done in the past.

5 **B. The Volume and Market Share of Parcel Post Are Small**
6 **Compared to UPS, the Dominant Provider of Surface-based**
7 **Parcel Delivery Service**

8 UPS argues generally that the Commission should disregard the
9 Postal Service's Parcel Post volume estimates, made using what the UPS
10 witnesses describe as a "proposed new methodology."⁴ Tr. 31/15354.
11 However, witness Sappington has no problem using the very same
12 proposed new methodology when he thinks it helps his argument. He
13 states that

14 [t]he Postal Service changed its methodology for measuring
15 Parcel Post volume and revenue after the R97-1 rate case.
16 The change provides a substantial increase in measured
17 Parcel Post volume.... However, if the new methodology
18 accurately reflects Parcel Post volume, the much higher
19 volume it reveals should allay any concerns the Commission
20 might have had in R97-1 that a sizeable increase in rates
21 would reduce Parcel Post volumes to unacceptably low levels.
22 [Tr. 31/15266, footnote omitted.]

23 Witness Sappington neglects to point out that should the
24 Commission reject the Postal Service's "proposed new methodology" and

⁴ To the extent that Parcel Post volume data are controversial, UPS argues for the lowest possible estimate. Presumably this is because cost data are independent of volume data, and a lower volume estimate would have the effect of increasing unit cost.

1 accept UPS's recommendation to use what he describes as the
2 "established" methodology (Tr. 31/15355), then his recommended rate
3 increase is totally inappropriate because the higher volumes would not
4 exist. That rate increase would reduce Parcel Post volumes and market
5 share by an unacceptably large amount, to an unacceptably low level.

6 Table 1 below reproduces the Parcel Post volume for 1994-1999 as
7 shown in witness Sappington's Table 7, and it also shows the UPS
8 forecast for Test Year Before and After Rates. The data shown in Table 1
9 are presented on a reasonably consistent basis. Witness Sappington's
10 proposed rate increase of 24.9 percent for Parcel Post would, by UPS'
11 own reckoning, cause a rather dramatic 14.7 percent decline from the
12 before-rates to after-rates volume, and an 8.6 percent decline in the
13 volume projected for 2000. On a percentage basis, the projected decline
14 in volume would be over three times that experienced in 1995, when
15 Parcel Post rates increased by 18 percent. The UPS after-rates volume
16 projection, at 266 million, would be slightly less than the Base Year 1998
17 volume, and only 19 percent above the 1994 volume.

1

2

Table 1

3

UPS-Preferred Parcel Post Volumes

4

5

6

7

8

9

10

11

12

13

14

15

	(1)	(2)
Fiscal	Parcel Post	% Change in
Year	Volume	Parcel Post
	(millions)	Volume
1994	224	19.8%
1995	218	- 2.7%
1996	213	- 2.3%
1997	237	11.3%
1998	267	12.7%
2000	290	8.6%
2001BR	311	7.2%
2001AR	266	- 8.6%

16

Sources: 1994-1998, UPS-T-6, p. 41, Table 7.

17

2000, UPS-Luciani-WP-3.2.1, p. 2 (rev. 6/20/00).

18

2001BR, UPS-Luciani-WP-3.2.1, p. 4 (rev. 6/20/00).

19

2001AR, UPS-Luciani-WP-3.3.1, p. 2 (rev. 6/20/00).

20

21

Table 2 compares the UPS-preferred volume data for Parcel Post

22

(shown in Table 1 and reproduced here in column 1) with UPS volume of

23

ground service packages (column 2). For the years 2000-2001, the UPS

24

volume is conservatively assumed equal to 1999 volume, with one

25

exception. For 2001AR, UPS volume is assumed to increase by the same

26

amount that Parcel Post would diminish. The total volume of Parcel Post

27

and UPS Ground Service combined is shown in column 3, and the share

1 of each is shown, respectively, in columns 4 and 5.⁵ From column 4, it
2 readily can be observed that (i) the UPS Ground Service volume is about
3 9 to 10 times greater than the volume of the Parcel Post, and (ii) in 1997-
4 98, the market share of Parcel Post was slightly greater than in 1995-96.
5 Thus, use of the UPS-preferred volume data and rate increases
6 recommended by UPS witnesses would, by their own reckoning, reduce
7 the 2001 After-Rates Parcel Post market share to less than it was in
8 1998. Inasmuch as the increase in e-commerce is projected to cause a
9 significant increase in the total market for parcel delivery, the already
10 small market share of Parcel Post likely would decline even further under
11 the UPS rate proposal.

⁵ Other firms also compete in the non-expedited surface-based parcel delivery business; see USPS-T-6, pp. 156-158.

1

2

Table 2

3

UPS-Preferred Parcel Post Volume and UPS Ground Service Compared

4

1994-2001

5

(millions)

6

(1)

(2)

(3)

(4)

(5)

7

UPS

8

Parcel

Ground

Parcel

UPS

9

Year

Post

Service

Total

Share

Share

10

1994

224

n.a.

n.a.

n.a.

n.a.

11

1995

218

2,517

2,735

8.0%

92.0%

12

1996

213

2,544

2,757

7.7%

92.3%

13

1997

237

2,409

2,646

9.0%

91.0%

14

1998

267

2,450

2,717

9.8%

90.2%

15

1999

2,544

n.a.

n.a.

n.a.

16

2000

290

2,544

2,834

10.2%

89.8%

17

2001BR

311

2,544

2,855

10.9%

89.1%

18

2001AR

266

2,590

2,856

9.3%

90.7%

19

Sources: Parcel Post: See Table 1

20

UPS Ground: 1995-1999, Response to PSA/UPS-8, Tr. ___/___.

21

2000 and 2001BR, assumed equal to 1999.

22

2001AR, assumed equal to (i) 2001BR plus

23

(ii) the difference between Parcel Post

24

Before Rates and Parcel Post After Rates volumes.

25

26

C. Parcel Post Revenues Will Exceed Attributable Costs

27

Witness Sappington relies on the Postal Service's CRA Reports for

28

his statement that "with only two exceptions, Parcel Post revenues have

29

fallen short of attributable costs in every year between FY 1989 and FY

30

1997." Tr. 31/15264, footnote omitted. Witness Sappington relies

31

wholly on unrevised Postal Post volume data, and does not use witness

32

Tolley's restated volume data (which start in 1993). He further

1 acknowledges that the Postal Service's CRA on which he relies does not
2 reflect the Alaska air adjustment to attributable cost, which the
3 Commission customarily makes. Tr. 31/15537-40. Consequently, he
4 does not know whether Parcel Post revenues have in fact covered
5 attributable cost during any or all of those years. Tr. 31/15541.

6 In assessing whether Parcel Post's attributable costs will possibly
7 exceed revenues, the growth in destination entry is an important
8 consideration. Destination entry did not begin until 1991. By 1997, it
9 had reached 63.4 percent of total Parcel Post volume,⁶ and destination
10 entry is projected to grow to 80.2 percent by 2001.⁷ From 1999 onward,
11 destination entry will include DSCF and DDU entry, as well as entry at
12 DBMCs. With DDU entered parcels, internal handling is minimized, with
13 delivery constituting most of the cost. Delivery costs tend to be more
14 stable than mail processing costs, hence more predictable.⁸ Thus,

⁶ USPS-T-6, p. 154.

⁷ TYAR; TYBR percentage is 78.7 percent. USPS-T-6, p. 6.

⁸ The Postal Service has admittedly found it difficult to reduce and control mail processing costs for parcels; see Motion Requesting That the Postal Service be Directed to Submit Evidence on Parcel Processing Costs, filed April 4, 2000 by District Photo, Inc., Mystic Color Lab and Cox Sampling. The focus on automation of First-Class Mail has seemingly had two effects, both perverse as far as Parcel Post is concerned. First, it made improved mechanization and automation of parcel handling equipment a low priority in the capital investment budget; second, successful automation of First-Class Mail, instead of reducing total employment, seemingly has increased costs for other subclasses that were not automated. See TW-T-1, p. 4, Tr. 24/11351.

1 bypassing the postal network helps not only to reduce costs, but also to
2 control costs better.

3 **D. Contrary to Witness Sappington's Assertions, the Value of**
4 **Parcel Post Service Has Not Increased**

5 Witness Sappington argues that

6 the Destination Delivery Unit ("DDU") and Destination
7 Sectional Center Facility ("DSCF") discounts introduced in
8 R97-1 have enabled Parcel Post to become an integral
9 component of even more expedited parcel services. To
10 illustrate, the Airborne@Home service provided by Airborne
11 Express delivers parcels to the DDU and obtains next-day
12 delivery by the Postal Service with great regularity....
13 [footnote omitted.] Arrangements of this sort make DDU
14 Parcel Post an integral component of a service that provides
15 high value to both the senders and the recipients of parcels.
16 [UPS-T-6, p. 44, ll. 10-15, Tr. 31/15265.]

17 Witness Sappington's argument contains several flaws. First, the
18 DDU and DSCF rates are used by (i) parcel shippers who enter mail
19 themselves, (ii) ground consolidators who gather mail from various
20 shippers, transport it via surface transportation to DSCFs and DDUs,
21 and enter it there in order to obtain the benefit of the lower rate, and
22 (iii) air consolidators such as Airborne. When a consolidator enters
23 parcels at DDU or DSCF rates, these components of the Parcel Post rate
24 structure can be viewed as part of the cost of end-to-end delivery service.
25 The value of the end-to-end service is the sum of its two component
26 parts: *i.e.*, (i) pickup, processing and transportation to the DSCF or DDU
27 by the consolidator, and (ii) delivery to the final customer by the Postal

1 Service. The usage and rates for DSCF and DDU entry should be viewed
2 in context, not through the myopic lens used by witness Sappington. In
3 other words, these rates should be viewed as components of the end-to-
4 end rates charged not only by air-based consolidators, but also by
5 ground consolidators, who must compete with other ground services
6 such as those provided by UPS. Air-based consolidators, such as
7 Airborne, probably represent a small portion of the total usage of DSCF
8 and DDU rates. Ground-based trucking consolidators, the major users,
9 are in a competitive, low-value business.

10 Furthermore, the fact that an air consolidator, such as Airborne,
11 undertakes the risk and considerable added expense of expediting
12 packages from shippers to the DSCF or the DDU does not add some kind
13 of special differential value to the final delivery portion. The use of air
14 transportation does make Airborne@Home a comparatively high-cost,
15 high-priced product. That alone, however, does not make the end-to-end
16 Airborne@Home service a successful product with high value to many
17 users. Witness Sappington's mere assertion that it is a high-value
18 product is not sufficient. He implies that the Postal Service receives too
19 small a share of the total end-to-end price charged to shippers of DSCF
20 and DDU entry parcels. However, he presents no evidence on the price
21 charged by Airborne, the volume (and growth in volume) of packages
22 using the Airborne@Home service, or the profitability of the

1 Airborne@Home service. Witness Sappington offers no evidence that the
2 end-to-end product offered by the Airborne-USPS combination is so
3 successful or so profitable as to warrant an excessive increase in the rate
4 for the Postal Service's portion of the service, which necessarily would
5 apply to all DSCF and DDU entered parcels.

6 For his assertion that parcels receive next-day delivery from the
7 DDU 97 percent of the time, the only "evidence" cited by witness
8 Sappington is "anecdotal customer feedback" from an interrogatory
9 response by Postal Service witness Kingsley. Tr. 31/15265 (fn. 58, citing
10 Tr. 5/1912). Such anecdotal feedback can be completely misleading.
11 Even if it may be marginally better than no information whatsoever, it
12 does not constitute a sufficient basis for determining value of service or
13 establishing rates, most especially large rate increases designed to
14 penalize Parcel Post users. Moreover, witness Sappington cites no
15 evidence, nor does he even suggest, that parcels, once they have reached
16 the DDU, receive any better delivery than in prior years; *i.e.*, no evidence
17 suggests any improvement since Docket No. R97-1 (or any other prior
18 docket) with respect to either (i) performance in the delivery of parcels
19 from the DDU, or (ii) the value of service given to parcels at the DDU.

20 Witness Sappington also notes that "[a]s of March 14, 1999, Parcel
21 Post shippers have the option of purchasing Delivery Confirmation for
22 their shipments. This new feature further increases the value of service

1 that Parcel Post now delivers to its users.”⁹ Witness Sappington fails to
2 mention that none of the costs of Delivery Confirmation are included in
3 the attributable costs of Parcel Post. Importantly, Delivery Confirmation
4 for Parcel Post is neither free, nor is it offered “at cost” (i.e., without a
5 markup). Delivery Confirmation, which is entirely optional for Parcel
6 Post, is separately and fully priced, with its own implicit cost coverages
7 (122 percent for manual, and 147 percent for electronic), which are
8 higher than the coverage for Parcel Post.¹⁰ Those mailers who use
9 Delivery Confirmation receive additional value **in exchange for an**
10 **additional payment that captures attributable cost plus the implicit**
11 **coverage.** For those mailers who elect not to use Delivery Confirmation
12 service, any value which they may perceive from availability of the option
13 clearly is less than the rate charged, and to many the option perhaps has
14 zero value; i.e., they would have no use for Delivery Confirmation even if
15 it were free (included in the base rate). Witness Sappington’s analysis of
16 Delivery Confirmation is an attempt to manufacture additional value for
17 Parcel Post where there is none. To make the argument completely
18 circular, the only thing missing is an assertion that the rate for Delivery
19 Confirmation should be increased because the value of Parcel Post has
20 gone up.

⁹ UPS-T-6, p. 45, ll. 3-5, Tr. 31/15266.

¹⁰ USPS-T-39, p. 54, ll. 10-12.

1 Finally, witness Sappington notes that “[c]ustomer behavior is
2 another indirect measure of service value. If customers repeatedly
3 choose a more expensive mail service when a less expensive service is
4 available, their choice provides strong evidence that they value the more
5 expensive service more highly.” Tr. 31/15254. As shown in Table 2,
6 *supra*, Parcel Post has had about one-tenth the combined volume of
7 Parcel Post and UPS Ground Service. Since other competitors also have
8 a share of the market for non-expedited surface delivery of parcels,
9 Parcel Post’s share of the total surface delivery market is somewhat less
10 than 10 percent. This means that over 90 percent of all shippers who
11 use non-expedited surface transportation for their packages value the
12 delivery service offered by competing firms more highly than Parcel Post.
13 For these reasons, one can only conclude that Parcel Post has a relatively
14 low value of service that, in the view of shippers, is considered to be low
15 when compared to competing products.

16 **E. Critical Information Normally Available in Competitive**
17 **Markets Is Withheld and Suppressed by Competitors, Dictating**
18 **a Conservative Approach to Rate Increases for Parcel Post**

19 When discussing Parcel Post’s value of service, witness Sappington
20 endeavors to show that the value of service has gone up, thereby
21 justifying his proposed 24.9 percent increase in rates. Witness
22 Sappington admits, however, that “[c]hanges in the qualities of

1 competitors' services can affect the incremental value of service."¹¹
2 Improvements in the quality of service provided by competitors,
3 especially by the dominant provider, is thus a critical factor in
4 determining Parcel Post's incremental value of service. At the same time,
5 UPS's own witnesses, including witness Sappington, neither know nor
6 can they provide any information concerning UPS delivery performance.¹²

7 In a similar vein, the Commission's information concerning rates
8 and other terms contained in negotiated contracts between UPS and its
9 customers is highly imperfect.¹³ Not only does the Commission have no
10 information on the actual rates being paid for the bulk of transactions in
11 the parcel market, it lacks information on other critical terms as well,
12 such as the extent to which the rates paid depend on guaranteed
13 volumes, other non-price considerations such as free software or free
14 logistics consulting, exclusive dealing requirements, and blended rates or
15 tie-in arrangements with respect to other product offerings such as
16 Overnight, or Two to Three day service, etc. UPS willingly provides its
17 published rates as a library reference, without qualification as to the

¹¹ Response to PSA/UPS-T6-19, Tr. 31/15393.

¹² Responses to AMZ/UPS-T6-15(b), PSA/UPS-T6-6, and PSA/UPS-T6-19(b). Tr. 31/15301-2, 15351, and Tr. ____/____, respectively.

¹³ See PSA-T-1, p. 11, ll. 5-8, Tr. 29/14133.

1 percentage of shipments that actually pays those rates, knowing that
2 those rates could mislead the Commission.

3 Witness Sappington notes that the Commission is never fortunate
4 enough to have perfect information about a number of factors, and
5 therefore the Commission must make do with whatever imperfect
6 information is has at its disposal. PSA/UPS-T6-20, Tr. __/_____. In
7 this, he is correct. He also states:

8 suppose Parcel Post's contribution to institutional costs
9 would decline if rates were increased above the level at which
10 they generate revenues that cover attributable costs and a
11 reasonable share of institutional costs based on a balanced
12 consideration of all of the criteria in 39 U.S.C. § 3622(b). In
13 this situation, I would not recommend that the Commission
14 raise Parcel Post rates above this level, and thereby diminish
15 Parcel Post's contribution to institutional costs. [Tr.
16 31/15280-1.]

17 By this counsel, the Commission must be careful not to raise Parcel Post
18 rates above the level which would cause the total contribution to
19 institutional costs to decline, and it must do so in the face of highly
20 imperfect information.

21 I would suggest that the Commission, in its deliberations
22 concerning Parcel Post rates, should give weight to the fact that imperfect
23 information and lack of record evidence with respect to competitors'
24 prices and their quality of service is no "accident" of the marketplace, but
25 rather the deliberate result of a conscious corporate policy by UPS and
26 others to suppress and withhold such information, not only from the

1 Commission, but also from their own customers. The market for Parcel
2 Post is highly competitive, the own-price elasticity of demand for Parcel
3 Post is among the highest of any subclass, and the Postal Service has
4 been reduced to a minor participant in the market for non-expedited
5 surface-transported parcels. Given the uncertainty caused by the lack of
6 information, and in light of UPS's dominant position, coupled with the
7 Postal Service's tenuous position, my advice to the Commission would be
8 to err on the conservative side with respect to any rate increases so as
9 not to damage Parcel Post's fragile market position.

10 **IV. WITNESS LUCIANI'S DDU AND DSCF RATE PROPOSALS**
11 **FOR PARCEL POST**
12

13 Witness Luciani's testimony deals with Parcel Post costs,
14 suggesting a proposed methodology for translating costs into rates and,
15 offering a rate proposal for DDU and DSCF entry. As indicated below,
16 these UPS proposals are seriously flawed.

17 **A. Witness Luciani's Proposal to Distribute City Carrier Elemental**
18 **Load Costs by Weight Is Flawed**

19 In an effort to increase the unit cost of Parcel Post, witness Luciani
20 latches on to one aspect of the testimony on the weight-cost relationship
21 of First-Class Mail, Periodicals and Standard A Mail by Postal Service

1 witness Sharon Daniel (USPS-T-28).¹⁴ Witness Daniel, in turn, in an
2 effort to respond to one particular criticism of a similar, prior study,
3 elected, based on an **unsupported assumption**, to distribute elemental
4 load costs for First-Class Mail, Periodicals, and Standard A Mail on the
5 basis of weight rather than pieces.

6 Witness Daniel had no study, no empirical data, nor any other
7 evidence to support her new **assumption** concerning the way she elected
8 to treat elemental load costs for First-Class Mail, Periodicals and
9 Standard A Mail. Moreover, neither Postal Service witness Karen
10 Meehan (USPS-T-11), when actually distributing elemental load costs for
11 the Base Year, nor any other Postal Service witness, adopted witness
12 Daniel's **assumption** with respect to elemental load costs. And contrary
13 to witness Luciani's assertion, Tr. 25/11939, at **no** point in her
14 testimony does witness Daniel **recommend** that the Postal Service or the
15 Commission change the way elemental load costs for First-Class Mail,
16 Periodicals, or Standard A Mail be distributed in the CRA. Tr. 25/11939.

17 It should be further noted that witness Daniel did not study the
18 weight-cost relationship for any Standard B Mail. **Standard B was**
19 **totally beyond the scope of her study.** Obviously, therefore, witness
20 Daniel made **no recommendation** with respect to the way elemental load

¹⁴ USPS-T-28 and the references therein.

1 costs should be distributed to Parcel Post, or to any other subclass
2 within Standard B.

3 Witness Luciani relies totally on the testimony of witness Daniel.
4 Tr. 25/11944-45. He has not done any study regarding the effect of
5 weight on cost in the delivery business, nor does he have any new,
6 independent evidence to offer on the issue. Tr. 25/11941-42. When
7 asked whether 2 cents per pound is an adequate amount to capture the
8 effect of weight on non-transportation cost (*e.g.*, delivery cost, including
9 elemental load cost), he answered "I have not examined this issue." Tr.
10 25/11855. And, when witness Luciani was asked whether he considered
11 any of witness Daniel's analyses to have accurately captured the effect of
12 weight on cost for any of the three subclasses discussed in her
13 testimony, he demurred. Tr. 25/11854. While declining to endorse any
14 of her findings with respect to the weight-cost relationship for any of the
15 subclasses which she did examine, witness Luciani whole-heartedly
16 endorses the adoption of her **assumption** concerning elemental load
17 costs for Parcel Post, which she did not examine. Tr. 25/11943.

18 Despite the fact that witness Luciani has no evidence of his own to
19 offer on the weight-cost relationship of Parcel Post (or any other subclass
20 within Standard B), he has no hesitancy to mischaracterize witness
21 Daniel's unsupported **assumption** as a "recommendation," then
22 extrapolate that assumption to Parcel Post (and, presumably, to the

1 other subclasses of Standard B) and, finally, proceed to recommend it for
2 the Commission's own adoption. Neither witness Luciani's testimony,
3 nor any other part of the record, contains any evidence that would
4 support a change in the way elemental load costs are distributed.

5 **B. Witness Luciani's Bottom-up Costs Significantly Exceed CRA**
6 **Costs**

7 As part of his effort to increase the unit cost of DDU entered Parcel
8 Post, witness Luciani states that:

9 [f]inally, I have conducted a bottom-up costing of parcel
10 delivery costs. Combining the cost from the Engineered
11 Standards study for loading and access costs with the
12 volume variable costs for route time and in-office costs and
13 adding the cost of the manual sort to carrier route conducted
14 by a clerk/mailhandler at the DDU yields a total cost of
15 \$1.14 per piece in comparison to the \$0.96 per piece noted
16 above that was derived using Mr. Plunkett's analysis. [Tr.
17 25/11806]

18 His analysis, derived in his Exhibit UPS-T-5I, is filed under seal.

19 Parcels entered at the DDU have no upstream mail processing or
20 transportation costs. Most of the costs in that exhibit consist of city and
21 rural carrier delivery costs. As a cross-check on witness Luciani's results
22 derived from the Engineering Standards study to which he refers, I have
23 conducted my own bottom-up costing analysis using CRA costs, rolled
24 forward on the basis of both FY 1998 and FY 1999 as the Base Year.

25 The results, presented in the Appendix hereto, reflect eight
26 different unit costs for delivery (see Table A-1, Section H). The different

1 unit costs result from the fact that my analysis uses the (i) Test Year
2 After Rates Costs rolled forward from both 1998 and 1999, as the base
3 years, along with (ii) both the Postal Service and the PRC cost
4 methodology, and (iii) the TYAR volumes proposed by UPS and the Postal
5 Service.

6 By way of summary, the CRA-based unit delivery costs range from
7 a low of \$0.39 to a high of \$0.60. Even if another 10 to 15 cents per
8 piece is allowed for handling within the DDU, **all** estimates are well
9 below Postal Service witness Michael K. Plunkett's (USPS-T-36) \$0.96 per
10 piece top-down estimate cited by witness Luciani, regardless of which set
11 of assumptions is used. Clearly, something is wrong with witness
12 Luciani's analysis. Additionally, witness Luciani did not attempt to
13 reconcile his analysis with the readily available CRA data, as I have done.
14 In any event, his bottom-up cost study is seriously flawed and I would
15 recommend that the Commission not rely on the results of that analysis.

16 **C. Witness Luciani's Proposed Methodology for Determining DDU**
17 **and DSCF Passthroughs for Parcel Post Is Flawed**

18 UPS witness Luciani, in his direct testimony, proposes to reduce
19 the passthrough for DDU and DSCF worksharing cost avoidances for
20 Parcel Post. Tr. 25/11804-11807. He determines the amount of his
21 reduced passthrough by first determining an explicit markup, which he
22 prefers to describe as an implicit markup.

1 Priority Mail is proposed to contribute approximately
2 63 cents to institutional costs on every underlying dollar of
3 attributed cost. A 63% markup on the attributed cost of
4 DDU-entry pieces is also appropriate. [Tr. 25/11805.]

5 Having determined what he thinks the markup ought to be, and
6 what he thinks ought to be the rate for DDU entry Parcel Post, witness
7 Luciani then backs into calculating the passthrough of avoided costs
8 necessary to reach his desired markup and rate. When questioned about
9 the use of markups to determine rates for an individual rate category
10 within a subclass, instead of explicitly determined passthroughs, witness
11 Luciani stated:

12 [a]s a general matter I don't think implicit markups are
13 necessarily the way that one would assign passthroughs in
14 general. However, for DDU Parcel Post, where we have
15 Priority Mail and DDU Parcel Post entry getting a comparable
16 level of service once they reach the DDU I think it is
17 appropriate here. [Tr. 25/11931].

18 Within the Parcel Post subclass, witness Luciani would arrive at
19 rates for some workshared rate categories in the usual way (i.e., through
20 worksharing discounts computed as a percent of costs avoided, and
21 where the percentage is determined without any reference to markups),
22 while explicitly using implicit markups as the basis for determining the
23 discounts (and rates) in other workshared categories.

24 In Docket No. R97-1, I calculated bottom-up costs for every rate
25 category in Standard A ECR, and recommended that the Commission
26 apply an appropriate markup to those bottom-up costs in order to arrive

1 at recommended rates.¹⁵ It was my recommendation that a uniform
2 markup be applied to the bottom-up costs for all rate categories within
3 standard ECR, unless the Commission could find reasons that justified
4 differential markups. Nevertheless, the Commission opted not to rely on
5 my approach; see Docket No. R97-1, *Op. & Rec. Dec.*, ¶5374.

6 It was my conviction then, and it remains so, that the Postal
7 Service and the Commission would be better served by developing and
8 using bottom-up costs as the basis for setting cost-based rates,
9 especially for products where the Postal Service faces strong competition,
10 as it does in Parcel Post. At no time, however, have I ever advocated
11 mixing the top-down and bottom-up approaches to rate-setting, as
12 witness Luciani would have the Commission do in order to achieve his
13 narrowly focused goal of higher rates for DDU and DSCF entry Parcel
14 Post. I can see nothing but problems in using such a mixed and
15 inconsistent approach for dealing with individual rate categories within a
16 subclass. It almost surely will open a Pandora's box.

17 One problem with witness Luciani's approach is his restricted
18 comparison of Parcel Post packages at the DDU with Priority Mail
19 packages at the DDU. He bases his markup on the unsupported
20 assertion that once parcels reach the DDU, 97 percent receive delivery

¹⁵ See Docket No. R97-1, VP/CW-T-1, Tr. 27/15038-165.

1 the next time carriers go on their rounds. Even if his assertion is
2 assumed to be true, and ignoring the fact that it is based only on
3 anecdotal information with no supporting quantitative performance
4 data, this means that Parcel Post packages, once they reach the DDU,
5 receive the same treatment as Priority Mail packages, regardless of where
6 in the system they are entered. In other words, he bases his markup on
7 the assertion that from the DDU to the addressee there is no meaningful
8 "priority" in Priority Mail. By witness Luciani's logic, an alternative
9 solution would be for the implicit markup on the delivery costs of Priority
10 Mail to be reduced to bring it into line with the lower markup on Parcel
11 Post.

12 Another serious problem I perceive with his mixed approach is the
13 precedent it would set for other postal products that also have DDU
14 entry. Currently, these include Periodicals, the two Standard A ECR
15 subclasses, and Bound Printed Matter (proposed). For each such
16 subclass, is the Commission now supposed to analyze performance data
17 from the DDU to addressee? Let us assume that it can be established on
18 the record that any (or all) of these subclasses, when entered at the DDU,
19 receive essentially the same handling and delivery as First-Class or
20 Priority Mail. If witness Luciani's new policy were to be adopted by the
21 Commission, it would then be required to use the markup on First-Class
22 or Priority Mail expressly to establish an implicit markup for the DDU

1 entry rates for these other subclasses, while using the top-down
2 approach for other rate categories within each subclass.

3 Still another problem is that witness Luciani bases his implicit
4 markup on only one of the non-cost criteria in Section 3622(b) of the
5 Postal Reorganization Act, value of service. It would appear that witness
6 Luciani realizes that using markups based on the non-cost criteria
7 contained in Section 3622(b) is a slippery slope. He attempts to “justify”
8 his truncated approach by stating that “because it’s a passthrough, I did
9 not apply the ratemaking criteria. I note the value of service seems very
10 similar.” Tr. 25/11936. If the Commission systematically applies
11 implicit markups — or coverages, since markups translate directly into
12 coverages — explicitly to some rate categories, it will necessarily have to
13 consider whether some (or all) of the other non-cost criteria in Section
14 3622(b) are also applicable. I would suggest that applying markups
15 selectively to some but not all rate categories, and then selectively
16 applying some but not all of the non-cost criteria in Section 3622(b) to
17 those rate categories, will lead to confusion and irrational rates.

18 **D. The Commission Should Reject Witness Luciani’s Proposed**
19 **DDU and DSCF Rates for Parcel Post**

20 Witness Luciani is UPS’s rate design witness for Parcel Post. He
21 limits his specific proposals, however, to markups and rates for DDU and
22 DSCF entry. As explained in the preceding sections, his

1 recommendations are based on cost analyses and a proposed
2 methodology that are both flawed.

3 I would urge the Commission to accept the Postal Service
4 proposals advanced by witness Plunkett in this case. In particular, I
5 would urge the Commission to accede to the Postal Service's
6 recommendation to leave the rates for DDU and DSCF entry unchanged
7 until more experience has been gained from these rates. They have been
8 in effect only since January 1999, and the FY 1999 billing determinants
9 indicate that the volume of DSCF and DDU entered parcels were only 0.5
10 and 4.0 percent of all parcels. See USPS-LR-I-259, § H-1.

APPENDIX

BOTTOM-UP COSTS FOR PARCELS ENTERED AT DDU_s

Overview

DDU entered parcels have essentially two cost components: (i) the cost of delivery, plus (ii) one handling within the DDU. The unit delivery costs for all Standard B Parcel Post in the Test Year, using CRA roll-forward costs, is developed in Table A-1. To this unit cost one needs to add approximately 10 to 15 cents for handling in the DDU by a clerk or mailhandler. The resulting "bottom-up" cost can be compared with (i) the bottom-up cost estimate developed by UPS witness Luciani using the Engineering Study data (\$1.14), and (ii) witness Plunkett's top-down cost estimate (\$0.96).

Table A-1

Section A shows the Test Year After Rates (TYAR) costs for city and rural carriers using Postal Service cost methodology. Column 1 shows TYAR costs rolled forward from the 1998 Base Year; costs in column 2 are rolled forward using 1999 as the Base Year. The city carrier data include both in-office costs (segment 6) plus out-of-office costs (segment 7).

Section B is similar to Section A, using PRC attributable costs.

1 Section C shows projected volumes using (i) UPS-preferred old
2 methodology, and (ii) the Postal Service's improved methodology for
3 determining the volume of parcel post.

4 Section D shows unit delivery costs computed by dividing the total
5 costs in Sections A and B by the volumes in Section C.

6 Section E shows the piggyback factors for city and rural carriers.
7 These are the same piggyback factors as used by witness Luciani to
8 develop his bottom-up costs.

9 Section F shows unit costs computed with the piggyback factors
10 shown in Section E.

11 Section G shows the number of city and rural routes in A/P 9, FY
12 2000. The percentage of each type of route, used to weight the unit costs
13 developed in Section F, is shown in column 2.

14 Section H shows the 8 final, weighted unit delivery costs (city and
15 rural carriers combined) that result from using UPS and Postal Service
16 volume estimates and PRC and Postal Service cost methodology. The
17 unit cost for delivery (excluding \$0.10 to \$0.15 for handling within the
18 DDU) ranges from a low of \$0.39 per piece to a high of \$0.60 per piece.

1

Table A-1

2

**Development of Test Year After Rates Bottom-up
Delivery Cost for Parcel Post**

3

4

5

6

	(1) TYAR (1998BY)	(2) TYAR (1999BY)
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7

A. USPS Costs (000)

8

[1] City Carriers	91,720	92,235
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9

[2] Rural Carriers	<u>15,295</u>	<u>19,685</u>
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10

[3] Total	107,015	111,920
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11

B. PRC Costs (000)

12

[4] City Carriers	94,884	95,827
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13

[5] Rural Carriers	<u>15,295</u>	<u>19,685</u>
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14

[6] Total	110,179	115,512
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15

C. Volume (000)

16

[7] UPS old preferred method	265,062	
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17

[8] USPS method	374,096	
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18

D. Unit Cost for Delivery (cents)

19

[9] USPS Cost - UPS old pfd method	40.4	42.2
------------------------------------	------	------

20

[10] - USPS method	28.6	29.9
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21

[11] PRC Cost - UPS old pfd method	41.6	43.6
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22

[12] - USPS method	29.5	30.9
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23

E. Piggyback Factors

24

[13] City Carriers	1.429	1.429
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25

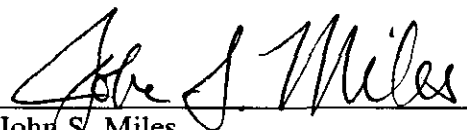
[14] Rural Carriers	1.242	1.242
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1	F. Unit Cost of Delivery, with Piggyback (cents)		
2		(1)	(2)
3		TYAR	TYAR
4		(1998BY)	(1999BY)
5	USPS City Carrier Cost		
6	[15] - UPS old pfd method	57.7	60.3
7	[16] - USPS method	40.9	42.8
8	USPS Rural Carrier Cost		
9	[17] - UPS old pfd method	50.1	52.4
10	[18] - USPS method	35.5	37.2
11	PRC City Carrier Cost		
12	[19] - UPS old pfd method	59.4	62.3
13	[20] - USPS method	42.1	44.1
14	PRC Rural Carrier Cost		
15	[21] - UPS old pfd method	51.6	54.1
16	[22] - USPS method	36.6	38.4
17	G. Number/Weighting of Routes		
18			
19		Number	Weight
20	[23] City Carriers	167,629	.716
21	[24] Rural Carriers	66,558	.284
22	H. Weighted Unit Delivery Cost (cents)		
23		TYAR	TYAR
24		1998BY	1999BY
25	[25] USPS Old Method	55.5	58.1
26			
27	[26] USPS New Method	39.4	41.1
28	[27] PRC Old Method	57.2	60.0
29	[28] PRC New Method	40.5	42.5

1	Sources:	
2	[1] & [2]	TYAR (1998BY), USPS-14K.
3		TYAR (1999BY), USPS-ST44V.
4	[3]	Sum of [1] + [2].
5	[4] & [5]	TYAR (1998BY), USPS-LR-I-131.
6		TYAR (1999BY), USPS-LR-I-424.
7	[6]	Sum of [4] + [5].
8	[7]	UPS-Luciani-WP-3.3.1 (revised 6/20/00)
9	[8]	USPS-T-6, Table 1, p. 6.
10	[9]	[3]/[7]
11	[10]	[3]/[8]
12	[11]	[6]/[7]
13	[12]	[6]/[8]
14	[13] & [14]	USPS-T-21 (Smith), Attachment 11, for Parcel Post.
15	[15]	[9]*[13]
16	[16]	[10]*[13]
17	[17]	[9]*[14]
18	[18]	[10]*[14]
19	[19]	[11]*[13]
20	[20]	[12]*[13]
21	[21]	[11]*[14]
22	[22]	[12]*[14]
23	[23] & [24]	Financial & Operating Statements, A/P 9, PFY 2000.
24	[25]	[15]*[23:Wt]+[17]*[24:Wt]
25	[26]	[16]*[23:Wt]+[18]*[24:Wt]
26	[27]	[19]*[23:Wt]+[21]*[24:Wt]
27	[28]	[20]*[23:Wt]+[22]*[24:Wt]

CERTIFICATE OF SERVICE

I hereby certify that I have this day served this document upon all participants of record in this proceeding in accordance with Section 12 of the Rules of Practice.


John S. Miles

August 14, 2000