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Before the

UNITED STATES POSTAL RATE COMMISSION

In the Matter of: POSTAL RATE AND FEE CHANGE

Docket No. R2000-1

RECEIVED
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POSTAL RATE COMMISSION
OFFICE OF THE SECRETARY

VOLUME 41

DATE: Friday, August 25, 2000

PLACE: Washington, D.C.

PAGES: 18016 - 18339

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BEFORE THE

POSTAL RATE COMMISSION

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In the Matter of: :

POSTAL RATE AND FEE CHANGE : Docket No. R2000-1

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Third Floor Hearing Room

Postal Rate Commission

1333 H Street, N.W.

Washington, D.C 20268

Volume XL

Friday, August 25, 2000

The above-entitled matter came on for hearing, pursuant to notice, at 9:30 a.m.

BEFORE:

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E X H I B I T S

P R O C E E D I N G S

[9:31 a.m.]

CHAIRMAN GLEIMAN: Good morning. Today we continue our hearings in Docket R2000-1 for the purpose of considering the Postal Service's Request for Changes in Rates and Fees.

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

Mr. McKeever.

MR. McKEEVER: Mr. Chairman, I did mention to Mr. Sharfman that there was a possibility that when Mr. Glick testifies, I may ask him to refer to certain forms that were produced by the Postal Service in a Library Reference that is under seal. We have determined that we believe Mr. Glick has in fact signed a certification with respect to that Library Reference because he refers to the forms in his testimony.

I will not be asking that the forms be transcribed into the record, nor will I be distributing copies except to Mr. Glick and his counsel, and I will just be asking him to confirm some what I believe are non-confidential items on those forms.

And so I just wanted to give you a heads-up though, and I have discussed this with the Postal Service counsel, as well as with Mr. May. We all believe that the few questions I have probably will not require any special measures, although I guess Postal Service counsel obviously always reserves the right when counsel hears the specific questions to raise a question about confidentiality, but I believe it is not going to be an issue. I did, however, want to mention it.

CHAIRMAN GLEIMAN: Mr. Glick does have one piece of testimony today, PSA-RT-3, that is under protective conditions, or relates to material that is under protective conditions. We will be placing that testimony in a separate volume that will be sealed. And I guess now I am a little bit confused and want to make sure I understand what you all have tentatively agreed to. Do the question relate to that?

MR. McKEEVER: No, they do not, and I will not have any questions for Mr. Glick on that piece of testimony.

CHAIRMAN GLEIMAN: Okay. Thank you.

Does anyone else have anything they would like to raise at that is point?

[No response.]

CHAIRMAN GLEIMAN: If not, then we have Witnesses Wittnebel, Elliot, Glick, Clark, Eggleston, Dowling, Zarnowitz and Rosenberg who will be presenting testimony today.

No participant has submitted a request for oral cross-examination of Recording Industry Association of

America Witness Elliot and, as is our practice, we will introduce this testimony first before we receive testimony that is subject to cross-examination.

Mr. Wiggins, is Mr. Elliot here today, or are we going to do this with paper?

MR. WIGGINS: Mr. Elliot is present, but I think it might be quicker just to do it with paper, and I do have two copies of the Supplemental Testimony of Stuart W. Elliot prepared for the Recording Industry Association of America, and an appropriate declaration that establishes the admissibility of that testimony.

I would move that the testimony be admitted into evidence and ask that it be included in the transcription of today's proceedings.

CHAIRMAN GLEIMAN: Is there any objection?

[No response.]

CHAIRMAN GLEIMAN: Hearing none, I will direct that counsel provide two copies of the rebuttal testimony of Witness Elliot to the court reporter and that testimony will be transcribed into the record and received into evidence.

[Supplemental Testimony of Stuart W. Elliot, RIAA-ST-1, was received into evidence and transcribed into the record.]

RIAA-ST-1

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

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

SUPPLEMENTAL TESTIMONY OF STUART W. ELLIOTT ON BEHALF OF RECORDING INDUSTRY ASSOCIATION OF AMERICA

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August 14, 2000

Dc1/119258

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Autobiographical Sketch

My name is Stuart W. Elliott. I am a Senior Analyst at Project Performance Corporation (PPC), a consulting firm based in McLean, VA. PPC provides management, information technology, and environmental consulting services to private and public sector clients.

I attended Columbia University, where I received a B.A. in Economics, summa cum laude, in 1985. I also attended the Massachusetts Institute of Technology, where I received a Ph.D. in Economics in 1992. In graduate school, my major fields were labor economics and industrial organization. I received postdoctoral training in experimental psychology at Carnegie Mellon University from 1991 until 1994.

Following my formal education, I was a Research Fellow at Carnegie Mellon University from 1994 until 1999, where I studied the impact of computers on jobs and productivity. During the 1997-98 academic year, I was also a visiting scholar at the Russell Sage Foundation. I joined PPC in 1999, where I have worked primarily on analysis related to postal economics.

1. Purpose and Scope of Testimony

The purpose of this testimony is to discuss the large increase in mail processing costs for Special Standard mail that occurred between BY 1998 and FY 1999. The testimony is a supplement to the case in chief of the Recording Industry Association of America (RIAA) in response to the Postal Service's revised Test Year forecasts incorporating FY 1999 data.

I argue that the increase in mail processing costs for Special Standard between BY 1998 and FY 1999 is not explained by changes in the characteristics of Special Standard mail and clearly deviates from the historical trend for mail processing costs in this subclass. Furthermore, I argue that the Postal Service has not provided an adequate explanation of the increase. Without an adequate explanation of the cost increase from the Postal Service, FY 1999 mail processing costs should not be used in any way for the determination of Special Standard rates. If the Commission decides to base its recommended rates on the FY 1999 update figures, I argue that in the case of Special Standard the BY 1998 mail processing cost figure should be used instead to derive an alternate FY 1999 mail processing cost estimate.

2. Special Standard mail experienced a 44 percent increase in mail processing costs from BY 1998 to FY 1999, while the volume and composition of the subclass were stable.

Special Standard mail experienced a large and unexplained increase in mail processing costs from BY 1998 to FY 1999. Table 1 shows that mail processing costs for this subclass increased by almost 44 percent using the Postal Service's R2000-1 costing method.[1]

Table 1: Changes in Special Standard, 1998 to 1999

	BY 1998	FY 1999	Percent Change
Mail Processing Cost USPS Method [1]	$80,866,000	$116,164,000	43.6%
Pieces – Total [2]	191,093,000	200,404,000	4.9%
Pieces – Single Piece [3]	155,739,000	149,784,000	- 3.8%
Pieces – Presort [3]	35,354,000	50,620,000	43.2%
Weight in pounds [4]	308,191,000	309,918,000	0.6%
Cubic Feet [5]	28,602,000	28,763,000	0.6%

[1] RIAA/USPS-1.
[2] USPS-T-4 Table 2 and 1999 update in response to POIR 17, Question 1.
[3] Billing Determinants for Special Standard USPS-LR-I-125 and USPS-LR-I-259.
[4] USPS-T-4 Table 3 and 1999 update in response to POIR 17, Question 1.
[5] Cost and Revenue Analysis, USPS-T-11 Exhibit-11C and USPS-LR-I-275.

From BY 1998 to FY 1999, measured total pieces increased only modestly so that the percentage change in mail processing unit cost is nearly as large as the percentage change in total mail processing cost. Using the R2000-1 method, mail processing unit cost increased by 37 percent, from $0.423 to $0.580.

Over this period, the proportion of Special Standard presort pieces increased from 18.5 to 25.3 percent, while Special Standard weight and cubic

[1] Costs showed a similar increase using the PRC method. According to USPS/RIAA-1, Cost Segment 3.1 costs using the PRC method increased by 46.3 percent from $83,658,000 in BY 1998 to $122,431,000 in FY 1999.

feet were stable. These measures suggest that the overall composition of Special Standard mail did not change substantially from BY 1998 to FY 1999. To the extent that change did occur it involved a shift toward higher levels of presort mail, which should be expected to have lower mail processing costs.

3. Although the mail processing cost estimate for Special Standard mail has a large coefficient of variation, it is not large enough to explain the increase in costs from BY 1998 to FY 1999.

Witness Ramage estimates a coefficient of variation of 6.13 percent for the BY 1998 estimate of the mail processing costs for Special Standard. USPS-T-2, Table 1. This coefficient of variation reflects the degree of uncertainty for the cost estimate given the size of the sample used to derive the estimate. Using this coefficient of variation, it is possible to derive a 95 percent confidence interval for mail processing costs for Special Standard that ranges from a low of $71,150,000 to a high of $90,582,000.[2]

Given the stable composition of the mail, the FY 1999 cost estimate should lie within the 95 percent confidence interval for the BY 1998 estimate, after making minor adjustments for inflation, increased volume, and increased presort. This is clearly not the case. The discrepancy between the BY 1998 and FY 1999 costs is too large to be caused by sampling variation alone. This suggests that there is either something wrong with the figures for one of the two years or that there was a significant cost change between the two years. In the

[2] This interval differs slightly from the interval reported by Ramage in USPS-T-2, Table 1, because total Cost Segment 3.1 costs include some adjustments to the mail processing costs reported by Ramage.

sections below, I argue that the former is the case and that the problem appears to lie with the FY 1999 cost estimates.

4. A historical comparison of Special Standard mail processing costs shows that the BY 1998 figure continues the historical trend whereas the FY 1999 figure is an anomaly.

To identify whether it is BY 1998 or FY 1999 that is unusual, I examined mail processing unit costs from FY 1994 to FY 1999 using the USPS method. I adjusted the costs to 1999 dollars using the CPI-W. I also adjusted the costs to reflect the different costing methods used in different years so that the unit costs could be compared across all years as though they had been calculated with the R2000-1 Method. Table 2 on the next page presents the results.

With these inflation and costing method adjustments, the unit costs in the last column of Table 2 can be compared from FY 1994 to FY 1999. This comparison shows that unit costs decreased from FY 1994 to FY 1997. The BY 1998 value shows no discontinuity when compared to the values from earlier years. In contrast, the FY 1999 value is unusually large. If these cost estimates are to be believed, Special Standard showed three years of improvement in unit mail processing costs that were then erased in a single year. This historical comparison shows that it is clearly the FY 1999 cost figure that is anomalous.

Table 2: Mail Processing Costs for Special Standard, USPS Method

Year	Cost (000s)	Pieces (000s)	Unit Cost	CPI-W	Unit Cost in 1999 Dollars	Unit Cost in 1999 Dollars at R2000-1 Level
	[1]	[2]	[3]	[4]	[5]	[6]
R94-1 Method						
FY 1994	$70,862	190,867	$0.371	145.6	$0.416	$0.555
FY 1995	$75,152	217,761	$0.345	149.8	$0.376	$0.501
FY 1996	$64,652	189,793	$0.341	154.1	$0.361	$0.481
R97-1 Method						
BY 1996	$65,485	189,793	$0.345	154.1	$0.365	
FY 1997	$64,114	202,732	$0.316	157.6	$0.327	$0.431
FY 1998	$61,440	191,093	$0.322	159.7	$0.329	$0.432
R2000-1 Method						
BY 1998	$80,866	191,093	$0.423	159.7	$0.432	
FY 1999	$116,164	200,404	$0.580	163.2	$0.580	$0.580

[1] Cost Segments and Components.
[2] Cost and Revenue Analysis.
[3] = [1] / [2]
[4] Consumer Price Index – Urban Wage Earners and Clerical Workers, U.S. Bureau of Labor Statistics.
[5] = [3] * 163.2 / [2]
[6] Unit costs in [5] for 1994-1996 are adjusted to the R97-1 Method using the ratio of (BY 1996 Unit Cost)/(FY 1996 Unit Cost). Unit costs for 1994-1998 are then adjusted from the R97-1 Method to the R2000-1 Method using the ratio of (BY 1998 Unit Cost)/(FY 1998 Unit Cost).

5. The Postal Service has not provided an adequate explanation of the increase in Special Standard mail processing costs from BY 1998 to FY 1999.

In response to an interrogatory from RIAA, the Postal Service has provided the following explanation of the increase in Special Standard mail processing costs:

> The costs for Special Standard increased between base year 1998 and fiscal year 1999 primarily due to an increase in Special Standard direct tallies. A

> change in the endorsement requirements for Special Standard in FY 1999 may have resulted in improved identification.

RIAA/USPS-1. In the Response of the United States Postal Service to Questions Raised at Hearings on August 3, 2000 [Tr. 35/16833], the Postal Service repeated this explanation,[3] while adding that "Special Standard observations could vary due to sampling error or underlying cost changes."

The Postal Service's explanation of the increase in Special Standard mail processing cost is inadequate. First, as noted above, the likely variation due to sampling error is far too small to explain the large cost increase. Second, a speculation that underlying costs could have increased does not qualify as an explanation for an increase of 44 percent until a substantive reason for such an astounding cost increase is proposed. Third, and most important, the change in the endorsement requirements is unpersuasive as an explanation because it is not consistent with the stability of Special Standard volume estimates. I detail this inconsistency below.

Mail processing costs are derived from the In-Office Cost System (IOCS), which provides a sample of employee activities in mail processing. USPS-T-2 at 3-4. In order to produce a Special Standard direct tally, the sampled employee must be handling a piece of mail that the IOCS data collector identifies as a piece of Special Standard mail. USPS-T-17 at 13. If Special Standard mail is

[3] In the Response of the United States Postal Service to Questions Raised at Hearings on August 3, 2000, the Postal Service also described the nature of the change in the endorsement requirements: "The change was that the Special Standard rate marking had to be in the postage area rather than just anywhere on the piece."

sometimes difficult to identify, then it is plausible that an improvement in endorsement requirements could lead to an increase in the number of pieces of mail that the IOCS data collector identifies as Special Standard.

However, if it were improved endorsement of Special Standard mail that had caused the increase in measured mail processing costs, then that improved endorsement should have led also to an increase in the measured volume of Special Standard mail. The volume estimates of Special Standard mail are based almost entirely on the Domestic Revenue, Pieces, and Weight (DRPW) system, which takes a sample of "mail exiting the postal system." USPS-T-4 at 4 and 10-11. For a piece of mail to be counted as Special Standard in the DRPW system, a DRPW data collector must identify it as a piece of Special Standard. If Special Standard mail is sometimes difficult to identify, then an improvement in endorsement requirements that helped IOCS data collectors correctly identify Special Standard mail should have also helped DRPW data collectors correctly identify Special Standard mail. As Table 1 above shows, the large increase in measured Special Standard mail processing costs between BY1998 and FY 1999 was not matched by a large increase in the number of measured pieces of Special Standard mail.

Furthermore, data for the IOCS and DRPW system are both entered into the same CODES computer system. A review of the instruction manuals for the IOCS and DRPW data collectors shows that the information provided for identifying Special Standard mail is very similar. For IOCS data collectors, the identifying instructions are as follows:

> j. **Special Standard Mail.** Enter this category for Standard Mail (B) mailable matter marked "Special Standard Mail." Books, printed music, sound recordings, and educational reference charts can be mailed at Special Standard mail rates.

USPS-LR-I-14 at 13-11. Similarly, for DRPW data collectors, the identifying instructions are as follows:

> 2 **Special Standard Single Piece** The piece is marked *Special Standard Mail.*
>
> 3 **Special Standard Bulk Presort** The piece is marked *Presorted Special Standard Mail.*

USPS-LR-I-37 at 3-243. Thus it appears that there is no basis for concluding that IOCS and DRPW data collectors would have behaved any differently in relation to identifying Special Standard mail. Indeed, based on these two sets of instructions, it appears that the IOCS data collectors had more informative instructions and so should have shown less improvement from an endorsement change than did the DRPW data collectors.

Until the Postal Service has a chance to investigate this matter more fully, it is clear that the most accurate explanation is the one provided by Witness Patelunas on cross-examination: "I haven't looked at that. I don't know." Tr. 35/16833.

6. The Commission should not use the FY 1999 mail processing cost estimates for Special Standard mail in its rate recommendations.

The Postal Service has not provided an adequate explanation of the large increase in Special Standard mail processing costs from BY 1998 to FY 1999. Until an adequate explanation is provided, the FY 1999 figure should not be used in determining Special Standard rates.

If the Commission decides to base its recommended rates on the FY 1999 update figures, the BY 1998 mail processing cost figures should be used instead to derive an alternate FY 1999 estimate for Special Standard. Table 2 provides a unit cost estimate for BY 1998 of $0.432 in 1999 dollars using the R2000-1 method. When this unit cost is multiplied by the FY 1999 estimate of 200,404,000 pieces, the result is an estimated FY 1999 Special Standard mail processing cost of $86,575,000. The Commission should use this FY 1999 cost estimate for Special Standard mail if it decides to base its recommended rates on the FY 1999 update figures.

DECLARATION
OF
STUART W. ELLIOTT

I declare under penalty of perjury that the foregoing Supplemental Testimony of Stuart Elliott on Behalf of Recording Industry Association of America (RIAA-ST-1) was prepared by me and that, if called upon to testify under oath, it would be my testimony.

Stuart W. Elliott
Stuart W. Elliott

Executed
August 23, 2000

dc1/119254

CHAIRMAN GLEIMAN: Mr. Elliot, inasmuch as you are here in the room, somewhere, Mr. Elliot, I just want you to know that we appreciate your contributions to our record. And I don't have to excuse you because you never got on the stand, but we do appreciate your contributions.

Our next witness is a PSA Witness. Mr. May, would you like to call your witness?

MR. MAY: Yes, I would ask Jon Wittnebel to take the stand.

Whereupon,

JON WITTNEBEL,

a witness, having been called for examination and, having been first duly sworn, was examined and testified as follows:

DIRECT EXAMINATION

BY MR. MAY:

Q You are Jon Wittnebel, the vice president of Delivery Services at CTC?

A That is correct.

Q I am going to hand you two copies of a document captioned "Supplemental Testimony of Jon Wittnebel on Behalf of Parcel Shippers Association," captioned "PSA-RT-2." I would ask you to examine this and see if that is the testimony you prepared for this proceeding?

A It is.

Q If you were to testimony fully today, would you adopt this as your testimony?

A That's correct.

MR. MAY: Mr. Chairman, I am handing two copies of PSA-RT-2 to the reporter and ask that they be transcribed in the record and received into evidence.

CHAIRMAN GLEIMAN: Is there an objection?

[No response.]

CHAIRMAN GLEIMAN: Hearing none, the supplemental testimony of Witness Wittnebel will be transcribed into the record and introduced into evidence.

[Supplemental Testimony of Jon Wittnebel, PSA-RT-2, was received into evidence and transcribed into the record.]

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AUG 14 3 46 PM '00
POSTAL RATE COMMISSION
OFFICE OF THE SECRETARY

PSA-RT-2

BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON DC 20268-0001

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

SUPPLEMENTAL TESTIMONY
OF
JON WITTNEBEL
ON BEHALF OF
PARCEL SHIPPERS ASSOCIATION

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Autobiographical Sketch

My name is Jon Wittnebel. I am the Vice President of Delivery Services at CTC, an RR Donnelley Logistics Company. CTC is a large mailer of parcels and our company makes heavy use of the Postal Service's Parcel Post Destination Delivery Unit (DDU) rates. In fact, my review of Postal Service Parcel Post volume data indicates that CTC DDU parcels comprise the vast majority of all DDU parcels delivered by the Postal Service.

In my role at CTC, I oversee our DDU entry program as well as our procedures for entering parcels at Postal Service delivery units. I also am on the board of the Parcel Shippers Association (PSA) and have participated on a variety of Mailers' Technical Advisory Committee (MTAC) work groups, including the Docket No. R97-1 Parcel Reclassification Implementation Readiness Team (IRT) that UPS witness Luciani (UPS-T-5) mentioned in his testimony.

I. Purpose and Scope of Testimony

In his testimony, Luciani speculates about what occurs at Postal Service delivery units when Parcel Post mailers enter DDU parcels. Tr. 25/11800-11801 (Luciani). In this testimony, I describe the activities that mailers perform when entering parcels at DDUs and the activities that the Postal Service performs. Rather than being based on speculation, my testimony is based upon my operational knowledge of what actually occurs at the more than 3,000 delivery units at which CTC enters DDU parcels. In addition, I have attached relevant excerpts from CTC's process documents regarding our DDU-entry procedures to this testimony.

I also rebut the conclusion that Luciani draws from reading minutes from a May 14, 1998 meeting of the MTAC Parcel IRT. Specifically, based upon minutes from this meeting, Luciani speculated that the Postal Service committed to helping mailers unload DDU parcels from mailer trucks. Tr. 25/11800 (Luciani). I was at that meeting and I can guarantee that the Postal Service made no such commitment. Furthermore, I can state categorically that, in practice, the Postal Service does not provide such assistance.

II. DDU-Entry Procedures

In its model of the costs avoided by DDU parcels, the Postal Service assumed that DDU parcels avoid sack shakeout costs and unloading costs. Tr. 13/5169, 5199 (Eggleston). In this section, I describe DDU-entry procedures and explain why these procedures are consistent with the Postal Service's assumption.

As documented in Attachment 1, when CTC enters parcels at the DDU, our drivers follow one of two procedures. If the parcels are bed loaded, our drivers separate them (by five-digit zip codes) directly into/on mail transportation equipment on the receiving dock within 20 minutes of arrival. If the parcels are palletized, our drivers remove the pallets from our trucks and place them on the dock within 20 minutes of arrival. Either way, our drivers are responsible for unloading our trucks. My understanding is that other mailers of DDU parcels follow similar procedures.

It is also worth noting that I have only described entry procedures for bed loaded and palletized parcels. This is because CTC does not enter DDU parcels in sacks. A very small percentage (less than 0.5 percent) of our DDU parcels are delivered in large plastic bags (which are used to ensure the integrity of five-digit separated parcels) and our drivers typically empty these bags upon arrival at the DDU. Again, my understanding from discussions with other mailers of DDU parcels is that they also do not enter DDU parcels in sacks.

III. The Parcel Reclassification Implementation Readiness Team

In his testimony, Luciani indicates that the minutes of the Parcel Reclassification IRT clearly show that the Postal Service will help mailers unload parcels at DDUs when available. Tr. 25/11800 (Luciani). His interpretation of these minutes is incorrect. In this section, I provide background on the IRT and provide a more appropriate interpretation of the IRT minutes.

The Parcel Reclassification IRT was formed in late 1997 to help the Postal Service and mailers prepare for the classification changes that would accompany the implementation of Docket No. R97-1 rates. It served as an informal forum for discussing potential issues associated with implementing the changes and, where possible, resolving them. However, it must be noted that the minutes of these meetings are in no way substitutes for Postal Service regulations and the minutes must be read in this context.

In response to an interrogatory, Luciani cited the following passage from the IRT minutes in support of his contention that the Postal Service will assist in unloading DDU parcels:

> VEHICLE UNLOADING Not part of R-97 rules, but mailer concerns were addressed. Do not require mailers to unload at DDUs. Mailers want assistance provided to truck drivers locally when they unloading if it is available. Cannot state in DMM that this will be possible. Cost saving is based on the fact that we will not unload trucks. Locally, USPS may be able to assist. Tr. 25/11841 (Luciani).

The minutes from this meeting do not provide the appropriate context to properly interpret this discussion. Specifically, parcel mailers viewed this conversation as raising an issue, not resolving it. The Postal Service's dropship procedures for DDU parcels make it clear that our drivers are responsible for unloading our trucks at the DDU. Tr. 13/5199 (Eggleston). Mailers do not question these procedures based upon the informal discussions that took place at the IRT meeting.

Attachment A. Excerpts from CTC Process Documents

EXCERPT FROM CTC SORT PROCESS DOCUMENT

3) CTC SORT

4) Delivery Process

a. Carrier is responsible for delivery of parcels/pallets to designated DDU address.
b. Carrier arrives at DDU and presents paperwork to the receiving clerk.
c. *Carrier unloads and places pallets/parcels in the designated U.S.P.S location (emphasis added).*
d. U.S.P.S. clerk accepts load.
e. Carrier continues to next DDU.

EXCERPT FROM CTC CARRIER PROCEDURES

<u>**DELIVERY TO DDU**</u>

1. *The driver or sorter must segregate and unload the freight for the DDU to the 5-digit zip code level if the pallets are not sorted as such (emphasis added).*

2. Deliveries must be made within the scheduled window.

3. If for any reason a delivery cannot be made, contact your sort center and the sort center will contact CTC immediately for disposition.

4. Carrier must provide equipment sufficient to perform pickups and deliveries on an acceptable schedule.

5. All delivery copies must be accepted by the USPS with the DDU name and date of receipt.

6. Do not alter the original copy of the 8125.

CERTIFICATE OF SERVICE

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

Timothy J. May

Dated: August 14, 2000

CHAIRMAN GLEIMAN: One party has requested oral cross-examination, United Parcel Service. Is there anyone else who wishes to cross-examine the witness?

[No response.]

CHAIRMAN GLEIMAN: If not, then, Mr. McKeever, when you are ready, you may begin.

MR. McKEEVER: Thank you, Mr. Chairman.

CROSS-EXAMINATION

BY MR. McKEEVER:

Q Good morning, Mr. Wittnebel.

A Good morning.

Q I just have a very few questions for you. Could you refer to page 2 of your testimony, and in particular, lines 26 to 28?

A Yes.

Q There you state that if the parcels are bed-loaded, our drivers, that is, I take it, CTC's drivers, separate them by 5 digit zip codes directly into, on mail transportation equipment on the receiving dock within 20 minutes of arrival. What type of mail transportation equipment are you referring to there?

A We will transfer the parcels onto either hampers or APCs, or whatever the Post Office actually designates, but it is primarily hampers and/or APCs.

Q Okay. After the driver puts them into the hampers, is it A?

A I believe the term is A as in alpha, P as in Peter, C as in Charles.

Q APCs. It is an All Purpose Containers?

A It is a metal container, All Purpose Container. Thanks. I couldn't remember the actual name.

Q Okay. Do you know what happens after the drivers puts the parcels either into the hamper or the APC, what the Postal Service does?

A Well, our function is completed at that point in time. We turn it over to the Post Office, and I would guess that they do their sorts beyond that, but I don't know. Our function is completed once we turn it over to the Post Office either in the hampers or the APCs.

Q Okay. Now, when your driver arrives there, I take it that he is met by a Postal Service employee?

A That is correct.

Q On the dock. Okay. And the employee examines the mail that is deposited, a Postal Service employee examines the mail that is to be deposited, is that the procedure that is required?

A Well, we actually turn the paperwork over, the 8125, which is a receiving document indicating the number of parcels and so forth. We turn that over to the Postal clerk.

Q At the time the parcels are brought to the dock?
A That is correct.
Q Okay. And what does the Postal clerk do with that document, do you know?
A I am not sure beyond that other than records whatever his proper recording procedures are.
Q Okay. But it is required that your driver make contact with a Postal employee who comes to the dock to receive the load, is that correct?
A That is correct.
Q And from that point on, it is up to the Postal Service to take that hamper or that All Purpose Container into the facility or do whatever the Postal Service has to do to make sure that it processes it for delivery?
A That is my understanding.
Q Okay. Is there any way you could tell me how full a hamper is when your driver drops off a load?
A Well, --
Q I am sure it varies, but is there some --
A Well, that will vary considerably. Hampers, and including pallets, so there may be pallet loads that we will drop off as well, so it varies from hamper loads to pallet loads at any one particular 5 digit zip.
Q Okay. But there certainly are times when either the pallet is full or the hamper is full, is that correct?

A That is correct.

Q Now, does your driver have to schedule an appointment to show up at the DDU?

A An appointment is scheduled, yes.

Q At the DDU?

A That is correct.

Q Okay. Now, the Postal Service, of course, also receives parcels at the dock that don't come from your drivers or other consolidators, but rather that come from its own facilities like BMCs or SCFs, is that correct?

A That is correct.

Q And in those instances, that requires a Postal Service employee at the DDU to come out and accept the shipment from its own Postal personnel?

A I am not really sure what the Post Office's rules and regulations are. We are primarily interested in our DDU entry.

Q Let me ask you to turn for just a moment to the Attachment A to your testimony, please.

A Okay.

Q First of all, it says excerpt from CTC Sort Process document. Am I correct that this is a retyping of part of the document or a photocopy?

A That is correct.

Q Okay.

In 4(a) it says carrier is responsible for delivery of parcels pallets to designated DDU address; do you see that?

A Yes, I do.

Q Who are you referring to when you use the term, carrier, there?

A We may use independent contract carriers in this case.

Q Okay, but it's basically what I'll call the CTC drive who may be an employee or who may be an independent contractor?

A That is correct.

Q Okay. Could you go down to the section that says delivery to DDU, Paragraph 1?

It says there the driver or sorter must segregate and unload the freight for the DDU; do you see that?

A Yes, I do.

Q The sorter, is that a CTC employee?

A It could be, not necessarily; it could be a contract employee or it could be a CTC employee.

Q Is this activity that's being referred to in 1, is that activity that occurs in a CTC facility or at the Postal Facility or where?

A It could occur on the back of the trailer or the unloading vehicle.

Q Oh, okay. Are there occasions then when one of your loads has not only a driver, but also a driver and a sorter accompany the load to the Postal Service?

A Generally only a driver.

Q Okay.

[Pause.]

In the case of the postage for the parcels, is that postage deducted from a CTC trust account or from a trust account maintained by what I will call the original mailer, or does it depend?

A It's deducted from a CTC trust account only.

Q In all cases?

A That's is correct.

MR. McKEEVER: That's all I have, Mr. Chairman. Thank you very much, Mr. Wittnebel.

THE WITNESS: You're welcome.

CHAIRMAN GLEIMAN: Is there any followup?

[No response.]

CHAIRMAN GLEIMAN: Are there questions from the Bench?

[No response.]

CHAIRMAN GLEIMAN: Would you like some time to prepare for redirect, Mr. May?

MR. MAY: There will be no redirect.

CHAIRMAN GLEIMAN: That being the case, Mr.

Wittnebel, that completes your testimony here today. We appreciate our appearance, your contributions to the record.

We thank you, and you are excused.

[Witness Wittnebel excused.]

CHAIRMAN GLEIMAN: You have the next witness also, I believe, Mr. May.

MR. MAY: Yes, I call Sander Glick to the stand.

CHAIRMAN GLEIMAN: I am pretty sure we have it right now, and that you are, in fact, finally under oath in these proceedings.

MR. GLICK: No, I'm not under oath.

CHAIRMAN GLEIMAN: You're not yet?

MR. GLICK: Not yet.

CHAIRMAN GLEIMAN: In all the times you've appeared here and all the testimony we have in the record from you and you're not under oath yet?

Mr. GLICK: Lots of declarations.

CHAIRMAN GLEIMAN: Well, let's do it right then.

Whereupon,

SANDER A. GLICK,

a witness, having been called for examination, and, having been first duly sworn, was examined and testified as follows:

DIRECT EXAMINATION

BY MR. MAY:

Q You are Sander Glick and you are the Co-Manager of Economic Systems at Project Performance Corporation, a consulting firm?

A Yes, that's true.

Q And I am going to hand you two copies of a document captioned Rebuttal Testimony of Sander A. Glick on Behalf of Parcel Shippers Association, PSA-RT-1, and I'd ask you to examine this and see if this is the testimony you prepared for the proceeding?

[Pause.]

A Yes.

Q Do you adopt this as your testimony today?

A I do.

MR. MAY: Mr. Chairman, I'm going to hand these two copies of PSA-RT-1 to the Reporter, and I ask that they be transcribed into the record and received into evidence.

CHAIRMAN GLEIMAN: Is there any objection?

[No response.]

CHAIRMAN GLEIMAN: Hearing none, the Rebuttal Testimony of Witness Glick, PSA-RT-1, will be received into evidence and transcribed into the record at this point.

[Written Rebuttal Testimony of Sander A. Glick, PSA-RT-1, was received into evidence and transcribed into the record.]

PSA-RT-1

BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, DC 20268-0001

POSTAL RATE AND FEE CHANGES, 2000

Docket No. R2000–1

REBUTTAL TESTIMONY
SANDER A. GLICK
ON BEHALF OF
PARCEL SHIPPERS ASSOCIATION

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Autobiographical Sketch

My name is Sander A. Glick. I co-manage the Economic Systems practice at Project Performance Corporation (PPC), a consulting firm based in McLean, Virginia. PPC provides economic and technology consulting services to private and public sector clients. I joined PPC in 1994 as an Analyst and am now a Program Manager. At PPC, I have worked on a number of economic and cost issues for mailer associations, the Department of Defense, and the Department of Energy.

In Docket No. R97-1, I testified on behalf of the Magazine Publishers of America (MPA) regarding the special service fee for Qualified Business Reply Mail (QBRM) and the appropriate method for distributing rural carrier costs to mail classes and subclasses. In this case, I have provided direct testimony on behalf of the Association for Postal Commerce (PostCom) and Recording Industry Association of America (RIAA) regarding Standard (A) rate design and on behalf of the Magazine Publishers of America (MPA) regarding the appropriate methods for distributing mail processing and rural carrier cost to mail subclasses and the Test Year cost savings that will result from reduced bundle breakage and improved bundle recovery.

I attended the Maxwell School of Citizenship and Public Affairs at Syracuse University, where I received a Masters of Public Administration in 1994, and Carleton College, where I received a Bachelors Degree, magna cum laude, in Physics in 1993. I am a member of the American Economic Association and the System Dynamics Society.

Purpose and Scope

In this case, UPS witnesses Luciani (UPS-T-5) and Sellick (UPS-T-4) presented direct testimony arguing that the Postal Service overstated Parcel Post revenue and understated Parcel Post costs. Furthermore, they argued that discounts for destination-entry Parcel Post should be smaller because the Postal Service's estimated cost avoidances and proposed passthroughs are too high. In this testimony, I show that their arguments are wrong. Specifically, I make eight points:

1. The joint Bulk Revenue, Pieces and Weight/Domestic Revenue, Pieces and Weight (BRPW/DRPW) system that the Postal Service used to estimate Parcel Post revenue, pieces, and weight is more accurate than DRPW, the system that the Postal Service used in past cases.

2. In the absence of a new study of the effect of parcel weight on elemental load costs, elemental load costs for parcels should continue to be distributed based on parcel pieces.

3. The costs for "Exclusive Parcel Post Routes" should not be distributed entirely to the Parcel Post subclass because, despite the unfortunate choice of name, Parcel Post volume makes up only a small portion of the mail delivered on these routes.

4. While Mr. Luciani's Destination Bulk Mail Center (DBMC) cost avoidance model is flawed, so is the Postal Service's model. Therefore, neither should be used to estimate the DBMC cost avoidance. I propose a middle ground alternative.

5. The Destination Delivery Unit (DDU) cost avoidance is larger than estimated by the Postal Service, not smaller.

6. Contrary to Mr. Luciani's suggestion, the Postal Service's method for distributing Alaska air costs to rate category is appropriate.

7. Just as it did in Docket No. R97-1, the Commission should pass through nearly 100 percent of the DDU cost avoidance. UPS has provided no justification for passing through less.

8. Mr. Luciani's bottom-up model of DDU costs is incorrect. Therefore, his related criticism of the Postal Service's rate design approach is irrelevant.

In the remainder of this testimony, I provide detail on each of these points.

1. The joint Bulk Revenue, Pieces and Weight/Domestic Revenue, Pieces and Weight (BRPW/DRPW) system that the Postal Service used to estimate Parcel Post revenue, pieces, and weight is more accurate than DRPW, the system that the Postal Service used in past cases.

Mr. Sellick believes that the new BRPW/DRPW method[1] for deriving **Parcel Post** RPW estimates is unreliable and that the Commission "should instead use the FY 1998 DRPW-only estimates." Tr. 31/15037 and 15039 (Sellick). However, Mr. Sellick does not provide a persuasive argument to substantiate his belief. Instead, he describes three possible problems with the new method, none of which is likely to cause a significant impact on the Parcel Post RPW estimates. Furthermore, the potential problems described by Mr. Sellick do not explain the 19 percent difference between the Parcel Post estimates derived by the new BRPW/DRPW method and those produced by the former DRPW-only method. Tr. 31/15034 (Sellick). On the other hand, the Postal Service's explanation is reasonable, can explain the entire discrepancy, and shows that the new method corrects a serious data collection problem with the DRPW-only method.

[1] The new BRPW/DRPW method estimates RPW for permit imprint Parcel Post from the BRPW system and RPW for all other Parcel Post from the DRPW system. The old DRPW-only method estimated RPW for the entire Parcel Post subclass using the DRPW system.

First, Mr. Sellick argues that the BRPW portion of the new BRPW/DRPW Parcel Post estimates is flawed because it does not include a trial balance revenue account adjustment. This adjustment was not performed for FY 1998 because a unique permit imprint Parcel Post trial balance revenue account was not available, Tr. 31/15037-15039 (Sellick); only an interim adjustment based on an FY 1997, PQ2 survey could be made. POIR No. 17, Question 4. However, Mr. Sellick has acknowledged that a separate Parcel Post trial balance revenue account did become available in FY 1999, PQ3 and PQ4. Tr. 31/15151 and 15162 (Sellick); POIR No. 17, Question 4. As a result, his critique applies to less than half of the FY 1999 revenue estimate. Furthermore, because the trial balance adjustment is larger than the interim adjustment factor that was used in FY 1998 and the first two postal quarters of FY 1999, it is more likely that the lack of a trial balance adjustment resulted in the new BRPW/DRPW system understating revenue, not overstating it. POIR No. 17, Question 4.[2]

Second, Mr. Sellick argues that the BRPW portion of the new BRPW/DRPW Parcel Post estimates is flawed because some BRPW data records are likely to be in error. Tr. 31/15039-15045 (Sellick). As I show below, Mr. Sellick's analysis did not uncover any significant flaws in the BPRW system:

- <u>BRPW Error Checking Process</u>. Mr. Sellick states that out of a total of 32,000 BRPW data records, about 60 records failed the Postal Service's data quality checks. However, he has acknowledged that these records are removed by the Postal Service's data cleaning process and that they represent only $3,048.49 in revenue and 463 pieces, or approximately 0.00032 percent of Parcel Post revenue and 0.00015 percent of Parcel Post pieces. Tr. 31/15122-15123 (Sellick); Exhibit USPS-11C.

[2] To correct for this understatement, the Commission could replace the interim adjustment factors used for FY 1999, PQ 1 and 2 with the average of the trial balance adjustments for FY 1999, PQ3 and 4.

In addition, he reports that "several hundred" BRPW data records would fail these tests if stricter failure criteria were used, but this still implies an error rate of less than 1 percent and there is no indication that these records bias the BRPW figures upward. Tr. 31/15122-15123 and 15164-15169 (Sellick). Furthermore, if the 12 records in Exhibit UPS-4C (which comprise only 0.007 percent of Parcel Post pieces) that fail Mr. Sellick's stricter criteria are at all representative of all of the records that failed Mr. Sellick's test, the piece-weighted error rate would be much less than one percent. Tr. 31/15148-15150 (Sellick).

- Findings of Audit Reports. Mr. Sellick reviews a set of 48 financial audit reports provided in library reference USPS-LR-I-323. He cites 14 passages from these reports that refer to problems in the financial and accounting systems of individual postal facilities, but he provides no argument that these problems bias the BRPW Parcel Post estimates, let alone bias them upward. Tr. 31/15111-15116 (Sellick).

Many of the cited passages refer to inadequate verification.[3] However, common sense suggests that inadequate verification would be more likely to cause an underestimate of BRPW Parcel Post revenue rather than an overestimate. For example, one might be concerned that some Standard (B) mailers would understate the number of pieces in their mailing or attempt to mail at lower Standard (A) rates unless their mail were adequately verified.[4] In support of this common sense argument, my

[3] Out of the 14 cited passages, only numbers 1, 3, 5, 10, and 11 do not refer directly to verification problems.

[4] Since Standard (A) rates for parcels weighing less than one pound are uniformly lower than the lowest Parcel Post rate, there is a disincentive to mail Standard (A) parcels at Parcel Post rates. Nonetheless, I asked several parcel mailers whether they mailed any parcels weighing less than one pound at Parcel Post rates in FY 1998 or FY 1999. Most of them indicated that they hadn't done so. A couple mailers indicated that a very small portion (less than two percent) of the parcels they mailed at Parcel Post rates in FY 1998 weighed less than one pound. However, after the implementation of Docket No. R97-1 rates, these mailers discontinued this practice. This is because, with the implementation of Docket No. R97-1 rates, the Domestic Mail Manual (DMM) no longer allows Standard (A) mail to be mailed at Parcel Post rates. Specifically, the DMM only allows Standard (A) mail to be mailed at Standard (B) mail rates if the Standard (B)

review of the audit reports revealed a number of statements of concern about possible revenue loss.[5]

Furthermore, while I agree with Mr. Sellick that the audit reports do express a general concern about bulk mail acceptance and business mail entry, Tr. 31/15126-15127 (Sellick), the Parcel Post subclass was only mentioned by name in one of the 48 audits. USPS-LR-I-323 at 56, Postal Inspection Service Audit Report: Financial Audit, Case No. [redacted] (March 1998), at 3. Standard (B) was mentioned by name in only one additional report. USPS-LR-I-323 at 317, Postal Inspection Service Audit Report: Financial Audit, Case No. [redacted] (July 1998), at 8.

Finally, Mr. Sellick fails to mention the findings from the one study, which was performed by an independent accounting firm, provided by the Postal Service that specifically focuses on assessing the Permit system that is the basis of the BRPW estimates. The Executive Summary of the "PERMIT System Data Validation Study" provided in library reference USPS-LR-I-279 summarizes the study's findings as follows:

> Our procedures did not identify any significant variances in the accumulation of Postage Statement data on the PERMIT Systems. However, we did identify insignificant variances which suggests that it may be appropriate for the Postal Service to routinely reconcile the AP PERMIT data to the PQ RPW data to verify that such variances continue to be insignificant. USPS-LR-I-279 at 1.

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mail rate is less than the Standard (A) mail rate. Domestic Mail Manual, Issue 54, Section E612.4.6. As noted above, Parcel Post rates are uniformly higher than Standard (A) rates.

[5] For example: "Internal controls governing the acceptance and input of business mail need to be strengthened to ensure that all revenue due the Postal Service is properly safeguarded." USPS-LR-I-323 at 31, Postal Inspection Service Audit Report: Financial Audit, Case No. [redacted] (August 1998), at 18. "Verifications of Periodical mailings and supporting documentation are needed to protect Postal Service revenues and to ensure publications continue to be eligible to mail at Periodical rates of postage, according to their authorizations." USPS-LR-I-323 at 71, Postal Inspection Service Audit Report: Financial Audit, Case No. [redacted] (April 1998), at 22.

- Analysis of Plant-Verified Drop Shipment (PVDS) Verification and Clearance Forms (PS Forms 8125). Mr. Sellick reviews more than 500 PS Forms 8125 provided in sealed library reference USPS-LR-I-314. These forms are a subset of the Forms 8125 reviewed in preparing the audit report on the plant-verified drop shipment system that was provided in library reference USPS-LR-I-176. It is important to note that the audit investigated three "judgmentally selected" sites, not a randomly selected set of sites. USPS-LR-I-176 at 2. Out of these, Mr. Sellick identifies two that appear to indicate Standard (B) mail with weights appropriate for Standard (A) mail. Tr. 31/15043-15044 (Sellick). Since the sites for the audit were not randomly selected, it is not possible to generalize to all Forms 8125, but even if the sites had been randomly selected these possible errors would represent an error rate of less than 0.4 percent.

  Furthermore, Mr. Sellick provides no evidence that these two forms indicate that incorrect data was entered into the BRPW system. As he notes in his testimony, it is postage statements that are used for entry into the PERMIT system that is the basis of the BRPW estimates. Tr. 31/15024 (Sellick). However, Mr. Sellick provides no evidence that the postage statements corresponding to the two aforementioned Forms 8125 would likely have been for Standard (B) mail.

  In fact, there is evidence to the contrary. In the first case, the Form 8125 indicates that the type of mail is "letters" and in the second case, the Form 8125 indicates that the type of mail is "flats" that are "automation compatible" – but the postage statement Forms 3605-R and 3605-PR for permit imprint Parcel Post mail do not include either letters or automation flats as possible mail types. Tr. 31/15050, 15052 and 15056-15057 (Sellick). On the other hand, the postage statement for Standard (A) Regular mail does include these possible mail types.

It is therefore likely that the postage statements corresponding to these two Forms 8125 were Standard (A) postage statements and that the only mistake made was in indicating the class on the Form 8125.[6] If the corresponding postage statements were correct, then there is no reason to believe that the Forms 8125 that Mr. Sellick discusses were associated with any errors being entered into the BRPW system.

Mr. Sellick has not provided an argument that BRPW data record errors are likely to have caused a significant impact on Parcel Post estimates. He does not show either that (1) the rate of BRPW errors is large, or that (2) they lead to a bias that would cause an overestimate of Parcel Post revenue.

Third, Mr. Sellick argues that the new BRPW/DRPW method could lead to double-counting for Parcel Post. He argues that this could occur, for example, if some permit imprint Parcel Post pieces were incorrectly recorded as metered pieces in the DPRW. If this happened, then those permit imprint Parcel Post pieces would not be removed from the DRPW system and so would be counted by both the BRPW system and the DRPW system. Tr. 31/15045-15048 and 15169-15171 (Sellick). However, Mr. Sellick fails to take into account that if such errors occur, then they are likely to occur in the reverse direction also. The reverse error would result, for example, in some metered Parcel Post pieces being incorrectly categorized as permit imprint pieces. As a result, these metered Parcel Post pieces would not be counted by either the BRPW system or the DRPW system. Mr. Sellick acknowledged in cross-examination that this reverse error would lead to under-counting of Parcel Post. Tr. 31/15171-15173 (Sellick). Thus, the general type of data collector errors that Mr. Sellick

[6] Indeed, it is not even clear that both forms indicate Standard (B) mail as Mr. Sellick asserts. On the second form, the error may lie only in Mr. Sellick's interpretation, since both strokes of the "X" mark touch the box for Standard (A). Tr. 31/15057 (Sellick). Even if Standard (B) was checked on the two forms identified by Mr. Sellick, it was probably due to sloppiness since the Standard (A) and Standard (B) boxes are separated by less than 1/8" on the PS Form 8125. Because the Standard (A) and Parcel Post postage statements are separate forms, such sloppiness could not have caused Standard (A) revenue to be recorded as Parcel Post revenue in the BRPW system.

discusses could lead to some double-counting and some under-counting. On balance, these effects would tend to cancel each other out, which would reduce the impact of this issue (if it is an issue at all) on Parcel Post estimates.

Therefore, Mr. Sellick has not provided a persuasive critique of the new BRPW/DRPW method for estimating Parcel Post. On closer examination, none of the three problems he describes is likely to cause a substantial impact on Parcel Post estimates. As a result, they fail to provide an explanation of the difference in the Parcel Post estimates produced by the new BRPW/DRPW method and the old DRPW-only method.

In contrast to Mr. Sellick's speculations, the Postal Service has provided a viable explanation of the substantial discrepancy between the new BRPW/DRPW method and old DRPW-only method. This explanation shows that the problem lies with the old system not the new one. Under the old method, permit imprint Parcel Post was counted by the DRPW system even though permit imprint Bound Printed Matter was not counted by the DRPW system. For this reason, DRPW data collectors were told not to count permit imprint Bound Printed Matter, but to still count permit imprint Parcel Post. USPS-LR-I-37 at 3-95.

The Postal Service believes that DRPW data collectors under the old system were mistakenly applying the rule for not counting permit imprint Bound Printed Matter to both Bound Printed Matter and Parcel Post, since both are Standard (B). This mistake would have resulted in a systematic underestimate of permit imprint Parcel Post under the old method. POIR No. 15, Question 2.

In fact, if only one out of every five DRPW data collectors misinterpreted this instruction, that would explain the entire discrepancy between the two systems. Specifically, the non-permit imprint DRPW piece estimate for Parcel Post was 78

Even Mr. Sellick agrees that having separate forms reduces the probability of erroneous reporting. Tr. 31/15129 (Sellick).

million. Tr. 2/714-715 (Pafford). Since the FY 1998 Parcel Post estimates were 266 million with the old DRPW-only system and 316 million with the new BRPW/DRPW system, Attachment to POIR No. 17, Question 7, the permit imprint estimate from the old system was 188 million while the estimate under the new system was 238 million. Because the permit imprint estimate from the old DRPW-only system is 21 percent less than the BRPW estimate, the erroneous estimate from DRPW could have resulted from 21 percent of the data collectors misinterpreting the DRPW procedures in the manner described by the Postal Service.

Because the new BRPW/DRPW system corrects this data collection mistake, which is the only reasonable explanation provided for the substantial discrepancy between the old DRPW-only system and the new BRPW/DRPW system, the Commission should use the new system to estimate Parcel Post RPW.

2. In the absence of a new study of the effect of parcel weight on elemental load costs, elemental load costs for parcels should continue to be distributed based on parcel pieces.

Neither Mr. Luciani nor the Postal Service has performed any quantitative analysis of the effect of weight on elemental load costs. Therefore, the Commission should continue to recommend that elemental load costs be distributed to mail subclasses based upon mail volume within shape. Not only is this consistent with the established distribution method, it is also consistent with the established cost attribution method.

By his own admission, Mr. Luciani is not an expert on the effect of weight on elemental load costs[7] and performed no quantitative analysis of whether elemental load costs are a function of weight. His decision to distribute

[7] When asked "Do you regard yourself, and are you offering yourself to this Commission as an expert witness on the effect of weight on elemental load costs?" Mr. Luciani responded, "I certainly have expertise in Postal ratemaking and the impact in Postal ratemaking of the relationship between weight and cost." Tr. 25/11988 (Luciani). There is a significant difference

elemental load costs for parcels based upon weight therefore relies primarily on Ms. Daniel's reexamination.[8] Tr. 25/11988-11989 (Luciani). Thus, to assess whether there is any merit to Mr. Luciani's decision, it is necessary to assess the quality of Ms. Daniel's reexamination of the relationship between parcel weight and elemental load costs.

Even a cursory review of the record indicates that Ms. Daniel's reexamination of the traditional assumption that elemental load costs vary with pieces by shape category is not sufficient for overturning the established distribution method. First, Ms. Daniel, herself, admitted that neither she nor anyone else at the Postal Service performed a quantitative analysis of the effect of weight on elemental load costs: "It's my understanding that there hasn't been a quantitative study of the impact of weight on street costs." Tr. 4/1395 (Daniel).[9] Second, even Ms. Daniel conceded that her assumption regarding elemental load costs is not accurate: "I chose to allocate elemental load costs on the basis of weight, although admitting that I felt it overstated the impact that weight may play in elemental load." Tr. 4/1395 (Daniel).[10] Apparently for this reason, Ms. Daniel distributed elemental load costs based upon number of mailpieces when she estimated unit delivery costs by rate category. USPS-LR-I-95, LR95del.xls,

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between being an expert on the effect of weight on cost and understanding the impact of this relationship.

[8] While Mr. Luciani and others have referred to Ms. Daniel's reexamination of the effect of weight on elemental load costs as a study, Tr. 25/11992 (Luciani), Ms. Daniel doesn't refer to it in this way. Rather, she simply states that she "reexamined previous assumptions." Tr. 4/1159 (Daniel).

[9] Note that, contrary to Mr. Luciani's belief, Ms. Daniel's reexamination of the effect of weight on elemental load costs does not have "a number of workpapers behind it, that took much time, much time to put forth and took a lot of thought." Tr. 25/11992 (Luciani). Her workpapers simply apply her assumption about the effect of weight on elemental load costs among other assumptions.

[10] Ms. Daniel justifies using a distribution method for elemental load costs that overstates the effect of weight on cost by stating "if anybody wanted to criticize or suggest that access and route time were weight-related, then this would be compensating for that." Tr. 4/1395 (Daniel). This is not the appropriate way to deal with such a situation. The appropriate way to have avoided this criticism would have been to perform a quantitative study of the effect of weight on access and route time costs. Furthermore, Ms. Daniel's argument that distributing elemental load costs to subclass based upon weight compensates for distributing route time costs based upon pieces is irrelevant for the purpose of distributing costs to subclass because the CRA distributes route time to subclass based upon weight. Tr. 4/1395-1397 (Daniel); USPS-LR-I-1 at 7-4.

worksheet "city load."[11] Therefore, there is no basis on this record for distributing elemental load costs for parcels based upon parcel weight.

On the other hand, there is evidence that elemental load costs for parcels do vary with the number of parcels delivered. The established method for estimating elemental load costs is to perform a regression with average load time per stop as the dependent variable and mail pieces by shape among the independent variables. PRC Op. R97-1, para. 3256. Therefore, to be consistent with this attribution method, it is appropriate to distribute elemental load costs to subclass using parcel volume. Furthermore, lacking a new study regarding the effect of weight on elemental load costs, this regression analysis remains the best evidence regarding the drivers of elemental load costs.

3. The costs for "Exclusive Parcel Post Routes" should not be distributed entirely to the Parcel Post subclass because, despite the unfortunate choice of name, Parcel Post volume makes up only a small portion of the mail delivered on these routes.

In his testimony, Mr. Luciani recommends that all costs for Exclusive Parcel Post Routes, $37.4 million, be distributed to Parcel Post because "Exclusive Parcel Post Routes are regular routes devoted entirely to the delivery of Parcel Post." Tr. 25/11785 (Luciani). Despite the unfortunate choice of name, Exclusive Parcel Post Routes are not devoted exclusively to the delivery of Parcel Post. In fact, these routes aren't even devoted primarily to the delivery of Parcel Post. As the Postal Service suggested in an interrogatory to Mr. Luciani, data collected in a study presented in Docket No. R97-1 indicates that Parcel Post pieces comprise only 12 percent of the pieces delivered on Exclusive Parcel Post Routes. Tr. 25/11868. To confirm that Parcel Post pieces comprise only a small portion of volume on these routes, I analyzed the data collected for the R97-1 study and was able to confirm the Postal Service's conclusion:

[11] Specifically, in this library reference, Ms. Daniel develops her unit delivery costs using Ms. Meehan's analysis of load costs, which distributes elemental load costs based upon number of

- On the 32 "Exclusive Parcel Post Route" route-days examined in the study, 2,612 pieces were delivered, and only 353 (13.5 percent) of the pieces delivered were Parcel Post pieces.

- On the 32 route-days, the percentage of deliveries that were Parcel Post pieces ranged from a low of 0 percent to a high of 34 percent.

- Finally, there were 5 route-days where, out of the 421 deliveries made, none of the pieces delivered were Parcel Post pieces.[12]

Therefore, because Parcel Post pieces comprise only a small portion of the pieces delivered on Exclusive Parcel Post Routes, I recommend that the Postal Rate Commission reject Mr. Luciani's proposal to distribute all costs for Exclusive Parcel Post Routes to the Parcel Post subclass as clearly inappropriate. I also recommend that the Postal Service consider renaming "Exclusive Parcel Post Routes" to better reflect the variety of mail delivered on these routes.

4. While Mr. Luciani's Destination Bulk Mail Center (DBMC) cost avoidance model is flawed, so is the Postal Service's model. Therefore, neither should be used to estimate the DBMC cost avoidance. I propose a middle ground alternative.

Mr. Luciani criticizes the Postal Service's DBMC mail processing cost avoidance model primarily because it makes one incorrect assumption: DBMC parcels incur no outgoing, non-Bulk Mail Center (BMC) mail processing costs. Primarily because of this flaw, he rejects the model. Although this criticism is correct, his alternative DBMC mail processing cost avoidance model is equally flawed. I propose a middle ground approach.

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pieces by shape.

[12] PSA-LR-I-1 contains a Microsoft Access 2000 data base containing the data from the Docket No. R97-1 study and the data queries I used to perform this analysis. This library reference also contains electronic versions of the SAS programs used to output the data to Microsoft Access.

Mr. Luciani's DBMC mail processing cost avoidance model uses Ms. Eggleston's bottom-up cost models to determine cost differences between DBMC and intra-BMC parcels at Origin Sectional Center Facilities (SCFs) and downstream facilities. Then, because Ms. Eggleston's models do not include Origin Associate Office (OAO) costs, he estimates costs avoided at OAOs using data from the In-Office Cost System (IOCS). In this part of his model, he assumes that DBMC parcels avoid outgoing mail processing costs at OAOs only in the LD43 (Unit Distribution - Manual), LD48 (Customer Service), and non-MODS cost pools. Tr. 25/11798-11799 (Luciani).

Mr. Luciani's model is flawed for three reasons. First, Ms. Eggleston does not believe that her bottom-up cost model is sufficient to estimate the DBMC cost avoidance at Origin SCFs and downstream facilities:

> In addition, to use the models in Attachment A [, which are the ones that Luciani used to develop his DBMC cost avoidance,] to calculate DBMC cost savings, it would be necessary to collect detailed cost information about mail processing activities at origin SCFs....Since the models in Attachment A are currently only used to estimate the cost differences between rate categories that both go through origin SCFs, the assumptions do not have a large impact on the estimated cost differences. The estimation of the cost difference between [intra-BMC] and DBMC would result in comparing a rate category that goes through the origin SCF to one that does not. Therefore, the assumptions used to estimate the costs at the origin SCF would have a large impact on the estimated cost difference. Therefore, more information would be needed to use these models to [estimate] DBMC cost savings. Tr. 13/5167-5168 (Eggleston).

Second, while Mr. Luciani indicates that he based his OAO cost avoidance model on "the response of Mr. Degen," Tr. 25/11979 (Luciani), he excluded costs for some Function 4 cost pools[13] despite Mr. Degen's statement that "Additionally, costs for some, not necessarily typical, parcel pieces may appear in other

[13] Function 4 cost pools represent operations that occur at customer service facilities. USPS-T-16 at 12, footnote [14]

Function 4 cost pools [other than LD43 and LD48]". Tr. 15/6548 (Degen). Excluding costs avoided in these other Function 4 cost pools referenced by Mr. Degen has the effect of understating the DBMC cost avoidance.

Third, Mr. Luciani performed no independent checks of whether all of the cost avoidances that aren't included in the OAO cost avoidance model are included in the bottom-up model and vice versa. Tr. 25/11978 (Luciani). This is particularly problematic since Ms. Eggleston views her model of origin SCF costs as insufficient for the role that Mr. Luciani assigned it in his DBMC cost avoidance modeling effort.

I propose a middle ground DBMC mail processing cost avoidance model that resolves Mr. Luciani's major criticism of the Postal Service's model[14] yet is not infected by the issues with Mr. Luciani's model that I've identified above. Rather than assuming that DBMC parcels incur no outgoing, non-BMC mail processing costs, this DBMC cost avoidance model simply assumes that DBMC parcels incur a smaller amount of outgoing, non-BMC mail processing costs than do non-DBMC parcels. As Table 1 shows, this assumption is clearly correct. Specifically, in FY 1998, DBMC parcels incurred 37.9 cents less mail processing costs per piece in the Base Year than did non-DBMC parcels.

Table 1. Calculation of Base Year DBMC Mail Processing Cost Difference

	Total Cost	Volume	Unit Cost
	[1]	[2]	[3]=[1]/[2]
Outgoing, Non-BMC Costs for DBMC Parcels	$9,342,929	209,712,994	$0.045
Outgoing, Non-BMC Costs for Non-DBMC Parcels	$45,090,994	106,434,805	$0.424

[1] Tr. 25/11814 (Luciani)
[2] USPS-T-26, Attachment E

[14]Another one of Mr. Luciani's criticisms -- the DBMC cost avoidance model uses basic function information from IOCS -- is unimportant. While Mr. Luciani is concerned that IOCS data collectors don't accurately record basic function, his concern is merely speculation. Tr. 25/11975 (Luciani).

Because the unit cost avoidance for DBMC parcels should be calculated with respect to intra-BMC parcels, Tr. 25/11797 (Luciani), I had to correct the outgoing, non-BMC costs for non-DBMC parcels to reflect the entry profile of intra-BMC parcels. Specifically, while non-DBMC parcels include parcels that are plant loaded to or entered at BMCs, intra-BMC parcels are not entered at BMCs. If they were entered at BMCs, they would be DBMC parcels instead. Therefore, intra-BMC parcels incur more outgoing, non-BMC mail processing costs than the average non-DBMC parcel.

To correct the non-DBMC unit cost to reflect this entry profile for intra-BMC parcels, I assumed that the unit non-BMC, outgoing cost for non-DBMC parcels entered at BMCs is the same as that for DBMC parcels.[15] As Table 2 shows, this assumption results in a 45.7-cent Base Year outgoing, non-BMC unit cost for intra-BMC parcels. Using this unit cost and the DBMC unit cost developed in Table 1, the Base Year and Test Year unit cost avoided by DBMC parcels can be calculated. As shown in Table 2, the resulting Test Year DBMC unit mail processing cost avoidance is 46.3 cents, which is approximately half way between the cost avoidances developed by Ms. Eggleston and Mr. Luciani. Tr. 25/11799 (Luciani); USPS-T-26 at 14. I believe that this cost avoidance is reasonable and should be used as the Test Year DBMC unit mail processing cost avoidance.

[15] The Postal Service's model essentially assumes that parcels deposited at any BMC avoid all outgoing, non-BMC costs. My assumption that non-DBMC parcels entered at origin BMCs incur some non-BMC, outgoing mail processing costs corrects for the same problem that my model corrects for DBMC parcels. USPS-T-26, Attachment F.

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Table 2. Calculation of Base Year and Test Year Unit Mail Processing Cost Avoidance for DBMC Parcels

		Total Cost	Volume	Unit Cost
Outgoing, Non-BMC Costs for Non-DBMC Parcels	[1]	$45,090,994	106,434,805	$0.424
Non-DBMC Parcels Entered at BMCs	[2]	$391,962	8,710,275	$0.045
Non-DBMC Parcels Not Entered at BMCs	[3]=[1]-[2]	$44,699,032	97,724,530	$0.457
Outgoing, Non-BMC Costs for Intra-BMC Parcels	[4]=[3]			$0.457
Outgoing, Non-BMC Costs for DBMC Parcels	[5]			$0.045
Base Year Unit Cost Avoided	[6=[4]-[5]			$0.412
Wage Rate Adjustment Factor	[7]			$1.124
TYAR Unit Cost Avoided	[8]=[6]x[7]			$0.463

[1] Table 1
[2] Unit Cost = DBMC Unit Cost from Table 1
Volume from USPS-T-26, Attachment F at 3
Total Cost = Volume x Unit Cost
[3] Unit Cost = Total Cost/Volume
[5] Table 1
[7] USPS-T-26, Attachment F at 2

5. The Destination Delivery Unit (DDU) cost avoidance is larger than estimated by the Postal Service, not smaller.

Mr. Luciani argues that the Postal Service-estimated DDU cost avoidance is too large. In this section, I rebut his argument and explain why the Postal Service's estimated DDU cost avoidance is actually too low.

A. Because the Postal Service's proposed nonmachinable surcharges for intra-BMC and DBMC parcels are not cost based, the DDU discount should be based on an average of the machinable and nonmachinable DDU cost avoidances.

Mr. Luciani argues that the DDU discount should be based upon only the machinable cost difference because "both intra-BMC and DBMC-entry non-machinable parcels are proposed to be assessed a cost-based surcharge." Tr. 25/11797, 11801 (Luciani). This is not the case. Mr. Plunkett is proposing to pass through only 35 percent of the nonmachinable cost difference. USPS-T-36 at **14**. Such a passthrough results in a surcharge that is closer to zero than to the actual cost difference. Therefore, this surcharge is not cost based and Mr. Luciani's argument is irrelevant.

Furthermore, while Mr. Luciani is correct that the DDU discount of 73.0 cents that Mr. Plunkett used in his preliminary rates is 5.7 cents per piece higher than the machinable cost avoidance, Tr. 25/11801 (Luciani), he fails to point out that the discount for nonmachinable DDU parcels implicit in Mr. Plunkett's preliminary rates is 60 cents less than the nonmachinable cost avoidance calculated by Ms. Eggleston. (See Table 3 below.) The fact that the discount for some subset of mail within a rate category is overstated and the discount for another subset is understated is a typical result of rate design and does not justify basing the DDU discount only on the cost avoidance for machinable parcels.[16]

Table 3. DDU Cost Avoidances and Plunkett's Effective Discounts

		Machinable	Nonmachinable
Mail Processing Cost Avoidance	[1]	$0.673	$1.780
DDU Discount Implicit in Preliminary Rates	[2]	$0.730	$1.180
Difference	[3]=[2]-[1]	$0.057	($0.600)

[1]USPS-T-26, Attachment J
[2]USPS-T-36, Attachment H. The implicit discount for nonmachinable parcels is equal to the DDU discount plus the DBMC nonmachinable surcharge.

B. Contrary to Mr. Luciani's belief, DDU parcels do avoid sack shakeout costs. This is because, as Parcel Shippers Association (PSA) witness Wittnebel (PSA-RT-2) testifies, DDU parcels are not delivered to the Postal Service in sacks. As Mr. Wittnebel further testifies, DDU parcels also avoid Postal Service unloading costs at the DDU.

Ms. Eggleston's model for estimating the DDU mail processing cost avoidance assumes that DDU parcels avoid unloading and sack shakeout costs at the DDU. USPS-T-26 at 17; USPS-T-26, Attachment A. Based upon a review of the DMM and minutes from Mailers' Technical Advisory Committee (MTAC) work group meetings, Mr. Luciani speculates that DDU parcels do incur sack shakeout costs at the delivery unit and therefore the DDU-entry cost avoidance should exclude sack shakeout costs. Mr. Luciani further argues that even if sack shakeout costs

[16] It is also worth noting that were it not for the low passthrough of the nonmachinable cost difference, the DBMC rate for machinable parcels (and therefore the DDU rate for machinable parcels) would be lower.

are avoided some of the time, "[e]xcluding only the 2.1 cents in sack shakeout costs is a reasonable way of accounting for the likelihood of Postal Service assistance in unloading and the lack of firm guidelines on DDU-entry policy in this regard." Tr. 25/11800-11801.

Based upon his operational knowledge of DDU entry procedures and his company's documentation of its entry procedures, Mr. Wittnebel testifies that DDU parcels do avoid sack shakeout and unloading costs at the delivery unit. PSA-RT-2 at 2-3. This is because mailers of DDU parcels do indeed unload their own trucks and don't deliver DDU parcels to the Postal Service in sacks.[17] Therefore, witness Ms. Eggleston's model is correct.

C. As PSA witness Zimmerman (PSA-T-1) testified, the Cost and Revenue Analysis (CRA) adjustment should be applied to the modeled Parcel Post costs used to determine the Destination Sectional Center Facility (DSCF) and DDU cost avoidances.

As stated by Mr. Zimmerman, "the Postal Service has understated the amount of cost avoidance in DSCF and DDU because USPS witness Eggleston failed to apply the normal CRA adjustment factor for Parcel Post" without a reasonable justification. Tr. 29/14144 (Zimmerman). Ms. Eggleston's statement that the CRA adjustment shouldn't be applied because the DSCF and DDU rate categories are new is simply wrong. USPS-T-26 at 11. By no means does newness of a rate category justify the rejection of an accepted method. This is particularly true in the case of the CRA adjustment because not performing the adjustment has the known impact of understating the cost avoidance. USPS-T-26 at 11; Tr. 13/5109-5110 (Eggleston). Therefore, Ms. Eggleston's mistake must be corrected. The question, therefore, is which of the two CRA adjustment factors -- Ms. Eggleston's or Mr. Luciani's -- presented in this case should be used.

[17] Mr. Luciani agrees that "if DDU entry pieces are not in sacks, there would be no cost associated with dumping sacks. " Tr. 25/11894 (Luciani).

Ms. Eggleston's factor should be used because Mr. Luciani developed his factor using inconsistent data. Specifically, Mr. Luciani included costs at DDUs and OAO costs in his weighted average modeled costs, but didn't include these same costs in the proportional CRA unit cost that he used to develop the proportional CRA adjustment. UPS-Luciani-WP-1F. As I detail in Exhibits PSA-1A and PSA-1B, including DDU and OAO costs in the proportional CRA unit cost increases Mr. Luciani's CRA factor to 1.162, which is slightly higher than Ms. Eggleston's CRA adjustment factor of 1.154. Table 4 summarizes this correction.

Table 4. Correction to Luciani's Proportional CRA Adjustment Factor

	Modeled Cost	Proportional CRA Cost	CRA Adjustment
Postal Service	0.8405	0.9698	1.154
Luciani	0.9581	0.9698	1.012
Luciani (As Corrected)	0.9581	1.1134	1.162

Source: Exhibit PSA-1A

6. Contrary to Mr. Luciani's suggestion, the Postal Service's method for distributing Alaska air costs to rate category is appropriate.

Ms. Eggleston used two methods to develop unit transportation costs by rate category and zone. To determine Test Year unit transportation costs for rate categories that existed in the Base Year (inter-BMC, intra-BMC, and DBMC), Ms. Eggleston basically rolled forward Base Year costs for these categories to the Test Year. To do this, she first allocated Base Year costs to transportation function (e.g., local, intermediate, long distance). Then, she applied a Base Year distribution key (developed from these Base Year costs by function) to Test Year costs (before final adjustments) to develop Test Year costs by transportation function. Finally, she allocated Test Year costs to rate category based upon the extent to which each rate category and zone uses each transportation function. USPS-T-26, Attachment M and N.[18]

This general approach to estimating unit transportation costs for rate categories that existed in the Base Year is appropriate because it assigns Test Year costs before adjustments have been made to reflect changes in mail mix (and therefore only reflect costs for the rate categories that existed in the Base Year) to the rate categories that existed in the Base Year.

Because the DDU and DSCF rate categories did not exist in the Base Year, Ms. Eggleston had to use a second method to model unit transportation costs for these rate categories. Specifically, because DSCF parcels only incur local transportation costs and because "all parcel post pieces travel on the same transportation from BMCs to P&DCs," she assumed that "the DSCF unit cost of transportation is equal to DBMC local unit costs." Docket No. R97-1, USPS-T-16 at 18 (Hatfield); USPS-T-26 at 27. She then modeled the unit transportation cost difference between DDU and DSCF parcels in order to determine DDU transportation costs.

Implicit in this method is the assumption that those DSCF and DDU parcels that destinate in Alaska incur the same attributable costs as DSCF and DDU parcels not delivered in Alaska. USPS-T-26 at 27-28.[19] The cost above this amount is due to the "universal service obligation" to serve Alaska and therefore Ms. Eggleston does not distribute them.

This implicit assumption is consistent with the Postal Rate Commission's principle for distributing nonpriority Alaska air costs to subclass. In Docket No. R90-1, the Postal Rate Commission first recommended that only a portion of nonpriority Alaska air costs should be distributed to subclasses, stating:

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[18] Note that in implementing this method she distributed all plant load and nonpriority Alaska air costs to the intra-BMC and inter-BMC rate categories because, by definition, these costs cannot be incurred by DBMC parcels. USPS-T-26 at 22.

[19] As discussed above, Ms. Eggleston states that she explicitly assumed that "the DSCF unit cost for transportation is equal to the DBMC local unit cost." USPS-T-26 at 27. Because the DBMC rate category is not available in Alaska, this is equivalent to the aforementioned implicit assumption. Furthermore, because the DDU cost savings is calculated relative to the DSCF transportation cost, the implicit assumption also applies for DDU parcels.

> The record supports a finding that nonpriority Alaska air costs are attributable only to the extent that they substitute for the surface costs that would be incurred if that transportation service were available. The remaining costs, which we refer to as the 'universal service obligation premium,' are institutional. Those costs are caused by the Postal Service's statutory obligation to serve the entire nation. PRC Op. R90-1, para. 3720.

Furthermore, in this same decision, the Commission indicated that the Alaska Air costs that are caused by the universal service mandate are not caused by any particular class of mail and therefore should not be allowed to distort the rates and services supplied to the entire country:

> Congress has made a determination to have universal mail service. Part of that mandate is to offer the same rates to each person in the country. Costs which are found to have been incurred solely to meet that mandate, however, are caused by the statute and not by any particular class of mail. **Those costs, moreover, should not be permitted to distort the rates and services supplied to all the country.** Costs which are not caused by parcel post should not be allocated to that subclass. Furthermore, it is neither rational nor reasonable that rates paid by Priority Mail -- which is constrained by the Private Express statutes for part of its volume -- should be affected by the necessity to fly parcel post to remote areas of Alaska.
>
> Some parcel post users argue that none of the costs from nonpriority air should be attributed to their subclass. However, those parcels are being transported to a domestic delivery address, and it is appropriate that the **usual** costs of transportation be included in the rate base (emphasis added). PRC Op. R90-1, para. 3769-3770.

On the other hand, Mr. Luciani's proposed adjustment to Ms. Eggleston's methodology clearly "distort[s] the rates and services supplied to all the country" by allocating more than the "usual" transportation costs to DDU parcels. Specifically, his adjustment doubles the unit transportation cost of all DDU parcels, not just the cost for those DDU parcels that destinate in Alaska. Tr. 25/11819 (Luciani). The fact that Mr. Luciani's method has such a significant influence on the unit transportation cost for all DDU parcels clearly conflicts with the Commission's aforementioned decision.

In addition, Mr. Luciani's adjustment amounts to double counting. Specifically, Mr. Luciani explicitly allocates a portion of Alaska air costs (above and beyond the amount distributed by Ms. Eggleston) to the DSCF and DDU rate categories. Tr. 25/11803 (Luciani). Because Ms. Eggleston already accounted for Alaska air costs in her DSCF and DDU models as discussed above, Mr. Luciani's allocation amounts to assigning Alaska air costs to the DSCF and DDU rate categories twice.

7. Just as it did in Docket No. R97-1, the Commission should pass through nearly 100 percent of the DDU cost avoidance. UPS has provided no justification for passing through less.

Mr. Luciani's proposed fifty percent passthrough of the DDU cost avoidance is inconsistent with Commission precedent and is based upon flawed logic. In this section, I first discuss Commission precedent for a 100 percent passthrough of the DDU cost avoidance. Then, I discuss the flaws in Mr. Luciani's arguments for a limited passthrough.

A. In Docket No. R97-1, the Commission passed through nearly 100 percent of the DDU cost avoidance. The Commission should do the same in this case.

In its discussion of Parcel Post rate design in its Docket No. R97-1 Decision, the Commission twice noted the importance of cost based rates.[20] First, it noted:

[20] Because 100 percent passthroughs set discounts equal to costs avoided, 100 percent passthroughs result in cost based discounts.

> Although limited passthroughs may be in order in specific cases, the Commission rejects a blanket recommendation of low passthroughs as general guidance. **Cost based rates** are important, and there has been a trend in reclassification generally and in this case to recognize cost evidence to a greater degree (emphasis added). PRC Op. R97-1, para. 5653.

Second, in its discussion of the DDU discount, the Commission stated: "The resulting cost avoidance is 72.4 cents per piece, at the level of cost attribution the Commission estimates for Parcel Post. A discount of 72 cents [nearly 100 percent of the DDU cost avoidance] per piece is recommended. The discounted category is fair, equitable, and **cost based**. It recognizes the interests of mailers and promotes worksharing (emphasis added)." PRC Op. R97-1, para. 5695.

Furthermore, a passthrough less than that recommended in Docket No. R97-1 would be inconsistent with the Commission's longstanding approach of "gradually increasing levels of passthrough as improved cost estimates become available." PRC Op. R97-1, para. 5525. While the passthrough should not be increased above 100 percent, decreasing it would certainly be inconsistent with the Commission's longstanding approach.

B. Setting the implicit markup on DDU parcels equal to the explicit markup on Priority Mail is a flawed method.

Mr. Luciani argues that the passthrough of the DDU cost avoidance should be set to ensure that the markup for DDU parcels is equal to that for Priority Mail because "there is little or no difference between the parcel handling practices for Priority Mail and for Parcel Post once the parcels arrive at the DDU." Tr. 25/11805 (Luciani). In this section, I explain why setting the implicit markup for a rate category equal to the explicit markup on a mail subclass that receives similar handling practices is a flawed concept.

First, under Mr. Luciani's method, rate anomalies would be common practice. Because Priority Mail parcels are handled with higher priority at the destination

SCF than are Parcel Post parcels, but are handled with similar priority as Parcel Post parcels at the DDU, the intrinsic value of service for DSCF parcels is lower than that for DDU parcels. For this reason, Mr. Luciani's implicit markup method would assign a lower markup to DSCF parcels than to DDU parcels. Therefore, the "implicit markup" rate for DDU parcels could easily be equal to or higher than the "implicit markup" rate for DSCF parcels despite the fact that DDU parcels are much less costly for the Postal Service to handle than DSCF parcels. This is an anomalous result and is clearly inconsistent with the important goal of developing cost based rates.

Second, Mr. Luciani's method assigns rate categories the same implicit markup as subclasses that receive similar handling practices (or similar value of service), Tr. 25/11805 (Luciani), despite the fact that explicit markups are not based solely on value of service. Specifically, explicit markups are based upon an evaluation of all of the noncost criteria identified in Section 3622(b) of the Postal Reorganization Act. Therefore, to determine the appropriate implicit markup for a rate category, one would first have to make adjustments to account for differences in other noncost criteria between the rate category and the analogous subclass before applying the subclass's markup to the rate category.

Not making such a correction would be equivalent to arguing that Standard (A) Nonprofit and Standard (A) Regular should have the same markup because they receive a similar intrinsic value of service and that Periodicals should have a higher markup than Standard (A) because Periodicals mail receive a higher intrinsic value of service than Standard (A) mail. Neither of these outcomes would be reasonable based upon an analysis of all of the noncost criteria.

C. Mr. Luciani misinterpreted the reason why Mr. Plunkett passed through only 80 percent of the DDU cost avoidance.

Mr. Luciani argues that the DDU passthrough should be no higher than 80 percent because "Mr. Plunkett has noted that he constrained DDU-entry rates to take value of service issues into account. Tr. 13/5005-06. He limited the DDU-entry passthroughs to 80% in this manner." Tr. 25/11806 (Luciani). Mr. Luciani clearly misinterpreted Mr. Plunkett's logic. Specifically, Mr. Luciani based his contention that Mr. Plunkett reduced the passthrough to 80 percent to take value of service into account solely on the following interrogatory response:

> The use of a 100 percent passthrough reflects my view that these rates ought to reflect, as nearly as is consistent with the statutory ratemaking criteria, the value of the work contributed by mailers and or consolidators performing worksharing activities. In considering the value of service of these particular rate categories, I did not consider the value of service of the worksharing passthroughs apart from the other elements used in rate design. The constraints that I imposed as the final stage in rate design [, which had the effect of reducing the passthrough to 80 percent,] were intended to capture value of service considerations, and were applied to the rates themselves, rather than the passthroughs used to develop the rates. Tr. 13/5005-5006 (Plunkett).

Although Mr. Plunkett could have been clearer in his response, Mr. Luciani's implication that Mr. Plunkett imposed constraints to capture value of service alone is simply wrong. In fact, Mr. Plunkett indicated that he didn't even "consider the value of service...apart from the other elements used in rate design." Tr. 13/5005 (Plunkett).

Furthermore, Mr. Plunkett's testimony is very clear on the reason why he imposed constraints. Specifically, he stated that he imposed constraints to mitigate rate changes: "Therefore, in the second phase of rate development, I imposed constraints in order to mitigate rate changes. Rates have been constrained such that no rate is allowed to increase by more than 10 percent. Moreover, for the newest rate categories, rate changes were restricted so that no rate could change by more than 2 percent in either direction." USPS-T-36 at 13-14.

Because I am proposing a DBMC cost avoidance that is smaller than that developed by Ms. Eggleston and used by Mr. Plunkett, mitigating rate changes is much less necessary. Therefore, Mr. Plunkett's logic would argue for passing through significantly more than 80 percent of the DDU cost avoidance should the Commission use the DBMC cost avoidance that I propose.

8. Mr. Luciani's bottom-up model of DDU costs is incorrect. Therefore, his related criticism of the Postal Service's rate design approach is irrelevant.

To assess whether the Postal Service's general rate design approach is reasonable, Mr. Luciani attempted to develop a bottom-up DDU cost estimate and then to compare this estimate with the DDU unit cost implicit in Mr. Plunkett's proposed DDU rate. Mr. Luciani apparently believes that if there is a discrepancy between the two estimates then some input into the Postal Service's rate design must be wrong. Tr. 25/11806-11807 (Luciani). While there is a discrepancy between the two estimates, the discrepancy is due to a flaw in Mr. Luciani's model.

The discrepancy identified by Mr. Luciani is that his bottom-up cost model produces a cost estimate of $1.14 while he derives a DDU cost of 96 cents from Mr. Plunkett's rate design. Tr. 25/11806 (Luciani). As I discuss in testimony filed under seal, because it discusses evidence filed under seal, the discrepancy vanishes once Mr. Luciani's model is corrected to reflect a mistake he made in estimating rural carrier costs for DDU parcels.

Once this mistake in Mr. Luciani's model is corrected, the model produces a unit cost for a DDU parcel of approximately **97** cents, **which is about the same as** the unit cost Mr. Luciani derived from Mr. Plunkett's analysis. **PSA-RT-3.**

Exhibit PSA-1A Development of Consistent CRA Adjustment Factor

(Revised Version of UPS-Luciani-WP-1F)

All Figures are in Test Year Dollars

			Inter-BMC		Intra-BMC		DBMC		TOTAL	CRA	CRA Multiplier
			Machinable	NMO	Machinable	NMO	Machinable	NMO			
	Postal Service As Filed										
[1]	Model Weight		12.0%	1.6%	7.0%	0.6%	74.7%	4.0%	100.0%		
[2]	Model Cost	$/piece	1.2058	2.7572	0.9218	1.9385	0.6731	1.7799			
	Wtd Modeled Cost	$/piece	0.1450	0.0446	0.0646	0.0118	0.5030	0.0715	0.8405	0.9698	1.154
	Cost with DDU Sort + Origin AO (Luciani's Estimate)										
	Model Weight		12.0%	1.6%	7.0%	0.6%	74.7%	4.0%	100.0%		
	Model Cost	$/piece	1.2058	2.7572	0.9218	1.9385	0.6731	1.7799			
[3]	DDU Sort	$/piece	0.0945	0.0945	0.0945	0.0945	0.0945	0.0945			
[4]	AO Cost	$/piece	0.1090	0.1090	0.1090	0.1090					
	Model Cost + DDU Sort + AO	$/piece	1.4093	2.9607	1.1253	2.1420	0.7676	1.8744			
	Wtd Modeled Cost	$/piece	0.1694	0.0479	0.0788	0.0130	0.5736	0.0753	0.9581	0.9698	1.012
	Cost with DDU Sort + Origin AO and Consistent CRA Costs (Corrected Version of Luciani's Estimate)										
	Model Weight		12.0%	1.6%	7.0%	0.6%	74.7%	4.0%	100.0%		
	Model Cost	$/piece	1.2058	2.7572	0.9218	1.9385	0.6731	1.7799			
[3]	DDU Sort	$/piece	0.0945	0.0945	0.0945	0.0945	0.0945	0.0945			
[4]	AO Cost	$/piece	0.1090	0.1090	0.1090	0.1090					
	Model Cost + DDU Sort + AO	$/piece	1.4093	2.9607	1.1253	2.1420	0.7676	1.8744			
	Wtd Modeled Cost	$/piece	0.1694	0.0479	0.0788	0.0130	0.5736	0.0753	0.9581	1.1134	1.162

Notes:

[1] USPS Witness Eggleston (USPS-T-26), Attachment A
[2] USPS Witness Eggleston (USPS-T-26), Attachment A
[3] The cost of the manual DDU sort is assumed to be the same cost as the manual sort at the DSCF. See USPS Witness Eggleston (USPS-T-26), Attachment A.
[4] Exhibit UPS-T-5F.
See LR-I-103 for outgoing MODS pool costs.
See UPS-Sellick-WP-3 for outgoing non-MODS pool costs.

Exhibit PSA-1B Parcel Post Mail Processing CRA Cost Pools

(USPS-T-26, Attachment A at 2 revised to develop CRA adjustment factor using Mr. Luciani's weighted average modeled cost)

From USPS LR-I-81

Cost Pools		Total (Cents)	Proportional (Cents)	Fixed (Cents)
MODS 11	BCS/	0.004		0.004
MODS 11	OCR/	0.007		0.007
MODS 12	FSM/	0.565		0.565
MODS 12	LSM/	0.000		0.000
MODS 13	MECPARC	0.328	0.328	
MODS 13	SPBS OTH	1.618		1.618
MODS 13	SPBSPRIO	0.347		0.347
MODS 13	1SACKS_M	0.916		0.916
MODS 14	MANF	0.138		0.138
MODS 14	MANL	0.254		0.254
MODS 14	MANP	2.398	2.398	
MODS 14	PRIORITY	0.303		0.303
MODS 15	LD15	0.000		0.000
MODS 17	1BULK PR	0.036		0.036
MODS 17	1CANCMPP	0.240		0.240
MODS 17	1OPBULK	1.357		1.357
MODS 17	1OPPREF	2.595		2.595
MODS 17	1PLATFRM	10.853	10.853	
MODS 17	1POUCHNG	2.059		2.059
MODS 17	1SACKS_H	1.938		1.938
MODS 17	1SCAN	0.169		0.169
MODS 18	BUSREPLY	0.245		0.245
MODS 18	EXPRESS	0.011		0.011
MODS 18	MAILGRAM	0.000		
MODS 18	REGISTRY	0.278		0.278
MODS 18	REWRAP	0.231		0.231
MODS 18	1EEQMT	0.178		0.178
MODS 19	INTL	0.841		0.841
MODS 41	LD41	0.011		0.011
MODS 42	LD42	0.000		0.000
MODS 43	LD43	5.411	5.411	
MODS 44	LD44	0.335		0.335
MODS 48	LD48 EXP	0.000	0.000	
MODS 48	LD48_SSV	0.203	0.203	
MODS 49	LD49	0.146		0.146
MODS 79	LD79	0.218	0.218	
MODS 99	1SUPP_F1	0.439		0.439
MODS 99	1SUPP_F4	1.068		1.068
Mods Subtotal		**35.741**	**19.411**	**16.330**
BMCS	NMO	6.682	6.682	
BMCS	OTHR	25.058	25.058	
BMCS	PLA	26.864	26.864	
BMCS	PSM	9.370	9.370	
BMCS	SPB	3.628	3.628	
BMCS	SSM	3.452	3.452	
BMC Subtotal		**75.052**	**75.052**	**0.000**
NON MODS	ALLIED	6.822	6.822	
NON MODS	AUTO/MEC	0.119	0.119	
NON MODS	EXPRESS	0.000	0.000	
NON MODS	MANF	0.199	0.199	
NON MODS	MANL	0.401	0.401	
NON MODS	MANP	8.131	8.131	
NON MODS	MISC	1.179	1.179	
NON MODS	REGISTRY	0.028	0.028	
Non Mods Subtotal		**16.877**	**16.877**	**0.000**
Total		**127.670**	**111.340**	**16.330**

CHAIRMAN GLEIMAN: What I would like -- well, I'm not sure what you have in your hand. Maybe we're going to --

MR. MAY: It's sealed.

CHAIRMAN GLEIMAN: Let's move the sealed, and this testimony will go into a separate transcript volume which will also be under seal.

BY MR. MAY:

Q Mr. Glick, I have a document captioned Rebuttal Testimony of Sander A. Glick on Behalf of Parcel Shippers Association, PSA-RT-3, to be filed under seal.

I'm going to ask that you examine this to see if this is the testimony you have prepared.

[Pause.]

A It is.

MR. MAY: Mr. Chairman, I'm handing the contents of this envelope which is labeled to be filed under seal and protected condition, to the Reporter, and ask that it be separately transcribed in the separate volume that contains materials under seal, and that it be received into evidence.

CHAIRMAN GLEIMAN: PSA-RT-3 will be transcribed into a separate volume and received into evidence, and that volume is to be a sealed volume.

[Written Rebuttal Testimony of Sander A. Glick, PSA-RT-3 was

received into evidence and
transcribed into a sealed volume.]

THE EXHIBITS ARE UNDER PROTECTIVE SEAL
AND MUST BE OBTAINED THROUGH THE COMMISSION
(PAGES 18340-18344)

CHAIRMAN GLEIMAN: Thank you, Mr. May, for your help on that one.

This brings us to oral cross examination. Two parties have requested oral examination with respect to testimony PSA-RT-1, United Parcel Service and the United States Postal Service.

Is there any other party that wishes to cross examine on this testimony?

[No response.]

CHAIRMAN GLEIMAN: If not, Mr. McKeever, you may begin.

MR. McKEEVER: Thank you, Mr. Chairman.

CROSS EXAMINATION

BY MR. McKEEVER:

Q Hello, Mr. Glick.

A Hello.

Q Mr. Glick, am I correct that Postal Quarters 1 and 2 include the Christmas season?

A Yes.

Q And those are the two quarters in Fiscal Year 1999 when the new permit imprint Parcel Post trial balance revenue account was not yet in effect; is that correct?

A That's true.

Q Mr. Glick, could you turn to page 5 of your testimony, please?

A Yes.

Q And, in particular, I'd like to direct your attention to Footnote 4.

A Yes?

Q There you state that since Standard A rates for parcels weighing less than one pound are uniformly lower than the lowest Parcel Post rate, there is a disincentive to mail Standard A parcels at Parcel Post rates; do you see that?

A Yes.

Q Now, you use the present tense in that sentence.

A Right.

Q Am I correct that back in 1998, there were a number of Standard A single-piece rates that were higher than Parcel Post rates?

A There were a small number of single-piece rates which were higher than a small number of Parcel Post rates.

MR. McKEEVER: Mr. Chairman, if I may, I would like to present the witness with a copy of pages from the Issue 53 of the Domestic Mail Manual, dated January 1, 1998, which contains the Standard A mail single-piece rates, as well as the inter-BMC and intra-BMC Parcel Post rates that were in effect at that time.

CHAIRMAN GLEIMAN: Most certainly.

BY MR. McKEEVER:

Q Now, am I correct, Mr. Glick, that beginning at nine ounces and up to 16 ounces, the Standard A single-piece rates were higher than the two-pound parcel post rate for intra-BMC local and intra-BMC zone 1 and 2 shipments?

Do you want me to do that again?

A I would appreciate it.

Q Okay. What I'm asking you to compare is the intra-BMC, parcel post intra-BMC local rate as well as the parcel post intra-BMC zone 1 and 2 rate.

A So the 224 and the 231 you're referring to.

Q Yes. Exactly.

A Uh-huh.

Q They are lower than the standard mail A single-piece rates beginning at nine ounces and above; is that correct?

A Yes, I would agree with that.

Q Okay. And then take a look at the two-pound parcel post rate. That's -- the two-pound rate is the lowest parcel post rate; is that correct? Two pounds is where the parcel post rates begin, right? There's no one-pound rate?

A There are many two-pound rates, but what you're saying, are two-pound rates lower than three-pound and higher rates, yes.

Q Okay. But there is no parcel post rate lower than the two-pound rate; is that correct?

A Within a particular rate category and zone, the two-pound rate is the lowest rate.

Q Right. Thank you.

A Okay.

Q That's what I was getting at.

A Okay.

Q I appreciate it.

Now, the parcel post rates for intra-BMC shipments to zone 3 or zone 4 were lower than the Standard A single-piece rate beginning at ten ounces and above; is that correct?

A Can you give that back to me one more time.

Q Sure. Sure.

I'm asking you to compare the intra-BMC two-pound parcel post rates for zone 3 and the intra-BMC two-pound parcel post rate for zone 4 with the Standard A single-piece rate beginning at ten ounces.

A If I'm reading this right, I think that beginning at eleven ounces, that that's true.

Q For zone 3 and 4 intra-BMC shipments?

A Okay. I'm sorry. You're at intra-BMC.

Q Yes.

A I would note that since there are 21 BMCs around the country, that only about one-twenty-first of parcel post probably would be intra-BMC.

Q Well, can you tell me, am I correct that the -- you say 21 percent of parcel post is intra-BMC?

A No. I'm sorry. Let me rephrase that. I said that there are 21 BMCs around the country.

Q Right.

A And so just assuming that single pieces are randomly distributed around the country, that there's only about a 5 percent chance that a single piece would actually be able to qualify for intra-BMC rates.

Q Do you think that parcels are randomly distributed across the country?

A I think it's a better assumption than to -- knowing nothing better, I think it's probably a pretty good assumption. Maybe it's 10 percent, maybe it's 20 percent, but it's certainly not a large percentage.

Q Okay. Am I correct, though, that beginning at ten ounces, the single-piece Standard A rate back in 1998 was higher than the two-pound intra-BMC parcel post rates for zone 3 and zone 4 shipments?

A Yes, I would agree with that.

Q And I only have one or two more.

A Okay.

Q Let's take a look at the -- compare the two-pound intra-BMC parcel post rates for all zones to the Standard A single-piece rate beginning at eleven ounces. Now, that's parcel post intra-BMC, all zones, as compared to the Standard A single-piece rate beginning at eleven ounces and rates for higher ounces for Standard A. Which are higher, which are lower?

A The parcel post rates are lower than -- the intra-BMC parcel post rates are lower than the parcel post -- than the single-piece Standard A.

Q And some of those differences are fairly substantial, aren't they?

Well, let's take an example, then. In the case let's say of a 13-ounce parcel, the Standard A single-piece rate was $2.95 back in 1998, correct?

A Yes.

Q Whereas the intra-BMC parcel post rates for a two-pound parcel ranged from $2.24, about 71 cents lower, to $2.63; is that correct?

A I would agree for those that would qualify for intra-BMC rates, yes.

Q And now could I ask you to just turn to the rate chart for inter-BMC parcel post, please.

A Yes.

Q Am I correct that inter-BMC parcel post rates for two-pound parcels were also lower than the Standard A single-piece rates in effect in 1998 for parcels weighing over 11 ounces going to zones 1 and 2 through zone 4? And I'll be happy to go through that again.

A I think I got you this time.

Q Okay.

A I think what you're saying is are the inter-BMC for zone 1 through 4, are those lower than the eleven-ounce and the 13-ounce single-piece rates.

Q Correct.

A I would agree with that.

Q Okay. And that situation continued into postal quarters 1 and part of postal quarter 2 in Fiscal Year 1999; is that correct?

A Yes.

Q Mr. Glick, could you turn to page 6 of your testimony, please?

A Yes, I'm with you.

Q There you refer to library reference I-279 near the bottom of the page. Do you see that?

A Yes, I do.

Q Am I correct that the review reported on -- do you have a copy of that with you?

A I don't have the entire report with me. I've got the executive summary with me.

MR. McKEEVER: Mr. Chairman, I do have a copy of the full report and with your permission, I would like to present a copy of that to the witness.

CHAIRMAN GLEIMAN: Most certainly.

THE WITNESS: Thank you.

BY MR. McKEEVER:

Q Now, am I correct, Mr. Glick, that the review or study reported on in that document focused principally on whether data on postage statements was properly recorded in the PERMIT system?

A I would agree that that's one of the things that were looked at. If you want to point me to a specific point --

Q Sure. Well, look at the bottom of page 1.

A Uh-huh.

Q It says, at management's request, our review focused principally on recording and summarizing activities for postal statements -- do you see that?

A Yes.

Q -- through the non-countable system. Do you see that?

A Right.

Q Okay. The report did not have as its primary object determining whether the information on the postage statements themselves were accurate to begin with; is that correct? And I would refer you again --

A Okay.

Q -- to the bottom of 1, top of 2, where the report indicates that while they focused principally on recording and summary activities -- summarizing activities, the study team did note several matters related to processes in place before mailing statements are entered into the postal systems.

A Okay. Can you go back to --

Q Sure.

A -- what the question was?

Q Sure. While the report contains several observations on processes that take place before a mailing statement is entered into the postal data system, that was not the main purpose of the study; is that correct? If you know.

A I would agree with you -- with what it says, that the review focused principally on recording and summarizing activities for postal statements through the non-countable sub-systems.

Q Okay. The report does note, though, on the bottom of page 1 and the top of page 2 that there were several problems related primarily to processes in place before mailing statements are entered into postal systems that were discovered; is that correct?

A It certainly noted things that they wanted to -- that I think a typical audit report probably would have noted.

Q Okay.

A I don't think that by any stretch the issues would condemn the system. I think that they would have noted it much more strongly if they believed that was the case.

Q Well, they didn't study that part principally; is that correct? They just were noting in passing that they found certain items that they did happen to observe? Or don't you know?

A I know what the report says. I wasn't at the audit.

Q Okay. Those problems, though, did include system overrides not being reviewed; is that correct?

A I do believe that's the case, but if you want to point me to it, I could --

Q Well, page 2 is one place.

A Yes.

Q What is a system override, do you know?

A My assumption is that -- I believe that a system override is when the postage statement is overridden, but I certainly don't know that one for sure off the top of my head.

Q Okay. Am I correct that the study also notes that there was -- and you can look at page 24 for this --improper verification of bulk mail?

A I would say that they found instances of that, yes.

Q Now, could you turn to page 11 of the study, please?

A Yes.

Q There the study notes that 286 -- and I'm looking really both at the top, the very first sentence, and at the sentence after the heading "Transactions Selected for PERMIT System."

A Okay.

Q The study notes that 286 transactions were selected from PERMIT system data extracts received from the Postal Service; is that correct?

A Are you referring to the first sentence on the page?

Q That, plus the first sentence under the heading. The first sentence gives you the 286 transactions.

A Right. I saw that one.

Q And the sentence under the heading, a little bit below the middle of the page, transactions selected from PERMIT system, that first sentence says using the PERMIT raw data extracts received from USPS. Do you see that?

A Yes.

Q Now, taking -- am I correct that from those 286 that were selected, 236 transactions were instances --

postage statements could be found only for 236 of those 286 transactions; is that correct?

A You're referring to the sentence that says, specifically we selected 236 transactions from PERMIT raw data for PQ Number 2 and verified that the sample items were properly supported by postage statements?

Q Well, that's the 286 number that were selected.

A I'm sorry. That is the 236 number.

Q Where are you looking?

A I'm sorry. I'm looking in the middle of the paragraph where it says, specifically, we selected 236 transactions from PERMIT raw data for PQ Number 2.

Q What page are you on?

A I'm on the same page that you referred me to, page 11.

Q Okay. Okay. You're right, I apologize.

So of the 286, 236 were selected from the PERMIT raw data. Okay. What I meant to ask, and I apologize, was that of the 236, postage statements were located in the case of 219 of those transactions; is that correct?

You might want to take a look at page 16.

[Pause.]

Do you want me to ask that question again?

A Yes, that would be great.

Q Okay. Okay. Page 16 indicates that 236 transactions were sampled from the PERMIT system, but that only 219 could be tested; is that correct?

A I would say the 219 it appears were tested.

Q Exactly. That's what --

A I'm not sure that I would agree that only 219 could have been tested. I don't know the extent to which they tried to. But I certainly would agree that 219 it appears were tested.

Q Well, the chart indicates that in the case of four transactions, the team did not receive any postage statements. It says non-responding confirmation request. And 13 required follow-up, and it was determined in consultation with postal management that further pursuit was not considered necessary.

Do you see that?

A I would agree.

Q Okay.

A I'm just saying that I don't know the reasoning behind why those four were not followed on, and --

Q Or why the --

A I'm saying -- I'm just objecting to the term "could."

Q Okay.

A I would agree with you that 219 were tested.

Q Okay. All right.

Now, am I correct, looking at page -- it's page 14. It doesn't bear a page number, but it's entitled Exhibit C and it's between pages 13 and 15. Do you see that?

A I do see that.

Q Now, of the 236 that were selected, only ten of those were for parcel post transactions; is that correct?

A I would agree with that. If I'm interpreting this table right, I would agree with that.

Q Okay. That's ten out of the 236 that were selected, correct?

A That's true, yes.

Q But of the 219 that were actually tested, we don't know how many of those were parcel post, do we? That's not revealed in the report, is it?

A I don't know the answer to that.

Q Okay. So at most, there were ten, and there could have been less.

A That appears to be the case, yes.

Q If you could take a look at page 11 again? Am I correct that the study originally was to focus on the six types of mail that comprise the bulk of the total revenue for the Postal quarter involved for RPW?

[Pause.]

A Can you repeat that question again?

Q Yes.

Originally the study was to focus on the six types of mail, the six RPW line items that comprised the bulk of total revenue for the Postal quarter involved; is that correct?

A I mean, if you're referring me to the bottom paragraph, I would say that they noted that six of the line items comprise 82 percent of the total revenue for PQ Number 2.

I would agree with that. I don't see an explanation there that says that that's the case, but it could be that that was the case.

Q Okay.

The Postal quarter involved was Postal Quarter 2 of Fiscal Year 1997; is that right?

A It appears that way.

Q Now, if you turn to page 12, the first full paragraph after what I'll call a chart at the beginning, the report notes that Postal Management had concerns that other classes of mail that are utilized less frequently than the six line items -- that's in the first sentence.

They were -- Postal Management was concerned that in those cases, bulk mail technicians or users of PERMIT may not be as familiar with the proper classification of mail for these less frequently utilized mail classes; is that correct?

A I would agree that it says that the USPS management did have concerns; I wouldn't say that the result of the audit was that those concerns were fleshed out and viewed as problematic.

Q Well, did the study test whether bulk mail technicians were properly identifying classifications of mail? It didn't deal with that; did it?

[Pause.]

Or do you know?

A I don't know.

Q Okay.

Am I correct that Parcel Post is not among one of the six line items listed on page 12, but rather is among the classes of mail that are, quote, "utilized less frequently," unquote?

A I would agree with that.

Q And Priority Mail also is not among the six, but rather is among the, quote, "less frequently utilized," unquote, classes; is that correct?

A Using the terminology from the report, yes.

Q Okay, back in 1998, Parcel Post and Priority Mail were both covered by the same postage statement form; isn't that correct?

A That's true in '98, yes.

Q Am I correct that Parcel Post rates are always lower than Priority Mail rates?

A I don't know if I'm comfortable with that.

Q Well, we can tell from rate charts.

A Yes.

Q You don't know?

A Well, I think that -- my assumption is that that's true.

Q Okay.

A I haven't looked at that.

Q Now, getting back to Library Reference 279, in addition to the 236 postage statements that were sampled, of which 219 were tested, the study also looked at 50 postage statements selected from five facilities in the Washington Metropolitan Area; is that correct?

And that's on pages 11 or 15.

A I see that 50 postage statements from five Postal facilities to verify that they were properly included in the PERMIT raw data files for PQ No. 2, and second sample -- I apologize.

So you are saying this second sample consisted of judgmental selecting without conscious bias, postage statements from bulk mail facilities in the Washington Metropolitan Area to verify that they were properly included in the PERMIT raw data extracts for PQ No. 2; that's what you're referring to?

Q Right.

A Fifty.

Q Yes, and if you look at page 15, I think you'll see that the 50 postage statements were taken from five facilities. It's about in the middle of the first paragraph on that page.

A Right, and that's consistent with what was said on 11.

Q Okay.

We don't know if any of those are Parcel Post transactions; do we?

A I do no know.

Q Okay.

Could you take a look at page 18, please?

A Yes.

Q There the report indicates with respect to those 50 transactions, no exceptions were noted except that one sample transaction had incorrect supporting documentation attached. As a result, while we tied in the transaction in total, we did not agree with the revenue pieces and weight for the transaction on a detailed basis. Do you see that?

A I do.

Q Now, that particular part of this study dealt with postage statements from five facilities, is that correct?

We just established that a minute ago.

A That appears to be the case, yes.

Q And on page 7 of your testimony, you note that the audit, a different report, the audit that Mr. Sellick referred to in his testimony involved three sites, is that correct?

A Yes.

Q Mr. Glick, do you know if mailers always use the current approved Postal Service forms when they tender mail to the Postal Service?

A I certainly know in the case of Library Reference 176 there was an indication that they did not always use the most up-to-date ones.

Q In fact, some of those forms are dated as early as February 1991, is that correct?

A That's possible.

MR. McKEEVER: Mr. Chairman, I would like to show Mr. Glick a copy of a number of forms from the Library Reference was produced by the Postal Service and is under seal. I do not, as I mentioned earlier today, intend to ask that these be transcribed into the record or to distribute them, other than to Mr. Glick and his counsel, and Postal Service counsel, if they want to see them. I really am just going to ask Mr. Glick to verify the date of the form, the proper Postal Service date, that is all.

CHAIRMAN GLEIMAN: I am sure that the Postal Service will let us know if they have concerns about crossing the line.

[Pause.]

BY MR. McKEEVER:

Q Mr. Glick, I have just handed you nine forms. Could you just confirm for me that by looking at the lower lefthand corner, the very last line in the lower lefthand corner, where it bears the Form 8125 designation and the date of the version of the form, that in every one of those cases, the form is either the March 1992 or the February 1991 version?

A I want to check it over a couple of times.

Q Sure. Take your time.

A There was one that I couldn't -- that the date, I couldn't find on it because of some photocopying potentially. Yeah, I would note that those nine out of about 550 forms are indicating '91 or '92.

Q Well, you say nine out of 550, have you reviewed all the others to see whether they are March '92 or February 1991 forms, or 1996 forms?

A I have reviewed all the forms. I did not look at them in this case. What I am saying is that these nine represent less than 2 percent of all the forms in there. It is possible that there are more in there.

Q Okay. So it is not your testimony that these are the only ones where outdated forms were used which -- excuse me. It is not your testimony that these are only forms that bear March 1992 or February 1991 dates, is that correct?

A It is simply my testimony that these are the only ones that you gave me.

Q Right. Okay.

A And those make up less than 2 percent of all the forms.

Q Right. But we don't know, at least based on those forms, whether there is more in that Library Reference that bear a date of March 1992 or February 1991?

A I certainly don't know.

Q Okay. Can you confirm for me that in the case of each one of those forms, the mail was tendered either in 1998 or 1999? And there you want to look at the stamp put on there by the Postal Service, the round stamp, as they call it.

A On the ones that I can make out a date, yes.

Q Well, how many can you make out a date on and how many can't you?

A Okay. Six I can make out a date on.

MR. McKEEVER: Okay. Mr. Chairman, that is all I have on those forms, so I will retrieve them from the witness.

BY MR. McKEEVER:

Q Mr. Glick, it is not unusual for mailers to present Standard A mail and Standard B mail to the Postal Service at the same time, is it? And I am not talking about rates they pay. But it is not unusual for mailers to present Standard A mail and Standard B mail to the Postal Service at the same time, is that correct?

A How do you define unusual?

Q It happens, it is not a rare occurrence. You don't know?

A Well, what I do know is that there are some mailers who only mail Standard A parcels. There are some mailers that only mail Standard B parcels, and some mailers who do both.

Q Okay.

A And I don't know the frequency with which people -- which mailers who mail both enter them together.

MR. McKEEVER: Mr. Chairman, I would, with your permission, like to present Mr. Glick with some additional forms from the sealed Library Reference that I will again show to his counsel and to the Postal Service first, and I just intend to ask him the dates of those forms, when the mail was presented and whether they cover, on each form, both Standard A and Standard B mail.

CHAIRMAN GLEIMAN: Certainly.

[Pause.]

BY MR. McKEEVER:

Q Mr. Glick, if I counted right, I believe there are 19 forms there. Could you check me on that?

A I'd love to.

[Pause.]

Yes, there appear to be 19 out of the 550 forms that were in that Library Reference.

Q Okay.

Am I correct that in the case of each one of those forms, the form indicates that the mail was presented to the Postal Service from the Postal Service round stamp now, either in 1998 or 1999?

A On the ones that I could make out a date, I assume you want me to tell you how many I can make out a date on?

Q Well, you see, I picked ones where I thought the date was pretty clear. I didn't put in the pack, ones where I wasn't sure -- where I thought I knew what the date was, but wasn't sure, so, yes, I would like you to confirm.

A Okay.

[Pause.]

I couldn't make out the year on three of them.

Q Is that the top three that you put on the pack there?

A Yes, they are, unless there's a place other than the date stamp that I could find that.

[Pause.]

I can make out the month and date.

[Pause.]

Q On that first handwritten one, do you see a date of arrival written in in the lower left-hand corner?

A Yes.

Q And what date is that?

A That is '98.

[Pause.]

Q On the third one, there are two round stamps.

A Yes.

Q There's one in the lower left-hand corner.

A Yes, on the second, the one on the lower?

Q Yes.

A It's almost certainly '98, but -- yes, it's '98.

Q Thank you.

Now, am I correct that in the case of every one of those forms, the Standard A block and the Standard B block is checked in the case of each form?

A I can't tell if they were just trying to scribble a loop on it, but it probably does have both marked.

And then -- but the others appear to be both Standard A and Standard B.

Q I only have two more like this; please bear with me.

A That's fine.

Q Am I correct that on a number of these forms, Zone Rates is also checked?

A I shouldn't have put it out there.

[Pause.]

I'm sorry, what was the precise question?

Q There was a block for Zone Rates, and since the forms are different years, it does appear in different places on different forms.

A Right.

Q But am I correct that in a good number of those forms, Zone Rates is checked? It's for most of them, in fact.

[Pause.]

A Most of them, but not all of them.

Q Okay, one last question. You only have to page through that pack one more time.

A Okay.

Q Am I correct that on all of them, the postage payment method indicated is permit imprint?

Again, it may appear in different places on different forms because they are different versions of the form.

[Pause.]

A I'm sorry, I haven't looked at these for a couple of weeks. Could you give me a little more guidance on where it is on the form?

Q Sure.

MR. McKEEVER: Mr. Chairman, may I approach the witness?

CHAIRMAN GLEIMAN: Most certainly, if it will move things along.

THE WITNESS: That's okay. Okay, I see it, and I can go from there.

It's pretty close to the same place each time.

BY MR. McKEEVER:

Q It is, but it's different.

A Yes, one thing I would note is that starting with January '99, that I know the Parcel Direct and I know that CTC had definitely had procedures, whether manual or automated, to make sure that the two mailings were separated, and they do separate them.

Yes, they're permit.

MR. McKEEVER: Okay, Mr. Chairman, I will now retrieve those forms since they are filed under seal.

Q Just one more form to look at, Mr. Glick, and this is one not under seal.

A Okay.

Q Do you have with you Postage Statement Form 3605R?

That was the form --

A That's the '98 one?

Q That is the '98 one. Correct.

A Yes, I do have that.

Q Okay. And that covers Parcel Post, is that correct, that form?

A It covered Parcel Post before January '99, yes.

Q Yes. Now, let me refer you to page 7 of your testimony, and in particular, lines 26 to 28. There you state that the Postage Statement Forms 3605R and 3605PR -- 3605PR is the 1999 one, right?

A Starting in January '99, yes.

Q And 3605R is the 1998 one I think we just agreed, right?

A I think we did agree to that.

Q Okay. There you state that the Postage Statement Forms 3605R and 3605PR for permit imprint Parcel Post mail do not include either letters of automation flats as possible mail types, do you see that?

A Yes, I do. And I think that you are going to ask me now does 3605R show letters, and I would have to say you are right, that one does show letters.

Q As a matter of fact, it shows a series of processing categories, letters, flats, et cetera, is that correct?

A Yes, it does.
Q Could I ask you --
A I would just note that in that same box it does have automation flats, it just has flats.
Q It just has flats, okay. But it does have letters and it does have flats?
A It has letters, it has flats. It does not have automation flats.
Q Okay.
A Whereas the new one does not have letters.
Q Could you turn to page 11 of your testimony, please?
A Yes.
Q At the very end of your footnote 10, you indicate that the CRA distributes route time to subclass based upon weight, do you see that?
A I apologize.
Q Take your time.
A I am on the wrong page. That is my understanding from Witness Daniel's response.
Q Are you aware that Mr. Baron has stated in his rebuttal testimony that the volume variability of routine loops and dismounts should be changed to zero percent and that Postal Service Witness Kay has instituted that change in her rebuttal testimony?

A I am aware that there was discussion of the subject. I don't know the details of it.

Q Okay. Now, the citation you provide in support of your statement that the CRA distributes route time to subclass based upon weight consists of Ms. Daniel's testimony and also Library Reference 1 at page 7-4, is that correct?

A Yes, I traced down where Daniel was referring to.

Q So your reference to Daniel is really meant to take you to that Library Reference I-1 at page 7-4?

A Yes.

Q Okay. And that Library Reference states on that page that volume variable routine looping dismount costs are distributed to classes and subclasses of mail on the basis of the estimate weight of mail carried on routine loops dismounts, is that correct?

A I don't have it in front of me right now, but that sounds right.

MR. McKEEVER: That's all I have, Mr. Chairman.

CHAIRMAN GLEIMAN: Mr. Reiter, how much cross do you think you have?

MR. REITER: Zero.

CHAIRMAN GLEIMAN: Well, in that case, I think we will just continue on with this witness. Are there any follow-up questions?

[No response.]

CHAIRMAN GLEIMAN: Questions from the bench?

[No response.]

CHAIRMAN GLEIMAN: Mr. May, would you like some time to prepare for redirect?

MR. MAY: Just a couple of minutes would be fine.

CHAIRMAN GLEIMAN: Certainly. Why don't we give you 10 and take our mid-morning break now.

[Recess.]

CHAIRMAN GLEIMAN: Mr. May?

MR. MAY: Mr. Chairman, there will be no redirect.

CHAIRMAN GLEIMAN: That being the case, Mr. Glick, we appreciate your appearance, your contributions to the record, and you are excused. Thank you.

[Witness Glick excused.]

CHAIRMAN GLEIMAN: Mr. Olson, I believe that you have the next witness. We may have to wait a minute. Apparently, the Postal Service counsel who is responsible for this particular area has not yet found his or her way back. I guess it's a his way back. The her part of the team is holding up her end, as it were.

MR. OLSON: We feel confident in the existing Postal Service counsel.

CHAIRMAN GLEIMAN: Well, we don't want to be accused of proceeding without the appropriate counsel in place, and wind up in some motion practice later on as a consequence.

So we'll just -- I think we're ready now. Would you introduce your witness?

MR. OLSON: Yes, Mr. Chairman, William Olson representing Amazon.com, Inc., and we would call to the stand, John L. Clark.

Whereupon,

JOHN L. CLARK,

a witness, having been called for examination, and, having been first duly sworn, was examined and testified as follows:

DIRECT EXAMINATION

BY MR. OLSON:

Q Mr. Clark, I'd like to hand you two copies of what is entitled the Rebuttal Testimony of John L. Clark on Behalf of Amazon.com, Inc., identified as AMZ-RT-2, and ask you if you could review these for us, and whether they were prepared by you or under your direction, and whether you adopt them as your testimony in this docket?

[Pause.]

A Yes, I adopt it that.

Q And just to clarify, Mr. Clark, insofar as you previously have been here as a witness for CTC, I want to clarify that today you are here on behalf of Amazon.com, not as their employee or agent, but rather because of your shared interest in the product of Standard B DDU entered mail, correct?

A That's correct.

MR. OLSON: Mr. Chairman, with that, we would move the admission of this testimony.

CHAIRMAN GLEIMAN: Is there objection?

[No response.]

CHAIRMAN GLEIMAN: Hearing none, if counsel would provide copies of the testimony of Witness Clark to the Reporter, I will direct that the testimony be transcribed into the record and received into evidence.

[Written Rebuttal Testimony of John L. Clark, AMZ-RT-2, was received into evidence and transcribed into the record.]

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.

William J. Olson
John S. Miles
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August 14, 2000

CONTENTS

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

[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.

CHAIRMAN GLEIMAN: One party has requested oral cross examination, United Parcel Service.

Is there anyone else who wishes to cross examine this witness?

[No response.]

CHAIRMAN GLEIMAN: If not, Mr. McKeever, you may begin when you are ready.

MR. McKEEVER: Thank you, Mr. Chairman.

CROSS EXAMINATION

BY MR. McKEEVER:

Q Mr. Clark, good to see you again.

A Good morning.

Q Could you turn to page 3 of your testimony, please?

A Okay.

Q There at lines 3 to 7, you indicate that the rate increases for Parcel Post recommended by Dr. Sappington and Mr. Luciani would have, and I'm quoting here, "a devastating long-range effect upon the survival of the Postal Service;" do you see that?

A Yes, I do.

Q Are you aware, Mr. Clark, that according to the 1999 Cost and Revenue Analysis Report issued by the Postal Service, Parcel Post constitutes about two-tenths of one percent of total Postal Service volume?

A I haven't see that statistic, but I don't doubt that it's correct.

Q And Parcel Post accounts for about one and one-half percent of total Postal Service revenue; does that sound right to you?

A Yes, it does, but as I go on to point out, I think this is a very significant growing market, and as a result of that, it's very important for the Postal Service to be able to participate and compete effectively in that market, especially in light of conditions in general that are causing an erosion of First Class Mail and other areas.

And it's not an untypical business solution to be able to hold your markets where you have a dominance or have an ongoing business, while you have an opportunity to develop new and emerging businesses.

And so that's what I go on to explain in the rest of this testimony.

Q Could you turn to page 4 of your testimony at line 9, please?

A Okay.

Q There, you refer to Priority Mail.

A Yes.

Q Does CTC present to the Postal Service, any Priority Mail shipments?

A Yes.

Q Do you have any idea of approximately what percentage of CTC shipments constitute Priority Mail?

MR. OLSON: Mr. Chairman, I think that I would object insofar as Priority Mail is not the subject of this testimony at all. That's a passing reference in the testimony, and getting into what may be confidential information about CTC's use of Priority Mail appears a bit far afield.

MR. McKEEVER: Mr. Chairman, I have a passing question to repassing reference. I think it's proper to find out what percentage of CTC shipments are Parcel Post and what percentage are Priority Mail.

THE WITNESS: I would say that without having specific numbers --

MR. OLSON: Mr. Chairman, let me just -- I know the witness is eager to cooperate, and if there is no confidential aspect to this, I guess the witness can go ahead.

I does seem to me to be irrelevant to the Parcel Post testimony before us, and I'd hate to -- I just wanted to assure -- repeat the issue that if there is confidential aspects to this, that this is something we should discuss further.

CHAIRMAN GLEIMAN: Well, let's see if the witness took all the coaching, or whether he still wants to talk.

MR. McKEEVER: Mr. Chairman, let me ask another question that may obviate the problem, but may not, based on what little bit I heard of Mr. Clark's answer.

BY MR. McKEEVER:

Q Mr. Clark, do you know what percentage of CTC shipments, approximately, are Priority Mail shipments?

A Not off the top of my head. I know approximately, and I guess I would fee comfortable in saying that CTC utilizes Priority Mail as a method of delivering parcels into the Postal network, not as a method of reaching a final consumer.

So it's somewhat different, and it would be akin to buying air freight.

MR. McKEEVER: Okay, Mr. Chairman, I will renew my question of approximately what percentage of CTC's shipments tendered to the Postal Service are Priority Mail.

THE WITNESS: I don't know the answer, specifically, and I guess I really couldn't come up with a good answer for you.

MR. McKEEVER: Okay, thank you.

BY MR. McKEEVER:

Q On page 8 of your testimony, Mr. Clark, at lines 19 to 21, you state that Dr. Sappington's testimony concerning Parcel Post volume trends ignores the effects of the UPS strike which occurred at the end of 1997; do you see that?

A Yes.

Q That strike occurred in August of that year; didn't it?

A August/September, yes.

Q That was in Postal Service Fiscal Year 1997?

A I think that is a September Fiscal Year.

Q And Parcel Post volume was, in fact, up in 1997 over 1996; wasn't it?

A I think it was, yes.

Q Now, according to Postal Service Witness Musgrave in his direct testimony at USPS-T-8, page 26, the strike occurred from August 4, 1997, to August 19, 1997; does that sound about right to you?

A It sounds about right.

Q Now, regardless of whose volume estimate you use for Fiscal Year 1998, the Postal Service's original volume estimate from DRPW or its revised volume estimate for that year, Parcel Post volume did increase in 1998 over 1997; didn't it?

A I haven't really studied those numbers. I have a table that is in Haldi's testimony.

Q Well, if you have something that you can refer to answer the question, I would appreciate it if you could do that.

A In this testimony from John Haldi it has 1997 Parcel Post volume of 237 million and 1998, 267 million.

Q Okay. So 1998 volume was higher than 1997 volume?

A Yes.

Q And according to the Postal Service's volume estimates, Parcel Post volume increased slightly. I am comparing Postal Service 1999 to Postal Service 1998 here. Parcel Post volume increased slightly in 1999 over 1998, is that correct? Do you know that?

A That is not on this chart.

Q Do you think that is right?

A Probably.

Q Okay. Could you turn to page 12 of your testimony, please? There you indicate at the top of the page, lines 3 to 6, that 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, do you see that?

A Yes.

Q What is the source of that 75 percent number that you use, where did you get that from?

A I have seen numbers as high as 80 and 85 percent, but I thought the 75 percent I saw somewhere in reviewing all of the testimony that I have gone through in this rate case, and I think it was a number that came from a UPS witness.

Q From a UPS --

A But I am not sure of that. I did see that analysis.

Q Okay. Do you know if it came from numbers provided by Postal Service Witness Tolley?

A I just saw it somewhere in the testimony, I can't go back and tell you exactly at what place.

Q Do you know if it counts, on the Postal Service's column, only Parcel Post volume?

A That is what I am referring to here as parcels.

Q So your answer is yes, that you believe it counts for the Postal Service only Parcel Post volume, is that correct?

A You mean compared to the 290 million we were looking at before for 1999, for example, and 1998?

Q Well, what I am asking you is, does the 75 percent -- that is a market share number, so for the Postal Service, is the figure used in calculating that only Parcel Post volume, or is it all the packages that the Postal Service handles, if you know?

A I think I am more relating to the total number of parcels that we are looking at in circulation. There are a number of different sources of information concerning relative market share, and they compare Federal Express, UPS, Airborne, all the other types of carriers. And even some of UPS's own numbers that they have come up with during their IPO as they have gone public have been in this ballpark.

I think it is, you know, I think 75 percent is a little bit conservative myself, when you look at the total marketplace.

Q Do you know whether the 75 percent number counts for Postal Service volume only Parcel Post shipments?

A I think that would be correct. I mean the idea of throwing in CDs and books and magazines, and different things like that, really isn't something that is traditionally done when making these kinds of comparisons.

Q Okay.

A Only UPS wants to do that. I mean they want to take that household diary and look at every, you know, little tiny parcel that has ever been shipped and make that the universe. Whereas, in most cases, from a financial perspective, those are not considered in the universe when calculating these numbers.

Q Right. Could you turn to page 14 of your testimony, please? There you state at lines 3 to 5 that 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 5 parcels per route, do you see that?

A Yes.

Q Can you go through that calculation with me, what those numbers are and how you arrived at that?

A Well, I can do that, I don't have those numbers in front of me here. I think that it is easy enough to do, I mean to come up with it.

MR. OLSON: Mr. Chairman, we would be glad to provide that for the record if counsel would like that.

MR. McKEEVER: Mr. Chairman, I would request that that information be furnished to us.

CHAIRMAN GLEIMAN: Mr. Olson, because time is getting short, I would ask that you provide that information by next Monday if possible, if not, by the 30th, certainly. Is that acceptable?

MR. McKEEVER: That is acceptable, Mr. Chairman.

MR. OLSON: I am sure we can get that done, yes.

CHAIRMAN GLEIMAN: Thank you.

MR. McKEEVER: I just have a couple of more questions about that calculation that Mr. Clark may be able to answer while he is here today.

BY MR. McKEEVER:

Q Can you tell me what types of volume you used for the parcel volume in that calculation? Were you talking Parcel Post volume or Parcel Post and Standard A, or what?

A Parcel Post.

Q Just Parcel Post?

A Standard B.

Q Do you remember what you used as the number of days in the year?

A 360 -- no, wait a minute. I am not really sure, it could be -- I don't remember if it was a 250 and then I figured that they were open on Saturdays, so we would add another 52 Saturdays, less the holidays and so on. But we will put the numbers together.

MR. McKEEVER: Okay. That's all I have, Mr. Chairman.

CHAIRMAN GLEIMAN: Is there any follow-up?

MR. OLSON: Just if I could have 15 seconds?

CHAIRMAN GLEIMAN: You bet.

[Pause.]

MR. OLSON: Mr. Chairman, we have nothing. Thank you.

CHAIRMAN GLEIMAN: That is an indication that there is no redirect, and that being the case, -- I don't believe there any questions from the bench. I don't want to deny my colleagues an opportunity, or anyone else to have done follow-up. I don't hear anybody speaking up, so I guess we are okay with this one.

Mr. Clark, that completes your testimony here today. We appreciate your appearance and your contributions to the record. We thank you and you are excused.

THE WITNESS: I would like to say this is the third time I have appeared here, and I appreciate the work of the Commission. You may be aware that I have sold the company and announced my retirement, so there is a good possibility I won't be back. But I do admire your work and I appreciate everything that you have put into making this come out correctly.

CHAIRMAN GLEIMAN: Thank you for your kind words. We are not envious of the fact that you have had to come here and testify three times, but some of us are envious of the fact that you are in a position to retire. We wish you the very best in retirement, and for some reason or another, knowing a little about you, I suspect that you will be retired, but we will still see you around in the community a bit. The very best to you, sir.

THE WITNESS: Thank you very much, Mr. Chairman.

[Witness excused.]

MR. HOLLIES: Mr. Chairman, I would like to raise a procedural matter at this point if I might.

CHAIRMAN GLEIMAN: Most certainly.

MR. HOLLIES: The Postal Service has been made aware that Mr. Levy is not available here today, in part because of a family tragedy. His intent was to conduct oral cross-examination of Mr. Dowling.

We, the Postal Service, we have considered the situation and we are prepared to have Mr. Dowling come back next week, that would be Thursday, as the second witness, if that would be amenable to the Commission, as an accommodation. And Mr. Dowling is here at the moment and I think is prepared to depart if we can lock this down.

CHAIRMAN GLEIMAN: Next Thursday, did you say?

MR. HOLLIES: I did say next Thursday.

CHAIRMAN GLEIMAN: You don't want to take your chances and make him the last witness, do you?

MR. HOLLIES: I think that is a safe statement, we do not.

CHAIRMAN GLEIMAN: No, I am just kidding, you know, because, as I mentioned the other day, it now appears that Thursday is going to be a very long day. I received the same information that you did about -- with regard to Mr. Levy's situation, and in the interest of ensuring that we give everyone an opportunity to question on the record if they wish to, I think that your offer is a reasonable offer and we will take you up on it.

Mr. Dowling, I am sorry that we are not going to get to you today. We appreciate your willingness to come back next Thursday and the few questions that I and my colleagues may have had, I don't know whether they had any or not, but I had one or two, we can hold those off until next week. I thank you for your willingness to accommodate us with the situation.

And that brings us to a Postal Service witness. Mr. Reiter.

MR. REITER: Our next witness is Jennifer Eggleston.

CHAIRMAN GLEIMAN: Ms. Eggleston, I believe you are already under oath, so we don't have to swear you in again. And just let me say at this point that now that Mr. Clark indicated this was his third visit here, I am wondering whether I swore him in when I didn't have to. It has just gotten terribly confusing for me trying to remember who has been here in this particular case. And if he had been here earlier in this case and had been sworn in, I didn't mean to suggest by swearing him a second time that he needed to give the oath for any special reasons. He is a good man of his word.

Whereupon,

JENNIFER L. EGGLESTON,

a witness, having been recalled for examination and, having been previously duly sworn, was examined and testified further as follows:

CHAIRMAN GLEIMAN: Mr. Reiter, you may proceed.

MR. REITER: Ms. Eggleston has already appeared in this proceeding, as I think you recall.

CHAIRMAN GLEIMAN: I do recall.

MR. REITER: But in the future we could specify that if it will help you.

CHAIRMAN GLEIMAN: Well, I sure can use the help, it is pretty obvious.

DIRECT EXAMINATION

BY MR. REITER:

Q Ms. Eggleston, I am handing you a copy of a document entitled "Rebuttal Testimony of Jennifer L. Eggleston on Behalf of United States Parcel Service," labeled USPS-RT-20. Was this testimony prepared by you or under your direction?

A Yes, it was.

Q And if you were to testify here orally today, would this be your testimony?

A Yes, it would.

MR. REITER: Mr. Chairman, I will give these two copies to the reporter and ask that they be entered into evidence.

CHAIRMAN GLEIMAN: Is there an objection?

[No response.]

CHAIRMAN GLEIMAN: Hearing none, counsel, if you would provide those copies to the reporter, I will direct that the rebuttal testimony of this witness be transcribed into the record and received into evidence.

[Rebuttal Testimony of Jennifer L. Eggleston, UPS-RT-20, was received into evidence and transcribed into the record.]

USPS-RT-20

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

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

REBUTTAL TESTIMONY
OF
JENNIFER L. EGGLESTON
ON BEHALF OF
UNITED STATES POSTAL SERVICE

TABLE OF CONTENTS

REBUTTAL TESTIMONY
OF
JENNIFER L. EGGLESTON

AUTOBIOGRAPHICAL SKETCH

My name is Jennifer Eggleston. I joined the Postal Service in July 1997 as an Economist in the Product Cost Studies division of Product Finance, which has since been renamed the Special Studies division in the office of Activity Based Management. Since joining the Postal Service, I have been involved with many issues dealing with Parcel Post and Standard (A) parcels. I have visited several Bulk Mail facilities (BMCs), Processing and Distribution Centers (P&DCs), delivery units, and other postal facilities. My previous work includes the Bulk Parcel Return Service (BPRS) Cost Study provided to the Postal Rate Commission in October 1998 to fulfill the requirements of Docket No. MC97-4 and testimony in Docket No. MC99-4 (BPRS Expedited Minor Classification Case).

Earlier in Docket No. R2000-1, I testified before the Postal Rate Commission concerning Parcel Post, Special Standard B, BPRS and Merchandise Return Service.

Before joining the Postal Service, I worked as an Economist for Research Triangle Institute (RTI), a non-profit research firm in North Carolina. I worked with two separate groups at RTI. In the environmental economics group, I was tasked with estimating the potential costs and benefits of specific government regulations. In the health economics group, my main responsibility was to perform cost and benefit analysis of new drug treatments. I also worked for one year for the Naval Center for Cost Analysis in Crystal City, VA. My main responsibility was estimating the costs of procuring weapons systems.

I earned a Bachelor's Degree in Economics from James Madison University in 1992 and a Master's degree in Economics from North Carolina State University in 1995.

I. Purpose

The purpose of my testimony is to rebut the testimony of United Parcel Service witness Luciani (UPS-T-5) and Florida Gift Fruit Shippers Association witness Ball (FGFSA-T-1). Specifically this testimony will rebut witness Luciani's proposal on the Parcel Post transportation final adjustment. It will also rebut witness Ball's accusation that the TRACS distribution keys are inaccurate.

II. Witness Luciani's belief that the Parcel Post final adjustments double counts cost savings is incorrect.

In his testimony, witness Luciani claims that the Parcel Post transportation final adjustments calculated by witness Daniel are incorrect. His view is that her final adjustments double count the cost savings of parcels being dropped at the destination SCF. His rationale is that Parcel Post transportation cost estimates in USPS-T-26 already reflect the cost savings due to the assumption in the model that 7.11 percent of DBMC parcels are dropped at the destination SCF. Therefore, he believes that the final adjustments, which reduce Parcel Post transportation costs for DSCF and DDU, double count the savings. Tr. 25/11777-80. The logical premise of Witness Luciani's proposal must be that 7.11 percent of DBMC volume is dropped at the destination SCF in the pre-mix volume,[1] but that this does not hold true in the post-mix volume. He also assumes that all DBMC parcels that are dropped at the DSCF in the pre-mix volume are entered as DSCF in the post-mix volume. Tr. 25/11860.

If it were true that 7.11 percent of DBMC is dropped at the destination SCF in the pre-mix volume, and not in the post-mix volume, then witness Luciani might be correct that there is some double counting. But if it is rational to assume that 7.11 percent of DBMC is dropped at the destination SCF in the pre-mix volume, then it is also rational to assume that 7.11 percent of DBMC volume is dropped at the destination SCF in the post-mix volume. Because DSCF has much more stringent requirements than DBMC, whatever DBMC parcels are entered at a destination SCF will not necessarily qualify for the DSCF rate. Even witness Luciani testified that he did not believe that DBMC parcels would be dropped at the destination SCF, because, if they were not sorted to 5-digits, they would need to be sent back to the destination BMC and would not qualify for the DBMC rate. Tr. 25/11927. This would imply that the percentage of DBMC parcels dropped at the destination SCF should be zero for both the pre-mix and post-mix volumes.

[1] This assumption is used in the Parcel Post transportation cost model.

Therefore, if one were to accept witness Luciani's argument, then the appropriate correction would be to change the 7.11 percent assumption to zero percent in the cost model supporting the final adjustments. This cost model is located in LR-I-98 (LR98sec4c.xls). Attachment A is a revised version of that file showing the results of the zero percent adjustment. For convenience, only the pages that contain data that change are shown in Attachment A.[2]

To incorporate the zero percent assumption into the final adjustments, the revised estimated unit costs shown in Attachment A (page 2, column 5) should be entered into LR-I-98, file "LR98sec4d.xls". Attachment B is a revised version of the file "LR98sec4d.xls". Changes to the spreadsheet are highlighted. The spreadsheet was also changed to conform with the errata to USPS-T-26 filed on March 22, 2000, by changing the average cubic feet of oversize parcel post from 10.84 to 8.04.

Next the estimated unit costs from Attachment B (LR98sec4d.xls) are entered into the Parcel Post transportation final adjustment page of LR-I-97 (lr97finad.xls). These changes are shown in Attachment C.

As can be seen on page 2 of Attachment C, the impact of the zero percent assumption is to change Parcel Post transportation before rates final adjustments from -9.960 to -11.906 and the Parcel Post transportation after-rate adjustments from -20.901 to -22.808.[3]

It should be noted that the change in the 7.11 percent assumption would also have to be made to the Parcel Post transportation model originally presented in

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[2] An electronic version of the file with all pages has been filed with this testimony.
[3] For purposes of analyzing the impact of the 7.11 percent assumption, holding the average cube of oversize Parcel Post constant has the impact of changing the Parcel Post before rates final adjustments from -9.960 to -9.861 and after rates final adjustments from -20.901 to -20.845.

USPS-T-26. For convenience, that model, with the new adjustment is contained in Attachment D.[4]

III. Witness Ball is clearly wrong in concluding that, because of differences between mail volumes and TRACS distribution keys, TRACS data cannot be relied upon.

In his testimony, witness Ball claims that TRACS is flawed based on his view that the Parcel Post DBMC distribution key is inaccurate. Witness Ball compares two tables of data and claims that they prove the TRACS distribution keys are not consistent with other measurements of Parcel Post. However, there are sound reasons why the two tables should be different, and any attempt to relate one table to the other needs to take these differences into account.

In the first table on page 13 of FGFSA-T-1, the column headings (intra-BMC and inter-BMC) refer to transportation modes. In the second table, those same titles refer not to transportation modes, but to rate categories. Transportation modes and rate categories do not have a one-to-one relationship. For example, matter mailed at Inter-BMC rates will generally incur both inter-BMC and intra-BMC transportation.[5]

To make matters worse, the first table shows TRACS BY 98 distribution keys based on cubic-foot-miles, whereas the second table contains total estimated TY01 cubic feet. Witness Ball's presumption that cubic-foot-miles should relate directly to cubic feet is absurd – it is equivalent to assuming that all mail pieces travel the same distance, or cost the same (per cubic foot) regardless of the distance traveled. Thus, although the comparison between BY 98 and TY 01 may not be erroneous on its own, the combination of it with the mismatch

[4] Attachment D is USPS-T-26, Attachments M and N. The electronic version of these attachments, originally filed in LR-I-171 as "cpp_tran.xls", is filed as "Attach_D.xls".

between units, transportation modes and rate categories renders witness Ball's comparisons meaningless.

Additionally, even if there were a problem with the TRACS distribution between DBMC and Parcel Post, it is irrelevant as long as the aggregate distribution of costs to the Standard (B) Parcel Post subclass by TRACS is correct. Although TRACS data collectors differentiate between DBMC and zone-rated Parcel Post, the TRACS data is only used at the aggregate subclass level. The distribution of Parcel Post TY 01 costs to the inter-BMC, intra-BMC and DBMC rate categories, as explained in USPS-T-26, attachment M, page 3, does not use TRACS data. Therefore, the Commission should rely on the Postal Service's distribution of transportation costs.

[5] In addition, approximately 68% of Standard A intra-BMC mail included in the second table is entered at the DSCF or DDU, and hence would be unlikely to even be transported on intra-BMC movements.

USPS-RT-20
Attachment A
Page 1 of 5
(Revised LR98sec4c.xls)

Division of Parcel Post Transportation Costs
Division of Functional Costs Into Rate Categories

	Local	Inter-mediate	Long Distance	
Transportation costs for all parcel post:	$143,930	$138,860	$111,694	1/
Transportation costs for Inter-BMC and Intra-BMC only		$11,535		2/
Total Transportation Costs	$143,930	$150,395	$111,694	3/
Inter-BMC cubic feet:	34,214,278	34,214,278	34,214,278	4/
Intra-BMC cubic feet:	14,153,710	14,153,710	14,153,710	5/
DBMC cubic feet:	207,674,244	207,674,244	207,674,244	6/
Total parcel post cubic feet:	256,042,233	256,042,233	256,042,233	7/
Percentage of inter-BMC parcels entered at origin BMCs:	4.48%	4.48%	4.48%	8/
Avg. number of local legs traveled by an inter-BMC parcel:	1.96			9/
Avg. number of intermediate legs traveled by an inter-BMC parcel:		1.96		10/
Avg. number of long distance legs traveled by an inter-BMC parcel:			1.00	11/
Percentage of intra-BMC cubic feet held out at the AO:	3.86%	3.86%	3.86%	12/
Avg. number of local legs traveled by an intra-BMC parcel:	1.92			13/
Avg. number of intermediate legs traveled by an intra-BMC parcel:		1.92		14/
Avg. number of long distance legs traveled by an intra-BMC parcel:			0.00	15/
Percentage of DBMC parcels entered at destination SCFs:	[redacted]	[redacted]	[redacted]	16/
Avg. number of local legs traveled by a DBMC parcel:	1.00			17/
Avg. number of intermediate legs traveled by a DBMC parcel:		[redacted]		18/
Avg. number of long distance legs traveled by a DBMC parcel:			0.00	19/
Transportation costs incurred by DBMC rated parcels:	$99,046	[redacted]	$0	20/
Transportation costs incurred by intra-BMC rated parcels:	$12,979	[redacted]	$0	21/
Transportation costs incurred by inter-BMC rated parcels:	$31,905	[redacted]	$111,694	22/
Transportation costs for all parcel post:	$143,930	$150,395	$111,694	23/

Sources

Row 1/: Attachment M page 2 row 19 (local), row 11 (intermediate), row 15 (long distance).
Row 2/: Attachment M, page 2, row 12.
Row 3/: Row (1) + row (2).
Row 4/: Attachment L, page 7, column 1, total inter-BMC cubic feet.
Row 5/: Attachment L, page 7, column 2, total intra-BMC cubic feet.
Row 6/: Attachment L, page 7, column 3, total DBMC cubic feet.
Row 7/: Row (4) + row (5) + row (6).
Row 8/: Docket No. R97-1 USPS-T-16, Appendix I page 13.
Row 9/: [1 * row (8)] + (2 * [1 - row (8)]) .
Row 10/: [1 * row (8)] + (2 * [1 - row (8)]).
Row 11/: Inter-BMC rated parcels should receive one leg of long distance transportation.
Row 12/: Attachment L, page 7, column 2, intra-BMC local cubic feet divided by intra-BMC total cubic feet.
The resulting quotient is multiplied by .5 to account for half of the intra-BMC parcels being held out at the local AO.
Row 13/: [0 * row (12)] + [2 * (1 - row (12)]).
Row 14/: [0 * row (12)] + (2 * [1 - row (12)]).
Row 15/: Intra-BMC rated parcels should not receive long distance transportation.
Row 16/: Docket No. R97-1 USPS-T-16, Appendix I page 13.
Row 17/: All DBMC parcels should receive one leg of local transportation.
Row 18/: [0 * row (16)] + (1 * [1 - row (16)]).
Row 19/: DBMC parcels should not receive long distance transportation.
Row 20/: Costs distributed based on number of legs and cubic feet.
Row 21/: Costs distributed based on number of legs and cubic feet.
Row 22/: Costs distributed based on number of legs and cubic feet.
Row 23/: Row (17) + row (18) + row (19).

Summary of Parcel Post Unit Transportation Costs by Zone

Cost per Cubic Foot by Zone for Each Rate Category

Inter-BMC

Zone	[1] Local costs	[2] Intermediate costs	[3] Long distance ZR costs	[4] Long distance NZR costs	[5] Total inter-BMC costs
Local	N/A	N/A	N/A	N/A	N/A
1-2	$0.9325	[redacted]	$0.4898	$0.0778	[redacted]
3	$0.9325	[redacted]	$1.0725	$0.0778	[redacted]
4	$0.9325	[redacted]	$1.9476	$0.0778	[redacted]
5	$0.9325	[redacted]	$3.5758	$0.0778	[redacted]
6	$0.9325	[redacted]	$5.2686	$0.0778	[redacted]
7	$0.9325	[redacted]	$6.8505	$0.0778	[redacted]
8	$0.9325	[redacted]	$10.1262	$0.0778	[redacted]

Intra-BMC

Zone	[6] Local costs	[7] Intermediate costs	[8] Total intra-BMC costs
Local	$0.5517	[redacted]	[redacted]
1-2	$0.9476	[redacted]	[redacted]
3	$0.9476	[redacted]	[redacted]
4	$0.9476	[redacted]	[redacted]
5	$0.9476	[redacted]	[redacted]
6	N/A	N/A	N/A
7	N/A	N/A	N/A
8	N/A	N/A	N/A

DBMC

Zone	[9] Local	[10] Intermediate costs	[11] DBMC costs
Local	N/A	N/A	N/A
1-2	$0.4769	[redacted]	[redacted]
3	$0.4769	[redacted]	[redacted]
4	$0.4769	[redacted]	[redacted]
5	$0.4769	[redacted]	[redacted]
6	N/A	N/A	N/A
7	N/A	N/A	N/A
8	N/A	N/A	N/A

DSCF Costs	$0.4769 1/
DDU Cost Avoidance (DSCF costs less DDU costs in $/cf)	$0.3959 2/

Sources

Column [1]: Attachment N, page 2, column 7.
Column [2]: Attachment N, page 2, column 8.
Column [3]: Attachment N, page 2, column 9.
Column [4]: Attachment N, page 2, column 10.
Column [5]: Column [1] + column [2] + column [3] + column [4].
Column [6]: Attachment N, page 3, column 7.
Column [7]: Attachment N, page 3, column 8.
Column [8]: Column [6] + column [7].
Column [9]: Attachment N, page 4, column 5.
Column [10]: Attachment N, page 4, column 6.
Column [11]: Column [9] + column [10].
Row 1/: Same as DBMC local costs, column [9].
Row 2/: Attachment N, page 5, row 12.

Parcel Post Transportation Costs By Rate Category and Zone

Calculation of Inter-BMC Transportation Costs per Cubic Foot by Zone

Inter-BMC parcel transportation costs by function and distance relation		
Local costs incurred by inter-BMC parcels (non-distance related)	$31,905	1/
Intermediate costs incurred by inter-BMC parcels (non-distance related)	[redacted]	2/
Long distance costs incurred by inter-BMC parcels (distance related)	$109,031	3/
Long distance costs incurred by inter-BMC parcels (non-distance related)	$2,662	4/
Total inter-BMC parcel costs	[redacted]	5/

Zone	[1] Percentage of inter-BMC cubic feet	[2] Percentage of inter-BMC cubic foot miles	[3] Local costs (000)	[4] Intermediate costs (000)	[5] Long distance costs - ZR (000)	[6] Long distance costs - NZR (000)
Local	0.00%	0.00%	$0	$0	$0	$0
1-2	9.08%	1.40%	$2,896	[redacted]	$1,521	$242
3	17.28%	5.82%	$5,513		$6,341	$460
4	28.01%	17.12%	$8,936		$18,663	$746
5	23.13%	25.96%	$7,381		$28,302	$616
6	10.50%	17.37%	$3,351		$18,935	$280
7	5.62%	12.09%	$1,794		$13,177	$150
8	6.38%	20.26%	$2,034		$22,092	$170
Total	**100.00%**	**100.00%**	**$31,905**		**$109,031**	**$2,662**

Zone	[7] Local unit costs ($/CF)	[8] Intermediate unit costs ($/CF)	[9] Long distance - ZR unit costs ($/CF)	[10] Long distance - NZR unit costs ($/CF)	[11] Total unit costs ($/CF)	[12] Reconcile to total costs (000)
Local	N/A	N/A	N/A	N/A	N/A	N/A
1-2	$0.9325	[redacted]	$0.4898	$0.0778	[redacted]	[redacted]
3	$0.9325		$1.0725	$0.0778		
4	$0.9325		$1.9476	$0.0778		
5	$0.9325		$3.5758	$0.0778		
6	$0.9325		$5.2686	$0.0778		
7	$0.9325		$6.8505	$0.0778		
8	$0.9325		$10.1262	$0.0778		
Total						

Sources

Row 1/: Attachment M, page 3, row 22.
Row 2/: Attachment M, page 3, row 22.
Row 3/: Attachment M, page 2, row 13.
Row 4/: Attachment M, page 2, row 14.
Row 5/: Row (1) + row (2) + row (3) + row (4).
Column [1]: Attachment L, page 7, column 1, inter-BMC cubic feet in the given zone divided by total inter-BMC cubic feet.
Column [2]: Attachment L, page 7, column 5, inter-BMC cubic foot miles in the given zone divided by total inter-BMC cubic foot miles
Column [3]: Row (1) * column [1].
Column [4]: Row (2) * column [1].
Column [5]: Row (3) * column [2].
Column [6]: Row (4) * column [1].
Column [7]: Column [3] * 1000 / Attachment L, page 7, column 1 (inter-BMC cubic feet by zone).
Column [8]: Column [4] * 1000 / Attachment L, page 7, column 1 (inter-BMC cubic feet by zone).
Column [9]: Column[5] * 1000 / Attachment L, page 7, column 1 (inter-BMC cubic feet by zone).
Column [10]: Column [6] * 1000 / Attachment L, page 7, column 1 (inter-BMC cubic feet by zone).
Column [11]: Column [7] + column [8] + column [9] + column [10].
Column [12]: Column [11] * Attachment L, page 7, column 1 (inter-BMC cubic feet by zone).

Parcel Post Transportation Costs By Rate Category and Zone
Calculation of Intra-BMC Rated Parcel Costs per Cubic Foot by Zone

Intra-BMC parcel transportation costs by function and distance relation		
Local costs incurred by intra-BMC parcels (non-distance related)	$12,979	1/
Intermediate costs incurred by intra-BMC parcels (non-distance related)	[redacted]	2/
Long distance costs incurred by intra-BMC parcels	$0	3/
Total intra-BMC parcel costs	[redacted]	4/
Percent of local intra-BMC that is held out	50.00%	5/

	[1]	[2]	[3]	[4]	[5]	[6]
	Cubic feet	**Average Local / Intermediate Legs**	**Average Cubic foot-legs**	**Percent**	**Local Trans Costs**	**Intermediate Trans Costs**
Local zone	1,092,724	1	1,092,724	4.02%	$433	[redacted]
Non-local zone	13,060,986	2	26,121,973	95.98%	$10,341	[redacted]
Intra-city / box route adjustment		6/			$2,206	
Total	**14,153,710**		**27,214,697**	**100.00%**	**$12,979**	[redacted]

Zone	[7] **Local unit costs ($/CF)**	[8] **Intermediate unit costs ($/CF)**	[9] **Total unit costs ($/CF)**	[10] **Reconcile to total costs (000)**
Local	$0.5517	[redacted]	[redacted]	[redacted]
1-2	$0.9476	[redacted]	[redacted]	[redacted]
3	$0.9476	[redacted]	[redacted]	[redacted]
4	$0.9476	[redacted]	[redacted]	[redacted]
5	$0.9476	[redacted]	[redacted]	[redacted]
6	N/A	N/A	N/A	N/A
7	N/A	N/A	N/A	N/A
8	N/A	N/A	N/A	N/A
Total				**$26,837**

<u>**Sources**</u>
Row 1/: Attachment M, page 3, row 21.
Row 2/: Attachment M, page 3, row 21.
Row 3/: Attachment M, page 3, row 21.
Row 4/: Row (1) + row (2) + row (3).
Row 5/: Assumption from Docket no. R97-1, USPS-T-16.
Row 6/: Row 1 * Attachment N, page 5, row 10. (even held out parcels incur these costs).
Column [1]: Attachment L, page 7, column 2, intra-BMC cubic feet in the local zone and in all other zones.
Column [2]: Local zone legs reflect half of the local parcels being held out at the AO. Non-local zone legs reflect typical intra-BMC parcel.
Column [3]: Column [1] * column [2].
Column [4]: Percentage of cubic foot legs from column [3].
Column [5]: [Row (1) - row (5)] * column [4].
Column [6]: Row (2) * column [4].
Column [7]: Local zone unit cost = (local zone costs from column [4] / local zone cubic feet from column [1]) + row (5) / total cubic feet.
Non-local zone unit cost = (non-local zone costs from column [4] / non-local zone cubic feet from column [1]) + row (5) / total cubic feet.
Column [8]: Local zone unit cost = local zone costs from column [5] / local zone cubic feet from column [1].
Non-local zone unit cost = non-local zone costs from column [5] / non-local zone cubic feet from column [1].
Column [9]: Column [5] + column [6].
Column [10]: Column [7] * Attachment L, page 7, column 2 (intra-BMC cubic feet by zone).

Parcel Post Transportation Costs By Rate Category and Zone

Calculation of DBMC Rated Parcel Costs per Cubic Foot by Zone

DBMC parcel transportation costs by distance relation		
Local costs incurred by DBMC parcels (non-distance related)	$99,046	1/
Intermediate costs incurred by DBMC parcels (distance related)	[redacted]	2/
Long distance costs incurred by DBMC parcels	$0	3/
Total DBMC parcel costs	[redacted]	4/

Zone	[1] Percentage of DBMC cubic feet	[2] Percentage of DBMC cubic foot miles	[3] Local costs (000)	[4] Intermediate costs (000)
Local	0.00%	0.00%	$0	$0
1-2	82.80%	54.83%	$82,008	[redacted]
3	14.68%	35.57%	$14,536	[redacted]
4	2.40%	8.42%	$2,380	[redacted]
5	0.12%	1.19%	$121	[redacted]
6	0.00%	0.00%	$0	$0
7	0.00%	0.00%	$0	$0
	0.00%	0.00%	$0	$0
Total	100.00%	100.00%	$99,046	[redacted]

Zone	[5] Local / DSCF Unit Costs ($/CF)	[6] Intermediate Unit Costs ($/CF)	[7] Total DBMC Unit Costs ($/CF)	[8] Reconcile to Total Costs (000)
Local	N/A	N/A	N/A	N/A
1-2	$0.4769	[redacted]	[redacted]	[redacted]
3	$0.4769	[redacted]	[redacted]	[redacted]
4	$0.4769	[redacted]	[redacted]	[redacted]
5	$0.4769	[redacted]	[redacted]	[redacted]
6	N/A	N/A	N/A	N/A
7	N/A	N/A	N/A	N/A
8	N/A	N/A	N/A	N/A
Total				[redacted]

Sources
Row 1/: Attachment M, page 3, row 20.
Row 2/: Attachment M, page 3, row 20.
Row 3/: Attachment M, page 3, row 20.
Row 4/: Row (1) + row (2) + row (3).
Column [1]: Attachment L, page 7, column 3, DBMC cubic feet in the given zone divided by total DBMC cubic feet.
Column [2]: Attachment L, page 7, column 7, DBMC cubic foot miles in the given zone divided by total DBMC cubic foot miles.
Column [3]: Row (1) * column [1].
Column [4]: Row (2) * column [2].
Column [5]: Column [3] / Attachment L, page 7, column 3 (DBMC cubic feet by zone, all cubic feet will have a local leg).
Column [6]: Column [4] / Attachment L, page 7, column 11 (regular DBMC cubic feet by zone since this is the cubic feet that will have an intermediate leg).
Column [7]: Column [5] + column [6].
Column [8]: (Column [5] * Attachment L, page 7, column 10) + (column [7] * Attachment L, page 7, column 11).

Inter-BMC	**NO PIG 14 + 8**								
Zone	**Total Inter-BMC costs**	cubic feet	total cost	vol	cost/pc	oversize cube	oversize cost	oversize vol	oversize cost/pc
Local	N/A	0							
1-2	[redacted]	3,106,035	[redacted]			[redacted]	[redacted]		
3	[redacted]	5,911,793	[redacted]			[redacted]	[redacted]		
4	[redacted]	9,582,517	[redacted]			[redacted]	[redacted]		
5	[redacted]	7,914,879	[redacted]			[redacted]	[redacted]		
6	[redacted]	3,593,854	[redacted]			[redacted]	[redacted]		
7	[redacted]	1,923,568	[redacted]			[redacted]	[redacted]		
8	[redacted]	2,181,632	[redacted]		Inter	[redacted]	[redacted]		Inter
		34,214,278	[redacted]	51,620,319	[redacted]	[redacted]	[redacted]	72,268	[redacted]
Intra-BMC									
Zone	**Total Intra-BMC costs**								
Local	[redacted]	1,092,724	[redacted]			[redacted]	[redacted]		
1-2	[redacted]	10,402,027	[redacted]			[redacted]	[redacted]		
3	[redacted]	2,049,770	[redacted]			[redacted]	[redacted]		
4	[redacted]	408,204	[redacted]			[redacted]	[redacted]		
5	[redacted]	200,985	[redacted]			[redacted]	[redacted]		
6	N/A	0							
7	N/A	-							
8	N/A	-			Intra	Intra over vol			Intra
		14,153,710	[redacted]	28,817,368	[redacted]	301,199	[redacted]	37,463	[redacted]
DBMC									
Zone	**DBMC costs**	DBMC cube	DBMC total $						
Local	N/A	0							
1-2	[redacted]	154,498,909	[redacted]			[redacted]	[redacted]		
3	[redacted]	27,385,185	[redacted]			[redacted]	[redacted]		
4	[redacted]	4,484,191	[redacted]			[redacted]	[redacted]		
5	[redacted]	228,306	[redacted]			[redacted]	[redacted]		
6	N/A	0							
7	N/A	-							
8	N/A	-		**DBMC vol**	DBMC $/piece	oversize dubic feet		oversize vol	DBMC
		186,596,590	[redacted]	267,762,878	[redacted]	[redacted]	[redacted]	53,552	[redacted]
				Volume		oversize cubic feet	Over Total $	Over vol	Over unit $
DSCF	$0.4769	1,559,143.71	$ 743,601	2,237,344	$0.33	[redacted]	[redacted]	447	[redacted]
DDU Cost	$0.0811	19,518,511	$ 1,582,262	28,008,725	$0.06	[redacted]	[redacted]	5,603	[redacted]

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(Revised LR97fnad.xls)

CLASS OF MAIL	1998GFY Volume 2001br	2001GFY BR Volume	2001BR Total Mixed Cost	Rollforward BR01 Unit Cost	TY Unit Cost	2001GFY AR Volume	2001AR Total Mixed Cost	Rollforward AR01 Unit Cost	
Parcel Post (USPS-T-14)	378	378	[redacted]	107.3	[redacted]	374	[redacted]	107.1	**includes vehicle servic
Inter BMC (LR-I-98 Section 4)	52	52	[redacted]	[redacted]	[redacted]	48	[redacted]	[redacted]	
Intra BMC	29	29	[redacted]	[redacted]	[redacted]	26	[redacted]	[redacted]	
DBMC	298	267	[redacted]	[redacted]	[redacted]	269	[redacted]	[redacted]	
DSCF	0	2	[redacted]	[redacted]	33	2	[redacted]	[redacted]	
DDU	0	28	[redacted]	[redacted]	6	28	[redacted]	[redacted]	
Inter BMC Oversize	0	0.07	[redacted]	[redacted]	[redacted]	0.07	[redacted]	[redacted]	
Intra BMC Oversize	0	0.01	[redacted]	[redacted]	[redacted]	0.01	[redacted]	[redacted]	
DBMC Oversize	0	0.35	[redacted]	[redacted]	[redacted]	0.35	[redacted]	[redacted]	
DSCF Oversize	0	0.00	[redacted]	[redacted]	[redacted]	0.00	[redacted]	[redacted]	
DDU Oversize	0	0.04	[redacted]	[redacted]	[redacted]	0.04	[redacted]	[redacted]	

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(Revised LR97fnad.xls)

Parcel Post (in millions) Transportation plus supervisor piggy vehicle service

BR01 Avg Unit	BR01 Mix Unit	BR01 Volume	BR01 Avg cost	BR01 Mix Cost	Difference
107.29	[redacted]	378	406	[redacted]	[redacted]

AR01 Avg Unit	AR01 Mix Unit	AR01 Volume	AR01 Avg cost	AR01 Mix Cost	Difference
107.15	[redacted]	374	401	[redacted]	[redacted]

Division of Parcel Post Transportation Costs

Division of Functional Costs Into Rate Categories

	Local	Inter-mediate	Long Distance	
Transportation costs for all parcel post:	$161,825	$138,860	$111,694	1/
Transportation costs for Inter-BMC and Intra-BMC only		$11,535		2/
Total Transportation Costs	$161,825	$150,395	$111,694	3/
Inter-BMC cubic feet:	34,214,278	34,214,278	34,214,278	4/
Intra-BMC cubic feet:	14,153,710	14,153,710	14,153,710	5/
DBMC cubic feet:	207,674,244	207,674,244	207,674,244	6/
Total parcel post cubic feet:	256,042,233	256,042,233	256,042,233	7/
Percentage of inter-BMC parcels entered at origin BMCs:	4.48%	4.48%	4.48%	8/
Avg. number of local legs traveled by an inter-BMC parcel:	1.96			9/
Avg. number of intermediate legs traveled by an inter-BMC parcel:		1.96		10/
Avg. number of long distance legs traveled by an inter-BMC parcel:			1.00	11/
Percentage of intra-BMC cubic feet held out at the AO:	3.86%	3.86%	3.86%	12/
Avg. number of local legs traveled by an intra-BMC parcel:	1.92			13/
Avg. number of intermediate legs traveled by an intra-BMC parcel:		1.92		14/
Avg. number of long distance legs traveled by an intra-BMC parcel:			0.00	15/
Percentage of DBMC parcels entered at destination SCFs:	[redacted]	[redacted]	[redacted]	16/
Avg. number of local legs traveled by a DBMC parcel:	1.00			17/
Avg. number of intermediate legs traveled by a DBMC parcel:		[redacted]		18/
Avg. number of long distance legs traveled by a DBMC parcel:			0.00	19/
Transportation costs incurred by DBMC rated parcels:	$111,360	[redacted]	$0	20/
Transportation costs incurred by intra-BMC rated parcels:	$14,593	[redacted]	$0	21/
Transportation costs incurred by inter-BMC rated parcels:	$35,871	[redacted]	$111,694	22/
Transportation costs for all parcel post:	$161,825	[redacted]	$111,694	23/

Sources

Row 1/: Attachment M page 2 row 19 (local), row 11 (intermediate), row 15 (long distance).
Row 2/: Attachment M, page 2, row 12.
Row 3/: Row (1) + row (2).
Row 4/: Attachment L, page 7, column 1, total inter-BMC cubic feet.
Row 5/: Attachment L, page 7, column 2, total intra-BMC cubic feet.
Row 6/: Attachment L, page 7, column 3, total DBMC cubic feet.
Row 7/: Row (4) + row (5) + row (6).
Row 8/: Docket No. R97-1 USPS-T-16, Appendix I page 13.
Row 9/: [1 * row (8)] + (2 * [1 - row (8)]).
Row 10/: [1 * row (8)] + (2 * [1 - row (8)]).
Row 11/: Inter-BMC rated parcels should receive one leg of long distance transportation.
Row 12/: Attachment L, page 7, column 2, intra-BMC local cubic feet divided by intra-BMC total cubic feet.
The resulting quotient is multiplied by .5 to account for half of the intra-BMC parcels being held out at the local AO.
Row 13/: [0 * row (12)] + [2 * (1 - row (12)]).
Row 14/: [0 * row (12)] + (2 * [1 - row (12)]).
Row 15/: Intra-BMC rated parcels should not receive long distance transportation.
Row 16/: Docket No. R97-1 USPS-T-16, Appendix I page 13.
Row 17/: All DBMC parcels should receive one leg of local transportation.
Row 18/: [0 * row (16)] + (1 * [1 - row (16)]).
Row 19/: DBMC parcels should not receive long distance transportation.
Row 20/: Costs distributed based on number of legs and cubic feet.
Row 21/: Costs distributed based on number of legs and cubic feet.
Row 22/: Costs distributed based on number of legs and cubic feet.
Row 23/: Row (17) + row (18) + row (19).

Summary of Parcel Post Unit Transportation Costs by Zone

Cost per Cubic Foot by Zone for Each Rate Category

Inter-BMC

Zone	[1] Local costs	[2] Intermediate costs	[3] Long distance ZR costs	[4] Long distance NZR costs	[5] Total inter-BMC costs
Local	N/A	N/A	N/A	N/A	N/A
1-2	$1.0484	[redacted]	$0.4898	$0.0778	[redacted]
3	$1.0484	[redacted]	$1.0725	$0.0778	[redacted]
4	$1.0484	[redacted]	$1.9476	$0.0778	[redacted]
5	$1.0484	[redacted]	$3.5758	$0.0778	[redacted]
6	$1.0484	[redacted]	$5.2686	$0.0778	[redacted]
7	$1.0484	[redacted]	$6.8505	$0.0778	[redacted]
8	$1.0484	[redacted]	$10.1262	$0.0778	[redacted]

Intra-BMC

Zone	[6] Local costs	[7] Intermediate costs	[8] Total intra-BMC costs
Local	$0.6200	[redacted]	[redacted]
1-2	$1.0654	[redacted]	[redacted]
3	$1.0654	[redacted]	[redacted]
4	$1.0654	[redacted]	[redacted]
5	$1.0654	[redacted]	[redacted]
6	N/A	N/A	N/A
7	N/A	N/A	N/A
8	N/A	N/A	N/A

DBMC

Zone	[9] Local	[10] Intermediate costs	[11] DBMC costs
Local	N/A	N/A	N/A
1-2	$0.5362	[redacted]	[redacted]
3	$0.5362	[redacted]	[redacted]
4	$0.5362	[redacted]	[redacted]
5	$0.5362	[redacted]	[redacted]
6	N/A	N/A	N/A
7	N/A	N/A	N/A
8	N/A	N/A	N/A

DSCF Costs	$0.5362 1/
DDU Cost Avoidance (DSCF costs less DDU costs in $/cf)	$0.4454 2/

Sources
Column [1]: Attachment N, page 2, column 7.
Column [2]: Attachment N, page 2, column 8.
Column [3]: Attachment N, page 2, column 9.
Column [4]: Attachment N, page 2, column 10.
Column [5]: Column [1] + column [2] + column [3] + column [4].
Column [6]: Attachment N, page 3, column 7.
Column [7]: Attachment N, page 3, column 8.
Column [8]: Column [6] + column [7].
Column [9]: Attachment N, page 4, column 5.
Column [10]: Attachment N, page 4, column 6.
Column [11]: Column [9] + column [10].
Row 1/: Same as DBMC local costs, column [9].
Row 2/: Attachment N, page 5, row 12.

USPS-RT-20
Attachment D
Page 3 of 5
(Revised USPS-T-26, Attach, N)

Parcel Post Transportation Costs By Rate Category and Zone
Calculation of Inter-BMC Transportation Costs per Cubic Foot by Zone

Inter-BMC parcel transportation costs by function and distance relation		
Local costs incurred by inter-BMC parcels (non-distance related)	$35,871	1/
Intermediate costs incurred by inter-BMC parcels (non-distance related)	[redacted]	2/
Long distance costs incurred by inter-BMC parcels (distance related)	$109,031	3/
Long distance costs incurred by inter-BMC parcels (non-distance related)	$2,662	4/
Total inter-BMC parcel costs	[redacted]	5/

	[1]	[2]	[3]	[4]	[5]	[6]
Zone	**Percentage of inter-BMC cubic feet**	**Percentage of inter-BMC cubic foot miles**	**Local costs (000)**	**Intermediate costs (000)**	**Long distance costs - ZR (000)**	**Long distance costs - NZR (000)**
Local	0.00%	0.00%	$0	$0	$0	$0
1-2	9.08%	1.40%	$3,256	[redacted]	$1,521	$242
3	17.28%	5.82%	$6,198	[redacted]	$6,341	$460
4	28.01%	17.12%	$10,047	[redacted]	$18,663	$746
5	23.13%	25.96%	$8,298	[redacted]	$28,302	$616
6	10.50%	17.37%	$3,768	[redacted]	$18,935	$280
7	5.62%	12.09%	$2,017	[redacted]	$13,177	$150
8	6.38%	20.26%	$2,287	[redacted]	$22,092	$170
Total	**100.00%**	**100.00%**	**$35,871**	[redacted]	**$109,031**	**$2,662**

	[7]	[8]	[9]	[10]	[11]	[12]
Zone	**Local unit costs ($/CF)**	**Intermediate unit costs ($/CF)**	**Long distance - ZR unit costs ($/CF)**	**Long distance - NZR unit costs ($/CF)**	**Total unit costs ($/CF)**	**Reconcile to total costs (000)**
Local	N/A	N/A	N/A	N/A	N/A	N/A
1-2	$1.0484	[redacted]	$0.4898	$0.0778	[redacted]	[redacted]
3	$1.0484	[redacted]	$1.0725	$0.0778	[redacted]	[redacted]
4	$1.0484	[redacted]	$1.9476	$0.0778	[redacted]	[redacted]
5	$1.0484	[redacted]	$3.5758	$0.0778	[redacted]	[redacted]
6	$1.0484	[redacted]	$5.2686	$0.0778	[redacted]	[redacted]
7	$1.0484	[redacted]	$6.8505	$0.0778	[redacted]	[redacted]
8	$1.0484	[redacted]	$10.1262	$0.0778	[redacted]	[redacted]
Total						[redacted]

Sources
Row 1/: Attachment M, page 3, row 22.
Row 2/: Attachment M, page 3, row 22.
Row 3/: Attachment M, page 2, row 13.
Row 4/: Attachment M, page 2, row 14.
Row 5/: Row (1) + row (2) + row (3) + row (4).
Column [1]: Attachment L, page 7, column 1, inter-BMC cubic feet in the given zone divided by total inter-BMC cubic feet.
Column [2]: Attachment L, page 7, column 5, inter-BMC cubic foot miles in the given zone divided by total inter-BMC cubic foot miles
Column [3]: Row (1) * column [1].
Column [4]: Row (2) * column [1].
Column [5]: Row (3) * column [2].
Column [6]: Row (4) * column [1].
Column [7]: Column [3] * 1000 / Attachment L, page 7, column 1 (inter-BMC cubic feet by zone).
Column [8]: Column [4] * 1000 / Attachment L, page 7, column 1 (inter-BMC cubic feet by zone).
Column [9]: Column[5] * 1000 / Attachment L, page 7, column 1 (inter-BMC cubic feet by zone).
Column [10]: Column [6] * 1000 / Attachment L, page 7, column 1 (inter-BMC cubic feet by zone).
Column [11]: Column [7] + column [8] + column [9] + column [10].
Column [12]: Column [11] * Attachment L, page 7, column 1 (inter-BMC cubic feet by zone).

Parcel Post Transportation Costs By Rate Category and Zone
Calculation of Intra-BMC Rated Parcel Costs per Cubic Foot by Zone

Intra-BMC parcel transportation costs by function and distance relation		
Local costs incurred by intra-BMC parcels (non-distance related)	$14,593	1/
Intermediate costs incurred by intra-BMC parcels (non-distance related)	[redacted]	2/
Long distance costs incurred by intra-BMC parcels	$0	3/
Total intra-BMC parcel costs	[redacted]	4/
Percent of local intra-BMC that is held out	50.00%	5/

	[1] Cubic feet	[2] Average Local / Intermediate Legs	[3] Average Cubic foot-legs	[4] Percent	[5] Local Trans Costs	[6] Intermediate Trans Costs
Local zone	1,092,724	1	1,092,724	4.02%	$487	$637
Non-local zone	13,060,986	2	26,121,973	95.98%	$11,635	$15,221
Intra-city / box route adjustment	6/				$2,471	
Total	**14,153,710**		**27,214,697**	**100.00%**	**$14,593**	**$15,858**

Zone	[7] Local unit costs ($/CF)	[8] Intermediate unit costs ($/CF)	[9] Total unit costs ($/CF)	[10] Reconcile to total costs (000)
Local	$0.6200	[redacted]	[redacted]	[redacted]
1-2	$1.0654	[redacted]	[redacted]	[redacted]
3	$1.0654	[redacted]	[redacted]	[redacted]
4	$1.0654	[redacted]	[redacted]	[redacted]
5	$1.0654	[redacted]	[redacted]	[redacted]
6	N/A	N/A	N/A	N/A
7	N/A	N/A	N/A	N/A
8	N/A	N/A	N/A	N/A
Total				**$30,451**

Sources
Row 1/: Attachment M, page 3, row 21.
Row 2/: Attachment M, page 3, row 21.
Row 3/: Attachment M, page 3, row 21.
Row 4/: Row (1) + row (2) + row (3).
Row 5/: Assumption from Docket no. R97-1, USPS-T-16.
Row 6/: Row 1 * Attachment N, page 5, row 10. (even held out parcels incur these costs).
Column [1]: Attachment L, page 7, column 2, intra-BMC cubic feet in the local zone and in all other zones.
Column [2]: Local zone legs reflect half of the local parcels being held out at the AO. Non-local zone legs reflect typical intra-BMC parcel.
Column [3]: Column [1] * column [2].
Column [4]: Percentage of cubic foot legs from column [3].
Column [5]: [Row (1) - row (5)] * column [4].
Column [6]: Row (2) * column [4].
Column [7]: Local zone unit cost = (local zone costs from column [4] / local zone cubic feet from column [1]) + row (5) / total cubic feet.
Non-local zone unit cost = (non-local zone costs from column [4] / non-local zone cubic feet from column [1]) + row (5) / total cubic feet.
Column [8]: Local zone unit cost = local zone costs from column [5] / local zone cubic feet from column [1].
Non-local zone unit cost = non-local zone costs from column [5] / non-local zone cubic feet from column [1].
Column [9]: Column [5] + column [6].
Column [10]: Column [7] * Attachment L, page 7, column 2 (intra-BMC cubic feet by zone).

Parcel Post Transportation Costs By Rate Category and Zone
Calculation of DBMC Rated Parcel Costs per Cubic Foot by Zone

DBMC parcel transportation costs by distance relation	
Local costs incurred by DBMC parcels (non-distance related)	$111,360 1/
Intermediate costs incurred by DBMC parcels (distance related)	[redacted] 2/
Long distance costs incurred by DBMC parcels	$0 3/
Total DBMC parcel costs	[redacted] 4/

	[1]	[2]	[3]	[4]
Zone	**Percentage of DBMC cubic feet**	**Percentage of DBMC cubic foot miles**	**Local costs (000)**	**Intermediate costs (000)**
Local	0.00%	0.00%	$0	$0
1-2	82.80%	54.83%	$92,204	[redacted]
3	14.68%	35.57%	$16,343	
4	2.40%	8.42%	$2,676	
5	0.12%	1.19%	$136	
6	0.00%	0.00%	$0	$0
7	0.00%	0.00%	$0	$0
	0.00%	0.00%	$0	$0
Total	**100.00%**	**100.00%**	**$111,360**	[redacted]

	[5]	[6]	[7]	[8]
Zone	**Local / DSCF Unit Costs ($/CF)**	**Intermediate Unit Costs ($/CF)**	**Total DBMC Unit Costs ($/CF)**	**Reconcile to Total Costs (000)**
Local	N/A	N/A	N/A	N/A
1-2	$0.5362	[redacted]		
3	$0.5362			
4	$0.5362			
5	$0.5362			
6	N/A	N/A	N/A	N/A
7	N/A	N/A	N/A	N/A
8	N/A	N/A	N/A	N/A
Total				[redacted]

Sources
Row 1/: Attachment M, page 3, row 20.
Row 2/: Attachment M, page 3, row 20.
Row 3/: Attachment M, page 3, row 20.
Row 4/: Row (1) + row (2) + row (3).
Column [1]: Attachment L, page 7, column 3, DBMC cubic feet in the given zone divided by total DBMC cubic feet.
Column [2]: Attachment L, page 7, column 7, DBMC cubic foot miles in the given zone divided by total DBMC cubic foot miles.
Column [3]: Row (1) * column [1].
Column [4]: Row (2) * column [2].
Column [5]: Column [3] / Attachment L, page 7, column 3 (DBMC cubic feet by zone, all cubic feet will have a local leg).
Column [6]: Column [4] / Attachment L, page 7, column 11 (regular DBMC cubic feet by zone since this is the cubic feet that will have an intermediate leg).
Column [7]: Column [5] + column [6].
Column [8]: (Column [5] * Attachment L, page 7, column 10) + (column [7] * Attachment L, page 7, column 11).

CHAIRMAN GLEIMAN: Again, only one party has requested oral cross-examination -- in this case, only one party has requested oral cross-examination, United Parcel Service. Is there anyone else who wishes to cross-examine?

[No response.]

CHAIRMAN GLEIMAN: If not, then, Mr. McKeever, you may proceed.

MR. McKEEVER: Thank you, Mr. Chairman.

CROSS-EXAMINATION

BY MR. McKEEVER:

Q Ms. Eggleston.

A Good morning.

Q Could you refer to page 2 of your testimony, please?

A I have that.

Q In the second paragraph on that page, the second sentence, I believe you indicate that it would be rational to assume that the same amount of DBMC volume was dropped at the DSCF in both the pre mix and post mix situation, is that correct?

A That is correct.

Q Now, the assumption in Docket R97-1 was that 7.11 percent of Parcel Post was dropped at the DSCF, is that correct?

A According to Witness Luciani, that number was actually an estimate of what -- how much volume of DSCF there would be in the test year.

Q It was based on a survey conducted by Ms. Mayes, is that correct?

A That's correct.

Q Okay. So mailers were already drop shipping, at least at the DSCF, and maybe at the DDU?

A I don't believe it was the amount being -- I don't know if it was the amount being dropped there or what mailers said they would drop.

Q Okay. You did use that 7.11 percent for base year 1998 in your direct testimony, is that correct?

A Yes, I did.

Q Now, we have some idea what the post mix DSCF and DDU volume is based on actual RPW information from Postal Quarter 3 of 1999, is that correct?

A That is correct.

Q That is what Mr. Plunkett used, the Postal Quarter 3, 1999 information to estimate the DSCF and DDU share of DBMC volume?

A I can't testify for Witness Plunkett, but that is my understanding.

Q Okay. I just have a few questions to see if I can understand or clarify something in my mind. Could you turn to your Attachment C, please?

A I have that.

Q And I am looking at page 1 of 2.

A I have that.

Q There is a number in the first column, 1998 GFY volume, and then it says 2001 BR, which I take to mean before rates.

A Yes. That is -- I took this directly from library reference I-97, and in there, Witness Daniel -- the majority of that column was 1998 volume, but for parcel post specifically, but was actually test year 2001 before mix is what she meant.

Q Okay. So that we can ignore in that column the 1998 GFY?

A Yes, you can.

Q Okay. Thank you.

Then the 298 next to DBMC in that column, does that indicate that there is expected to be 298 million DBMC pieces in 2001 before rates?

A What that is, is a test year estimate of the amount of drop-shipped parcel post, and in the test year before we do the cost reductions, we have not yet adjusted for the fact that some of that drop-ship is DFCF and DDU volume.

Q Okay. So the 298 million really represents DBMC DSCF and DDU combined?

A Yes.

Q Now, am I correct in reading this that the post mix, the after rates, I guess, situation would be that about 30 million of those parcels would be DSCF and DDU parcels? And I'm looking at the second -- well, that's a before-rates volume number, so I'm not sure. That's really my question.

A What that is, is that is when you take that 298 and distribute it among what we assume is DBMC, DSCF and DDU.

Q Okay. If you go over to the column a little bit -- right around the middle of the page, 2001 GFY AR volume -- that's after rates volume -- do you see that?

A Yes.

Q So does that column indicate that in the after-rates test year situation, you would be expecting 2 million DSCF parcels and 28 million DDU parcels?

A Yes, that is correct.

Q Out of about 298, 299 million parcels total?

A Yes, approximately that.

Q And is that mix based on the RPW quarter 3 1999 data, do you know?

A The before rates are based off the -- I believe they're based off the quarter 3 1999 data. We get after-rates volumes -- I'm not sure where she got them. It might be Thress, it might be Tolley, but I don't know how they adjust for the impact of rates.

Q Okay. Well, if you look at column 2, which, I take it, is the 2001 GFY before rates volume, and compare it to the 2001 Government Fiscal Year after-rates volume, the DSCF and the DDU numbers stay the same; do you see that?

A They stay the same as they're shown. Those numbers have decimal points to them, and I do not know if they change or not off the top of my head.

Q Okay. If they do change, I take it they change past the decimal point under --

A That would be correct.

Q Okay. So looking at the after-rates volume numbers, then, of the total of 299 million after-rates, I think it comes to 269 plus 30. Do you see that?

A Yes.

Q About ten percent, 30 million out of 299 million pieces, would be dropped at the DSCF and the DDU?

A Approximately ten percent, yes.

MR. McKEEVER: That's all I have, Mr. Chairman.

CHAIRMAN GLEIMAN: Is there any follow-up?

Questions from the bench?

Would you like some time to prepare for redirect?

MR. REITER: There will be no redirect.

CHAIRMAN GLEIMAN: That being the case, Ms. Eggleston, that completes your testimony here today. We appreciate your appearance, your contributions to the record, and you're excused.

THE WITNESS: Thank you.

[Witness excused.]

CHAIRMAN GLEIMAN: Mr. Reiter, I think you have the next witness also.

MR. REITER: You are correct, Mr. Chairman. Our next witness is Dr. Victor Zarnowitz.

CHAIRMAN GLEIMAN: And I know the answer on this one.

MR. BUC: Mr. Chairman, Mr. Ackerly was informed by me several minutes ago that Mr. Dowling was cancelled and Mr. Ackerly is on his way.

CHAIRMAN GLEIMAN: Thank you, Mr. Buc. I appreciate your help on that.

Dr. Zarnowitz, if I could please get you to stand and raise your right hand.

Whereupon,

VICTOR ZARNOWITZ,

a witness, was called for examination and, having been first duly sworn, was examined and testified as follows:

DIRECT EXAMINATION

BY MR. REITER:

Q Dr. Zarnowitz, I am handing you a copy of a document entitled Rebuttal Testimony of Victor Zarnowitz on

Behalf of the United States Postal Service labelled USPS-RT-2. Was this document prepared by you or under your direction?

A Yes, it was.

Q And if you were to testify orally today, would your testimony be the same?

A Yes, it would.

MR. REITER: Mr. Chairman, I will provide two copies of that document to the reporter and ask that they be entered into evidence.

CHAIRMAN GLEIMAN: Is there an objection?

[No response.]

CHAIRMAN GLEIMAN: Hearing none, the testimony of this witness will be received in evidence and transcribed into the record.

[USPS-RT-2, Rebuttal Testimony of Victor Zarnowitz, was received in evidence and transcribed in the record.]

USPS-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
VICTOR ZARNOWITZ
ON BEHALF OF THE
UNITED STATES POSTAL SERVICE

CONTENTS

AUTOBIOGRAPHICAL SKETCH

My name is Victor Zarnowitz. I am an economist working for The Conference Board, the premier worldwide business membership and research network. I am Professor Emeritus of Economics and Finance in the Graduate School of Business of the University of Chicago, and Research Associate at the National Bureau of Economic Research (NBER). I have been with the NBER since 1952, and teaching at Chicago since 1959. I have been a consultant to the Bureau of Economic Analysis in the U.S. Department of Commerce, the Census Bureau, the Energy Department, and the Congressional Budget Office. I have visited and lectured at the Universities of Mannheim, Munich, Zurich, Columbia, Harvard, and Stanford. I have authored numerous articles and several books on business cycles, indicators, and forecasting.

In addition, I was in charge of the *ASA-NBER Quarterly Survey of the Economic Outlook* from 1968 to 1990; a coeditor of the *Journal of Business* and associate editor of several other professional journals; and an editor of and regular contributor to *Economic Forecasts: A Monthly Worldwide Survey.* I am a Fellow of the National Association of Business Economists, a Fellow of the American Statistical Association, and Honorary Member of the Center for International Research on Economic Tendency Surveys. I earned my Ph.D. in economics at the University of Heidelberg (Germany) in 1951.

I. PURPOSE AND SCOPE OF TESTIMONY

I have been asked by the Postal Service to rebut testimony presented to the Commission which asserts that economic conditions will continue to be stable and that inflation will continue to be relatively low and predictable over the projected rate cycle. Specifically, I address comments by witnesses Buc (USPS/DMA-T1), Burns (USPS/OCA-T2), Rosenberg (USPS/OCA-T3), and Stapert (USPS/CPRA-T1).

II. THE RELEVANCE OF NEW ECONOMICS OF A PERPETUAL NONINFLATIONARY BOOM

The United States Postal Service has included in its request for changes in rates and fees a provision for contingencies of 2.5 percent of test-year expenses.[1]

Intervenor witnesses diverge in their estimates of the nature and extent of the "contingencies" now faced by Postal Service management.

Those contingencies relate to uncertainties in real economic activity (aggregate employment, production, and incomes) and the overall nominal changes (in inflation and interest rates). The following issues are relevant to the evaluation of these uncertainties. Has the business cycle been abolished? What was the risk of a slowdown or recession when the Postal Service case was filed and how has it changed since? What was the risk of increased inflation

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[1] According to 39 USC § 3621:

> Postal rates and fees shall provide sufficient revenues so that the estimated income and appropriations to the Postal Service will equal as nearly as practicable total estimated cost of the Postal Service. For purposes of this section, "total estimated costs" shall include (without limitation) operating expenses, depreciation in capital facilities and equipment, debt service . . ., and a reasonable provision for contingencies.

then and what is it now? What can we learn from economic and financial history? How should inflation, growth trends and cycles be measured in this context?

It is on these questions concerning the economy, its state and likely changes, that this testimony will concentrate. The main reason for this is my qualifications as a witness: as stated above, I am an economist who has spent a long career studying, teaching, and writing about macroeconomics and finance, with particular attention paid to business cycle theory and history, indicators, and forecasting. A secondary reason is that, in my judgement, changes in the economy are a very important set of factors for the problem that we address here.

Consider the witness opinion that the Postal Service's provision for contingencies amounting to 2.5 percent of its total estimated costs is not reasonable. This view, represented in particular by the direct testimony of economist Edwin A. Rosenberg on behalf of the Office of the Consumer Advocate (OCA), is based on a highly optimistic appraisal of the state of the U.S. economy. According to witness Rosenberg, "The United States is currently enjoying the longest economic expansion in over half a century. We continue to have robust economic growth combined with low and relatively stable inflation." Tr. 22/9815. Similar comments are made by witness Buc, Tr. 22/9750, while witness Burns relies on information from witness Rosenberg's testimony (Tr. 22/9746-47). Witness Stapert refers to witness Buc's characterizations of the economy, as well as projections by "Congressional and Administration sources" that forecast favorable economic conditions. Tr 22/14456, 14475.

These statements are similar to those made by proponents of the "New Economy" paradigm that has now been held by some enthusiastic or interested parties for years without much change and without much evidence and analysis. Under this paradigm, the economy is seen as undergoing a sea change and entering a new era of indefinite prosperity. The current business expansion is believed to be uniquely long, strong, and stable, with inflation no longer feared to be a serious threat to prosperity.

But each of these points is highly questionable. My testimony will show that, although the U.S. economy has benefited from benevolent economic conditions since the mid-1990s, there has been a gradual increase in the imbalances and risks that accompany any boom. This process has accelerated in the immediately past and current year, resulting in a much higher level of uncertainty about the direction of the economy.[2]

III. U.S. ECONOMIC ACTIVITY AND LEADING INDICATORS: SIGNS OF A SLOWDOWN?

Witness Rosenberg speaks of the present U.S. expansion as being the longest on record. While this is true, it has not been the strongest: the cumulative gains in total output (real GDP) and nonfarm employment were

[2] I have analyzed the subject in three recent papers, from which I shall draw selectively in the arguments that follow. See Victor Zarnowitz, "Has the Business Cycle been Abolished?" *Business Economics*, vol. 23, no. 4, pp. 39-45 (1998); "Theory and History Behind Business Cycles: Are the 1990s the Onset of a Golden Age?" *Journal of Economic Perspectives*, vol. 13, no. 2, pp. 69-90 (1999); "The Old and the New in U.S. Expansion of the 1990s" National Bureau of Economic Research (NBER) *Working Paper* 7721 (May 2000).

greater in the 1960s and even in the 1980s than in the 1990s (measured over the same number of periods since the initial troughs; see Chart 1). This is because the early recovery in 1991-92 was unusually sluggish, as shown in particular by stagnant employment and rising unemployment. Only since 1996 did U.S. economic growth become remarkably high and stable. This reduces the claim that a new pattern of noninflationary growth and noncyclical prosperity is already firmly entrenched and underscores the continued relevance of lessons from the long business-cycle history.

Second, total output and employment flattened in the late stages of past long U.S. expansions, as shown by the patterns for the 1960s and the 1980s: slowdowns often precede recessions. There is no sign yet that this is occurring now in our chart 1, panel A, for real GDP. However, this graph ends in Q1 2000 (years and quarters used in my testimony are calendar years and quarters). There is new evidence that growth of consumption declined substantially in the second quarter (see section VII below for detail). Growth in employment tapered off slightly by June 2000 (panel B). Business investment accelerated but some of it is likely to be reversed, since inventories increased strongly relative to sales. The rise in government expenditures on the military and Census 2000 is also apt to prove temporary.

Third, and more importantly, a slowdown shows up first in the leading indicators before it does in the coincident indicators such as output and employment. The Composite Index of Leading Economic Indicators (LEI) reached a high of 106.3 (1996=100) in January 2000, then stayed flat and eased to 106.0 by May (Chart 2). Its average monthly percent change drifted down from 0.8 percent to 0.3 percent between June - December 1999 and November 1999 – May 2000.

In particular, the financial sector subindex of the LEI moved sharply down at the end of 1999, propelled by changes in each of its three components. Real money supply (M2) grew more slowly since the Fed began to tighten by raising its benchmark interest rate about a year ago. Stock prices (S&P 500) flattened in 2000 after rising sharply in the late 1990s, and the market's exuberant technology sector declined. The interest rate spread (10-year Treasury bonds less Federal Funds), which moved in the 0.7-1.2 percent range from June 1999 through February 2000, has plunged into negatives lately (-0.43 percent in June 2000). Such yield spread inversions, when caused by increases in short-term interest rates, usually occur before and near business cycle peaks, and are viewed as relatively reliable adverse signals. (However, note that reductions in the supply of long-term Treasury bonds related to fiscal policy contributed recently to increases in prices and decreases in yields of such bonds. This blurs somewhat the meaning of the recent U.S. yield inversions, but they still represent lower profit margins for the banks and raise a disturbing prospect of conflicting effects of monetary and fiscal policies on the direction of interest rates.)

Series that represent costs of doing business such as the inventory-sales ratio, change in unit labor cost, average prime rate charged by banks, and commercial and industrial loans outstanding are components of the U.S. Index of Lagging Indicators. So are such measures of consumer and social costs as ratio of installment credit to personal income, change in the consumer price index for services, and average duration of unemployment. Thus, an accelerated rise in the lagging index, which often occurs late in an expansion, provides a warning that an imbalance due to rising costs may be developing. When their scales are inverted (put upside down) some of the laggers turn into long leaders. The ratio of the Coincident to the Lagging Index, which had leads of 8-11 months at most recent U.S. business cycle peaks, has now risen to a new high-plateau level (above 110 in March-May 2000).

In his July 20 testimony to the Senate Banking Committee, Federal Reserve Chairman Greenspan stated that demand may be slowing and getting better aligned with the economy's potential output growth, while impressive productivity advances continue. The Fed has raised the overnight bank lending (Federal Funds) rate six times since June 1999 to 6.5 percent. "Even without the rise in interest rates," Greenspan said, "an eventual leveling out or some tapering off of purchases of durable goods and construction of single-family housing would be expected." Further, the cessation of huge market gains this year should dampen the "wealth effect," which has consumer spending, particularly on homes and durables, driven up by rising stock prices.

Chart 2 shows that the U.S. Leading Index increased but very gradually in the first five years of the present expansion, much faster and steadier in the next four years (see panels A and B for levels and six-month smoothed and annualized growth rates, respectively). Remarkably, the cumulative gains of the leading index in the 1990s were quite modest compared with the 1960s and even with the 1980s. However, since 1996 the growth rate of the leading index was relatively high and stable. Its decline in the latter half of 1999 and 2000 still looks moderate and reversible.

IV. UNEMPLOYMENT AND INFLATION: THE SUCCESSES AND THE RISKS

Intervenor witnesses cite a low unemployment rate as evidence of strong and continuing growth in the U.S. economy (for example, Tr. 22/9750 (witness Buc)). At first glance, the combination of low unemployment and low inflation does look remarkable. The U.S. unemployment rate rose from over five to nearly seven percent of the civilian labor force during the recession and initial recovery in 1990-92, then declined gradually back to 5 percent in 1992-97. Meanwhile, U.S. consumer price inflation fell sharply from about 7 percent annual rate early in 1990 to around 3 percent in 1992-95 and then less than 2 percent in 1996-97 – contrary to the conventional forecasts from the Phillips curve that assume an inverse relationship between the two variables (see Chart 3, panels A and B). However, after moving narrowly around a low floor in 1998, inflation in 1999-2000 rose irregularly from below 2 percent to around 4 percent. At the same time, unemployment continued on its slow way down to near 4 percent now (only a little above its record lows of the late 1960s).

Thus, the enormous surge of U.S. consumption and investment demand in the second half of the 1990s succeeded in reducing the jobless rate drastically (below the most optimistic expectations). Yet inflation was stable or declining most of the time, and rising only lately and that still in the moderate range.

These several factors show that we were very fortunate in the recent past but they are not such as to be highly reassuring about the future.

Abroad, disinflation and, in some countries, deflation contributed much to the recent declines in U.S. inflation through lower prices of imports, materials, and finished products. But this is largely over since the upturns following the Asian recessions. The price of oil rose sharply and prices of some industrial materials such as metals rose moderately. Internationally, the forces of deflation weakened and those of inflation strengthened. Also, globalization defined broadly as a trend toward increased integration across countries of product, input, and asset markets apparently reduced the powers of U.S. corporations to raise prices and of U.S. labor markets to raise wages. But again these effects must be expected to decrease when, as many expect, the economic climate abroad improves relative to that in the United States.

In addition, falling prices of computer hardware and software have helped to contain inflation as has Internet marketing. In a way, this credits good luck, in the form of a coincidence of favorable "supply shocks" – again, not something that can be comfortably projected into the future.

The latest news is that the U.S. Consumer Price Index (CPI) increased 0.6 percent in June 2000, the highest rate since March (0.7%). In the first half of this year, the CPI rose at a 4.2 percent annual rate, up from 2.2 percent in the first half of 1999. Most of this acceleration reflects sharply higher gasoline and natural gas prices, which jumped by 7.8-8.8 percent in June. In view of the importance of energy and food costs, I see little consolation in the fact that the "core" inflation (which excludes these costs) is still rising at much lower levels (from 1.7 to 2.6 percent).

The Federal Reserve wants to prevent further increases in inflation, and its policy to this end is to raise interest rates, thus presumably reducing the liquidity in the economy and growth of overall demand. According to this thinking, higher prices of inputs, including presumably higher wages, arise from pressures of excess demand and must be countered by lowering the pace of the expansion.

The Fed's reputation is that its resources and powers are big enough to make its policies likely to succeed and unwise to oppose; hence, a slowing of the economy is widely expected. Moreover, the prevailing view appears to be optimistic in anticipating a "soft landing" rather than a "hard landing" – meaning that the slowdown will not worsen into a recession. But knowledgeable observers recognize that the risk of things going wrong is significant here. *One* substantial retardation in aggregate real activity occurring during a long business expansion (for whatever reason, not necessarily associated with policy or external shocks) is a frequently observed and hence by no means a surprising event. On the other hand, it is not often that *two* such sluggish episodes of cyclical dimensions interrupt a single expansion (as did happen in the 1960s).

Historically, U.S. inflation tended to increase in late stages of expansion and early stages of contraction, decrease before the troughs and thereafter during recoveries. Inflation, then, being mostly procyclical and lagging, has at times picked up during slowdowns and even after downturns (see chart 3B for some examples). Declines in demand presumably reduce inflation, but the corresponding declines in supply have the opposite effect. The adverse and policy-defying combination of lower real growth and higher inflation, far from uncommon in recent times, should not be thought of as necessarily a thing of the past.

V. WILL WAGE GAINS STAY MODEST? SOME LESSONS FROM COST, PRODUCTIVITY, AND PROFITABILITY RECORDS

In addition to focusing on unemployment and inflation, there are a number of other factors to consider when making a judgement about the state and direction of the economy. One of these is trends in cost and productivity. Average hourly compensation increased most of the time at considerably lower rates in this expansion than during the 1960s and the 1980s (Chart 4A). Growth of nominal wages so measured had a downward drift in 1990-94, an upward drift and less variability thereafter, and some weakening in the last two years (Chart 4B).

In real (inflation-adjusted) terms, hourly wages rose strongly in the recovery of 1991-92, but changed little in the next four years before gaining sharply in 1997-98 and slowing down again in 1999-2000 (Chart 5A). Growth of real wages fluctuated largely in the percentage range of -2% to +4%; it declined from over 4 percent to less than one percent in 1999-2000 (Chart 5B).

Total costs of employment in dollars, including fringe benefits covered by employers, increased by more than 50 percent in 1982-90, less than 30 percent in 1991-98. The annual growth rate of these costs fell in the first half of the

1990s from almost 6 percent to 2.5 percent, but it then drifted up most of the time in the second half to end up at 4.5 percent in Q1 2000. In the 1980s, growth of the Employment Cost Index (ECI) was throughout higher, on the average by about one percentage point (see Chart 6, panels A and B). Most recently (July 27), the ECI was announced to have increased by one percent in the second quarter of 2000 after a rise of 1.4 percent in the first quarter (the largest in a decade). The sharp rise in the ECI in 1999-2000 is unusual in having been maintained for four consecutive quarters. It supports the fears (apparently shared by the Fed) that the labor market may yet tighten so as to fuel wage raises, which lead to more price inflation or a squeeze on profits.

The six-month smoothed annualized growth rate of unit labor cost (ULC) in the nonfarm business sector stayed relatively low in this expansion after the first year of recovery. It rose from near zero to three percent in 1996-mid-1998, then fell back to small fractions in the last quarter of 1999 and the first quarter of 2000 (Chart 7B). In the past, ULC typically moved up in late expansion stages, as shown here for the 1960s and 1980s. The series is classified as lagging, and its recent decline is unusual.

Nonfarm output per hour of work (labor productivity, LP) grew in the 1990s at rates that for some time were about as variable as those in the comparable stages of the cycles in the 1960s and 1980s, and often lower. Productivity stabilized and rose since 1997 but its growth may look surprisingly moderate to the new technology enthusiasts. However, the recent increase in LP growth, from two percent to four percent, stands in contrast to the weakness of the same series in late 1980s and its decline in late 1960s (Chart 7A). The patterns for the earlier expansions agree with the long observed tendency for the LP growth to be procyclical and leading.

Chart 8A shows that corporate profits after taxes in constant dollars have doubled in the present expansion (after a slow start in the first two recovery years) and are still going strong. Profit margin-ratio of domestic profits adjusted for inventory valuation and capital consumption to corporate domestic income - increased more steadily from about 7 percent to 11 percent (Chart 8B). The closely related ratio of the implicit price deflator to unit labor cost in the U. S. nonfarm business sector had an even more persistent upward trend that accelerated recently (Chart 8C).

Profit margins are associated positively with growth rates of real GDP and labor productivity, negatively with inflation, interest rates, and risk aversion measured by the difference, yield on new high-grade corporate bonds minus yield on long-term Treasury Bonds.[3] This helps to explain why economic slowdowns carry the risk of recession: when growth of total output slows, profits decline, which drags down stocks, investment in plant and equipment, and ultimately incomes, spending, and general business activity. Such developments occurred in late stages of many earlier business expansions (see the patterns for the 1960s and 1980s in Chart 8, for example). But in the current cycle the profit variables declined only mildly in 1997-1998 so far.

[3] For evidence and analysis, see Victor Zarnowitz, "Theory and History Behind Business Cycles: Are the 1990s the Onset of a Golden Age?" *Journal of Economic Perspectives*, vol. 13, no. 2, pp. 69-90 (1999).

However, a long and strong expansion in profits can present its own problems inasmuch as it coincides, and is presumably associated, with a relative weakness of wages. Such shifts in income distribution have not been uncommon in the past, and they would be expected to prove temporary. If booms benefit profits, periods of more moderate or weaker activity are likely to strengthen or restore the share of labor income.

In particular, consider the recent situation, in which the growth rates of real wages and unit labor costs declined to very low levels even while labor productivity (output per hour) increased handsomely and corporations enjoyed high profitability (review Charts 5-8). The combination of such conditions would make intensified pressures for higher wages very likely – the more so, the longer it lasted. If the demand for wage and salary raises gained force and spread, the rising costs could squeeze profits sufficiently to produce a major slowdown or recession necessary to relieve the pressures.

VI. STOCK PRICES SOAR FAR BEYOND PROFITS: AN UNSUSTAINABLE RISE?

One of the most remarkable features of the current expansion, and one of the favorite explanatory mechanisms of proponents of the "New Economy" paradigm, has been the tremendous rise in equity prices. The Standard and Poor' s Index (1941-48=10), which covers common stock prices of 500 large and medium -size companies using their capitalization numbers as weights, provides a fair, though certainly incomplete picture of the U.S. equity market. The S & P 500 index rose quite slowly in the first four years of this expansion through 1994, but then just about doubled in 1995-96 and doubled again in 1997-99 with only one sharp but brief setback. Its growth become less explosive and more irregular in the first half of the year 2000. The previously most exuberant technology sector suffered a major slowdown but not a much feared crash. The comparisons with the 1960s and the 1980s show that the recent bull market has been indeed exceptionally strong but also increasingly volatile (Chart 9A).

While the stock price index quadrupled in 1991-2000 for the S & P 500 companies, their profits or earnings less than doubled so that the price to earnings (PE) ratio increased from about 15 to 35 or 2 1/3 times. That ratio was far higher in this expansion than in the previous long U.S. cycles (Chart 9B). In 1999-2000, P/E slid from 35 to 30, still high enough historically for the fears of an overheated market to persist. Some prominent finance scholars, including the Nobel laureate Franco Modigliani and Robert Shiller, a long-time student of market trends and fads, see a bubble about to burst, though with unpredictable timing; others, e.g. Jeremy Siegel of Wharton, are less pessimistic, but almost all are increasingly cautious. In any event, it is no longer the case that new companies in the popular high-tech area enjoy generous market pricing even without showing any actual or near-term prospective profitability.

The most recent study by Yale's professor Ray Fair, performed on his well-researched econometric model, concludes among others that "the current level of stock prices implies an unrealistically large share of profits in GDP in the future." It seems unlikely that profits would increase annually by some 14 percent over the next ten years (more than twice the rate observed since 1952).

Moreover, should the market fall to a value consistent with its average historical growth, then the "Fed does not have the power through interest rate changes to prevent a recession from taking place."[4]

That a significant and persistent overvaluation developed in a substantial part of the stock market very recently (that is in the last few years of the century) is actually conceded even by many seasoned observers and forecasters who are basically optimistic. They believe that the new technology decreased the relative prices of computers and other capital goods and increased productivity strongly by substitution of capital for labor, and that this explains much but not all of the recent stock market boom. However, they also think that the likely effects of this will include a higher real rate of interest and a greater "wealth effect" on consumption demand of the rising stock market. To counter the potential for higher inflation, a tighter monetary policy and higher market interest rates will be needed.[5]

VII. MORE UNCERTAINTY ABOUT INTEREST RATES AND THE PACE OF EXPANSION

Witness Rosenberg testified that Federal Reserve Board actions are intended to keep inflation at moderate levels. Tr. 22/9812. It is not clear, however, that the recent rise in interest rates is having the desired effect on the economy.

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[4] Ray C. Fair, "Fed Policy and the Effects of a Stock Market Crash on the Economy", *Business Economics*, Vol. 35, No. 2, April 2000, pp. 7-14 (quotations from p. 13).
[5] Joel L. Prakken, " Potential Productivity and the Stock Market in the 'New' U.S. Economy", *ibid.*, pp. 15-19.

The observed nominal interest rates are procyclical, that is, they usually rise in expansion and decline in contractions. This reflects largely expectations of inflation, which have a similar procyclical pattern. In addition, interest rates show longer trends-upward in the 1960s and 1970s, downward in the 1980s and 1990s. These movements were very large, from about 2-4 percent to 14-16 percent and back to low single digits. Recently, these nearly symmetrical trends overwhelmed the cyclical changes in the rates, producing declines during the expansions of the 1980s and 1990s (Chart 10, A and B).

Thus, both the 3-month Treasury bill note and the new high-grade corporate bond yield (representing short-term and long-term interest rates, respectively) show predominantly upward movements in the 1960s but downward or sideward movements in the two most recent business cycles. However, the short rate increased from 4 percent to 6 percent and the long rate from 6 percent to 8 percent in the past year. These rises, like the previous ones in 1994, reflect the Fed' s tightening moves and also the bond market's own changing expectations of inflation and the effects of monetary and fiscal policies.

As already noted, the spread or difference, long minus short interest rate, typically reaches a peak early in a business expansion, then embarks on a long descent that may end in negatives, that is, in the inversion of the spread (normally, the long rate exceeds the short rate). Chart 10, panel C, illustrates these patterns for all three of the recent U.S. expansions, and shows the latest inversion of the spread in April 2000 (still shallow but deepening in June). Currently, the Federal Funds (overnight bank lending) rate is 6.5 percent, the five-year and thirty-year Treasury bond coupon rates are 6.75 percent and 6.25 percent, respectively.

Will the economy slow sufficiently for the Fed to cease raising the interest rates in the near future? Or will the tight labor market drive up wage demands and, ultimately, price inflation? Will interest rates continue rising and will the short rates rise further relative to the long rates? No one can be sure about the answers and the uncertainties surrounding each of these questions appear to be rising.

What the latest data do establish is that the U.S. economy still resists showing a decline in the rate of growth for its most comprehensive output measure, the real gross domestic product (GDP). According to the first estimates of this series released on July 28 (subject to future revisions), GDP rose in the second quarter of the year 2000 at a faster-than-expected 5.2 percent annual rate. Consumer spending did slow to 2.3 percent from a 3.5 percent increase in the first quarter, so the higher interest rates are likely to be having a deferent effect, particularly on outlays for durables such as automobiles. But at the same time business invested heavily in new equipment and software (for the second time, at a 21% pace!) and built up inventories (at almost twice the annual rate of the first quarter). However, note that some of the surge in inventories was presumably brought on by the slower growth of sales, hence unintended and to be followed soon by business efforts to reduce the stocks of unsold goods.

Government spending rose at a 6 percent annual pace, up from only about one percent in the first quarter. The trade deficit continued to widen, which in the long run is unsustainable and a major problem: in Q2 2000, exports increased at a 7.3 percent annualized rate, imports at a 17 percent rate (!), all in real terms.

VIII. MONETARY GROWTH RATES: STRONGLY UP IN 1995-98, DOWN THEREAFTER

Again, although judging from emphasis in official announcements, the Fed's main concern in the 1990s was recurrent fears that the economy will overheat and reignite inflation, the actual behavior of the variables under Fed control suggests that keeping the economic expansion going was also important, at times even more so. Thus, growth of the monetary base (MB), which includes currency and bank reserves, was kept very high during the sluggish early 1990s but then allowed to drop sharply in 1994-95, when a counterinflationary slowdown was the policy's target. In the second half of the expansion, MB growth picked up strongly and reached an explosive rate of 15 percent briefly last year (presumably to counter the Y2K problem). Even after a quick downward correction this year, MB growth stayed high at about 8 percent (Chart 11A).

Growth of M3 (currency, checking, savings and time deposits, etc.), which is very difficult to control, was low in 1990-94, increased strongly, from about 2 percent to 11 percent in 1995-98, but then declined to around 8 percent (Chart 11B). This is still relatively high. Despite worries about the bull market's momentum and its concomitants--the wealth effect driving up personal consumption, including imports, and severely depressing personal saving, the Fed evidently did little to influence the huge flow of money and credit feeding the demand for stocks.

When expressed in constant dollars (deflated with the Consumer Price Index), the broad money supply tends to be a leading indicator: M2/CPI, for example, reaches an early peak when nominal money supply slows while prices rise(M2 covers mainly currency, time and savings deposits). Chart 12A shows that growth of real M2 declined from about 7 percent to 2 percent in 1999-2000. The growth rate of the M2+ aggregate (M2 and mutual bond and stock funds) starts earlier and extends from 9 percent to less than 1 percent (Chart 12B). If maintained, such low growth of real money supply could well contribute to slowing down the pace of economic activity. (Note the low and negative growth rates of deflated M2 and M2+ in the late stages of the expansions of the 1960s and 1980s--but also in 1990-95. Similar developments can be observed in the M3 growth rate; see Chart 12C).

IX. LOW SAVING, HIGH BORROWING

Another risk to the rosy economic scenario is the decrease in savings, and the increase in debt. Federal receipts increased more steadily but cumulatively somewhat less in the past decade than in the corresponding stages of earlier long U.S. expansions (Chart 13A). Their growth accelerated in recent years due to a surge in taxes. Federal expenditures rose much less in the late

1990s than in the late 1960, and the late 1980s (Chart 13B). This can be largely attributed to major reductions in military spending.

As a result, federal budget deficits declined greatly and were eventually replaced by increasing surpluses beginning in 1998. National debt increased from 40 percent of nominal GDP in 1990 to 49 percent in late 1993, then decreased back to 40 percent by late 1999. The relatively restrained fiscal policy helped to keep interest rates low and had generally positive effects (let us hope the recent rise in government spending does not signify a reversal to more prodigal ways).

While the government ceased dissaving and started saving in the form of surpluses, the personal saving rate dropped persistently from nearly 7 percent of disposable personal income in 1992 to less than 2 percent in late 1999. The presumed reasons center on the strong increases in tax receipts and in capital gains from appreciation of housing and stocks. Gross business savings (undistributed corporate profits and business depreciation allowances) were high, above 15 percent of nominal GDP, in 1995-99, reflecting the strength of profits.

With low personal saving, high consumption, high imports, and the stock market boom, there was a great increase in private borrowing. The bull market in very volatile or illiquid securities involved investors and traders buying on margin, a particularly risky and expensive type of credit (when the stocks which back the loans fall in value, buyers on margin must put up more money to make up the shortfall). The nonfederal (mostly private) debt is huge, exceeding the current value of GDP by almost half, and creeping slowly upward.

As the U.S. economy grew much more quickly than its trade partners, since mid-1990s, the nation's trade deficits swelled to record levels, absolutely and relative to GDP. The excess of real imports over real exports, i.e., the foreign trade deficit financed by foreign borrowing, already large in late 1980s, grew particularly fast since 1997. This is a long-run problem but a fundamental one: to avoid piling up foreign debt and exposure to adverse exchange-rate and trade effects, we need to save more and export more.

X. SUMMARY AND CONCLUSION

In the preceding sections of this testimony (II-IX), I have presented and evaluated considerable evidence of the following:

1. The Business Cycle. The vigorous economic boom in the U.S. developed only in the second half of the 1990s, the early recovery in this cycle having been unusually sluggish. The expansions of the 1960s and 1980s were actually stronger over the same durations. Abroad, the past decade witnessed numerous financial crises and major recessions. The business cycle is far from dead and must be considered in any serious forecasts. Historically, long expansions often ended in slowdowns that risk recessions by reducing profits and investment. (See sections II, III, and V).
2. The Risk of a Slowdown. The Fed raised its benchmark interest rate seven times before the U.S. economy slowed in 1995 and again six times

last year in an effort to bring down what it considers an unsustainably high and potentially inflationary pace of the expansion. Consumption growth has finally declined substantially in the second quarter of the year 2000, but business investment and government spending accelerated. Some of the latter is temporary and likely to be reversed. Thus, business is likely to try and reduce inventories that rose relative to sales. Any slowdown should show up first in the leading indicators before it does in output and employment (the coincident indicators). In fact, the U.S. Composite Index of Leading Indicators (LEI) flattened and eased slightly by May 2000. Its financial subindex, including stock prices, real money supply, and the yield spread, shows considerably stronger signs that the economy may turn more sluggish. The frantic bull market of the late 1990s cooled a great deal this year, especially in the overvalued parts of the popular new technology sector. The interest-rate spread turned negative recently, an adverse inversion signal. Monetary growth rates, strongly up in 1995-98, declined thereafter, and so did the deflated monetary aggregates. The rise of lagging indictors, which reflect costs of doing business, is also worrisome.

In sum, the uncertainty surrounding the continuation of U.S. business expansion has undoubtedly increased since the fall of 1999. (See sections III, VI, VII, and VIII.)

3. The Risk of a Rise in Inflation. The surprising coincidence of both the rate of unemployment and the rate of inflation falling in the United States over

most of the 1990s was due largely to special factors such as declining prices of imports, industrial materials and commodities, computer software and hardware. Foreign deflation, financial crises and economic contractions contrasted with great strength of the U.S. economy and the dollar in the context of increasing globalization, new technology and new marketing. But, after recoveries in a number of economies, prices of oil and other commodities increased and inflationary tendencies are again gaining internationally. One cannot count on the continuation of favorable "supply shocks" -- indefinite declines in import, commodity, and computer-related prices, for example. Wage gains have been modest in this expansion, given the sizable increase in labor productivity growth and the very large increase in corporate profit totals and margins. Growth rates of real wages and unit labor costs fell to low levels. But pressures for higher wages are very likely to develop under these conditions. Indeed, the Employment Cost Index (ECI) has already risen in four consecutive quarters lately, including as much as 1.4 percent and 1.0 percent in Q1 and Q2 2000, respectively. Both short and long interest rates turned up and increased significantly in the past year.

I conclude that costs of labor, materials, finance, and (probably to a lesser degree) productive capital are subject to increasing upward pressures. Even if a slowdown develops, inflation may still rise for some time (it happened repeatedly in the past). (See sections IV, V, VII, VIII, and IX).

4. The Risk of Overdependence on Foreign Capital. Since American households are not saving enough, American business investment is financed to a large extent by borrowing abroad. Imports rise much faster than exports and the current account deficits swell. Although this is probably more of a fundamental long-term problem than an immediate threat, aggravated dependence on foreign borrowing has been cited by Chairman Greenspan in his congressional testimony earlier in July as another possible reason for more interest rate increases.

Clearly, the undersaving and overborrowing imbalance has been getting worse over time, and it is not going away. Here again my conclusion is that, at the very least, the uncertainty about the outcome has increased considerably this year. (See section IX.)

5. The Policy Dilemma. There is also rising uncertainty about the path to be followed by monetary policy, which can be stated as follows. Leaving things as they are, that is, at a still rather moderate degree of tightening, risks more wage inflation and probably in the end more price inflation as well, since the economy, even if slowing, remains quite buoyant. Sufficiently high, persistent, and pervasive growth of labor productivity is unlikely to develop quickly enough to provide a timely solution. Yet raising interest rates and curtailing the growth of money supply much further raises the danger of a stock market crash, or at least a serious downward adjustment of equity prices. Should a major slowdown occur, profits and

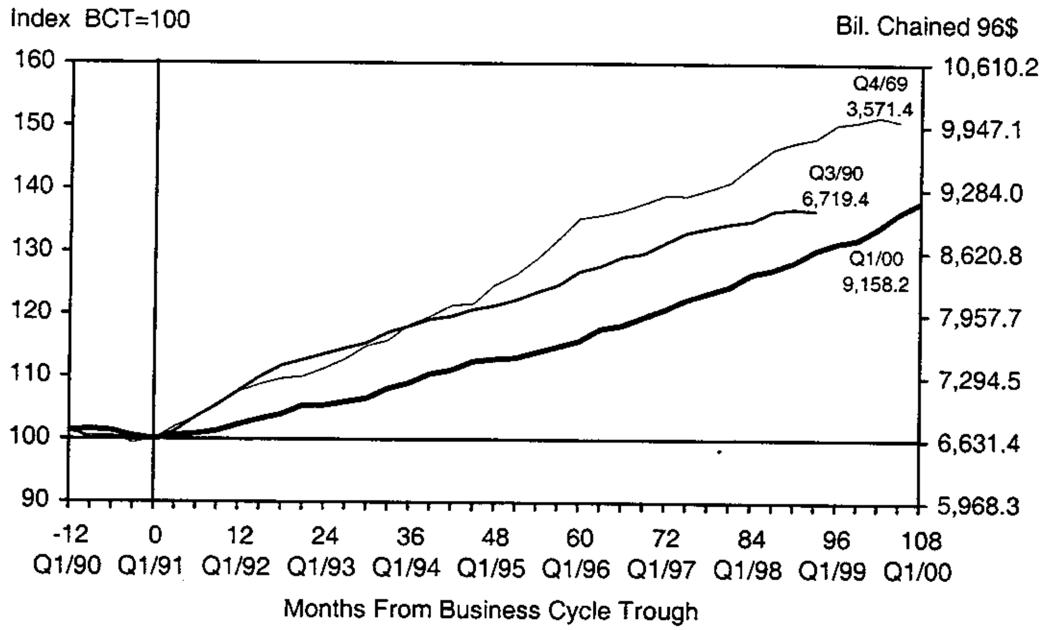
investment would suffer, raising the risk of a downturn. (See sections VII and VIII.)

6. Overall Conclusion. Since mid-1990s, the U.S. economy benefited from higher employment, consumption, technical innovations, investment, productivity, and profitability--just as in previous vigorous business expansions. But it also experienced a gradual increase in the imbalances that tend to accompany all booms and produce rising risks. This process greatly accelerated during the past and, particularly, the current year. This can be seen from slower growth in leading indicators, employment, and consumption; more upward pressures on costs of employment and finance; interest-rate hikes by the Fed to cool the economy and prevent a bout of inflation; and the more subdued and irregular behavior of the stock market. Persistent trade and current-account deficits, low saving and high borrowing all add up to a condition that tends to become more uncertain and more risky over time.

In my opinion, then, the least plausible assumption about the present state of the U.S. economy is that it will remain unchanged in the foreseeable future. The risk of a slowdown has increased, and so has the risk of higher inflation and interest rates. Future destabilization of the stock market cannot be precluded. Hence there is more uncertainty now than before about the forecasts of the economy in the years ahead. This includes the projections of the Postal Service, which will generally need more protection or insurance against unexpected adverse events (the presumed function of a contingency provision) than it has in recent years.

Chart 1
U.S. Output and Employment

A. Real Gross Domestic Product



B. Employees on Nonfarm Payrolls

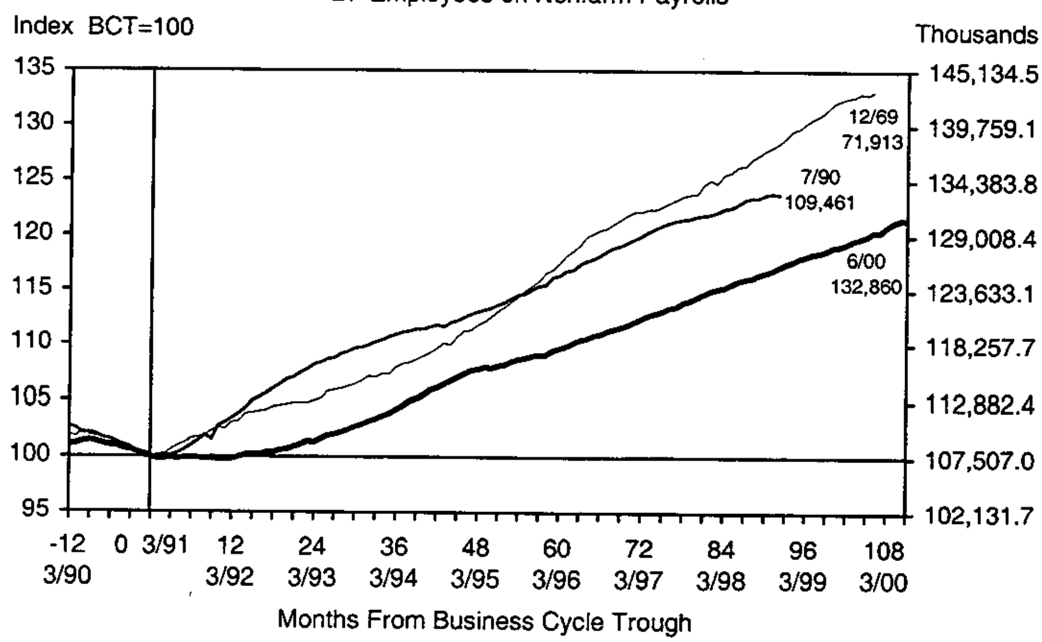
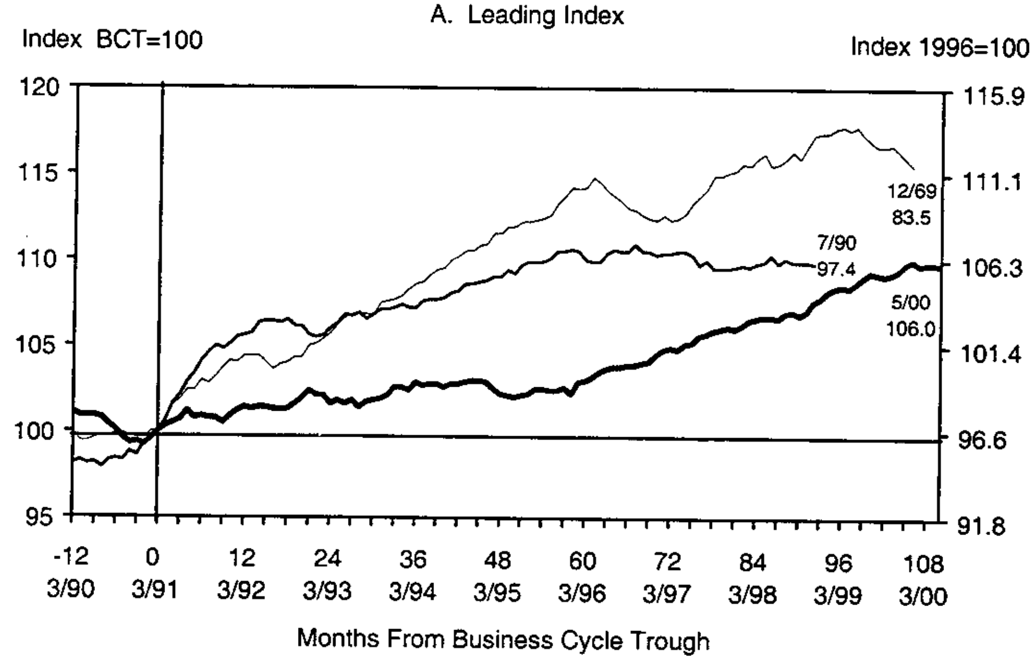


Chart 2
U.S. Composite Index of Leading Indicators

A. Leading Index



B. Leading Index Growth Rate

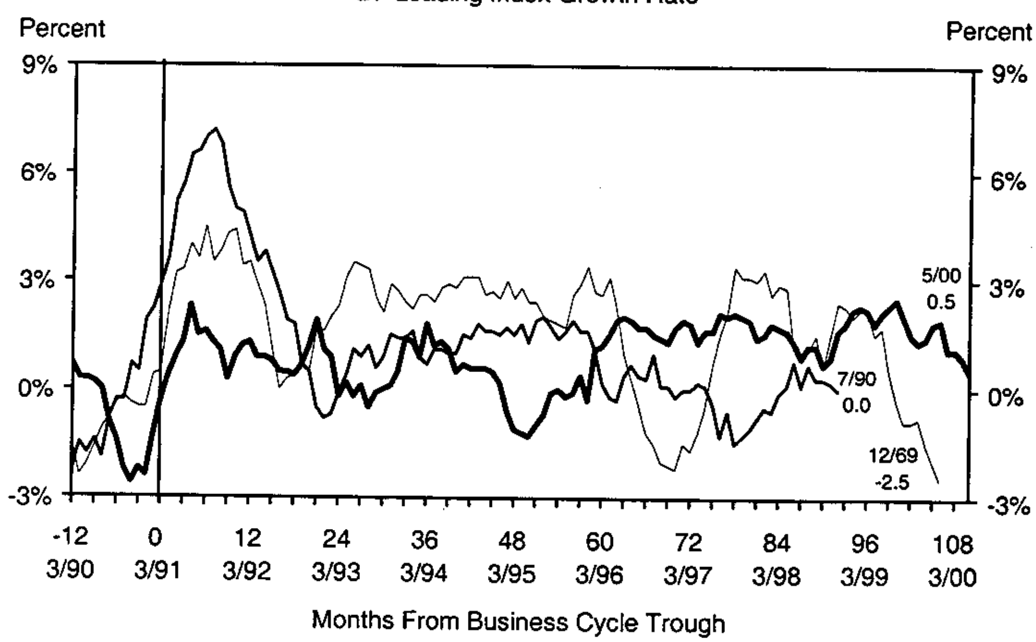
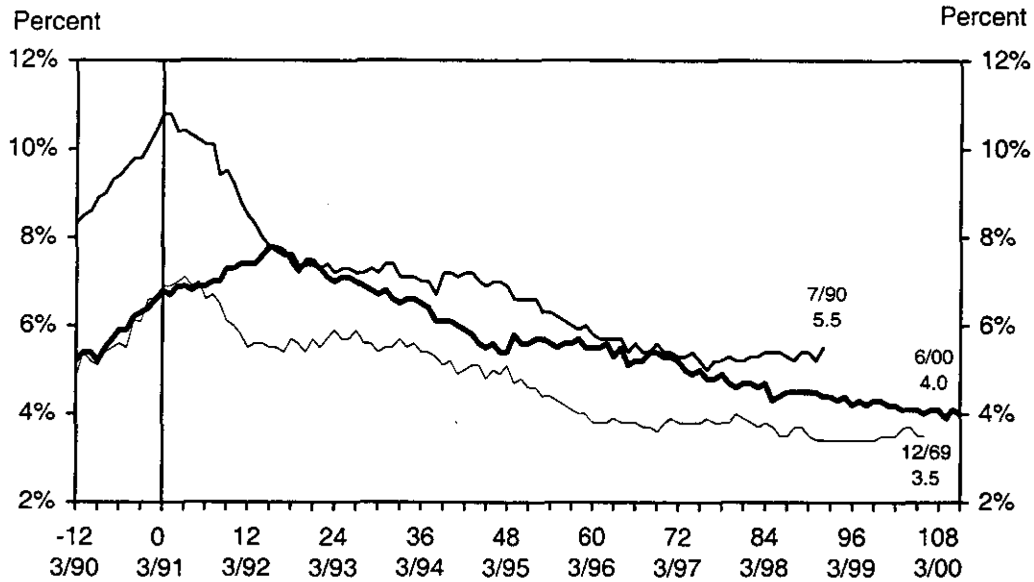


Chart 3
Unemployment and Inflation

A. Unemployment Rate



B. Consumer Price Index Growth Rate

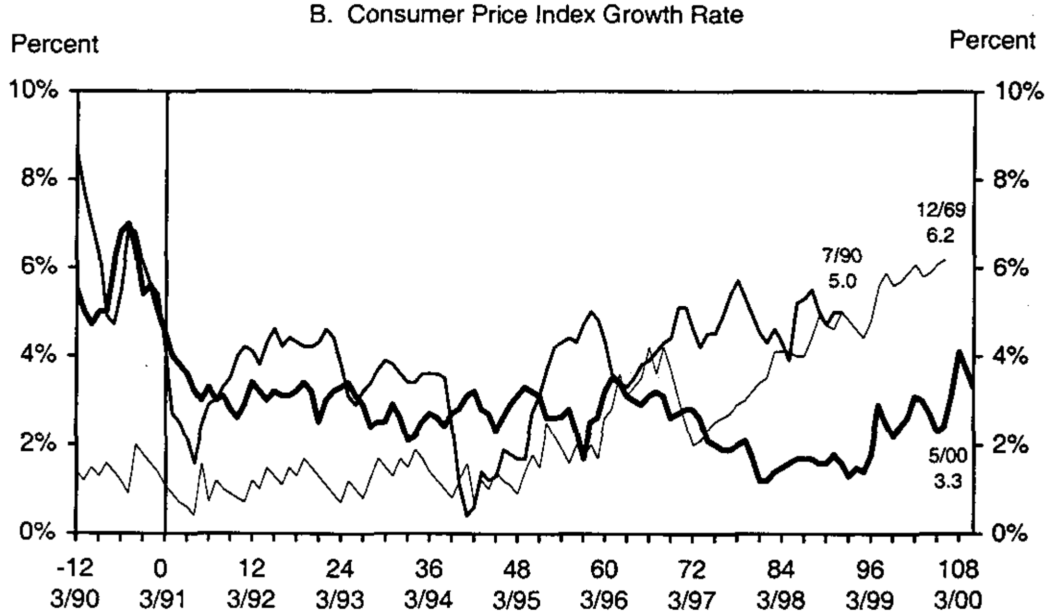
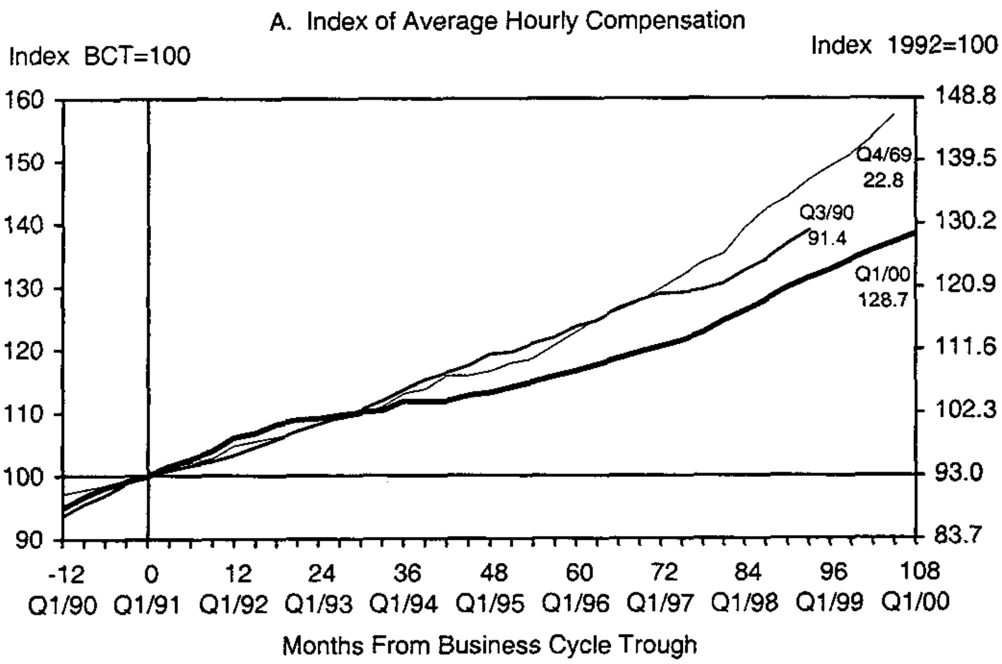


Chart 4
Nominal Wages, Nonfarm Business Sector



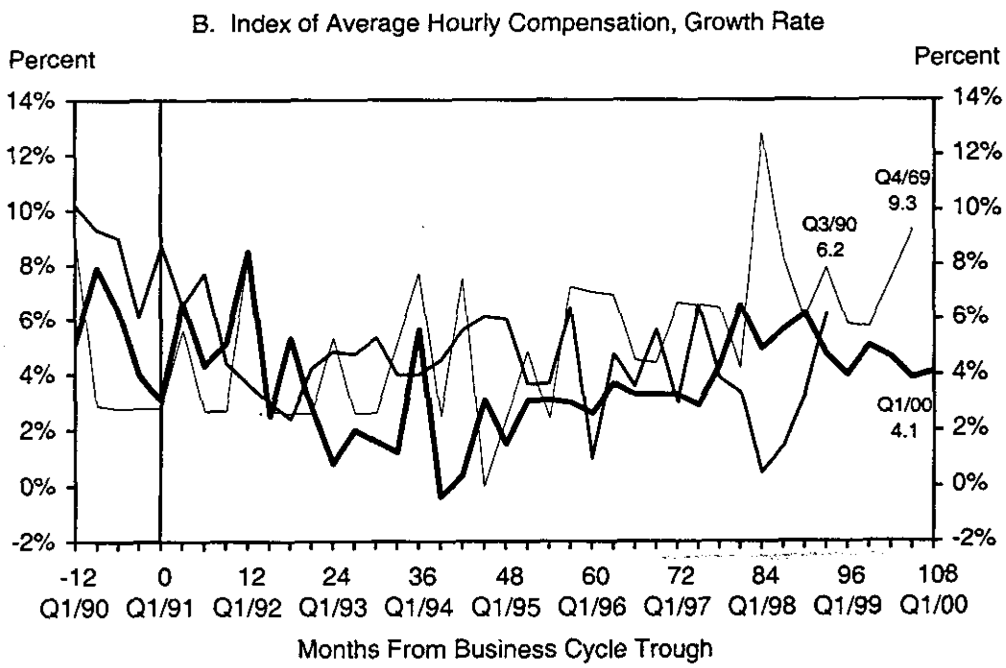
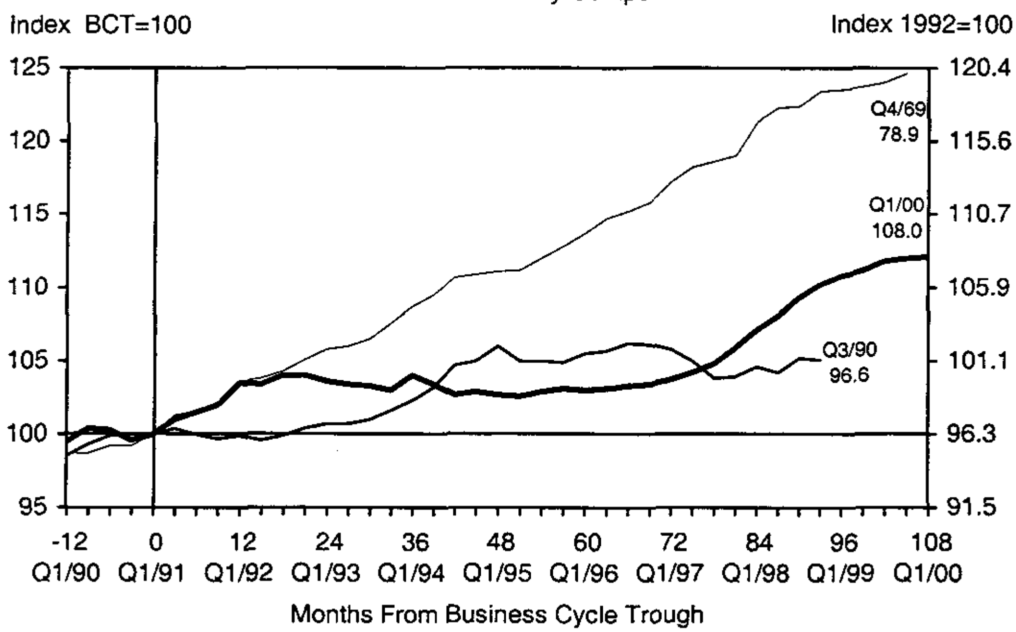


Chart 5
Real Wages, Nonfarm Business Sector

A. Index of Real Hourly Compensation



B. Index of Real Hourly Compensation, Growth Rate

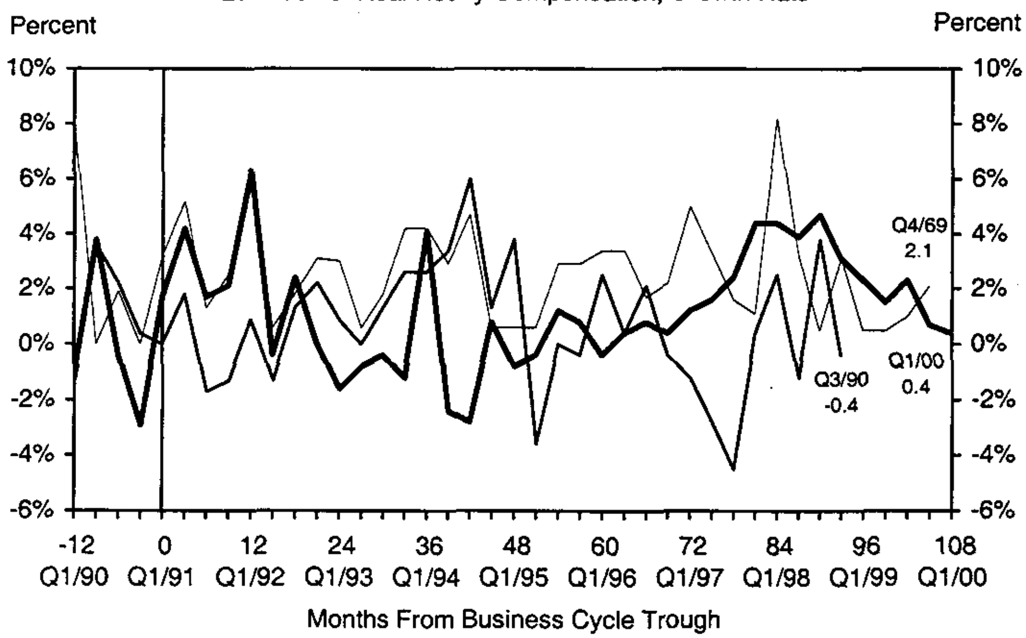
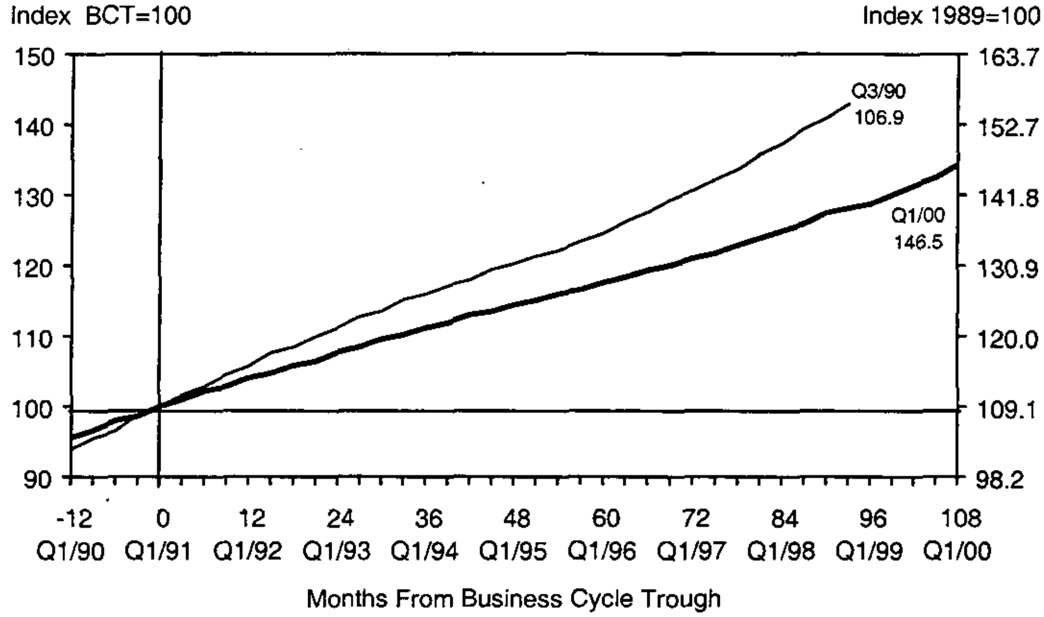


Chart 6
The U.S. Employment Cost Index

A. Employment Cost Index



B. Employment Cost Index Growth Rate

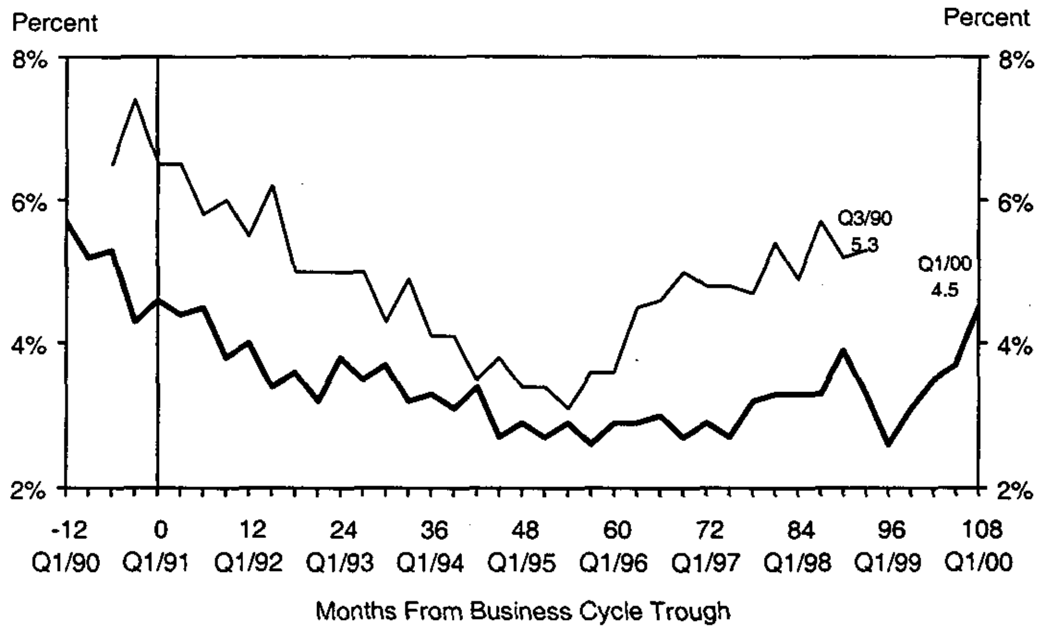
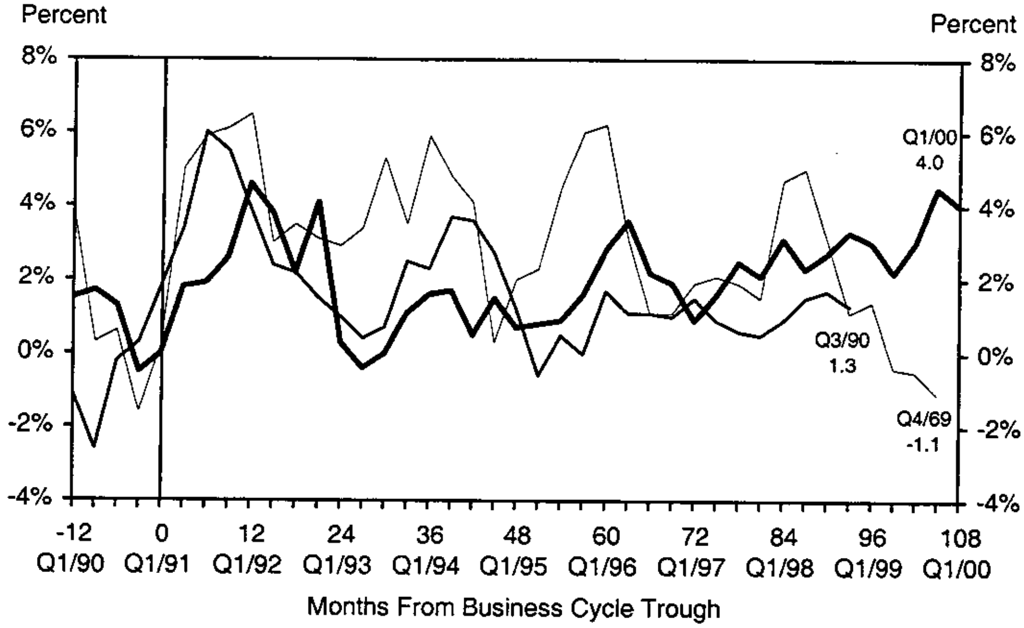


Chart 7
Cost and Productivity

A. Output per Hour, Nonfarm Business Sector, Growth Rate



B. Unit Labor Cost, Nonfarm Business Sector, Growth Rate

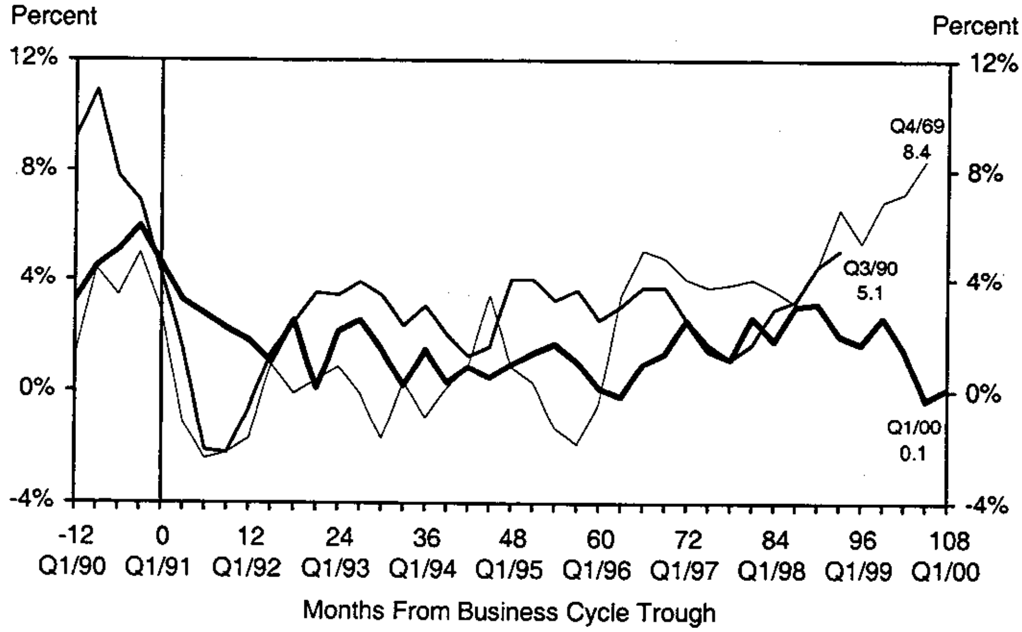
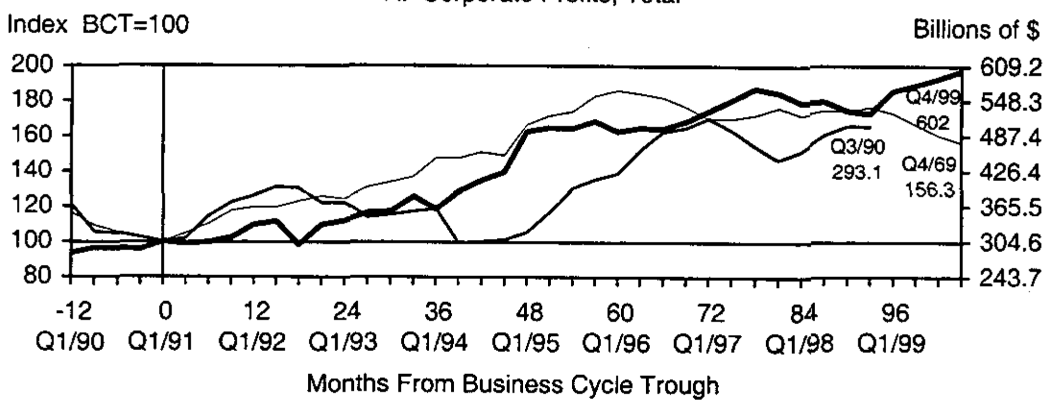
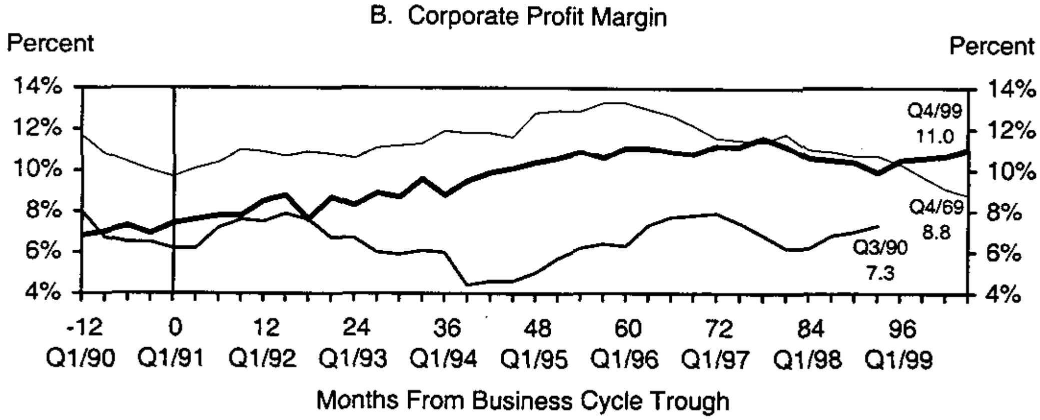


Chart 8
Three Measures of Profitability

A. Corporate Profits, Total



B. Corporate Profit Margin



C. Price/Labor Cost Ratio

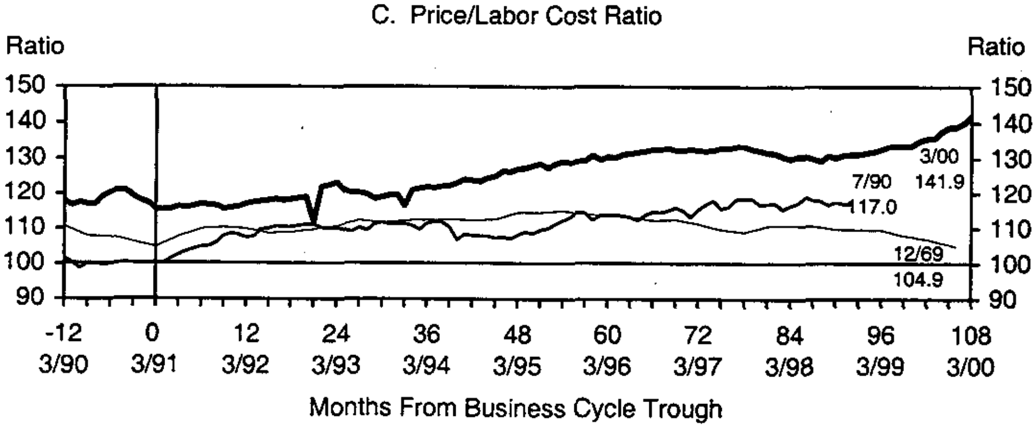
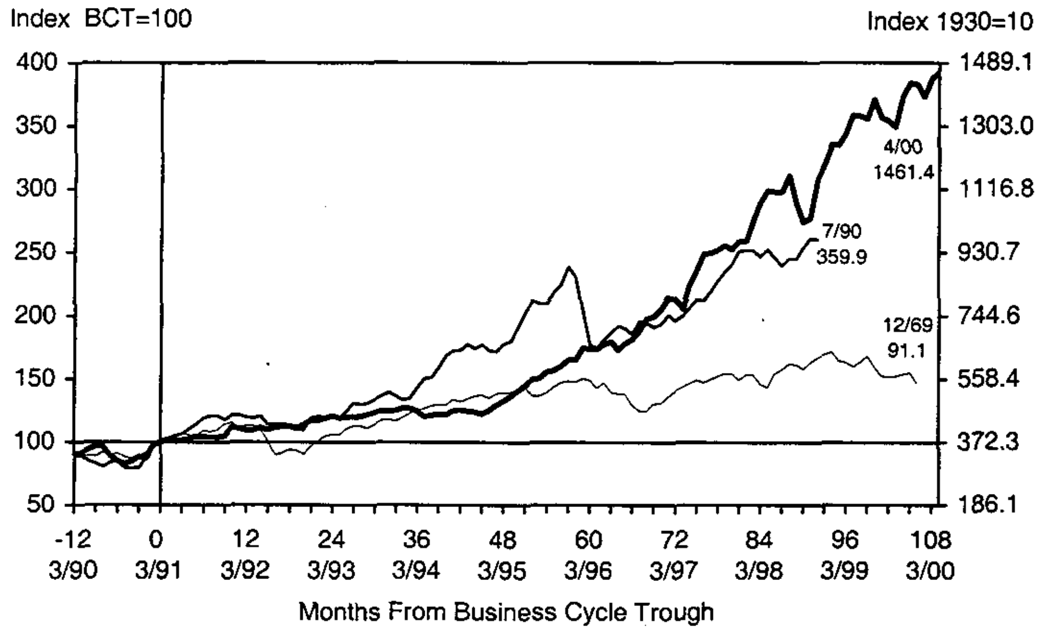


Chart 9
Stock Prices and Price to Earnings Ratio

A. S&P 500 Stock Price Index



B. Price to Earnings Ratio (for S&P 500 Companies)

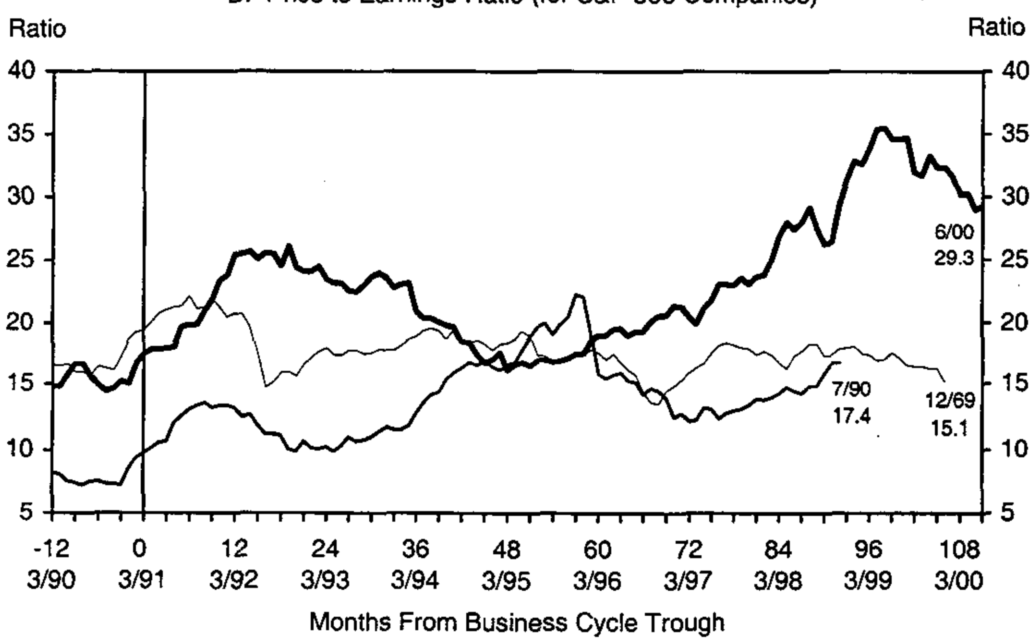
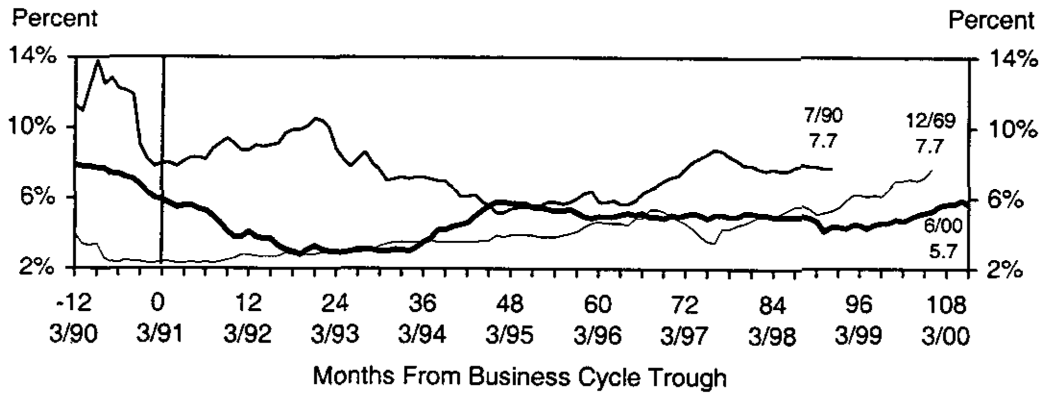
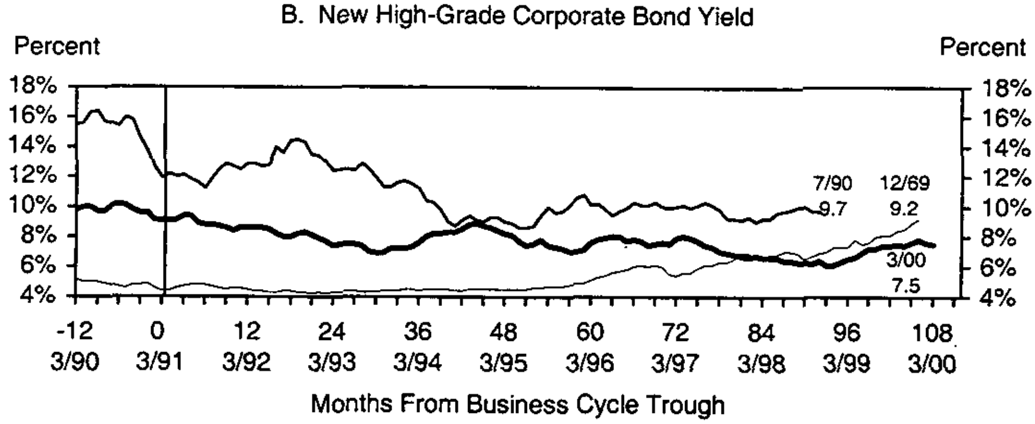


Chart 10
Short and Long Interest Rates

A. Treasury Bill Rate



B. New High-Grade Corporate Bond Yield



C. Yield Spread (10-year minus 1-year Treasury Bond yields)

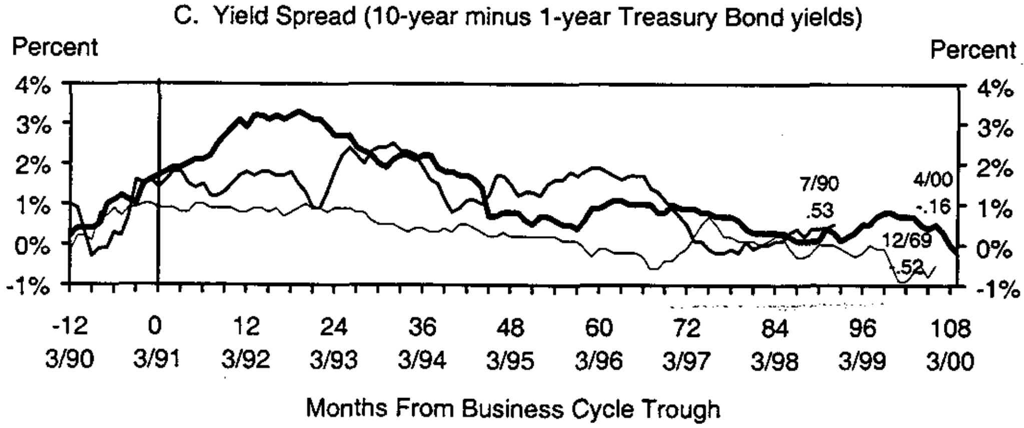
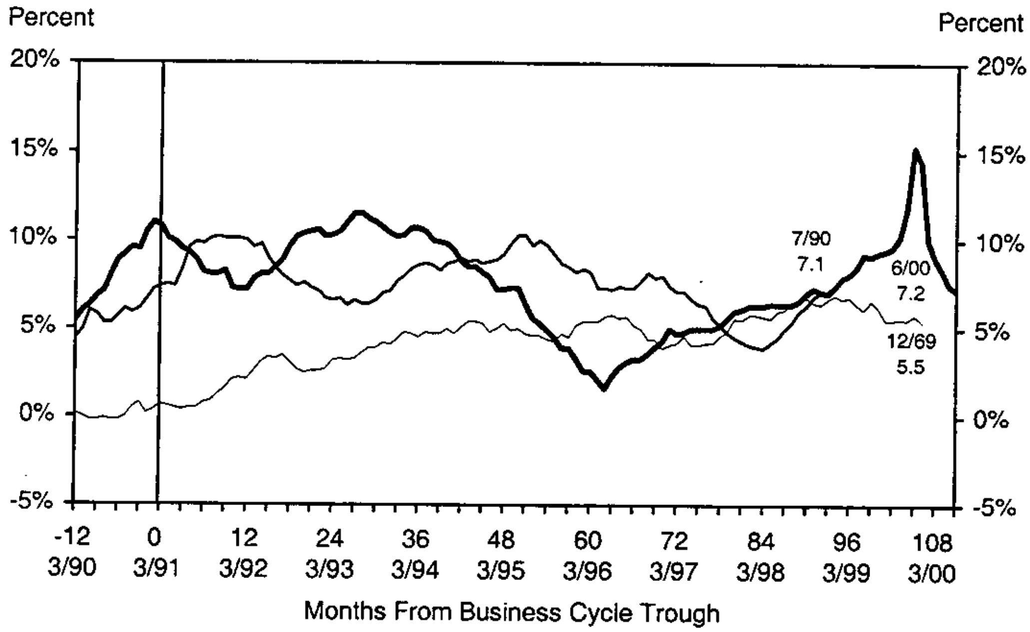


Chart 11
Monetary Base and Money Supply

A. Monetary Base Growth Rate



B. Money Supply (M3) Growth Rate

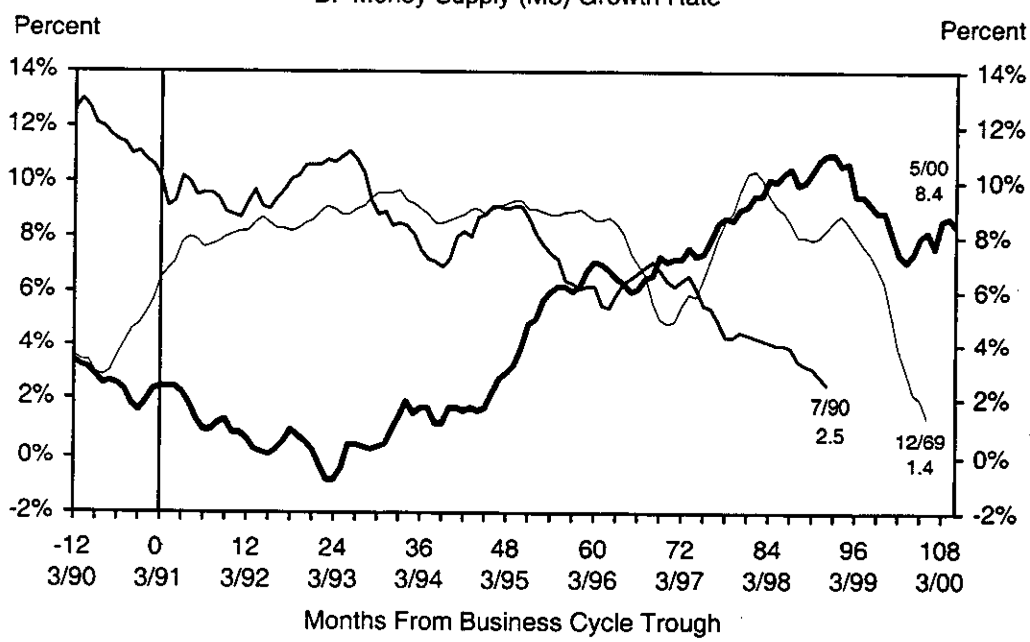
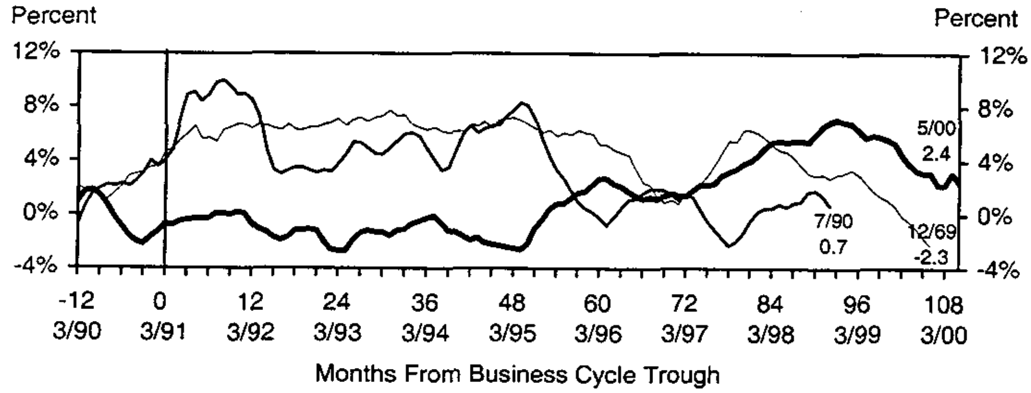
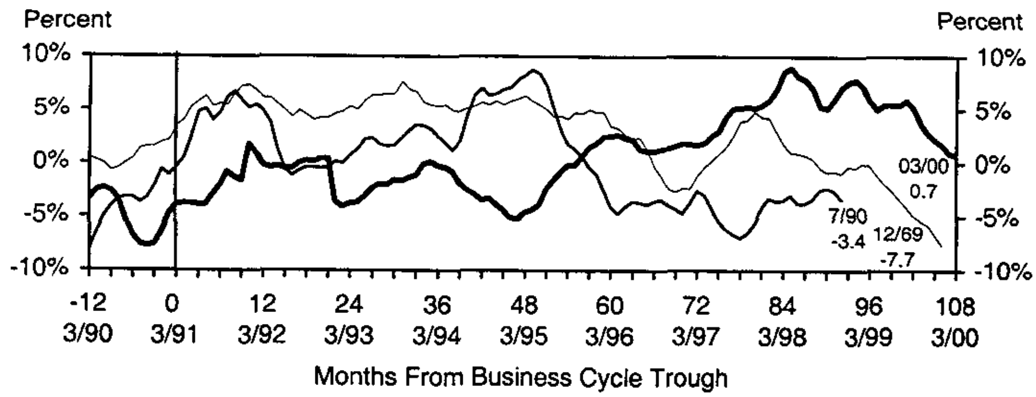


Chart 12
Real Money Supply

A. Deflated M2 Growth Rate



B. Deflated M2+ Growth Rate



C. Deflated M3 Growth Rate

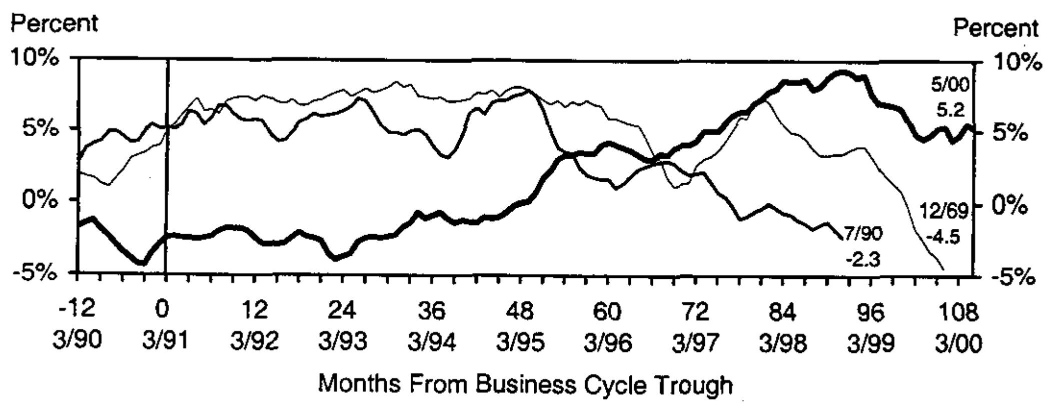
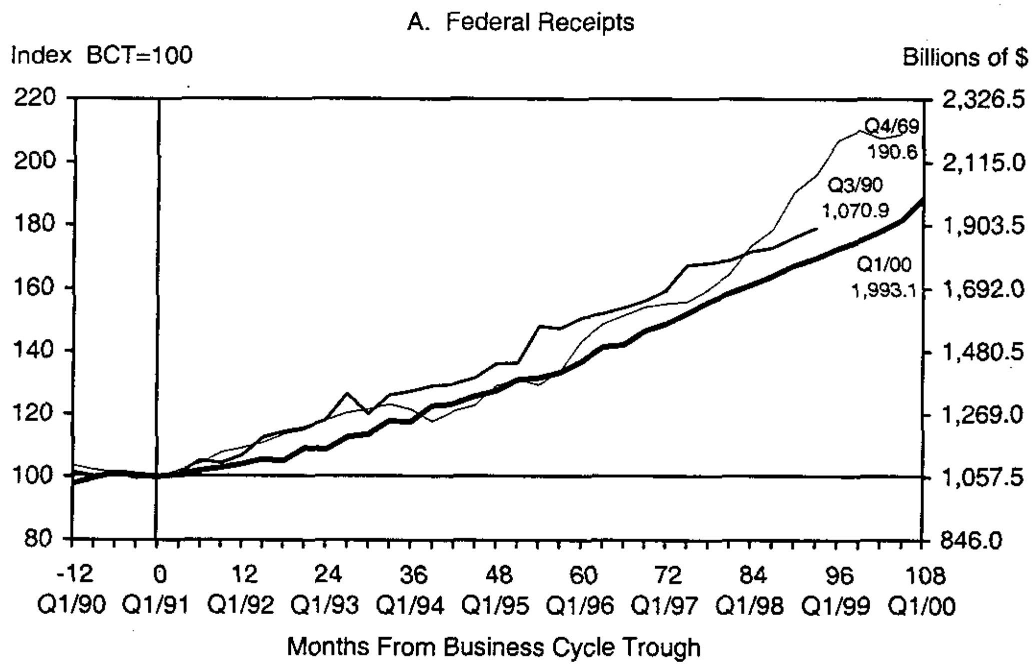
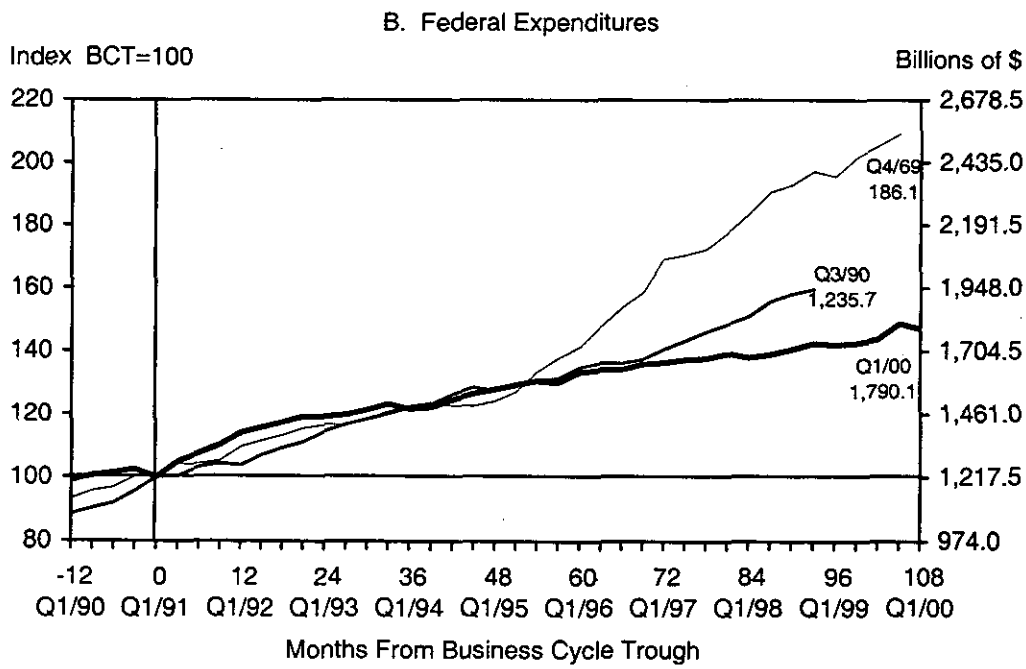


Chart 13
Federal Receipts and Expenditures





CHAIRMAN GLEIMAN: Two parties have requested oral cross examination: Direct Marketing Association and the Office of Consumer Advocate. Is there anyone else who wishes to cross examine this witness?

I was informed just recently, as some of you may have heard, that Mr. Ackerly, who is counsel for Direct Marketing Association, is on his way over, and he will do his cross examination following that of the Office of the Consumer Advocate. Or maybe not.

Is Consumer Advocate going to cross examine? We can take a break now if we need to to accommodate Mr. Ackerly and the OCA.

When we go faster than people expect us to with a long list of witnesses, it sometimes creates a little bit of havoc for folks who don't want to come and sit in the hearing room all day. Appropriate for this witness, when people think about short-term and long-term risks, the real risk is in assuming that we're going to go fast and be out of the hearing room early on any given day. So I think folks hedged their bets, put in a bit of contingency of time and planned to come a bit later than usual. But this is one of those days where I think unknown unknowns occurred in a favorable sense for those of us who like to go home at a reasonable hour.

With that, I'll quit rambling around and let Mr.

Gerarden, who appears to be in first chair for the Office of Consumer Advocate, begin his cross examination.

MR. GERARDEN: Well, as I came in, Mr. Chairman, I thought I heard you saying that potentially the parties can have a short recess.

I had talked with Mr. Ackerly this morning and I know he's monitoring the proceedings through the Internet and his office is close by. So I am sure that he is on his way. In the discussion I had with him this morning, he had assumed that he would cross examine first, and I don't want to deprive him either of that opportunity or of the opportunity of hearing any cross examination of Dr. Zarnowitz.

So if it would not be inconvenient for the Commission, I think it would be a courtesy to Mr. Ackerly and his clients if we could recess briefly until he can arrive.

CHAIRMAN GLEIMAN: I have no problem with that. We'll take a ten-minute break. Of course, the Commission is working on a technology which not only will stream broadcast our hearings, but will allow us to stream the attorneys and witnesses into the hearing room. But I think that's a little bit downstream. We won't have that by the end of this case for sure.

MR. GERARDEN: Thank you.

[Recess.]

CHAIRMAN GLEIMAN: We actually do have technology that would have just allowed you to reverse stream right into the hearing room, you know, molecule by molecule, but we're keeping it under wraps because we know that this will do damage to the Postal Service's parcel volume if we turn it lose and we don't want to do anything like that.

Mr. Ackerly, you're up.

MR. ACKERLY: Thank you, Mr. Chairman.

CROSS EXAMINATION

BY MR. ACKERLY:

Q Good morning, Dr. Zarnowitz. My name is Todd Ackerly, I'm representing the Direct Marketing Association in this proceeding.

Could you turn, please, to your testimony at page 1. Your autobiographical sketch says you have authored numerous articles, several books on business cycles, indicators, forecasting and the like. Do you consider yourself an expert on forecasting?

A Yes, I am.

Q Would you say that you are reasonably well known within the forecasting profession by others who also do forecasting?

A Yes, I would.

Q Would you say that your reputation among these other forecasters was forecasters was being a little on the pessimistic side?

A   Depends on the time you're referring to. You mean now?

Q   In general over the last three or four years.

A   I wouldn't say that because I simply didn't make -- I refrained from making explicit forecasts in this period, so I don't know how they could characterize me as relatively pessimistic and so on. But they would probably characterize me as relying more on history than many others, skeptical on the so-called new paradigm or new economy, yes.

Q   In a January 6th, 1993 Newsday story, you are quoted as saying there is, quote, "no such thing as a single best forecaster or forecasting model." Is that a correct attribution to you?

A   Yes.

Q   In Time Magazine, on June 25, 1995, there was an article entitled "Is That Something In the Air a Recession?" And I would like to hand you a copy of that article.

A   Thank you.

Q   The article says, quote, "The month before witnessed the third decline in a row of Leading Economic Indicators which is used to forecast economic conditions six to nine months from now."

You are quoted as saying, quote, "This is a pretty sizable slowdown," close quote.

Quote, "In many ways, it resembles past slowdowns that have become recessions."

Do you see that?

A I'm sorry, I cannot find a reference to -- oh yes.

Q At the top of the second page.

A At the top of second page, right.

Q Do you recall making that comment?

A I must have made the comment. I don't recall. I was pretty often asked to comment on this or that, but it must be accurate.

Q Was there a recession in 1996 or 1997?

A No, there was a slowdown of cyclical proportions. The slowdown was caused, to a large extent by a sevenfold increase in the Fed Funds Rate by the Fed.

It was a whole long string of efforts on the part of the Fed. That was the first such string, and the next one came last year, six times when they tried to cool the economy, and they did.

And in 1995, slowdown was comparable to slowdowns in previous recessions, and I should like to stress that all of these recessions had only one slowdown except 1966, the 60s recession, the longest one before the present one and that had two successful slowdowns, successful in the sense of what's called soft landing.

Q I am now handing you a copy of a transcript from National Public Radio, the Morning Edition, dated September 4, 1996.

[Pause.]

I direct your attention to the bottom of the first page where you are quoted as saying, quote, "If we were to have a period without a recession for another Presidential term, we would have to beat all records for nine and a half years or 114 months. That would be by far the longest expansion. It simply didn't happen yet in history, so I would give it a low probability," end of quote.

That low probability ended up occurring; didn't it?

A Yes.

Q Now, if you would turn, please, to page 2 of your testimony?

[Pause.]

Do you have that?

A Yes.

Q You state at the top of the page, quote, "I have been asked by the Postal Service to rebut testimony presented to the Commission which asserts that economic conditions will continue to be stable and that inflation will continue to be relatively low and predictable over the projected rate cycle," end of quote.

What did you mean by projected rate cycle?

A Well, it refers to the test year, which is to begin in September and end in October and September of 2001.

Q So, the projected rate cycle that you were referring to ends roughly 13 or 14 months from now; is that correct?

A Right.

Q Now, on page 26 of your testimony -- and would you please turn to that for a moment?

A Yes, it's the last page?

Q Yes. This is the conclusion of your various conclusions. I direct your attention to the part of it beginning at line 16.

You state, quote, "In my opinion then, the least plausible assumption about the present state of the U.S. economy is that it will remain unchanged in the foreseeable future," end of quote.

Now, by, foreseeable future, are you referring back to the projected rate cycle, this 13 to 14-month period that we've just been talking about?

A Yes, roughly. In my opinion and based on the research I have done over many years on evaluating forecasts.

And I would like to stress that I'm not that much of a forecaster myself, but when I talk about forecasting, I talk about forecast evaluation. That is one of my main subjects.

So I have both conducted surveys of forecasts, mostly business economies of years that are now being still conducted by the Federal Reserve Bank of Philadelphia, same methodology, same thing, a survey of professional forecasters.

And I have evaluated the results. And based on this research, I would say that for short term and intermediate term forecasts, one year or two years ahead is about the limit.

It gets very, very poor after that. The forecasts' accuracy declines systematically with the span of the forecast, and so this is about the foreseeable future, a year or so.

Q And the period of time that we are talking about here through the end of the rate cycle, is well within that one- to two-year period where forecasts have at least a certain amount of reliability; is that correct?

A That's correct, but they also decline within this period in accuracy, quarter-by-quarter.

Q Is it easier to forecast a one-year as opposed to a two-year period?

A Yes.

Q Now, referring again to page 26, the sentence that follows the one that I just quoted states, "The risk of a slowdown has increased and so has the risk of higher inflation and interest rates." Do you see that?

A Yes.

Q You are talking about two risks in that sentence, are you not, the first is the risk of a slowdown in the overall economy and the second is the risk of higher inflation. It is correct that you sort of state that higher inflation would be accompanied by higher interest rates?

A It might very well be accompanied, I can give examples, numerous examples from the past.

Q And the reason that the increase in inflation would be accompanied by higher interest rates, perhaps among other reasons, is that it is likely that the Fed will increase interest rates to try to tame inflation, is that correct?

A That is one reason. Another reason is that the bond market and, in general, market interest rates are very sensitive to inflation and tend to increase with inflation.

Q Am I correct in my understanding of general economic principles that those two risks tend to counteract each other? In other words, if the economy is slowing down, the risk of inflation and higher interest rates is reduced and vice versa?

A That is correct over time, but it requires considerable lags. Inflation is pro cyclical, that is to say it tends to increase in expansions and tends to decrease in contraction. At the same time it is lagging, in other words, it can continue to increase even during early recessions, not to speak of slowdowns. So very often, you have a combination of the two because of the lags that are involved.

Q Would you now turn back to page 2 of your testimony, please? Again, in that important opening sentence where you discuss the scope and purpose of your testimony, you state that you are addressing comments by four witnesses, Buc, Burns, Rosenberg and Stapert. Could you tell me to what extent each of those witnesses addresses the two points that you are referring to, that is the stability of the overall economy and the stability in the rate of inflation?

A My conclusion from reading the testimonies, all four of them, was in general that each one of them contemplates a very -- very much a status quo, a continuation of the present conditions during the next year or so, or maybe even longer, because they talk about low, a continuation of low and stable inflation, and high growth at the same time. So, in other words, the same situation that characterized the last, I would say the last five years, since 1996, not the whole expansion by any means, that this situation is going to continue without much of a change. That is the tenor of their remarks.

Q Without asking you to review right now the testimony of those four witnesses, obviously, their testimony will speak for themselves, but to focus specifically on Mr. Buc's testimony, is it your understanding that his recommendation with respect to the size of a reasonable contingency depends upon a belief or an estimate that economic conditions will continue to be stable and that inflation will continue to be relatively low and predictable?

A That was the impression I gained from the testimony.

Q Do you have any understanding right now as to the source of the numbers that Mr. Buc used in his testimony?

A I would have to refresh my memory on that, if I may.

Q That's fine. I'm just wondering if you knew the answer to that.

[Pause.]

Would you accept, subject to check, that the numbers that he uses are produced by DRI, the same source of the numbers that the Postal Service uses?

A I would.

Q DRI is a reputable forecasting firm; is it not?

A Oh, yes.

Q Dr. Zarnowitz, this is the first time you have appeared before this Commission; is it not?

A Yes.

Q Are you generally familiar with the process that this Commission uses to set Postal Rates?

A I was informed, in general, about the methods and procedures. I cannot claim that I have any thorough knowledge of these matters.

Q For example, are you familiar with the fact that the Commission sets rates based on projected costs and revenues in the test year?

A Yes.

Q And do you know what that test year is in this case?

A Yes.

Q What is your understanding about the current test year?

A When it is?

Q When it is, yes.

A Well, it runs from September to October, 2000-2001.

Q So it's the Postal Service's Fiscal Year 2001?

A Right. As you said, 13, 14 months ahead of us.

Q Do you know how the Commission calculates its estimates of costs for the test year?

A Well, what I was concentrating on, after reading the testimony and having been given some explanations, is this contingency provision which I see as a kind of insurance against unforeseen, unforeseeable events which we also sometimes call exogenous or outside shocks of all kinds.

That presumably gives the Postal Service some more leeway in raising rates, possibly, so as to achieve in the long run, at least, the required given situation.

Q If I were to use the term, unknown unknowns, would that ring a bell with you as an appropriate way to describe what the contingency provision is supposed to provide a cushion against?

A Yes, except, you know, that we should be free to speculate about what the unknowns are and what they will be and how they will be shaped by the future.

Q In other words, the probability of unknown unknowns occurring and the likely size of the unknown unknowns?

A Well, I said in the testimony, I believe, and I have repeatedly stressed that this is what I can do, and perhaps the only thing that I can do in this situation, is that concentrate on the economy, inflation and so-called real variables, unemployment, employment, production, and so on.

This is my area of competence. But I also stress that these factors are very important for the contingency problem.

Q Would you accept, subject to check, that the way the Postal Service calculates its estimates of test year costs, is by taking actual costs in a past base year, as it's known, and then rolling them forward by applying various cost estimation and other factors, into the test year?

A Right. Now, the rollover should take into account, the prospects for increases in costs that exist, or decreases, as the case may be.

Right now, the case is for increase, particularly in the labor markets.

Q And are you familiar with the filing that the Postal Service recently made in this case that, among other things, updated the inflation factors and the other costs increase factors that are applied to roll forward the base year numbers to the test year?

A Well, I only know it from this additional testimonies.

Q For example, are you familiar with the estimate, the specific estimate that the Postal Service uses to inflate labor costs from the base year to the test year?

A No, I haven't dealt with it at all in my testimony.

Q So, you don't know, for example, whether that estimate was produced by DRI or some other source? You're just not aware of that?

A No, I am not. I haven't studied how it was done and how good it is.

Q Are you familiar with the fact that this case was filed back in January?

A Yes.

Q Would you expect that an estimate for, for example, the ECI, which is the index that is used to inflate labor costs in this case, would you expect that the estimate for the ECI that was used in January of this year more reliable or less reliable than an estimate for the ECI that was developed in July of this year if the year in which it is being applied stays the same, i.e. the test year?

A Yes, I would. I mean, when I said that the longer ahead you look, the weaker your forecast is likely to be. The converse is also true. You come close to -- generally true, not always -- but as you come closer to the events you forecast, the time period that you forecast, you are likely to have better and more information. If you use the information correctly, your forecast is likely to be better.

Q So the fact that the ECI number has been recently updated decreases the risk that it will be wrong in the test year.

A Somewhat, yes. But we are still pretty far from the end of the -- or the latter part of the test year.

Q Could you turn, please, back to page 2 of your testimony. I'm sorry, I misspoke. Could you turn to page 4 of your testimony, please.

A Yes.

Q I am directing your attention to the paragraph that begins at line 3 and continues at line 9, and I would direct your attention to the fact that the previous paragraph makes references to the testimony in this case by Mr. Buc, Mr. Rosenberg, and others. Then the paragraph on page 4 starts out with the following statement, quote: "These statements are similar to those made by proponents of the new economy paradigm." Then there is a gap. "Under this paradigm, the economy is seen as undergoing a sea change and entering a new era of indefinite prosperity." End of quotation.

Is it your understanding that Mr. Buc, for example, depends upon an error of indefinite prosperity in arriving at his recommendation concerning a reasonable contingency?

A No, I couldn't say that. He probably doesn't rely on that. But the statements that I read contain no doubts on that matter. I mean, they are very, very general and they just repeat that this is the longest expansion, this is the period of low and stable inflation, and that it is expected to continue. There is no statement when it will change or if it will change at all.

Q So to the extent that your testimony states that we are likely not to have an error of indefinite prosperity, your testimony doesn't really address the arguments made by Mr. Buc, does it?

A Well, I would say that it addresses again the general sense of the -- or tenor of the testimony or testimonies in plural. None of them deal with the problem of what might happen if the current period of expansion comes to an end, and in my opinion, it will come to an end. At least all the past expansions did, and there is no good reason why this one should be different in this respect. And I think that this is a very, very important problem here, and in the past, the transition was often very, very quick, much quicker than people expected, so it is not to be precluded. Something like that could come even in the next year.

I will not stress it very much. As you pointed out, I have been wrong on that before, many others have. But that does not change the basic problem that we are facing.

Q Would you say that increases in overall productivity in our economy would support continued stability in economic conditions and serve to tend to keep inflation rates relatively low?

A Yes, I would agree with that, but if I may add, I would say that my work in this area and the charts that I have produced on cost, wages, productivity and so on, shows that the productivity growth is well within historical perspective. In fact, it was often higher in the '60s than it is now, and surprisingly so, maybe because we cannot measure productivity in some areas very well, particularly services. But there is nothing terribly revolutionary in these figures when you look at them closely.

So the idea that we will have a stable productivity growth and a very high growth again for, you know, the indefinite future, at least not defined that it might change -- it is likely to change -- that is not the right way to look at that. We had technological revolutions, innovations of enormous scope before, so this is not the first one, not unique, not very different even from the previous ones.

Q Dr. Zarnowitz, I am handing you a copy of an article from this past Sunday's Washington Post that deals with the general issue of productivity. Do you see on the left-hand side the chart that shows as its source the Bureau of Labor Statistics? Apparently these figures relate to increases in U.S. productivity, and the statement here is, quote, "Continued strong increases in U.S. productivity have helped keep inflation in check despite tight labor markets." End of quotation.

Have you reviewed in the recent past, before today, the numbers on productivity produced by the BLS?

A Yes.

Q Does it appear to you that the numbers in this chart are accurate?

A Well, they are maybe accurate, but they are not sustainable. You can have -- you cannot have 5.3 percent increase in productivity with 5.2 percent increase in GDP, which is what happened in the second quarter. It's actually falling slightly. This is an outlier, so to speak, as a statistician would call it.

If you look at my chart 7 on productivity, you see such outliers all the time, in the '90s, in the '80s, in the '60s. It's going to happen, you know? It's not something that you can sustain. It's obvious that you cannot have a situation in which you have profits in the double digits continually or productivity that high. At the same time, growth in the economy cannot really exceed, let's say, let's be very optimistic, say four percent. Most people would put it lower. Let's even say 4-1/2 percent. It's not sustainable at these levels. It's practically impossible to think that this can continue as it does now, this kind of boom. It's a boom, it's a cyclical boom and we are all happy about it. I certainly am very happy about it myself and I am happy including the fact that I have been wrong in the past. I wish I were wrong in the future in the same way, but I doubt it very, very much. Just think about it -- it's not consistent. It's almost mathematically impossible to make compatible these kinds of numbers on productivity, on profitability, with other numbers. It's also impossible to think that wages will be as moderate and will continue to be as moderate.

That's all I'm saying. I cannot put an exact time on it. The timing is the most difficult part of this story. That's why forecasters go wrong. But at least qualitatively, they will be proven right sooner or later.

Q Dr. Zarnowitz, are you familiar with the decision taken earlier this week by the Open Market Committee concerning the level of interest rates?

A Yes.

Q Can you relate generally what that decision was?

A They decided not to change interest rates because -- well, a very important argument was the high productivity. Another argument was the inflation, while higher, certainly in labor costs, is still relatively moderate.

Q Dr. Zarnowitz, I have just handed you a document that I obtained from the interactive edition of the Wall Street Journal. It purports to be the full text of the FOMC statement of August 22, 2000.

I would like you to focus on the second paragraph, which states, and I quote, "Recent data have indicated that the expansion of aggregate demand is moderating toward a pace closer to the rate of growth of the economy's potential to produce. The data also have indicated that more rapid advances in productivity have been raising the potential growth rate as well as containing costs and holding down underlying price pressures." End of quotation.

Do you see that?

A Yes.

Q I guess based on your earlier statement, it's your view nevertheless that the recent increases in productivity are not sustainable over the medium to long term?

A Yes.

Q I have just handed you a copy of an article from the BNA Daily Report for Executives, dated August 23, 2000. That is just two days ago.

The article refers to the decision on August 22nd of the Open Market Committee concerning interest rate levels, and it also contains certain quotations from the statement that I just read.

In particular, I would refer you to the fourth paragraph up from the bottom of the first page. I would quote you the next paragraph which states, quote:

"Wall Street cheered the Fed's unchanged interest rate policy, with the Dow Jones Industrial Average gaining 59.34 points to an 11,139.15 close." End of quotation.

Without asking you about the specifics of the Wall Street and the market's reaction, are you surprised that the stock market, in general, would react favorably to the Fed's decision to leave interest rates unchanged?

A I'm not at all surprised. This is a natural reaction. Anything that keeps interest rates down is good for the market.

Q In your testimony, you refer to a hard landing and a soft landing. Could you describe what you mean when you use those terms?

A Yes. An example of soft landing, although there are other elements involved, is the 1995 slowdown, probably as good as an example as I can find.

There was a sequence of seven increases in the Federal Funds Rate, which is the benchmark rate that the Fed uses, the overnight interbank borrowing rate.

And that, no doubt at least contributed strongly to that slowdown that occurred, which was mild and short, relatively, but significant, and which probably prolonged the life of this expansion.

And now they try again the same thing. Seven times they increased the Federal Funds Rate. By the way, in the meantime, they decreased it, too, in answer to that slowdown.

So, the slowdown itself was something that was welcome, but not too much of it, so, of course, they reacted very quickly and very strongly with decreases again in interest rates.

This is their main instrument, though they also use, of course, the growth rate of those monetary aggregates that they can control, like the monetary base.

In my testimony I showed a chart that shows that the monetary base, for example, was increased very, very dramatically in order to preserve this expansion.

At the same time that they complained about all kinds of other things about this rate of inflation, they provided the liquidity that the economy and the markets needed.

So, that's what's going on. Now it's the second time and the risk is considerably greater in the second time, but it can happen that they succeed again in causing a soft landing which means a slowdown but not a recession.

At the same time, there are a lot of economists who perhaps exaggerate, blame the Fed for previous recessions, that they engineered these slowdowns and that the slowdowns degenerated into a recession.

And, indeed, almost all major recessions in the past has been preceded by a slowdown. Few have been followed by a slowdown. Recoveries were generally a time of very, very strong growth.

But in the 90s, it was very different, so those people who says the 90s and 80s were one long expansion are definitely wrong. There was a recession in between, partly caused by outside factors, but partly by the slowdown that did degenerate into a recession in 1991-1993.

Well, now again we are facing a very similar situation. It's not over. I mean, right now the situation is such that they refrain from increasing the rates again, but if there is not enough of a slowdown in their view, they will press again, they will definitely increase interest rates again.

Whether they will calibrate it sufficiently well to cause a soft landing, meaning a slowdown, another slowdown that will not degenerate into recession but will be followed by renewed expansion, it's very, very hard to predict. But the risk is very considerable.

Q So, when you use the term, hard landing, you mean a rather abrupt, sudden decrease in economic output in this country?

A Precisely.

Q And a soft landing is perhaps an economic slowdown, but one that happens gradually and over a longer period of time; is that correct?

A Well, the difference is that in one case you have a slowdown, a positive growth rate, though diminished, and that's the soft landing; and the hard landing is an actual decline, a decline in absolute numbers, in levels, levels of employment, levels of production, a recession, in other words, by definition.

Q Am I correct in understanding that Chairman Greenspan and the Fed are trying to create a soft landing?

A Yes.

Q Am I also correct in understanding that Chairman Greenspan has a pretty good track record in accomplishing his goals?

A Yes, I would say that, certainly in the last decade or so.

MR. ACKERLY: Mr. Chairman, I have no further questions. I have one procedural matter, and that is, I have handed the witness and the Bench a large number of documents, and I am concerned that the record be clear.

My suggestion is that unless somebody would like to put them in the record, that most of them not be put in the record, however, there are two of them. One of them is the text of the FOMC statement, an the other is the article from the Wall Street Journal that does have the Bureau of Labor Statistics in there.

I'm not proposing that they go in as evidence, but rather that they be included in the record as cross examination exhibits. I think it would just help the clarity of the record.

CHAIRMAN GLEIMAN: Mr. Reiter?

MR. REITER: Just for clarity, were you talking about the Washington Post article?

MR. ACKERLY: Yes.

MR. REITER: And were you not referring to the most recent document discussing the Fed statement?

CHAIRMAN GLEIMAN: I have three documents here.

MR. REITER: I do, too.

CHAIRMAN GLEIMAN: One is the Washington Post article; the other is a Wall Street Journal Interactive Edition article that's marked at the top, page 1 of 2; and the third is the Daily Report for Executives on the Fed's Open Market Committee.

MR. ACKERLY: My proposal would be that the third not be put in the record, but that the other two, which seem to me to have a little more substance, because they contain information from or statements by a public body, that might usefully be put into the record as cross examination exhibits.

CHAIRMAN GLEIMAN: Mr. Reiter, do you have any problem with their being transcribed?

MR. REITER: I don't have a problem with their being transcribed. I would suggest that all three be transcribed, just for sake of clarity. I have no problem with that.

I do note that the Washington Post article, this is just part of the article. I wonder if Mr. Ackerly happens to have the rest of it, again, for the sake of clarity of what these documents are.

MR. ACKERLY: I don't have the additional page or pages, Mr. Chairman. The information from this sheet of paper from the Washington Post that I focused on was simply that the chart of productivity numbers and not the article itself.

CHAIRMAN GLEIMAN: Help me out a little bit, Mr. Reiter. Dr. Zarnowitz is RT-2?

MR. REITER: Yes.

CHAIRMAN GLEIMAN: So why we're going to have a DMA/USPS-RT-2-XE-1, 2, and 3. Do you have any preference as to what order, since they're all just being transcribed?

MR. REITER: WHy don't we put them in the order that they were referred to by Mr. Ackerly. That might help in viewing the transcript.

MR. ACKERLY: I believe the order was the Washington Post article first, the FOMC statement second, and the BNA article third.

CHAIRMAN GLEIMAN: All right, let's mark the copies I have here, and then we'll see if we can't scare up another set for the Court Reporter. Washington Post is XE-1; Wall Street Journal is XE-2; and the Daily Report for Executives is XE-3.

MR. ACKERLY: Mr. Chairman, if you would hand me that set of paper, I have a second set that I will copy the identifying numbers onto the second set, and we can give both sets to the Reporter, is that's agreeable.

CHAIRMAN GLEIMAN: That's quite agreeable, and these three documents are going to be transcribed but not admitted into evidence.

[Exhibits numbered DMA/USPS-RT-2-XE-1, DMA/USPS-RT-2-XE-2, and DMA/USPS-RT-3 were marked for identification and were transcribed into the record.]

of transferring a credit-card balance to get a better rate.

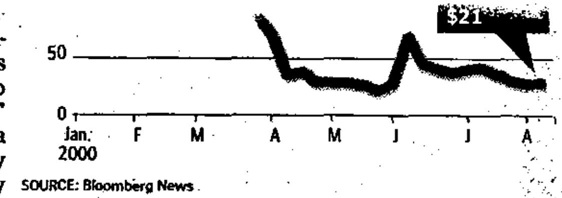
Marketers like Saylor see new technology putting much of America's commerce up for grabs—supplanting even the Internet as we know it. In particular, they see advanced cellular phones and other wireless devices both extending the Internet and becoming powerful new tools to reach consumers. A race is on to conquer this emerging market.

The question now is whether MicroStrategy has the wherewithal to fulfill the vision that Saylor has evange-

In other words, if MicroStrategy can't raise more money, it will have to cut back. The company said it will continue to market its core MicroStrategy 7.0 e-business software. But, already, the company said it expects to "minimize our overall advertising and marketing efforts."

In a brief interview Wednesday after delivering a speech at a trade show, Saylor said that MicroStrategy had been seeking funding for its Strategy.com subsidiary

See SAYLOR, H13, Col. 1



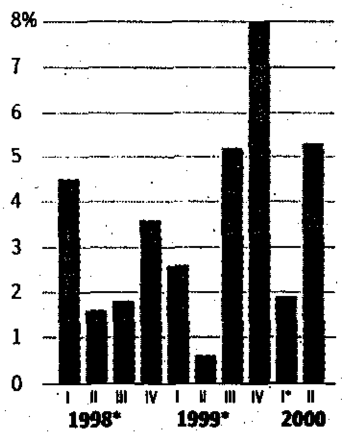
SOURCE: Bloomberg News

THE WASHINGTON POST

Fed Quandary: Push Jobless Rate Up to Curb Inflation?

Productivity Pays Off

Continued strong increases in U.S. productivity have helped keep inflation in check despite tight labor markets.



SOURCE: Bureau of Labor Statistics

THE WASHINGTON POST

By John M. Berry
Washington Post Staff Writer

Economists have their quarrels. Even when times are good and economic policy appears to be working well.

So it is that even while Federal Reserve policymakers have good reason to be upbeat when they meet Tuesday, they do so amid a continuing debate over why inflation has remained so tame despite unusually tight labor markets.

And while it may sound arcane, it is a debate that matters for American workers because it raises the question of whether the Fed, in an effort to keep inflation under control, may eventually have to raise interest rates further to drive the unemployment rate higher.

The Fed has raised rates six times since June 1999 in an effort to cool a U.S. economy that threatened to overheat and to prevent inflation from taking off. Fed policymakers should be upbeat because it increasingly appears that those actions have worked, combining with other factors to slow U.S. economic growth while core inflation and unemployment remain low.

More and more analysts, including a number of Fed officials, have concluded that, for the second time in five years, good policy and perhaps a large dollop of good luck have enabled the central bank to put the economy on a sustainable, non-inflationary growth path. And, they say, the inflation threat appears to have dissipated without raising the specter of a recession.

As a result, for the second meeting in a row, policymakers almost certainly will leave their target for overnight interest rates unchanged.

A large group of analysts also say the Fed won't need to raise rates again any time soon. But some other analysts, such as those at Goldman Sachs in New York who have scuttled their earlier predictions of several rate increases in coming months, still anticipate that the Fed's target for overnight rates, now 6.5 percent, will be lifted to 7 percent during 2001.

For those expecting no change in interest rates Tuesday, the clincher was the report last week that labor productivity—the amount of goods and services produced for each hour worked—at businesses other than farms rose at a 5.3 percent annual rate in the April-to-July period. That meant that the vast majority of the country's growth in the spring quarter came from greater productivity rather than from increases in the number of hours worked. And the gain in labor efficiency was so large, the cost of labor going into each unit of production actually declined even though workers' pay was rising substantially.

Those were unprecedented numbers for the U.S. economy in the 10th year of an economic expansion, and they convinced many doubters that the surge in productivity growth that began a few years ago is not just the result of strong economic growth. Historically, in periods of strong growth, productivity gains have accelerated as businesses get enough orders to use their workers and machines at full efficiency. But later in the business cycle, when economic growth begins to slow, that process usually reverses itself and productivity gains diminish.

This time that hasn't happened, which "supports the view that recent productivity growth is more structural than cyclical," said economist L. Douglas Lee of the consulting firm Economics From Washington. In other words, something fundamental has changed in the economy.

Even with the recent data, many academic economists remain skeptical, arguing

See FED, H4, Col. 1

DMA/USPS-RT2-X2-1

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August 22, 2000

Full Text of FOMC Statement

The following is the full text of the statement released Aug. 22, 2000, by the Federal Reserve's committee on monetary policy.

The Federal Open Market Committee at its meeting today decided to maintain the existing stance of monetary policy, keeping its target for the federal funds rate at 6-1/2%.

Recent data have indicated that the expansion of aggregate demand is moderating toward a pace closer to the rate of growth of the economy's potential to produce. The data also have indicated that more rapid advances in productivity have been raising that potential growth rate as well as containing costs and holding down underlying price pressures.

Nonetheless, the Committee remains concerned about the risk of a continuing gap between the growth of demand and potential supply at a time when the utilization of the pool of available workers remains at an unusually high level.

Against the background of its long-term goals of price stability and sustainable economic growth and of the information currently available, the Committee believes the risks continue to be weighted mainly toward conditions that may generate heightened inflation pressures in the foreseeable future.

DMA/USPS-RT-XE-2

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BNA, Inc.
Daily Report for Executives

No. 164
Wednesday August 23, 2000
ISSN 1523-567X
Page AA-1

Leading the News

Monetary Policy
FOMC Holds Line on Interest Rates, Warns of Inflation Risks, But Softens Tone

The Federal Reserve's policy-setting Open Market Committee (FOMC) opted to leave interest rate targets unchanged at its
Aug. 22 session, but the group warned that inflation risks still could threaten future economic growth.

On the other hand, the Fed seemed to adopt a more satisfied tone in its four-paragraph announcement, noting that recent data suggest that activity is slowing to a pace more consistent with noninflationary growth. In fact, unlike its June 28 statement, the FOMC made no explicit mention of either core or energy prices Aug. 22, economists noted.

Analysts said the announcement suggests the Fed can take a stand-pat position on monetary policy over the next few months, although it may want to nudge short-term interest rates up another quarter-point before the end of the year.

"They're on the alert, but certainly not enough to move today," said Carol Stone, deputy chief economist with Nomura Securities International in New York.

The FOMC, as expected, left the federal funds rate target at 6.5 percent, where it has been since mid-May, and it maintained the tightening bias that has been in place since February. The federal funds rate is the fee depository institutions charge each other on overnight loans.

The panel, which includes the Fed Board of Governors and five of 12 Fed district bank presidents, noted that strong productivity growth has lifted the nation's potential growth rate, that is, the pace of economic activity that can be maintained without goading inflation pressures.

"Recent data have indicated that the expansion of aggregate demand is moderating toward a pace closer to the rate of growth of the economy's potential to produce," the FOMC said in a prepared statement. "The data also have indicated that more rapid advances in productivity have been raising that potential growth rate as well as containing costs and holding down underlying prices pressures."

Wall Street cheered the Fed's unchanged interest rate policy, with the Dow Jones Industrial Average gaining 59.34 points to an 11,139.15 close.

Satisfaction

Most economists had bet that the inflation-wary Fed would hold short-term interest rates steady at the FOMC's Aug. 22 meeting, arguing that economic data point to the scenario the central bank had been aiming for: a slower pace of economic growth with few signs of inflationary pressure.

Nonfarm payroll growth sank in July, home sales retreated, manufacturing activity eased, and consumer spending--which accounts for about two-thirds of all U.S. economic activity--decelerated. In addition, stock

DMA/USPS-RT2-XE-3

market gains have eased considerably over the last year, taking some steam out of wealth-effect spending.

Analysts said the Aug. 22 policy statement is "friendlier" than the one issued in late June, when the central bank dubbed the signs of slowing demand "tentative and preliminary." The wording of the announcement suggests a modicum of comfort--both with current policy and the state of play in the economy--on the Fed's part.

"It's a much better statement for those who want to get sanguine about it," said David Seiders, chief economist with the National Association of Home Builders. "The explicit reference to raising the potential growth rate is a pretty power statement right there."

Seiders said that, while the Fed has not specifically said what it believes the nation's potential growth rate is, most economists put it at 4 percent.

Stone seemed to agree, noting that the Fed's discussion of moderating growth and rising productivity suggest "a statement of some satisfaction."

Keeping an Eye on Inflation Risks

But the Fed's more sanguine tone does not signal the end of the line on interest rate hikes.

The central bank clearly flagged its inflation worries, noting that they remain concerned about demand growing faster than supply and excruciatingly tight labor markets.

"[T]he committee remains concerned about that risk of a continuing gap between the growth of demand and potential supply at a time when the utilization of the pool of available workers remains at an unusually high level," the central bank said.

Most economists have forecast at least one more quarter-point rate increase before the end of the year, which would lift the federal funds rate target to 6.75 percent. Others have a second quarter-point gain that they expect the Fed to put in place early next year.

"They're not sure that the battle's done," Seiders explained, referring to the fight to maximize growth without spurring a runup in prices.

Richard Berner, chief U.S. economist with Morgan Stanley Dean Witter in New York, said the FOMC could tighten policy again as early as November. "At that point in time, we will have a clearer read on whether those [inflation] risks they are talking about have materialized again," he said.

But tighten policy they will. "What's unclear is the timing," Berner said.

Joel Prakken, economist with Macroeconomic Advisers LLC in St. Louis, and Diane Swonk, chief economist with BancOne Corp. in Chicago, both noted that labor market pressures are extremely taut. The risk that wages could surge and boost consumer price gains is still very real and very high, they said.

"We think the inflation numbers will gradually deteriorate," Prakken said. "Utilization rates are too tight."

In addition, productivity growth rates are unlikely to double, but wages well could, goading cost pressures and upending the Fed's battle to restrain inflation forces, Swonk asserted.

Besides, the nation already is experiencing an acceleration of inflation. "It's just occurred from such a low level that it's still benign," the BancOne official explained. "There is no need to move aggressively. They [the Fed] don't like the trend, but there's no urgency."

But there are only four states with unemployment rates exceeding 5 percent, and that does not leave a lot of slack in the economy, productivity gains or no productivity gains, she said.

FOMC's Aug. 22 Statement

The Federal Open Market Committee at its meeting today decided to maintain the existing stance of monetary policy, keeping its target for the federal funds rate at 6-1/2 percent.

Recent data have indicated that the expansion of aggregate demand is moderating toward a pace closer to the rate of growth of the economy's potential to produce. The data also have indicated that more rapid advances in productivity have been raising that potential growth rate as well as containing costs and holding down underlying price pressures.

Nonetheless, the Committee remains concerned about the risk of a continuing gap between the growth of demand and potential supply at a time when the utilization of the pool of available workers remains at an unusually high level.

Against the background of its long-term goals of price stability and sustainable economic growth and of the information currently available, the Committee believes the risks continue to be weighted mainly toward conditions that may generate heightened inflation pressures in the foreseeable future.

By Susan McInerney

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MR. ACKERLY: I have no further cross examination, Mr. Chairman.

CHAIRMAN GLEIMAN: If it doesn't confuse things, while the second set is being marked and both sets will then be handed to the Court Reporter, we'll proceed with cross examination that OCA may have.

MR. GERARDEN: Thank you, Mr. Chairman.

CROSS EXAMINATION

BY MR. GERARDEN:

Q Good afternoon, Dr. Zarnowitz. I'm Ted Gerarden for the Office of the Consumer Advocate.

First, I want to follow up on a few questions that Mr. Ackerly had for you regarding the time period for your testimony.

I think you indicated to him that at page 2 when you refer to the projected rate cycle, you're really referring to the test year of this case; is that correct?

A Yes.

Q Then on page 3, lines 4 and 5 of your testimony where you indicate that you're going to concentrate on questions concerning the economy, its state and likely changes, am I to understand that you are concentrating on the economy, its state and likely changes between now and September of 2001?

A Well, I must say that I wasn't specific on that.

Perhaps that's my fault, and I should have gotten more information.

I think in somewhat longer and less definite terms, but certainly, at least this year. I'm saying it because, as I indicated before, I am uncertain about the timing, and probably everybody is; much less uncertain about the qualitative aspects of the development we are likely to face; and entirely, almost certain about the great lack of likelihood that things will remain the same for a long time.

So, all of that is part of my thinking.

Q All right. In other words then, your evaluation of how things may not remain the same is not confined to the period between now and September 2001?

A No, it's not confined to that, and it's probably -- I mean, the longer the period, the greater the likelihood of major changes.

But I would not at all exclude the next year, as I said before. People have very, very wrong ideas about something being entrenched and therefore bound to repeat itself or to continue. That is very seldom the case in the economy.

One of the great economists of -- perhaps the greatest American economist, Wesley Mitchell who founder of the bureau I worked for for many years, has said that economic change is the law of life.

So, it's much more likely that we'll experience changes that we had in the past, than that there will be no change in the sense of an indefinite expansion -- much more likely.

You know, that's what I'm saying. Now, about the timing, about the timing, I think that we should think about possible changes in the Postal Service and then the period that will follow under these changes, and that if there is forecasting, it should start from there, and be aware of the diminishing accuracy of the forecasting over time.

Q And when you speak of changes, the conditions that we have experienced before, change can be in any direction, isn't that right? I mean it can be positive changes as well as negatives changes?

A Oh, yes. Yes. But it is very difficult to improve on the present situation.

Q Let me step back, when were you engaged by the Postal Service to provide by this testimony?

A I think maybe in June and July we had some discussions.

Q June or July of this year?

A Right. This year.

Q Had you worked with the Postal Service in this case previously?

A Previously, no.

Q Before that?

A No, I have known about work of my colleague at the University of Chicago, Dr. Tolley.

Q I take it then that you did not supply any of your views to the Postal Service before they filed the rate case?

A I did not.

Q I take it then that you did not supply any views to the Postal Service before the filed the rate case, which was in January of this year?

A No.

Q As I read your testimony, it appeared to me that all of the data that you provide and discuss in the testimony is historical data, is that correct?

A That is correct.

Q You do not have any forecast data in your testimony?

A No.

Q And generally, the historical data is through May or perhaps June of 2000?

A I used it -- I update it as much as possible using the most recent information.

Q All right. I think in response to a question from Mr. Ackerly you indicated you understand that the Postal Service uses DRI forecast data?

A Yes.

Q And are you aware that Dr. Rosenberg also used DRI forecast data in his testimony?
A Yes.
Q And that he used DRI forecast data for the years 2000 and 2001?
A Yes. I must say with no -- with all respect for the DRI, which is one of the better econometric forecasting bureaus that we have, I am very skeptical about forecasts longer than a year, generally, and about econometric model forecasts to a large extent. The record is probably much less inviting, less comfortable than most people, including many users, imagine.
Q And that is the part of the reason that you prefer to rely on historical data in your analysis?
A I prefer to rely on historical data. I understand the need for forecasting, of course. I think that forecasting should be based to a large extent on a combination of methods, on econometric models, on indicators, leading indicators and other indicators, on surveys of expectations. We get better results this way. We should use all the information that we can and the best judgment that we can muster, and then our job is done.
But we should also realize that it is a very, very imperfect art, rather than science, economic forecasting.
Q At pages, starting at page 2 in your testimony, at

line 10, you mention the provision for contingency of 2.5 percent. And then you have a little bit of discussion at line 15 about what the contingencies relate to. Am I correct, though, that you do not take any position on the selection of 2.5 percent as the provision for contingency in that is case?

A I have not dealt with the numbers there. I tried to answer the question of whether there are good reasons to assume that the uncertainties concerning the situation, concerning the economy, inflation and possible slowdown and possible recession, that these uncertainties have decreased, or increased, or remained the same. That is the problem I dealt with on the understanding that that has relevance for the contingency provision.

Q But you did not take the next step of attempting to draw any connection between the uncertainties you discuss and the level of the contingency that should be allowed?

A No, I did not.

Q Thank you. At pages 3 and 4 of the testimony, Mr. Ackerly referred to this a little bit, because he noted that toward the bottom of page 3 you mentioned DMA Witness Buc. At line 15 on page 3, you mention Dr. Rosenberg, and lines 17 to 19, you have a quote that is taken from page 11 of Dr. Rosenberg's prepared testimony, and there are two sentence there. The first one is "The United States currently enjoying the longest economic expansion in over half a century." Do you see that?

A Yes.

Q You agree with that statement, don't you?

A Well, I agree that it is a correct statement if the criteria are the same that the NBR, the National Bureau of Economic Research, used last time it met, and determined that March 1991 is the trough, so-called, the lower turning point, the beginning of the current expansion.

I might mention that I am a member of this NBR dating committee, and that I dealt with the dating of business cycles for many, many years before the committee was appointed by the present president of the NBR, Martin Feldstein. I have been with the NBR since I came to this country, which is 1952, and I am still with them.

So I am still a member of this dating committee and we agreed, after very considerable debate, that this would be the date, based -- that is kind of fact-finding committee, it is not a forecasting committee. So it happened a year after the expansion actually was already underway. But it was based almost exclusively on production, on industrial production, on GDP and so on. Employment was still very stagnant, and unemployment was even rising, the unemployment rate.

And, therefore, I must say, even though we have a rule that we don't discuss the proceedings, we have to reach a unanimous agreement and that is it, you know, and we did. But I was troubled by that because it is very unusual that you have employment still so weak. And that was, you remember the time that people, even today, think of recession rather than -- continued recession rather than a recovery, because of the employment.

So if the criteria is production, yes. If the criterion is employment, no, because it happened much later. And that is very unusual.

Q The employment rate didn't begin to decline until about the summer of 1992?

A Right. So, yes, I agree because we agreed that we have to make a decision and the decision was based solely on production in this case. In the past, there was no significant conflict between production and employment on the date.

Q But if you looked at other factors such as employment then, you would this expansion as somewhat shorter than the conventional wisdom?

A Right. Precisely. Right.

Q All right. The second sentence that you quote from Dr. Rosenberg at lines 18 and 19 of page 3, Dr. Rosenberg said we continue to have robust economic growth combined with low and relatively stable inflation. Is that a false statement?

A No, it is not. It is a statement for the present again, it is not -- it does not imply that we are going to continue to have these happy conditions, again, let me say for better in the indefinite future, or in the foreseeable future.

Q And then at page 4, and Mr. Ackerly referred to this also, the paragraph that starts at page 3, you discuss these statements, which I assume includes the quote that you provided from Dr. Rosenberg, as similar to those made by proponents of the new economy paradigm, the sea change, the indefinite prosperity. Can you point to any portion of Dr. Rosenberg's testimony that talks about a new economy paradigm, a sea change, indefinite prosperity or similar concepts?

A No, not directly, but, again, let me just say that I don't find in these testimonies any awareness of a possibility of a change compared with the present situation. The status quo is, in fact, assumed.

THE REPORTER: The status quo is, in fact, what?

THE WITNESS: Assumed in this, by this witness.

BY MR. GERARDEN:

Q Would it be fair to say then that your difference with Dr. Rosenberg is really a degree of confidence?

A Yes, probably. It probably is, although, you know, I cannot speak for him.

Q In reviewing Dr. Rosenberg's testimony, did you find that he discussed anything beyond the DRI forecast data for 2001? And when I say anything beyond, I mean anything in the future beyond 2001.

A I don't recall now. I don't know whether I should state a time, or whether I am allowed to. In looking up what is there, I don't recall.

Q Well, I understand you told Mr. Ackerly that had reviewed all the testimony, so I assume that you have reviewed Dr. Rosenberg's testimony carefully?

A Yes, I did, but my memory of it may be somewhat deficient. However, you know, if you say that he used on DRI, then this is it.

Q Well, I think that will be fine. Thank you. You referred in a footnote, on page 4 of your testimony, to some articles, and you indicate that you are drawing selectively on those articles for your testimony.

A Yes.

Q And picked the middle one, the 1999 article that appeared in the Journal of Economic Perspectives, to review. And in reviewing that, it appeared that in your opening paragraph, you described the views that some hold in similar terms to what you have in this testimony, a golden age, widespread euphoria, a vision of endless uninterrupted expansion of total employment. And in the conclusion you seem to reach a similar conclusion to what you have in your testimony, that a long business expansion tends to generate imbalances that are difficult to sustain.

A Right.

Q Is it fair to say that the views that you had in the articles that you referred to in the footnote on page 4, the articles from 1998 and 1999, and from the working paper from this year, are essentially the same that you have expressed in the testimony?

A They are very, very similar, very close. We are all, I certainly am trying to learn, as I go along, from and keep up with current events and forecasts. By the way, I referred to some of these people who are also referred in the -- I notice now in the submitted papers, like Joel Prakken and so on.

There are two other references in my paper to forecasts with econometric models, but not DRI. One is Ray Fair model on page 16, at footnote 4 and Joe Prakken, who is in the St. Louis outfit of Meyer's, now of the members of the Federal Reserve Board, on page 17.

And I just mention it in order to show that not all forecasts, even from econometric models, are the same. And so you have views similar to mine and rather dissimilar from, you know, DRI in some of these cases.

Q In other words, there is a divergence of opinion and range of views from very reliable and respected sources?

A Yes. Yes. And I may say, you know, it is very hard to say who is in the minority, who is in the mainstream, but I think that changes tend to be, I would say in my direction. And the reason for that is this year is the flatting of the stock market, some uncertain still indications of a slow down, and possibly other things, growing concerns about low saving in particular, and high foreign borrowing.

Q At page 4, lines 18 to 19, you refer again to Dr. Rosenberg, and this again is the statement about the present expansion being the longest on record, and you say, while this true, it has not been the strongest. Is that a bad thing, that it hasn't been the strongest?

A I documented in Chart 1 --

Q Yes, I looked at that.

A Growth, real growth for the Gross Domestic Product and for employment. It shows that the cumulative gain over -- and I start from March 1991, and I start similarly from the NBR trough dates for the '60s and '80s, and over the same period it seems that the gains were stronger in the '60s and even in the '80s compared with the 1990s.

Now, unlike the previous ones, this is still going on, and if it lasts long enough, it will probably exceed the

previous one, but it would be over longer periods of time.
Q Okay. But my question was, is it a bad thing, that is not as strong as the 1960s or 1980s expansion?
A Well, it is hard to know, but, you know, I just tried to rebut the idea, which is very prevalent, that ours is a very unique expansion not only in terms of duration but in terms of amplitude or strength.
THE REPORTER: In terms of what?
THE WITNESS: Amplitude, strength, overall strength, you know, and it isn't.
BY MR. GERARDEN:
Q Did Dr. Rosenberg made any statements about the strength of the expansion?
A No. No.
Q What was the purpose of pointing this out in response to Dr. Rosenberg?
A I thought that Dr. Rosenberg, like so many others, I don't necessarily hold it against him, but that he shares this opinion of this being a period that is uniquely long and strong, and also, by implication, entrenched, so that that would give him the basis to extrapolate it without any change. And my position is that this is not correct, that you should take more seriously the possibility of a change that has occurred in the past and will likely occur in the future.

Q But I am still unclear as to why you made this point in response to Dr. Rosenberg?

A Well, I didn't --

Q Was there anything in Dr. Rosenberg's testimony addressing the strength of the expansion?

A Perhaps I didn't, you know, make it explicit enough, but this is -- these statements are of general events and I believe validity, and not just relating to this particular one, a paragraph from Dr. Rosenberg's testimony.

Q So your comment on the strength of the expansion is a more general one?

A Yes.

Q At page 5 of your testimony, the sentence at lines 5 through 7, you said there, this reduces the claim that a new pattern of non-inflationary growth and noncyclical prosperity is already firmly entrenched, et cetera. Is that a claim that was made by Dr. Rosenberg?

A No. It a claim that is being done by all those who, in effect, don't consider the possibility or probability of cyclical changes ahead.

Q At line 11 on page 5, I wanted to clear something up. I wasn't sure I understand the testimony. I am referring to the sentence that says, there is no sign yet that this is coming now, and you refer to Chart 1. But please review lines 9 through 12.

A Well, if you look at Chart 1 --
Q Could you review lines 9 through 12 in your testimony?
A You are referring to page 5, lines 5 to --
Q Page 5, lines 9 through 12.
A Nine through 12. Yes.
May I ask what the question is?
Q Yes. And what I would like to know is, when you say there is no sign yet that this is occurring now, what is the "this" referring to?
A Oh, it refers to the slowdowns.
Q It refers to slowdowns, not recessions. Now, are you measuring slowdowns by the data that you show in Chart 1, Panel A, the real GDP data?
A Right. I measure slowdowns by growth rates generally. Growth rates are smooth annualized sixth months growth rates in the variables of concern. I didn't show it for outward and employment in Chart 1, only levels are shown. But, for example, for the leading indicators, Chart 2, Panel B, shows what I am using to evaluate the growth rates.
Q And thank you, I did want to ask you why there was no growth rate chart for GDP.
A Well, I have it, you know, I didn't show everything. And also it perhaps wasn't very necessary. It

is very clear, I think, from Chart 1 that both in the '60s and the '80s, there was a slowdown before the end. Whereas, it is not yet so for this expansion, very clearly. In fact, there has been some acceleration, a slow First Quarter.

But I also mentioned in the text, the Quarter Two shows some slowdown, to which these papers refer, and Chairman Greenspan referred to that repeatedly. Actually, it is still very -- it is very uncertain what it shows. And what I quote in the testimony is a clear decline in consumption growth from more than 3 to something 2.4, or something like that. The numbers are there.

So this is a clear moderation, but it was offset, more than offset by investment and government, which, however, are probably temporary.

Q The point that you are making here in line 11 is that the GDP data does not yet show evidence of a slowdown?

A That's right.

Q Is the GDP data that which is most commonly used to identify a recession?

A It's very commonly used, too commonly, in my opinion, you know. It is subject to great revisions in the near future, and great uncertainties.

It is the most comprehensive, however, and a very, very commonly used measure.

Q Okay. Dr. Zarnowitz, I'm going to give you a copy of a two-page document, which is marked OCA/USPS-RT-2-XE-1. This was previously provided to your counsel.

MR. GERARDEN: And we are providing copies Commission and counsel at the counsel tables.

[Exhibit Number OCA/USPS-RT-2-XE-1 was marked for identification.]

BY MR. GERARDEN:

Q This is a chart that was taken off of the website of the Conference Board. I understand you are affiliated with the Conference Board?

A Yes.

Q Okay.

And the second page comes from the same website, a summary table of composite indexes, also supplied by the Conference Board.

Page 1 of this exhibit shades time periods which represent recessions, and as I believe you indicated in your testimony earlier, the most recent recession ending early in 1991 is indicated here.

How does the GDP data which you refer to in Chart 1, relate to the leading index or coincident index that's shown on the chart here from the Conference Board?

A The GDP is itself a coincident time series, meaning that it moves with the economy, of course. It actually represents the economy, reflects the economic change directly as it occurs now.

And the same goes for the coincident index, but the coincident index doesn't use GDP because it used only monthly --

Q I'm sorry, uses only?

A Uses only monthly data. It tries to be more timely, therefore, it uses only monthly data.

It is a combination of industrial production, non-farm employment, and personal income, which is the only part of GDP which is monthly in real time, deflated with the CPI, and finally manufacturing and trade, wholesale and retail sales.

These four time series in combination constitute the coincident index. Now, the leading index tries to anticipate the coincident index and GDP.

It consists of series that have early timing. For example, the average work week tends to precede employment; orders for investment goods tend to precede shipments and expenditures for investment groups, et cetera. There are many of these series.

We combine them in this leading index. Now, I have that in Chart 2 in my testimony, the same data that I used in a different form in this composite indexes chart from the Conference Board that you submitted.

And what it shows now and what we expect it to show is that any slowdown, for example, that's desired by the Fed and so on, would show up in the leading index before it shows up in the coincident index, and it does.

The peak in the leading index so far occurred at 106.3 in January this year, and then it flattened at 106 and still remains at 106, practically without change. There were only two changes in January and March this month.

Q I think you referred to 106.0 in May in your testimony?

A Right.

Q And page 2 of the cross examination exhibits indicates that it remains at 106.0 in June?

A Right.

Q Now, do you find the GDP and the coincident index track each other fairly well?

A Pretty well, but not perfectly. GDP is broader. I mean, industrial production only includes manufacturing, mining, and utilities, a rather and even declining part of the economy. Employment is very comprehensive, non-farm employment, and manufacturing and retail sales are fairly comprehensive, and so is, of course, personal income.

So we try to use comprehensive coincident monthly indicators, but they are not as comprehensive as GDP.

On the other hand, they have considerable advantages. They are monthly, that is, more frequent, more up to date, and they are less subject to revisions, to changes.

And GDP is subject to great revisions, great uncertainty.

Q Now, the coincident index which is shown on Cross Examination Exhibit 1 continues to show an upward trend; does it not, in the most recent data for June?

A Right.

Q There's an increase above the level of May, which was above the level of April?

A Right. And there's a clear upward trend, and will be in the coincident index and in GDP. Ours is a growing economy.

And the declines, the absolute declines called recessions are relatively rare, short, and so on, because to a large extent because ours is an economy that tends to grow over time.

Population grows, employment grows. Your know, the technology improves all the time, and all of that happens.

Now, the leading index is not so good in that. Many of its components do not have trends. Like I mentioned average work week, that is practically trendless.

Housing permits have very little trend. On the other hand, orders and some other components have trends.

But you can see that the leading index has much less of a growth in your chart than the coincident index. That has to be taken into account in interpreting the results.

Q And so those factors that you must mentioned make the leading index less reliable in terms of anticipated and future conditions?

A No. In general, predicting turning points and even predicting month-to-month, it's a very good predictor. I mean, we test it all the time.

If you take, for example, the coincident index or the GDP and regress it on its own previous values, that is because of the upward trend and so on that it is a relative strong focus. It's not so easy to contribute more to it, but the leading index does.

In other words, if you add the leading index to this regression that we call out-regression; that is regression on its own past, for GDP or for the coincident index, you gain predictability.

So, no, the leading index is in many ways good, but it has to be compensated, and we have ways for compensating the lack of trend.

CHAIRMAN GLEIMAN: Excuse me, Mr. Gerarden, do you have much more to do in the way of cross examination?

MR. GERARDEN: Not very much more. I see. I didn't realize how the time had flown.

CHAIRMAN GLEIMAN: I'm not all that concerned about the clock, it's in terms of the amount of time that the witness has been sitting there and I have been sitting here. I do care about a few other people who may have been sitting for a long period.

MR. GERARDEN: I do appreciate that, and I had not kept track of the time. But this would be a good time for a recess.

CHAIRMAN GLEIMAN: I'd like to take a break for about ten minutes then and let everybody stretch and maybe move around a little bit.

But before we break, we have one more witness today. It is an OCA witness, and I believe the Postal Service is the only party that has requested cross examination, and that would be Witness Rosenberg.

Do you have a sense about the length of cross examination that the Postal Service will have? I'm just trying to plan whether we plow through or whether we break for lunch.

MR. REITER: It will be relatively short, but we can't promise.

CHAIRMAN GLEIMAN: Okay, then, we may try and just plow through the next witness also, but we'll take a ten-minute break now, thank you.

[Recess.]

CHAIRMAN GLEIMAN: Mr. Gerarden, you may continue.

MR. GERARDEN: Thank you, Mr. Chairman.

BY MR. GERARDEN:

Q In chart 2 with your testimony, you provide the leading index and also, in panel B data, the leading index growth rate. That's what chart 2 represents?

A Yes.

Q In looking at the panel B data, the leading index growth rate, the Y axis starts at negative 3 percent, goes to zero, and then positive 3 percent and so forth. So if one draws a line across at the zero percent mark of the Y axis, will that line then allow you to compare when the growth rate has actually turned negative?

A Yes.

Q And doing that indicates that the growth rate did turn -- well, trended down beginning in March of 1994 and actually turned negative in the beginning of 1995; is that correct?

A That's correct. That coincided with a slow-down.

Q That was the slow-down which resulted in the soft landing you discussed earlier?

A Right.

Q At present, the leading index growth rate is trending down but has not yet turned negative; is that correct?

A Correct.

Q And looking at the line which represents the current expansion, there are three -- approximately three other instances, three or four instances in which the growth rate turned negative but then rebounded -- I'm sorry -- the growth rate trended down but then rebounded without turning negative; is that correct?

A Yes. It was flat or slightly declining in the positive range, right.

Q At page 6 of your testimony, you have a discussion at lines 9 through 20 about yield spread inversions. Do you recall that part of your testimony?

A Yes.

Q And is that associated with the data that you show in chart 10? Specifically panel C data, at the --

A Correct.

Q -- the bottom of the page.

A Yes. That is the spread, yes.

Q Okay. And here again, if one were to draw a line parallel to the X axis at the zero percent mark on the Y axis, that would be allow you to compare the instances in which there has been a yield inversion?

A Correct.

Q In doing so, it appears that there was a significant period of yield inversion in the 1960s lasting

approximately 15 months, around 1966; is that correct?
A Uh-huh. Yes.
Q And that was about three years before the end of that expansion?
A Yes.
Q And there was a short period of a yield inversion in the 1980s, approximately 1988?
A Yes.
Q But it was a very short and relatively small yield inversion --
A Right.
Q -- at that time? Is that correct?
A Pardon me?
Q Is that correct that there was a short --
A Yes.
Q -- and mild yield inversion approximately 1988, about two years before the end of that expansion.
A Yes.
Q Pages 12 to 13 of your testimony, you discuss certain other indices or indicators, and as I understand the discussion -- and this is page 12, line 11 through page 13 -- these are indicators that are shown in chart 7 and 8 that are running contrary to or trending in the opposition direction from what one would expect to see at the end of an expansion; is that correct?

A I beg your pardon, I don't think I got it.

Q Well, I'm referring to the discussion you had on pages 12 and 13 of your testimony, --

A Yes, I am looking at it.

Q -- the unit labor cost, which is shown in chart 7, panel B data?

A Yes.

Q And then a discussion that you have of profit margins, and you refer to data in chart 8.

A Yes.

Q And do I understand correctly that your discussion here is to illustrate that these indicators, chart 7 indicators on cost and productivity and chart 8 measures of profitability, are all trending in the opposite direction of the trends they took at the end of the expansions in the 1960s and 19890s.

A Yes, you are correct. You can see from chart 7, for example, that there were -- that the productivity fell before -- it's a leading indicator, again, growth of productivity, labor productivity, output per hour, it tends to decline late in expansion. It has not done so in this expansion. Unit labor costs have declined, which is unusual.

Q Unit labor costs?

A Right, have declined in 1999 and 2000 so far, and they usually increase late in expansion, yes.

Q So then would it be fair to say that looking at the various data as a whole, it presents a mixed picture?

A Yes, it is a mixed picture, but probably a large reason for that is that the durations vary. We still are in an expansion that is relatively strong compared to the '60s and '80s.

Q When I was asking you the questions about the yield inversions discussed at page 6 of your testimony and in chart 10, I missed one question I wanted to ask you. You have a parenthetical discussion at lines 14 to 19 of your testimony.

A On page?

Q This is page 6.

A Page 6.

Q Lines 14 through 19.

A Uh-huh. Yes.

Q Do I understand correctly from your discussion here that the point you're making is that we have an unusual situation in that the current budget surplus means that there is less of a need for treasury bonds to be issued?

A I don't see it on page 6. Are you saying --

Q Staring at line 14.

A Yes, yes, I see it. Yes, that is a new situation.

Q All right, and that's different from the situation that occurred when there were yield inversions that we discussed back in the 1960s and 1988?

A Right.

Q Sorry I missed that question when I was asking you about the yield inversions.

A Perhaps an explanation is needed, a short explanation, no?

Q Well, I was happy with the answer you just gave, thank you.

A All right.

MR. GERARDEN: May I have your indulgence for a moment, Mr. Chairman?

[Pause.]

BY MR. GERARDEN:

Q At page 9 of your testimony, lines 14 to 17, you have some comments about computer hardware and software; do you recall that part of your testimony?

A You're referring to page 9?

Q Page 9, lines 14 to 17.

A Yes?

Q All right, do you consider the contribution of computers, both hardware and software capacity and features, to be a significant contribution to increased productivity during this expansion?

A Oh, yes.

Q By this comment on page 9 of your testimony, are you suggesting that it was simply good luck?

A I am suggesting that, again, there are limits here. The computer has, no doubt about it, created conditions for increased productivity in many industries.

The computer use in services, however,is now more important than in manufacturing, and yet we observe much larger increases in productivity in manufacturing than in services.

And no one -- practically no one understands why, why this is so. So there are still many puzzles there.

And it's pretty clear that this again has a limit and is probably temporary. In other words, you know, while it has contributed to the productivity and in an uneven way, it can hardly continue to do so indefinitely in the future.

Q And at page 9, lines 16 to 17 where you say, again, not something that can be comfortably projected into the future, does that reflect your view that the contributions of computer capacity and software utilization are coming to an end in terms of increased productivity?

A No, they are not coming to an end, but they are going to be more moderate than in the past.

Q On what do you base that opinion?

A It's what happens normally in any innovation.

Innovation has itself a cycle, and it's usually a long cycle, much longer than business cycles.

For example, in the late 80s and early 90s we had this recession and sluggishness both before and after the recession. Why did it happen?

Well, it happened probably because of downsizing on a very large scale that happened at that time; that is, substitution of capital for labor. That was the beginning of this computer revolution that we are having now.

And we reap the fruit now. Now, the same happened to many other innovations, other technologies in the past. They reached a peak and they receded. This will happen again in this case.

Q But as I understand it, you don't have any specific study, forecast, or other data on which your --

A Not my own, but there is a lot of studies going on in this area now, particularly at the Conference Board, international studies of productivity. And they all point in this direction.

There are many things that we don't understand. For example, according to the scenario that says we are in a new era, new economy, new paradigm and all of that, we should have much steadier and much higher productivity gains, particularly in services, but we don't. We don't observe it.

That has been pointed out time and time again by very, very prominent economists who are decidedly, you know, in favor of technology as being very important, Solow, for example, a Nobel Prize laureate.

COURT REPORTER: Solow?

THE WITNESS: Robert Solow, S-O-L-O-W.

MR. GERARDEN: Thank you very much, Dr. Zarnowitz; it has been an honor. I have no further questions, Mr. Chairman.

CHAIRMAN GLEIMAN: Followup questions, Mr. Ackerly?

FURTHER CROSS EXAMINATION

BY MR. ACKERLY:

Q Doctor, let me follow up just briefly on the last line of questioning by Mr. Gerarden. I believe you acknowledge that the computer does and has had a positive impact on productivity, both in the services sector and in the manufacturing sector?

A No doubt about it.

Q But you're questioning how long the computer can continue to increase productivity; is that right?

A Well, I stated that the gains of productivity are smaller and less regular than would be expected on the basis of the idea that this is a unique and practically permanent expansion; that's what I said.

Q Are you familiar with the computer systems that this Commission has put into effect?

A No.

Q Are you familiar with the increases in productivity of the activities of the people participating in these proceedings?

A No, I haven't dealt with it.

Q And you therefore don't have any idea as to what the future productivities may be of the systems that the Commission may be putting into effect in the future?

A I wouldn't venture that.

[Laughter.]

MR. ACKERLY: No further questions, Mr. Chairman.

CHAIRMAN GLEIMAN: There are no questions from the Bench. Are there further followup questions?

MR. GERARDEN: No further followup.

CHAIRMAN GLEIMAN: There are no questions from the Bench, but perhaps it would be timely, since Mr. Ackerly was asking questions about productivity generated by or made possible by Commission computer systems, that if someone wanted to, they could as of 12:00 noon today, click on the archive word that's listed on our banner, and have available to them, the archive database of Commission documents going all the way back to 1971, the very, very large majority of which are available in searchable form.

There are some early documents that could not be formatted and OCR'd into the system in searchable form, but those of you who have had an opportunity to work with our LaserFee System inhouse, and our feeble efforts to get it linked to our web page will be pleasantly surprised because, as I said, as of noon today, it's up and running, and I've got my fingers crossed that it keeps running.

And the only regret I have is that we weren't able to get this up and running much, much earlier in this case, which would have resulted in significant productivity improvements for lots and lots of people, I would think.

There are no questions from the Bench. Mr. Reiter, would you like to have some time with your witness to prepare for redirect?

MR. REITER: No, there will be no redirect.

CHAIRMAN GLEIMAN: If there is no redirect, then, Dr. Zarnowitz, that completes your testimony here today. We appreciate your appearance and your contributions to our record. We thank you, and I certainly personally thank you.

It's always interesting to listen to people who have worked long and hard in an area and have developed expertise. It gives us an opportunity to go to school without having to pay the tuition. We do pay a price having to sit here, but not tuition. Thank you, and you are excused, sir.

THE WITNESS: Thank you very much, Mr. Chairman.

[Witness Zarnowitz excused.]

MR. GERARDEN: One procedural manner in respect to Dr. Zarnowitz's testimony, Mr. Chairman. Could I move the admission of Cross Examination Exhibit OCA/USPS-RT-2-XE-1, two copies of which have been provided to the Reporter?

CHAIRMAN GLEIMAN: Now, the Reporter now has two copies, and without objection, the material will be transcribed into the record and admitted into evidence.

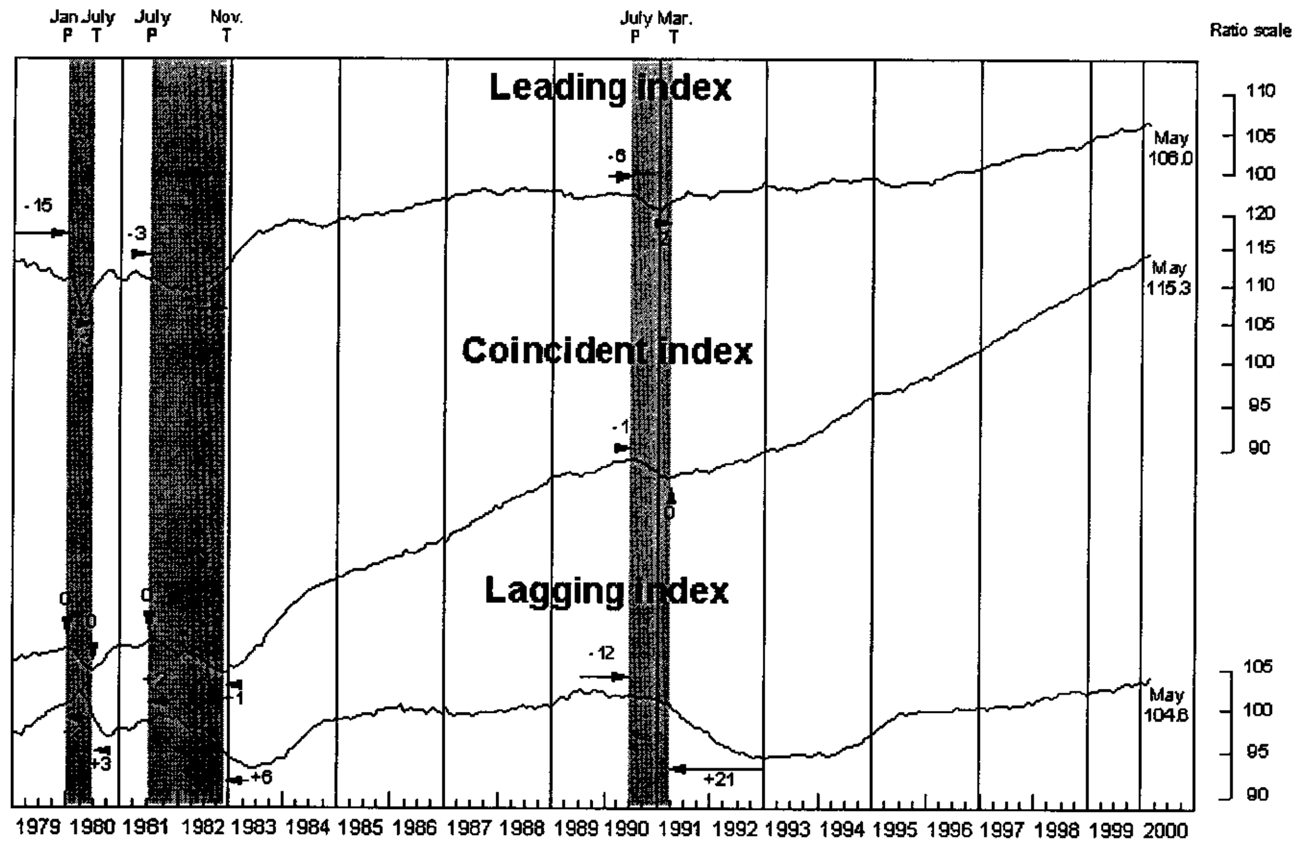
[Exhibit Number OCA/USPS-RT-2-XE-1 was received into evidence and transcribed into the record.]

Composite Indexes Chart - The Conference Board

OCA/USPS-RT-2-XE-1

COMPOSITE INDEXES

(1996=100)



NOTE.- P (peak) indicates the end of general business expansion and the beginning of recession; T (trough) indicates the end of general business recession and the beginning of expansion (as designated by the NBER). Thus, shaded areas represent recessions. Arrows indicate leads (-) and lags (+) in months from business cycle turning dates.

Source: The Conference Board

Return to Latest Leading Economic Indicators

18294

Table 1. - Summary Table of Composite Indexes

	2000 Apr	May	Jun	6-month Dec - Jun
Leading index	106.1	106.0	106.0p	
Percent Change	0	-.1	0p	-.1
Diffusion	60.0	30.0	55.0	40.0
Coincident Index	115.1	115.3	115.5p	
Percent Change	.3	.2	.2p	1.7
Diffusion	75.0	87.5	83.3	100.0
Lagging Index	104.4	104.6	105.4p	
Percent Change	.5	.2	.8p	1.8
Diffusion	92.9	57.1r	100.0	100.0

n.a. Not available p Preliminary r Revised

Indexes equal 100 in 1996

Source: The Conference Board

Return to Latest Leading Economic Indicators

CHAIRMAN GLEIMAN: Okay, thank you, and, again, Dr. Zarnowitz, thank you.

Our next witness and last witness of the day today is OCA Witness Rosenberg. Ms. Dreifuss, whenever you're ready, proceed.

MS. DREIFUSS: The OCA calls Edwin A. Rosenberg to the stand.

CHAIRMAN GLEIMAN: And Mr. Rosenberg is already under oath in this proceeding, so there won't be any need to swear him in. That was a question. I say that as a statement, but everyone should always take it as a question now.

[No response.]

CHAIRMAN GLEIMAN: Nobody is telling me that the answer is that he's got to be sworn in, so whenever you're ready, counsel, you may proceed.

Whereupon,

EDWIN A. ROSENBERG,

a witness, having been called for examination, and, having been first duly sworn, was examined and testified as follows:

DIRECT EXAMINATION

BY MS. DREIFUSS:

Q Dr. Rosenberg, do you have before you, two copies of a document entitled Rebuttal Testimony of Edwin A.

Rosenberg, and captioned OCA-RT-2?

A I do.

Q Did you prepare this testimony or was it prepared under your direct supervision?

A It was. I prepared it and it was, yes. I prepared it.

Q If you were to testify orally today, would this be your testimony?

A Yes, it would.

MS. DREIFUSS: Mr. Chairman, I move that this document be transcribed into the record and entered into evidence.

CHAIRMAN GLEIMAN: Is there any objection?

[No response.]

CHAIRMAN GLEIMAN: Hearing none, if counsel would please provide copies to the Court Reporter, I'll direct that the Rebuttal Testimony of Witness Rosenberg be transcribed into the record and entered into evidence.

[Written Rebuttal Testimony of Edwin A. Rosenberg, OCA-RT-2, was received into evidence and transcribed into the record.]

OCA-RT-2
Docket No. R2000-1

REBUTTAL TESTIMONY

OF

EDWIN A. ROSENBERG

ON BEHALF OF

THE OFFICE OF THE CONSUMER ADVOCATE

AUGUST 14, 2000

TABLE OF CONTENTS

UNITED STATES OF AMERICA
Before The
POSTAL RATE COMMISSION
WASHINGTON, D.C. 20268-0001

Postal Rate and Fee Changes, 2000) Docket No. R2000-1

DIRECT TESTIMONY OF EDWIN A. ROSENBERG

I. STATEMENT OF QUALIFICATIONS

My name is Edwin A. Rosenberg. I am an economist, and I have been employed since 1991 by The National Regulatory Research Institute (henceforth, NRRI), which is located at The Ohio State University in Columbus, Ohio. The National Association of Regulatory Utility Commissioners (NARUC) established the NRRI in 1976, and the NRRI's primary mission is to provide research and advice to members of NARUC, such as the Postal Rate Commission. A more complete statement of my qualifications is contained in OCA-T-3, which was submitted earlier in this proceeding.

II. PURPOSE AND SCOPE OF TESTIMONY

The purpose of my testimony is to reconsider the conclusion of my previous testimony in this proceeding (OCA-T-3). That conclusion was that the contingency provision of one percent of total estimated costs, which was allowed in Docket No. R97-1, should be continued in this Docket. I have reconsidered my conclusion in light of the updated test-year revenue and expense estimates contained in the testimony of USPS witness Richard Patelunas (USPS-ST-44).

III. SUMMARY OF THE UPDATED TEST-YEAR REVENUE AND EXPENSE ESTIMATES

The original estimates of test-year revenues, expenses, and the revenue requirement were contained in USPS witness Tayman's testimony.[1] In his supplemental testimony, Mr. Patelunas used actual revenue and expense figures for FY 1999 and updated estimates or forecasts of various factors to develop updated estimates of revenues and expenses both for FY 2000 and for the test year, FY 2001. The updated test-year revenue and expense estimates reflect a number of changes, including the use of actual 1999 revenue and expenses as the basis for the FY 2000 and test-year estimates and the use of updated, and generally higher, forecasts or estimates of various inflation factors for 2000 and 2001. As a result of the update, estimated after-rates, test-year revenues and expenses increased by $252.8 million and $451.5 million, respectively.

[1] USPS-T-9.

In addition, the updated revenue requirement estimates were adjusted to reflect the fact that the Postal Service now projects a net loss in FY 2000 rather than the net income it had originally projected. The swing from a projected FY 2000 net income of $65.6 million[2] to a projected FY 2000 loss of $325.5 million[3] leads to an increase in the allowance for recovery of prior years' losses from $268.3 million to $311.7 million.

The original and updated estimates of test-year revenues and expenses are shown in Table 1, below. In Table 1, I also show the effect of using a one percent provision for contingencies instead of the 2.5% provision requested by the Postal Service in this proceeding. Please note that the revenues are as requested by the Postal Service and that the contingency amounts are treated as expense items in Table 1.[4]

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[2] USPS Exhibit 9L.

[3] USPS Exhibit ST-44E.

[4] While Table 1 displays the contingency as if it were an expense amount, this is a misleading approach. It is inappropriate to include the requested contingency provision in a calculation of net income or, for that matter, the shortfall from the annual or cumulative equity restoration targets (Exhibit USPS ST-44G). Including the contingency provision in those calculations may lead to a distorted – and much more negative – view. The contingency provision is a part of the revenue requirement. It is not, however, an actual cost that the Postal Service incurs. It is not, therefore, a cost that must be recovered. Rather, the contingency provision is an amount added to the sum of estimated test-year costs and the allowance for recovery of prior years' losses to determine a revenue requirement that offers the Postal Service a reasonable chance to attain its long-run breakeven goal.

Table 1
Test-Year Revenues, Revenue Requirement and Net Surplus or (Deficiency)
($ 000,000)

	Original[5]		Updated[6]	
	Before Rates	After Rates	Before Rates	After Rates
Total Revenues	66,328.4	69,116.8	66,579.0	69,369.6
Total Cost Segments	68,046.6	67,190.6	68,357.5	67,642.1
Estimated Net Income (Loss)	(1,718.2)	1,926.2	(1,778.5)	1,727.5
Contingency Provision (Using One Percent of Total Cost Segments)	680.5	671.9	683.6	676.4
Recovery of Prior Years' Losses	268.3	268.3	311.7	311.7
Total Revenue Requirement Assuming a 2.5% Contingency Provision	70,016.0	69,138.7	70,378.1	69,644.9
Total Revenue Requirement Assuming a One Percent Contingency Provision	68,995.4	68,130.8	69,352.8	68,630.2
Net Surplus (Deficiency) Assuming a 2.5 Percent Contingency Provision.	(3,887.8)	(21.8)	(3,799.1)	(275.3)
Net Surplus (Deficiency) Assuming a One Percent Contingency Provision	(2,667.0)	986.0	(2,773.8)	739.4

[5] See USPS-T-9, Table 15 and USPS Exhibit 9A.

[6] See USPS Exhibit ST-44A. Please note that the Postal Service filed several sets of errata on August 11, 2000, concerning the "net surplus (deficiency)" figure. For example, in a revised response to Presiding Officer's Information Request No. 14, Item 2(b) and (e) Errata, witness Patelunas states: "Had the $200 million Field Reserve been incorporated into the update as it should have been, certain of the Operations cost reductions, as well as the Grand Total All Programs, would decrease. The overall Test Year After Rates impact would be to increase the deficiency shown on Exhibit USPS-ST44A from –$275.3 million to approximately –$475.3 million." I have not reflected this erratum in my Table 1 because witness Patelunas has not yet revised his testimony, exhibits, nor the underlying library references.

IV. THE UPDATED EXPENSE ESTIMATES MAY OVERSTATE THE REVENUE REQUIREMENT AND THE REVENUE DEFICIENCY

A. The Use of Conservative Estimates of Cost Savings Resulting from the Breakthrough Productivity Initiative May Result in an Overestimate of Actual Test-Year Costs, Revenue Requirement, and Revenue Deficiency

The Postal Service is putting its multi-year Breakthrough Productivity Initiative into effect.[7] This Initiative includes a number of factors, including reengineering work processes, employing technology to achieve savings, and reducing the size of the workforce. Estimates or targets of the cost savings resulting from this Initiative have been in the range of $700 million to $1 billion annually over four years. However, $200 million of projected or targeted cost reductions were classified as "Field Reserve" and were not reflected in the updated test-year cost reductions.[8] Although the Postal Service does not view the exclusion of $200 million of projected or targeted cost reductions as being a form of contingency provision,[9] the exclusion of that $200 million in targeted cost reduction increases the estimated test-year revenue requirement and revenue deficiency by $205 million (using the Postal Service's requested 2.5%

[7] See "Breaking Through to a New Golden Age of Mail," Remarks of William J. Henderson, Postmaster General/CEO United States Postal Service, at the National Postal Forum, Nashville, Tennessee, March 20, 2000," United States Postal Service, *Postal News*, (undated); Statement of William J. Henderson, Postmaster General and Chief Executive Officer, United States Postal Service, before the Subcommittee on Treasury, Postal Service, and General Government Committee on Appropriations, U.S. House of Representatives, April 4, 2000; "Postal Service to Cut 700 Jobs, Reduce Costs by $1 Billion Annually for Four Years," *PostCom Bulletin*, June 30, 2000; and Statement of William J. Henderson, Postmaster General and Chief Executive Officer, United States Postal Service, before the Subcommittee on International Security, Proliferation, and Federal Services, Governmental Affairs Committee, U.S. Senate, July 13, 2000.

[8] See Mr. Patelunas's response to OCA/USPS-ST44-11 at Tr. 35/16652. Please see footnote 6 concerning errata filed on August 11, 2000.

[9] See the Postal Service's institutional response to OCA/USPS-ST44-11(e).

contingency provision). Using a one percent contingency provision, the estimated test-year revenue requirement and revenue deficiency are increased by $202 million. Thus, to the extent that the Postal Service is able to achieve its cost-reduction target in FY 2001, the estimated costs, revenue requirement, and revenue deficiency are overstated.

B. The Shift from ECI Minus One Percent to ECI to Estimate Test-Year Wage Increases May Tend to Result in an Overestimate of Actual Test-Year Costs, Revenue Requirement, and Revenue Deficiency

The Postal Service had previously based its estimates of bargaining-unit wage increases on the rate of growth of the Employment Cost Index (ECI) minus one percent. In his updates, Mr. Patelunas deviated from this approach and used the projected rate of increase in the ECI.[10] This is not an insignificant shift, as wage costs are a major part of total Postal Service costs, and the increase in test-year costs resulting from this change is estimated by OCA witness Pamela Thompson to be approximately $230 to $245 million.[11]

To the extent that the Postal Service is able to hold wage increases below the rate of growth in the ECI during the test year, labor cost figures contained in the updated test-year expense estimates will tend to be overstated. Moreover, as I noted in the above discussion of the exclusion of the "Field Reserve" from estimated cost reductions, to the extent that estimated costs are overstated, the estimated revenue requirement and the estimated revenue deficiency will be overstated by that amount

[10] See Mr. Patelunas's response to AAP/USPS-ST44-5 and Tr. 35/16796-800.

[11] See OCA-RT-3, p. 15.

plus whatever contingency provision is allowed on the overestimate. Although Mr. Patelunas offered no explanation for the shift to ECI from ECI - 1, one observer has commented that, "A cynic might suggest that ECI - 1 was abandoned to give the USPS a $230 million cushion."[12]

C. No Attempt Was Made To Validate the Updated Rollforward Estimates of Revenues and Expenses for FY 2000 Against Actual Realized Revenues and Expenses for FY 2000 to Date

The estimate of test-year revenues and expenses is based on a rollforward of estimated FY 2000 revenues and expenses, which are based on a rollforward of actual FY 1999 revenues and expenses. Estimates based on actual FY 1999 data are generally preferable to estimates based on estimated FY 1999 data. However, since Financial and Operating Statements for 10 of the 13 accounting periods in PFY 2000 were available by the time the updates were filed, it might have been useful to use data derived from PFY 2000 to date to check or validate the rollforward estimates. Mr. Patelunas notes that the actual partial-year PFY 2000 data was used only on a limited basis in developing the updated rollforward estimates.[13]

There will be some differences between the PFY 2000 results and the FY 2000 results due to slightly different time periods.[14] Nevertheless, the PFY and FY results are likely to be fairly similar. For example, the AP13 year-to-date net income figures for

[12] See "Short Takes," *Business Mailers Review*, August 7, 2000.

[13] See Mr. Patelunas's response to OCA/USPS-ST-44-6, Tr. 35/16644-46.

[14] PFY 2000 began on September 11, 1999; FY 2000 began October 1, 1999.

the 1998 and 1999 PFYs were $586.5 million and $348.8 million, respectively,[15] while FY 1998 and 1999 net incomes were $550.3 million and $363.4 million, respectively. Although seasonality in volumes, revenues, and expenses must be considered when using partial-year data, the PFY 2000 results to date might have been used to estimate PFY results and thereby to assess the accuracy and validity of the rollforward estimates.

Through PFY 2000 AP11, the Postal Service had a year-to-date net income of $436.0 million. Assuming that PFY 2000 and FY 2000 net incomes are similar in magnitude, in order to realize Mr. Patelunas's FY 2000 estimated net loss of $325.5, the Postal Service would have to lose approximately $761.5 million over the two final accounting periods of PFY 2000. For this to happen, the Postal Service's net losses for PFY 2000 AP 12 and AP 13 would have to be $132.5 million more than called for in the PFY 2000 Operational Plan. This could happen, but I note that the combined net losses for AP 10 and AP 11 of PFY 2000 were only $500,000 less than called for in the PFY 2000 Operational Plan. Moreover, if Postal Service managers act successfully on the recent service-wide directive to control expenses and limit discretionary spending,[16] the actual loss may end up being less than the $325.5 million shown in the updated rollforward estimates.

In fact, there is some indication that the estimated loss might not materialize at all. Postal Service Acting Chief Financial Officer Strasser has recently been quoted as

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15 See USPS Financial and Operating Statements, Accounting Period 13, PFY 1999, p. 1.

16 See *Postal Bulletin* 22029, July 27, 2000, p. 3.

standing by the original projections for a positive FY 2000 net income of $66 million.[17] Moreover, he stated that, "Concerted management action, with a surge in revenue in Accounting Periods 12 and 13 (better than 3%), still make it possible to end the year with a positive net income."[18]

To the extent that the actual net loss for FY 2000 turns out to be less than $325.5 million, or actual net income is positive, the recovery of the prior years' losses component of the revenue requirement will be overstated if an estimated loss is included in the RPYL calculation, as will the revenue deficiency.

D. The Use of More Recent Forecasts of Revenues, Expenses, and Inflation Factors Support a Less Generous Contingency Provision

Mr. Patelunas has noted that the revised cost level forecasts, which are based on more recent forecasts by DRI, are likely to be more accurate than those contained in the original filing.[19] This makes sense: the closer the Postal Service's estimates are to the forecasted period, the more accurate its forecasts are likely to be. The use of more recent, and therefore presumably more accurate, forecasts of the economic environment during the test year lowers the level of uncertainty and supports a smaller contingency provision than would otherwise be the case.

OCA witness Thompson provides a table showing the extent of the updating of indices used in the revised cost-level forecasts. Table V of OCA-RT-3 notes that

[17] See "Short Takes," *Business Mailers Review*, August 7, 2000.

[18] Ibid.

[19] See Mr. Patelunas's response to OCA/USPS-ST-44-28, Tr. 35/16670.

indices in most cases are current as of April-May 2000. The use of more current indices is very significant in considering the appropriate level of the contingency provision to be recommended.

E. Although Higher Than in the Past, Fuel Prices Are Not Likely To Continue Their Recent Rapid Upward Trajectory

In the updated inflation indices,[20] the component showing the largest difference is the index for gas and oil. The original filing reflected FY 2000 and FY 2001 increases in that index of 17.66% and –2.11%, respectively. The revised filing reflects FY 2000 and FY 2001 increases in that index of 30.69% and 6.13%, respectively. The difference between the original and revised filings is +13.03% for FY 2000 and +8.24% for FY 2001.

Gasoline and oil prices are volatile, responding to changes in such factors as OPEC policy, the behavior of individual OPEC members, and weather fluctuations. Gasoline prices sometimes take sudden upturns, but the rate of increase often moderates or turns negative after a major rise.

DRI's July 2000 forecast estimates the rate of increase in gas and oil prices for 2000 and 2001 to be 28.1% and –1.2%, respectively.[21] The U.S. Department of Energy's Energy Information Administration (EIA) forecasts that the average retail price of regular unleaded gasoline will increase by 22.9% in 2000 and decline by 11.0% in 2001. Similarly, the EIA forecasts that the retail price of No. 2 diesel fuel will increase

[20] See USPS Exhibit ST-44AB.

[21] See DRI, Standard & Poor's, *The U.S. Economy 2000/7*, July 2000, p. 29.

by 26.8% in 2000 and decline by 9.2% in 2001 and that the retail price of No. 2 heating oil will increase by 38.6% in 2000 and decline by 12.3% in 2001.[22]

The Postal Service may point to fuel price volatility as the sort of uncertainty that justifies the requested 2.5 percent contingency provision. Use of the May 2000 DRI figures, however, would overstate these test year expenses compared to use of the more recent July 2000 forecast. Available data also indicates that fuel prices frequently fall back after a sharp increase. Figure 1 shows the time path of the annual average retail price of regular unleaded gasoline from 1976 to 2000. The 2000 estimate is based on the average of the monthly prices through July.[23] Figure 2 shows the monthly time path of the average retail price of regular unleaded gasoline from January 1998 to August 2000.[24]

[22] See EIA, *Short-Term Energy Outlook*, August 2000, Table 4. Accessed August 8, 2000 at http://www.eia.doe.gov/emeu/steo/pub/4tab.html.

[23] Data from EIA's *Monthly Energy Review*, Table 9.4. Accessed August 8, 2000 at http://www.eia.doe.gov/pub/energy.overview/monthly.energy/mer9-4).

[24] July 2000 value estimated from EIA weekly data. The August 2000 value is the weekly value for August 7, 2000. Data accessed August 8, 2000 at http://www.eia.doe.gov/pub/oil_gas/petroleum/data_publications/weekly_retail_gasoline_prices/current/txt/rtlgas.txt.

Figure 1
Regular Unleaded Gasoline Retail Price
(annual average 1976 - 2000e)

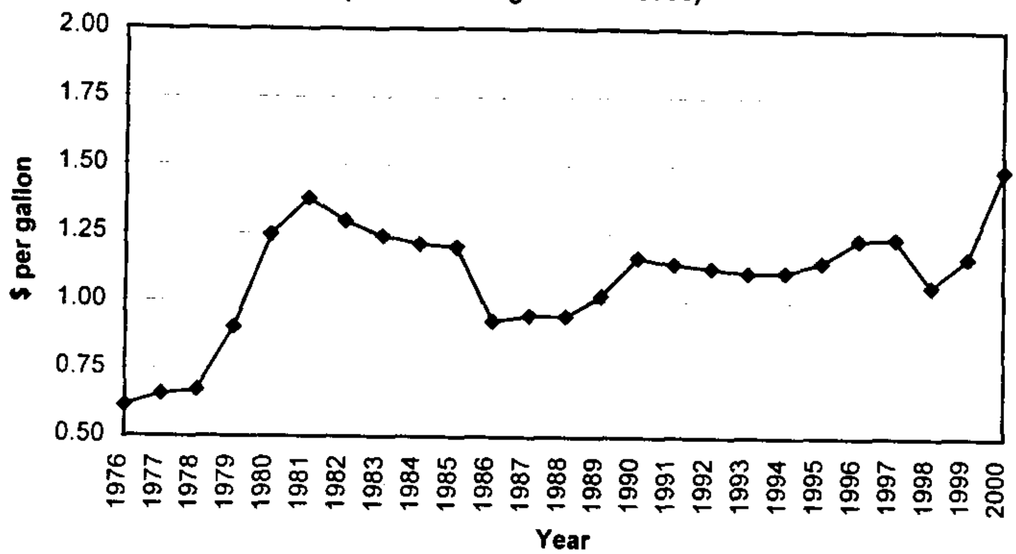
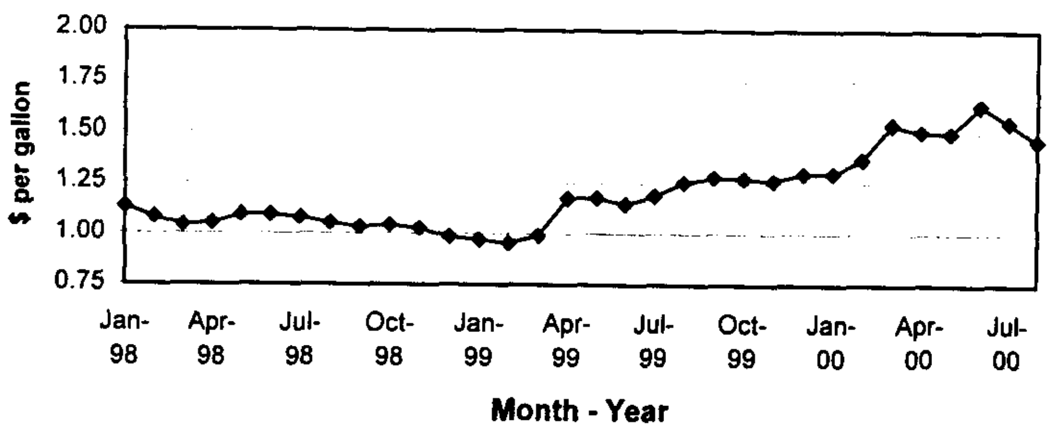


Figure 2
Monthly Average Retail Price of Regular Unleaded Gasoline
(January 1998 - August 2000e)



V. CONCLUSION

Using the estimated test-year costs presented by Mr. Patelunas, which, as noted above, may tend to be overstated, a one percent contingency provision allows an estimated revenue surplus of $739.4 million. If costs are lower than estimated, or if FY 2000 net loss is less than estimated (or a positive income is realized), the surplus will be even greater. Based on the foregoing discussion, and the fact that more recent forecasts of test-year inflation factors have been used to update the test-year cost estimates, I maintain my previous recommendation that a contingency provision of one percent of total estimated costs be used in this proceeding.

CHAIRMAN GLEIMAN: Only one party has requested oral cross examination, the Postal Service. Is there any other party that wishes to cross examine?

[No response.]

CHAIRMAN GLEIMAN: If not, then, who's in first chair? Mr. Reiter? You may begin when you're ready.

COMMISSIONER LeBLANC: Do you have enough water?

THE WITNESS: I do. Thank you.

CROSS-EXAMINATION

BY MR. REITER:

Q Good afternoon, Dr. Rosenberg.

A Good afternoon, Mr. Reiter.

Q Would you turn to page 6 of your testimony, please, specifically lines 6 through 8? You say there that the shift from ECI minus 1 percent to ECI to estimate test year wage increases may tend to result in an overestimate of actual test year costs, revenue requirement and revenue deficiency, is that correct?

A I do.

Q I am interested in your phraseology there, you say the shift may tend to result in an overestimate of actual test year costs. Is there a reason you didn't say something with greater conviction such as the switch to ECI will result in an overestimate?

A Well, if the Postal Service maintains its strategy or its goal of achieving ECI minus 1 in its labor negotiations, it will result, in my opinion, in an overestimate. It wasn't clear in anything I have seen to date why the Postal Service specifically made the shift from ECI minus 1 to ECI. But certainly the tendency will be, if you increase labor costs, if you increase the cost estimates built into the total expense estimates and, therefore, the revenue requirement, and yet the ECI minus 1 bargaining strategy or goal is still maintained, that you will tend to increase the costs, and the revenue requirement and the revenue deficiency will look larger than what might actually result.

Q So is it now your testimony that that will result, is that what you are saying?

A No. I am saying if the costs that are included in the roll forward, new roll forward estimates are based on ECI, as opposed to ECI minus 1, ignoring the fact that the ECI estimate itself has been raised somewhat since the original filing, and if the Postal Service maintains and is successful in its bargaining strategy to hold wage increases to ECI minus 1, then, you know, to the extent there is a revenue deficiency and it is not clear to me that there is one, it will look worse. I mean it looks worse on paper than it will actually turn out to be.

I am not sure what you are -- maybe I am missing something in the predicate of your question, sir.

Q Yeah, my question is very simple. Your written testimony said that this switch may tend to result in an overestimate, and I am simply asking you why you didn't say that it will result?

A Well, it creates a tendency for it. You know, what you have is an estimate, it means that the estimates may tend to overstate the actual test year results, and that is what we are sort of trying to estimate here. And so if you are building higher numbers into your estimates, it creates a tendency to overstate those relative to the actual that might result.

Q If you have higher numbers, isn't that more than a tendency, isn't that -- doesn't that result directly? Again, my question is --

A Well, it does raise the estimates and it raises the stated revenue requirement. You know, what happens sort of in the ex post numbers when you look at the actual outcomes that will actually occur in 2001, it may be somewhat different.

Q Let me ask it this way, did you use the phrase "may tend to" in order to protect against the possibility that you might be wrong?

A Well, you know, in Part A, I just said, in discussing the -- let me back up in terms of language, but in Part A when I was discussing the field, so-called field reserves, or the rather conservative amount of cost savings that were included in the new roll forward estimates, I said these may result in an overestimate. You know, if I -- in this the word "tend" is "tend to" instead of "may result," I say "may tend to result" versus "may result."

You know, what we have is an estimate, and the estimate is an estimate of actual, which we don't know. If you are raising the actual, depending on how you are raising -- excuse me -- raising the estimate, for various reasons, as you add things to the estimate, the more you add to the estimate, the more likely the estimate is to overestimate or to miss the actual on the high side. And so we call it a tendency, it may do that. I think the more dollars you add in to your estimate, the more likely it is that you will be high.

Q Is the issue here that when you are looking into the future, as you point out, when we are dealing with estimates, that it is reasonable to try to protect any statement that you might make against the possibility that it is wrong, because it is the future and it is not known?

A The future is rarely knowable with certainty.

Q And so in discussing the future, it is not unreasonable to use terms like you have used, as opposed to making absolute statements about what will result? I am just trying to understand the reason for your phrasing it that way.

A I am not trying to play semantic games. I don't mean to -- you know, the future is what will be, and we don't exactly know the future. And to a certain extent we do not have perfect control over the future. Some things in the future we can control, some things we can't. To the extent that we raise our estimates of things in the future, the more likely we are to miss them on the high side. If the estimate had been lowered, then we might be more likely to miss it on the low side.

So if that -- I don't know if that is being responsive to your question, but I think any estimate of the future has some risk associated with it.

Q So when you are looking into the future, it is a reasonable thing to protect yourself against the possibility that you might be wrong? Not you, anyone.

A Well, it is one thing to protect yourself. I mean if you say, should I always add a fudge factor to my estimates of the future, as opposed to my best realistic estimate of the future, then I would say that is an iffy call. I mean did I make my best estimate and then add something to it? I think it is the sort of thing that depends on the cost of being wrong.

Q And, also, aren't there things in the future that can't be estimated based on what we know now?

A There are things that I would have some difficulty estimating. There are some things that maybe you would have difficulty even imagining, that could happen in the future. If you try to protect yourself against all possible contingencies, from whatever source, then that is an extremely risk averse posture and you are led to all kinds of behavior that have tremendous costs in the short run to protect yourself against possible problems that might happen, or might not happen.

So one has to assess both the likelihood of an event, the size of an event, the effect of an event and determine whether it is something that you really need to control for or to prepare for.

Q Let's get back to something more specific. Do you think that the wage increases that your testimony I quoted before refers to could end up being at or above ECI?

A I have no specific knowledge as to what the wage increase might be. The negotiations, as far as I know, have not started. I don't know what positions the various unions have taken, nor what position the position the Postal Service plans to take in the negotiation.

Would I totally rule out the possibility? I have no way to rule that out. I would hope the Postal Service would do everything to avoid that and keep wages down to a reasonable level.

Q You are aware that the Postal Service already has a contract that will be in place in the test year with one of its major unions, are you not?

A I have been made aware of that, yes.

Q Are you aware that it is the city carriers?

A I think so, I have seen some reference to a new -- I have seen some reference made to that union, yes.

Q In your statement that I quoted earlier that, in switching from ECI minus 1 to ECI, that that may tend to result in overestimated test year costs, did you consider the effect that the city carrier labor contract could have on wage increases for the other contracts?

A I did not. The city carrier, for clarification, the city carrier contract, was that a negotiated agreement that came in at ECI plus, or was that --

Q I was asking whether you considered it, that's all.

A Well, you something about negotiations.

Q It is an existing contract that is in effect now. And I believe said you did not consider it.

A I did not consider it.

Q So you don't know whether the city carrier contract in the test year increases wages less than, greater than or equal to ECI, is that right?

A I have seen reference to something that the increase may be above the ECI. I don't know how much it is. I thought I saw a number, but in looking at some of the details of that, it wasn't exactly clear how much the increase was.

Q And you didn't consider --

A Now, was that, --

Q Sorry.

A Was the increase, was that -- that was the contract that the increase was due to the fact of the reclassification of employees?

Q I get to ask the questions.

A Well, I am trying -- I am just seeking clarification, sir.

Q Did you consider it or not? That is really all I want to know.

A I did not consider the impact of --

MS. DREIFUSS: Excuse me, Mr. Chairman. If the Postal Service wants to proceed with this line of questioning, it probably would be best if counsel for the Postal Service would clarify some of the details of the contract about which he is questioning Mr. Rosenberg.

It may be that Mr. Rosenberg is somewhat familiar with the contract, but he is not following this line of questions without something to refresh his recollection.

So if counsel for the Postal Service could refresh his recollection, we might get more informed answers from our witness.

MR. REITER: Mr. Chairman, I wasn't asking the witness about the details, and I won't ask any other questions, so you need not rule on that.

BY MR. REITER:

Q Would you turn to your testimony at page 8, please, lines 8 through 13?

A I have it before me, sir.

Q And there you say that assuming that PFY 2000 and FY 2000 net incomes are similar in magnitude, in order to realize Mr. Patelunas's FY 200 estimated net loss of $325.5 million, the Postal Service --

MS. DREIFUSS: Excuse me, I'm sorry to interrupt. We've lost the reference. Could you give me that again, please, the cite?

MR. REITER: Surely, page 8, beginning at line 8.

MS. DREIFUSS: Thank you.

BY MR. REITER:

Q I'll go on: The Postal Service would have to lose approximately $761.5 million over the two final accounting periods of PFY 2000. For this to happen, the Postal Service's net losses for PFY 2000 AP-12 and AP-13, would have to be $132.5 million more than called for in the PFY

2000 operational plan; do you see that?

A I do.

MR. REITER: Counsel, do you have that now?

MS. DREIFUSS: Yes, thanks.

MR. REITER: Sure.

BY MR. REITER:

Q Is it your understanding that FY 2000, the time period that Mr. Patelunas's roll forward applies to, will include results for only two more accounting periods, 12 and 13?

A No, I think there's a 14th period, sort of reconciliation period to bring the two back into line, because there's not 100 percent overlap of the two periods.

There's the 13 accounting periods, as I understand it. First of all, there's a two-day difference in timing. One is 364 days and 366 days is in this PFY 2000.

And also, as I note in the testimony, the accounting year begins a little bit earlier. There is, you know, a two-week or so, little -- let's see -- the PFY began September 11th, and the actual fiscal year begins October 1, 1999, so they're not quite contiguous, but, you know, for most of the time.

At least looking at 1998, 1999, the 13 periods, the 13 accounting period statements, the income figures are different. One year, they're higher than the actual fiscal year's income; one year, they're lower.

But in terms of order of magnitude, they're pretty close.

Q So, to be fully accurate, though, the statement that I just read to you, should that have said the Postal Service's net losses for PFY 2000 APs 12, 13, and 14, would have to be $132.5 million more?

A Well, to the extent that 14 reconciles the two, yes, but I don't think there is a plan that I've seen for AP 14. I'm aware that AP 14 exists for reconciliation purposes, but at least on the statements that I've seen, don't necessarily show a plan for AP 14.

Q So do you know whether there could be a loss in AP 14 that would contribute to the $325 million net loss?

A I don't know, but as I note in my testimony, Mr. Strasser has sort of said just very recently that they still expect to show up a net profit for the actual year. He's on record as having made that statement.

COMMISSIONER LeBLANC: Excuse me, Mr. Rosenberg, but could you speak up. You seem to be trailing off, and I'm having trouble picking you up. I'm sorry. Thank you.

THE WITNESS: I'm sorry, Commissioner LeBlanc.

BY MR. REITER:

Q Let me ask you this then: Would you acknowledge that at this stage it's possible for the Postal Service to end FY 2000 with approximately a $325 million net loss?

A I certainly would consider it possible.

Q And would you say it's also possible that the Postal Service could end up with a net income of, say, $100 million?

A I would say that's also possible.

Q And do you think it's possible on either side of that range that the numbers could be bigger?

A I don't know about the negative 325. Based on what I've seen, sort of year to date, I find it unlikely that the net income figure would be higher than $100 million.

Q So we're talking about a possible range of $425 million, just based on the numbers we're talking about now, not to hold you to them.

A Well, the Postal Service's original Fiscal Year 2000 plan did call for $100 million in positive net income. The latest roll forwards say $325.5 net loss, and I guess the original filing and some statements that had it around $66 or $68 million positive.

So there have been various numbers that have been submitted at various times.

Q If we look first at the range from minus 325 to plus 1000 of about -- that's a range of about 425 million, right?

A It is.

Q Would you accept, subject to check, that that's .7 percent of the Postal Service's expenses; does that sound about right?

A I think that's about right, yes, $67 to $69 million, .7, yes, okay.

Q And there's about a month left in the current fiscal year; is that right?

A Well, there are also revenues, too. I mean, you know -- I mean, you're saying that they are both revenues and expenditures and expenses to be considered in the next few months.

Q So what would your prediction be for the end of FY 2000?

A I've made no prediction. What I've said in this testimony is that it might have been possible to, rather than using the roll forward strictly by itself, to look at the accounting period data existing, develop a forecast, see how that's tracking and see how the income figures for the year are likely to be based on that.

That, to me, would be just as legitimate as the roll forward data.

Q And having looked at all of that, you don't have a prediction?

A I have not made the calculations. As I indicate in the testimony, because of the seasonality of Postal Service expenses and revenues and volumes, you know, it would require taking all that into account, and that's something that I was not asked to do.

And you can't just take -- for instance, I would never just take the first ten or first 11 accounting periods' data and say that's -- then take -- then factor that up, because that would be ignoring seasonality and other factors.

Q Even with only a month to go then, it's very hard to be certain, I take it?

A I think if you had a number of years of Postal data and you could look at some seasonal factors and look at the trends and estimates, you might be able to come up with a reasonable estimate from this point forward of what the data is going to be. I've not done so.

Q Would you look at page 10, line 16 of your testimony, please?

A I see it.

Q And there you provide the July DRI forecast for oil and gas; is that correct?

A I believe that's correct, yes.

Q Is that what you provide?

A That's what I attempted to do.

Q Is there some doubt about it?

A Well, no, I mean, I believe that that is -- that I -- that the forecast is what was -- I sourced the forecast, I believe I transcribed the numbers correctly.
Q These are calendar year forecasts, are they not?
A They are.
Q And do the rates of change that you've provided represent average changes for the year or do they represent the change between one point in time and another?
A I'm not sure.
Q Are you aware that most DRI factors used by the Postal Service represent fiscal year averages?
A Yes.
Q And if that were true and if -- given that -- I'm sorry -- given that, doesn't that make the DRI data that you cite inconsistent with the DRI data used by the Postal Service?
A I'd say there's a slight mismatch of periods, but is it incompatible? I don't think so.
Q Do you know what the comparable July DRI estimates on an FY average basis are?
A I haven't seen them. If that's -- I mean, on postal fiscal year estimates? Is that --
Q Approximately, or Government.
A I haven't calculated those. They have the estimates for the fourth quarter for 2000, but they don't

have quarterly data for the rest of 2001.

Q Isn't it likely that the lower 2001 percentage of -1.2 percent versus the increase of 6.13 percent is due to the fact that the -1.2 is a projection farther into the future and beyond the test year?

A Well, for the 2001, for DRI's annual 2001 forecast, the only part that would not be part of the Postal Service's test year would be the fourth quarter of 2001. So if all of that changes, it is because of the fourth quarter. You know, I'm not saying it's impossible, but the -- just looking at the Energy Information Administration's forecast for 2000, they seem to see most fuel prices will be declining from their 2000 peaks.

Q Could another -- I'm sorry, go ahead.

A But I freely admit and I've stated in the testimony fuel prices tend to be somewhat volatile. They tend to rise, fall. If you look at monthly data over a number of years, gasoline prices spike up and fall back down.

Q Could another factor contributing to the difference be the fact that the -1.2 percent represents the December 2001 index divided by the December 2000 index, which is different from the 6.13 percent fiscal year average reflected in the update?

A Well, I don't know how the number in the update was calculated, but if that was based on a forecast of September 2000 or -- yes, September 2000 or September -- excuse me -- September 2001 -- September 2000, if that shows that sort of difference, that's the difference.

Q On page 10 of 11, you cite Department of Energy forecast of gasoline, diesel fuel and heating oil prices. Are they also calendar year 2001 data?

A I think those are calendar year data.

Q Would you look at page 11, line 6 of your testimony. You state there that fuel prices frequently fall back after a sharp increase; is that correct?

A Yes.

Q I'm looking at your tables. Is it correct that fuel prices increased for five years in a row between 1976 and 1981?

A Yes, they did.

Q And they increased four years in a row between '86 and '90; is that correct?

A Yes.

Q And they increased three years in a row between '94 and '96; is that right?

A Well, they were rising during that time. It's sort of hard to tell from this graph exactly which -- you know, whether -- certainly from '94 to '95 to '96, there was an increase in those two years, from '94 through '96.

Q They increased in '94 and '95 and '96; is that right?

A It does look like the bottom was '93 and '94 is slightly higher than --

Q That was -- I'm sorry.

A It's sort of hard to tell given the precision of this -- the plot of this graph, but that sort of appears to be the case. It looks like a slight increase in '94, yes.

Q So that was three years in a row.

A Three years in a row.

Q Are there any instances on your chart where prices fell back after less than three years?

A These are annual prices. I mean, if we're talking about monthly prices, certainly monthly prices are more volatile than annual prices.

Q Just looking at annual prices, has there been any instance where they've fallen back after less than three years?

A Not looking at this data, not as depicted here.

Q How long has it been since fuel began its current spike upward?

A Well, it appears to have bottomed out in sort of late 1998, early 1999, and it has been rising to various degrees since then.

Q So that has been two years?

A Yes.

Q Yes. Thank you.

MR. REITER: That's all I have, Mr. Chairman.

CHAIRMAN GLEIMAN: Is there any follow-up?

Questions from the bench?

I have a question, I think, but I have to think a moment before I speak.

In response to a question from Mr. Gerarden, Dr. Zarnowitz commented, as I recall, that -- or characterized your testimony or part of your testimony as reflecting the present as opposed to the future. I'm sure that, you know, if I'm off target here, Postal Service counsel or somebody else may jump in.

Indicators measure or reflect numbers that are here-and-now numbers, do they not? I mean, the numbers on all these graphs are real numbers, they took place, you know, we know them, they're either present or past.

THE WITNESS: That's correct, the numbers on Dr. Zarnowitz's charts, the historical numbers, the ones that we know, yes, are actual numbers.

CHAIRMAN GLEIMAN: So if something represents the future -- I mean the present or reflects the present, that doesn't mean that doesn't have value for the future. If it had no value, then we wouldn't call them indicators because they wouldn't be indicating anything. Is that a reasonable assumption on my part?

THE WITNESS: I think so. I mean, as Dr. Zarnowitz discussed, the Conference Board spent a lot of time trying to find various economic indices that -- the leading economic indicators that are called that because they have shown some reliability in forecasting downturns and to a certain extent bottoms of recessions, you know, using current data, currently available data, and the coincident indicators are ones that tend to move very closely with current economic activity.

CHAIRMAN GLEIMAN: All right. Now, the name Greenspan has been bandied about this morning, and as it turns out, this very day while we've been sitting in here, this fellow Alan Greenspan has been out in Jackson Hole, Wyoming, speaking to the Conference on Global Economic Integration that was organized by the Kansas City Federal Reserve Bank, and during the course of his presentation, he made a couple of interesting comments.

Greenspan, and I'm quoting from a report that is on the AP Wire, I believe. It's titled Productivity, dated Friday, August 25th, 10:07 a.m. Eastern Time, Greenspan: Few Signs of Productivity Fade; says that: Latest technological developments had helped raise the rate of productivity growth, that the pace of growth would inevitably slow, quote, "at some point in the future." He then went on to say: It is still hard to find credible evidence in the United States that the rate of structural productivity growth had stopped increasing". There is a comma after the word increasing, and then close quote.

Now, that statement, "It is still hard to find credible evidence in the United States that the rate of structural productivity growth has stopped increasing," when he's talking about finding evidence, he's looking at the present.

THE WITNESS: Yes, sir.

CHAIRMAN GLEIMAN: And when he talks about it -- productivity growth stopped increasing, he is in effect projecting into the future, he's saying that, I don't see anything on the table now that tells me things are going to be less than they are downstream.

THE WITNESS: He sees no -- I interpret that as the fact that he sees no evidence of that.

CHAIRMAN GLEIMAN: So he talks about the present, but the present has an impact on the future. Okay.

Do you know of any credible evidence that the rate of structural productivity growth has stopped increasing in the United States?

THE WITNESS: Mr. Chairman, I only know what I read.

CHAIRMAN GLEIMAN: You haven't read anything along those lines lately?

THE WITNESS: I haven't seen anything. You know, I don't mean to digress, but for a long time, Chairman Greenspan was to a certain sense a reluctant convert to the idea that there has been a shift in productivity growth which possibly allows a higher sustained rate of growth of economic activity. You know, for a number of years, he seemed to be somewhat more -- or somewhat less optimistic about that than he is now. I think he is a rather late convert or adherent to that.

I think he's still a little bit skeptical, possibly as befits the chairman of the Federal Reserve Board.

CHAIRMAN GLEIMAN: He doesn't sound very skeptical about the prospects for the immediate future, so --

THE WITNESS: No.

CHAIRMAN GLEIMAN: You know --

THE WITNESS: He did not use irrational exuberance with respect to productivity growth.

CHAIRMAN GLEIMAN: Well, I want to thank you, Mr. Rosenberg. You're far ahead of me because you know what you read and I read a lot, I'm not always sure I know what I read, especially when I'm involved in a rate case.

I have no further questions. I don't know if there's any follow-up to the bench. There is.

MR. REITER: Yes.

FURTHER CROSS EXAMINATION

BY MR. REITER:

Q In that vein of education, could you define, Dr. Rosenberg, what structural productivity growth is? I think that would help clarify the record.

A Well, there are a couple of kinds of productivity growth. One is related to specific productivity growth that you can actually put a finger on what caused it, whether it's a -- and there's sort of the general -- sort of the structural productivity growth is the part that I understand that you -- the residual that you can't define what caused it specifically. I mean, sometimes it's caused by new investment. At least a part of, I understand, the structural productivity factor might be the residual, just a shift.

CHAIRMAN GLEIMAN: I think we'll get Chairman Greenspan in here and ask him his definition.

BY MR. REITER:

Q Would you expect there to be a whole lot of evidence with respect to structural productivity growth since it's kind of a hard thing to put your finger on?

A I've made no studies of productivity growth per se, but I sort of -- you asked my view of what that means.

Q One other follow-up on something the Chairman was asking you about in terms of historical numbers. In a sense, aren't historical numbers also estimates? We don't really know what the gross domestic product is; we just have hopefully reliable ways of estimating it; isn't that right?

A The Bureau of Economic Analysis, the Bureau of Labor Statistics, various people, you know, they are doing estimates. We're not counting, we're not totally bean counters. The 5.2 percent estimate for real GDP growth the second quarter this year will almost certainly be revised. It was a preliminary number. Sometimes they're revised, as Dr. Zarnowitz said. Sometimes they go back and revise numbers from a couple of years ago so that -- as, you know, as the data changes a little bit. But we're working with what we have.

Q Sure. But even those revisions are ultimately estimates.

A They were revised estimates.

Q Right. Exactly.

MR. REITER: Thank you.

That's all I have, Mr. Chairman.

CHAIRMAN GLEIMAN: It makes one wonder, if we don't know where we've been and we don't know where we are, how we can project that things are going to get worse in the future?

MR. REITER: I think the witness just said we do the best we can. I would agree with that.

CHAIRMAN GLEIMAN: If there's nothing further, then the question arises as to whether OCA would like some time with its witness to prepare for redirect.

MS. DREIFUSS: The OCA would like five minutes, please.

CHAIRMAN GLEIMAN: You have it.

[Recess.]

CHAIRMAN GLEIMAN: Counsel?

MS. DREIFUSS: The OCA has one question for Dr. Rosenberg.

REDIRECT EXAMINATION

BY MS. DREIFUSS:

Q It concerns the use of the DRI economic forecast information. Counsel for the Postal Service asked you or asked you to make a comparison between the forecast that you had used and the ones that the Postal Service had used.

Were you able to make a direct comparison to fiscal years based on information you had available from DRI?

A No, I was not.

Q Do you know whether the Postal Service has customized runs that it gets from DRI in order to make its fiscal year forecasts?

A That's my understanding. There's a Postal Service model of some sort that --

Q Right. You only had information for the last quarter of 2000, but not on a quarterly basis for 2001; is that correct?

A No, I did not.

MS. DREIFUSS: No further questions.

CHAIRMAN GLEIMAN: Recross?

There doesn't appear to be any. That being the case, Mr. Rosenberg, that completes your testimony here today. We appreciate your appearance, your contributions to the record. We thank you and you're excused.

THE WITNESS: Thank you. Thank you, sir. I'm sorry that I'm the one that held up everyone's lunch.

CHAIRMAN GLEIMAN: You didn't hold up anyone's lunch; we'll just eat a little later lunch today, which will still for earlier than the dinner that we had last night.

[Witness excused.]

CHAIRMAN GLEIMAN: I have several requests that I need to make of the Postal Service.

In the status report that the Postal Service filed concerning a request that was made on August 3rd at the hearings, the request -- the status report was I believe filed on August the 10th indicating that information concerning changes in the Emory contract costs and configuration would be available by early next week, and we're just wondering what the status is of the information on the Emory contract cost and configuration.

The other matter involves library reference 102, and what I would like to know is -- when we've reviewed this library reference, it contains volume details for FY '98, and these volume details are used as inputs to a number of special studies that had been updated with FY '99 data.

What I would like to request is that the Postal Service also provide an updated library reference -- that's reference number 102 -- and if possible, that they file that reference, updated library reference, by August the 30th, which is next Wednesday, I believe.

That, as far as I can tell, unless someone else has something else they would like to bring up now, concludes today's hearings. We'll reconvene on Monday morning, the 28th of August, at 9:30, and we'll receive testimony from Witnesses Bradley, Pickett, Young, Elliott, Baron, Heath, Taufique, Prescott and Thompson.

I want to thank you all for your help today and I hope you have a nice weekend.

[Whereupon, at 2:24 p.m., the hearing recessed, to reconvene Monday, August 28, 2000, at 9:30 a.m.]