AMZ-RT-2

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

POSTAL RATE AND FEE CHANGES, 2000) Docket No. R2000-1

Rebuttal Testimony of

JOHN L. CLARK

on Behalf of

AMAZON.COM, INC.

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Counsel for Amazon.com, Inc.

August 14, 2000

Original

CERTIFICATE OF SERVICE

I hereby certify that I have this day served this document upon all p[illegible] in this proceeding in accordance with Section 12 of the Rules of Practice.

John S. Miles

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AUTOBIOGRAPHICAL SKETCH

My name is John L. Clark. I am founder, and was until February of 2000, Chairman and Chief Executive Officer of CTC Distribution Services, L.L.C. ("CTC"). CTC began operations in 1982 in the city of Minneapolis, Minnesota. I testified as a rebuttal witness for CTC Distribution Services, L.L.C. (CTC-RT-1) in Docket No. R97-1.

CTC serves the direct marketing community by developing and managing distribution programs designed to deliver small parcels in a timely and cost-effective manner. Its core process is the consolidation of parcels at its 13 operating hubs. This process involves the collection, sortation, documentation and transportation of parcels to entry points close to the shipment's final destination. Final delivery is made by a parcel delivery company.

The company's principal customers sell goods through catalogs, infomercials, home shopping networks, direct mail, and the internet, and require a cost-effective means of shipping these goods to consumers. As a freight forwarder and consolidator of small parcels, CTC offers its clients a number of shipping alternatives, and is a user of prominent shipping companies such as the United States Postal Service and United Parcel Service ("UPS"), as well as local and regional carriers, for the final delivery of its shipments. CTC is, therefore, very familiar with the various competitive offerings available to small parcel shippers.

During the period from 1982 through 1991, CTC relied almost exclusively on UPS for the final delivery of its shipments. After careful analysis of the Postal Service's shipping rates — particularly the destination entry discounts which became effective in 1991 — CTC began offering Postal Service as well as UPS delivery for a final delivery option to its clients. By 1993, almost all of CTC's business had migrated to the Postal Service.

CTC's business has grown rapidly while utilizing DBMC entry rates. Since 1991, it has shipped 660 million parcels through the Postal Service. CTC currently employs over 1,300 hundred people in nine states.

PURPOSE

The purpose of the following testimony is to rebut the testimony of UPS witnesses David E. M. Sappington (UPS-T-6) and Ralph L. Luciani (UPS-T-5) insofar as they advocate higher rates for Parcel Post and to urge and encourage the Postal Rate Commission to recommend the Postal Service's requested rates for the entry of parcels at Origin Bulk Mail Centers, Destination Bulk Mail Centers, Destination Sectional Center Facilities, and Destination Delivery Units.

INTRODUCTION

I have studied the testimony, interrogatories and oral cross examination of UPS witnesses Sappington and Luciani. Their advocacy of substantial rate increases for Parcel Post, if accepted and recommended, would have a dramatic negative impact on shippers of small parcels and an equally devastating long-range effect upon the survival of the Postal Service.

While this prediction of the effect of Parcel Post rate increases may seem to be overstated, the Commission is no doubt aware that the distribution of goods to America's homes and businesses is undergoing swift and dramatic changes. Application of the science of logistics to businesses is driving costs out of the delivery network. As inventories turn at a faster clip, the need for the efficient delivery of smaller shipments is ever increasing. The sector of the economy most dramatically impacted by this phenomenon is the nation's transportation network and, most specifically, those enterprises delivering small parcels.

While America's businesses are utilizing these distribution advances to improve service and efficiency, America's homes are also benefiting from improved channels of distribution. Almost every conceivable household need can now be delivered right to the doorstep, and most likely in the form of a small parcel.

The number of companies competing for this rapidly growing market is increasing, and familiar names, such as UPS and Federal Express, are expanding and improving their service offerings and capabilities. These enterprises are no longer considered in a single dimension such as ground delivery or expedited delivery. Each company is competing for virtually all segments of the market.

In the midst of these dramatic changes, the Postal Service is being left far behind. It faces the significant threat of electronic diversion to its primary product, First-Class Mail. Its flagship product, Priority Mail, faces significant upward cost pressures at the same time it attempts to maintain market share in the face of competition. Parcel Post has shown potential, but it also faces ever increasing competition. If the Postal Service is to survive in these times of rapid change, it must be allowed to compete for the growing markets while it adapts to changes in declining markets. It is both significant and ironic that its chief antagonist, UPS, plays such an aggressive role in influencing Postal Service pricing.

Since 1991, the Postal Service has proven that it can compete for the delivery of small parcels, but only for home delivery of lower priced merchandise. The Postal Service is not competitive for the delivery of parcels to businesses. The extensive delivery network, originally designed for the mandated delivery of First-Class Mail to American homes, is the foundation upon which the Postal Service has built its parcel delivery business.

With the emergence of e-commerce and business-to-consumer ("B-to-C") marketing over the internet, the largest competitors realize that they must have a B-to-C delivery solution. They want that "internet" multiple for their stock, and they will not get it without residential delivery.

These factors pose a significant threat to Parcel Post's future.

I. SAPPINGTON TESTIMONY

With this background, I would ask the Commission to consider an alternate view of some of the points made in the UPS witness Sappington testimony (UPS-T-6).

The essence of this testimony seems to be that: (1) Parcel Post looks like it has been doing okay; (2) the intrinsic value of Parcel Post is increasing; (3) shippers of small parcels have alternatives against price increases; and (4) the Postal Service has enjoyed an unfair advantage over competitors and has damaged competitors due to low cost coverage assignments. According to UPS, the Commission needs to increase rates in response to increasing attributable costs and increase Parcel Post's cost coverage so that it makes a much higher contribution to overhead.

A. Intrinsic Value — Own Price Elasticity

It is a serious error to believe that the intrinsic value of Parcel Post is increasing. This is a product, when compared to alternate offerings, which has declined in relative value. This is a product which is extremely price sensitive because if offers so few enhancements to a basic delivery service.

In selecting a parcel delivery carrier, a typical shipper would compare the price and features of Postal Service delivery with the additional cost and value provided by each alternative delivery carrier. The greater value provided by alternative carriers is evident from such features as basic insurance (included at no additional charge), tracking, proof of delivery (signature), consistency or predictability of delivery times, freight charge refund if not delivered when promised, the cost of dealing (over the telephone) with an irate consumer, and the risk of alienating a consumer if the delivery service is deficient in any way.

A shipper assigns a value to all of these features. If that value plus the price offered for the basic service offered through the Postal Service is sufficiently below the alternative carriers, the mailer will choose the Postal Service. A careful examination of the small parcel business which has been won by the Postal Service over the last nine years will show that mostly low value merchandise (less than $65.00 at retail) is currently being handled by

Parcel Post. This is the merchandise which is most sensitive to shipping cost.

Rate increases at the level recommended by UPS witness Sappington will have one of the following effects. The rate for an individual shipment will increase sufficiently relative to the next alternative carrier to cause a dramatic shift to that carrier. Alternatively, the rate will rise to a level which will cause shippers to reduce, or eliminate completely, the sale of lower priced merchandise which cannot bear the increased cost of shipping. The third possibility is that the alternative delivery company will simply raise its prices, using the postal rate as an umbrella under which it operates.

On that latter point, it is important to be reminded that a large proportion of the nation's population still depends on "mail order" to buy and receive the items needed for everyday living. The quantity of shoes, dresses, and other garments, games and hobbies delivered by Parcel Post is substantial. Many of these items are purchased by older Americans and those living in rural areas without ready access to large shopping malls. Can a \$10.95 purchase stand a delivery charge of \$7.00?

Witness Sappington suggests that the availability of Delivery Confirmation adds value, even as an unused option, to Parcel Post. The Commission needs to appreciate the fact that this service adds very little value to this product. When it works, it only reports when the parcel was delivered. It is not a proof of delivery. There is no signature. No information about the shipment is available while in transit, only the delivery time. Consumers and shippers now want to know where their shipment is at all times. They want pipeline visibility.

If the Postal Service does not confirm delivery and a claim is filed, the Postal Service will not pay for the lost parcel. It might, after a tussle, give the consumer back the fee paid for Delivery Confirmation. As a result, shippers use the data derived from this service only to monitor delivery times. Typically, a sophisticated parcel shipper will only select this service on parcels destined for selected destinations to draw a profile of transit times. To suggest that the mere existence of this option enhances the value of Parcel Post is not credible. This service needs to be dramatically improved before it is comparable to the more advanced type of feature offered by other carriers. To those parcels where the option is declined, the value is *de minimis*.

B. Volume Trends

Witness Sappington's conclusions concerning strong volume trends as showing Parcel Post can sustain a high rate increase completely ignores the effects of the UPS strike, which occurred at the end of 1997. While I am not aware of any definitive studies of the volume impact of the event, UPS volume averaged slightly more than 11 million parcels per day. Multiplying that by the 15-day duration of the strike, it is easy to see that the Postal Service delivered a fair portion of those 165 million parcels that UPS was unable to deliver. There was also at least another 15-day period during which UPS re-started operations and the Postal Service continued to deliver substantial numbers of diverted parcels.

C. The Postal Service As Unfair Competitor

Witness Sappington argues that maintenance of low rates protects the Postal Service from competition, inhibits potential entries into the market and unfairly disadvantages existing suppliers.

There is no evidence that the Postal Service has been protected from effective competition. All evidence, in fact, indicates that the inability of the Postal Service to implement competitive pricing and services has allowed competitors to inhibit significantly the competitiveness of the Postal Service in the delivery of parcels.

No evidence supports the proposition that entry and innovation in the "delivery industry" have been discouraged. Just the opposite is true. Parcel shippers now have more choices than ever as to the type of service and pricing levels they can utilize. Consider only that Roadway Parcel Service ("RPS") is now actively rolling out a home delivery service. Airborne freight, while using the Postal Service for the final mile, is also offering shippers an alternative. Many new entries competing for parcel delivery are tied to pricing initiatives sponsored by the Postal Service and recommended by the Commission. Consider only the so-called "consolidator industry" which has many new entries since the introduction of additional work sharing incentives. Partnerships with private industry have allowed the Postal Service to enjoy the benefits of more, not less, efficient production technology without burdening shippers with "unnecessarily large institutional costs."

Witness Sappington fails in every way to demonstrate any damage to a competitor. His reluctance to advance any information concerning his client, UPS, on a number of different occasions and subjects, appears to demonstrate that no case can be made for the proposition he is advancing.

D. Competition

The Postal Service provides its services through two operating scenarios. In one, it is a monopoly. In the other, it faces competition from many directions. The issue of a cross-subsidy between First-Class Mail and other classes has been beaten to death. It seems that after all the effort and analysis, we should be pretty close to the objective of assuring that each class of mail pays its own way. I find these arguments ironic since the so-called competitive classes of mail actually benefit First-Class Mail. If the contribution these classes make did not exist, is it not logical that First-Class rates would have to be significantly higher?

The UPS witnesses in this docket seem to advance the idea that applying a certain percentage markup to the attributable cost of a given class of mail is the only objective of the rate making process. The idea that a business, in a competitive market, can set its margin at some predetermined level, without regard for the real world consequences of an excessive price, defies common business sense. To discuss, in conjunction with such a calculation, the real possibility of giving up 45 million parcels as a result of such pricing as if it were worth accepting that consequence in order to achieve compliance with a markup percentage objective also boggles the mind. I am not aware of any business which would not take a little less markup to preserve market share and then work to make as much profit as possible from that level of pricing. The loss of this volume of business has very significant consequences for the people losing their jobs, the shippers paying higher rates and the ability of the Postal Service to regain the volume once it is lost. To me, it seems to be irrelevant that some precedent, formula or witnesses and lawyers can establish that Parcel Post should have a particular markup in the abstract. Markup should be set at a level to generate total dollar contribution to institutional costs. This can mean more volume driven by lower prices. Lower prices encourage more parcels to be shipped because the businesses one serves can make more profit because of lower shipping costs.

There is another reason to keep Parcel Post price competitive. Our society is already faced with a situation where 75 percent (or more) of the parcels shipped and delivered in the United States via surface transportation are under the control of one company, UPS. Society is not well served when one company can control such a significant portion of any market, let alone the delivery of products that may be considered essential to the everyday well-being of society's members. The market has new entrants, but they are not capable of replacing the Postal Service delivery network. These considerations must prevail over vague allegations of injury to alternative suppliers of delivery service.

II. LUCIANI TESTIMONY

UPS witness Luciani (UPS-T-5) raises a number of points which need to be reviewed and examined.

The first problematical claim he makes is that the Postal Service has spent $18.5 million dollars on advertising Parcel Post. According to Postal Service officials whom I have questioned, an amount less than $1 million was spent on Parcel Post. The Postal Service recently (August 7, 2000) responded to a UPS interrogatory (UPS/USPS-55) showing test year after rates Parcel Post advertising costs would be a mere $0.555 million.

Second, in his testimony (Tr. 25/11780), witness Luciani contends that the cost of parcel delivery is driven by the weight. He makes the point that "[i]f weight is a proper basis for reflecting cost differences within the narrow ranges from one ounce up to thirteen ounces for First Class Mail ... then it surely should be used in the case of the more significant weight differences between the lighter-weight and the heavier-weight classes of mail."

While there is an obvious cost differential between items that fit in a mail box and those that do not, this decision is not driven by weight but by size. Witness Luciani makes the point that it costs more "to hand someone a parcel than to place an item in the mail box." However, this distinction is not a function of weight. If the parcel is the same size, there is no added cost in 20 pound parcel as opposed to a 10 pound parcel.

Upon close questioning, witness Luciani was not able to present convincing evidence that additional costs, such as those he proposes in his Table 3, should be added to Parcel Post.

At Tr. 25/11783, witness Luciani attempts to make the point that there is a cost which should be assigned to parcels which is incurred in the sorting and sequencing by route drivers. He concludes, based upon one

DDU visit, that the sorting of 30 or so parcels on a route must occur. First of all, 30 parcels per route seems to be quite an unlikely and exaggerated number. A simple effort in arithmetic using parcel volume, days of the year, and number of routes in the United States results in an average daily volume of about five parcels per route. Secondly, witness Luciani makes no attempt to account for those parcels which are picked up at a DDU by the consumer. Under questioning (Tr. 12011-12017), witness Luciani was not able to make a strong case for isolating and transferring costs from a street support number to parcels. It would seem to me that more than one visit lasting 25 minutes, during which he observed five or ten routes being assembled, should be required to make a credible recommendation to the Commission for changes in cost assignments.

A. Sack Shake Out

Witness Luciani misunderstands what happens at DDUs. Parcels delivered to DDUs typically are palletized or bed loaded. In either case, when they arrive at a DDU, they are typically transferred by the driver to hampers, one for each zip code. The hampers are on wheels and they are then rolled into the Postal Unit for final sort to the routes. If there is an occasional sack, which in CTC's operation would only occur if there were multiple smalls,[1] the contents of the sack would be emptied into the same hampers by the driver.

B. Non-machinable Parcels

The method of averaging machinable and non-machinable parcels to derive the cost avoided is the correct way to calculate the appropriate discount. Witness Luciani conveniently forgets that companies bringing parcels to DDUs confront the same cost and handling issues faced by the Postal Service when handling non-machinable parcels. If there is an extra incentive in the form of an additional work sharing discount, it is a proper incentive.

C. DDU Mail

Witness Luciani states that DDU parcel post is attracting "substantial" volumes because of the promise of next day delivery. He provides no evidence supporting his assertion, but nevertheless proceeds to conclude that because of this "fact," DDU should receive the same markup as Priority Mail. On his single visit to a DDU, he noted that it seemed to him that parcels received the same treatment as Priority Mail.

The simple fact is that in the total universe of Parcel Post, DDU-entered parcels are only a small percentage. Users of this entry option have been faced with the daunting task of building the volume and network

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[1] One definition of "smalls" is anything that will fit through a coat hanger —

required to support a program that shippers could rely upon for compelling pricing (after the cost of preparing and delivering parcels to the DDU) as well as consistent delivery times. Very few have been able to achieve a meaningful utilization of DDU rates and service. Compounding the challenge for DDU users has been the Postal Service's inability to provide DDU entry times that would result in faster delivery times. It is important to remember that the transit time from the DDU to the consumer is only one element of the total time in transit experienced by a shipper. If certain parcels entered at a DDU do receive next day service, that transit time is only one element of the total time in transit, and those delivery times certainly have not been comparable to Priority Mail. The idea of a 63 percent markup is absurd.

CONCLUSION

UPS witnesses Sappington and Luciani have presented volumes of data, testimony and analysis of the Postal Service recommendations for Parcel Post rates. Their single objective is obviously to cause the Commission to raise parcel rates to a level which would cripple the Postal Service's ability to compete in this market. This would provide maximum benefit to their client, United Parcel Service.

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typically a bag or small box.

We have seen many of these arguments and assumptions before, and they simply do not reflect reality.

I urge the Postal Rate Commission to accept and recommend, without change, the proposals of the Postal Service for DBMC, OBMC, DSCF, and DDU. These rates are not subsidized by any other class of mail and make an appropriate contribution to institutional costs. This action will allow mailers of lower priced merchandise to continue to offer their product to the American public at reasonable prices. It will give the Postal Service time to deal with the enormous changes we all know are on the horizon. Parcel delivery providers will continue to thrive as they have done over the last several years. The Postal Service is a long way from being able to harm any of them competitively.

The Postal Service must be allowed to compete effectively in the market place for small parcel delivery.