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

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OFFICE OF THE SECRETARY

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

INITIAL BRIEF

OF THE

ASSOCIATION OF PRIORITY MAIL USERS, INC.

William J. Olson
John S. Miles
WILLIAM J. OLSON, P.C.
8180 Greensboro Drive, Suite 1070
McLean, Virginia 22102-3860
(703) 356-5070

Counsel for
Association of Priority Mail Users, Inc.

September 13, 2000

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STATEMENT OF THE CASE

Course Of Proceedings

On January 12, 2000, the United States Postal Service filed a request, pursuant to the Postal Reorganization Act (39 U.S.C. sections 3622 and 3623), for a recommended decision by the Postal Rate Commission on certain rates and fees, including proposals relating to Priority Mail rates, as well as certain changes to the Domestic Mail Classification Schedule.

On January 14, 2000, the Commission issued a Notice of Filing of the Postal Service's submission (Order No. 1279), which notice of filing, *inter alia*, established procedures for the new Docket (Docket No. R2000-1), regarding consideration of the requested changes by the Commission.

In accordance with Order No. 1279 and Rule 20 of the Commission's Rules of Practice and Procedure (39 CFR 3001.20), the Association of Priority Mail Users, Inc. ("APMU") filed its notice of intervention on February 9, 2000.

The Postal Service's Request

The Postal Service's Request for a Recommended Decision initiating this proceeding requested rate and fee changes affecting all classes of mail, and asserted that without those changes the Postal Service would incur a revenue deficiency of $3.7 billion in the requested test year (FY 2001). According to the Postal Service's initial filing, the requested rates would approximately break even, generating a small revenue deficit of approximately $21.8 million in the test year.

The Postal Service's case-in-chief requested changes in Priority Mail rates, resulting in an average increase of 15.0 percent. Its proposed rate increases range from a low of 9.84 percent to a high of 20.31 percent. The Postal Service proposes creation of a new one-pound Priority Mail rate which would smooth the transition from heavy-weight First-Class Mail to Priority Mail rates. The Postal Service continues to offer electronic delivery confirmation at no additional charge, with the retail version of the product at 40 cents, increased from 35 cents. The Postal Service would offer signature confirmation, at the rate of $1.25 for electronic version, and $1.75 for retail version. The pickup service charge would increase from $8.25 to $10.25.

Discovery of the Postal Service's Case-in-Chief

Counsel for APMU conducted written cross-examination of 10 Postal Service witnesses with respect to their identified direct testimony:

Witness William P. Tayman (USPS-T-9)	Tr. 2/236-64
Witness Linda A. Kingsley (USPS-T-10)	Tr. 5/1601-05

Witness Karen Meehan (USPS-T-11)	Tr. 6/2592-613
Witness Cameron Kashani (USPS-T-14)	Tr. 2/614-15
Witness Nancy R. Kay (USPS-T-23)	Tr. 17/6708-10
Witness Virginia J. Mayes (USPS-T-32)	Tr. 11/4217-25
Witness Maura Robinson (USPS-T-34)	Tr. 7/2692-738
Witness Michael K. Plunkett (USPS-T-36)	Tr. 13/4986
Witness Susan W. Mayo (USPS-T-39)	Tr. 14/5362-64
Witness Richard L. Patelunas (USPS-ST-44)	*See* Tr. 46c/20708-13

The Postal Service provided institutional responses to APMU interrogatories directed to Postal Service witnesses, which appear in the record at the identified pages:

Tr. 21/8691-9, 46C/20705-07	Redirected from witness Robinson
Tr. 21/8700-1	Redirected from witness May
Tr. 46C/20708-13	Redirected from witness Patelunas

Counsel for APMU conducted oral cross-examination of the following Postal Service witnesses, which appears in the record at the identified pages:

Witness Tayman	Tr. 2/530-33
Witness Kingsley	Tr. 5/2025-36
Witness Robinson	Tr. 7/2809-45
Witness Mayes	Tr. 11/4617-26

APMU Direct Testimony

APMU sponsored the direct testimony of witness John Haldi concerning Priority Mail (APMU-T-1, Tr. 25/11496-584), filed on May 22, 2000. During discovery, a total of 62 interrogatories and requests for production of documents were propounded to witness Haldi by Douglas F. Carlson (DFC/APMU-T1-1-2), United Parcel Service (UPS/APMU-T1-1-22, 23-24, and 25-27), and the Postal Service (USPS/APMU-T1-1-24, 25-28, and 29-33). Responses of witness Haldi to 54 of these interrogatories were designated as written cross-examination in the transcript (Tr. 25/11586-669, 11672-77).

On July 11, 2000, during the hearings, oral cross-examination was conducted of witness Haldi on his direct testimony (Tr. 25/11678-759).

Direct Testimony of Other Intervenors

The Parcel Shippers Association sponsored the direct testimony of witness Win Zimmerman (PSA-T-1) opposing the Postal Service's proposed average 15 percent increase to Priority Mail (Tr. 29/14123-50). Oral cross-examination of witness Zimmerman appears at Tr. 29/14165-80.

United Parcel Service ("UPS") sponsored the direct testimony of four witnesses regarding Priority Mail:

- Witness Stephen E. Sellick (UPS-T-2) proposed modifications to the attribution of mail processing (Cost Segment 3) costs, thereby attempting to add $168 million to Priority Mail's Base Year attributable costs (Tr. 27/13120-29). Oral cross-examination of witness Sellick appears at Tr. 27/13136-38.

- Witness Kevin Neels (UPS-T-3) proposed reallocations of premium air network and purchased transportation costs, thereby attempting to add $81 million to Priority Mail's Base Year attributable costs (Tr. 32/15992-6056). Oral cross-examination of witness Neels appears at Tr. 32/16099-134.
- Witness Ralph L. Luciani (UPS-T-5) served as UPS' cost witness for Priority Mail (Tr. 25/11770-834). Oral cross-examination of witness Luciani appears at Tr. 25/11929-2020.
- Witness David E. M. Sappington (UPS-T-6) recommended a 40.3 percent increase to Priority Mail rates (Tr. 31/15219-67). Oral cross-examination of witness Sappington appears at Tr. 31/15472-640.

APMU Discovery of Other Intervenors

APMU submitted a total of 28 interrogatories and requests for production of documents to other intervenor witnesses. Twenty of the responses to the APMU interrogatories were designated as written cross-examination of these witnesses. These responses appear in the record as follows: Witness Sappington (APMU/UPS-T6-1-7, 9-13, and 15-22, Tr. 31/15305-18, 15322-43).

Counsel for APMU orally cross-examined the following three intervenor witnesses on their direct testimony: Neels (UPS-T-3) (Tr. 32/16099-107), Luciani (UPS-T-5) (Tr. 25/11947-57), and Sappington (UPS-T-6) (Tr. 31/15514-27).

Rebuttal Testimony

APMU sponsored the rebuttal testimony of witness Haldi (APMU-RT-1, Tr. 45/19590-610). Witness Haldi's rebuttal testimony critiqued: (i) witness Neel's (UPS-T-3) proposal attributing network premium costs to Priority Mail (Tr. 32/15992-16056); and (ii) witness Sappington's (UPS-T-6) proposal to raise Priority Mail rates by over 40 percent (Tr. 31/15219-67).

In addition to rebuttal by witness Haldi, witness Neels' testimony (UPS-T-3) was rebutted by Postal Service witness John T. Pickett (USPS-RT-9, Tr. 43/18522-38).

No testimony was filed attempting to rebut witness Haldi's direct testimony relating to Priority Mail.

Witness Luciani (UPS-ST-2) revised UPS' recommended increase to Priority Mail rates to 43 percent (Tr. 38/17239-57). Oral cross-examination of witness Luciani appears at Tr. 38/17259-63.

SUMMARY OF ARGUMENT

The Postal Service proposes Priority Mail rate increases which are too high, are unjustified, and are potentially more damaging to Priority Mail volume than the Postal Service projects. Its proposed rates should not be recommended.

Witness Haldi proposes a comprehensive rate schedule for Priority Mail, with several advantages over the Postal Service's proposed rates. Witness Haldi also proposes a new discount for Priority Mail pieces used to transport other classes of mail for dropshipment at Destination Sectional Center Facilities; this discount should be recommended.

Witness Haldi proposes a classification change reducing the maximum weight of First-Class Mail from 13 to 11 ounces, in conjunction with the Postal Service's proposed unzoned one-pound Priority Mail rate. This recommendation would make the transition between First-Class and Priority Mail rates more reasonable.

The astonishing rate increases proposed by United Parcel Service witnesses, averaging nearly three times the level of the rate increases sought by the Postal Service, are unsupported, would be excessively damaging to Priority Mail, and should not be recommended.

ARGUMENT

I. THE POSTAL SERVICE'S PROPOSED PRIORITY MAIL RATES ARE TOO HIGH AND SHOULD NOT BE RECOMMENDED.

Witness Robinson (USPS-T-34), the Postal Service's Priority Mail rate design witness in this Docket, proposes an average rate increase of 15.0 percent, with individual rate cell increases which range from a low of 9.84 percent to a high of 20.31 percent. By way of comparison, in Docket No. R97-1, the Commission approved an average Priority Mail rate increase of 5.6 percent. The only change in Priority Mail rate design requested by the Postal Service is creation of a new unzoned rate for pieces that weigh one pound or less.

A. The Postal Service's Proposed Priority Mail Markup and Rates Are Too High, and Are Unsupported by the Record.

The Postal Service's proposed rate increases reflect both a cost coverage of 181 percent, USPS-T-32, p. 25, and a 23 percent increase in costs per piece from BY 1998 to Test Year After Rates. (APMU-T-1, Table 1, p. 7.) Although some of the increase in rates is due to an increase in the systemwide average, as demonstrated *infra*, the dramatic jump in cost-per-piece for Priority Mail is being driven substantially by the dramatically unsuccessful and now planned to be terminated Emery Worldwide Airlines Priority Mail Processing Center ("PMPC") contract.

Witness Mayes testifies that, in setting her recommended cost coverage for Priority Mail, it was necessary to "mitigate" the proposed rate increase (to keep it no higher than 15 percent). (Tr. 11/4513.) Notwithstanding this "mitigation,"the level of

the Postal Service's proposed cost coverage is unnecessarily high, risky, and potentially damaging to the Postal Service's own long-term interests.

Witness Mayes observes that "[b]oth the cost coverage and the rate increase are substantially above the system average." (USPS-T-32, p. 25, ll. 12-13.) The Postal Service's proposal thus would depart radically from the rate principles applied by the Commission in the last omnibus rate case. In Docket No. R97-1, the Commission recommended rates reflecting a reduced proportional contribution (*i.e.*, coverage) by Priority Mail to institutional costs. This determination was based upon: (1) the continuing deterioration in Priority Mail's market share; (2) evidence presented by witness Haldi demonstrating that Priority Mail's standard of service was either inferior to, or, at best, equal to that of First-Class Mail; and (3) evidence that Priority Mail lacked desirable features common to competing products. (*Op. & Rec. Dec.*, Docket No. R97-1, paras. 5306-09.) The application of these tests to the record evidence in this Docket demonstrates that the proportional contribution for Priority Mail should not increase as proposed by the Postal Service.

1. Priority Mail's Market Share Continues to Decline.

Priority Mail's market share has continued to decline, dropping from 76 percent (by volume) in 1990 to 72 percent in 1993, to 61.3 percent in the first three quarters of 1999. (APMU-T-1, Table 8, p. 41, Tr. 25/11539.) Apparently, the Docket No. R97-1 rate increase — averaging 5.6 percent, nearly 10 percent less than the proposal in this

Docket — contributed to the drop in market share between 1998 (62.4 percent) and 1999 (61.3 percent).[1] *Id.*

In Docket No. R94-1, the Commission recommended rates reflecting "a below systemwide average rate increase" to Priority Mail due to its decline in market share. (*Op. & Rec. Dec.*, Docket No. R94-1, para. 5116.) Clearly, this concern, which also led the Commission to reduce Priority Mail's markup in Docket No. R97-1, remains an issue in this Docket.

2. Priority Mail's Service Performance Is Both Worse than that of First-Class Mail, and Deteriorating.

Likewise, Priority Mail's measured performance is consistently and substantially worse than that of First-Class Mail. APMU-T-1, pp. 44-51, Tr. 25/11542-49; *see also* Commissioner Goldway's examination of witness Mayes, Tr. 11/4602-06. For example, ODIS data for FY 1999 indicate:

- Priority Mail with an overnight standard met that standard 85 percent of the time, compared to 93 percent for First-Class Mail;
- Priority Mail with a two-day standard met that standard 74 percent of the time, compared to 87 percent for First-Class Mail; and
- Priority Mail with a three-day standard met that standard 76 percent of the time, compared to 85 percent for First-Class Mail. (APMU-T-1, Table 9, p. 50, Tr. 25/11548.)

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[1] The 1999 market share is also a full percent lower than the 62.3 percent market share referenced in the *Opinion and Recommended Decision* for Docket No. R97-1 (for "CY 1995/96"). *See* para. 5305.

Even witness Mayes was astonished by the evidence of how poor Priority Mail service has been. When she looked at the performance gap between Priority Mail and First-Class in recent years, she characterized it as "alarming." (Tr. 11/4618-22.) Commissioner Goldway's suggestion — that in light of the data documenting Priority Mail's performance, its cost coverage should be reviewed — is well founded. (Tr. 11/4606, ll. 8-10.)

Witness Haldi's testimony further documents that Priority Mail's service performance has deteriorated since Docket No. R97-1. Developing calculated mean values of Priority Mail performance from ODIS data in both that Docket and this, the performance of overnight Priority Mail was **down** approximately 1 percent, while two-day Priority Mail was **down** over 3 percent, and three-day Priority Mail was **down** another 3 percent. APMU-T-1, pp. 10-11, Tr. 25/11508-09.[2]

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[2] Priority End To End ("PETE") is a comparatively new performance measurement system for Priority Mail. The volume of Priority Mail measured in the PETE system is negligible compared to ODIS volumes. *Compare* attachment to DFC/USPS-49, p. 2 of 5, Tr. 21/8845, with Response of witness Robinson to Questions Posed During Oral Cross-Examination, Tr. 21/8564. Likewise, PETE testing involves a much smaller sampling of destination pairs than ODIS.

During oral cross-examination of witness Haldi, counsel for UPS indicated that PETE data show some improvement in FY 1999 Priority Mail delivery performance as compared to the performance in FY 1998 and FY 1997. However, no foundation was laid with regard to the significance of (or the margin of error associated with) the PETE data. The Postal Service does not officially release PETE data. Tr. 21/8558.

PETE was established in the second quarter of 1997, so no data are available to compare Priority Mail delivery performance from FY 1995 and FY 1996. This makes it impossible to contrast PETE performance in Docket R97-1 and this Docket, such as witness Haldi developed such an analysis using ODIS data. Furthermore, the Postal Service observes that "PETE is neither a system-wide measurement of Priority Mail performance, nor is it a statistical sample of live Priority Mail." Response to UPS/USPS-10.

The fact that PETE data (which measures end-to-end delivery times) curiously reports better performance than ODIS (which measures originating Post Office to destinating Post Office delivery times) constitutes an illogical result, according to witness Mayes (Tr. 11/4621),

3. Priority Mail Still Lacks Competitive Features.

Another important consideration supporting the reduction of the Postal Service's proposed markup is the comparison of Priority Mail's features with those of competing products. In omnibus rate dockets, it is customary to recite the industry standards which are not met by Priority Mail. Witness Mayes offers only a brief recitation in her testimony: "Priority Mail does not necessarily include all of the product features, such as guaranteed service commitments, free insurance and free tracking service" provided by competitors. (USPS-T-32, p. 26, ll. 13-15.) Witness Haldi, in his comparison of Priority Mail with its competitors, also notes that Priority Mail lacks consolidated billing and payment options, reliable delivery, scheduled pick-up services, negotiated prices, volume discounts, and signature confirmation (which would cost an additional $1.25 for electronic manifest, and $1.75 for manual mailers under the Postal Service's proposal). (APMU-T-1, p. 23, Tr. 25/11521.) Witness Haldi provides a useful summary comparison of Priority Mail and competitor features as reproduced below. (APMU-T-1, p. 24, Table 3, Tr. 25/11522.) Witness Haldi further observes that Priority Mail appears competitive with alternative products only in terms of published rates. (APMU-T-1, p. 24, Tr. 25/11522.)

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and raises additional questions regarding the representativeness and credibility of PETE data. *See* oral cross-examination of witness Haldi. Tr. 25/11682.

Comparison of Two- and Three-Day Expedited Services
APMU-T-1, Table 3

	Service	Delivery Time	Insur-ance	Guar-antee	Signa-ture	Track & Trace	Sat Del.	Sun Del.
USPS	Priority	5PM *	NO	NO	NO **	NO	YES	NO
FedEx	2-Day	4:30PM-7PM***	YES	YES	YES	YES	NO	NO
FedEx	Express	4:30PM-7PM***	YES	YES	YES	YES	NO	NO
UPS	AM	12PM	YES	YES	YES	YES	NO	NO
UPS	2nd Day Air	5PM	YES	YES	YES	YES	NO	NO
UPS	3 Day Select	5PM	YES	YES	YES	YES	NO	NO
Airborne	2nd Day	5PM	YES	YES	YES	YES	NO	NO

* Variable according to zone.
** In her testimony, on page 142, witness Mayo proposes signature service fees of $1.25 for mailers who use an electronic manifest, and $1.75 for "manual" mailers, those who mail at a USPS counter. Thus this service is not included in the basic Priority Mail service.
*** Residential.

As for the supposed value of the new delivery confirmation service, Amazon.com, Inc. witness John L. Clark describes the very limited value that delivery confirmation provides to Standard B mailers in terms which are equally applicable to Priority Mail users:

> 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. [AMZ-RT-2, p. 8, Tr. 41/18132, ll. 2-5.]

In addition, witness Haldi shows that past advantages enjoyed by the Postal Service are being eroded. For example, FedEx and UPS have greatly expanded their networks of collection boxes, and have fitted collection slots in many of their delivery vehicles. What is more, such collection boxes often have later final collection times

than are available with Postal Service collection boxes (particularly in the East and Midwest). Perhaps due to the growth in e-commerce, additional companies are entering the residential delivery market as competitors of the Postal Service.

Priority Mail's competitive disadvantages increase with the influence of the Internet. Not only does the Internet increase the ease of access to alternative services (*e.g.*, by providing locations of nearby FedEx Corporation and UPS collection boxes with collection times), it also exposes Priority Mail's failure to meet industry standards with regard to the services mentioned above. As an example, witness Haldi quotes from the iShip.com web site, which reports:

> Most services automatically protect your shipment up to $100. However, USPS Priority Mail and Parcel Post do not have automatic protection. Some USPS services have no available Loss Protection. [APMU-T-1, p. 28, Tr. 25/11526.]

Likewise, the absence of a guaranteed delivery time in using Priority Mail is prominently displayed on the front page of SmartShip.com. *Id.*

4. Comparative Factors Support Witness Haldi's Proposed Markup for Priority Mail.

Based on the factors considered above, witness Haldi proposed rates reflecting a cost coverage of 168 percent. (APMU-T-1, p. 64, Tr. 25/11562.) These rates are estimated to provide a contribution to institutional costs of $2.343 billion. *Id.* This level of contribution is only $15 million less than that estimated to be derived from the Postal Service's proposed rates (once those costs are adjusted to reflect the Postal

Service's over-attribution of rehabilitation costs to Priority Mail, and the Postal Service's later adjustment to test year Priority Mail advertising costs).[3]

B. The Priority Mail Rates Proposed by the Postal Service Would Be Damaging to Priority Mail.

Witness Haldi's testimony demonstrates how Priority Mail rates are only marginally competitive with competitors' published rates. He demonstrates that the Postal Service's proposed Priority Mail rates would be higher than published UPS 3-day Select rates at Zone 5, for weights at or above 30 pounds. (APMU-T-1, Table 5, p. 34, Tr. 25/11532.) At higher weights, even the undiscounted published rates for FedEx and UPS are very close to the proposed Priority Mail rates. *Id.*

As witness Haldi observes, since significant qualitative differences exist between Priority Mail and competing products from private companies, Priority Mail primarily competes by offering lower rates. Witness Haldi demonstrates that recent Priority Mail rate increases have seriously eroded this advantage. However, the news may be even worse, as a significant percentage of FedEx and UPS volume is provided at negotiated — not published — rates. Since proposed Priority Mail rates are barely lower than competitors' published rates, they may in fact be above commonly available negotiated rates. This could result in a "tipping effect" not captured in the Postal Service's forecasting models, which do not contain an accurate index of competitors' actual rates because of shipper-enforced secrecy surrounding their negotiated contracts.

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[3] *See* Section II.B.1, *infra*, for more detailed discussion.

Witness Haldi observes that it is difficult to obtain record evidence on such negotiated rates, as the vendors require their negotiated contract rates be treated as confidential information. However, in his testimony, witness Haldi provides an analysis of FedEx's federal government contract rates, which are publicly available. Witness Haldi demonstrates that, when comparing FedEx's federal government rates with the Postal Service's proposed rates, all Priority Mail rates **over one pound** would not be competitive with the FedEx Priority Overnight Service (next-day 10:30 a.m.), which is clearly a superior product. (APMU-T-1, Table 6, p. 37, Tr. 25/11535.) Additionally, even **current Priority Mail rates are higher** than the FedEx Priority Overnight rates at weights between **2 and 60 pounds**.

Priority Mail's continuing loss of market share, discussed above, is one way to evaluate volume. Viewed in terms of volume trends, Priority Mail volume, which had increased 14 percent from 1996 to 1997, and 10 percent from 1997 to 1998, increased only 2 percent from 1998 to 1999, following implementation of a 5.6 percent average rate increase. (APMU-T-1, Table 7, p. 39, Tr. 22/11537.) One can only speculate as to the impact that a 15 percent average rate increase would have, including an increase of over 20 percent in the most popular rate category. As witness Robinson admits, "people responsible for the marketing of Priority Mail are very concerned about the impact of a 20 percent increase in the two pound rate on their ability to retain and attract new customers to Priority Mail." (Tr. 7/2828, ll. 13-17.)

Witness Haldi observes that, when competitors' negotiated rates fall below the higher rates proposed for Priority Mail, the resulting loss in market share can be far

more dramatic than anticipated by the econometric forecast produced by Postal Service witness Gerald L. Musgrave (USPS-T-8). Postal Service volume estimates rely solely on historical data, including past rate relationships. If the rates recommended in this Docket were to be set above the rates actually charged by competitors, a major change in rate relationships would result, calling into question the ability of previous models to provide reliable forecasts. (APMU-T-1, p. 42, Tr. 25/11540.) Witness Haldi's testimony indicates that the Postal Service's rate proposal may result in such a major change in rate relationships — essentially reducing Priority Mail into an afterthought in a market which it once dominated, following the example of Express Mail.

C. Priority Mail Must Not Be Allowed to Go the Way of Express Mail.

Express Mail has gone from having one of the highest to one of the lowest markups for any subclass which does not enjoy special statutory status. While the Postal Service pioneered expedited overnight delivery, its entry in that market currently enjoys a market share estimated at 11 percent. Likewise, Express Mail's contribution to institutional costs dropped from $313 million in 1984 to $145 million in 1993 (not adjusted for inflation). (*Id.*, Appendix A, pp. A-1 through A-4, Tr. 25/11573-76.)

In Docket No. R90-1, the Commission recommended that Express Mail receive a cost coverage which was 41 percentage points below the level recommended in the previous omnibus rate proceeding. The Commission noted that many competitors had entered the expedited delivery market, that it had become increasingly competitive, and that "[t]he very high cost coverage that was possible previously is unrealistic if there is

to be any Express Mail volume at all." (*Op. & Rec. Dec.*, Docket No. R90-1, para. 6550.)

Similarly, in Docket No. R94-1 the Commission adopted a further reduction in markup, recommending a cost coverage of 119 percent, which represented a markup index of 0.33. (*Op. & Rec. Dec.*, Docket No. R94-1, para. 5398.) The Commission concluded that this reduction was justified by "basic marketplace considerations with regard to customers and competitors." (*Id.*, para. 5408.)

In Docket No. R97-1, the Commission adopted an even lower coverage of 114 percent. (*Op. & Rec. Dec.*, Docket No. R97-1, paras. 5005, 5011, 5013.) Due to "basic marketplace considerations," Express Mail was no longer capable of making significant contributions to Postal Service institutional costs.

Should Priority Mail rates be increased as dramatically as has been proposed by the Postal Service in this Docket, Priority Mail certainly could go the way of Express Mail. For the sake of Priority Mail, its users, the Postal Service, and mailers who use other classes and benefit from the substantial contribution to institutional costs generated by Priority Mail, this must not be allowed to happen.

D. High Costs from the Emery PMPC Contract Drive Priority Mail Cost Increases, Yet Such Costs Should End During the Test Year.

Witness Haldi testified in Docket No. R97-1 that the PMPC contract was dramatically increasing Priority Mail costs, while it was likely to degrade service performance. (APMU-T-1, p. 6, Tr. 25/11504; *Op. & Rec. Dec.*, Docket No. R97-1,

para. 5302.) In this Docket, additional evidence has come to light regarding the impact of the PMPC network. As witness Haldi observes, his testimony in Docket No. R97-1 unfortunately has proven "somewhat prophetic." (APMU-T-1, p. 6, Tr. 25/11504.) However, even the evidence provided in this Docket is far from complete.

The Postal Service has diligently prevented APMU — and the Commission — from gauging what benefit, if any, Priority Mail has received from the PMPC contract. Except for unquantified assertions by the Postal Service, unsupported by evidence, that PMPC performance is superior to that of Priority Mail processed within the Postal Service itself (*see, e.g.,* Tr. 7/2818; Response to APMU/USPS-T10-2), nothing suggests that any additional value has resulted from the PMPC contract. In fact, the Postal Service's data show that, overall, Priority Mail performance has deteriorated since Docket No. R97-1. (APMU-T-1, pp. 10-11, Tr. 25/11508-09.)

By contrast, evidence of the additional costs charged to Priority Mail by means of the PMPC contract is abundant. In Docket No. R97-1, the Test Year (1998) PMPC expenditures were estimated to be $265 million, accompanied by $127 million in corresponding cost reductions. Actual 1998 expenditures were $289 million, including $21 million in "mutually beneficial" payments pursuant to a supplemental letter agreement. (APMU-T-1, p. 12, Tr. 25/11510.) In her review of the PMPC network, the Postal Service's Inspector General concluded that such FY 1998 expenditures included "$101 million more than if the same volume had been processed in-house without a network." (Response to APMU/USPS-T34-41, Tr. 46D/21781; *see also* APMU-T-1, p. 14, Tr. 25/11512, and USPS-LR-I-315, p. i.)

In this Docket, Test Year Before Rates expenditures of the PMPC contract are estimated to be $522 million, $233 million more than BY 1998 (an 81 percent increase). (Response to APMU/USPS-T34-12, Tr. 7/2695.) The Postal Service asserts that this entire increase is due to increased volume of Priority Mail to be handled by the PMPC network. (*Id.*) Yet it refuses to provide any data regarding volumes of such mail, which would help confirm whether the volume increases are commensurate with the payment increases. (Tr. 7/2819; *see also* Objection of United States Postal Service to APMU Interrogatories APMU/USPS-T34-33-39, 41-42 to Witness Robinson filed on March 17, 2000.) The Postal Service also refused to identify how much of the $522 million "would be attributed if the same volume were to be processed in-house without a network." (Response to APMU/USPS-T34-41, Tr. 46D/21781.)

Furthermore, Test Year estimates of Priority Mail costs, incorporating PMPC-related costs, may be excessive, since it is highly unlikely that the Emery PMPC network will operate throughout the Test Year. Witness Robinson observed that "[t]he Postal Service is currently evaluating the Priority Mail processing network, and has not decided how it will be configured in the future." She then notes that her testimony (and the supporting cost studies) "assume that the current network configuration ... exists in the test year." (USPS-T-34, p. 13, ll. 18-22.) Witness Robinson later refers to "the degree of uncertainty surrounding the future Priority Mail network configuration, and the potential effect of unknown network changes on the cost structure of Priority Mail." (*Id.*, p. 15, ll. 8-11.)

Witness Robinson's remarks are supported by additional evidence. Postal Service witness Patelunas has confirmed that Postal Service Headquarters has required the formulation of transition plans which would involve bringing PMPC functions back into the Postal Service within a 90-day period. (Postal Service Institutional Response to APMU/USPS-ST44-4, Tr. 46C/20712.) Options under consideration include canceling the PMPC contract and hiring Emery workers. (*Id.*) Concurrently, Emery has sought unilateral authority to terminate the contract, by means of litigation in federal court. (APMU-T-1, p. 7, Tr. 25/11505.)

Given such uncertainty regarding the expenditure of over $500 million in the test year, APMU asks the Commission to mitigate the impact from this 81 percent jump in Base Year PMPC costs by reducing the markup on Priority Mail, as discussed previously.

E. Priority Mail Is One of the Postal Service's Most Important Products, Making the Third-Greatest Contribution to Institutional Costs.

Priority Mail has been a highly profitable and successful product for the Postal Service. The FY 1996 revenues and operating profit (*i.e.*, contribution to institutional costs) of Priority Mail were, respectively, $3,321.5 million and $1,681.3 million. As of FY 1999, revenues and operating profit had grown to $4,533.3 million and $1,772.2 million. (Library Reference USPS-LR-I-275, "USPS Cost and Revenue Analysis, FY 1999.")

The operating profit from Priority Mail exceeded the combined operating profit of all domestic postal classes of mail, special services, and international postal classes of mail combined, excepting First-Class Mail and Standard A commercial mail. *Id.* Furthermore, the contribution by Priority Mail has equaled more than $1.5 billion annually since 1995. (APMU-T-1, p. 19, Tr. 25/11517, l. 4.) This contribution is expected to grow substantially in the Test Year. APMU's proposed rates in this Docket would contribute over $2.3 billion, while the Postal Service optimistically estimates that its proposed rates would contribute nearly $2.5 billion to institutional costs. Additionally, further increases in institutional contribution can be anticipated when the Emery PMPC contract is no longer in force, and related costs thereby cease hemorrhaging.

Thus, the Postal Service has grown heavily dependent upon the institutional cost contribution from Priority Mail. This explains APMU's concern, expressed by witness Haldi, that the Postal Service's proposed rates may "kill the goose that lays the golden eggs." (APMU-T-1, p. 19, Tr. 25/11517, ll. 8-9.)

II. WITNESS HALDI'S PROPOSALS WOULD PROTECT PRIORITY MAIL'S CONTRIBUTION TO INSTITUTIONAL COSTS.

A. Witness Haldi Proposes Priority Mail Classifications Which Reflect the Product's Declining Performance and Market Share.

Witness Haldi observes that "Priority Mail needs a pricing structure which sufficiently compensates for its disadvantages at every weight level and in each zone." (APMU-T-1, p. 55, Tr. 25/11553, ll. 9-11.) Witness Haldi supports the establishment of a one-pound rate, a reduction in the maximum weight for First-Class Mail (to 11 ounces), and establishment of a discount for Priority Mail (containing other classes of mail) dropshipped to a Destination Sectional Center Facility.

1. A One-pound Rate Should Be Established.

In several recent omnibus rate dockets, the Commission has commented regarding the "gap" between the maximum rate for First-Class Mail and the minimum rate for Priority Mail. In Docket No. R97-1, the Commission addressed the concern regarding this "gap" by adopting witness Haldi's recommendation that the maximum weight of First-Class Mail be raised from 11 ounces to 13 ounces. However, the Postal Service's pending proposal to establish an unzoned one-pound Priority Mail rate offers a more permanent solution to this recurrent problem. (APMU-T-1, p. 59, Tr. 25/11557.)

The proposed solution makes sense, both because it reduces the weight differential between First-Class and Priority Mail by 16 ounces, and because competitors to the Postal Service also offer one-pound rates. However, the Postal

Service's proposed rate for this product is problematic, as it reflects an increase from the current two-pound rate. (*Id.*, pp. 60-61, Tr. 25/11558-59.)

Witness Haldi questions the cost data for Priority Mail under one pound (which has an estimated unit cost of $1.90, while the approximate unit cost of an 11-ounce piece of First-Class Mail is estimated to be only $0.80). No explanation is given for this extreme divergence in unit costs. Notwithstanding such anomalous unit cost data, however, witness Haldi proposes a one-pound rate of $3.00. In order to be highly conservative, he derived this rate using the higher unit cost estimate. (APMU-T-1, pp. 64-66, Tr. 25/11562-64.)

2. The Maximum Weight of First-Class Mail Should Be Reduced to Eleven Ounces.

In conjunction with the one-pound rate proposal, witness Haldi proposes that the maximum weight of First-Class Mail be reduced from 13 ounces to 11 ounces. The current maximum weight of 13 ounces was proposed by witness Haldi in Docket No. R97-1 and recommended by the Commission to address the gap between the maximum First-Class Mail rate and the minimum Priority Mail rate. However, establishment of the one-pound Priority Mail rate should effectively resolve this recurrent problem.

Under the proposed (and current) First-Class Mail rate structure, the 13 ounce First-Class rate establishes too high a floor for the one-pound Priority Mail rate. Therefore, if the one-pound Priority Mail rate is recommended, the maximum weight for First-Class Mail should be returned to 11 ounces.

3. A Dropship Discount Should Be Established for Priority Mail Terminating at a Destination Sectional Center Facility.

Priority Mail is sometimes used to expedite the delivery of smaller items of different mail classes (*e.g.*, Standard A Mail) to Destination Sectional Center Facilities ("DSCFs"). At the DSCF, the Priority Mail pieces (*e.g.*, sacks) are opened and the constituent mailpieces are entered into the mailstream. Such Priority Mail pieces tend to be heavier, and to travel longer distances, than an average Priority Mail piece.

These Priority Mail pieces used for dropshipment avoid all handling and transportation costs beyond the SCF, as well as all delivery costs. Such avoided costs correspond to the costs incurred by DSCF-entry Parcel Select mailpieces. These Priority Mail pieces generate high unit profits to the Postal Service, and therefore additional volume should be encouraged by means of an appropriate discount. (APMU-T-1, pp. 62-63, Tr. 25/11560-61.) Moreover, failure to establish a discount may result in the loss of current volume, as such mailpieces are subject to increasing competition from alternative carriers, who offer services not available through Priority Mail. (*Id.*, p. 72, Tr. 25/11570.)

Witness Haldi proposes a discount for all such mailpieces weighing over five pounds. He observes that the constituent mailpieces pay a destination entry rate, reflecting costs avoided by their having been dropshipped, but the Priority Mail pieces are forced to pay the full rate, notwithstanding the handling, transportation, and delivery costs which they avoid. Thus, this proposed discount would also promote fairness and equity. (*Id.*, pp. 70-71, Tr. 25/11568-69.)

Witness Haldi's proposed discounts are derived by applying a 75 percent passthrough to the corresponding Parcel Select DSCF costs. The discounts are averaged over 10-pound increments (except the 10-pound level, which reflects 6-10 pound costs), and rounded to the nearest nickel. Witness Haldi estimates a revenue loss of $9.9 million, but anticipates that additional volume (both for Priority Mail used for dropshipment and the constituent mailpieces) would make up much or all of this estimated loss. (*Id.*, pp. 71-72, Tr. 25/11569-70.)

B. Witness Haldi Proposes Priority Mail Rates Which Reflect the Product's Declining Performance and Market Share.

1. The Postal Service's Revenue Requirement for Priority Mail Reflects Inflated Costs.

Witness Haldi proposes Priority Mail rates which would make a contribution to institutional costs of $2.343 billion — $135 million less than the estimated contribution arising from the Postal Service's Priority Mail rates. However, the evidence in this Docket supports the reduction of the revenue requirement assigned to Priority Mail.

For example, in this Docket, the Postal Service did not revise its desired revenue requirement for Priority Mail to reflect the over-attribution of FY 2000 rehabilitation costs to Priority Mail. Witness Kashani acknowledges having erroneously distributed $48.350 million to Priority Mail. (Tr. 2/660-62, 686-87.) When multiplied by the contingency and the Postal Service's proposed markup, the Priority Mail revenue requirement should therefore be reduced by $89.8 million. (APMU-T-1, pp. 16-17, 64, Tr. 25/11514-15, 11562.)

Likewise, the Postal Service updated its test year cost estimates to reflect reduced advertising expenditures for Priority Mail. The Postal Service's most recent estimate of test year advertising costs is $54.9 million. The original estimate had been $71.2 million. (Library References USPS-LR-I-150, C/S 16.3.5 and USPS-LR-I-407, C/S 16.3.5, as cited in UPS-ST-2, Table ST-1, p. 3, Tr. 38/17243.) This overstatement of $16.3 million in attributable costs to Priority Mail, when increased by the contingency and the Postal Service's proposed markup, reduces the revenue target by an *additional $30.2 million.*

Correction of these two attributable cost overstatements ($89.8 million and $30.2 million) reduces the Priority Mail revenue requirement by $120 million. As a result, after these corrections, witness Haldi's proposed rates meet a revenue requirement which is only $15 million less than the adjusted Postal Service desired Priority Mail revenues — an amount easily retrieved from any downward adjustment in contingency.

2. Witness Haldi Presents a Set of Moderated Priority Mail Rates.

APMU proposes a one-pound Priority Mail rate of $3.00; a two-pound rate of $3.75; $1.00 increments for the three-, four-, and five-pound rates; and moderated zoned rates reflecting a reduced markup. (APMU-T-1, p. 64, Tr. 25/11562.) Such moderation of Priority Mail rates is necessary due to the precarious market position of Priority Mail, the overstatement of Priority Mail costs, and the uncertainty regarding PMPC contract costs, as discussed throughout this brief. As witness Haldi observes, "the entire Priority Mail product is in the highly precarious situation of going from a

low-cost, low-quality product to a **high-cost**, low-quality product." (*Id.*, p. 61, Tr. 25/11559, emphasis added.)

Thus, APMU proposes Priority Mail rates which are simple and logical, with uniform intervals between the unzoned 2 and 5 pound rates, and a uniform markup on zoned rates. These Priority Mail rates are designed to preserve Priority Mail's high contribution to institutional costs, and prevent it from going the way of Express Mail. They are worthy of the Commission's recommendation.

III. THE PRIORITY MAIL PROPOSALS OF UPS LACK EVIDENTIARY SUPPORT, AND WOULD DEVASTATE PRIORITY MAIL.

A. Network Premium Costs Should Continue to Be Allocated Solely to Express Mail.

UPS witness Neels proposes to re-allocate to Priority Mail $65 million in network premium costs (*i.e.*, the difference between commercial air costs and actual costs incurred by the Postal Service's air networks). Transportation provided by the air networks operated by the Postal Service is far more expensive than transportation purchased from commercial airlines (according to witness Neels, premium network costs make up 60 percent of all network costs; in other words, it costs $100 to ship on the Postal Service's network what would cost $40 to ship on commercial carriers). The Postal Service insists, however, that it needs to maintain its own air networks to guarantee that it will meet Express Mail service standards. In other words, Postal Service witness Kay states that if Express Mail were terminated, the Eagle and Western Air networks would cease to exist. In light of the additional expense involved, and the logic behind the network, the Commission allocated all network premium costs to Express Mail in Docket No. R97-1. The Postal Service's proposal in this Docket also allocates all network premium costs to Express Mail.

Witness Neels objects to this treatment of network premium costs. He asserts that the Postal Service believes that the networks exist to serve both Express Mail and Priority Mail. He observes that in the Base Year, Express Mail was only 24 percent of Eagle Network volume, and 9 percent of Western Network volume, while Priority Mail represented 47 percent of the volume on the Eagle Network, and 64 percent of the

volume on the Western Network. He also discusses Postal Service efforts to expand network capacity, which he views as evidence that the networks were not solely designed to benefit Express Mail. Witness Neels identifies several aircraft — smaller than those chosen by the Postal Service — which he states would have been sufficient to handle just Express Mail volumes. (UPS-T-3, pp. 3-11, Tr. 32/15996-16004.)

In his rebuttal testimony (APMU-RT-1), witness Haldi identifies several weaknesses in witness Neels' analysis of the postal air networks. Witness Haldi cites data provided by witness Neels, in response to an interrogatory, which showed that larger planes can sometimes cost less to operate (and consistently cost much less per cubic foot of capacity to operate) than smaller aircraft. Witness Haldi also observes that witness Neels never demonstrates whether the smaller turboprop airplanes suggested in his testimony even have the range and speed necessary to supplant the jets currently in use and meet the network's operational requirements. Witness Haldi notes that witness Neels never explores whether the larger networks are economically rational, in light of the extensive economies of scale and scope (which are not present in the commercial air transportation contracts). Witness Neels admits that the larger current network capacity enjoys a "greater service reliability and quicker turnaround time ... compared to the commercial system." Such capacity also facilitates the handling of Express Mail when volumes are larger than normal, as well as permitting future growth in volumes. (APMU-RT-1, pp. 3-10, Tr. 45/19595-19602.)

Witness Haldi further observes that the carriage of other classes of mail also works to reduce the costs attributed to Express Mail, by providing more volume to

share incurred fixed costs. He rebuts witness Neels' suggestion that the networks are designed to handle Priority Mail air transportation, and points out the small percentage of total Priority Mail volume actually transported by the networks. (*Id.*, pp. 10-11, Tr. 45/19602-03.) Based on the rebuttal testimony of witness Haldi and Postal Service witness Pickett (USPS-RT-9), the UPS proposal must be rejected.

B. UPS Rate Proposals Would Cause Priority Mail to Lose Volume and Market Share.

Currently, UPS proposes a 43 percent increase to Priority Mail rates. (UPS-ST-2, p. 9, Tr. 38/17249.) The probable impact of the Postal Service's proposed 15 percent rate increase, and the consequences from Priority Mail's development into a high-cost, low value service, already have been discussed at length. The impact of a rate increase nearly three times larger can easily be imagined.

UPS presents unduly sanguine estimates of Priority Mail contributions, predicting that its 43 percent rate increase will result in a contribution of nearly $2.5 billion. (UPS-ST-2, p. 9, Tr. 38/17249). Small wonder that witness Haldi expressed greater confidence that his rates would generate his estimated contribution exceeding $2.3 billion, than that UPS's much higher rates would generate nearly $2.5 billion. (Response to UPS/APMU-T1-23, Tr. 25/11620.)

Based upon Postal Service witness Musgrave's (USPS-T-8) volume forecasting model, UPS estimates that its proposed rate increase would produce a 22.7 percent drop in Priority Mail volume, equal to a loss of 308.5 million pieces, compared to Test Year

Before Rates volume. UPS' rates would thus bring, the Priority Mail volume below 1997 levels, to 1,048 million pieces. (UPS-Luciani-WP-Supp-2-1.1.) Given the increases in the market since 1997, such a drop in volume would signify a dramatic (likely irretrievable) loss of market share.

However, as witness Haldi observes, as Priority Mail rates steadily creep towards the negotiated (and even the published) rates of competitors, UPS' estimate of volume loss may well prove to be quite conservative. If so, then Priority Mail's actual contribution to the Postal Service's institutional costs will be sharply reduced, as the product enters a death spiral of higher costs and rates. Ironically, even UPS witness Sappington acknowledges that Priority Mail rates should not be set so high as to deliberately reduce its contribution to institutional costs. (APMU-RT-1, p. 13, Tr. 45/19605.)

It is interesting to note that UPS' revenue per piece (for Second-Day Air and Three-Day Select, combined) has risen a total of 10.5 percent between 1995 and 1999, a compound annual increase of 2.5 percent. (*Id.*, p. 16, Tr. 45/19608.) Even under the Postal Service's proposed rate increases in this Docket and Docket No. R97-1, the average compound annual increase would be 4.9 percent, nearly twice as high as that of competing UPS products. (*Id.*, p. 17, Tr. 45/19609.) Only if Priority Mail receives moderated rate increases, as under witness Haldi's proposed rates, can it retain any hope of continuing to compete with private carriers and continue to generate the substantial contribution to institutional costs on which the Postal Service and other mailers have come to depend.

CONCLUSION

APMU submits that the record supports its Priority Mail rate and classification proposals, that the UPS proposals for Priority Mail rate increase should be rejected, and that the Postal Service's request should be modified as set forth in witness Haldi's testimony.

Respectfully submitted,

William J. Olson
John S. Miles
WILLIAM J. OLSON, P.C.
8180 Greensboro Dr., Suite 1070
McLean, Virginia 22102-3860
(703) 356-5070

Counsel for
Association of Priority Mail Users, Inc.

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.

William J. Olson

September 13, 2000