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

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POSTAL RATE COMMISSION
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POSTAL RATE AND FEE CHANGES, 2000

Docket No. R2000-1

REPLY BRIEF OF THE
UNITED STATES POSTAL SERVICE

UNITED STATES POSTAL SERVICE

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CONCLUSION

I. THE STATE OF THE RECORD SUPPORTS THE POSTAL SERVICE'S PROPOSALS

In Part I of its initial brief, the Postal Service explained why the state of the record in this somewhat unusual proceeding still supports its proposals. Initial Brief at I-1 - I-28. In contrast with that comprehensive approach to evaluating the status and effects of various update efforts, many parties in their briefs hardly addressed the issue at all. Some briefs omit *any* discussion of the matter. Some briefs come down firmly in the Postal Service's camp that the efforts to incorporate FY99-based information have not been successful, and the Commission should employ as the foundation for its recommendations the FY98-based information furnished with the filing. Although the Postal Service does not in all instances necessarily agree with the reasoning by which those conclusions are reached, among the briefs in which those views are expressed are those of ABA&NAPM at 9-13, AAP at 24-30, Continuity Shippers at 5-6, MMA at 2-3, and MOAA at 29-31.

Because the Postal Service's position was presented in such detail in the initial brief, and because the other parties have generally chosen not to frame their arguments to focus on the update issue in isolation, the Postal Service will not attempt to repeat its earlier arguments, or condense all of the arguments that touch on this issue in one section. Instead, for the most part, appropriate views are expressed throughout this brief in the context of responding to the specific arguments in the parties' briefs.

Nevertheless, the Postal Service firmly maintains the positions set forth and explained in Part I of its initial brief. The Postal Service continues to urge the

Commission to rely on the record created pursuant to the Postal Service's Request, based on its test year estimates utilizing a FY 1998 base year. Efforts to create a new base year foundation for test year estimates have resulted in errors, gaps, and due process concerns. The Postal Service seeks only the revenue goals embodied in its Request. The record based on FY 1998 information provides a reasonable and adequate basis to support the Postal Service's proposals.

One point meriting special emphasis regarding potential deviation from that approach is what the *practical consequences would be, were the Commission to abandon FY 1998 as the base year*. The Postal Service, of necessity, relied upon the only complete information available at the time of filing, data from FY 1998, to prepare and defend its proposals. As noted in our initial brief at I-11 - 12, the practical effect of replacing FY 1998 as the base year would be to eliminate the foundation for the Postal Service's integrated Request, and virtually to nullify the Postal Service's specific proposals. As events unfolded in this docket, it was plainly unrealistic to expect that the Postal Service could produce and document updates based on the existing proposals, prepare necessary rebuttal to intervenor proposals, and yet also simultaneously reevaluate the new financial information, the new cost relationships, and then develop and explain new rate levels and rate elements designed to achieve breakeven in the test year, following full-blown iteration through the volume forecasting and cost rollforward models.

Even assuming, contrary to reality, that such a feat would have been possible in the time allotted (i.e., by August 14th), there would have been no viable way for the parties to respond within the short remaining balance of the statutory 10-month

timeframe, and protect their due process rights, if the Postal Service had actually revised its rate proposals to reflect fully the totality of ramifications of a new base period. In other words, the practical consequence of updating would be to wipe out the Postal Service's case as filed, while depriving the Postal Service of the realistic opportunity to fully incorporate the new information into comprehensive new proposals.

It must be stressed that the Postal Service stands in a totally unique posture in this respect. Obviously, in this case, as in every case, it is the rates to be charged by the Postal Service that are at issue. But of equal importance is the fact that no other participant even attempts to prepare a comprehensive proposal designed to achieve breakeven across all subclasses. It is relatively easy for parties to grab new data relating to the particular subclass or subclasses of interest to them, and simplistically argue that this requires different rate levels.¹ Without the discipline imposed by the need to balance push-ups with push-downs, parties do not necessarily see the inherent difficulty for the Postal Service in coming to grips with the totally new foundation for ratemaking that a new base year represents. Without the need to iterate their proposals through volume forecasting and cost rollforward models, parties severely underestimate the sheer magnitude of why it is so much more difficult for the Postal Service to develop a *comprehensive* set of *breakeven* proposals than it is for them to focus on the one or two subclasses to which their attention is limited. The constrained manner in which updating unfolded in this case, however, brought this dilemma into

¹ It is never difficult to predict how these exercises will turn out -- mailers will always find ways to justify lower rates, and competitors always seem to find ways to justify higher rates.

stark relief. This factor strongly reinforces the conclusion reached above: the insertion of a new base year would constitute a violation of the Postal Service's due process rights to have its proposals evaluated on the same factual basis as they were developed.

In this respect, it is useful to examine the arguments of UPS, the party that has most vigorously advocated reliance on an FY 1999 base year. Unlike most parties, UPS does include a separate section of its brief addressing the update issue. UPS Brief at 11-14. The crux of the Postal Service's disagreement in this matter with UPS comes from the assertions by UPS that it is now clear that it is certainly feasible to substitute FY 1999 for FY 1998 as the base year, and that the Commission and the Presiding Officer have successfully accommodated the due process concerns of the parties. UPS Brief at 12. If the Postal Service were as sanguine as UPS regarding the analytic integrity and the completeness of the new information, and the ability of the update process to accommodate its due process rights, the conclusions reached by UPS might appear more reasonable. Although the Postal Service agrees that good faith efforts have been made by all involved, our assessment of the result is the diametric opposite of that proffered by UPS. For all the reasons set forth in our initial brief at I-1 - I-13, the effort to replace the base year has resulted in an inadequate ratemaking foundation, and has not afforded the Postal Service adequate due process protection. The further reasoning and case law presented by UPS, based on a faulty contrary premise, is therefore inapposite.

As also more fully developed in Part I of our initial brief, however, if the Commission should conclude that it wishes to rely on the Order 1294 (and related)

update information over the objections of the Postal Service, it must nonetheless treat the update information as a unified package. Proposals to selectively pick and choose among the components of that information, in the manner advocated, for example, by the OCA, must be rejected.² Recommendations based on updated information must satisfy the Postal Service's revenue needs. The Postal Service has tried in its initial brief to provide a useful roadmap to the refinements, corrections, and methodological advances which would also need to be applied to the available update submissions. With a few exceptions discussed therein, the updated information still supports the Postal Service's rate and fee proposals.

² The specific extreme positions advocated in the OCA brief are refuted in a separate discussion in the revenue requirement portion of this brief, *infra*.

II. THE POSTAL SERVICE'S REVENUE REQUIREMENT SHOULD NOT BE ADJUSTED

A. The Postal Service's Proposed Contingency Provision Is Reasonable and Should Be Recommended

After nearly thirty years, the debate over the level of the Postal Service's revenue requirement has not changed much. In particular, disputes over the size of the contingency element, which has been challenged in all ten rate cases, have a familiar ring. Several fundamental questions of statutory interpretation and ratemaking policy lie at the core of disagreements between the Postal Service and the challengers over the years, and in this case. These include the legal authority of the Commission to alter the Postal Service's proposed revenue requirement, the fundamental nature of the contingency provision, and the standard that should be applied to its review in Commission recommended decisions.

Positions on these issues, furthermore, have tended to be polarized. On one end stands the Postal Service, which, in general, advocates that the Board of Governors has a managerial prerogative to subjectively determine a reasonable contingency provision, as an element of financial and operating policy. On the other end stand an array of intervenors and the OCA, who understand that one sure way to lower the level of rate increases is to induce the Commission to recommend a reduced revenue requirement. They typically argue that contingency can be proved as an objective fact on the narrowest basis conceivable. Somewhere in between, the Commission stands, its ultimate position depending on the particular circumstances and the evidentiary record with which it is confronted. On one hand, as a matter of principle and statutory construction, the Commission agrees with those who advocate maximum authority for

the Commission to set the level of revenues generated by postal rate and fee changes. On the other hand, the Commission has only once reduced the proposed contingency provision. As a consequence, the Commission's principles have no doubt been effectively neutralized in the estimation of the intervenors.¹

It would be overly optimistic to expect that the Commission is likely to change its mind about its authority or its analyses of this issue, as a result of any argument the Postal Service will present in this case. Like the Commission, the Postal Service's views on the matter have not retreated from those outlined by the Postal Service and the Governors in the early rate cases. In other words, the Commission will not hear anything fundamentally new in this brief, except as it relates to the instant record. Not even after the Governors and the courts soundly rebuffed the Commission's one attempt to reduce the contingency did the Commission modify its basic positions, except through the narrowest interpretations of the court of appeals' decisions.² It is probable that the disagreements over the statutory and policy issues involved will persist until the Governors and the courts once again address them in a concrete context, such as this case. In this regard, we urge that the Commission not listen to the

¹ There have been a number of occasions where the Commission's recommendations have, in effect, embodied a lower provision for contingencies (as a percentage of actual expenses in the test year), based on the overall level of the revenue requirement supporting the Commission's rate recommendations, combined with evidence indicating subsequent inflation of the expense estimates presented in the Postal Service's Request. In some cases, the Commission has explicitly acknowledged this development in its Opinion; in others the result is suggested by the Postal Service's or the Governors' positions. See, e.g., PRC Ops., R71-1, R74-1, R76-1, R77-1, R80-1, and R90-1.

² PRC Op., R84-1, Vol. 1, at 18-25.

voices that have influenced it in the past to challenge the Postal Service's revenue requirement, or other matters, on the basis of these fundamental disagreements over statutory authority. We are firmly convinced that we, and the courts, are right on these issues; however, we also sincerely believe that confrontation will impede the productive relationship between the Postal Service and the Commission as partners that has prevailed in many instances in the past. Moreover, in this case, we believe that the Commission can find that the record adequately supports the Postal Service's proposed contingency. Most particularly, we believe that the intervenors' proposals in this case are not supported, either on the record or as a matter of law, and that a reduction of the contingency provision would not be sustained by the Governors or in court.

1. The Commission's authority to adjust the revenue requirement is limited.

DMA et al., Greeting Card Association and Hallmark Cards (GCA/HC), and the OCA, joined by others, urge the Commission to reduce the Postal Service's proposed contingency provision. They argue variously that the Commission has the legal responsibility to reduce the contingency to a level determined by the Commission. Their assertions are founded in part on the Commission's often-expressed conviction that its authority in rate cases fundamentally includes considerable control over the total amount of revenue to be recovered by the rates and fees it recommends. The Commission and the Governors, however, have disagreed for years over the appropriate nature and scope of the Commission's authority to alter the revenue needs of the Postal Service, as endorsed by the Board of Governors in the Postal Service's Request.

The *Newsweek* decision³ should have been a watershed in interpreting the respective authorities in the statutory scheme with regard to the contingency provision. The proceeding from which the *Newsweek* appeal arose, Docket No. R80-1, marks the only time the Commission has reduced the Postal Service's proposed contingency provision. The Court of Appeals for the Second Circuit firmly rejected the Commission's attempt. It found that the reduction was arbitrary and not supported on the record. It further concluded that it was "an unlawful intrusion into the policy-making domain of the Board." *Newsweek*, 663 F.2d at 1205. The Postal Service has read that decision broadly, and we think fairly, to place significant limits on the Commission's authority to alter the contingency provision and to control the size of the revenue requirement generally.⁴ Perhaps understandably, the Commission has construed the *Newsweek* opinion as narrowly as possible, limiting its implications to the strict holding of the court in the precise circumstances facing the parties in Docket No. R80-1.⁵ The parties challenging the contingency in this proceeding stand firmly behind this narrow interpretation. DMA, *et al.* Brief at 3-5, GCA/HC Brief at 29-31.

³ *Newsweek, Inc. v. United States Postal Service*, 663 F.2d 1186 (2d Cir. 1981); *affirmed on other grounds sub nom, National Association of Greeting Card Publishers v. United States Postal Service*, 462 U.S. 410 (1983) (hereinafter *Newsweek*).

⁴ We will not belabor the details of the Postal Service's interpretation and application of the *Newsweek* decision, which was first addressed comprehensively in its briefs to the Commission in Docket No. R84-1. See United States Postal Service Brief to the Postal Rate Commission, Docket No. R84-1, at 1-2-4 (July 9, 1984); United States Postal Service Reply Brief to the Postal Rate Commission, Docket No. R84-1, at 1-1-10 (July 19, 1984). These views have subsequently been expressed in various contexts in the succeeding general rate cases and in other court appeals.

⁵ See PRC Op., R84-1, vol. 1, at 14-30. The Commission has frequently referred to and elaborated on this analysis.

Notwithstanding the qualifications inherent in the doctrine of *stare decisis*, we are particularly struck by the facility with which the Commission in the past, and the challengers in this case and in others, overlook or dismiss dicta and conclusions in other court decisions arising out of the same disputes in Docket No. R84-1. The Commission itself has strained to evade the courts' statements, relying on the limitations inherent in the holdings in *Newsweek* and the other cases to dismiss their significance. *Id* at 24. Nevertheless, parties seeking to induce the Commission to reduce the revenue requirement too lightly gloss over the court of appeals' characterizations of its findings in *Newsweek*.

In particular, in discussing the Commission's legal authority to make such changes in this case, the challengers ignore some very important judicial language.⁶ *DMA et al.* Brief at 3-5. In *Time Incorporated v. United States Postal Service*, 710 F.2d 34, 36-37 (2d Cir. 1983) (*Time II*), the court of appeals stated:

Congress has created a unique legislative scheme that divides postal ratemaking authority between two independent executive agencies...

The Board is the business manager of the Postal Service, in day-to-day control of policymaking and operations. It is responsible for determining revenue requirements based upon total estimated costs ...see 39 U.S.C. § 3621.... Whereas the Board is in charge of management, the PRC controls ratemaking. It is responsible for establishing postal rates, fees and classifications. 39 U.S.C. § 3622(a) (1976). Its primary responsibility in a rate proceeding is to allocate to each class of mail the direct and indirect costs attributable to that class in accordance with ...39 U.S.C. § 3622(b)(3) ...[and]

⁶ In light of the significance of this issue, the Postal Service respectfully urges each Commissioner, in the course of his or her evaluation of this matter, to read (or re-read) the full text of the court decisions cited in this section.

institutional costs ... through the pricing process in accordance with the policies defined in 39 U.S.C. § 3622(b)

In another decision, the court stated:

We held in *Newsweek* that the PRC's reduction of the Service's revenue requirements was an unlawful encroachment upon the policy-making domain of the Board....Significantly, because *Newsweek* was filed after the Board exercised its modification powers, the PRC was never given the opportunity to comply with our mandate that it accede to the Service's revenue needs as anticipated by the Board.

Time, Inc. v. United States Postal Service, 685 F.2d 760, 775 (2d Cir. 1982) (*Time I*) (emphasis added).

This conclusion is supported by the Supreme Court's observation in the appeal from *Newsweek's* determination of the central costing issues in that case.⁷ Ironically, the Commission has frequently cited the pertinent statement by the Court in this case to support expressions of the Commission's broad ratemaking authority, including authority over the revenue requirement. The Supreme Court stated:

Although the Postal Reorganization Act divides ratemaking responsibility between two agencies, the legislative history demonstrates "that ratemaking...authority [was] vested primarily [in] the Postal Rate Commission. [citations to legislative history and lower court opinions omitted.] The structure of the Act supports this view. While the Postal Service has final responsibility for guaranteeing that total revenues equal total costs, the Rate Commission determines the proportion of the revenue that should be raised by each class of mail.

The Postal Service reads this language as validating the clear division of responsibilities with respect to the revenue requirement that are reflected in the lower

⁷ *National Association of Greeting Card Publishers v. United States Postal Service*, 462 U.S. 810, 821 (1983), affirming *Newsweek, Inc. v. United States Postal Service*, 663 F.2d 1186 (2d Cir. 1981) (hereinafter "NAGCP IV").

courts' decisions. Supported by intervenors challenging the revenue requirement, the Commission reads the phrase "determines the proportion of the revenue that should be raised by each class of mail" to signify the Court's broad endorsement of global authority by the Commission to *determine* the revenue requirement. Regrettably, this difference of opinion is not likely to resolve itself short of another court challenge. We think, however, that the fairer reading of the Court's statement is that it was acknowledging the courts of appeals' conclusions below regarding authority to alter the revenue requirement. The phrase the challengers frequently rely on can be easily reconciled as referring to the Commission's authority over overall cost allocation to "each class of mail," in the break-even context, which was the focus of the Court's consideration of *Newsweek*.

Like the Commission, DMA, *et al.*, and GCA/HC argue that *Newsweek* is inapplicable, because it "involved a unique set of circumstances that bear no resemblance to the instant one." DMA *et al.* and GCA/HC argue that the Commission's reduction of the contingency in Docket No. R80-1 was found unlawful only as "an attempt to punish the Postal Service for its refusal to file rate cases as frequently as the Commission wanted." DMA *et al.* Brief at 3-4, GCA/HC Brief at 30.

These arguments are unpersuasive regarding the courts' meanings. First, the courts' statements must be read to constitute their views of the division of powers between the Postal Service and the Commission established by the Postal Reorganization Act. Their interpretations of the Act did not depend on, and indeed

should not vary, based on the circumstances of that or any particular rate case.⁸ While a litigant might try to avoid the broader implications of these views by arguing that, as precedent, the cases should be limited strictly to the holdings, they stand as potent expressions by these courts of the proper interpretation of the Act. Second, DMA *et al.*'s and GCA/HC's arguments ignore the *Newsweek* court's explicit statement that its holding did not depend on the Commission's intent. The court stated: "Whether or not it was the intent of the PRC to cause more frequent rate filings by eliminating nearly \$1 billion from the Postal Service's revenue requirement, the Board determined that the PRC's action would necessarily have that effect." *Newsweek* at 1204. Moreover, in discussing the *Newsweek* decision in a later case, the court made it clear that its view was not confined to a particular circumstance, but rather represented a general view of the division of authority between the two agencies. It commented: "We stated quite firmly in *Newsweek* that the PRC must accede to the Board's estimates of the Service's revenue needs. 663 F.2d at 1203-06." *Time I*, 685 F.2d at 775.

⁸ In an earlier case, after reviewing the legislative history of the Postal Reorganization Act, the Court of Appeals for the D.C. Circuit held:

We think this history demonstrates the intention of Congress to vest in the Board of Governors exclusive authority to manage the Postal Service. As a "partner" of the Board the Postal Rate Commission was assigned the duty and authority to make recommendations with respect rates and classifications. ... Congress did not intend that the Postal Rate Commission regulate the Postal Service; one partner does not regulate another, and authority to assist in ratemaking and classification does not include authority to interfere in management.

Governors of the United States Postal Service v. Postal Rate Commission, 654 F.2d 103, 114-15 (D.C. Cir. 1981) (emphasis added; footnote omitted).

A more complete understanding of the conflict between the Commission's and challengers' views regarding the Commission's authority to alter the revenue requirement, and the Postal Service's and the Governors' views, traces back to the origins of ratemaking under the Postal Reorganization Act. From the very start, the Commission has asserted the view that it has the authority to adjust the revenue requirement, and particularly to "disallow" elements, based on its assessment of whether costs were incurred in accordance with the standard of "honest, efficient, and economical management."⁹ The Commission has painstakingly analyzed both the statute and the legislative history to conclude that it has near-global powers to review, assess, and adjust the revenue requirement, as well as to pass judgment on whether cost elements can be included in revenues to be generated by the rates and fees recommended. See PRC Op. R71-1, at I-269-71. The foundation of its analysis, which we believe the Commission approached honestly and thoroughly, is the expression of the *Governors'* authorities in ratemaking embodied in 39 U.S.C. § 3621. The fulcrum, moreover, is the "break-even" standard in § 3621, which the Commission incorporates through § 3622(b)'s reference to "policies of this title." Thus, in the first rate case, Docket No. R71-1, the Commission stated:

In judging whether the Service's total cost and revenue estimates conform to those statutory policies, the Governors are entitled to the benefit of the Commission's recommendations. Under 39 U.S.C. § 3622(b), the Commission is expressly required to make its recommendations **"in accordance with the policies of this title and the ***factors"** specifically enumerated in § 3622(b). (Emphasis

⁹ We have elsewhere discussed the application of this standard to evaluation of the revenue requirement. See Postal Service Initial Brief at II-14-26; and the instant brief, *infra*.

added.) Like the parallel concepts in § 3622 (b) and 3662, this plainly incorporates the above-quoted § 3621 policies governing rate level. The provision's effect is to empower this Commission to advise the Governors whether, in our independent judgment, the proposed rates conform to the Act's rate-making policies.

Id. at I-269. This description and analysis soon solidified in the following succinct expression of the Commission's asserted authority:

It follows that the Commission, upon receipt of a request for a change in mail rates and fees from the Postal Service, is initially confronted with the essential task of determining the Postal Service's revenue requirement in accordance with the criteria set forth in Section 3621 of the Act. In making that determination, the Commission must examine and consider the estimated costs and income of the Postal Service under the then existing rate and fee schedule and under any proposed adjusted rate and fee schedule.

PRC Op., R74-1, at 12-13. See also PRC Op., R76-1, at 15-17. The Commission has never retreated from this essential position.

Not surprisingly, also from the start, the Governors firmly resisted what they regarded as an impermissible expansion of the Commission's authorities under the Act. The focus of their concerns was the potential for intrusion by the Commission's recommendations into the domain of management, which includes the determination of cost elements comprising the Postal Service's overall revenue needs, and a range of operating decisions that lead to cost incurrence. In their decision in the first rate case, the Governors stated:

The postal system of this nation cannot be managed effectively, and we cannot function effectively as members of the Board of Governors, if major management decisions having cost consequences are subject to modification or reversal by outside parties. Much of the impetus behind postal reform derived from the fact that the postal system was failing because its managers were unable to manage; responsibility and authority were divided among various agencies and individuals. If the Commission is permitted to

use its recommendations to undercut management's cost decisions, then a major purpose off postal reorganization – centralized management authority and responsibility – may be nullified.¹⁰

Regarding their decision on the Commission's recommendations, the Governors stated:

Our real options are few and narrow. We may modify Commission recommendations only under limited circumstances. Even if it were practical to go through the protracted proceedings that must precede modification, the dissent of a single Governor would nullify the judgment of the rest. The Commission's rate recommendations are, in actual effect, apt to be tightly binding; if they should interfere with basic management decisions having significant cost consequences, as most such decisions do, they would prevent us from meeting our responsibility as members of the Board to direct the exercise of the powers of the Postal Service.

The Commission's outstanding professional competence equips it to make major contributions to the success of the Postal Service. Its expert advice can assist us greatly in carrying out our obligations. But "advice" on matters outside its plain jurisdiction must be just that. If the Commission's "advice" becomes a part of its recommended decisions, it will be more coercive than advisory.

The Commission rests its contested jurisdictional claims largely on the statutory requirement that it make its recommendations "in accordance with the policies of this title" (i.e., title 39 of the United States Code). But carrying out the policies of the title that are not expressed in sections 3622 and 3623 is the job of those on whom the title itself confers responsibility – the Congress, the Governors, the Board, and the Postal Service – not the Commission.

Id.

As conceded from the outset, it will likely serve no purpose to track this fundamental disagreement through history. While it is possible to refine each side's positions in the context of particular actions in particular rate cases to identify concessions and inconsistencies, the basic schism over the Commission's authority

¹⁰ United States Postal Service Decision of the Governors on Rates of Postage and Fees for Postal Services, Docket No. R71-1, at 1-368 (June 5, 1972).

remains, and likely will need attention by a court to be reconciled. We make this observation, notwithstanding the various expressions in the past by both the Commission and the Postal Service and its Governors that indicate that their respective positions are not necessarily monolithic.¹¹ The Postal Service has agreed that corrections of errors in the Postal Service's expense estimates are appropriate in Commission recommendations, so long as they are based on the record and do not infringe upon a management policy choice.¹² In recent cases, furthermore, the Commission has altered the proposed revenue requirement based on incorporating actual, as opposed to estimated, data and information supplied by the Postal Service, and the Governors have not objected.¹³

In light of these refinements, however, one issue stands out: at what point do the Commission's corrections, adjustments, and updates infringe upon the domain of management? To what extent, furthermore, can the Commission's authority to recommend rates interfere with postal management's prerogatives to assess and determine how much revenue the Postal Service will need to operate, given the full range of policy choices dictating operations, service, and financial management that are

¹¹ The Commission has occasionally emphasized that it has no intention of infringing upon management prerogatives. See, e.g., PRC Op., R71-1, at I-269.

¹² See Postal Service Brief, Docket No. R84-1, at I-5.

¹³ See Decision of the Governors of the United States Postal Service on the Recommended Decision of the Postal Rate Commission on Postal Rate and Fee Changes, Docket No. R84-1, at 2-3, n. 1 (Dec. 11, 1984); Decision of the Governors of the United States Postal Service on the Recommended Decision of the Postal Rate Commission on Postal Rate and Fee Changes, Docket No. R87-1, at 3 (March 22, 1988).

clearly within the Postal Service's exclusive authority under the Act? Again, these are broad questions that we cannot resolve definitively on the record of this case. We submit, however, the following observations.

First, it is quite common in rate cases to hear parties, even Commissioners, refer to the process of Commission review of the revenue requirement as being directed toward how much the Commission will "give" or "allow" the Postal Service to gain as revenues from recommended rate changes. In the early rate cases cited above, the Commission itself expressed its position in terms of the Commission's authority to *determine* the Postal Service's revenue requirement. In this regard, with full understanding of the Commission's meticulous analysis justifying its asserted authority, we might ask rhetorically, how can the scheme of the Postal Reorganization Act be reconciled with the Commission's purported revenue requirement authority? The Act was intended to give the Postal Service, as an independent establishment, substantial control over its own finances and destiny. Yet, the Commission's interpretation would allocate the most basic authority to manage finances and operations to an independent agency, whose mission, as interpreted repeatedly by the courts, is to assist the Postal Service as a partner, and not a regulator.¹⁴ Furthermore, by what sensible rule of statutory

¹⁴ We need not engage in detailed speculation regarding the extent of the Commission's authority to affect managerial prerogatives in reviewing the revenue requirement. It bears noting, however, that, in spite of a difficult history of disagreements between the Postal Service and the Commission over appropriate financial policy, the Commission has had a significant influence in a number of important instances. A good example is the Board of Governors' response to the Commissioners' views on the appropriate use of funds generated through incorporation of a prior year loss component in the Postal Service's revenue requirement. These views were cogently expressed in Commissioner LeBlanc's dissenting opinion in

(continued...)

construction does the indirect reference in § 3622(b) to the *Governors'* authority in § 3621 come to be stood on its head to authorize the *Commission* to *determine* Postal Service's revenue requirement?

Second, there is clearly a difference of opinion concerning the nature of the contingency element, as discussed below. In the context of the Commission's authority to alter the revenue requirement, it becomes pertinent to ask, beyond assessing the reasonableness of the proposed contingency, where does the Commission derive its authority to *determine* an alternative contingency?

2. The provision for contingencies represents a basic policy choice subjectively determined by the Postal Service and its Board of Governors

The contingency is determined at the highest levels of the Postal Service. When the Board of Governors authorizes the filing of a particular omnibus rate request, it authorizes the amount of the contingency provision as well.¹⁵ Witness Strasser testified that the contingency represents a fundamental policy judgment embodying the degree of risk against unforeseen and unforeseeable adversities that the Postal Service determines should be built into its rates and fees. Tr. 46-A/20183. It is, in effect, an

¹⁴ (...continued)

Docket No. R94-1, and they no doubt contributed to the Board's decision to adopt Resolution 95-9 governing the restoration of equity through the prior year loss component. The Postal Service's adherence to this Resolution has resulted in a significant restoration of equity since its adoption.

¹⁵ This can be contrasted with the provision for recovery of prior years' losses. While the Board is informed of and is interested in this provision as well, the determination of the *amount* to include is a mathematical exercise that follows from the timing of the Board's decision to file, and is not a matter of independent judgment. (This assumes, of course, no proposal for a different amortization period or for other methodological changes, which the Board would have the authority to include in its Request.)

insurance policy, intended by Congress to give the Postal Service a measure of protection to enable it to maintain enough working capital to meet adverse financial situations. Tr. 46-A/20238-39. As a tool to assist the Postal Service in its compliance with the break-even requirement, it represents an important element of the Postal Service's financial policies.

In other words, the contingency is not a cost estimate, like other rate case cost estimates. It is not a series of cost estimates. Nor is it a variance around cost estimates. If it were any of these things, it could have been described as such in § 3621, as opposed to being characterized as a "reasonable provision." Rather, the contingency was intended as a cushion to insure against a deficit caused by unforeseen circumstances. In an early case, the Commission indicated its agreement with this view of the function and purpose of the contingency provision:

[T]he contingency allowance performs an important function in the financial management of the Postal Service. Unlike most other regulated enterprises, the Postal Service is operated on a break-even basis. It has no retained earnings on which to rely during periods of financial stringency. Being untaxed, it does not maintain tax reserves which can drain down during short-term tax deficiencies. In sum, the contingency provision plays a preeminent role – which in most private enterprises is assumed by a variety of other financial devices – in insuring the ability of the system to continue rendering service to mailers.¹⁶

It is true that the expenses associated with contingencies, after they occur, ultimately end up as costs grouped in particular cost components.¹⁷ By their nature, however,

¹⁶ PRC Op. R76-1, at 52-53. The Commission linked this description to its conclusion that it has authority to review and alter the revenue requirement.

¹⁷ During the appearance of witness Strasser, Commissioner Goldway seemed troubled (continued...)

they cannot be precisely anticipated or predicted. They can only be insured against prospectively.

This distinction is highlighted in the intervenors' insistence that the reasonableness of the contingency can only be evaluated as a prediction, or like any other cost estimate. Their analytical approach, furthermore, leads to one of the primary arguments leveled against the proposed contingency by the intervenors, namely, that it represents "double counting." GCA/HC Brief at 26-29; DMA *et al.* Brief at 10-11. Because the contingency is not an expense item, however, it is not based on "counting." So, it makes no sense to allege that it represents double-counting.

¹⁷ (...continued)

by the fact that the Postal Service does not track expenses that are unforeseen. Her comments suggest the belief that some accounting treatment should be given to the expenditure of funds associated with the provision for contingencies in the Postal Service's rate case revenue requirement. Tr. 46-A/20369-72. The purpose of accounting for contingencies would apparently be to provide a more objective basis on which to evaluate proposed contingency provisions in the future. In this regard, the suggestion of tracking contingencies is not novel, and has been made by intervenors and the Commission in past cases. The proposal is certainly not illogical, although its value probably does not outweigh the practical difficulties it presents. First, an accounting record of contingency expenses, like variance analyses, is not likely to be of significant utility in predicting future *unknown* developments. It would produce data, but the data are not likely to have statistical significance. Furthermore, separate accounts for contingencies are liable to be tremendously complex and expensive to administer in light of the Postal Service's decentralized organizational structure, operations, and systems of accounts. Difficulties in determining the causes of expenses, beyond the standard accounting categories, would further complicate administration of such a system. For example, there is unlikely to be any scientific way to isolate the degree to which any reductions in the rate of growth of, or absolute reductions in, First-Class Mail volumes are due to faster than anticipated electronic penetration, changes in national economic conditions, or to other completely unknown factors. The Postal Service is certainly willing to reconsider constructing an accounting treatment in the future; however, it must be demonstrated that the benefits outweigh the costs, and that it can be practically implemented.

A simple illustration might help clarify this issue. Assume that expenses for transportation have been projected to be X million dollars in the test year, including projected increases in fuel prices of Y percent for the test year, based on the best information available. It turns out, however, that a war in the Gulf, or a decision by OPEC, or some other unanticipated event leads to fuel price increases of $Y + A$ percent, resulting in transportation costs of $X + B$ million dollars. The contingency provides a cushion that will cover that additional B million dollars. GCA/HC and DMA *et al.*'s argument would exclude this possibility for consideration in the contingency, because transportation costs have already been counted. This makes no sense in the real world.

The contingency is not a cost estimate; it is a cushion to protect against the possibility that costs might end up being higher than could have been anticipated, due to a variety of unknown developments. These might include:

- forecasting errors, which have been small, but could increase again;¹⁸
- unexpected changes in known events, such as internet diversion, general economic conditions, uncertainties surrounding workers compensation liabilities, health benefits, legislation correcting retirement system mis-assignments, etc., which may cause greater expenses than could reasonably have been anticipated during the rate case;

¹⁸ No party has presented convincing evidence that a statistically reliable pattern is reflected in any of the variance analyses or comparisons presented in the record of this case.

- completely unforeseen events (no one can say what they are, what expenses they affect, and to what degree).

The "double counting" argument actually amounts to "double discounting." The parties' argument maintains that anything objective that we know exists and can forecast is already included in the estimate of test year expenses. These costs are considered to be known with certainty and cannot be considered in determining the contingency. DMA *et al.* Brief at 9. Then they argue that anything we don't yet know exists is something too subjective to be considered in determining the contingency. DMA *et al.* Brief at 8. Essentially, they discount the possibility of both objective *and* subjective judgment in determining the contingency, contrary to the Commission's expressions quoted above that both kinds of judgment are appropriate.

The framework advanced with this argument simply doesn't allow a reasonable contingency to be developed. One wonders how DMA *et al.* justify even the 0.25 percent post-update contingency they now advocate. DMA *et al.* have provided no "bottom up" analysis of how this amount was determined, and no objective analysis of what this 0.25 percent is expected to cover. Yet, they demand this from the Postal Service. All that is left, under this argument, is historical variance analysis¹⁹— which is

¹⁹ In a colloquy with witness Buc, Commissioner Le Blanc seemed to share the view that witness Buc provided lots of criticism of the Postal Service, but little support for his own contingency recommendation. "It's my understanding that your criticism of witness Tayman, is in effect, there wasn't a lot of support for the 2.5%, but then you don't go into a lot of detail, other than the variances, as I remember." Tr. 22/9605. In response to the Commissioner's request that witness Buc provide the basis for his contingency recommendation, witness Buc cited variance analysis, inflation, and the financial position of the Postal Service. *Id.* As discussed below, witness Buc admitted that the Postal Service and the Commission do not evaluate the latter two factors at all

(continued...)

of no value in predicting the future—and the hope that the Commission will keep rates artificially low. The only way the Postal Service could assure itself of justifying a contingency, under DMA *et al.*'s framework, would be for it (or the Commission) to project costs inaccurately in the previous case, so that significant variances could subsequently be measured.

DMA *et al.*'s framework fails to acknowledge the obvious. Even though the Postal Service and the Commission endeavor to produce the best test year estimates possible, it remains possible that costs will develop in unforeseeable ways that will adversely affect the Postal Service's financial condition, in addition to the example of fuel costs discussed above. For example, labor costs resulting from negotiations or arbitrations are far from predictable or controllable. As another example, there could be some technological change that accelerates diversion to the Internet, leading to unforeseeable, adverse trends in volumes, and thus the Postal Service's finances. As a recent Washington Post headline put it: "Is Another Energy Crisis Ahead?: Winter Fuel Costs Will Rise; After That, Nothing Is Certain."²⁰ The contingency is designed to help protect against adverse financial consequences in the event that adverse eventualities occur, causing previously predicted trends to change course.

DMA *et al.* complain that "[n]either Strasser nor Zarnowitz explain why the economic risks they are concerned about are not already reflected in the Postal Service's Test Year estimates." DMA *et al.* Brief at 10-11. First, Dr. Zarnowitz did not

¹⁹ (...continued)
differently, leaving only historical variance analysis.

²⁰ The Washington Post, Business, page H-1 (Sunday, September 17, 2000).

testify on Postal Service test year estimates. Tr. 41/18188. His expertise, as the creator of the leading economic indicators, was drawn upon by postal management to help confirm the degree of economic uncertainty at the present time. Based on Dr. Zarnowitz's expertise, witness Strasser explained postal management's concern that test year estimates could end up being seriously off due to unforeseen turns of economic events. Dr. Zarnowitz indicates that there is evidence of significantly increased risk now, compared to earlier in this calendar year, that the economy could take a turn for the worse. Tr. 41/18212. Postal management would be irresponsible not to take into account the possibility that current economic forecasts will turn out to be wrong. That is one of the purposes of the contingency. To suggest that "uncertainty in the general economy cannot support" the contingency, as DMA *et al.* do in their brief at page 11, is to misunderstand the purpose of the contingency provision.

3. Section 3621 establishes the limited standard by which the provision for contingencies must be evaluated.

All parties challenging the contingency, and the Commission in its past recommendations, acknowledge that the standard for reviewing the contingency provision is expressed directly in the statute. In describing the constituent elements of "total estimated costs," section 3621 identifies a "*reasonable* provision for contingencies."

Over the years, the Commission has labored conscientiously to formulate a systematic analysis leading to a test of reasonableness in this context. In this regard, we must state at the outset that, while the Commission's opinions purporting to elaborate on this standard may be cited for their explanatory value, the Postal Service

does not concede as a matter of law that the Commission's views on what constitutes a reasonable contingency represent an authoritative interpretation of "reasonable," or establish precedent that must be followed by the Governors or in court. In particular, in light of the principal focus of section 3621 on the Governors' authority to establish rates and fees that achieve break-even, the Commission's interpretation of that standard is no more authoritative than the Postal Service's or the Governors.

By contrast, the intervenors challenging the contingency in this case maintain a diametrically contrary view. They argue that over the course of many rate cases, the Commission has established clear and binding criteria dictating a set method of analysis, as well as substantive standards by which the reasonableness of a contingency provision must be proved and justified. See OCA Brief, at 58-74; DMA *et al.* Brief, at 6-12; GCA/HC Brief, at 25-29. They argue that the Postal Service's testimony supporting its proposed contingency provision fails to meet the Commission's articulated standards, primarily because it is judgmentally derived and subjective, based on unchecked management discretion, and lacks the systematic analytical rigor that the Commission demands. They also fault the proposed contingency because it is not based on objective proof, such as variance analysis, statistical probabilities, or other factors based on firm prediction of future conditions.

Over the course of the previous rate cases, the debate over adequate justification of the contingency provision has tended to focus on whether its selection results from an essentially judgmental determination or whether it is objectively derived. The Postal Service has generally maintained the view that the contingency is essentially a

subjective policy choice, while the parties challenging the contingency have argued for an objective assessment. As the Commission stated in Docket No. R87-1:

It is understandable that the Postal Service would emphasize the subjective element of the determination of the contingency reserve above all others, since it tends to relegate that determination to the province of management. It is also understandable that the parties with an interest in adjusting the proposed contingency should emphasize the objective element of that determination, since it tends to subject that determination to outside criticism and analysis. In prior dockets, we have concluded that the subjective element of the contingency determination entitles management's determination to a good measure of deference, but that it does not render that judgment unreviewable. As we noted in Docket No. R84-1, judgment implies opinion or assessment, and is not necessarily equated to management discretion. Because the statutory requirement that a contingency be supported by substantial evidence remains in effect, management must still provide such evidence, and the Commission must still review it. PRC Op. R84-1 at para. 1046-47.

PRC Op. R87-1, vol. 1, at 35-36.

In fact, while DMA *et al.*, the OCA, and GCA/HC contend that the Commission has erected a formidable standard of objective, quantitative proof, the Commission has not rejected the use of what DMA *et al.* call "managerial intuition about potential unforeseen financial risks." DMA *et al.* Brief at 7. DMA *et al.* rely on a quotation from the Commission's Opinion in Docket No. R87-1, but they ignore the second sentence and reinterpret the quote to mean that only objective criteria can support the contingency. *Id.* The Commission stated:

The Postal Service argues that unforeseeable risks, because they are unknown, by their very nature cannot be articulated or analyzed, but must remain in an intuitive realm. But in our view, if such risks are to be the predominant basis of the Postal Service's contingency determination, management's perception of those risks must be articulated to a reasonable degree in order to satisfy the substantial evidence requirement.

PRC Op., R87-1, Vol. 1, at 36.

This conclusion does not support the view that intuitive or subjective judgment cannot primarily underlie the contingency. Indeed, it says the opposite: that unforeseeable risks can be the predominant basis of the Postal Service's contingency determination if its perception of those risks is properly articulated. Specifically, those unforeseeable risks must be "articulated to a reasonable degree." As discussed in our initial brief, the Postal Service, primarily through the testimony of witness Tayman, has articulated these risks to a reasonable degree.²¹ Postal Service Initial Brief at II-6.

The Postal Service regards the Commission's qualification "to a reasonable degree" as subject to two mutually consistent interpretations. First, the articulation of risks must be reasoned, *i.e.*, have some basis in logic. Second, the articulation of risks, given their nature, need only be articulated to a reasonable extent. In other words, the Commission recognizes that the articulation of future, unforeseen risks, based on intuitive, subjective analysis cannot be held to the same standard as the evaluation of objective facts. This interpretation is not fanciful. The Commission, on the page following the one quoted by DMA *et al.*, says as much:

[T]he Commission views the contingency determination as a blending of subjective judgment concerning unknown risks, and objective judgment concerning forecast errors and their sources. The former can and should be articulated, *even if it is primarily intuitive*, while the latter can and should be subjected to statistical analysis. The Commission has never advocated that statistical analysis be the exclusive determinant of the proper contingency amount, nor that it should be accepted uncritically, in terms of its precision, or its ability to account for external factors.

²¹ Witness Strasser, in rebutting the participants' opposing testimony, elaborated on witness Tayman's testimony and re-examined the issue in light of subsequent events.

PRC Op., R87-1, Vol. 1, at 37. The Commission then notes that the Postal Service also examines past trends in determining the contingency, but "seems only to object to a systematic approach to evaluating those trends."

The Postal Service believes the Commission fairly described the relatively small difference between its and the Postal Service's views on this matter. Both agree that judgment is appropriate and that past trends should be considered. The only difference concerns the usefulness of statistical variance analysis.²² The Postal Service questions its validity in predicting the future. Indeed, even the Commission, as expressed in the language quoted above, views statistical variance analysis's purpose only in terms of evaluating forecast errors and their sources. The Postal Service, however, has not relied on forecast errors as a significant underpinning of the contingency provision, so it does not rely on, and sees no need for, the Commission to rely on historical variance analysis. The predominant risks are not from mechanical errors whose sources can later be pinpointed, but from the effect of factors or events that could not have been foreseen, or whose actual magnitude, due to changed circumstances beyond the control of the Postal Service, could not have been projected. Thus, we return to the

²² The Commission first adopted variance analysis in Docket No. R77-1, as a means to objectively evaluate, and prospectively prescribe the contingency provision. See PRC Op. R77-1, Vol. 1, at 31-40. As explained herein and in the Postal Service's Initial Brief, the Commission has relied upon variance analysis somewhat inconsistently in its subsequent recommendations. The high-water mark of the analytical method came during Docket No. R80-1, when, except for a questionable adjustment based on recognition of actual data, and a relatively minor adjustment for external economic factors and the Postal Service's equity position, the Commission's recommended contingency provision derived almost entirely from its variance analysis. See PRC Op. R80-1, Vol. 1, at 18-38. The court of appeals in the *Newsweek* decision found the Commission's recommendation to be arbitrary and unsupported in the Commission's Opinion. *Newsweek*, at 1205.

predominance of subjective judgment, whose use in supporting the contingency the Commission accepts, and which, by its very nature, while capable of being articulated, cannot be described with perfection. In Docket No. R84-1, Arthur Eden²³ testified to this effect on behalf of a broad coalition of mailers, including DMA:

No one can thoroughly justify a contingency provision because, by its very nature, it deals with the unforeseen."

Docket No. R84-1, Tr. 21/10242.²⁴ DMA *et al.* now demand perfection, having apparently forgotten Mr. Eden's teaching.

In this regard, DMA *et al.* witness Buc admitted that the Postal Service and the Commission do not view the contingency particularly differently. Although in his written testimony, witness Buc maintained that the Postal Service's past contingency amounts were not properly reasoned, on cross-examination, it was revealed he had no real basis for this opinion.

Q ... [I]n your opinion none of the past contingency amounts were properly reasoned. Is that right?

A It's correct.

Q So is it your opinion that the Commission recommended unreasoned amounts on those instances where it recommended the same amount that the Postal Service requested?

²³ Mr. Eden, who served as Assistant Postmaster General for Rates and Classification before his retirement from the Postal Service in 1975, Docket No. R84-1, Tr. 21/10169, testified on behalf of the Reader's Digest Ass'n, American Bankers Ass'n, American Retail Fed'n, Ass'n of American Publishers, Council of Public Utility Mailers, Direct Marketing Ass'n, Mail Order Ass'n of America, Parcel Shippers Ass'n, Recording Industry Ass'n of America, Reuben H. Donnelley Corp., and Third Class Mail Ass'n [now PostCom].

²⁴ Mr. Eden, also stated: "Perhaps I should have said that if the Postal Service can thoroughly justify a contingency provision, it would not be a contingency; it would be included in the line item cost projections." He recognized the dichotomy discussed above between cost estimates and the contingency.

A No, actually the Commission can come up with a reasonable decision even if the request wasn't reasonable, I believe.

Q So what did the Commission do to transform an unreasoned request into a reasoned amount when it was the same amount?

A Well, the Commission, as they have articulated their framework, has always thought about what the variance showed. They have always thought about what economic conditions looked like, and they have put those two together and decided that in view of those the amount that the Service asked for is okay.

Q Is it your testimony that in the past the Postal Service did not look at economic conditions?

A No. I think the Postal Service does look at economic conditions.

Q So the missing piece is purely the historical variance analysis?

A No. I think the Commission, as I outlined in my testimony, approaches it in a whole different way.

Q Could you articulate what that is?

A Sure. We can go through it if you care to do that. I believe that the Commission says that the variance analysis is the starting point for thinking about the contingency. It is the point of departure. It is what they think about first, but having thought about what the Postal Service variance analysis shows as the starting point, they then think about what sort of shape the Postal Service is in financially. They then think about what general economic conditions are. They put all those together and they come up with an answer on what they think the contingency ought to be.

Q And when the Postal Service has done this in the past, have they thought about what shape they are in financially and what they think the outlook is economically for the future? I think those are the two things you just mentioned.

A They do present those numbers.

Q So the missing part is reliance on the historical variance analysis?

A No, because I think that *the Postal Service just reasons slightly differently*. If you review the Postal Service requests, the Postal Service basically talks a lot about management discretion and they talk a lot about this is what we think we need, but there is not a whole lot of what I see as reasoning in the request.

Q So there isn't reasoning with regard to their financial condition, there isn't reasoning with regard to predictions of economic conditions in the future --

A I think there is micro-reasoning. I don't think they followed the outline, the approach that the Commission has told them they should follow.

Q How did the Commission evaluate economic forecasts differently from the Postal Service?

A I am not sure that they do.

Q How did the Commission evaluate the Postal Service's financial position differently for the future from how the Postal Service did?

A It is not clear that they do.

Tr. 22/9596-99 (emphasis added).

In essence, witness Buc testified that, with the exception of historical variance analysis, the Postal Service and the Commission look at essentially the same factors in the same way. It is just that the Postal Service "reasons slightly differently." Witness Buc failed to articulate any substantive differences between the factors considered by the Commission and the Postal Service, and failed to articulate how the Postal Service's "unreasoned" contingencies are transformed into "reasoned" contingencies when recommended by the Commission. Ultimately, he was forced to admit that, in essence, the Postal Service's contingencies are reasoned, just slightly differently. In another context, this might be a way to say that "reasonable minds can differ," although that aphorism would be more applicable to a situation where the Commission reached a different result, rather than recommending the exact contingency percentage that the Postal Service had used. In fact, the Commission has, in each instance since the court reversal of Docket No. R80-1, evaluated essentially the same factors as the Postal Service, and did so in a way that witness Buc was unable to characterize as any different from the Postal Service. The Commission recommended the Postal Service's contingency provisions in all cases. It is hard to understand how it can be argued that those provisions were unreasoned, and it is therefore not surprising that witness Buc was unable to support his testimony in that regard, when questioned.

4. The contingency in this case is reasonable and reasoned, as demonstrated by substantial evidence on the record

Several parties rely on simple-minded arguments giving great weight to the purported importance of the number of pages or number of reasons relating to the

contingency in the Postal Service's direct case. See, e.g., *DMA et al.* Brief at 8. This type of reasoning is akin to grading papers by tossing them down the stairs to see where they land.

A better approach would be to actually examine the reasons given by Postal Service witnesses Tayman and Strasser. Such an examination shows that all of the types of concerns specified by the Commission in past Opinions have been evaluated by the Postal Service. Certainly, the Postal Service's presentation meets the substantial evidence standard. The Postal Service has explained what factors it considered, how it considered them, and what conclusion it drew from them. The record shows that the Postal Service's contingency provision was reasoned and is reasonable. There is no basis for the Commission to substitute its judgment on this vital issue of financial policy for that of the Board of Governors.

In addition, objective analysis concerning inflation was presented in witness Strasser's Table 1 and Exhibit 1A. These data show not only the appropriateness of the current and most past contingencies, but they also validate the risk with the 1.0 percent contingency that was taken by the Postal Service in Docket No. R97-1, as witness Tayman testified. They show that a contingency of even greater than 2.5 could have been justified in this case.

B. The Arguments Challenging the Postal Service's Contingency Amount Do Not Provide a Basis for A Reduction in the Postal Service's Contingency Provision

1. Previous contingency amounts do not determine future amounts; a new determination is made in the circumstances of each case.
 - a. The appropriate frame of reference is the current circumstances of this case, not the contingency in the last case.

Several participants argue that the contingency provision should not be "increased" from the 1.0 percent used in the last omnibus rate case. OCA Brief at 42-58; DMA *et al.* Brief at 12-21. The idea that the previous level of the contingency provision prevails in subsequent cases has no precedent in judicial or Commission opinions. In each rate case, both the Postal Service and the Commission have treated the determination of the contingency provision as a *de novo* exercise based on the particular circumstances of the case at hand. While they have looked to the range of past contingency provisions as a guide to what might be considered generally appropriate, that has never meant that the previous contingency amount is automatically regarded as binding on the subsequent case, in the absence of substantial evidence to the contrary.

Docket No. R97-1 is instructive in this regard. Even though DMA *et al.* view all previous contingency provisions as "unreasoned," there was no groundswell of opposition from DMA *et al.* or any other party against the Postal Service's "unreasoned" "reduction" of the contingency provision from 2.0 to 1.0 percent in that docket. As noted in our initial brief, variance analysis was not even mentioned by the Commission in its Opinion. Moreover, there was, curiously, no suggestion—by DMA or any of those parties joining in its brief in the instant case—of the inadequacy of witness Tayman's reasoning, which followed the same lines as his testimony in the current docket. One can only conclude that the Postal Service is being held to a double standard. When it includes a contingency provision that it says may be inadequate, there is no hue and cry about its lack of reasoning. When it returns from this bare minimum, back to a more customary range (and to the low end of that range, as it happens), suddenly variance analysis is back in vogue, and the type of reasoning on which the Postal Service

supported every contingency provision since Docket No. R84-1, all of which were accepted by the Commission, is suspect.

- b. There is no lawful precedent for the Commission to reduce the contingency provision.

DMA *et al.* allege that the Commission has reduced contingency requests since Docket No. R84-1, but gives only one example, that of Docket No. R97-1. DMA *et al.* rely on an alleged reduction in the contingency in Docket No. R97-1 from 1.5 to 1.0. DMA *et al.* Brief at 5. The Postal Service's contingency provision was 1.0 percent, and it never changed that. It is not clear whether this is DMA *et al.*'s misinterpretation or whether it is simply repeated the court's mistake regarding a fact that did not affect the issues before it. Nevertheless, it is clear from the Postal Service's testimony that the Postal Service never changed its contingency determination.²⁵ Indeed, DMA *et al.*

²⁵ Witness Porras testified in some detail on these matters:

The Postal Service opted to assume additional risk by requesting the smallest percentage contingency provision ever in this filing because of an overriding desire to keep rate increases as low as possible and below the rate of inflation. Faced with balancing the conflicting goals of providing adequate protection against unforeseen events during the test year and beyond, and keeping rate increases below the rate of inflation, the Postal Service chose to emphasize the latter in this case. The Postal Service opted to live with a level of protection below what it normally would have considered adequate in order to accommodate its rate level goals. As witness Tayman testified, "the Postal Service might have opted for a larger contingency if the test year costs projected for this filing had been lower." Tr. 9/4458. Let me reinforce Mr. Tayman's testimony by stating that had the moderately lower expenses I have documented in my testimony been known, I would have recommended a slightly larger contingency to the Board.

Docket No. R97-1, Tr. 35/18586-87.

Regarding the question of whether to update, witness Porras testified that the Postal Service maintained its revenue requirement, including the 1.0 percent contingency. However, if the Commission were to update, he testified that the resulting effective contingency in the range of 1.5 percent would be reasonable:

(continued...)

misinterpret clearly qualified statements by Postal Service witnesses regarding what they might have initially recommended or making the suggestion that the Postal Service would be satisfied with a larger "effective" contingency, if the Commission were to make certain other reductions in the revenue requirement, which it was the Postal Service's position that the Commission should not make.

2. The Postal Service's financial condition does not provide a rationale for reducing the contingency.

With respect to the Postal Service's financial condition, *DMA et al.*'s argument at page 17 that the Postal Service's recent successes support a lower contingency is flawed. It ignores the fact that, despite recent net incomes, the Postal Service has yet to break even over time. *DMA et al.* claim that the Postal Service's "improved condition gives it greater flexibility to respond to unexpected reversals of the current stable

²⁵ (...continued)

The Postal Service remains satisfied with its filing based on its original estimates and its requested revenue requirement and does not believe changes are necessary or warranted. Recommending the revenue requirement requested by the Postal Service could be viewed as the recognition of moderately lower expense levels that are offset by a slightly larger contingency. However, should the Commission be inclined to make significant changes or attempt to update the Postal Service's revenue requirement, it should consider the practice followed in prior cases where it refrained from explicitly incorporating evidence of increased costs based on actual experience. The resulting revenue requirement effectively provided less for contingencies than originally requested. In this case, the revenue requirement requested by the Postal Service to carry out Board policies leaves more for contingencies if the Commission reduces estimates based on actual experience. The resulting effective contingency in the range of 1.5% would be very reasonable.

Id. at 18588-89. See also Decision of the Governors of the United States Postal Service on the Recommended Decision of the Postal Rate Commission on Postal Rate and Fee Changes, Docket No. R97-1, at 18 (June 29, 1998).

conditions." But, past net incomes do not promise net incomes in the future. DMA *et al.* implicitly acknowledge this by its following sentence, essentially a non-sequitur from the previous one just quoted: "For example, it could file a new rate case seeking increased rates to respond to whatever condition might arise *on short notice*, and it would have adequate financial strength simply to absorb the unexpected losses while its request is considered by the Commission." First, as the Commission noted in the early days, the Postal Service "has no retained earnings on which to rely during periods of financial stringency."²⁶ Second, it is not possible, under the Commission's current rules and procedures, for the Postal Service to produce a rate request "on short notice." Rather, it takes months. Then, there is the ten-month litigation period and the two- to three-month implementation period. DMA *et al.*'s suggestion that for 18 months the Postal Service should suffer losses that might have been prevented by a reasonable contingency in the current case is not only irresponsible, but it is inconsistent with Resolution No. 95-9, and would lead to further erosion of equity. DMA *et al.*'s position is essentially: why should I pay now, if I can pay later?

DMA *et al.*'s second suggestion in lieu of the contingency is, for the Postal Service to fund its capital investments by borrowing, rather than using operating revenues. Simply put, there is a limit to borrowing, and, in any event, the Commission may not reduce the contingency in order to force a change in management's financial policies, which is essentially what DMA *et al.* are urging. Even if the reduction of the contingency has the result, as opposed to the intent to do so, it still violates *Newsweek*.

²⁶ PRC Op., R76-1, at 52-53.

DMA *et al.*'s argument that the contingency is overstated because the Postal Service carries its real estate at book rather than market value is of no value. The Commission long ago dismissed this argument: "We agree with the Postal Service that the current market value of assets that can not readily be liquidated in any realistic sense, is of very limited relevance to determining the proper contingency amount." Op., R87-1, Vol. 1, at 48-49.

3. *The state of the economy does not provide a rationale for reducing the contingency.*

The OCA, at page 45 of its Brief, argues that witness Strasser's Table 1, which shows that the 2.5 percent contingency is consistent with the trends in inflation indices, actually supports the OCA's proposed 1 percent contingency. The OCA focuses on the relationship of the contingency to the ECI and CPI during the Docket No. R97-1 rate cycle. The OCA completely ignores the fact that the contingency was deliberately set arbitrarily low in that Docket to satisfy the goal of keeping rates as low as possible. The OCA also focuses on the CPI, which is a less relevant indicator of postal cost increases than ECI, which measures inflation in a much larger portion of postal costs. The application of the OCA's logic to the ECI would argue for a much higher contingency than 2.5 percent. In the three cases prior to Docket No. R97-1, the contingency averaged 0.45 percent less than the ECI. The same gap in this case would call for a 3.6% contingency. The OCA also ignores the increase in the other indices between the last rate case and this one. Eight of the nine other indices are up, and many of them are up dramatically.

The OCA then argues that witness Strasser conceded that the July DRI showed a downward trend in the ECI and the CPI. OCA Brief at 46. This argument fails to mention his further explanation that the downward part of the trend fell beyond the test year, because the OCA was using calendar year monthly data which would affect FY 2002, not the test year. Tr. 46-A/20294.

In summary, the facts with respect to both the Postal Service's financial condition and the economy in general support the Postal Service's contingency determination, rather than the arguments against it. The CPI is trending up (not down as witness Rosenberg testified at Tr. 22/9819). Tr. 46-A/20196-7. ECI is higher than it has been in 15 years. *Id.* The city carrier contract is at well above ECI. The Postal Service does not appear to be finishing the year at planned levels. See discussion in Postal Service Initial Brief at II-2 (as revised, 9/19/00). While the Postal Service is seeking to implement aggressive cost cutting measures in the coming years, success will be a significant challenge, and is far from guaranteed.

4. It is wrong to suggest that the Postal Service ignores historical variance analysis.

DMA *et al.* state that the Postal Service "inexplicably" "ignored" the variance analysis it presented. DMA *et al.* Brief at 16. Apparently, someone failed to read witness Tayman's testimony. He actually testified at some length on the subject:

I believe historical variance analyses should not be the basis for determining the need for a contingency or its size. The Postal Service's financial performance is under much greater pressure and is subject to substantially greater risks than it was at the time of the last two omnibus rate cases. No matter what results an historical variance analysis produces, it is not appropriate to use historical data to determine the size of the contingency in lieu of management's judgment about the future.

These calculations are included for informational purposes only. To conclude from any historical variance analysis that a certain level of unforeseen events will occur in the Test Year would be both irresponsible and illogical. No one can predict the future, but the evidence clearly suggests that management's past judgment regarding the size of the contingency required has been good.

I am convinced that variance analysis cannot be relied upon in a vacuum as the basis for determining an appropriate contingency level. Variance analysis can only show us what happened in the past, and should not be relied upon exclusively to determine the prudent amount of cushion against unforeseen events in the Test Year. Regardless of what history shows, management must be allowed to assume its responsibility to determine the amount of contingency most appropriate for achieving its goals.

It is also important to realize that the variance analyses reflected in pages 5 through 8 of my Exhibit 9J attempt to show hypothetically how future costs and revenues would behave if the individual segment variances experienced in the past were to be precisely repeated in the Test Year.[footnote omitted] Since this does not allow for management's judgment regarding the future and the influence of management's subsequent actions, these types of analyses can only serve as information to be considered by management in setting Postal Service policy. In consideration of the Postal Service's goals and the risks involved, a contingency of two and one-half percent has been used for the purpose of estimating this revenue requirement.

USPS-T-9, at 45-46. DMA *et al.* may not agree, but to ignore this explanation on the record, is completely unjustified and undermines their criticism of witness Tayman's presentation.

4. There is no danger of managerial "slackness" and, in any event, the Commission may not substitute its judgment for the Board's prerogative in managing the Postal Service.

OCA witness Rosenberg presents the argument that the contingency must be reduced to avoid the "moral hazard" of "slackness" or the lack of "cost minimizing behavior." Tr. 22/9896. DMA *et al.* argue: "Providing the Postal Service with a large contingency will reduces the incentive for managers to find other cost savings and develop better mail-handling processes." DMA *et al.* Brief at 19. No party has provided any proof that there is any relation between the size of the contingency and managers'

incentive to find cost savings and other efficiencies. Indeed, witness Strasser testified to the contrary. First, he explained:

[W]e have, as you know, added our breakthrough productivity to the normal array of cost reductions we have given to the Postal field, and the field units are going to have to reduce work hours, compared to this year, twice as much as they have achieved in the reductions this year. In other words, it is going to be somewhere in the range of 1.5 percent to a 2 percent reduction in work hours compared to the work hours in this fiscal year.

Tr. 46-A/20295-96. Second, he also indicated that the effect of rate increases, including the contingency, does not affect the EVA (economic value added) variable pay system. Tr. 46-A/20331. To even suggest, as the OCA does in its brief at page 46, that managers do not have adequate incentives to hold down costs, in the face of the breakthrough productivity goals announced by the Postmaster General, which they are so confident will be met (see OCA Brief at 34-35), is to ignore reality. In addition, most postal managers probably have never even heard of the contingency provision. Their budgets do not include contingency provisions. In fact, in this era of cost-cutting, a certain amount of money is held back from their budgets. This is the "field reserve" that the OCA wishes to cut from the revenue requirement, in addition to the reduction in the contingency. OCA Brief at 32-35. This has no relation to managerial slackness, but the OCA's double cuts would significantly increase the likelihood that there will be insufficient funds to cover costs in the test year. The OCA, meanwhile, ignored witness Strasser's testimony that if the field reserve does not end up being needed for field operations, the reserved funds will be spent on infrastructure improvements, other capital projects, and to increase a reduced advertising budget. Tr. 46-A/20295-97. It is a real expense, not a further contingency, and not a cause for "managerial slackness."

Even accepting hypothetically the "moral hazard" argument, it is the Board, not the Commission, that gets to determine the degree of "hazard" it will tolerate in postal operations. Interference in that judgment by the Commission is of the type *Newsweek* prohibited. Postal management is in a unique position to understand the risks inherent in meeting the commitments, goals, and challenges facing the Postal Service in the test year. As has been described by the Postal Service's financial witnesses, these factors were taken into account in determining the contingency provision.

Finally, the Commission, in prior cases, has been presented the same argument concerning the effect of the contingency on efficient operations. Each time, it has rejected it. See PRC Op., R74-1, at 24; PRC Op., R77-1, Vol. 1, at 30; PRC Op., R80-1, Vol. 1, at 38-39.

5. Reality check: DMA and other mailers would rather pay later than pay now for current postal services.

DMA *et al.* argue that the contingency should be reduced because rate increases hurt mailers. While the Postal Service shares mailers' concerns about rate increases, it takes this into account, to the extent possible, in deciding when to file a rate case, in determining its revenue requirement, in setting cost coverages, and in designing rates. Mailers will always seek to avoid rate increases. DMA *et al.* express "mailer preference for smaller, more frequent rate increases." DMA *et al.* Brief at 14. The Commission should be cognizant, however, that while this might be the desire of the large mailers joining the DMA brief, it is far from the universal preference of mailers.

At the same time, DMA *et al.* complain, inconsistently, that rate cases have been filed too frequently. DMA *et al.* Brief at 15 & n. 18. DMA *et al.* ignore one of the

reasons that recent cases have been filed more frequently: the Board's desire to restore equity, expressed in Resolution No. 95-9. DMA *et al.* complain that the contingency is a "subsidy of future mailers by current mailers." DMA *et al.* Brief at 15. DMA *et al.* forget that current mailers are already subsidizing past mailers. Restoration of equity is designed to end that situation. The only way that equity will be restored is for the Postal Service to continue to have healthy net incomes. DMA *et al.* also ignore the fact that an inadequate contingency in the face of increased uncertainty is likely to increase the need for future ratepayers to continue to subsidize current mailers.

6. Periodicals costs should not be adjusted downward by elimination of the contingency.

The Periodicals mailers, based on the arguments of witness Morrow, urge that the Commission "take the fully justified, although unprecedented, step of specifying a separate contingency for the Periodicals class – a contingency of zero." Periodicals Mailers Brief at 50. They are correct that this step would be unprecedented; they are dead wrong that it is justified.

The Periodicals mailers assert, again based on witness Morrow's testimony, that there is no reason not "to examine whether it is appropriate to apply the same contingency to each postal product." *Id.* at 55. The Periodicals mailers evidently misapprehend the purpose of the contingency. That purpose is to protect the *entire* postal system and *all* mailers against unexpected and unplanned for adverse events. There is simply no basis, within this framework, to treat classes and subclasses differently; to do so reeks of inequity and unfairness. If there is a war or a natural disaster, Periodicals will be as affected as First-Class Mail or Parcel Post.

If rate relief is appropriate for a particular class or subclass of mail, there are other proper ways to accomplish the goal. This is what the whole business of markups is about. In addition, this case provides an example of the Postal Service and the Periodicals mailers working together to identify savings opportunities that could act to mitigate the Periodicals rate increase. Also, on occasion, both the Postal Service and the Commission have constrained certain rates to prevent rate shock. The contingency simply has no place in this set of rate remedies.

Finally, the practical consequences of trying to implement such a scheme are formidable. What criteria does the Commission follow in determining the winners and losers? How is determining the appropriate contingency per product to be distinguished from determining the appropriate markup per product? How would this scheme affect rate design determinations? Does it apply at the class, subclass or even rate category level?

This proposal of the Periodicals mailers has no basis in theory, precedent, or fundamental logic. It must be rejected.

C. If Updating Is Done, It Must Be Done Comprehensively

As the Postal Service explained in Section I above, and in its Initial Brief, it does not believe that the Commission should attempt to create an updated base year. But if it does so, or even engages in less drastic forms of updating based on more current information, it must do so comprehensively, using all of the updated information on the record.

1. The OCA's internally inconsistent and result-oriented argument that updates should be made selectively must be rejected

To the contrary, the OCA argues that the Commission should update projected expenses, but should do so selectively. The OCA believes that certain Order No. 1294 adjustments are not acceptable and must be excluded. The OCA maintains this position because the updates were made to conform with the ongoing FY 00 budget process, because they are "subjective" or "judgmental," and because "participants have had little or no opportunity to probe the underlying bases for such adjustments." OCA Brief at 23. The OCA includes labor contract expenses and workers' compensation expenses in this category, but excludes the additional breakthrough productivity cost reductions. In other words, the OCA conveniently rejects the items that increase costs, but embraces the ones that reduce costs. Ironically, the support for both the updated labor contract costs and worker's compensation costs consist of verifiable technical calculations which have been documented and explained in great detail. The breakthrough productivity savings, on the other hand, were supported more by judgment than by calculations and hard data. Fair application of the OCA's criteria should make the cost reduction savings less acceptable than the labor contract costs and workers' compensation costs, which are based on verifiable calculations. It is also difficult to understand the OCA's logic that participants had time to "probe the underlying assumptions" for breakthrough productivity, but had no time to "probe the underlying assumptions" of the cost reduction savings. A review of the record will show that the OCA and others spent a great deal of effort and time probing the labor assumption but spent little or no time probing the cost reductions. The OCA also

complains that the labor assumption and workers' compensation cost changes cannot be verified to the proposed FY 2000 operating budget because it does not exist. The same point can be made regarding the breakthrough productivity savings, which were also said to be consistent with the proposed FY 2000 operating budget. The OCA uses a double standard to decide that higher cost savings are acceptable but higher costs are unacceptable. Finally, it must be pointed out that while the FY 2000 operating budget had not been finalized, there were parts of the budget which were at or near completion, and these items included workers' compensation expenses and the cost of the new labor contract. It is also interesting to note that the OCA is not concerned about the fact that revenue projections were not updated. Is it possible OCA has realized that an update of revenue might result in a lower number and a larger deficit?

At page 36 of its Brief, the OCA says that the workyear mix adjustment traditionally reduces the revenue requirement, and complains because it now demonstrates that costs are going to increase. The OCA once again has failed to review all of the facts provided and fails to understand those they have reviewed. First, this is not the "traditional" workyear mix adjustment. As explained on page 506 of LR I-127, the methodology was changed. The impact of the extended step adjustment, which calculates the impact of employees retiring and being replaced by lower cost entry level employees, is no longer accounted for in the workyear mix adjustment. This amount is now reflected as an offset to step increases elsewhere in the same Library Reference. If this change had not been made, the workyear mix adjustment would have shown a decrease in the original filing and a much smaller increase in the Order No. 1294 update. These savings are still reflected; however, they are included elsewhere in the

Library Reference, as explained fully on page 506. Second, the notion that the workyear mix adjustment should always be a savings is false. It is what it is. In this case, the main reason it reflects an increase is the fact that workyear cost reductions are so large that the opportunity to reduce workyears for career employees is exhausted. There are simply not enough retirements expected in career clerks and mail handlers to satisfy the targeted number of workyear cost reductions.

Consequently, the number of casuals was reduced to make up the difference. Since casuals have a lower average cost, the overall cost of workyears is higher than it would have been if all of the cost reductions had been taken from career employees, which is the approach that was used in the past. This was explained on page 7 of witness Patelunas's supplemental testimony and in the response to OCA/USPS-ST44-47. The idea that this is a reserve to protect against failing to achieve a targeted workyear mix is simply untrue. OCA should have asked for further clarification if it did not understand the adjustment or asked for an explanation at the technical conference. Instead, it has read into the explanation whatever suits its argument. The first question that should be asked is how can the OCA make a recommendation to eliminate the adjustment when by its own admission it doesn't understand it. Its motivation is clear: increases are invalid and decreases are valid, regardless of the cause.

The OCA's selections are entirely result-oriented and demonstrate the validity of the Postal Service's long-held position that, if the Commission determines to update, it must do so using all updated information available on the record. It may not, as the OCA suggests, pick and choose arbitrarily among such data.

2. Both OCA's and DMA *et al.*'s efforts to recalculate FY 2000 results are woefully flawed.

a. The OCA's calculations of FY 2000 expenses are erroneous.

The OCA, in trying to project FY 2000 expenses, in calculations shown at pages 17 through 22 of its brief, makes several errors. The method it uses does not account for actual prior period adjustments through A/P 12, and as a result it leaves out \$180 million. A more correct method is to use the year-to-date amount for A/P 12, which includes prior period adjustments. The second error made by the OCA is the use of the \$172 million number for the extra day in leap year, which is described on page 7 of USPS-LR-I-489 (Integrated Financial Plan).²⁷ The OCA incorrectly assumes this accounts for all of A/P 14 expenses. However, the \$172 million includes only the effect of one of the two days that make up A/P 14, and does not include the inflation on three weeks of expenses for the period between September 8, 2000 (the end of the PFY) and September 30, 2000 (the end of the GFY), relative to the comparable period at the other end of the year, which must be subtracted to arrive at a GFY total. It is not difficult to see that 4 to 5 percent inflation on three weeks of expense is not a *de minimis* amount, but rather would amount to approximately \$200 million.

To arrive at an estimated GFY total, which is necessary to be consistent with the expense estimates reflected in the Request and the Order No. 1294 update, the total year-to-date A/P 12 PFY 2000 planned expense of \$59,513 million reflected in the FOS can be subtracted from the total GFY 2000 planned expense of \$65,324 million. Tr. 2/190. This results in a difference of \$5,811 million, which is made up of Accounting

²⁷ Tr. 46-A/20321A (as renumbered by Presiding Officer's Ruling No. 146).

Period 13 planned expense of \$5,226 and Accounting Period 14 estimated expense of \$585 million. The planned and estimated amounts for Accounting Periods 13 and 14 can then be added to the Accounting period 12 year-to-date actual expense to arrive at a total GFY expense of \$65,047 million. This is \$593 million higher than the \$64,454 million total expense for the year calculated in OCA's brief, and is much closer to the one estimated by the Postal Service in the Order No. 1294 update. Neither method accounts for year-end audit adjustments, which will affect expenses further.

The OCA's approach also fails to examine revenue, which is critical to any analysis of where the Postal Service will end Fiscal Year 2000. Through A/P 12, the Postal Service was \$641 million below plan for revenue.

b. Witness Bernheimer's testimony comes from a "parallel universe."

DMA *et al.* argue that "there is a reasonable scenario under which the Postal Service will also break even in FY 2001 without any rate increase whatsoever!!" They rely on the analysis of their witness Bernheimer. Witness Bernheimer presents testimony which purports to demonstrate, by means of a series of other-worldly convolutions, that the Postal Service has overestimated its FY 2000 and test year accrued costs, and therefore has also overstated its revenue requirement for the test year. He badly underestimates FY 2000 accrued costs due to the omission of Accounting Period 14 expenses, which are larger than normal in FY 2000 due to the leap year. He incorrectly includes the contingency and prior year loss recovery as part of test year accrued costs in an attempt to show that test year cost increases projected by the Postal Service are excessive. He uses an overly simplistic method to estimate test year accrued costs, which does not take into account current trends and other

relevant current information. He makes similar errors in projecting volume and revenue, and overlooks the fact that the contingency is intended to protect against the possibility of revenue underruns, as well as expense overruns. His methodology and analysis is technically and conceptually flawed, and as a result reaches completely erroneous conclusions. His oral and written testimony show clearly that he has no clue about how postal finances and ratemaking work.

Witness Bernheimer himself, when questioned about his estimation techniques, testified that he lives in a parallel universe.

That's the point; in other words my approach is different. We live in parallel universes.

Tr. 46-A/29458. He alleged, without any support, that the rate case data are not real, but that his estimates are real:

I live in the universe in which revenue and costs, real revenue and real costs relate to each other, and you end up with a real profit and a real cash flow, and I don't live in the world of – the rate case world.

Id.

i. A/P 14 exists in the real universe

Unfortunately for witness Bernheimer, all of his figures are suspect, because he misunderstands that Accounting Period (A/P) 14 is real, that it exists in the universe inhabited by the Postal Service, the Commission, and, indeed, his clients, the mailers. Witness Bernheimer believes that A/P 14 is included in A/P 13. He testified that A/P 14 is "what the Postal Service uses to build in all the fudge that it wants to at the end of the year." Tr. 46-A/ 20437. This remark clearly demonstrates that he has no clue about how A/P 14 really works, but is simply bashing the Postal Service. He apparently thinks A/P 14 and the year-end audit are the same thing. He also implies that the Postal

Service "fudges" its numbers during the year-end audit. This is an outrageous allegation, which has absolutely no basis in fact.

When asked to assume that he has erred in assuming that A/P 14 is in A/P 13, witness Bernheimer again reverted to emotional bashing of the Postal Service in order to divert attention from his errors and inability to come up with a rational answer:

A If that were to be the number, and that's the way the Postal Service does business, then I would say it does a poor job of budgeting and reporting its information.

Q Because you misunderstood it?

A No, because the Postal Service should not have that many adjustments at the end of the year. It knows about them earlier; it should take them earlier.

Tr. 46-A/20451. It is clear that he is thoroughly confused and thinks A/P 14 is the year-end audit.

At several points in his cross-examination, witness Bernheimer insisted that A/P 14 is included in A/P 13. Tr. 46-A/20444 Even if one didn't know that A/P 14 is the accounting period used to convert from PFY to GFY, it is intuitively obvious that A/P 14 would not be in A/P 13 any more than A/P 13 would be in A/P 12, which comes before it. When witness Bernheimer was asked to explain how he determined that A/P 14 is included in the A/P 13 report he testified that "in many of your accounting statements you print an asterisk on the previous year and you say this has been adjusted to match the audited statement or some such wording." *Id.* A review of the PFY 1997 through 1999 A/P 13 Financial & Operating Statements (FOS), on file with the Commission, shows that no asterisk appears on any of the revenue and expense data in the report, and all such data are clearly labeled as A/P 13 data. The cover of the PFY 1999 report clearly indicates that A/P 13 ended on September 10, 1999. Balance sheet data for

both the Postal Fiscal Year and the Government Fiscal Year are reflected in the A/P 13 FOS report, and the GFY balance sheet data are labeled September 30 and footnoted as reflecting audited year-end data.

If there were any doubt that the A/P 13 (PFY) revenues and expenses are different from the A/P 14 (GFY) revenues and expenses, a comparison to the Annual Report should satisfy even the most skeptical. Year-to date revenue and expenses reflected in the A/P 13, PFY 1999 FOS are \$62,428.5 million and \$62,079.7 million, respectively. The FY 1999 Annual Report, on the other hand, reflects GFY revenues and expenses of \$62.7 billion and \$62.4 billion, respectively. It is not hard to see that the amounts are several hundred million dollars different. To dismiss A/P 14 as non-existent or insignificant is wrong.

- ii. Witness Bernheimer makes other fundamental errors that undermine his credibility.

Witness Bernheimer is apparently unfamiliar with the statutory scheme governing the subject of his testimony. He testified, contrary to the terms of the Postal Reorganization Act and 30 years of postal ratemaking precedent:

Well, if I were sitting on the Postal Rate Commission, I would eliminate the contingency request entirely, but that's not all I would do. But in this case, I would throw out the contingency request completely.

Tr. 46-A/20457. He does not seem to care that the absence of a contingency would increase the odds that a loss will occur in the test year: "Yes, I would agree that reducing the Postal Service's revenue would increase the odds of a loss, yes." *Id.* He also realizes, but seems not to care, that this would result in future ratepayers' having

to pay for the cost of current operations: "If, the Postal Service were to experience a loss, yes." *Id.*

Witness Bernheimer testified that the possibility of cost overruns is more important than revenue shortfalls in deciding the appropriate amount of contingency. Tr. 46-A/ 20447. This is another example of his flawed thinking. Obviously, a revenue shortfall would be just as financially crippling as an expense overrun of the same amount, and both possibilities need to be protected against. There is no support for the suggestion that the possibility of revenue shortfalls is not a valid consideration in determining the contingency.

Witness Bernheimer further demonstrated that he does not understand accrual accounting, the breakeven mandate, or the borrowing limits established by the Postal Reorganization Act. He testified:

They have applied funds that they have generated from operations to pay for \$20 billion in capital outlays, and reduced debt by \$5 billion.

So, what they basically have done is charged higher rates than were necessary, because management also has the option, like many businessmen or businesspersons, I should say — I lost my head — to finance their capital outlays by borrowing money.

Tr.46-A/ 20454. To have set rates low enough to have generated \$25 billion less revenue, as Bernheimer suggests, would have resulted in billions of dollars in losses over the seven-year period in question; a clear violation of the requirement that the Postal Service break even on an accrued cost basis. He further suggested that the cash deficit created by his approach should be financed through borrowing. Borrowing of this magnitude would have put the Postal Service over its debt limit and incurred billions of dollars of additional interest costs. In any event, the Commission would be

intruding into management's authority over the financial policy of the Postal Service, if it were to base a reduction in the contingency on its opinion that the Postal Service ought to borrow more for capital.

When asked if the Postal Service should recover prior years' losses, witness Bernheimer demonstrated his lack of awareness of Postal Service finances:

I wouldn't say that; I would say that there is no mandate for it, and, in fact, the Postal Service could forego it for many years. There is no need to recover prior year losses.

Tr.46-A/ 20453. As is typical of much of his testimony, witness Bernheimer makes an emotional statement, which is not supported by any analysis of the consequences, beyond the fact that it will result in lower rates for mailers. The Board, however, adopted Resolution 95-9, which affirms the Board's goal of restoring equity between general rate increases.

Witness Bernheimer errs again when he asks (rhetorically, one supposes):

Well, and what's the big deal about restoring equity? What's the big deal about that?"

Tr. 46-A/ 20456. While he says he understands that "the Governors think it's a big deal," *id.*, he would be well advised to read the report on equity restoration prepared by Price Waterhouse LLP for the Board and the Commission's Opinion in Docket R97-1, in which it stated: "Until the Postal Service's equity is restored, it would be premature to eliminate an item that the Commission has argued is vital to the financial health of the Postal Service." PRC Op., R97-1, Vol. 1, at 22.

When asked to confirm that his method simply looks at recent history and assumes that recent trends will continue, witness Bernheimer denied that this was the case. Tr.

46-A/20459. When pressed to show where in his testimony he took other factors besides history into consideration, he admitted that there was no documentation but it was all in his head.

Q Could [you] show me where in your testimony you took into account those possible changes in expenses, what they do to inflation or fuel or whatever else you mentioned?

A They're all in the final number.

Q In which number?

A 4.3 percent.

Q And how did they get there?

A Based on my thinking.

Q And could you explain that for us?

A I just explained it. I looked at what the history has been. I look at what other factors are going on in the real world, and then, I adjust accordingly in my mind, and I put it on paper.

Q There is no calculation we have?

A There is no calculation. I did no research; I didn't do any market research; I didn't refer to anybody else's documents.

Q It's just in your head?

A It's just me.

Tr. 46-A/20460.

The Postal Service is confident that the Commission will not base its Recommended Decision to any degree on information undocumented anywhere on the record, but that exists, by the witness's admission, only in his head.

The fact is, as the chart below shows, once witness Bernheimer's method is corrected by adding in expenses for A/P 14 (\$585,000, as calculated above), his theory that the Postal Service has exaggerated its costs is proved to be erroneous.

Analysis of Test Year Expense Growth Under Various Assumptions. \$ Millions							
	Bernheimer Method	Corrected Bernheimer w/o Contingency	Corrected Bernheimer w/ Contingency	Postal Service Request w/o Contingency	Postal Service Request With Contingency	Order 1294 Update Without Contingency	Order 1294 Update With Contingency
FY 00	64,513.5	65,099.0	65,099.0	64,751.8	64,751.8	65,171.5	65,171.5
TYAR Accrued							
Costs	67,642.1	67,642.1	67,642.1	67,190.6	67,190.6	67,642.1	67,642.1
Contingency	1,691.1		845.6		839.9		845.6
RPYL	311.7						
Total Costs	69,644.9	67,642.1	68,487.7	67,190.6	68,030.5	67,642.1	68,487.7
% Increase In Cost	8.0%	3.9%	5.2%	3.8%	5.1%	3.8%	5.1%

Sources:

Bernheimer Method: DMA-ST-3, at 3.

Postal Service Request: Exhibit USPS 9A.

Order No. 1294 Update: Exhibit USPS ST 44A.

3. The Postal Service's updated labor cost estimates are realistic and do not represent a change in policy.

Several parties challenge the Postal Service for allegedly having changed its assumption regarding labor costs. The record shows that the Postal Service has not done so. In any event, as the Commission has recognized in the past,²⁸ it must not interfere with postal management's approach to labor contract negotiations.

The Postal Service has in recent cases used an assumption, when the actual test year level of labor costs is not known, that labor costs would increase one percentage point below the Employment Cost Index (ECI). The Postal Service applied this assumption in this case as well.

²⁸ PRC Op., R77-1, Vol. 1, at 62.

The ECI minus 1 assumption is a mechanical calculation, not a policy. It constrained the total of wages from the new labor contract and carryover wages from the old contract to ECI minus 1. This was mechanically done by subtracting carryover from the total amount of effective wage changes calculated at ECI minus 1, leaving a residual amount for new wages under the new labor contract.

When the Postal Service responded to the Commission's Order No. 1294 to update its test year cost estimates, it projected total labor costs that represent an increase of ECI minus 1.7 percent for the new contract. The OCA shows that it just doesn't get it when it states on page 26 of its initial brief that the Postal Service "anticipates wage increases in the upcoming contract negotiations on the order of ECI rather than its initial assumption of ECI - 1." This is incorrect. The Postal Service assumes that new wages will be 1.7% less than the ECI, and when the new contract costs are added to carryover from the old labor contract, which cannot be changed, the total mathematically equals the estimated change in the ECI. Thus, there has been no change in postal management's position, and the updated cost information provided by witness Patelunas in USPS-ST-44 in response to Order No. 1294 is consistent with management's position.²⁹

²⁹ Postal management's bargaining position in labor negotiations is a separate, but not unconnected, matter. There is nothing in the rate case assumptions that would prevent management from seeking wage increases resulting from the new contracts at ECI, ECI minus 1, or ECI minus 2. Even if management had changed its positions, either with regard to the rate case assumption, its bargaining position, or both, the Commission should not, as noted above, dictate or interfere with management's financial or labor policies.

OCA further demonstrates its confusion when it states on page 30 that mail handlers are assumed to receive a general wage increase equal to the ECI, or \$1,646.99. This is incorrect. The impact of wages from the old contract (carryover), plus the impact of new wages from the new contract, is mechanically calculated to equal ECI, or \$1,646.96. This is made up of \$770.31 from the old contract and new wages of \$876.65, which annualizes to \$1,009.39, or 2.84 % less than the ECI.

Based on the Postal Service's statements that it has not changed its position, the OCA argues that \$245 million should be excluded from the updated estimates. As demonstrated above, even when the \$245 million is included, the level of the labor contract increases is well below ECI minus 1.

4. Updates do not decrease uncertainty

DMA *et al.* and others argue that the updated estimates "reduce the uncertainty facing the Postal Service, further reducing the need for a contingency." See, e.g., DMA *et al.* Brief at 20-21. While the update accounts for some known changes and provides the benefit of a more recent DRI forecast, that does not mean there is less risk for the remaining time period. The amount of risk must be re-examined in light of the additional and updated information that has become available. Additional information may reveal that risk has increased since the earlier forecast, and this is precisely what has occurred in this case. The revised information used for the Order No. 1294 update has provided evidence that the level of risk for the remaining time period has increased. For example, the inflation forecast has trended higher, and the probability that the DRI Control (baseline) forecast will occur has diminished. FY 2000 expenses have trended higher, and FY 2000 now reflects a loss of \$325 million, and the test year reflects a

deficiency of \$475 million. Workers' compensation cost trends have worsened, and the amount reflected in the update for the test year is less than indicated by the workers' compensation model. Additional cost reductions in the form of breakthrough productivity have been added in the update. They are very aggressive and have a higher degree of risk associated with them. The same thing is true regarding the revenue generation programs, which resulted in the addition of more than \$300 million to the test year revenue estimate. These are very aggressive targets, and there is a higher degree of risk that they may not be achievable. There is also more risk in the revenue estimate, due to the higher probability of an economic downturn.

DMA *et al.* and others argue that the update does not reflect the "full savings the Postal Service has committed to achieving" in the test year. DMA *et al.* Brief at 20. It is interesting that knowledgeable, veteran postal observers are suddenly unwilling to understand, or perhaps just to admit, that a speech by the PMG containing a "commitment" is a commitment to the objective, a "challenge" to postal management and not a guarantee of the future. The PMG has a good deal of power, but guaranteeing the future is not one he, or any human being, can claim. For instance, if an environment develops in which fuel, labor, or other costs end up rising faster than projected by the Commission in this case, the PMG's "commitment," if blindly carried forward, could prevent the Postal Service from providing the level of service that mailers expect and deserve. In such a situation, is there any doubt that the commitment will have to be sacrificed to some extent? This is not a new question, and the past experience tends to show that service would not be allowed to deteriorate beyond a certain level, at which point expenses would have to rise.

D. DMA *et al.*'s Suggested Adjustment to Other Elements of the Revenue Requirement Should Be Rejected

1. DMA *et al.*'s argument that the Postal Service underestimates the savings created by the rollforward program for supervisors is unpersuasive.

DMA *et al.* make two arguments that the Postal Service's rollforward methodology understates the cost savings for supervisors. The first argument is that, in Docket No. R97-1, the Commission agreed with witness Buc and significantly reduced the Postal Service's estimates of supervisor work hours and costs. DMA *et al.* Brief at 21. The Postal Service addressed this in its Initial Brief at II-27: "[A]ctual results show that witness Buc's adjustment, adopted by the Commission in Docket No. R97-1, deviated significantly from reality, compared to both the Commission's unadjusted estimate and the Postal Service's estimate." Specifically, the Postal Service's estimate was \$3 million more than the actual of \$3,512 million; the unadjusted Commission estimate was \$9 million more than the actual, and the Buc adjusted Commission estimate was \$92 million more than the actual.

The second argument made by DMA *et al.* is that the Postal Service failed to make the adjustment to supervisor costs,

even though it realized that changes in craft labor induce corresponding changes in supervisor labor. As the USPS stated: "for any substantial or prolonged change in the level of nonsupervisory employee effort for a given work activity, there will be an accompanying change in first-line supervisory requirements.

DMA *et al.* Brief at 21. While this may be true in a relatively static environment, even "witness Buc agreed that supervisory workhours would only vary directly with clerk workhours in an environment where all things remain equal." Tr. 22/9595. Witness Buc further testified that "if management changes the supervisory requirements of the new

operating environment, the *ceteris paribus* conditions will no longer hold." *Id.* Tr. 38/17143.

As presented in the Postal Service's Initial Brief, witness Buc's mechanical application of reduced supervisors' costs is inconsistent with operating realities, in which changes in the operating environment resulting from the introduction of cost reduction programs result in additional supervisory complexities and responsibilities that do not allow for a reduction in supervisor costs that is directly proportional to the reduction in craft employee costs. *Postal Service Initial Brief at II-27.*

2. DMA *et al.* are wrong that the Postal Service has understated AFSM cost reductions

DMA *et al.* contend that the AFSM cost reduction analysis of witness Buc "should be adopted by the Commission and the revenue requirement reduced by slightly more the \$202 million." DMA *et al.* Brief at 22. As discussed in the Postal Service's initial brief, witness Buc's analysis suffered from several significant flaws: it ignored piggyback costs; it made no adjustments for additional floor space; it excluded allied labor costs; and it was based on unrealistic assumptions not reflective of the operating environment. *Postal Service Initial Brief at II-27.* Witness Patelunas stated that this "is the combination of numerous optimistic ideal assumptions into one model." Tr. 38/17155.

Opportunistically combining bits and pieces of optimistic assumptions from several different sources can lead to confusing and conflicting results. As another example, nearly 30 percent of the difference between witness Buc's cost savings calculation and his approximation of witness Tayman's cost savings is the result of witness Buc's use of

100 percent volume variability in mail processing. Witness Buc calculates an additional \$202 million of cost savings using his assumption of 100 percent mail processing volume variability. Tr. 22/9556. He calculates only an additional \$143 million of cost savings using the Postal Service's mail processing volume variabilities. Tr. 22/9586. The difference between these results is about \$59 million (\$202 - \$143), slightly more than 29 percent of the base of \$202,131,000.

If not opportunistic, the 100 percent volume variability used by witness Buc is far from conservative. The initial brief of the Periodicals Mailers states:

The separate brief of DMA *et al.*, in which the Periodicals Mailers have joined, demonstrates that the Postal Service has understated the savings forecast from deployment of the AFSM 100s. As explained more fully there, witness Buc, using data provided by Postal Service witnesses, showed that Postal Service witness Tayman understated the Test Year cost savings that will be achieved from procurement and introduction of the AFSM 100.

Periodicals Mailers Initial Brief at 14. Later in that same initial brief, the Periodicals Mailers state:

The weight of the operational and econometric evidence argues strongly in favor of mail processing volume variability factors that are less than 100 percent. There is no evidence to support the contrary conclusion. The Commission should adopt the Postal Service's econometrically and operationally sound estimates of volume variability in place of the traditional but indefensible assumption that volume variability is 100 percent.

Periodicals Mailers Initial Brief at 39. It would appear that nearly one-third of witness Buc's so-called conservative estimate of cost savings is the result of his reliance on 100 percent volume variability, which is dismissed by the very parties that rely on his calculations.

In addition, DMA *et al.* contribute to the confusion in footnote 25 of their Initial Brief at 24. Footnote 25 states: "Although Tayman appears to be the "official" USPS witness

of AFSM cost savings in the Test Year, Smith made an estimate of this number for his own calculation of purposes. See Tr. 7/2018-21 (Smith explanation of his estimate.) Smith's number, \$274.8 million, is very different than the \$169 million associated with Tayman's testimony, although still substantially below Buc's estimate."

This is an "apples and oranges" comparison that focuses on only the cost savings implications of the AFSM 100 deployment. Witness Tayman's cost reduction calculations are net of clerk and mailhandler labor savings associated with shifting the flats processing from manual sorting to AFSM 100. They reflect the net of the cost savings for decreased staffing for manual flat sorting operations against the additional costs for increased staffing for the AFSM 100 operations. The savings in staffing for manual flat sorting is the gross savings, without the accompanying costs in the AFSM 100 environment. Witness Smith indicates at Tr. 7/2963 that the \$274.8 million is "the gross savings for manual flat sorting for FY 2001." See also Tr. 7/3018-21.

E. ANM's Misleading Criticisms of Witness Dowling Uniformly Lack Merit

In the course of repeating witness Haldi's testimony (ANM-T-1) – which has been thoroughly rebutted³⁰ – ANM's supplemental initial brief on investment in flats processing equipment makes several downright misleading assertions regarding the content of Postal Service rebuttal witness Dowling's testimony. ANM's misleading assertions and hyperbolic retreat into vitriol underscore the lack of merit to ANM's position.

³⁰ The factual, analytical and legal flaws in witness Haldi's assertion that under-investment in flats processing equipment has improperly inflated flats processing costs are addressed in the Postal Service Initial Brief at II-10-24.

ANM asserts, "[Witness Dowling] was unaware that unit costs for processing flats mail rose from 1993 to 1999" so his testimony is entitled to no weight. ANM Initial Brief at 12. The following exchange appears on the transcript page cited by ANM (Tr. 46-A/20483):

Q Now, in fact, in the 1990s, the unit costs for processing flats mail rose from 1993 through 1998, did they not?

A I don't have that data. I didn't review that data in preparing this testimony, sir.

Q So, you don't know --

A I did not review that data in preparing this testimony, so I could not answer this question.

Q And you don't have any other knowledge as to the direction of the unit costs of processing flats during the 1990s?

A I would be hesitant to quote data concerning that, sir.

Mr. Dowling plainly understood Mr. Levy to have been inquiring about specific data which had not been reviewed in preparation for the appearance on the stand. Indeed, an exchange a few minutes later, also with Mr. Levy, confirms that Mr. Dowling was aware of the general increase in costs over time, that it was the source of concern, and the basis for further study.

Q And that would entail -- were you at any point in the 1990s alerted, you personally alerted to the phenomenon of rising unit costs of processing flats for labor?

A Yes; I was generally aware that we were having rising costs of processing flats.

Q Did you or anyone under you or anyone at your direction in the late 1990s perform any kind of study whether you might save money as an interim measure by buying more 881s and avoiding some labor costs?

A In the late 1990s?

Q In the mid to late 1990s.

A In the mid to late 1990s. We discussed and looked at the issue of capacity. We concluded in the mid 1990s that we did need additional capacity. We chose to respond to that capacity by adding additional FSM 1000s rather than 881s, because FSM 1000s had roughly equivalent throughputs and productivities but could handle a wider mail base than an 881. There was -- I have never -- this is -- I find it -- nobody ever asked me to

buy another 881 that I could recall. Certainly, no mailer ever asked me to buy another 881, but they were asking me to meet with equipment manufacturers from the publishing and newspaper industries to find machines that would handle a broader range of mail.

Q In the mid or late 1990s, did anyone at the Postal Service undertake any cost-benefit analysis to see whether buying even more FSM 1000s might be justified by the savings and labor costs?

A The DAR that purchased the second buy of FSM 1000s considered shortfall and capacity on a site-by-site basis using all data that we had available in the Postal Service; discussing that data with our field organizations; and doing economic analyses on those machines down to the point where we were buying FSM 1000s at below the hurdle rate. So while the DAR may not have a specific section that says there was an incremental analysis done, the incremental analysis is done by my staff.

Tr. 46-A/20501-02. Thus, not only is ANM's citation to the record misleading, it is directly contradicted but a few pages later in an exchange with counsel for ANM. As Vice-President of Engineering since 1992 (Tr. 46-A/20473), Mr. Dowling has paid close attention to flats processing costs, continuously increasing capacity and expanding the capabilities of its flats processing equipment. Tr. 46-A/20474-81.

This latter quoted section of the transcript, moreover, directly contradicts other misstatements in ANM's brief, including: 1) "no [cost-benefit] analysis apparently was ever performed" (ANM Initial Brief at 10), and 2) the Postal Service should have purchased additional 881s (*id.* at 5-7).

ANM's misleading characterizations of Mr. Dowling's testimony continue on pages 12-13 where it is claimed that he first "professed to be ignorant" of how much capital investment fell short of plan, but then "ultimately conceded" that the amount was approximately \$500 million. Far from being "ignorant" about the shortfall, Mr. Dowling's original response was "I can't quote a number on that. I'd have to go back and examine data." Tr. 46-A/20485. Then, after being shown a page from witness Haldi's testimony

that supposedly quantified the overall shortfall, and after being asked what portion of it related to flats processing equipment, Mr. Dowling was able to confirm the \$500 million ballpark estimate. Tr. 46-A/20486-87. Mr. Dowling, moreover, was also familiar with the fact that favorable pricing alone had achieved savings in excess of 10 percent, thus contributing to the shortfall. Tr. 46-A/20488. Thus, far from being "ignorant" as ANM claims, Mr. Dowling was in fact well informed and lacked only specific recollection of exact, actual numbers. ANM's claim of Mr. Dowling's "ignorance" is simply an example of the well-used kettle calling the shiny new tea pot black.

ANM's blatant mis-characterization of the record continues with the assertion that, "Mr. Dowling professed to be unaware that the management shakeup" was related to the shortfall in capital spending as compared with plan. ANM Initial Brief at 13. Indeed, within the very pages cited by ANM, Mr. Dowling indicated awareness that PMG Runyon was directed (shortly after he arrived on the job) by the Board of Governors to revalidate the automation program, that the resultant impact in 1992 was substantial, and that the specific impact was upon the remote barcoding portion of the letter automation program. Tr. 46-A/20487-89. ANM counsel was unable to get Mr. Dowling to agree that the management changes by themselves, as opposed to the Board directive, had a "substantial" impact upon the shortfall in each of 1992 through 1995. *Id.*

Continuing in the same misleading vein, ANM asserts "Mr. Dowling also contended that the Service's shortfall in capital investment for flats was due to a downturn in non-carrier route flats volume. 46A Tr. 20475." ANM Initial Brief at 13. Examination of that transcript page shows that what he really stated was:

In the early and mid 1990's, issues concerning flats automation were also clouded by the uncertainty of projected flats volume growth. The Standard A letter/flats rate differential introduced in 1991 initially reduced non-carrier route flats volume. It was unclear whether that trend would continue. It did not.

Uncertainty about prospective growth, not retrospective reports of actual volume, was the focus of Mr. Dowling's testimony regarding the uncertain investment climate which existed at that time. As he emphasized on oral cross-examination, "[We] didn't know it would be a one-year drop." Tr. 46-A/20487.

ANM's final argument regarding Mr. Dowling's rebuttal testimony criticizes the timing of flats automation equipment purchases. ANM Initial Brief 13. The seeming simplicity of that argument belies the truth. One does not simply buy a piece of equipment and magically realize efficiency gains. As Mr. Dowling testified, many early adopters of flats processing equipment struggled to make it work; unlike machines bought by early adopters, those purchased by the Postal Service "worked". Tr. 46-A/20508. Equipment must be developed, and once purchased it must be upgraded and expanded. Tr. 46-A/20474-75. These necessities are implicit, even in the form of ANM's argument, which recites that "the Postal Service first saw a *prototype* of the Alcatel machine *that ultimately became* the AFSM 100 in 1992." (Emphasis added.) If observing a prototype itself brought efficiency gains, there would be no need to develop it, let alone expand or upgrade it.

The Postal Service has engaged in a consistent pattern of investment, including research and development of new opportunities for efficiency gains, purchase of new equipment, upgrades to existing equipment, and encouragement of industry to invest in and serve the needs of its largest customer; these efforts, which have been and

continue to be fully supported by postal management and the Board of Governors, in no sense reflect an imprudent pattern of investment in flats processing equipment.

F. The Commission's Limited Powers under the Act Cannot Be Expanded by Reliance on the WMATC Cases Cited by ANM.

To support its erroneous contention that the "honest, efficient, and economical management" (HEEM) provision of section 3621 can be applied to require "disallowance of needlessly high cost, even if actually incurred by the regulated firm," ANM cites only cases involving the Washington Metropolitan Area Transit Commission (WMATC). ANM Brief at 13-14. The cases cited, however, have no relevance to the actual statutory scheme for postal ratemaking. The relevant statutory language, legislative history, and judicial interpretation of the Postal Reorganization Act were set forth in the Postal Service's initial brief at pages II-14 - II-26. They differ from the WMATC cases in all salient respects.

First, the language of the corresponding WMATC provision³¹ lacks the "maintain and continue the development of postal services of the kind and quality adopted to the needs of the United States" language that gives the HEEM provision in section 3621 its forward-looking cast, which was essential to the Congressional intent to improve the abysmal state of postal operations.³² Second, the WMATC provision was directed specifically at the WMATC, and appeared explicitly within the list of factors --

³¹ Quoted at 466 F.2d 408, n. 98.

³² Recall that in the Sectional Analysis portion of the House Report, quoted in the Postal Service's initial brief at II-17, the paraphrase focused exclusively on exactly the above type of language which does not appear in the WMATC law, and omitted any mention of the "honest, efficient, and economical management" language which does appear.

corresponding to the list in section 3622(b) -- that the WMATC was to consider in prescribing bus fares. Third, the context of the WMATC provision was regulation of a profit-seeking private entity, with no overriding breakeven constraint such as that required by section 3621. In all of these respects, the WMATC provision stands on a very different footing than the HEEM provision in our Act.

Most importantly, the D.C. Circuit in the WMATC cases felt that the WMATC was obligated to probe the management efficiency of the transit company, and to take broad action if necessary to remedy any shortcomings. See 485 F.2d at 903-908. For example, not only did WMATC deny the proposed fare increase, but it also established alteration of the company's capital and debt structures as a condition precedent to consideration of any future fare increases. 466 F.2d at 401-04. The court approved this action on the basis of what it perceived to be the WMATC's broad-based regulatory authority. 466 F.2d at 410-413.

Such broad-based regulatory authority, however, is exactly what the courts (including the D.C. Circuit) have found to be lacking in the Postal Rate Commission. In the *Governors* case, the D.C. Circuit found that because of its limited statutory responsibilities, the Commission may not rely on the general authority of other regulatory agencies. The court cited with approval an opinion of the District Court in the Eastern District of Pennsylvania which, in rejecting an analogy between the Postal Rate Commission and other regulatory agencies with broader mandates over private industry, stated:

The responsibilities of the Postal Rate Commission are strictly confined to relatively passive review of rate, classification, and major service changes, unadorned by the overlay of broad FCC-esque responsibility for industry

guidance and of wide discretion in choosing the appropriate manner and means of pursuing its statutory mandate. [455 F.Supp.] at 873.

Governors, 654 F.2d at 117. In the *Governors* case, the court held that it is not the function of the Commission to regulate the management of the Postal Service and that, in straying from its ratemaking and classification powers to intrude upon the management functions of the Board, the Commission had exceeded its authority. *Id.* at 115.

In the *Newsweek* decision, it was the Second Circuit that found that the Commission had exceeded its authority. The Commission in that instance was claiming to rely upon the HEEM standard as a justification for its attempt to cut the revenue requirement. That attempt was firmly rejected in the court's decision, which agreed with the *Governors* that the Commission was seeking to place itself in a "disciplinary" role over the Postal Service, and found that "nothing in the Postal Reorganization Act empowers the Commission to act as disciplinarian." *Newsweek*, 663 F.2d at 1204.

The court concluded:

We stress that the Board, and not the PRC, is responsible for making policy decisions for the Postal Service. Should the Board exceed its authority or make questionable policy choices, remedies may be pursued through congressional amendment or judicial review. Further, the President may influence the Board's policy decisions through his appointment powers. Aside from these checks, the Board is free to fashion the policies of the Postal Service without interference, including from the PRC.

Id. at 1204-05. These findings by the court stand in stark contrast with the judicial description of the authority of the WMATC in the cases cited by ANM.

More recently, the D.C. Circuit's decision in the *MOAA* case not only warned in general terms against Commission actions with the effect of unduly intruding on the

management and direction of the Postal Service (see 2 F3d at 422-425), but also specifically stated that "the overall pace and course of extending the Postal Service's automation must generally fall within the Postal Service's exclusive authority over management issues," and that "it is not within the Commission's province to recommend rates and classifications in order to accelerate the expansion of Postal Service automation." *MOAA*, 2 F3d at 423. ANM, however, is in essence asking the Commission to do just that. The case law cited in the ANM brief has no relevance to postal ratemaking, and cannot be relied upon to contradict the express directives set forth by the courts in reviewing previous postal rate matters under the Postal Reorganization Act.

III. ISSUES RAISED BY INTERVENORS REGARDING THE QUALITY OF INFORMATION PROVIDED BY THE TRACS, IOCS AND RPW DATA SYSTEMS DO NOT IMPACT THE INTEGRITY, ACCURACY OR RELIABILITY OF THE DATA THEY PROVIDE.

The Postal Service Initial Brief addressed four data systems, TRACS, IOCS, CCS, and RPW upon which the Postal Service relies to assist in decision making, and upon which the Commission has long relied in fashioning decisions on ratemaking requests. As discussed in Section III of the Postal Service Initial Brief, each is supported by Category 1 library references. Intervenor raise issues regarding three of these in their initial briefs. As shown below, none of these issues impact the appropriate use of information from these systems for ratemaking purposes in this docket.

A. FGFSa and UPS Attacks on TRACS Lack Substantive Merit.

1. FGFSa Is Confused about the TRACS Sample Design, and its Allegation of a Bias Is Based on a Fundamental Misunderstanding of Statistical Sampling Concepts.

FGFSa continues to be confused about the TRACS sample design. This is demonstrated by its criticism of the TRACS sampling weights. "TRACS samples are randomly selected, and the data produced by each sample should have equal weight in the development of the distribution key". FGFSa Brief, at 8. This would be correct if TRACS employed simple random sampling. Apparently, FGFSa has an incorrect notion about the TRACS sample design. TRACS uses a stratified sample design, not simple random sampling. An entire section of USPS-LR-52 was dedicated to describing the TRACS stratified sample design. USPS-LR-52, at 8. In the TRACS sample design, samples are randomly selected with equal weights within a stratum, but

the selection probabilities vary between strata, like inbound BMC or outbound SCF. The data are then weighted in the expansion process to reflect the selection probabilities, with appropriate correction for missing or aborted tests. To give all the observations equal weight, as advocated by FGFSa, would produce biased estimates and be contrary to sound statistical practice.

The initial brief of FGFSa criticizes the TRACS sample allocation, claiming that it makes the sampling non-representative and biased since it does not reflect the relative mail volumes on inbound and outbound trips. FGFSa Brief, at 7. This assertion is based on a simplistic notion that the sample allocation should be proportional to mail volumes or truck utilization. As was pointed out by Witness Xie, TRACS is designed to estimate mail category proportions of cubic-foot-miles, not mail volumes. Tr. 17/6845-6847. The relevant criterion for optimally allocating the sample is the variation in cubic-foot-miles of mail unloaded, by mail category, between stop-days. As UPS witness Neels pointed out, "[a]n optimized sample design will allocate sample units across strata in such a way as to give relatively more weight to higher-variance strata, and thus produce the highest degree of overall precision possible for the selected sample size." UPS-T-3, at 35-36. Mail volumes are not estimated by TRACS, and their use is neither necessary nor sufficient for an optimal allocation.

Furthermore, as was pointed out repeatedly by witness Xie (Tr. 17/6751, 6796, 6847) and highlighted in the Postal Service Initial Brief, the sample allocation only affects the efficiency, and not the accuracy (bias) of the estimates. The Horvitz-Thompson type estimator that TRACS uses properly accounts for the selection probabilities regardless how samples are allocated in each stratum, and produces

unbiased estimates for the cubic-foot-miles used in the distribution key calculation. See Postal Service Initial Brief at III-3. TRACS estimation formulas reflect the application of sound science, whereas when FGFSa witness Ball was asked to demonstrate the alleged bias using rigid mathematical formula and describe the magnitude and direction of the bias, his answer was "I did not use a rigid mathematical formula". Tr. 30/14323.

Despite the fact that the Postal Service has in this proceeding provided concise *documentation and rigorous estimation formula in the hopes of promoting a better understanding of TRACS*, it is abundantly clear that FGFSa's criticisms of TRACS are largely due to its confusion about the TRACS sample design and its misunderstanding of statistical sampling concepts. Fortunately, as evidenced by the many boxes of fine, fresh Florida citrus in December, FGFSa is better at transporting quality fruit than it is in the practice of statistics. The Commission should disregard FGFSa's allegations of bias and accept the TRACS results, which are based on the sound application of statistical theory.

2. FGFSa Is Wrong in Arguing That the Postal Service Has Not Followed the Commission's Recommendation to Keep Data Collection and Reporting Separate from Empty Space Expansions.

As stated in the Postal Service Initial Brief, the Postal Service provided final analysis files ('Z-file') and a consolidated SAS program to process the Z-files and produce distribution keys. In preparing the Z-file, the Postal Service followed the Commission's recommendation to keep the data collection and reporting separate from the imputation. The Z-file keeps separate all the data that were recorded from the data collection, prior to any imputation and expansion. All imputations and expansions were performed by the SAS program using the Z-file as the primary input file. Omitting the

expansion to truck empty space is just a matter of changing two lines of code in the program while using the same Z-file.¹ As a matter of fact, the same program, after changing the two lines of code, was used to implement Dr. Bradley's compromise method for allocating empty space. As demonstrated in Dr. Bradley's rebuttal testimony, distribution keys generated using the compromise method are mathematically equivalent to those generated by omitting the expansion to truck empty space. USPS-RT-8, at 62-63.

3. FGFSa's comparison between mail volumes and TRACS distribution keys is both meaningless and irrelevant.

FGFSa compares two tables of data, one with BY98 TRACS distribution keys and the other with TY01 volume estimates for Standard (A), Parcel Post, and DBMC mail. It claims that the differences indicate that TRACS cannot be relied upon, and recommends that the keys be adjusted to conform with known volumes and cubic feet. FGFSa initial brief, at 9-10. The Postal Service has already offered numerous substantial reasons why the comparison of the two tables is meaningless. USPS Initial Brief, at III-6. In the interests of ensuring that this already failed, and presumably dead horse is not somehow miraculously resuscitated, supplemental information may be useful.

First, as previously mentioned, there is a mismatch in time periods between the two tables. The mismatch between BY 98 and TY 01 would not be terribly egregious if

¹ In BY98, TRACS did not collect the necessary information to allow omitting the expansion to fill unused space in a container. The data collection procedures and software were revised in PQ1, FY2000 to collect such information. The Postal Service should be able to provide data to allow such analyses.

the proportions of cubic-feet remained relatively constant between BY98 and TY01 for these mail categories. Unfortunately, this is not the case. Additional drop ship discounts for Standard (B) mail were introduced in FY99, and the predicted growth for drop-shipped parcels far exceeds the predicted growth for zone rated parcels. This caused a significant shift in the mail category proportions between BY 98 and TY 01. The following table compares the actual BY 98 cubic-feet with the TY01 cubic-feet used by FGFSa for the three subclasses of Parcel Post. It shows that DBMC only accounted for 70% of Parcel Post in BY98, but accounts for 81% in TY01,² and that zone-rated parcel post is projected to decline. Clearly, the effect of the change in volume proportions grossly exaggerates the differences between volumes and TRACS distribution keys.

Rate Category	BY98 Volume (cubic-feet)	BY98 Proportions TY01 Volume ¹	(cubic-feet)	TY01 Proportions
Zone-Rated Parcel Post	61,705	30%	48,367	19%
Intra-BMC	19,825 ²	10%	14,153	6%
Inter-BMC	41,880 ³	20%	34,214	13%
DBMC	146,409 ⁴	70%	207,674	81%
Parcel Post	208,114	100%	256,041	100%

Notes:

1. FGFSa Initial Brief at 10.
2. USPS-LR-105, Attachment E, Table 27.
3. USPS-LR-105, Attachment E, Table 30.
4. USPS-LR-105, Attachment E, Table 33.

Second, FGFSa's comparison between Parcel Post volume and TRACS Intra-BMC distribution key is based on an overly simplistic view that trucks carrying Parcel Post mail within a BMC service area are all under Intra-BMC contracts. What it ignored

² In TY01, what is called "DBMC" was formerly called dropship Parcel Post.

is that all contract types can provide such transportation. This is further evidenced by the TRACS distribution keys. USPS-LR-I-52, SAS Log, ZEXP4, FINAL DISTRIBUTION KEYS BY CON_TYPE FOR 498. They show that Parcel Post mail accounts for 10% of Intra-SCF and 6% of Inter-SCF transportation costs. Therefore, without taking the whole transportation network into consideration, any attempt at comparison is meaningless.

Third, the Standard A volumes included in FGFSAs second table were developed based on the "Transportation Flowpath Model" presented by the Postal Service witness Crum. USPS-T-27. While it is very useful for its intended purpose, the flowpath model represents a simplified view of the Postal Service transportation network. In the real world, the transportation network is substantially more complicated. The flowpath model defines Inter-BMC transportation as trips between the origin BMC and destination BMC only. USPS-T-27, Attachment A, Table 2. However, a truck under an Inter-BMC contract may stop at one or more SCFs on its way from one BMC to another BMC. USPS-LR-52, at 4. The TRACS PQ4, BY98 sample frame shows that, of 209,040 stops on Inter-BMC contracts, only 89,680 are at BMCs. The majority of stops, over 55%, on Inter-BMC contracts are not at BMCs. USPS-LR-I-52, SAS Logs, ZEXP4, at 11. Thus, whereas the flowpath model defines "Path 11 (BMC to SCF)" as Intra-BMC transportation, this transportation can also be provided by a truck under an Inter-BMC contract. When that happens, the mail tested by TRACS will show up in the Inter-BMC distribution key instead of the Intra-BMC key, as FGFSAs assumed. Similarly, while the flowpath model shows two paths for Inter-SCF transportation (Paths 8 and 9), in reality a truck under an Inter-SCF contract route can provide transportation

for Paths 1, 3, 8, 9, and 13. Thus, with careful scrutiny it becomes patently obvious that any attempt to compare volumes from the flowpath model with TRACS distribution keys by contract type is nearly impossible, regardless of how superficially alluring it may be.

Beyond the fact that FGFSAs comparisons are meaningless, there is also the issue of relevance. As witness Eggleston pointed out, "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. ... TRACS data is only used at the aggregate subclass level." Even if, due to oversight or improper endorsement, a TRACS data collector erroneously recorded a DBMC parcel as Zone-Rated Parcel Post, the aggregate key for Parcel Post would still be correct, and the aggregate key is what was used in this proceeding.

FGFSA's self-serving suggestion to redistribute costs using mail volume instead of TRACS distribution keys is based on a meaningless comparison, and should be rejected by the Commission. The Commission should continue to rely upon TRACS for the distribution of purchased highway transportation costs.

4. TRACS properly accounts for weight and density in the distribution of highway transportation costs.

At the 13th hour of these proceedings, FGFSAs argues that cubic foot miles should not be the sole criteria in the distribution of highway transportation costs, and that weight and density should also be taken into account. FGFSAs Initial Brief at 9. However, they seem to ignore the fact that weight and density are already taken into account. TRACS data collectors record the weight of the mail. The product of weight and density is used to determine cubic feet. Finally, the product of cubic feet and miles

determines the cubic foot miles used in the TRACS distribution keys. USPS-LR-I-52 at 17-22. So, how should weight and density be used yet again, in a sound and meaningful way to distribute highway costs? Unfortunately, FGFSa offers no suggestions as to how this would be done or why this would be appropriate, neither in direct testimony, rebuttal testimony, nor their initial brief. The only linkage to the record is a solitary reference to Witness Nelson's testimony, where he states that trucks loaded solely with parcels might cube out before they weigh out, whereas trucks loaded solely with periodicals may weigh out before they cube out. Tr. 28/13407. What does this have to do with the cost of transportation of mail in the U. S.? Scant little. As can be ascertained by reviewing the data in the Z-file (USPS-LR-I-52), very few vehicles are loaded solely with parcels or periodicals. Instead, they are typically loaded with a mixture of classes and shapes of mail. Furthermore, given the relatively low average utilization of cubic capacity (Tr. 30/14303), one can readily infer that very few vehicles actually cube out. Vehicles weigh out much more frequently than they cube out.

5. *Self-serving speculation by UPS about the mail moving on emergency contracts and exceptional service movements should not be afforded the status of "evidence".*

UPS states that "the evidence on the nature of these movements suggests that, on average, emergency contract and exceptional service movements are likely to contain higher proportions of time-sensitive mail than do regular movements." UPS Initial Brief at 34. Witness Neels expectations alone, without any supporting data, should not be elevated to the status of "evidence". Tr. 32/16069. In fact, neither the Postal Service nor UPS has any data to either support or repudiate this highly speculative assertion. Exceptional service movements, by their very nature, would be

almost impossible to sample in a statistically meaningful way. Since these movements occur with almost no advance notice, it would be operationally impossible to develop a sampling frame to capture them. As for emergency contracts, it may be possible to sample them in TRACS, but given the short duration of these contracts, the sampling frame will be very dynamic. This will result in a large proportion of tests for which the frame unit no longer exists, and substitution of similar frame units will be operationally difficult. Nothing in the evidentiary record supports the conclusions UPS wishes that the Commission to draw regarding the mail moving on emergency contracts and exceptional service movements. Accordingly, the Commission cannot take any actions based on UPS' speculation.

6. The fact that DBMC parcels are found on Inter-BMC and inbound Intra-BMC trips is evidence that TRACS captures all facets of the actual transportation of mail, and is not evidence of a TRACS problem as asserted by FGFSa.

FGFSa makes an absurd assertion that parcels mailed at the DBMC rate should not be found on Inter-BMC trips. They assert that, since TRACS shows about 3 percent of DBMC on Inter-BMC trips, this is evidence of a TRACS problem. FGFSa Initial Brief at 9. However, it is not the case that Inter-BMC contracts only go from one BMC to another BMC, with no stops in between. Inter-BMC contracts "[p]rimarily carry mail between BMCs. Stops may be made at SCFs." USPS-LR-I-52 at 4. Only 43 percent of the stops on Inter-BMC contracts are at BMCs. The remaining 57 percent of stops are at SCFs or AOs. USPS-LR-I-52, SASLOGS, ZEXP4, at 11. Furthermore, as explained by witness Xie, it is also possible that these DBMC parcels are being returned/forwarded, or were mis-sent, mis-sorted, or mis-entered. Tr. 17/6942. TRACS

data collectors are instructed to record the subclass based on the endorsement on the mail piece. Thus, contrary to FGFSAs assertion, the fact that some DBMC parcels were recorded on Inter-BMC trips demonstrates that TRACS captures all facets of the actual transportation of mail, and is not constrained by overly simplistic assumptions about how mail should flow.

FGFSA similarly asserts that TRACS must be flawed since it found "a significant number of DBMC parcels on the inbound trip back to the BMC". FGFSA Initial Brief at 9. Contrary to FGFSA's underlying assumption, the Intra-BMC network is not strictly composed of trips from a BMC to an SCF and then back to the BMC. An inbound Intra-BMC truck can start from an SCF and make intermediate stops at AOs and/or other SCFs before going to the BMC. Tr. 17/6921-6922. A DBMC parcel, with its final destination at an AO, can be sent from the destination BMC to an SCF on an outbound Intra-BMC truck, and then picked up by an inbound Intra-BMC truck that started from the SCF, stops at the AO facility where the parcel will be delivered, and continues on to the BMC. Furthermore, a returned, forwarded, mis-sent, mis-sorted or mis-entered DBMC parcel may be found on an inbound Intra-BMC trip. Again, the fact that some DBMC parcels were recorded on inbound Intra-BMC trips demonstrates accuracy and reliability of TRACS.

Furthermore, even if FGFSA was correct, which it is not, it would have no effect on the distribution of costs between DBMC and Parcel Post. Although TRACS data collectors differentiate between DBMC and zone-rated Parcel Post, the TRACS data are only used at the aggregate subclass level. Tr. 17/6943 and USPS-RT-20, at 5.

7. The expansion to container size in TRACS purchased highway transportation is appropriate.

In this case, FGFSa questions the propriety of the expansion to container size in TRACS. FGFSa argues that witness Ball raised this issue in his testimony and "voiced objection that it penalized mail on the inbound trip." FGFSa Brief at 8. FGFSa offers no specifics on exactly how mail on the inbound trip is penalized, much less any calculations establishing this asserted adverse impact.

The propriety of this expansion was raised and fully addressed in Docket No. R97-1. Witness Pickett's rebuttal testimony in that docket persuasively demonstrated why it was both logical and fair to distribute the costs of empty space found on containers to the mail in those containers. As he explained, in TRACS, the sampled mail cube is expanded to the cube of the containers in which the mail travels to account for the space that the mail is actually occupying on the truck, which is larger than the actual cubic volume of that mail. Docket No. R97-1, Tr. 35/18763. Witness Pickett concluded, "[M]ail in containers is assessed the full cube of the container, because the container and its contents use the space occupied by the container. That space thus becomes unavailable for use by other mail." *Id.* Moreover, witness Pickett discussed some practical reasons why containers are partially filled:

1. container contents are sampled at destinations after some settling has occurred, thus causing the appearance of empty space in the container;
2. to meet dispatch times, partially-filled containers are loaded on trucks; and
3. for safety reasons, the weight of the mail in a partially-filled container rules out additional loading.

Id. at 18674-75. Although the Commission in Docket No. R97-1 expressed some concerns about the expansion process, it nonetheless accepted the TRACS methodology as it has since Docket No. R90-1 and the Postal Service's new methodology appropriately modifies supporting TRACS documentation to isolate the expansion. See Postal Service Initial Brief at II-2-3.

If FGFSa desires to change the TRACS process of expansion to container size, then it needs to offer specific evidence of bias. FGFSa's bald assertions provide no basis for the Commission to depart from precedent.

B. IOCS Estimates of Within County and Classroom Processing Costs Are Reasonable.

CPA and NNA both criticize IOCS for the data it provides on, respectively, Classroom and Within County Subclasses. See, e.g., CPA Initial Brief at 6, NNA Initial Brief at 22. The basis for their respective arguments relates to the comparatively small size of those subclasses; as with any sampling system, estimates of rare characteristics have larger C.V.'s compared with other estimates. See USPS-T-2 at 8-12. CPA and NNA take somewhat different tacks in attacking IOCS data.

CPA argues that a "tiny and erratic" sample for classroom periodicals is the source of the problem. CPA Initial Brief at 6. While IOCS captures relatively few observations of employees handling classroom periodicals, the IOCS sample is 820,000 observations of employee work time – large by any standard. USPS-LR-I-12, Section II.C, Table 3. Increasing the sample size as a way of reducing substantially the C.V.'s for these two small subclasses is impractical. Tr. 17/6989-90.

NNA cites to USPS-LR-I-276 (which contains the 1999 CRA) as the source for its claim that the most recent increase in Within County mail processing costs "is most likely to result from statistical noise." NNA Initial Brief at 22. The 1999 CRA says no such thing. NNA does not attempt to explain or define "statistical noise" or what specific impact it might have on IOCS estimates.

What cannot be claimed is that IOCS fails accurately to identify which subclass a periodical is mailed at. Markings themselves on periodicals may not permit subclass identification, but collection of the ISSN numbers permits unequivocal identification of the appropriate subclass. USPS-LR-I-12, §§ VI.D, VI.I, VI.J, and Appendix D.

While higher C.V.'s are a necessary attribute of rarely observed employee work time, a longer term solution is proposed by witness Taufique in this proceeding in the form of combining periodicals subclasses. USPS-T-38 at 4-5; Tr. 17/6989-90.

C. Criticisms of the RPW System Do Not Withstand Close Scrutiny.

The Postal Service has provided extensive information regarding Revenue, Pieces and Weight System (RPW), one of several supported by Category 1 library references. See Postal Service Initial Brief at III-11-16. As indicated therein, only two real issues regarding RPW's reported results have arisen in this docket: 1) UPS' preference that a former method of estimating Parcel Post continue to be used because the net effect would increase Parcel Post rates; and 2) NNA's familiar, plaintive cry for any relief from the longstanding downward trend in Within County RPW volumes in

whatever form the Commission can see fit to provide.¹ Each of these is addressed separately below.

1. UPS' Preference for DRPW Estimates of Permit Imprint Parcel Post Rather than BRPW Estimates Constitutes Wishful Thinking That Lacks Record Support.

Without any regard for what record evidence shows, UPS basically throws any possible point that it can conceive of into an argument that the RPW estimates for Parcel Post should be based exclusively upon DRPW, rather than BRPW.² The arguments identified in its Initial Brief include:

- 1) The Postal Service did not explain the switch from DRPW to BRPW, even in response to requests from the Commission;
- 2) The revised estimation methods miscount Standard Mail (A) as Standard Mail (B);
- 3) The lack of a unique revenue account for permit imprint Parcel Post dooms the quality of the BRPW estimates;
- 4) The BRPW error checking routines fail to check for errors;
- 5) Establishment of a new postage statement Form 3605-R concedes a pattern of erroneous PERMIT System data entries; and
- 6) The revised method double counts volume.

UPS Initial Brief at 66-78. Not one of these arguments can be sustained by record evidence in this docket.

¹ NNA's interest in getting similar relief via adjustment of IOCS cost reports is addressed separately.

² The Postal Service advised the Commission of the change to using BRPW numbers for permit imprint Parcel Post, instead of DRPW in a January 13, 1999 letter to the Commission Secretary. As reflected in that letter, this change was consistent with a long term trend of increasing use of postage statement data where appropriate as previously had been accomplished for both First-Class Mail and Standard Mail (A) presort and automation categories.

- a. The Postal Service Has Explained and Fully Justified the Switch from Counting Permit Imprint Parcel Post Using BRPW Rather than DRPW.

Presumably because UPS feared the answer, it has never inquired directly into the switch from DRPW to BRPW. Instead, it chose to attack the foundation of the numbers used to build BRPW estimates, ultimately without success. See P.O. Ruling R2000-1/72 (finding that wholesale mining of a Category 1 data system was not necessary to establish its evidentiary foundation). Testimony and responses provided by the Postal Service to explain the switch are found in response to Presiding Officer's Information Requests (POIRs) 15 (Tr. 46C/21031-32) and 17 (Tr. 46_/21543-46), as well as testimony, USPS-RT-24, USPS-RT-26 (Tr. 43/18782-808).

This information demonstrated a longstanding concern about the accuracy of DRPW based estimates that differed from postage statement derived estimates and ODIS³, a wide range of research into the possible reasons for the divergence between DRPW and BRPW estimates, a general preference for census-like BRPW data absent some reason to avoid it, and acknowledged and increasing difficulties for data collectors in identifying needed postage and subclass information. *Id.*

³ Somewhat disingenuously, UPS claims that witness Prescott never provided any ODIS data that supported his conclusion that the switch from DRPW to BRPW was appropriate. UPS Initial Brief at 76. UPS counsel did make an informal request for such data prior to witness Richard Prescott's scheduled August 28 appearance on the stand. This information was provided on August 25, but for reasons never elucidated, UPS chose not to use it in oral cross-examination. ODIS data are used routinely in Commission proceedings (a late August search identified 81 documents addressing such data – many of them involving UPS), so one can only assume that UPS chose to believe the provided ODIS information and not inquire further into it.

Moreover, the Postal Service has complied to all requests for more complete enumeration of the changes as they affect 1998 and 1999 RPW estimates. See, e.g., UPS/USPS-40 (Tr. 46C/20983); responses questions 2(a) and 2(c) to POIR 15 (Tr. 46C/21031-2); and as promised in those POIR responses, witness Prescott's rebuttal testimony (Tr. 43/18792-4).

Counsel for UPS stipulated that the markings on parcels were insufficient for DRPW data collectors to identify the proper Parcel Post discount drop-ship rate category (Tr. 31/15195), with which witness Sellick agreed. Tr. 31/15197. The Postal Service, therefore, has established that "it would have inaccurately estimated the revenue and volume for Parcel Post and its rate categories..." had "... the Postal Service not switched to using PERMIT System-derived postage statement data in FY 1999." Tr. 43/18790.

The Postal Service agrees with PSA that suitable and appropriate explanations for the switch have been provided to the Commission and that the change from DRPW to BRPW for permit imprint Parcel Post constitutes a worthwhile improvement. See PSA Initial Brief at 11-21.

b. The Revised Method for Parcel Post RPW Estimates Does Not Miscount Standard Mail (A) as Standard Mail (B).

While PSA witness Glick was able to identify some instances where parcels weighing less than one pound were entered at Standard Mail (B) rates, he could not confirm that this occurred with any substantial frequency. Tr. 41/18064-65. Moreover, any such under-weight parcels were unlikely to be entered using permit imprints, meaning they would be captured by DRPW rather than BRPW. Tr. 46B/20654-56.

Further, if such parcels are entered as permit imprint Parcel Post, beginning in 1999 such parcels would also have been marked accordingly, meaning that their costs would also be borne by permit imprint Parcel Post and introducing no bias in the data collection systems. Tr. 43/18804. PSA also makes in these arguments in its Initial Brief, at 16-18, and the Postal Service joins them.

Finally, the rate incentives that would encourage mailers to enter Standard Mail (A) as permit imprint Parcel Post were infrequent, as confirmed by UPS witness Sellick. Tr. 46B/20656. No record evidence quantifies an impact caused by potential entry of Standard Mail (A) as Standard Mail (B), and the qualitative evidence indicates the effect would be trivial. Accordingly, there is no record basis for adjusting BRPW permit imprint Parcel Post estimates based on this conjecture.

c. The Lack of a Unique Permit Imprint Parcel Post Revenue Adjustment Has No Impact upon the BRPW Estimates.

UPS claims that the absence of a unique permit imprint Parcel Post revenue adjustment factor dooms the BRPW estimates; it then goes on to argue that the book revenue adjustment originally applied to DRPW estimates for permit imprint Parcel Post in 1998 under the old methodology should be applied to the BRPW estimates. UPS Initial Brief at 70-71.

This argument fails for three independent sets of reasons: 1) the Postal Service developed an interim adjustment factor to replace the previously available revenue adjustment factor; 2) revenue adjustment factors are not used by "virtually all other permit imprint BRPW-based estimates" as claimed by UPS witness Sellick; and 3)

application of a DRPW-based adjustment factor to BRPW results is illogical and tantamount to asserting that an apple must wear an orange's skin.

In the absence of a revenue account, the Postal Service conducted a survey of post offices for the interim period to estimate the proportion of Parcel Post revenue not accounted for by the PERMIT System offices which was filed as USPS-LR-I-403 on June 27, 2000. The result was the temporary use of the "interim trial balance adjustment factor" value of 1.0092075 (see Tr. 2/814-5 and USPS-LR-I-230 filed on March 13, 2000). No evidence supports UPS' speculation that this factor would bias the 1999 Parcel Post estimates in the direction of overstating revenue. Indeed the revenue adjustment factors that first became available in the last half of 1999, approximately 1.063 and 1.035 for PQ 3 and PQ 4 (Tr. 46_/21232), suggests that, if anything, the 1.0092075 adjustment factor was too low.

As witness Prescott explains, "The use of a trial balance account to control RPW inputs is not mandatory in RPW report production." Tr. 43/18795. He supports this by saying that, "...BRPW estimates for precanceled stamp and meter presort and automation First-Class and Standard Mail (A) are used in RPW, and there are no specific trial balance categories for these items." Id. Furthermore, he goes on to say that "FY 1998 PERMIT System Parcel Post data controlled to an interim factor (1.0092075) constructed from recent census data ... is more accurate than using an underestimate of Parcel Post from DRPW." Id.

The Book Revenue Adjustment Factor applied to the original DRPW-based Parcel Post estimates for FY 1998 is the ratio of trial balance to the probability-based sampling system estimate from DRPW (see USPS-LR-I-27 and the response to

UPS/USPS-56, filed on August 14, 2000). Therefore, the Book Revenue Adjustment Factor of 0.94 is a statistical sampling-based measure. Thus, application of the 0.94 factor to BRPW estimates would serve to perpetuate the undercounting error that led to the change in the first place.

Witness Sellick testifies that the BRPW-based Parcel Post estimates are not based on a statistical sample (Tr. 31/15092,96). Yet he wants to apply this 0.94 BRPW sample-based factor to BRPW estimates (Tr. 31/15039). Witness Sellick cites education and experience with Statistical Systems (Tr. 31/15085-89), and admits to being "...reasonably well versed in statistics.." (see Tr 31/15179). Yet, the proposal to apply a factor developed for "apples" to "oranges" is not surprising given his inclination to apply statistically misleading terminology (Tr. 31/15093-97, 102-3, 189-193), as well as his inability to explain simple statistical measures (Tr. 31/15183-89).

The Commission should not be fooled by this red herring of an argument by UPS.

d. The BRPW Error Checking Routines Properly Check for Errors.

The BRPW error checking process ensures the reasonableness of the input data in terms of its being categorized correctly by subclass and rate category (VIP Code level), as well as more generally to the general level revenue per piece and weight per piece. This process is well documented in USPS-LR-I-25. It has as its foundation the postage-based PERMIT system, which has its own set of checks. *Id.*

As part of a review of why a divergence between DRPW and BRPW permit imprint Parcel Post existed, an independent accounting firm review of the PERMIT

System was conducted in 1997-1998 that focused on 1) the comparison of PERMIT System records against source postage statement information, and 2) verifying postage statement information in the PERMIT System for a sample of bulk mail facilities. USPS-LR-I-279. Moreover, it reviewed a relatively larger proportion of Parcel Post volume than other subclasses and subcategories. Response to UPS/USPS-T5-43 (April 5, 2000). The results of the study indicated no instances of error in capturing and reporting of the PERMIT System postage statement revenue and volume information used in BRPW. *Id.* As the PERMIT System data entry process is structured, and based on the results of this study, lighter Standard Mail (A) pieces are not likely to be mistakenly entered into the PERMIT System as other mail.

Witness Sellick refers repeatedly to audit report findings which he claims call into question the reliability of the postage statement data (Tr. 31/15043), yet when asked to quantify the impacts related to Parcel Post, he confirmed that the audits are ill-suited for this task (Tr. 31/15111), and could offer no other alternatives (Tr. 31/15116). The Postal Inspection Service routinely conducts reviews of revenue collection activities including bulk mail acceptance practices for the purpose of identifying areas needing improvement, not to quantify the impacts of these findings on the revenue and volume estimates. The existence of such audits merely demonstrates the seriousness with which the Postal Service examines its own data systems to verify and assure that the best possible data are used for Category 1 data systems – for both business and ratemaking decisions.

- e. New Postage Statement Form 3605-R Is a Natural Outgrowth of Improvements in Revenue Reporting.

UPS argues that the Postal Service introduced new postage statement 3605-R to reduce confusion and resultant data entries.⁴ UPS Initial Brief at 72-73. This unsupported speculation on UPS' part simply reflects its "any argument into the hat" approach in arguing against the PERMIT System based methodology for permit imprint Parcel Post.

The establishment of separate postage statements is the natural outcome of continual improvements in field level revenue reporting. In addition, practical considerations often come into play. As a result of the establishment of several new rate categories for Parcel Post in Docket No. R97-1, no room was available on the former postage statement to accommodate all that came before together with what was added. (A copy of the new form appears at Tr. 31/15052-3 and USPS-LR-I-26 at 25-26.) The Postal Service undertook the development of a new form, not to cure problems of misreporting on the form, but as established business practice.

Witness Sellick attempts to buttress the speculation on miscounting by pointing to minor inconsistencies he found on Forms 8125 (Plant Verified Drop Shipment). Tr.

⁴ UPS also attempts to tie this argument to "keystroking errors" apparently found in USPS-LR-I-403. That library reference, responsive to POR R2000-1/72, provided a means of emulating a replication of the BRPW input data files separately provided in USPS-LR-I-194. While the Postal Service believes that the LR-I-403 data did reflect keystroke errors in three records accounting for a substantial 55 million pounds, it was not able to determine the source of those errors. Of significance, however, is that those errors did not occur in the actual BRPW input files; hence they appear to have been introduced after the PERMIT System data were extracted and rolled up via CBCIS into the BRPW input records and did not constitute keystroke errors by PERMIT System data entry personnel.

31/15132, 15044, 18109; see UPS Initial Brief at 73. However, he could not confirm that Form 8125s are more accurate than postage statements based on his limited review. Tr. 31/15132. The fact that he found a few instances of unexplained discrepancies on 8125's (Tr. 31/15043-44) is irrelevant given that PERMIT System data are entered from postage statements, not 8125s (Tr. 31/15415, 15175); postage statements are the basis for financial transactions between the Postal Service and the mailer (Tr. 31/15175), and witness Sellick would himself "...want my personal postage statements to be accurate...". Tr. 31/15176. The fact that UPS is simply speculating here is confirmed by witness Sellick, who says that there is no evidence to "... quantify the reduced possibility of erroneous reporting." (Tr. 31/15129).

f. The Hybrid DRPW/BRPW Method of Estimating Parcel Post Does not Double Count.

UPS argues (Initial Brief at 77) that the hybrid estimation method of DRPW/BRPW increases the possibility of double counting specific pieces. However, witness Sellick was unable to provide any quantified support for this contention. When asked specifically if he has "any evidence.. [that]... quantifies such incorrect recordation...", and whether he has any reason "... to expect an incorrect recordation in the other direction [metered recorded as permit imprint]" he says "...there is no information available which permits the frequency with which this occurs to be quantified." Tr. 31/15135. Further, he has "...no basis to confirm or not confirm this statement." Id. Especially because the likelihood of actual data collector confusion is low (see, e.g., PSA Initial Brief at 18-19), these assertions are pure speculation that lacks any quantitative or qualitative support.

2. NNA's Criticisms of Within County RPW Estimates Fail to Recognize the Efforts By the Postal Service to Improve Those Estimates and Reflect Poor Understanding of Statistics and Statistical Sampling Techniques.

NNA effectively prostrates itself at altar of the small size of the Within County subclass to argue that the Postal Service has failed to sustain its burden of proof that the RPW estimates are accurate. NNA Initial Brief at 1. NNA identifies no evidence showing how the subclass size allegedly affects the accuracy, precision or reliability of the BRPW estimates of revenue and volume totals, nor does it identify where in the record the RPW data for either the FY 1998 or FY 1999 periods are shown to be "shaky" (per NNA Initial Brief at 5). In the absence of evidence, NNA resorts to implying that there might be an undercount of Within County volume since no sufficient explanation for the remarkably consistent year-to year decline in volumes has appeared. See, Tr. 2/772. NNA Initial Brief at 6. The Postal Service submits that the record demonstrates the RPW estimates, which measure revenue and volume by mail category (but cannot explain the "why" behind change over time), are accurate.

a. The Postal Service Has Improved Within County Data RPW Estimates Since Docket No. R97-1.

Postal Service efforts to improve Within County data collection since the last omnibus docket include undertaking a census of Periodicals Mail activity; updating the Periodicals supplemental office panel to ensure accuracy and high precision; meeting with NNA in an ultimately futile search to answer the "why" question that NNA is unable to explain with respect to its portion of Within County mail alone; and planning and development of an AIC revenue control account that will be the end of any question as to RPW's accuracy. See Postal Service Initial Brief at III-14-16.

The quantitative evidence that NNA seeks to rely upon is not credible because it applies weak statistical techniques to study a population that differs from RPW's examination of Within County volume. Tr. 24/11144-45. See also, Postal Service Initial Brief at 15-16.⁵

NNA reproduces in its Initial Brief (at 6) the real story behind RPW's demonstrated trends for Within County volume: it has been dropping in relatively stable increments since 1986. Yet that table does show some sets of two data points in which an increase might be shown. While a trend cannot be demonstrated with just two data points, that is exactly what witness Elliott tries to do.

- b. The Postal Service Has Provided Comprehensive Documentation of its BRPW Estimates for Within County.

NNA itself rebutted its assertion that "The total sum of witness Hunter's explanation for BRPW as it applies to Periodical volume" is found on two pages of its testimony (NNA Initial Brief at 10-11) by the mere fact that it took advantage of discovery to pose 47 interrogatories totaling 115 subparts. This material is in addition to USPS-LR-I-25, 26, and 28 (identified at USPS-T-5 at ii), a technical conference (in which NNA effectively asked no questions and departed early) and numerous other

⁵ NNA witness Elliott attested to the NNA's survey results. He could not understand basic statistical concepts such as "accuracy" and "precision". Tr. 24/11162. One might hope that a background in statistics would be appropriate for a expert who questions the reliability of the Postal Service's statistical measures. It is little wonder that given the NNA study reported C.V. of 296.8 percent (Tr. 24/11088), the witness, when asked about the usefulness of a C.V., remarked "... I don't really like using coefficients of variation myself." Tr. 24/11149. This becomes compounded by his erroneous beliefs that certain values in an attained 95% confidence interval (and particularly those of interest to NNA) are more probable than others in the interval, and that the probability that a single attained 95 percent confidence interval actually includes the true but unknown parameter of interest is 95 percent. Tr. 24/11151.

responses to interrogatories and information requests. Witness Hunter has been fully responsible and responsive in this proceeding and NNA's characterization to the contrary is unwarranted and undeserved.

c. NNA Apparently Does Not Understand How the BRPW Estimation Process Operates.

Notwithstanding all this explication, NNA still does not appear to have attained a full understanding of the BRPW methodology, including the sample selection process. The automated office (PERMIT System) segment of the panel is continuously updated each AP to capture births (first time Periodicals reporting offices). Since FY 1996, this segment of the panel has grown in count by over 26 percent from 1,603 to 2,025 offices. USPS-LR-I-230 Appendix A at 3, and Tr. 2/791. For the non-automated office segment, a supplemental office panel is updated periodically after identifying all non-zero, non-automated Periodicals reporting offices and their revenue. The supplemental (non-automated) office panel for the 1998 base year period was updated in 1996 (USPS Initial Brief at III-15) and is based on a stratified random sample of size 25 from 6,103 non-zero Periodicals offices. See also, USPS-LR-I-230 Appendix A at 3 under strata population and sample size columns titled NH and NHSAMP, respectively.)

NNA fails to understand that a sizable gain in estimator precision is realized by limiting the population to the units of interest (non-zero members) since the contribution of zero volume units to the sum of the squared deviations about the mean in the computation of a variance is considerable. All non-zero Periodicals offices are stratified into six non-overlapping and homogeneous strata based on the In-County revenue (Tr. 2/294). This design ensures an efficient sample from the standpoint of achieving

attained precision at or near the 2.2 percent reported level for the FY 1998 base year. Because each of the six non-automated office strata is homogeneous with respect to the In-County measure and only a small sample need be selected from each stratum to precisely estimate the contribution of the stratum to the total, combined with the fact that the total trial balance revenue is known, the appropriate statistical estimator is the combined ratio estimator of a total. See Cochran, W, *Sampling Techniques*, 3rd ed., at 165-67 (John Wiley & Sons, 1977).⁶ NNA also ignores information provided to them showing that the average In-County revenue measured by census for stratum 2.5 is only \$202.94. USPS-LR-I-230 Appendix A at 3 (RI column divided by 2,642), and Tr. 2/792 at part (f). Additionally, the total revenue for this stratum is only approximately \$536,000. It would be senseless as well as wasteful for the Postal Service to sample such a small unit office stratum at a rate higher than that necessary to achieve an overall precision level near that reported for FY 1998 (C.V. of 2.2 percent).

d. BRPW Estimates for Within County Account for Office Births and Deaths.

NNA claims that the BRPW panel of automated and non-automated offices fails to account for offices with first-time Within County volume (births) and those which lose all such volume (deaths). NNA Initial Brief at 14-15. However, many births would be included in the per-AP update in the automated panel, which shows an increase of 422 offices since the panel was first created. Tr. 2/792-93. These new automated offices

⁶ On average one would need to quadruple the sample size of a simple random sample (srs) in order to achieve a reduction in the C.V. of just half. Thus, under a simplifying srs assumption, the sample size of the supplemental panel would need to be increased to 100 in order to halve the already low C.V. of 2.2 percent (to 1.1 percent). This results in only a small or modest gain in precision at best.

could arise from both zero and non-zero non-automated offices; to the extent they formerly were non-zero non-automated offices, the remaining non-automated offices would over-estimate Within County volume. Third, births at prior zero revenue offices would likely be offset by deaths in such offices; indeed given that deaths are more likely in smaller offices, this tradeoff might also lead to overestimation of Within County volume in the non-automated portion of the panel. Finally, the use of a trial balance revenue account corrects for either undercounting or over counting of volume.⁷ Thus changes owing to births and deaths are fully accounted for in the BRPW panel – especially given the lack of any *a priori* reason to expect significant migration either into or out of the Within County subclass.

⁷ In BY 1998, three of four quarters had ratios of AIC 135 book revenue to estimates of less than one, suggesting slight over-estimation rather than under-estimation. Tr. 21/8485.

IV. THE ARGUMENTS ADVANCED BY THE PARTIES IN THEIR BRIEFS FAIL TO SUPPORT THEIR CLAIMS THAT ANY ADJUSTMENTS IN THE POSTAL SERVICE'S PROPOSED COSTING METHODOLOGIES ARE WARRANTED BEYOND THOSE ACKNOWLEDGED IN OUR INITIAL BRIEF

In their initial briefs, many of the parties claim that, for one reason or another, the cost methodologies upon which the Postal Service has predicated its rate proposals are incorrect. As discussed in this part of the brief, such claims lack merit. We address those specific costing proposals which have been addressed in the initial briefs of other parties in such fashion as to warrant a reply. (In some instances, either because no party commented on a proposal, or because all of the matters they raised were amply addressed in the Postal Service's initial brief, no further discussion is included in this brief. With regard to costing, as with all other aspects of this case, the mere fact that the Postal Service has not specifically responded in this reply brief to arguments made by other parties in their initial briefs in no way indicates that the Postal Service necessarily agrees with the positions they have espoused.)

In general, this section of the brief does not address costing level issues, in the rollforward/revenue requirement sense, nor the update issues addressed at some length in Section I of the Postal Service's initial brief. Rather, for the most part, this section covers the variability and distribution issues relating to the various cost segments. Before proceeding to those more focused costing issues, however, some brief response to more general matters raised by UPS is warranted.

A. UPS Blows Hot and Cold on the Costing/Pricing Requirements of the Act

At pages 8-11 of its brief, UPS has a section in which it broadly discusses its theory of costing and pricing under section 3622(b) of the Act. In large measure, it

repeats similar (in some cases, identical) arguments made in its initial brief in Docket No. R97-1. The Postal Service comprehensively addressed those arguments (and parallel ones made by NAA) in its reply brief in Docket No. R97-1, at pages IV-1 through IV-15, and sees no point in reproducing that material here. The Postal Service stands by the positions stated in that portion of its Reply Brief in Docket No. R97-1. Nevertheless, it may be useful to highlight some of the more salient points relevant to UPS's current claims.

UPS offers the following discourse on the appropriate interpretation of the cost floor required by subsection 3622(b)(3):

The Supreme Court has held that the Act "requires that all costs reliably identifiable with a given class, *by whatever method*, be attributed to that class." *NAGCP*, 462 US at 820 (footnote omitted)(emphasis added). The Court delivered a clear message -- if a particular cost is "capable of being considered the result of providing a particular class of service," the Commission should attribute that cost. *NAGCP*, 462 US at 833-34, n.29. Moreover, in deciding what costs are attributable, the Commission must strive to meet "Congress' broad policy ... to mandate a rate floor consisting of all cost that could be identified ... as causally linked to a class of mail service." *Id* at 833.

UPS Brief at 9. It would be hard for the Postal Service to disagree with these statements, as they are in large measure nothing more than excerpts from the Supreme Court's opinion. Nor would the Postal Service disagree with what would appear to be nothing more than a logical corollary to those statements:

There is no gray category of costs which are caused by a class of mail but which may be assigned to other classes of mail on the basis of non-cost considerations, such as demand or "economic value of service."

UPS Brief at 11.

The Postal Service, in fact, has faithfully followed these prescriptions, and

developed a sophisticated analytic framework which takes great pains to identify exactly the costs spoken of by the Court -- all costs causally linked to each subclass. Those costs are the incremental costs. In the Postal Service's version, those costs are presented by witness Kay (USPS-T-23). In his related testimony, moreover, Prof. Bradley (USPS-T-22) expressly describes the careful attention the Postal Service has paid to providing an incremental cost framework which is flexible enough to easily accommodate other versions of costs. If the Commission were to reject elements of the Postal Service's proposed cost methodologies, it can incorporate the necessary revisions to the incremental cost model just as easily as it incorporates its revisions to the Postal Service's volume variable cost models. Given the very stern position taken by UPS in terms of the statutory requirements, one would expect that UPS would be leading the charge to urge the Commission to embrace incremental costs as the statutory attributable cost floor.

Not exactly. UPS, of course, did offer the testimony of Dr. Sappington agreeing with Prof. Bradley that "attributable costs" (volume-variable plus specific fixed) systematically understate incremental costs when marginal costs decline with volume. Tr. 31/15238. UPS, moreover, does not contend that overall marginal costs do not decline with volume (i.e., UPS does not challenge variabilities of less than 100 percent in, for example, carrier and transportation operations). Nevertheless, UPS is willing to settle for a cost floor limited to volume-variable plus specific fixed costs. UPS Brief at 10. In so doing, UPS is inviting the Commission to do exactly what UPS proclaims with great fanfare that the Act prohibits, the creation of a "gray category of costs which are caused by a class of mail but which may be assigned to other classes of mail on the

basis of non-cost considerations." When it is convenient for UPS, in other words, a "gray category of costs" -- the difference between incremental costs and "attributable" costs -- can be countenanced, despite the Supreme Court's "clear message" that if a particular cost is "capable of being considered the result of providing a particular class of service," the Commission should include it in the cost floor.

Not only is UPS much less concerned than one might expect from reading its brief that ratemakers follow the prescriptions actually made by the Supreme Court, but UPS is also intent on injecting requirements that are neither in the statute nor in the Court's opinion. Specifically, UPS implies that there exists some requirement that cost coverages and markups be established with reference to "attributable" (volume variable plus specific fixed) costs, rather than just volume variable costs. UPS Brief at 8, 10-11. In point of fact, however, the statute makes no reference to either cost coverages or markups.^{1/} Neither the statute nor the Court's opinion purport to define the process by which conclusions are reached as to what constitutes a reasonable share of residual, non-causally related, costs. As explained in some detail in the Postal Service's reply brief in Docket No. R97-1, evaluating the appropriate contribution for each subclass relative to its volume-variable (marginal) costs in no way conflicts with the statute, as long as it is done in conjunction with the application of an incremental cost test which precludes rates falling below the (b)(3) floor.^{2/} Moreover, as also addressed in the reply

^{1/} If the Supreme Court's opinion makes any such references, UPS has certainly failed to cite them in its brief. The Postal Service is aware of none.

^{2/} Furthermore, in contrast to the "attributable" cost approach supported by UPS in which causally-related costs are capped at volume variable plus specific fixed, this approach actually does preclude the existence of a "gray category" of costs caused by

brief in the last case (at IV-10 - 11), this approach does not conflict with the Court's two-step ratesetting process -- costing is still the first tier, establishing reliable causal relationships between costs and classes of mail, and pricing is still the second tier, using those costs and the non-cost criteria to develop rates. UPS's continued allegation in that respect (UPS Brief at 10) is just as wrong in this case as it was in the last.^{3/}

In practical terms, the issue of the markup base is something of a non-issue. The statute does not refer to reasonable markups, it refers to reasonable rates. The rates proposed by the Postal Service speak for themselves. In this case, the Postal Service has provided volume-variable costs and incremental costs. Although not sponsored by its witnesses, and therefore of questionable evidentiary status, the Postal Service has also made available versions of the Commission's attributable costs. Other parties, such as UPS and the OCA, have presented their own versions of costs. The Postal Service's proposed rates, and the reasonableness of each subclass' share of residual costs, can be evaluated against any and all of those costs.^{4/} Indeed, parties

one subclass of mail, but assigned to the other classes through the pricing process. The claim to the contrary on page 11 of the UPS brief is both erroneous and misleading.

^{3/} It can only be described as ironic that UPS challenges the Postal Service's approach to pricing, which clearly and directly addresses the (b)(3) cost floor established by incremental costs, while at the same time claiming that an alternative approach can pass muster, even though that approach consciously and unequivocally violates the (b)(3) cost floor by ignoring incremental costs.

^{4/} One important caveat is in order here. As explained in great detail in the Postal Service's Initial Brief in Docket No. R97-1, at pages IV-5 - IV-11, markups based on anything other than volume variable costs, which therefore includes markups based on incremental costs, cannot appropriately be used to address concerns of economic

have done exactly that.^{5/} Moreover, by using conventions such as cost coverage and mark-up indices, parties can translate relative evaluations of the pricing criteria into factors which can be applied to alternative cost bases. (The UPS brief in its discussion at the bottom of page 43 illustrates how this can be accomplished.) UPS does not contend that the structure of the Postal Service's costing presentation has impeded its own or any other party's ability to evaluate and respond to the Postal Service's proposals, and, even if such an allegation were made, the Postal Service would dispute it.

efficiency. In this docket, witness Mayes makes essentially the same point in USPS-T-32 at 17-18. Therefore, attempting to base markups *exclusively* on incremental costs, just as if based exclusively on "attributable" costs, inevitably would cause the loss of information important to the pricing process.

^{5/} The Postal Service has also done that. For example, witness Mayes discusses her proposed rate level for Express Mail in terms of the cost coverage relative to both volume variable costs (222 percent) and incremental costs (148 percent). USPS-T-32 at 28-29. Likewise, she discusses the Priority Mail coverage in terms of both measures of costs. Id. at 25. Indeed, on one of the very pages cited by UPS in its brief (at 12), witness Mayes states that "[i]n the process of assessing whether the rate levels proposed in this case are fair and equitable, and further incorporate the guidance of the remaining pricing criteria, [she uses] both volume-variable as well as incremental cost measures." Id. at 19. The suggestion by UPS that the Postal Service is proposing to mark up only the volume variable costs is, at the very least, overly simplistic, as is the same claim made by NAA (NAA Brief at 45).

- B. The Record in this Case Demonstrates by Overwhelming Evidence That the Volume Variability of Mail Processing Costs is Less than 100 Percent and that the Postal Service's Variability Estimates and Cost Distribution Methodology Remain the Most Accurate Treatment of Mail Processing Costs.

The Postal Service has presented a comprehensive treatment of mail processing costs in this case that fully addresses both Commission and intervenor criticisms raised in Docket No. R97-1. The fundamental conclusion of this massive effort is the same as in the last case -- every single piece of reliable evidence proves that the volume variability of mail processing costs is unalterably and unequivocally less than 100 percent.

1. The proper course for the Commission is clear.
 - a. The Commission must not be diverted by the self-serving protestations of certain intervenors.

The primary intervenors, OCA and UPS, who opposed the Postal Service's mail processing variability analysis in the last docket, are also opposed here. This comes as no surprise. Both OCA and UPS, despite facile claims to the contrary and for different reasons, are entrenched in their resistance to anything less than 100 percent volume variability.

OCA is quite candid about the basis for its opposition, stating, "The effect would be to shift substantial costs to the institutional category to the detriment of those classes of mail and services (such as First-Class Mail) that are assigned high cost coverages." OCA Brief at 3.¹ While understanding the OCA's evident desire to

¹ MMA cites the identical, fallacious reason for urging the Commission to reject the Postal Service's mail processing volume variability estimates. MMA Brief at 12.

somehow protect First-Class Mail, the Postal Service is at a loss to understand how any subclass of mail actually benefits by being saddled with more costs than it causes. This is contrary to both the Act and to common sense.

UPS, on the other hand, is not so open about its true motivation. UPS, like OCA, expresses a desire to protect First-Class Mail, but also wants to protect competitors. UPS claims that the Postal Service has a "goal of maximizing volume and market share at the expense of monopoly First Class Mail letter users and private sector businesses," and that, at least in part, "[t]he Postal Service seeks to achieve these results by once again asking the Commission to abandon the Commission's well-established treatment of mail processing labor costs as fully volume variable." UPS Brief at 1-2. Whatever gloss UPS desires to put on the matter, its opposition to the Postal Service's mail processing volume variability analysis is grounded on a desire to enhance its own business interests. In UPS' hoped for resolution, higher levels of cost attribution means higher Postal Service rates for competitive products. As PSA has succinctly said, in the context of Parcel Post rates,

We do know that many large parcel shippers have special deals with UPS that are secret and that undercut current Parcel Post rates. Any increase in Parcel Post rates will simply provide UPS with an opportunity to increase its own prices without suffering volume losses, and thereby damage competition.

PSA Brief at 1-2.

If the bases upon which OCA and UPS resist the notion of less than 100 percent variabilities are clear, it is equally clear that this resistance is immutable. The porridge will always be either too hot or too cold for OCA and UPS; it will never be just right. This is demonstrated by the constantly shifting arguments advanced by OCA and

UPS. For example, UPS witness Neels touted the cross-section or "between" model in Docket No. R97-1;² in this case, an argument he abandoned in UPS-T-1 in favor of claims that a time series analysis is superior.

Another, even more striking example is OCA's constantly shifting interpretation of Figure 5 from witness Degen's direct testimony. USPS-T-16, at 29. When Dr. Smith's testimony was filed, he stated,

The two most important points in the diagram are points A and C. They represent the real labor costs of processing mail at each of the plants when operating at plant design capacity -- the level for which they were designed, based on the evolving mail processing network as described by Mr. Degen.

Figure 5 has two types of plots in it. The facility by facility plots (labeled "Plant A" and "Plant B") are the types of plots that both Dr. Bradley and Dr. Bozzo generate and estimate. These are short-term plots of data. Alternatively, one could allow for the treatment of the data of a pooled basis or a cross sectional basis. ***In that case, one would estimate the line AC. Such a modeling approach would be consistent with the data and an underlying longer-term capacity expansion path.***

OCA-T-4 at 63, Tr. 27/13212 (emphasis added). By the time of his oral cross-examination, Dr. Smith had difficulty seeing how the plants could expand along the line between points A and C:

Q: Does your response indicate that point C would not necessarily represent the optimal capacity to [which] plant A would expand if the amount of processing it performed increased from TPH sub zero to TPH sub 1?

A: ***C is a different plant, and so I have trouble talking about plant A expanding.*** In fact, Dr. Bozzo has indicated that due to a fixed effects of various plants, they have different costs, so one could imagine that, for example, a rural plant that expanded would be a bit different from an urban plant.

² See Docket No. R97-1, Tr. 28/15626-30.

Tr. 27/13335 (emphasis added). On brief, OCA now offers several new interpretations of Figure 5,

[O]ne could assume that it is the labor demand function related to the expansion path for the set of existing plants, remembering that the analysis does not consider (incorrectly) the addition of new plants. ***The labor demand function results from the expansion path but is not the expansion path.*** One would have a group of short-run relationships grouped around a long-run relationship. Alternatively, one could assume that Plant A and Plant B are identical plants, with Plant B operated by incompetent management”

OCA Brief at 116 (emphasis added). OCA’s arguments do not improve for all the modification. Presumably, OCA will have yet another interpretation to offer in its reply brief. All of the twisting and turning on this issue seems a bit over the top, given that Dr. Smith’s original purpose was to show that Mr. Degen’s graphs could be interpreted to demonstrate that the fixed-effects model was “unsuitable” (OCA-T-4 at 58, Tr. 27/13207) --- an enterprise doomed from the start to failure given the fact that witness Degen’s “graphs depict a situation in which ***the fixed-effects model is by construction the correct model.***” USPS-RT-5 at 8, Tr. 38/17313 (emphasis added).

As if the constant “morphing” of the OCA and UPS arguments were not bad enough by itself, the constant barrage of changing objections raises impossibly high hurdles that no study of mail processing volume variability could ever overcome. As Professor Greene stated, specifically with regard to data set issues, “The intervenors in this case have thrown up an array of criticisms . . . that raise a standard that could never be met.” USPS-RT-7 at 6, Tr. 46E/22041. In fact, there seems to be a double-standard applied to the mail processing studies. For example, as the Postal Service noted in its initial brief, analytical costing models with R-squared values lower than those associated with Dr. Bozzo’s models have been accepted by the Commission in

other areas. Postal Service Brief at V-43. Yet, here, UPS witness Neels takes issue with the explanatory power of Dr. Bozzo's models. UPS-NOI/POIR-T-1 at 12. Tr. 46E/22280.

Nowhere is the double standard more apparent than in the OCA's uncritical embrace of Dr. Neels's "reverse regression" analysis of the relationship between TPH and FHP. OCA Brief at 123. Dr. Neels's sponsorship of the analysis, it seems, magically erases concerns that the OCA considers showstopping for the variability analysis. Does Dr. Neels use an appropriately accurate and verified data set? Dr. Neels, after all, uses the same data as Dr. Bozzo. Does Dr. Neels employ appropriate econometric methods? Dr. Neels uses an econometric method that Professor Greene -- the man who wrote the book to which Drs. Neels and Smith cite when it suits them -- clearly indicates does not solve the problem for which it is advanced. Has Dr. Neels explained the implications and reasonableness of the results? Dr. Neels's offers no explanation of the economic and operational implications of a finding that implies massive diseconomies of scale in mail processing operations. The OCA cannot reach such divergent conclusions without applying different standards in evaluating Dr. Neels's analysis than it does in evaluating Dr. Bozzo's.

Moreover, there are other interests besides those of OCA and UPS. Mailers -- such as the book publishers and the Periodical mailers -- have an interest in correct cost allocation and lower rates. See AAP Brief at 10-12; Periodicals Mailers Brief at 36-46.³ Their views are entitled to serious consideration.

³ "Periodicals Mailers Brief" refers to the joint brief of the Alliance of Nonprofit
(continued...)

The party with likely the most at stake concerning mail processing volume variability is the Postal Service. Mail processing costs represent an enormous amount of the Postal Service's total costs. Incorrect allocation of those costs thus has a huge impact, and as noted by the Presiding Officer, may have an even greater impact in the future. Tr. 38/17392-93. As witness Degen concluded, "[T]he magnitude of the costs involved makes it important to get it right." Id. at 17397.

- b. The Postal Service's volume variability study contained many new elements and incorporated elements from the Docket No. R97-1 analysis where appropriate.

The impression created by the rather colorful rhetoric contained in the OCA and UPS briefs is that the Postal Service simply dusted off Dr. Bradley's mail processing volume variability analysis from Docket No. R97-1, slapped on a new cover page, and refiled it in Docket No. R2000-1. OCA characterizes the Postal Service's study as "deja vu all over again" and UPS calls it "a recycled analysis." OCA Brief at 83; UPS Brief at 2. This simply is not the case. The truth is that Dr. Bozzo undertook a complex and time-consuming analysis, making numerous major revisions in order to carefully address the concerns raised by the Commission in Docket No. R97-1. To address concerns that MODS alone could not provide "sufficient information to estimate the mail processing labor demand models," Dr. Bozzo employed data from a number of data sets other than MODS. UPS-T-15 at 89-94. Where Dr. Bozzo did retain elements of the Docket No. R97-1 analysis, he did so only after further investigation or based on

³ (...continued)

Mailers, American Business Media, Coalition of Religious Press Associations, Dow Jones & Company, Inc., Magazine Publishers of America, Inc., National Newspaper Association, the McGraw-Hill Companies, Inc., and Time Warner, Inc.

sound reasoning, as fully explained in his direct testimony. In these instances, it simply made no sense to throw out the baby with the bath water.

It is also somewhat inconceivable that, if Dr. Bozzo had made a modeling choice that ignored contrary statistical test results, OCA and UPS would have failed to criticize Dr. Bozzo's econometric practices. Of course, ignoring good econometric practice and rejecting statistically supported models -- when those models produce less than 100 percent volume variabilities -- is a centerpiece of both Drs. Neels' and Smith's arguments. In addition, not all of the analysis upon which the Postal Service's methods are based is econometric. The Postal Service presented a detailed operational analysis, in the testimonies of witnesses Degen and Kingsley, that shows that the structure of mail processing operations is fully consistent with variabilities less than 100 percent. Mr. Degen shows that Dr. Bozzo's results are fully consistent with the operational analysis.

In Docket No. R97-1, the Commission expressed concerns over the accounting period (AP) frequency of Dr. Bradley's data and the use of a single AP lag in his models. These concerns became associated in a confusing and incorrect manner with the debate over the appropriate length of run, as discussed by Dr. Bozzo. USPS-T-15 at 17-18. Nonetheless, Dr. Bozzo made changes. First, he used quarterly data in his regressions. See USPS-LR-I-107. Also, he included "lagged effects up to the SPLY quarter" and calculated volume variability factors "as the sum of the current and lagged TPH/F elasticities." *Id.* at 18.

The Commission also took issue in the last docket with Dr. Bradley's data scrubs, finding them "excessive" due to the large number of observations excluded, but

still "ineffective" as they did not guarantee identification of all erroneous observations. The Commission stated that Dr. Bradley's scrubs biased his variabilities downward. Although Dr. Bozzo correctly concluded that the assertion of a downward bias in the variabilities as a result of the scrubs "is simply unsupported by the record" in Docket No. R97-1, he nonetheless determined that substantial modifications to the scrubbing procedures should be made. *Id.* at 19-20. Dr. Bozzo's scrubs were "designed to use as much of the available data as possible without admitting seriously erroneous observations." *Id.* at 21. In his testimony, Dr. Bozzo analyzed Dr. Bradley's scrubs at length and determined to keep a version of the threshold scrub, to abandon the continuity scrub,⁴ and to modify the productivity scrub "to apply some operational knowledge to the process and tailor the selection rules to the characteristics of the activities." *Id.* at 102.

In Docket No. R97-1, the Commission additionally expressed its belief that certain of the control variables -- the manual ratio and the site-specific intercepts --used by Dr. Bradley were probably volume variable. Dr. Bozzo further investigated each of these variables. With regard to the manual ratio, Dr. Bozzo determined that it was possible that the manual ratio could be affected by volume, but only in the very limited sense that the manual ratio might increase due to short-term capacity constraints, and further concluded that this was exactly the type of "excessively short-run volume variability factor" that all seemed to agree was not appropriate. *Id.* at 24-25. Moreover, Dr. Bozzo demonstrated mathematically that treating the manual ratio as volume

⁴ Dr. Bozzo stated, "Therefore, I chose not to impose any continuity requirement at all, beyond that required by the specification of the labor demand models." *Id.* at 101.

variable has no effect at all on the variabilities at the cost pool level, and that the impact of such at treatment of subclass costs is small. See *id.* at 25 and App. C.

With regard to the site-specific intercepts, or “fixed effects,” Dr. Bozzo explained that since, as the Commission observed in Docket No. R97-1, “it is [not] possible for the fixed effects to control for differences between the facilities that are not fixed over time” (PRC Op. R97-1, Vol. 2, App. F at 41), the fixed effects “capture the effect on cost of unmeasured cost-causing factors that ***do not vary with volume on the margin.***” *Id.*, emphasis added. Since volume varies continuously, but the fixed effects must, by definition, be fixed, it would therefore be “a logical contradiction for these factors to be both volume-variable and invariant over a sample period in which there have been significant volume changes.” *Id.* Dr. Bozzo did not merely assert that the fixed-effects model was the appropriate estimator, he tested it and found it to be supported by the data.⁵ Nor did Dr. Bozzo consider it unnecessary to model additional factors that might cause persistent cost differences between sites. He added significant additional control variables to his regressions – for instance, he included, in a manner consistent with established econometric practice, the number of possible deliveries in a site’s service area as a quantitative measure of the network. *Id.* at 26. Dr. Bozzo nonetheless

⁵ In fact, in this case, the results obtained by both Drs. Bozzo and Neels for their NOI 4 responses demonstrate that Model C, the most general fixed-effects model explored in this proceeding, is statistically the most appropriate. The results presented by Drs. Bozzo and Neels show that the difference between the Model C results and Dr. Bozzo’s recommended results in USPS-T-15 are trivial. See Tr. 46E/22245 and 22279.

cautioned, "While ***possible deliveries*** are positively correlated with mail processing volumes . . . they are ***clearly not caused by mail volumes.***" *Id.* (emphasis added).⁶

Dr. Bozzo also examined the potential relationship between wages and mail volume and found that there was none. He examined the Postal Service/APMU contract and "found that the wage schedules in the contract depend on the employee's pay grade and length of service, but not on mail volumes." *Id.* at 27. Dr. Bozzo also considered whether variations in volume might cause wage variations resulting from changes in the labor mix. He concluded that labor mix changes which would decrease wages "cannot be sustained over the rate cycle" and thus do not belong in the variability regressions. He reached his conclusion because "the Postal Service faces contractual restrictions that prevent it from permanently shifting its labor mix to the lowest cost labor categories, particularly casual labor." *Id.* at 28. As a result of his investigation, Dr. Bozzo determined that adding wages as a control variable to his regressions was required to ensue consistency with economic cost theory. *Id.* at 27-28. Dr. Bozzo also indicated that the results of including the wage rate as an explanatory variable yielded the result that the elasticity of workhours with respect to the wage rate is negative, "as economic theory would predict." Consequently, "if the only sustainable labor mix change were one that leads to an (unobserved) increase in wages, the real labor demand would decrease in response." *Id.*

⁶ It should be noted that in Docket No. R87-1, the Commission concluded, "The Postal Service cannot be said to have control over the delivery points it is required to serve. If homes or businesses are built, the Postal Service must adjust its carrier routes to serve them." PRC Op., R87-1, Vol. 1, at 303.

Another area of Commission concern in the last docket was the number of untested assumptions inherent in the new methodology. As Dr. Bozzo persuasively argues, however, the 100 percent assumption rested on untested assumptions as well. For example, the so-called "proportionality" assumption is inherent in all treatments, past and present, of mail processing variability -- whether the Postal Service, UPS or Commission methods -- because all treatments are variations on the "distribution key" method. "[A]ll apply IOCS-based distribution keys to MODS- and/or IOCS-based pools of volume variable cost." *Id.* at 29. Of course, the biggest untested assumption of all has been the assumption that mail processing labor costs vary 100 percent with volume. That assumption has been put to the test twice, and failed both times.

Dr. Bradley's evaluation of his volume variability factors at the sample mean was also a source of concern in the last docket. Dr. Bozzo calculates his results at the sample mean of the explanatory variables, as well as under alternative methods advocated by intervenors (in the context of carrier costing) in Docket No. R90-1. He determines that the sample mean method is supportable, but also demonstrates that the results are not materially altered under the alternative methods. *Id.*

In Docket No. R97-1, the Commission seemed to find the economic underpinning of Dr. Bradley's models to be questionable. In this docket, Dr. Bozzo specifies a more traditional labor demand function and accordingly includes a labor price (wage) and capital variable in his regressions. *Id.* at 31.

The Commission also seemed distrustful of Dr. Bradley's results since they seemed to run counter to simple data plots, which appeared to support the 100 percent volume variability assumption. Reliance on simple data plots should be put to rest,

once and for all, in this docket. The dangers of "eyeballing" data plots have been convincingly demonstrated by Dr. Smith's conclusion that witness Degen's graphs "can be used to justify" the pooled or between models, when witness Degen ***specifically constructed the graphs so that the fixed effects model was the only correct one.*** Compare OCA-T-4 at 58, Tr. 27/13207 with USPS-RT-5 at 8; Tr. 38/17313. As Professor Greene stated, "I would caution the Commission against relying on any visual devices of this sort. I do not believe that the eye is capable of resolving such evidence at a level approaching "compelling" or even convincing." USPS-RT-7 at 36, Tr. 46E/22071.

If there has been any element of "deja vu all over again" in this case, it has been the interminable rehashing of the argument that MODS data are no good. This is not to say that data error is not a concern; it surely is. As has been proven in this case, however, the concern is totally out of proportion to the problem. For one thing, Dr. Bozzo's data screens have eliminated much questionable data. See Postal Service Brief at V-47-49. Perhaps more importantly, however, are Professor Greene's conclusions. Professor Greene, a prominent authority on econometrics, whose work, *Econometric Analysis*, has been relied upon by virtually every econometrician in recent proceedings, concluded:

The MODS and PIRS data are obviously far from perfect. But, from my vantage point, they appear to be quite good, and in the absence of a well designed and sharply focused data set designed specifically for studying volume variability, are as good as an analyst of mail processing costs could hope for.

USPS-RT-7 at 5, Tr. 46E/22040.

Professor Greene also forcefully disputed the assumption from both the last docket and this one that the existence of measurement error automatically translates into a downward bias in the variabilities. Professor Greene said, "The suggestion that measurement error biases all coefficients downward is ***generally not correct.***" Id. at 23 (emphasis added). Furthermore, Professor Greene concluded that it is not even known whether biases in the coefficients carry through to biases in the volume variability factors. Id. In addition, Professor Greene demonstrates how the effect of measurement error can be insignificant. He shows that even a variation of as much as 20 percent in either direction from the true value of a variable results in a mere 1 percent bias in the estimated coefficient. Id. at 25. As a result, Professor Greene concludes that "criticisms of the models based on measurement error, while certainly to be taken seriously, are greatly exaggerated." Id. at 26.

Professor Greene observes that the R-squared values for Dr. Bozzo's models are extremely high, which is significant because an effect of measurement error would be to push the R-squared values downwards. Id. at 24-25. This led Professor Greene to conclude, "Given values this high, I suspect that measurement error is not a major factor here." Id. In other words, if the MODS data were as infected with error as has been asserted, Dr. Bozzo's models simply would not work. But the fact is they do work quite well.⁷

⁷ Dr. Neels shapes level variability models also have high R-squared values, which clearly reinforces Professor Greene's conclusion that measurement error is not a significant issue.

Finally, the Commission and the parties cannot have it both ways. If MODS data are sufficiently reliable for cost pool formation for cost distribution, then they are just as reliable for the variability analysis.

- c. The appropriate resolution, and the only one supported by substantial evidence of record, is to recommend lower volume variabilities now.

Although the Postal Service's mail processing volume variabilities in this case and the last one have generated controversy, that does not mean that they have produced wrong results. On the contrary, substantial evidence of record shows that the results are correct. Likewise, the existence of controversy over a proposal does not mean that acceptance of that proposal should wait for another day. There have been other controversial costing proposals which were accepted by the Commission and upheld by the courts, where supported by the evidence of record. For example, in *Newsweek, Inc. v. U. S. Postal Service*, 663 F.2d 1186 (2d Cir. 1981), the Court upheld the Commission's finding that purchased transportation latent capacity costs were volume variable, where "the PRC was addressed by witnesses of ten parties on this subject, with evidence supporting as well as rejecting a conclusion of volume variability." *Id.* at 1208. There is no basis to postpone a decision adopting less than 100 percent volume variabilities.

A "working group", as suggested by OCA, will **not** work. Because of their entrenched interests, discussed above, both OCA and UPS have no desire to resolve any issues connected with volume variability, whether those issues are real or manufactured. Nor is there any evident basis for consensus between the Postal Service, the OCA, the Periodicals mailers, UPS, and other potentially interested

intervenors. Such a working group would go on endlessly, with OCA and UPS raising ever-changing obstacles, as they have before the Commission. Moreover, the working group would raise due process concerns associated with attempting to resolve important costing issues outside of the traditional rate case arena.

The origins of the 100 percent volume variability assumption plainly show that it was created because rather unsophisticated efforts (at least by current standards) at regression analysis failed. USPS-T-15 at 6. In this case and the last one, the Postal Service has sponsored comprehensive, sophisticated econometric studies that have demonstrated beyond any doubt that, to whatever extent the assumption may have been correct when conceived, the 100 percent variability assumption is not empirically supported. In fact, every shred of credible evidence on this record demonstrates that variabilities differ by operation and are less than 100 percent. Dr. Bozzo's fixed-effects models show this, as do the Model A and C results from NOI No. 4. Even models that have upward biases and other conceptual problems, such as Dr. Bozzo's pooled model, the Model B results from NOI No. 4, and Dr. Neels' shape level and time series models (with appropriate necessary modifications) do not produce variabilities of 100 percent or greater. The evidence of record simply does not justify continuation of the 100 percent variability assumption.

Dr. Bozzo's results are clearly supported by substantial evidence of record, and the Postal Service urges their adoption. The Postal Service does not believe there is another equally reasonable alternative. It does, however, see some merit in the argument set forth in the Periodicals Mailers Brief that the Commission could choose variabilities for each cost pool within the range "bracketed" by Dr. Bozzo's fixed-effects

model, at the lower end, and his pooled model, at the upper end. See Periodicals Mailers Brief at 45-46. As the Periodicals Mailers have stated, "Wherever the line is drawn, it will reflect econometric results vastly superior to the totally unproven and unsupported assumption of 100 percent mail processing volume variability." *Id.* at 48. While this proposal represents only a "second-best" choice, it certainly has more foundation in the record of this proceeding than does continued adherence to an outmoded and disproven assumption.

2. Witness Degen's operational analysis provides convincing evidence that mail processing volume variabilities vary by cost pool and are less than 100 percent.

The Postal Service's initial brief (pages V-15 – V-21) summarizes the operational analysis of witness Degen, the supporting analyses of witnesses Kingsley and Stralberg, and Mr. Degen's responses to the only intervenor opposing that analysis, UPS witness Neels. Taken by itself, Mr. Degen's analysis is sufficient evidence for the Commission to conclude that mail processing volume-variabilities are less than 100 percent and vary across cost pools.

In Docket R97-1, the Commission rejected Dr. Bradley's measured variabilities in favor of the traditional assumption that mail processing costs are 100 percent volume-variable. As Dr. Bozzo explains in his direct testimony, the genesis of the traditional assumption is an ad hoc classification of mail processing cost segments as either fixed, specific-fixed, or 100 percent volume-variable. USPS-T-15 at 4-9. Whatever issues the Commission may have with respect to Dr. Bozzo's measured variabilities in this case, the operational analysis presented here is more than sufficient evidence to disprove the earlier assumption.

The brief of the Periodicals Mailers supports our conclusion referencing "the operational analyses of witnesses Degen, Cohen, and Stralberg that show why volume variability is less than 100 percent." Periodicals Mailers Brief at 36. The briefs of UPS and OCA are conspicuously quiet on the operational analysis. The UPS brief contains no mention of Mr. Degen's operational analysis even though witness Neels offered some criticisms, which witnesses Degen and Stralberg rebutted. The OCA brief contains only one mention of witness Degen's operational analysis, in a section discussing witness Cohen's recommendation to extend measured variabilities to other cost pools. The OCA brief says, "The subjective interpretations of witnesses Degen and Cohen do not replace the need for satisfactory quantitative demonstration of that view." OCA Brief at 128. Ironically, this statement is made in defense of the traditional assumption which lacked **any** quantitative demonstration. In this docket, the measured variabilities are a validation of Mr. Degen's operational analysis.

3. There is substantial evidence of record supporting the Postal Service's estimates of volume variability.
 - a. The OCA misrepresents the basis for the 100 percent variability assumption.

The OCA states in its initial brief that "The source of the 100 percent volume variability tradition is usefully recounted in witness Bozzo's testimony." OCA Brief at 77. However, without reference to the record of this or any other proceeding, the OCA contends that "a careful reading [of the Docket No. R71-1 record] indicates the intuitive logic of the 100 percent tradition in the face of unsatisfactory quantitative variability analyses." *Id.* The record evidence in this proceeding, recounted in the Postal Service's Brief at V-21 to V-23, contradicts the OCA's interpretation.

The OCA's reading misses the forest for, at best, a couple of the trees. As Dr. Bozzo showed, the 100 percent variability result was adopted not because of its incontrovertible intuitive logic, but rather "because, as the Commission and the Chief Examiner agreed, no other party offered a viable alternative." USPS-T-15 at 8, *citing* PRC Op., R71-1 at 41, 56; Docket No. R71-1, Chief Examiner's Initial Decision at 110. Furthermore, the logic behind the 100 percent variability assumption is so weak that Drs. Neels and Smith, the assumption's most ardent (in fact, its only) supporters, cannot rule out the possibility that Dr. Bozzo's results are correct on theoretical grounds. Postal Service Brief at V-26 to V-27.

- b. The OCA admits that Dr. Smith's main theoretical argument in opposition to the Postal Service's analysis is a distinction in search of a difference.

A central element of Dr. Smith's criticism of both Dr. Bozzo and Dr. Bradley was the contention that the "expansion path" was the economic relationship of interest. OCA-T-4 at 18, Tr. 27/13167. In this proceeding, the Postal Service investigated the basis for Dr. Smith's contention in several interrogatories. As Dr. Bozzo noted:

Witness Smith himself establishes that the expansion path argument does not constitute a criticism of the Postal Service's variability methods at all, for the simple reason that the cost function and expansion path are conceptually identical. Citing several authoritative texts, Dr. Smith explains, "the set of all possible pairs of output and cost along the expansion path define the cost curve."

USPS-RT-6 at 50, Tr. 46E/22199. The theory cited by Dr. Smith implies that the labor demand function approach is theoretically appropriate:

It follows immediately from the theory that Dr. Smith cites that the degree of volume-variability along the expansion path is the elasticity of labor demand (workhours) with respect to output. These are precisely the quantities Dr. Bradley and I estimated.

Id. At 51. Importantly, the OCA admits that Dr. Bozzo's argument is **correct**, as is evident from straightening out the double negative in the OCA's statement, "nothing witness Bozzo has stated in the above testimony [quoted above] is theoretically wrong." OCA Brief at 108.

Notwithstanding the fact that Dr. Bozzo (and Dr. Bradley before) estimated theoretically correct quantities, the OCA nevertheless maintains that "the sentences are misleading." Id. Once again without reference to the record, OCA claim that Dr. Bozzo "is confused about the short run and long run." The OCA further contends that "witness Bozzo mingles terms related to cost functions, expansion paths, and factor demand functions" and that Dr. Bozzo's theoretical specification is "imprecise." Id. Record evidence shows both arguments to be incorrect.

Dr. Bozzo is not "confused" about length of run issues at all. He indicates clearly that his analysis corresponds to the economic "short run" – a point on which nobody seems to disagree – and, further, that the time horizon of the "rate cycle" corresponds to the economic short run since the Postal Service cannot vary all of its productive inputs in such a relatively short period of time. USPS-RT-6 at 48; Tr. 46E/22217-18. Dr. Bozzo's statements are clear and comport well with economic theory. Evidently, OCA believes Dr. Bozzo is "confused" because he does not agree with Dr. Smith's erroneous prescriptions on "length of run." The OCA's substantive arguments on "length of run" will be discussed further, below.

Dr. Bozzo's so-called "mingling" of terms was, itself, not an instance of imprecision but rather a statement of the economic result that enables the variability

analysis to proceed in terms of factor demand functions rather than the cost or production functions from which they are derived:

Economic cost theory provides the powerful result that cost, production, and factor supply or demand functions all embody the same information about the underlying production function. Therefore, estimating labor demand functions, rather than cost or production functions, to obtain the volume-variability factors is a theoretically valid modeling approach.

USPS-T-15 at 42. Far from being "imprecise," Dr. Bozzo clearly states the theoretical result he uses. This is, of course, simply Dr. Bozzo's original statement of the theoretical point that the OCA concedes is correct. Furthermore, Dr. Bozzo specifically identified the relevant result and provided a detailed citation to its mathematical proof in response to the OCA's interrogatory OCA/USPS-T15-20(b), Tr. 15/6315. The terms were not "mingled" to confuse their meaning, but to state a result that specifically establishes that the labor demand function is appropriate – a result which, it should be noted, was originally published in 1953 in Shepard's monograph, *Cost and Production Functions* (Princeton, NJ: Princeton University Press). The OCA attempts to press its claim that Dr. Bozzo's theoretical foundations are incorrect even while admitting that Dr. Bozzo's theoretical arguments that establish the foundation for the labor demand function approach are correct.

Consequently, the OCA's criticisms of the labor demand function approach are empty and should be rejected. The OCA's admission that Dr. Bozzo's theoretical arguments were correct in this instance should be kept in mind in considering all of the other theoretical criticisms of Dr. Bozzo's methods tossed about in the OCA Brief.

- c. Contrary to UPS' assertions, Dr. Neels's alternative analyses do not support the 100 percent variability assumption.

UPS contends that Dr. Neels's alternative analyses, "while not definitive," corroborate the 100 percent variability assumption. UPS Initial Brief at 24. UPS' argument rests on a variety of gross errors in Dr. Neels's alternative analyses and should be rejected. Professor Greene identifies several significant flaws in the statistical reasoning underlying, among other things, Dr. Neels's time series and "reverse regression" analysis of FHP and recommends that the alternative analyses "should be rejected on that basis alone." USPS-RT-7 at 5; Tr. 46E/22040. However, the flaws in Dr. Neels's alternative analyses are not merely theoretical. As established by Dr. Bozzo, the result that the aggregate time series and FHP analyses corroborate the 100 percent variability assumption completely vanishes when minimal efforts are made to correct Dr. Neels's gross errors. USPS-RT-6 at 7, 21; Tr. 46E/22156 and 22170. Further, as both Dr. Bozzo and Mr. Stralberg note, without the inappropriate FHP adjustment, Dr. Neels's shapes level models yield variabilities significantly *below* 100 percent, and indeed an overall level of variability *lower* than that produced by Dr. Bozzo's models. Id at 23; see also TW-RT-1 at 18; Tr. 38/17286.

- d. The UPS and OCA criticisms of the use of TPH as the cost driver for the mail processing operations are invalid.

UPS and the OCA contend that "the Postal Service persists in using an inappropriate cost driver for determining the volume variability of mail processing costs." UPS Initial Brief at 18; see also OCA Initial Brief at 101-03. The argument is based on the incorrect characterization that Dr. Bozzo (and Dr. Bradley) "use... piece handlings

Conceptually, the "cost driver" should "reflect the essential activity of the cost pool." Tech Report 1 at 18.⁹ In that regard, TPH (or, for automated operations, TPF) is clearly superior to FHP. The "essential activity" of the activities studied by Dr. Bozzo is sorting the mail. By definition, TPH measures of the number of sorts performed in the operation, and thus is an appropriate choice of cost driver for sorting operations, as described in the Postal Service's Initial Brief at V-32-33. FHP, on the other hand, has two major conceptual deficiencies, described by Dr. Bozzo. USPS-T-15 at 50-51. First, FHP counts are only recorded in the operation where a piece is first handled. No FHP are recorded in downstream operations. Thus, FHP represents only a fraction of the sorts performed in an operation. Second, the work content per FHP varies from piece to piece depending on how many sorts are required. FHP completely ignores the workload involved in re-handling. According to UPS, "Dr. Neels does not dispute that TPH may be more closely related to workload than is FHP." UPS Brief at 20. UPS's admission is significant, as the preceding discussion establishes that identifying the best measure of workload is the goal for identifying a cost driver. It follows immediately that since TPH is a better measure of sorting operation workload than FHP, it is a better

⁸ (...continued)

pool. UPS has omitted to clarify that the assumption is only applied within cost pools, and that the relationship between volume and handlings is allowed to vary from year to year. Dr. Bozzo's discussion in his direct testimony explains these appropriate qualifications. USPS-T-15 at 53-55.

⁹ Identifying the "essential activity" of a cost pool, it should be noted, is primarily an operational, as opposed to an econometric, issue. Thus, UPS' contention that Mr. Stralberg's observations on the appropriateness of TPH as a cost driver have "limited utility" because Mr. Stralberg is "not an econometrician" is inapt. UPS Brief at 20. The lack of relevant experience with Postal Service operations of Drs. Neels and Smith is arguably more important in this context.

choice of cost driver than FHP. Dr. Neels's claims to the contrary are conceptually unsupportable.

UPS claims that Dr. Bradley "testified... [that] a disproportionate relationship between the measured cost driver and volume requires that the elasticity estimates be adjusted to reflect that relationship." UPS Brief at 18. UPS further contends that Dr. Neels "made that adjustment in the case of mail processing." *Id.* In Dr. Bradley's cited testimony, the antecedent of "elasticity" is the elasticity "of cubic foot-miles with respect to [RPW] volume," not the elasticity of cost with respect to cubic foot-miles. USPS-RT-8 at 3, Tr. 43/18388. Dr. Bradley clarifies that "the established models [of purchased transportation variability]... are designed to estimate the response in cost with respect to changes in cubic foot-miles." *Id.* Dr. Bradley further indicates that Mr. Nelson's claim regarding the lack of proportionality between cubic foot-miles and volume "does not imply adjusting existing econometric models." *Id.* But the real point of Dr. Bradley's discussion was to establish that Mr. Nelson had provided "no evidence" regarding the relationship between cubic foot-miles and the relevant — RPW — volumes. *Id.* at 4. In this regard, Dr. Neels and Mr. Nelson are in the same boat, as Dr. Neels admits that he has not conducted any analysis of the relationship between TPH and RPW volumes — which would be needed to put Dr. Bozzo's real "proportionality assumption" to the test -- and that his FHP adjustment requires a proportionality assumption of its own. Tr. 27/13046-7. Accordingly, as Dr. Bozzo states:

[T]he evidence Dr. Neels provides purporting to overturn the "proportionality assumption" does nothing of the sort. Dr. Neels employed an inappropriate estimation method to produce a nonsolution to a nonproblem. The Commission should reject his analysis.

USPS-RT-6 at 21; Tr. 46E/22170.

UPS argues that “even if Dr. Neels’[s] estimate of the TPH/FHP elasticity overstates the true elasticity, Dr. Bozzo’s calculation understates that elasticity.... Given the spread between those bounds, one cannot comfortably conclude that the relationship is proportional.” UPS Brief at 19 (citation omitted). UPS’s statistical logic is flawed. Generally, one only rejects a “null hypothesis” value of a measured quantity (in this case, 100 percent) if it falls outside established bounds. In this case, 100 percent variability of TPH with respect to FHP falls *within* those bounds, wide though they are. Furthermore, UPS ignores an important point raised by Professor Greene in the material it cites in support of its argument. Professor Greene states that “It is tempting to average those two [the direct and reverse regression estimates], but that would be incorrect. It doesn’t bracket it [the true value] symmetrically.” Tr. 46E/22102. Consequently, the width and asymmetry of the brackets does not indicate the likelihood that the variability of TPH with respect to FHP is actually greater than 100 percent. For that to be shown, it would have to be the case that the direct regression estimates yielded a greater than 100 percent variability, which they do not.

UPS also ignores Professor Greene’s most damning critique of Dr. Neels’s reverse regression analysis, that it does not solve the errors-in-variables problem, and indeed introduces a bias entirely of its own:

Whether or not there is measurement error -- indeed, independently of the measurement error -- the Neels [reverse regression] estimator will overestimate the true coefficient that he seeks.

USPS-RT-7 at 35; Tr. 46E/22070. The reason is that the “reverse regression” estimator introduces a correlation between the “independent variable, y” and the reverse

regression disturbance, in violation of an assumption of the regression model. Id. So, even if there were no measurement error, there would be a spread between the direct and reverse regression estimates. However, in that case, the direct regression estimates would be unbiased and consistent, while the reverse regression estimates would be biased. The only conclusion that can safely be drawn is that no evidence has been presented to overturn the proportionality assumption.

- e. Graphical analysis is not a compelling alternative to quantitative statistical analysis.

The OCA persists in repeating Dr. Smith's claim that visual inspection of plots of workhours and TPH can provide a "compelling" indication of the degree of volume-variability. OCA Brief at 118 et seq. The fatal statistical errors embodied in the visual approach have been described in depth by both Dr. Bozzo and Professor Greene, and on that basis alone, visual analysis should be rejected as a basis for determining the variability of mail processing. USPS-T-15 at 59-63; USPS-RT-7 at 36-38; Tr. 46E/22071-3.

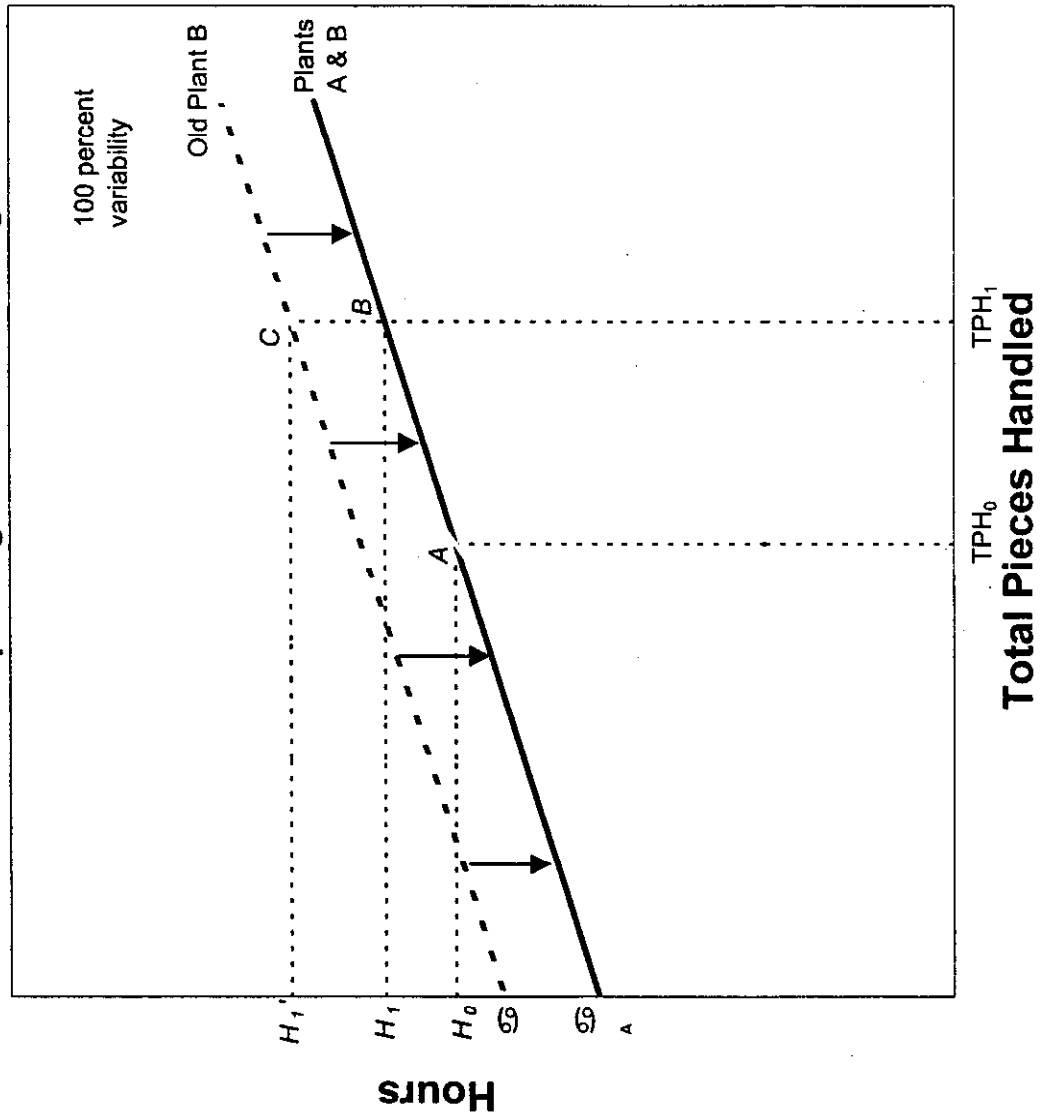
In this case, even Dr. Smith drives, perhaps unwittingly, a few nails into the lid of the coffin. Dr. Smith observes that the simple regression models to which the visual analysis corresponds are "econometrically indefensible." OCA-T-4 at 67, Tr. 27/13216; see also Tr. 27/13329. Additionally, Dr. Smith attempts to reinterpret a graphical example in Mr. Degen's testimony in an attempt to show that the "fixed effects approach is unsuitable." OCA-T-4 at 58-63. However, in "seeing" the pooled line in the example constructed by Mr. Degen, Dr. Smith was demonstrating the fallacy of the visual analysis. In Mr. Degen's example, the fixed-effects model was by construction

the correct model, and the pooled line, which was superimposed for comparison's sake, had nothing whatsoever to do with the process that generated the "data." USPS-RT-5 at 8, Tr. 38/17313. The problem is that the eye cannot resolve the finer structure of the data in plots such as those that Dr. Smith examined in Docket No. R97-1.

Nevertheless, the OCA continue to try to resurrect Dr. Smith's reinterpretation, advancing the Mr. Degen's Figure 5 (repeated by Dr. Smith at Tr. 27/13211) graph as a possible illustration of the case in which the plants are otherwise identical, with the higher cost plant "operated by incompetent management." OCA Brief at 118. This interpretation, in fact, makes matters even worse than Dr. Smith's previous muddle. In the example the OCA offers, the difference in the plants' levels of cost is, by definition, the result of the poor management at "Plant B." The situation described by the OCA is depicted in Figure A, below, which is based on Mr. Degen's Table 5. In this case, the 100 percent variability line would inappropriately attribute the cost difference to volumes, when by definition it is due to the management inefficiency. Furthermore, if, in the long run, the "incompetent management" at plant B were to be fired, and replaced with management as good as that at "Plant A," the effect of the shift would be to make the "Plant A" cost relationship the correct one for *both* plants. The effect will not be for the plants to shift to the 100 percent variability line.

In short, no amount of twisting and turning can remedy the fatal flaws in the *graphical analysis*. The Commission must recognize that mail processing *vairabilities* can only be appropriately resolved through an appropriate, quantitative statistical analysis.

Figure 5'
Effect of Replacing Inefficient Management



- f. Dr. Bozzo's discussion of the relationship between the labor and capital variabilities has been mischaracterized by the OCA.

The OCA claims that Dr. Bozzo's "treatment of homotheticity is wrong." OCA Initial Brief at 115. To clarify the record, the Postal Service notes that Dr. Bozzo's "treatment" was not the presentation of an empirical result, but rather a statement that there is a basis in cost theory for the "piggyback" treatment of capital costs in which the Postal Service "applies the estimated volume-variability factors for mail processing labor cost pools to the corresponding capital cost pools." USPS-T-15 at 39-40. The piggyback treatment is not unique to capital costs in the Postal Service's CRA. Both the Postal Service and Commission CRAs rely on "piggyback" assumptions for a number of cost components where direct analyses of variability do not exist for one reason or another.

In the case of capital costs, Dr. Bozzo indicates that there are significant complications to the direct estimation of capital variabilities that "would add an additional layer of controversy to those already present in volume-variability estimation for labor costs." *Id.* at 40. He concludes that "deploying reasonable assumptions to link labor and capital variabilities is a simple, feasible alternative." *Id.* Dr. Bozzo further indicates that the homotheticity assumption has precedent in the econometric cost literature: "In the empirical factor demand studies, this assumption has been used to allow the constant returns to scale assumption to be tested in a dynamic system" *Id.*

The real error is that the OCA mischaracterizes and misinterprets Dr. Bozzo's testimony. The OCA quotes Dr. Bozzo's statement, that "the capital and labor variabilities will be identical, in equilibrium, under the assumption that the cost pool-level

production (or cost) functions are *homothetic*." The statement clearly is made with relation to cost pools and not mail processing as a whole. Nonetheless, the OCA concludes, without citation to the record, "This would mean that the capital intensity of mail processing is unaffected by growth in mail volume." OCA Brief at 115. This conclusion cannot be appropriately drawn from the economic theory described by Dr. Bozzo. In his direct testimony, Dr. Bozzo, again explicitly noting that the analysis applies at the operation level, stated that the correct implication of homotheticity is that, for example, "in an automated sorting operation, the possibilities for increasing output by adding labor without increasing capital input via increased machine utilization are limited; adding machines without labor to run them would be similarly futile." USPS-T-15 at 40.

The OCA's claim of error is based on the observation that there has been a "major push by the Postal Service towards increased capital investment and automation." OCA Brief at 116. As Professor Greene, who authored "pioneering studies... of the marriage of theory and empirical estimation of cost and factor demand equations" (USPS-RT-7 at 13, Tr. 46E/22048) observes, Dr. Smith's arguments on the homotheticity topic represent a "noteworthy error" in that they have no bearing on the question of whether or not the relevant production relationships are homothetic:

Nowhere does the theory state that the firm in equilibrium will never adjust its capital labor ratio in response to changes in relative prices. Even if the technology is homothetic, the firm will respond to a change in relative prices by substituting away from the factor that is becoming more expensive unless it is unable to. This has nothing to do with whether the production function is homothetic or not.

Id. It is Dr. Smith's irrelevant arguments, which the OCA continues to promote, that are the "red herring."

- g. All the evidence supports Dr. Bozzo's treatment of capital and the manual ratio as econometrically "predetermined" variables.

The OCA suggests that a simultaneous equations model might be needed to estimate Dr. Bozzo's labor demand models, based on claims of Drs. Neels and Smith that those variables are "endogenous." OCA Brief at 113; see also Tr. 46E/22280-81. The criticism is incorrect as a matter of econometric theory, statistically unsubstantiated, and inappropriate as a characterization of the Postal Service's investment decision process.

As Dr. Bozzo indicates, the relevant econometric question is not whether or not capital and the manual ratio are "endogenous," or determined by the Postal Service, but rather whether those variables and labor are determined simultaneously. As Dr. Bozzo indicated:

I treated capital as "predetermined." This term reflects the fact that the investment decisions that determine current period capital occur well in the past, as well as explaining my choice of estimation procedure. In econometrics, **"predetermined" variables include** exogenous and **lagged endogenous variables**—the term is used in virtually every textbook treatment of the simultaneous equations problem... **The significance of the term is that a simultaneous equations estimator is not needed for a regression in which all of the explanatory variables are predetermined.**

USPS-RT-6 at 35, Tr. 46E/22184 (citation omitted, emphasis added). Accordingly, the "endogeneity" criticism is a straw man argument. Dr. Bozzo's characterization of the variables as "predetermined" does not deny that the variables are endogenous (in the sense that they are determined by the Postal Service in some way), but simply reflects

the econometric result that predetermined variables do not cause the econometric problem implied by Drs. Smith and Neels.

Dr. Neels provides no evidence at all, and Dr. Smith provides no valid evidence, to contradict the "fact that the investment decisions that determine current period capital occur well in the past." In fact, as Dr. Bozzo notes, the material cited by Dr. Smith --- in an attempt to establish support for Dr. Smith's contention that "the current level of capital is related to the current level of activity" --- actually supports Dr. Bozzo's treatment of the data as "predetermined":

The material he [Dr. Smith] cites does not support his characterization of capital costs. For example, he cites my response to OCA/USPS-T15-14, which does not concern capital costs at all. My response to OCA/USPS-T15-13, also cited, indicates that major equipment deployments usually take more than one year. Witness Degen's cited testimony, emphasizes that "One reason for this deliberate pace [of new plant construction] is the enormous time and capital commitments involved. From initial proposal to project completion, it may take anywhere from 6 to 9 years to bring a new plant on line" ... ***These responses make it clear that there are long lead times between investment decisions and the appearance of new plants and capital equipment on the workroom floor. The conclusion Dr. Smith draws from the cited material is virtually the opposite of its plain meaning. The cited material supports my treatment of capital as predetermined.***

Id. at 36-37 (emphasis added). The evidence clearly supports Dr. Bozzo's treatment of capital as predetermined.

- h. Contrary to the claims of the OCA and UPS, Dr. Bozzo's models do not treat mail processing operations as independent of each other.

UPS contends that interrelationships among operations are "largely ignored by Dr. Bozzo's analysis. UPS Brief at 25. OCA, likewise, claims that Dr. Bozzo "appears to ignore the internal configuration and interaction of activities." OCA Brief at 102.

Fundamentally, these contentions are not true. Dr. Neels indicates that Dr. Bozzo does, in fact, account for potential interactions of operations. Tr. 27/12950.

Dr. Bozzo accounts for those interactions in two distinct ways. First, he includes as an explanatory variable the "manual ratio," which "as a measure of the degree of automation, is clearly an indicator of the sites' organization of mailflows in letter and flat sorting operations." USPS-T-15 at 46-47. Far from being "meaningless," as Dr. Smith groundlessly contends (see OCA-T-4 at 25, Tr. 27/13174), the manual ratio reflects the "internal configuration" of plants and the "interaction of activities" within a shape-based mailstream. Second, the much maligned capital variable captures additional interactions between operations and the overall configuration of the plant. In response to an OCA interrogatory asking why Dr. Bozzo used the manual ratio "instead of a measure of the amount of automated equipment at the facility," Dr. Bozzo indicated that the "amount of automated equipment is captured in the [capital] variable" so it would be incorrect to say that he had used one measure instead of the other. Response to OCA/USPS-T15-53, Tr. 15/6355. Dr. Bozzo also explained that the reason for using a facility capital variable was that:

it is not obvious that a cost pool level capital measure would be the sole—or even the primary—economically relevant measure of capital. The effect of including the facility capital index is to capture the net effect... of the capital services employed in that cost pool as well as the capital services employed in other cost pools.

Response to UPS/USPS-T15-24(b), Tr. 15/6398-99. It is, to say the least, ironic that OCA and UPS, while contending that every operation is interconnected in myriad ways, would object to this treatment of facility capital.

Additionally, UPS' contends that Dr. Neels's alternative analyses capture those interactions. UPS Brief at 25. The argument is incorrect, and based on a fundamental statistical error in the presentations of the aggregated models: the erroneous suggestion that aggregation can add information to the estimation process. See USPS-RT-7 at 5, Tr. 46E/22040 et seq. The most "richly specified" of the alternative models, Dr. Neels's shapes-level models presented in UPS-T-1 at 57-59, Tr. 27/12829-31, includes ***exactly the same set of explanatory variables as Dr. Bozzo's cost pool models***. See also UPS-T-1, App. F, Tr. 27/12881-3. The only difference is that Dr. Neels aggregated the total piece handlings and hours by summing them over cost pools by shape. The problem, as Professor Greene notes, is that such an aggregation procedure can never add detail relative to a disaggregated model. UPS acknowledges that it "certainly can be the case" that the "aggregation hides helpful information." UPS Brief at 25, n. 11. However, the substantive implication is that if it were appropriate to aggregate -- i.e., if the hidden information were irrelevant --

then the aggregated and disaggregated approaches would produce similar estimates of the same parameters. The disaggregated approach cannot make things worse. When [the aggregated and disaggregated results] differ substantially, as they do here, the right conclusion to draw is that the aggregated approach is causing the problem. ***To reiterate, the disaggregated approach will give the right answer whether or not [the aggregated] approach is correct.***

USPS-RT-7 at 32-33, Tr. 46E/22067-68 (emphasis added). The correct inference to draw from the differences between Dr. Neels's shapes-level models and Dr. Bozzo's cost pool models is that the aggregation to shapes is inappropriate. The same

argument applies to the aggregate time series analysis. *Id.*¹⁰ To the extent the aggregate time series analysis disagrees with the disaggregated analysis, it is the aggregate time series analysis that is causing the problem.

As a further indication of problems with Dr. Neels's aggregated approach, Dr. Neels notes that it is impossible to infer differences in marginal costs between automated and manual operations. Response to USPS/UPS-T1-43, Tr. 27/12990-1.

In this case, the shapes level models obliterate a distinction—the relative costs of manual versus automated sorting operations—that is critical to accurately measuring the costs of processing letter- and flat-shape mail.

In short, the interactions of operations are not captured in the alternative models to any greater extent than they are in the disaggregated cost pool models. The arguments to the contrary are based on a basic statistical error and should be rejected.

- i. The OCA and UPS overstate the extent and importance of data problems in the MODS data set.

As they did in Docket No. R97-1, the OCA and UPS offers a great deal of speculation but no hard analysis as to the likely effect of errors in the MODS data on the estimated volume-variability factors. UPS Brief at 15-17; OCA Brief at 94-98. The Postal Service has established that the data quality criticisms advanced by the OCA and UPS greatly exaggerate the true extent of the problems, which the evidence indicates are unlikely to be severe enough to materially affect Dr. Bozzo's results.

¹⁰ Additionally, as Professor Greene notes, the time series analysis makes a large number of unwarranted assumptions regarding the structure of mail processing costs. USPS-RT-7 at 32.

Accordingly, the MODS data issues do not provide legitimate grounds for rejecting the volume-variability results. Postal Service Brief at V-46-58.

- i. UPS's arguments draw inappropriate conclusions for the overall quality of the MODS data from the manual parcel and Priority Mail cost pools. A proper appraisal of MODS data quality must correctly reflect the data collection techniques used in various cost pools.

UPS's discussions focus disproportionately on the data for the manual parcels and manual Priority Mail operations. UPS Brief at 15-17. As the Postal Service has previously indicated, those cost pools represent only six percent of the costs examined by Dr. Bozzo's study. Postal Service Brief at V-46. Furthermore, as Dr. Bozzo has indicated, the manual parcels and manual Priority Mail operations employ a different procedure for measuring TPH than manual letters and flats, which use weight conversions and "downflows," and automated operations, which use machine counts. USPS-RT-6 at 29; Tr. 46E/22178. As a result, it is inappropriate to generalize from manual parcels and Priority Mail to the other cost pools. This has not stopped Dr. Neels from doing so, however. UPS repeats Dr. Neels's contention that "there is evidence of the commingling of Manual Parcels data with SPBS data." UPS Brief at 15-16. The purpose of the theory, clearly, is to infect MODS data that are not especially problematic with the potentially more significant errors in a couple of relatively small cost pools.

The problem is that the data commingling theory is not true. At the heart of the data "commingling" theory is a basic mischaracterization of Dr. Bozzo's testimony. USPS-RT-6 at 30, Tr. 46E/22179. Dr. Bozzo noted, in response to a UPS interrogatory

related to exactly one site, that inquiries had revealed that the site had handled the pieces together "up to a point prior to separating them according to the technology that was used to sort them." *Id.* Dr. Neels's theory would require that the manual pieces enter the SPBS machine counts without being handled on the SPBS. That theory is, as Dr. Bozzo testifies, "quite simply, incorrect and inconsistent with MODS data collection procedures." *Id.* at 31. Indeed, after lengthy protestations to the contrary, Dr. Neels quietly conceded that it would be "consistent with MODS TPH and TPH recording procedures for mechanized operations" if the SPBS TPH and TPF for the site in question represented "*the machine counts of the pieces handled on the SPBS equipment,*" in which case the SPBS data for that site would not be erroneous. Tr. 27/13000-13003.

- ii. UPS overstates the likely effect of undetectable errors in the MODS data.

UPS provides additional speculation, but no analysis, as to the likely effect of "undetectable" errors in the MODS data. However, the subject is addressed by Professor Greene, who demonstrates that the effect on the regression coefficient estimates even of relatively large errors in the piece handling data are likely to be trivial, using the "guidance" from the simple textbook results. USPS-RT-7 at 25, Tr. 46E/22060. The Postal Service also demonstrated that, extending Professor Greene's example to the errors-in-variables results discussed in the August 31 hearing, the potential magnitude of the errors-in-variables bias of the fixed-effects estimates --- which is unlikely to be greater than a few percent --- remains small. Postal Service Brief at V-57. In these simple cases, which tend to overstate the magnitude of the

potential errors-in-variables problem, the errors-in-variables bias is dwarfed by the bias resulting from inappropriately applying the 100 percent variability assumption. A further indication of the maximum degree of the errors-in-variables bias is that the "pooled" variabilities, and the very similar variabilities from Dr. Neels's "Model B" estimates, which the received wisdom would suggest are biased upward in the presence of errors-in-variables, are themselves significantly below 100 percent. See USPS-T-15, App. F; Tr. 46E/22296 and 22319 (Neels). That even upwardly biased results fail to support the 100 percent variability assumption provides a powerful indication that the assumption is wrong.

- iii. Dr. Neels's inability to explain certain of the MODS data does not make the data inexplicable.

UPS's arguments also illogically suggest that Dr. Neels's inability to explain certain characteristics of the MODS renders the data issues inexplicable. In fact, many of the issues discussed by Dr. Neels were anticipated and explained in Dr. Bozzo's direct testimony, and consequently were dismissed in the Postal Service's Brief at V-47-49. For instance, UPS describes as "inexplicable" FHP values exceeding TPH. UPS Brief at 17. On the contrary, the simple explanation is that the FHP are determined through the application of national weight conversion factors whereas TPH and TPF for automated operations are based on machine counts. Postal Service Brief at V-32. Since the machine counts are, in principle, more accurate than the weight conversions, Dr. Bozzo not inexplicably advocates using the machine counted data.

- iv. Most of the MODS data make sense, and Dr. Bozzo's results are robust to the details of the data screening process.

UPS contends that "much of the data just does not make sense," but pointedly avoids quantifying "much" outside of the manual parcels and manual Priority Mail cost pools. UPS Brief at 17. As the Postal Service has demonstrated, for the other eight operations that account for the vast majority — 94 percent --- of the costs analyzed by Dr. Bozzo, "much" means a couple to perhaps ten percent. Postal Service Brief at V-47. For those operations, the error rates are routine by the standards of the statistics literature. Dr. Bozzo's treatment of these erroneous observations is to drop them from the sample or to attempt to correct them, which is also appropriate statistical practice. USPS-T-15 at 81. In other words, *most* of the data -- from two-thirds or so in the case of the manual parcels operation to over 95 percent for automated operations such as BCS and OCR --- do not exhibit obvious errors.

Even in the case of manual parcels and manual Priority Mail, UPS completely fails to acknowledge that Dr. Bozzo conducted a number of sensitivity tests of his results to the choice of regression sample, and no matter how the data are (or are not) screened, the variabilities for those operations are low. For instance, relaxing the minimum observations requirement to four observations from eight increases the number of manual parcels observations passing the threshold, productivity, and *minimum observations screens* by 379 observations, or 9.6 percent, from 3936 observations to 4315 observations. See Tr. 15/6428 (Bozzo); USPS-LR-I-107, Section 1 (varnl-tph-4obs.out). The estimated manual parcel variability changes by only a fraction of a percentage point, to 0.518, as a result of adding those observations.

USPS-T-15, App. B., at 141. If the screens are tightened so that only those sites whose entire data series pass the screens are included, the variability from the much smaller resulting sample is 0.531. *Id.* Dr. Bozzo shows that his results are robust to the inclusion or exclusion of observations at the margins of the data screens. *Id.* at 140-141.

Finally, Professor Greene observes that, from a statistical standpoint, the amount of data discarded in the screening process, in itself, is not relevant. USPS-RT-7 at 15, Tr. 46E/22050. Rather, the relevant issue is whether the estimates resulting from the remaining sample are biased as a result of the screens. *Id.* Had Dr. Bradley or Dr. Bozzo randomly thrown away three-quarters of the data, the variabilities could have been based on the remaining quarter without introducing a bias. *Id.* In reality, while the amount of observations discarded "might seem extreme" in a few cases, "it must be recalled that the sample[s] that remain contained thousands of observations, not dozens, and the analysis only attempted to estimate a relative handful of coefficients." Accordingly, given the choice to use obviously erroneous observations or to eliminate them, "scrubbing" is "the right course." *Id.* at 20. Professor Greene also reviews Dr. Bozzo's procedures and results and finds no evidence that the screens systematically biased the results downwards. *Id.* at 18.

- v. The questions raised in Docket No. R84-1 as to the suitability of the MODS data have long since been resolved.

UPS raises sixteen-year-old Postal Service concerns to question the suitability of the MODS data for mail processing volume-variability analysis. UPS Brief at 15. As the Postal Service noted in its initial brief, the substantive issues raised by the Postal

Service in Docket No. R84-1 were resolved in the 1987 M-32 handbook, which established the required standard procedures for MODS operation classifications, workhour, and volume measurement. Postal Service Initial Brief at V-44. Consequently, the concern cited by UPS is unfounded. In any event, if age of citation is the criteria for the validity of using MODS data, Dr. Bozzo trumps everyone with his citation to Docket No. R71-1 material recommending that "regression techniques should be applied to WLRS [a precursor of MODS] data on manhours and piece handlings, to determine whether they will yield meaningful fixed and variable components." USPS-T-15 at 14, citing PRC Op. R71-1, Vol. 4 at 4-132. Furthermore, if the concerns raised about MODS data in Docket No. R84-1 were still valid, it would be impossible to derive the statistically meaningful and robust results demonstrated by Drs. Bozzo and Bradley from those data.

- j. UPS's claim that the Postal Service's cost estimates are inappropriately "short run" are incorrect.

OCA and UPS contend that the Postal Service has produced inappropriately short run cost estimates. UPS contends that, while Dr. Bozzo's models reflect a greater length of run than Dr. Bradley's, they are still too short run. UPS Brief at 21. UPS also suggests that Dr. Bozzo's analysis inappropriately fails to capture the cost effects of a variety of operational adjustments. *Id.* at 22. OCA simply maintain that "long run" cost estimates are economically appropriate. OCA Brief at 109. The Postal Service has noted that the appropriate time horizon, the "rate cycle," relates to a period of time in which not all of the productive inputs and technologies employed by the Postal Service can be freely varied, and therefore that time period does not correspond to the

economic concept of the "long run." Postal Service Brief at V-40-41. Therefore, the OCA's recommendation of long-run costing is incorrect.

The Postal Service has previously noted that Drs. Neels and Smith, in pressing the arguments that the Postal Service's analysis is excessively "short run," neglect the critical role played by the rollforward model – described by witness Degen in USPS-T-16 – in ensuring that the Postal Service's cost analysis appropriately reflects operational changes over the "rate cycle." Postal Service Brief at V-41-42.

Mr. Degen's testimony is far from the first or only description of the essential interaction of the historical Base Year and rollforward analyses to provide appropriate economic cost estimates for ratemaking. The role of the rollforward model Mr. Degen describes has also been recognized by the Data Quality Study as an essential element of the overall analysis of costs for ratemaking. The Data Quality Study authors note that:

To comply with the requirement that such cost estimates [product attributable costs] be forward looking, costs estimated using historical data must be "rolled forward" to account for expected changes. Such roll forward procedures are well understood in the Postal Service.

Tech Report 1 at 5. The Data Quality Study further concludes that because the Base Year costs are "estimated using historical data" but "forward-looking" costs are required, the application of the rollforward "to reflect expected changes going forward... is appropriate." Tech Report 1 at 14. The roll forward mechanism explicitly accounts for the "forecast operating regime":

The Postal Service uses forecast demand for the various postal products along with an assumed or forecast operating regime to derive the total cost of operations for future periods. The impact of these forecast demands on each

cost pool (segment, component or element) is extrapolated to derive the total future cost of operations.

Tech Report 1 at 22. The Base Year volume-variability analysis does not and, conceptually, should not shoulder the full burden of representing the correct "length of run" for the analysis. Thus, criticisms that imply that the Postal Service's Test Year costs for ratemaking are overly "short run" because of the short run nature of the base year variabilities are incorrect and should be rejected.

Finally, the belief expressed by both the OCA and UPS that a longer run analysis will lead to the assumed 100 percent volume-variability result is erroneous. In support of the assumed 100 percent variability of mail processing operations, UPS alleges that the Postal Service can change mail processing capabilities to respond to volume changes in a number of ways, and that Dr. Bozzo's analysis fails to capture the impact of volume on longer term changes in the mix of resources used to adopt to volume changes. UPS Brief at 24.

In many respects, this argument is similar to one advanced by UPS in Docket Nos. R84-1 and R87-1 with respect to purchased transportation. In those dockets, UPS witness Higinbotham *assumed*, in the absence of any data to the contrary, that the number of vehicles will increase over time by the same percentage as mail volume, and that, with this assumption, the long run variability of highway transportation is 100 percent. See, PRC Op., R87-1, Vol. 1 at 315. UPS described this assumption as reasonable, and argued that any other approach would presume that the Postal Service is operating inefficiently. *Id.* at 316. The Commission rejected that approach:

The record shows that managers chose from a full range of alternatives in meeting the demands caused by volume changes. Many less costly

alternatives , such as requiring an extra trip, or rearranging the routes serving a number of facilities, may be employed before an additional truck is put under contract. We conclude that a proportionate increase in the number of vehicles as volume increases is not an acceptable theory of how the network operates. Therefore, we cannot accept witness Higinbotham's interpretation of his longer-run regression analysis, which supports his assertion that purchased transportation costs are completely variable with volume.

Id. Consequently, in Docket No. R87-1, the Commission accepted the conclusion that highway costs are less than 100 percent variable, and that conclusion has been universally accepted ever since.

In this case, Drs. Neels and Smith are in much the same position as Dr. Higinbotham. They claim that they don't have the data and analysis to definitively resolve the degree of mail processing variability, be it 100 percent or some other number (or numbers). Nevertheless, they are quite confident that when you throw everything into the hopper, over longer stretches of time, it can safely be assumed that costs will respond in direct proportion to volume. See OCA Brief at 109-11. Despite what amounts to unequivocal evidence that mail processing hours in processing operations change *less* than proportionately in responses to changes in mail volumes in those operations, the argument goes, other factors preclude the Postal Service from capturing such "short run" economies. The response to this should be the same as that of the Commission to Dr. Higinbotham in Docket No. R87-1. If the Postal Service has a "full spectrum" of responses to changes in volumes, as Dr. Neels suggests it would in the longer run, then it makes absolutely no sense to assume that the Postal Service would use that flexibility to employ more costly, rather than less costly, alternatives to existing mail processing methods. See also TW-RT-1 at 15-17, Tr. 38/17283-85. As

the Commission noted with respect to purchased transportation, this "is not an acceptable theory of how the network operates." PRC Op., R87-1, Vol. 1, at 316.

4. The Postal Service's distribution of mail processing costs must be adopted.
 - a. The MODS-based partition of clerk and mail handler costs is well supported and without real criticism in this record; the Commission should adopt it.

Initial briefs confirm that this record contains substantial support for and only minor criticism of the Postal Service's proposed MODS-based partition of clerk and mail handler costs. Mr. Degen's support and Mr. Stralberg's qualified support for the Postal Service's proposed partition are summarized in the Postal Service's initial brief, which also documents Mr. Sellick and Dr. Neels's lack of criticism of the Postal Service's proposal. Postal Service Brief at V-62-65. The briefs of UPS and the Periodicals mailers do not argue otherwise.

The only contested issue with respect to the proposed MODS-based partition, remains witness Stralberg's argument that the not-handling costs, "migrated" from window service to mail processing should be distributed to subclass using the window service distribution key. Tr. 24/11390.

Witness Stralberg is concerned with not-handling tallies for which there appears to be conflicting information. The tallies at issue indicate that the observed clerks were clocked into MODS mail processing operations, yet observed working in window service locations. The brief of the Periodicals mailers argues that witness Degen "denigrates" witness Stralberg's anecdotal evidence of such anomalies. Periodicals Mailers Brief at 27. A more complete reading of Mr. Degen's cited testimony shows that Periodical

Mailers are simply setting up a straw man to refute, rather than addressing Mr. Degen's real criticisms.

Mr. Degen's testimony clearly states that he "do[es] not dispute that this [clerks assigned to window duties without re-clocking] occurs, but the extent is unknown." Tr. 38/17310. Witness Degen is not questioning the number of tallies showing workers clocked into mail processing who are observed at window service locations. He is disputing Mr. Stralberg's conclusion that **all** these workers were, in fact, performing the retail sales activities that constitute the bulk of the window service activities in cost segment 3.2. Witness Degen goes on to explain that "clerks who move between mail processing and window service can perform only very limited functions." Id.

The fact that mail-processing clerks would not have stamp stock and could not perform cash transactions is not disputed or even acknowledged by the Periodicals Mailers. Further, witness Stralberg is unable to quantify the extent to which the tallies at issue represent mail processing workers actually performing window sales activities versus activities such as customer pick-up of mail or obtaining collection mail from the window. Consequently, the Commission has no basis to modify the Postal Service's proposed distribution of these "migrated" costs.

- b. The record contains substantial support for and no opposition to broad distribution of allied not-handling costs.

The Postal Service, the Periodicals mailers, AAP, and UPS all support broad distribution of allied not-handling costs in there respective briefs. Postal Service Brief at V-67, Periodicals Mailers Brief at 22-23, AAP Brief at 14, and Tr. 27/13125 (Sellick). The Commission has no basis in the current record to do otherwise.

- c. There is substantial support for the broad distribution of mail processing support costs across the cost pools being supported and the Commission should adopt this proposal.

The Postal Service proposed that support cost pool costs be broadly distributed across the mail processing operations that they support. UPS and the Periodicals mailers support this proposal. Tr. 27/13125 (Sellick) and Tr. 24/11388 (Stralberg). However, the Periodicals mailers argue for one modification. Citing the testimony of witness Stralberg, they call for the direct tally costs in the support cost pools to be distributed to the subclass with which they are identified. Page 28. Witness Degen explained that piece handlings were incidental to support activities and, therefore, were not causing the associated support activities. USPS-T-16 at 57 and Tr. 38/17329.

The Periodicals mailers point out that these "incidental" costs are \$80 million. Periodicals Mailers Brief at 21, n.8. They are using the wrong definition of incidental. Mr. Degen is arguing that piece handlings of support workers are "without intention or calculation" not "minor consequences." *Webster's New Collegiate Dictionary*, 1975. Mr. Degen's testimony is very clear. He says, "actual piece handlings are incidental to, **rather than the cause of**, those support activities [emphasis added]." Tr. 38/17329. There is no testimony in this record that demonstrates or even hypothesizes why there should be a causal link between support activities and the pieces support workers may handle. The Periodicals mailers argument in this proceeding is somewhat ironic given that, as early as Docket No. R94-1, Time Warner and Dow Jones (correctly) "dispute[d] the long-held presumption that a direct tally always represents an attributable cost." PRC Op., R94-1, at III-4 (referencing Time Warner and Dow Jones reply brief). The

Commission should, therefore, accept the Postal Service proposal, which distributes *all* support cost pool costs over the activities being supported.

- d. There is some agreement and some disagreement with respect to the Postal Service's proposed mixed-mail distribution.

There are several issues regarding mixed-mail cost distribution that have arisen in this docket. Witness Sellick adopts the Postal Service's mixed-mail distribution methodology as proposed for his calculations. Tr. 27/13124-13126. The Periodicals mailers recommend broadening the distribution of allied mixed-mail costs and the use of question 19 data to distribute mixed-mail for allied, support, and Function 4 cost pools. Periodicals Mailers Brief at 28. AAP supports broadened distribution of allied mixed-mail costs. AAP Brief at 14. The Postal service accepts a broader distribution of allied mixed-mail costs, but rejects reliance on question 19.

- i. The Postal Service accepts the broadening of allied mixed-mail distribution, but item/container information must be used.

The Postal Service proposed in its direct case that mixed-mail distribution by item and container be confined to cost pool except for the platform cost pool, for which the distribution key is based on all allied cost pools. In response to questioning from MPA, witness Degen accepted that a broader distribution of allied mixed-mail costs would be reasonable inasmuch as it would increase the sample size for the distribution key, though it would not necessarily be more accurate. Tr. 38/17323. However, he also indicated that strong associations between item/container and subclass are well established and should not be ignored, as the Commission did in its Docket No. R97-1

methodology. Tr. 38/17322-17323. The evidence supports a broadened distribution of allied mixed-mail costs *within* item and container type.

- ii. Use of question 19 in lieu of item/container discards useful information and relies on an unjustifiable association between location and shape; the Commission should reject it.

Witness Stralberg outlines his proposal for mixed-mail distribution based on question 19 in his direct testimony. Tr. 24/11378-11386. Witness Degen criticizes the question 19 proposal for discarding information and relying on location to infer activity. Tr. 38/17324-17325. On brief, the Periodicals mailers say that Mr. Degen missed the point; item/container type and question 19 "can be used together, or separately."¹¹ Periodicals Mailers Brief at 27, n.14. On the contrary, as Mr. Degen demonstrates in USPS-RT-6, using question 19 adds essentially no information that is not already in the item/container information. Tr. 38/17324, 17349. Mr. Degen also notes that the question 19 data may be misleading. For instance, Mr. Degen explains that "When a platform worker, creating a flat-bundle or parcel sorting corral, is tallied retrieving an empty hamper from a BCS operation, Question 19 will report the BCS location. If, as witness Stralberg proposes, those costs were distributed only to letters, then flat and parcel costs would be biased downward." Tr. 38/17325.

¹¹ Section I'VE. of witness Stralberg's testimony (Tr. 24/11378-11386), which lays out his question 19-based distribution methodology, includes no statements regarding the joint or separate use of item/container information with question 19. It would appear that this is the conclusion of the attorneys, not the witness.

The Commission should reject the question 19-based proposal of witness Stralberg because it discards item/container information and because location is not evidence of causality for allied, support, and Function 4 cost pools.

- iii. The Postal Service has demonstrated that the results of its mixed-mail distribution process are reasonable; no further study is required.

In Docket R97-1, the Commission requested a study of bias, which the Postal Service had already begun. One element of that analysis was collection of a set of platform tallies from which no bias could be inferred. The sample was small, not because it was a small effort, but because studies of this type are very difficult and time consuming. The actual result of the Platform Study was contrary to witness Stralberg long-held belief that Periodicals costs are biased upward because the Postal Service's methodology assumes that mixed-mail costs have the same subclass distribution as direct costs by item type. Witness Degen's other analysis indicates that the potential bias from the other assumptions, on which the Postal Service's mixed-mail distribution are based, do not justify additional study.

Witness Degen's analysis of potential bias from the Postal Service's mixed-mail distribution assumptions remains essentially unchallenged in this record. The brief of the Periodicals mailers cites "grave inadequacies" in the Platform Study as documented by witness Glick. Periodicals Mailers Brief at 24, n.12. A thorough reading of Mr. Glick's cited testimony (Tr. 24/11221-11222) reveals only his concern with the large standard errors, which resulted from the small sample size, a fact Mr. Degen cited in his direct testimony, concluding that, even though Periodicals had a larger share of costs in

the Platform Study, there was not sufficient evidence to say Periodicals costs were being understated in the IOCS distribution. USPS-T-16 at 65.

Mr. Stralberg's theories of bias from pallets were not confirmed by the Postal Service's study, yet the Periodicals mailers repeat them, calling for still more work. The Commission should accept the Postal Service's analysis and not request additional study of this issue.

5. The Postal Service's treatment of overhead costs as volume variable is proper.

In developing base year costs in this case, as in other cases going back many years, the Postal Service assumes that overhead costs (breaks/personal needs, clocking in/out, and not-handling tallies in the empty equipment operations) are volume-variable to the same degree as non-overhead activities in those cost pools. The AAP brief argues that witness Siwek showed that the Postal Service's assumption was "sweeping in its breadth" and that "one could equally justify the unsupported assumption that these overhead costs have no relationship to volume whatsoever." AAP Brief at 12.

Mr. Siwek **showed** no such thing. He simply asserted that it was true. Tr. 30/14573. His views do not withstand scrutiny. For example, in the established methodology, breaks/personal needs are assumed to be proportional to workhours, which means that they would be volume-variable to the same degree as non-overhead costs in their respective cost pools. Breaks vary in proportion to workhours by contract, and the assumption that personal needs change in response to changes in workhours is so obvious as to make arguments to the contrary unsustainable on their face.

Clocking in and out occurs at the beginning and end of every shift as well as at the lunch break. At least those clockings must vary in proportion to the number of employees, if not directly with workhours. Finally, the not-handling costs in the empty equipment cost pool are assumed to be proportional to handling costs, just as they are in all other costs pools.

Mr. Siwek has completely overlooked the fact that for cost pools for which measured variabilities are used, the Postal Service is relying on quantitative evidence of the appropriate level of volume-variable costs, irrespective of whether those costs can be classified as "overhead." For the cost pools without measured volume-variabilities, the Postal Service has employed the Commission's long-approved method, except for the broad distribution of not-handling costs, which AAP supports.

Thus, Mr. Siwek's conclusions regarding overhead costs are simply speculations that are contrary to the facts underlying their incurrence. Common sense, much less even a minimal understanding of the behavior of overhead costs, shows that Mr. Siwek's assertion, that they could actually be unrelated to volume, is patently unrealistic.

6. If FY99-based costs are used, no adjustment to the costs of Special Standard mail is warranted beyond that proposed by witness Degen.

The brief of RIAA discusses the observed cost increase between FY 1998 and FY 1999 for Special Standard mail, and concludes that the Commission should follow the recommendation of its witness Elliot and ignore the FY 1999 mail processing costs reported for that subclass. RIAA Brief at 14-19. If the Commission were to adopt the approach advocated by the Postal Service and rely only on FY98-based data, the

Postal Service would be in agreement with RIAA. If, however, the Commission alternatively decides to rely on FY99-based data, the Postal Service submits that the extreme position taken by RIAA with regard to this matter is not well-founded. After incorporation of the adjustment identified by witness Degen, there is no valid reason why the FY 1999 Special Standard mail processing costs should be excluded in favor of the costs reported for that subclass in FY 1998.

Mr. Degen's adjustment is predicated on the fact that an analysis of IOCS tallies linked with the Special Standard subclass showed a significant growth between FY 1998 and FY 1999 of the subset of tallies coded as Special Standard in IOCS question 23b, but which did not have Special Standard markings in question 23c. Tr. 45/20054. As Mr. Degen indicated, there were instances of this in FY 1998, but there was significant growth in this subset of tallies in FY 1999. Tr. 45/20066. Mr. Degen's conclusion was that this subset included tallies which perhaps should have been recorded as Standard A, but instead were coded as Special Standard. The shape and weight characteristics of this group of tallies seems consistent with that possibility. Tr. 45/20054. Since he was unable to quantify which, if any, of these tallies definitely belonged in or out of Special Standard, he proposed that they all be shifted to Standard A. Tr. 45/20066.

Mr. Degen's hypothesis as to why such miscoding might have occurred in FY 1999 was that it was related to changes in the DMM regulations governing endorsements on Standard A pieces. Those changes became optional near the end of FY 1998, and were included in the package of DMM regulation changes which were published in conjunction with the January 1999 implementation of R97-1 rates. Tr.

45/20052, 20065, 20068-69. The increases in direct tallies were larger after the R97-1 rates went into effect. Tr. 45/20054. Mr. Degen also explained why the confusion that caused IOCS tallies to have been miscoded might not be expected to have caused the same effect in the RPW system. Tr. 45/20072-73.

In its brief, RIAA tries to make much out of the fact that the operative portion of the published DMM regulation is small. RIAA Brief at 17. The operative portion of the same publication that changed the single-piece First-Class rate for letters weighing under 1 ounce from 32 cents to 33 cents was also probably quite small, but that did not alter the result that the consequences of that particular change were quite substantial. Moreover, the Postal Service undertakes many additional efforts, beyond merely publishing the Postal Bulletin, to publicize changes and educate mailers on optimal mail preparation practices. Other postal publication highlight such changes, and Postal Forum workshops and MTAC sessions also keep the industry apprised of such developments. Out of necessity, large, sophisticated mailers pay close attention to changes in mail preparation regulations, and alter their mail pieces accordingly.

Moreover, RIAA overlooks the more fundamental fact that Mr. Degen did not proceed directly from a published change in allowed endorsements to a conclusion of miscoded tallies. RIAA totally fails to focus on the critical middle step in the analysis, which shows that for *some* reason, the subset of potentially miscoded tallies, based on potentially inconsistent responses to questions 23b and 23c, increased significantly from FY 1998 to FY 1999. Something happened in FY 1999 to cause that type of tally

to increase, and Mr. Degen offers a very credible explanation of what that something might be.¹²

In any event, Mr. Degen has undertaken a careful analysis of all of the available information. He has removed *all* of the tallies which he found any reason to question. Beyond that, he has found no other anomalies in the Special Standard direct tallies. Tr. 45/20061. The remaining increases in direct tallies (after his adjustment) are very broadly distributed across pay period, office, facility type, and MODS operation pool. To the extent that this information suggests an increase in Special Standard FY 1999 costs relative to those reported for FY 1998, there is no reason why that information should be ignored. After all, given variations caused by sampling error, FY 1998 could have been an unusually low year for Special Standard direct tallies just as easily as FY 1999 could have been unusually high.

RIAA's criticisms of the rationale behind Mr. Degen's proposal to shift an identified group of tallies gets them nowhere in terms of providing any legitimate basis to question the validity of the tallies that are unaffected by witness Degen's adjustment. Dr. Elliott's proposal to simply discard all of the FY 1999 mail processing tallies is much too extreme. Mr. Degen has presented an analysis which objectively identified questionable tallies, removes those tallies, and results in an overall cost increase which is large, but not implausibly so. If the Commission chooses to rely on FY99-based data, it should use the FY 1999 IOCS tallies, as adjusted by witness Degen.

¹² As described above, in some sense, identification of the significant increase in the number of questionable tallies was the first step in the analysis, rather than the middle step, but there would seem to be little point in attempting to belabor what boils down to a chicken-and-egg issue.

- C. The Commission Should Utilize the ES-based approach advocated by witness Baron to attribute city carrier costs.

The arguments raised in the initial briefs of intervenors and the OCA concerning city carrier costs have largely been addressed in the Postal Service's initial brief. There are a few points, however, that warrant comment.

1. UPS's further attempts to burden parcels with additional city carrier costs should be rejected.

In its initial brief, UPS recapitulates or recasts arguments advanced by witness Luciani in support of UPS's position that additional city carrier costs should be attributed to parcels. UPS Brief at 35-41. UPS argues that elemental load costs should be distributed among classes and subclasses of mail on the basis of weight, that the costs of sequencing parcels at the dock should be distributed to parcels, and that the costs of so-called "exclusive parcel post" and parcel post combination routes should be attributed to the classes of mail delivered on those routes. *Id.*

With the exception of UPS's attribution proposal for exclusive parcel post and parcel post combination routes costs, which is new, the Postal Service has already responded to the thrust of UPS's city carrier cost attribution arguments. See Postal Service Initial Brief at V-98-103. On brief, however, UPS makes a few points that merit refutation.

First, faced with the overwhelming expert testimony which proves that parcels are not systematically sequenced when loaded into vehicles (See Postal Service Initial Brief at V-99-102), UPS now implies that the testimony of witness Kay supports the attribution of parcel sequencing costs to parcels. UPS notes that "on cross-examination Ms. Kay agreed that there are specific and explicit written requirements for Special

Purpose Routes which instruct city carriers to sequence parcels in delivery order when loading their vehicles." UPS Brief at 38. Despite the fact that this testimony pertains strictly to special purpose routes, UPS strains to make it apply to city carrier routes generally, advancing the bold, and completely unsupported, claim that "carriers likely follow that procedure for all types of routes." *Id.* at 39.

Not only is there no record basis for assuming that carriers on regular routes sequence parcels in the same way as carriers on special purpose routes, there is every reason to reject this conclusion. Regular letter routes, to which UPS witness Luciani's analysis applies, are distinguished by the regularity of the delivery points on the route, which allow letter mail to be sorting by mail processing equipment into delivery sequence. On the other hand, special purpose routes, particularly parcel routes, are distinguished by irregularity of delivery points. Contrary to the situation on regular letter routes, the sequence of delivery on a special purpose route is determined by the mail carrier based on the mail to be delivered on each day. The special purpose route carrier must therefore review each mail piece to determine the most efficient delivery sequence. This point is emphasized in Section 624.2 of Handbook M-41, where a carrier is directed to "[r]oute parcels to insure shortest distance between stops and to prevent deadheading or excessive travel distance." See Tr. 39/17797. The UPS argument that the requirement for special purpose route carriers to sequence parcels in delivery order applies to regular letter routes has no merit, and the attribution proposal based upon it must be rejected.

In another portion of its brief, UPS tries to resuscitate witness Luciani's attempt to attribute the costs of so-called exclusive parcel post routes to parcels. Perhaps

conceding that Mr. Luciani's original argument erroneously rests upon the inexact naming of these routes, UPS now changes position. UPS now argues that because the majority of mail delivered on Exclusive Parcel Post and Parcel Post Combination routes consists of parcels (largely Priority Mail and Standard (B)), the costs for these route types should be distributed to the classes of mail causing these costs.

Unfortunately, UPS has not explained how its new proposal differs, if at all, from the existing distribution of special purpose route costs, or why it would be superior to the existing analysis if different. Postal Service witness Kay has already briefly discussed this point in her rebuttal testimony. See Tr. 39/17769, note 7. As Ms. Kay notes, in Docket No. R97-1, Postal Service witness Nelson calculated distribution keys to distribute all special purpose route costs to mail subclasses by activity. These distribution keys were weighted by route type, so that the proportion of each route type to the population of special purpose routes is accurately reflected in the key. Therefore, the distribution keys already accurately distribute costs for each route type. In addition, Mr. Nelson's analysis was more complete than the one now vaguely suggested by UPS. Mr. Nelson calculated volume variabilities for the various activities to which the distribution keys apply, an important consideration that UPS and its witness overlook. See Tr. 25/11870-71 (Luciani). UPS has provided no basis to disturb this analysis.

Finally, in an attempt to buttress its argument that elemental load costs should be distributed among the classes and subclasses of mail on the basis of weight, UPS points to the fact that "Postal Service witness Baron provided the results of a regression analysis which demonstrates that large parcels take significantly longer to load -- about 14 seconds more, on average -than do small parcels." UPS Brief at 36. It is true that

Mr. Baron's ES route-level regressions show that the average marginal load time for small parcels and rolls (SPRs) is 22.48 seconds, while the average marginal load time for parcels is 36.50 seconds. See Tr. 39/17837-38. However, UPS ignores the fact that this disparity can be accounted for by shape differences, rather than weight. Ironically, UPS acknowledges this on brief when it asks, rhetorically: "Can there be any question that most Standard Mail (A) parcels probably fit in a mailbox, while most Parcel Post parcels must be delivered at the door . . . ?" UPS Brief at 37. The ability to fit in a mail receptacle clearly is shape-related, rather than weight-related.

Moreover, the differences in SPRs and parcels are already separately accounted for in Mr. Baron's most recent load time analysis. The revised CRA worksheet for cost segment 7, provided in USPS-LR-I-450, correctly applies these load time elasticities to produce volume variable load costs. Volume variable cost for loading SPRs and for loading parcels is calculated using the above elasticities times accrued load cost. These volume variable load costs are distributed to subclasses using the CCS distribution key for parcels, since CCS counts both SPRs and parcels together. In sum, the distribution key developed by Mr. Luciani based on weight increments is unnecessary, since the ES route-level regressions already correctly develop volume variable load costs for SPRs and parcels, and the CCS provides a distribution key that can be used for both.

2. The OCA and NAA can't have it both ways: There is no compelling reason why the ES data cannot, or should not, be used to produce updated, more accurate load time variabilities as well as street time proportions.

In their briefs, both the OCA and NAA extol the obvious usefulness, timeliness

and reliability of the Engineered Standards data collected by Postal Service witness Raymond and employed by witness Baron to estimate updated street time proportions. OCA Brief at 133-35, NAA Brief at 34-38. Both of these parties concede that the ES study produces data that are more than sufficient for ratemaking purposes. *Id.* Nevertheless, despite the fact that the more recent, more reliable ES data would permit the Commission and the Postal Service to replace a mid-1980s study with data that more accurately represent test year costs (as in the parallel case of the outdated STS study), both of these parties take the contradictory stance that the ES data should not be used to update load time variabilities. OCA Brief at 135-143, NAA Brief at 42-44.

Apart from the obvious fact that the new variabilities would differ from variabilities previously used by the Commission (forming part of what these parties appear to regard as a sacrosanct precedent with respect to variabilities, but not to the reestimation of street time proportions), one or both of these parties offer a variety of arguments allegedly favoring the continued use of increasingly-stale load time variabilities. First, it is argued that the new variabilities were presented too late, have undergone revision during the case, and have received too little review to be adequately considered. Second, the objection is raised that Mr. Baron's preferred, updated route-level attribution approach does not employ the single subclass ratios used by the Commission in recent cases to attribute costs. Third, the OCA speculates that because the ES-based regression is derived from route level data, it fails to account for the effects of variation in non-volume stop characteristics on load time. Fourth, the OCA complains that the ES data have been manipulated in order to generate believable regression results. Fifth, the OCA states that the cost elasticities derived from the ES-

based regression are likely based on incorrect volume data.

It can readily be seen that these arguments do not justify the abandonment of data that are admittedly more current and reliable, and would produce more accurate cost estimates, in favor of load time variabilities that are certain to be outdated and less accurate. Some of the arguments put forward are just plain specious. Consider, for example, the argument that the new, ES-based elasticities are "likely based on incorrect volume data." OCA Brief at 141. This argument suffers from two fatal deficiencies. First, as the OCA acknowledges, the ES data used by witness Baron is fairly recent, dating to 1996-1998. At worst, these data can be described as slightly out of date; they certainly are not "incorrect."¹ Second, the LTV variabilities, upon which the OCA would have us rely instead, are based on data collected in the *mid-1980s*. If inaccuracy and staleness are the issues, the ES-based variabilities must replace the old LTV variabilities.

Or consider the complaint regarding the degree of manipulation involved in developing an ES-based regression based on ES tally data the OCA itself deems believable. OCA brief at 141. The OCA complains that the original specification of the regression "produced nonsensical results," and that the recommended ES-model specification therefore included "dummy variables to control for a subset of route level, volume-to-load-time, observations that varied significantly from the rest of the sample." *Id.* As anyone familiar with Commission proceedings can attest, manipulation of data,

¹ The ES-based regressions could certainly be updated using the most recent CCS data. The fact that Mr. Baron was never asked to do so on this record does not prohibit this analysis from being performed in future cases.

or refinements of regression analyses, are far from uncommon in Commission proceedings, and certainly have never before acted as a bar to the use of particular analyses by the Commission.²

Consider, for example, the extensive "manipulation" of the SDR, MDR, and BAM stops-level regressions as computed by the Commission in its off-the record Docket No. R90-1 analysis. See Docket No. R90-1, PRC LR-10. These regressions also include numerous dummy variables. Moreover, these variables, which account for receptacle and container types, are also required to prevent the stops-level regression model from producing "nonsensical results." Thus, if the OCA truly believes that the inclusion of dummy variables to ensure the credibility or "believability" of a regression analysis constitutes unacceptable "manipulation," then its critique applies with equal force to the stops-level regressions.

The OCA also expresses apprehension regarding whether the ES-based regression, which is derived from route-level data, fails to account for the effects of variation in non-volume stop characteristics on load time. Witness Baron has already negated this concern in his response to interrogatory UPS/USPS-T12-16(a)-(b). As this response explained, the ES-based analysis effectively accounts for non-volume effects through the inclusion of delivery-type variables on the right-hand side of the ES-based regression. These variables measure the percentage of total delivery points on a route-day that fall within the centralized, NDCBU, curbside, and other delivery categories, and

² Furthermore, in advocating the use of operationally implausible measures of attributable coverage-related load time based on the application of single-subclass ratios to a residual, the OCA again has taken a position contradictory to that which it espouses here.

the coefficients on these variables directly account for the effects of changes in delivery type composition on load times. Tr. 46-D/21100-10.

The purely procedural argument that the ES-based regressions were presented too late to be used in this docket also is without merit. This approach was first introduced as early as May 12, 2000, with the filing of USPS-LR-I-310, Draft Report on Load Time Variability Analysis Provided in Response to ADVO/USPS-T12-11. The pending filing of this analysis, moreover, was announced as early as April 24, 2000, in response to interrogatory ADVO/USPS-T12-11. Tr. 18/7094. Parties thus have been on notice since the early stages of this case that the ES data could and would be used to update load time variability. In cross-examination regarding his direct testimony, Mr. Baron early on indicated the desirability of such an approach.³ Tr. 18/7339-41.

There is no question that had an intervenor produced such an analysis in direct testimony filed in late May, or early June, the Commission would be able to consider it.⁴ The fact that the analysis was produced earlier by the Postal Service in response to discovery makes no difference, as the parties clearly had an adequate opportunity,

³ The unavoidable delay in producing desirable analyses described by witness Baron explains why the Postal Service did not employ the ES-based regression in its direct case. See Tr. 18/7339-41. The failure to employ such data in the direct testimony is not an indicator of unreliability, as the OCA implies. See OCA brief at 140. It simply means that additional time was required to produce an analysis that was sufficiently developed to release to the parties.

⁴ In fact, the Commission based its Docket No. R97-1 decision that the residual measure of coverage-related load time is correct on a mathematical analysis presented by witness Crowder in testimony filed over a month after the deadline for the filing of *intervenor* testimonies in that docket. Thus, this testimony was filed much later in Docket R97-1 compared with when Mr. Baron filed his ES-based regression analyses in the current docket.

through follow-up interrogatories and rebuttal testimony, to explore all issues surrounding the use of ES data to update load time variabilities.⁵ Furthermore, the Commission itself has accommodated receipt of a host of updated information much later in this proceeding than that provided by the Postal Service on May 12. See, e.g., Presiding Officer's Ruling No. R2000-1/71 (*Presiding Officer Ruling Revising the Procedural Schedule to Accommodate Actual FY 1999 CRA Cost Data*, issued May 26, 2000). Given that the parties have had an opportunity, both in the direct and rebuttal stages of this proceeding to explore and respond to the updated LTV analysis, it would be clear error for the Commission to eschew this analysis on procedural grounds.

The remaining argument of these parties, the implication that the updating of stale load time variabilities somehow prevents or is inconsistent with the use of single subclass ratios, also is incorrect. First of all, it should be clear that, regardless of whether ES data are employed to update variabilities, witness Baron, and the Postal Service generally, have been consistent in opposing the use of single subclass ratios to displace marginal cost measures. The Postal Service contends that such ratios have a

⁵ To the extent that the OCA considers the record "thin," (OCA Brief at 140) therefore, it must be borne in mind that the OCA and others had ample opportunity to flesh out the record on this issue. In any event, the record, which includes USPS-LR-I-310 and other documents, is as extensive on this issue as in many other issues in this and prior proceedings. Furthermore, during the discovery period after witness Baron filed the ES-based regression analysis, the OCA did not direct a single interrogatory to Mr. Baron regarding this analysis. Over that same period, United Parcel Service obtained answers to numerous interrogatories (not including subparts to multiple subpart interrogatories) regarding the ES-based regressions. These interrogatory responses produced a final ES-based regression that is far superior to the LTV stop-level regressions. Unfortunately, the OCA has chosen to ignore all of the evidence that witness Baron presented to conclusively establish this superiority. See, e.g., Tr. 46-D/21100-10, Tr. 43/18703-8.

role to play, but it is in the area of calculating incremental costs. The Postal Service has in this case provided the single-subclass stop information necessary to utilize single subclass ratios. See USPS-LR-I-151.

It should also be clear that neither the OCA, nor any party, nor the Commission is precluded from applying a single-subclass ratio methodology to the attribution of coverage-related load time. As witness Baron has demonstrated, coverage-related load time based on the ES-regression analysis is defined as the product of total accrued load time and the regression-based elasticity of load time with respect to deliveries. Since this correctly defined coverage-related load time equals load time that is fixed with respect to the amount and shape mix of the mail volume loaded at actual deliveries, it would be appropriate to apply single-subclass ratios to this fixed load time to compute incremental coverage-related load time costs by subclass.⁶ Similarly, witness Baron has demonstrated that the product of this accrued coverage-related load time and the elasticities of deliveries with respect to volume produce the correct measures of volume-variable coverage-related load time by subclass. See Tr. 46-D/21100-10, Tr. 43/18709, 18713.

3. Witness Baron has correctly interpreted the deliveries variable in the ES-based regression.

In their brief, Advo, Inc. et al., object to the Postal Service's decision to define coverage-related load time as the product of total accrued load time and the elasticity of load time with respect to actual deliveries. Joint Brief Concerning City Carrier Cost

⁶ It must again be emphasized that these costs would be incremental costs, not volume-variable costs.

Attribution ("Joint Brief") at 24-5. Their objection applies to the Postal Service's proposed method of deriving this elasticity. This method, as applied to the Postal Service's recommended ES-based load-time regression, defines the elasticity as the partial derivative of load time with respect to the deliveries variable times average deliveries per route, divided by the predicted load time at that average. The Joint Parties object, specifically, to the presumption in this definition that the deliveries variable in the ES-based regression, although explicitly defined as possible deliveries, is really a proxy for actual deliveries. *Id.*

Witness Baron's analysis already has explained why the coefficients of the deliveries variable in the ES-based regression can be interpreted as the effects of changes in actual deliveries, not possible deliveries, on load time. See USPS-T-12 at 19-22, Tr. 43/18709-13. Thus, contrary to the contentions of the Joint Parties, possible deliveries can be thought of as a proxy for actual deliveries. The Joint Parties are incorrect in asserting that the deliveries variable must be viewed as a control variable, and not as a proxy for actual deliveries. See Joint Brief at 24-25.

4. The OCA ignores the evidence of record, including the testimony of its own witness, in disparaging fixed time at stop as a measure of coverage-related load time

In its Initial Brief, the OCA reviews the Postal Service's application of the SDR, MDR, and BAM regressions to the calculation of volume-variable load-time costs. This procedure, as proposed by witness Baron in his rebuttal testimony, is a revised version of the method proposed by the Postal Service in Docket No. R97-1. The revision is to explicitly account for witness Ewen's argument that fixed coverage-related load time, which is fixed solely with respect to volume and volume mix, still varies across stops in

response to variations in receptacle type, container type, and other non-volume characteristics. The revised Postal Service method thus estimates fixed stop time as the weighted average of the 1985 LTV one-letter load times recorded for various combinations of receptacle and container types. The Postal Service further regards this fixed stop time estimate as the best available measure of coverage-related load time that can be derived from the stop-level regressions and 1985 LTV data set.

The OCA Brief claims that the Postal Service's new fixed-stop time definition of coverage-related load time is "a fictional construct founded upon an incorrect interpretation of prior Commission opinions." OCA Brief at 138. According to the OCA, moreover, this definition is "based on a strained and unnecessary extension of the activity-based functional approach for allocating street-time among the major carrier activities into the assessment of load-time volume variability." *Id.*

In advancing these positions, the OCA ignores the theoretical and empirical evidence presented by witness Baron (summarized in the Postal Service's initial brief) that shows that coverage-related load time is indeed fixed stop time, and that the revised weighted-average minimum load time estimate is the best estimate of this fixed stop time. The OCA further ignores the fact that its own witness, Mark Ewen, confirms key elements of the fixed stop-time concept of coverage-related load time.

The theoretical evidence consists of witness Baron's analysis showing that the same Crowder mathematical analysis that the Commission endorsed now establishes -- when applied to the correctly identified non-linear form of the load time equation -- that the correct measure of accrued coverage-related load time equals fixed stop time plus a de minimus non-fixed portion. Furthermore, this correct coverage-related load time

deviates substantially from the invalidated residual measure of coverage-related load time advocated by the OCA. Moreover, not only is the non-fixed portion of this correct measure of coverage-related load time too small to be of concern at this time, the Crowder mathematical analysis produces no methodology to derive such a measure. See Postal Service Brief at V-82-91.

OCA witness Ewen has confirmed key aspects of this analysis. Importantly, he agrees that coverage-related load time, at the very least, includes fixed stop time. In response to USPS/OCA-T5-12(a)(1), Mr. Ewen stated that fixed stop time "must be embedded in the coverage-related component," and that "this time increment is fixed with respect to volume and volume mix, but may vary across stop types due to factors other than volume (e.g., receptacle type)." Tr. 25/12063-64.

The testimony of OCA witness Ewen also stands in contradiction to the OCA contention that the coverage related load measurement approach favored by witness Baron is a "strained and unnecessary" application of the functional approach to costing used throughout the city carrier cost analysis. See OCA Brief at 129-130. As OCA witness Ewen acknowledges, elemental load time and coverage related load time are functionally distinguishable for at least one reason: only coverage-related load time encompasses the fixed stop time activity. As Mr. Ewen states, the "elemental load time analysis estimates the portion of load time at the stop level that varies with volume delivered," establishing that "'fixed stop load time' cannot be embedded in the elemental portion of load time," and must be strictly coverage-related. See Tr. 25/12063-64, 12069-70. Furthermore, Mr. Ewen explicitly defines this fixed-time coverage-related component in functional terms. He describes it as the time spent

engaged in "loading *activities* that are not influenced by the volume of mail delivered to the stop." *Id.* at 12068 (emphasis added). He goes even further by defining these activities to include opening and closing the receptacle, and opening and closing a satchel. *Id.* at 12068, 12110. In short, Mr. Ewen confirms that these functional activities are coverage-related activities, not elemental load activities.

Beyond these conceptual matters, the OCA similarly overlooks the empirical evidence represented by witness Baron's revised estimates of fixed stop-time cost. These estimates range from 0.6 to 1.6 seconds per stop, which are clearly realistic from an operational perspective. By contrast, the OCA's preferred residual formula produces coverage-related load times ranging from 6.65 seconds per SDR stop to absurdly high values of 17.35 seconds and 39.90 seconds per stop for MDR and BAM stops, respectively.⁷ Thus, in terms of operational believability, the evidence indicates that the Postal Service estimates are superior to the residual-based estimates of coverage-related load time.

⁷ The OCA claims that witness Baron's revised fixed stop time estimates "must . . . overstate fixed time at stop," (OCA Brief at 139), despite the fact that, ranging from 0.6 seconds to 1.6 seconds, they are much smaller than the residual based estimates the OCA prefers.

D. The Postal Service's Treatment of Purchased Transportation Costs is Supported by Substantial Evidence of Record.

The Postal Service's treatment of purchased transportation costs, including its estimates of purchased highway variabilities, its calculation and allocation of network premiums, and its distributions to classes and subclasses of mail are appropriate and are based on substantial record evidence. No intervenor has put forth any valid reasons to deviate from the Postal Service's proposals, with the minor exception of a proposed change to the rail empty equipment distribution key, which the Postal Service does not oppose.

1. Dr. Bradley's purchased highway transportation variabilities are in accord with established precedent and are the only valid estimates on the record.
 - a. MPA witness Nelson's variabilities cannot be used.

In their brief, the Periodicals mailers argue that witness Nelson's purchased highway variability estimates, as refined by Dr. Bradley, should be accepted by the Commission. See Periodicals Mailers Brief at 31.¹ First, this is a bit disingenuous. A fair reading of Dr. Bradley's rebuttal testimony is that he totally disavowed MPA witness Nelson's variability analysis. By pointing out problems with it, he was *not* suggesting refinements that would resuscitate it. As one example, Dr. Bradley stated, "This evidence makes clear that arbitrary elimination of statistically significant higher order terms caused Mr. Nelson to mis-specify his models. The estimated coefficients from

¹ "Periodicals Mailers Brief" refers to the joint brief of the Alliance of Nonprofit Mailers, American Business Media, Coalition of Religious Press Associations, Dow Jones & Company, Inc., Magazine Publishers of America, Inc., National Newspaper Association, the McGraw-Hill Companies, Inc., and Time Warner, Inc.

witness Nelson's model are thus subject to bias and are unreliable." Tr. 43/18407. As another example, Dr. Bradley said:

I am not endorsing the "cost per run" or the "double log" approach proffered by witness Nelson. As I demonstrated above this approach has fundamental flaws and does not meet the basic standards for econometric work set by the Commission. The Commission most definitely should not adopt the results of this approach.

Id. at 18413. It is difficult to see how anyone could read anything into Dr. Bradley's statements other than a total repudiation of Mr. Nelson's untenable analysis.

The Periodicals mailers also repeat on brief witness Nelson's argument that Dr. Bradley's variabilities are overstated because they do not reflect the ability of the Postal Service to adjust capacity by altering vehicle sizes rather than adding trips. Periodicals Mailers Brief at 32. This is just plain wrong, as demonstrated in the Postal Service's initial brief. Postal Service Brief at V-119. As pointed out, the HCSS-based data set reflects all changes, including changes in both vehicle size and trip frequency. Dr. Bradley concluded, "There is no need to modify the specification to take into account specific ways the Postal Service adjusts capacity. These methods are already embodied in the estimated cost function." Tr. 43/18387.

The Periodicals mailers further selectively choose bits and pieces from the record to present a distorted and misleading view of the record when they cite Dr. Bradley's "refinement" of witness Nelson model by including the number of runs as an explanatory variable. Periodicals Mailers Brief at 32. As explained by Dr. Bradley, this is not a "refinement" but a correction of the specification errors in witness Nelson's own model. Dr. Bradley simply applied the correct mathematics to derive the model witness Nelson thought he was specifying:

While I am not endorsing this approach or functional form, I do think that if one is going to pursue the "cost-per-run" approach, then the appropriate equation should be estimated.

Tr. 43.18402. Although the Periodicals mailers cite this correction, they do not cite its results – variabilities nearly identical to those produced by Dr. Bradley under the established methodology. For example, the average variability for tractor trailer transportation is 96.2 percent under the established methodology and 95.2 percent using the "number of runs" variable. Id. at 18414. In their brief, the Periodicals mailers choose to ignore this and, as explained below, instead attempt to construct a new undocumented variability.

In similar fashion, the Periodicals mailers attempt to claim that Dr. Bradley imposes "a hypothesized 'plus/minus 1' relationship between the coefficients." Periodicals Mailers Brief at 33. Dr. Bradley neither hypothesizes nor imposes any restriction on Mr. Nelson's model. He simply provides the mathematical implications of Mr. Nelson's own model. Tr. 43/18401. It is Mr. Nelson who has advanced the "cost per run" approach and any subsequent restrictions associated with the model, not Dr. Bradley. Unfortunately for Mr. Nelson, when his mistakes are corrected, one does not obtain results anywhere near his original ones. Thus the need for obfuscation in the Periodicals mailers' brief.

Nowhere is this obfuscation more apparent than in the brief's discussion of mean centering. The Periodicals mailers have attempted to transmogrify their own confusion about mean centering into a vacuous criticism of the established methodology. As Dr. Bradley explained in his direct testimony, and the Postal Service explained in its initial

brief, ***mean-centering has no effect upon the estimated variabilities***. See Postal Service Brief at V-113-14. Dr. Bradley would have obtained the exact same variabilities had he not mean centered. The Periodicals mailers are simply wrong in their statement that mean centering somehow make variabilities produced under the established methodologies "unsound."

Furthermore, contrary to the implication left by the Periodicals mailers brief, neither Dr. Neels nor Dr. Greene "demonstrated flaws" in Dr. Bradley's method of mean centering. Dr. Greene, for example, never even saw Dr. Bradley's transportation testimony. Tr. 46E/22118-19. Moreover, Dr. Greene confirmed Dr. Bradley's and the Postal Service's exact point, stating, "The ***coefficients*** in the model ***will be different***, but they'll be different in such a way that the ***elasticities***, which are not equal to the coefficients, ***will be the same***." Tr. 46E/22079 (emphasis added). Dr. Neels likewise asserted that Dr. Bradley's correct method of mean centering would lead to slightly different ***coefficients*** than a non-mean centered equation. But, he concluded that mean centering "shouldn't change the ***results***." Id. at 21925 (emphasis added). As explained the Postal Service's initial brief, in no way does mean centering affect the estimated variabilities.

Finally, the Periodicals mailers indicate that Dr. Bradley sponsored "corrections" that "fix all of the 'defects' he was able to identify in Nelson's econometric analysis." Periodicals Mailers Brief at 33 (citations omitted). They further claim that the composite variability from these "corrections" is approximately 65 percent, and that the "corrected" variabilities constitute "the best available evidence for estimating highway transportation variabilities." Id. at 34 (citation and footnote omitted). Again, as was made clear above,

Dr. Bradley totally rejected Mr. Nelson's analysis; he was not proposing any "cures." Moreover, how this alleged 65 percent composite variability was calculated is not at all clear. Apparently, according to a singularly unenlightening footnote in the Periodicals Mailers' Brief, it is some mishmash concocted from Table A1 in Dr. Bradley's direct testimony, Table 1 in Mr. Nelson's direct testimony, and Dr. Bradley's written response to a request made by counsel for the Periodicals mailers at hearing. *Id.* at 34, n.16. It is too late for the Periodicals mailers to be, in effect, attempting to calculate new variability estimates in their Brief; other parties have no opportunity to examine or question them. This is particularly egregious where Dr. Bradley, in his response that is being cited as part of the basis for the calculation, completely renounced the results he was forced to provide:

Inspection of the following table clearly shows that the two sets of parameters are different and the specification must be rejected. This means that one must resist the temptation to present either of these sets [of] estimated β parameters as the estimated variabilities for purchased highway transportation. In addition as explained in my testimony, the estimates suffer from other empirical defects that disqualify them from consideration.

Written Response of United States Postal Service Witness Bradley to Oral Request of MPA, et al. (Tr. 43/18462-64), August 30, 2000.

Dr. Bradley is not, in any way, shape or form, claiming that Mr. Nelson's variabilities, corrected or uncorrected, constitute reliable variability estimates of purchased highway transportation. In addition, the Periodicals mailers belated attempts to breathe some life into witness Nelson's flawed estimates, through introduction of a new composite variability calculation, would deny others due process. For these reasons, the Commission must reject Mr. Nelson's estimated variabilities, either as

presented in his direct testimony or as presented in the Periodicals Mailers Brief.

- b. FGFSa witness Ball's variability proposal for purchased highway transportation must be rejected.

FGFSa argues that Dr. Bradley's purchased highway transportation variabilities must be rejected because he "did not use mail volumes to determine variability," and proposes instead that the variabilities should "be based on the vehicle utilization for Inter-BMC and Intra-BMC transportation." FGFSa Brief at 5-6. Both of these issues were dealt with in the Postal Service's initial brief. See Postal Service Brief at V-128-133.

To recap, Dr. Bradley investigated using data from either TRACS or TIMES to develop volume measures which might be used for purchased highway transportation costing and both systems were found unsuitable for that purpose. In addition, Dr. Bradley indicated that there was an operational basis for the assumption. Thus, there is no reason to abandon the long-held assumption of proportionality between volumes and cubic foot-miles.

Also, Dr. Bradley properly did not make any adjustment for vehicle utilization in his variability analysis. As long as the assumption that empty space varies with volumes is maintained, such an adjustment is not appropriate. FGFSa does not make clear, in any event, exactly how such an adjustment should be made.

2. If Dr. Bradley's empty space allocation proposal is not adopted, then the Postal Service's initial proposal is preferable to that advanced by UPS witness Neels.

UPS witness Neels had developed a new distribution key to allocate empty space based on his theory that it is the subclasses of mail "that create the need for the

total capacity," -- subclasses on "fuller" trucks -- that bear the responsibility for the empty space. Tr. 32/16011. Dr. Bradley, in his rebuttal testimony, instead proposed an alternative distribution key that allocated empty space based on information from all tested legs in the network. Tr. 43/18443-44.

On brief, UPS has praise for Dr. Bradley's proposal, stating, "While Dr. Neels' approach does a better job than does the present distribution method, Dr. Bradley's "compromise" also represents an improvement over the current approach." UPS Brief at 35 (footnote omitted). While still urging that the Commission adopt Dr. Neels' distribution key, UPS says, "At the very least, it [the Commission] should adopt one of the two new proposed methods." *Id.*

The Postal Service believes that Dr. Bradley's approach should be adopted. If the Commission determines not to implement Dr. Bradley's approach, then the Postal Service's original empty space distribution proposal is superior to Dr. Neels' approach. Although the Postal Service's original proposal may not be perfect, it at least uses actual data from the observed leg, whereas Dr. Neels uses an average of legs with higher volumes. As Dr. Bradley states:

Thus, his [Neels'] method not only misses the responsibility of the mail observed on a leg causing empty space, but also misses measuring the mail actually responsible for determining capacity on that leg.

Consequently, it is quite possible that Dr. Neels is assigning the responsibility for empty space on a particular leg to classes that have nothing to do with capacity on that leg.

Tr. 43/18441 (footnote omitted). A simple hypothetical will illustrate the problems inherent in Dr. Neels' approach.

Assume that a substantial number of vehicles were loaded to capacity solely with either parcels (vehicles were "cubed out") or Periodicals (vehicles were "weighed out"). In this situation, the application of Dr. Neels' proposed empty space adjustment would unfairly penalize the parcel mailers. Since the cubic capacity of vehicles with parcels would be fully utilized, the empty space on the less full vehicles (those transporting Periodicals) would be distributed to the parcels, even though the vehicles carrying Periodicals were loaded to their full weight capacity. This would be unjust. Use of the Postal Service's current empty space algorithm would clearly be much more fair. With the Postal Service's current method, the parcels would incur the cost of the parcel movements, and the Periodicals would incur the cost of the Periodicals movements.

The Postal Service reiterates its belief that Dr. Bradley's method is the best on the record and should be adopted. If the Commission, however, does not use Dr. Bradley's approach, then it should use the established method, rather than that proposed by Dr. Neels.

3. There is no highway contract "renewal premium" and it cannot be taken into account.

In a footnote in their brief, the Periodicals mailers state, "While USPS argued with Nelson about the magnitude of the 'renewal premium,' the record establishes that 'renewal' contracts with highway transportation providers cost far more than do 'non-renewal' contracts." Periodicals Mailers Brief at 11, n.5. This statement misses the point. Renewal contracts may well cost more than non-renewals in general, but that does not establish the existence of a "renewal premium." The crucial issue is that the

cost difference is not related to the renewal process; rather it is related to other characteristics of the contracts.

Dr. Bradley established, through empirical testing, that there was virtually no support for any theory that inefficiencies in the renewal process caused higher costs for renewal contracts. See Postal Service Brief at V-137-41.² Moreover, witness Young has clearly testified that renewals are necessary to ensure the stability and reliability of the Postal Service's purchased highway transportation system. Thus, there is no basis in the record for a finding that a "renewal premium" exists.

4. It is proper to distribute the WNET and Eagle premiums exclusively to Express Mail.

UPS urges the Commission to depart from the precedent established in Docket No. R97-1 of allocating the WNET and Eagle premiums exclusively to Express Mail. UPS wants the premiums to be allocated to both Express and Priority Mail.

UPS argues that "Priority Mail is by far the largest user of these networks." UPS Brief at 30. While true, this is not the point.³ The point is "that overnight dedicated air networks are absolutely needed to support a guaranteed overnight product. Without that product, the overnight network, with its early mail acceptance times, would be superfluous." Tr. 43/18538. Moreover, the shares of Express Mail on both Eagle and

² At hearings, Dr. Bradley was asked to calculate an alleged "premium" paid by the Postal Service for intra-SCF and inter-SCF highway transportation, using certain coefficients from his testimony. Dr. Bradley did so, but stated, "I do not endorse this calculation and do not agree with the characterization of it as a 'premium.'" Written Response of United States Postal Service Witness Bradley to Oral Request of MPA, et al. (Tr. 43/18495-500), September 5, 2000 at 1.

³ In its brief, APMU points to witness Haldi's testimony that the percentage of total Priority Mail transported by the networks is small. APMU Brief at 31.

WNET are very close to what they were in Docket No. R97-1, when the Commission first allocated the premiums solely to Express Mail. The Express Mail share in Docket No. R97-1 was 27 percent on Eagle and 11 percent on WNET compared with Base Year 1998 shares of 24 percent on Eagle and 9 percent on WNET. Tr. 43/18536.

UPS also argues that witness Pickett does not rebut Dr. Neels' argument that if Express Mail were of prime importance, then the networks could be operated with smaller aircraft. See UPS Brief at 30-32. Witness Pickett clearly established that "a jet aircraft is required to meet operational linehaul and terminal handling requirements" on the networks. Tr. 43/18532. The basis for witness Pickett's statement is not the volume of mail of whatever subclass might fill the plane; rather it is the need to deliver Express Mail on an overnight schedule. Factors such as speed, containerization, ability to deal with mountains and atmospheric conditions, and ability to fly in adverse weather conditions due to sophisticated avionics thus become more desirable elements, regardless of the volume carried. See *id.* at 18532-34. Also, as pointed out by APMU witness Haldi, larger aircraft can cost less to operate in general, and cost less to operate per cubic foot of capacity, in particular. See Tr. 45/19597. Moreover, as APMU states, "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)." APMU Brief at 30.

UPS also cites to several documents concerning a meeting in 1995, where there was a concern expressed with improving service for Priority Mail on the WNET, as evidence that the networks are configured for both Express and Priority Mail. See UPS

Brief at 32. As discussed in the Postal Service's initial brief, these concerns arose out of early departure times in two cities. Postal Service Brief at V-155. The fact that postal managers were concerned with improving service for Priority Mail, and today are concerned with improving service for both Priority and First-Class Mail simply does not prove that the networks are configured for Express, Priority and First-Class Mail.⁴

UPS also claims that since, as witness Pickett acknowledged, the Eagle network is similar to what it was in 1990, then the premium should be allocated to both Express and Priority Mail in line with what the Commission did in Docket No. R90-1. UPS Brief at 32. Although the Eagle network may not have changed in its basic characteristics, what has changed is that the Postal Service, by virtue of its incremental cost analysis introduced in Docket No. R97-1, had reason to re-examine the assumptions underlying this allocation and found them wanting. The Commission agreed.

A more perplexing change since Docket No. R90-1, is UPS' position on the premium. In Docket No. R90-1, UPS urged that the entire premium be allocated to Express Mail because "the presence of a substantial amount of First-Class on the Eagle Network means that the Postal Service cannot be using that transportation to provide premium service to Priority Mail." PRC Op., R90-1, Vol. 1, at III-183. In fact, in both Base Year 1998 and FY 1999, the shares of First-Class Mail on both Eagle and WNET are higher than the First-Class share of Eagle in 1990. Tr. 43/18537. UPS, unlike the Postal Service, has articulated no clear reason why its views have changed.

The Postal Service also discussed other evidence in its initial brief -- such as

⁴ UPS, somewhat inconsistently, does not argue that the premium should be allocated, in part, to First-Class Mail.

penalty provisions and references to special treatment -- which make clear that the overnight networks are configured for Express Mail. Postal Service Brief at V-155. One of the most telling facts in support of this is the experience with the Priority Mail Processing Centers. As witness Pickett explained:

One would expect that if the Eagle network were truly caused by Priority Mail, the implementation of the PMPCs would have caused some downsizing or a significant re-configuration of Eagle flights in the areas affected by the PMPCs. This did not happen.

Tr. 43/18537.

It is clear that WNET and Eagle exist and are configured for Express Mail. It is thus proper that the premium be allocated exclusively to Express Mail.

5. There is no basis for adjusting costs based on an asserted Amtrak "premium" or other rail savings that will not materialize.

The Periodicals mailers assert that their costs could be reduced by \$15 million in the test year by eliminating the Amtrak "premium." Periodicals Mailers Brief at 15. According to MPA witness Nelson, overall costs would be reduced by \$19 million. Tr. 28/13420. Postal Service witness Pickett effectively rebutted Mr. Nelson's analysis, but the Periodicals mailers claim that "Pickett's analysis . . . is flawed." Periodicals Mailers Brief at 15.

They first claim that witness Pickett "ignores the fact that if the Postal Service switched mail from Amtrak to highway transportation, it would not need to send the mail through Chicago to be consolidated." Id. Witness Pickett admitted that the mail on a truck would not have to go through Chicago, but he also said, "Now, if the truck was carrying a light load, you would want to consolidate that load if you were going a long distance, and that would have to be done *someplace*." Tr. 43/18541 (emphasis

added). The point is that the consolidation service performed by Amtrak in Chicago, Philadelphia and elsewhere would have to be performed by the Postal Service if Amtrak volumes were sent via purchased highway transportation and this likely would cost "several million dollars." Id. at 18530.

The Periodicals mailers also find fault with witness Pickett's statement that witness Nelson overstated his cost savings by basing it only on new contracts rather than on all contracts. The Periodicals mailers claim that "mail that is now being transported on Amtrak would presumably have to be carried on new contracts or renegotiated contracts." Periodicals Mailers Brief at 15. There is no evidence in the record, however, to support this presumption. The Postal Service could send the volumes on a mix of new contracts, renegotiated contracts, and renewed contracts. As witness Pickett said, "They could put it on either renewal or non-renewal contracts. The non-renewals could be adjusted, could be amended and trips could be added to them." Tr. 43/18548. There is no evidence that indicates what cost difference there might be, if any, between new contracts and renegotiated contracts in such an instance. Moreover, there would be some administrative cost associated with letting the new contracts that were required and renegotiating others. There are additional considerations -- service, for example. As witness Pickett stated, "And I would disagree that the goal is to get the lowest cost contract without qualification." Id.

The Periodicals mailers further claim that witness Pickett was wrong to criticize Mr. Nelson for failing to include the cost of returning empty trucks to their origin in his analysis. Periodicals Mailers Brief at 15-16. They claim that truckers can carry mail on the outbound run and other commodities on the backhaul or inbound run. Id. at 16.

This may be true in the instance of a one-way trip, but there are other considerations. As witness Pickett stated, "We need the trailers back in time to schedule regularly scheduled service on a fixed schedule. So our needs are such that we need to have those trailers returned in a timely fashion for a preferential network." Tr. 43/18551. In addition, one-way trips are not the norm. Witness Young described the typical situation:

But as a rule, we are running mail from a facility to a facility, it is moving on a time-definite schedule, and you have got people waiting at both places to work it and process it and get it to the customer. That is the way the system is set up, that you move mail in both directions. You don't always get a full load in both directions, as I said earlier, that is the reality of going everywhere, everyday, serving the American public.

And so you are not going to always get a load coming west to east, or south to north, but have got to come back and bring whatever mail is available, you have got to bring it back.

Id. at 18604.

Finally, the Periodicals mailers opine that witness Pickett mischaracterized witness Nelson's testimony. They claim that Mr. Nelson said "that the Postal Service can procure different sizes of trucks depending on the volume to be hauled," but that witness Pickett asserted that witness Nelson assumed "that highway capacity can be purchased in infinitely small increments." Periodicals Mailers Brief at 16. The Periodicals mailers are nitpicking over the way things are worded, rather than addressing the gist of witness Pickett's argument, which is understandable as they do not have a good counterargument.

Mr. Pickett makes it abundantly clear that he is bending over backwards to fairly analyze Mr. Nelson's testimony. For example, in this part of his analysis, witness Pickett allowed for half, rather than full, trailer loads to be provided in order "[t]o give Mr.

Nelson the benefit of a doubt." Tr. 43/18528. n.2. If witness Pickett had used full trailer loads, Mr. Nelson's purported "premium" would have been further reduced. Id. In any event, witness Pickett aptly expressed the gist of his argument,

And that is the essence of what [the] incremental trailer analysis in my testimony is, is that you sort of have to have a particular size trailer to get the job done. And that means you have to bring back a particular size trailer. You can't bring back a third of a trailer.

Tr. 43/18552. Moreover, witness Pickett stated that it was not always advisable to use a smaller truck, even with lesser volumes. For one thing, straight trucks cannot be run long haul. Id. at 18553. In addition, as witness Pickett summarized,

But staying in the world of tractor-trailers, there is no reason you would want to run a smaller tractor-trailer if you can consolidate a load and make a bigger load, because you are going 1,000 - 2,000 miles in some of these instances.

Id. at 18554-55.

Witness Pickett has demonstrated beyond cavil that witness Nelson's Amtrak "premium" analysis is defective. It thus should not be adopted.

On brief, the Periodicals mailers also restate witness Nelson's arguments for test year cost savings based on (1) the break-up of Conrail reducing certain freight rail rates, and (2) speculation that the Postal Service should be able to obtain freight rail volume discounts. Periodicals Mailers Brief at 16. These issues were discussed in the Postal Service's initial brief. Postal Service Brief at V-147-48. Witness Young, who is responsible for the purchase and contract management of rail transportation, testified that he simply did not see any likelihood of either event transpiring.

In sum, there is no evidence that witness Nelson's speculation about what might happen in the freight rail industry will come to pass. Accordingly, there is no basis for

the Commission to accept his cost savings estimates.

6. The Postal Service and the Periodicals mailers are in agreement on revisions to the Roadrailer and rail empty equipment distribution keys.

In his direct testimony, MPA witness Nelson had proposed a revised distribution key for Roadrailleurs, which would reduce Periodicals costs by \$3.1 million in Base Year 1998, even though he admitted that the composition of mail on Roadrailleurs was unknown. Tr. 28/13413. On rebuttal, witness Pickett presented another revised distribution key, which would reduce Periodicals mailers costs by \$2.3 million in Base Year 1998, based on the results of a special Postal Service study of Roadrailleurs.⁵ The Periodicals mailers are now in agreement with the Postal Service that witness Pickett's "new distribution key for Amtrak Roadrailleurs is appropriate." Periodicals Mailers Brief at 35.

Also, both the Postal Service and the Periodicals mailers agree on the revised distribution key for rail empty equipment presented by witness Nelson, which will reduce Periodicals costs by about \$5 million in Base Year 1998. As the Postal Service stated, it "finds this to be a sensible proposal." Postal Service Brief at V-151.

Accordingly, the Commission should recommend the revised distribution key for Roadrailleurs proposed by witness Pickett and the revised distribution key for rail empty equipment proposed by witness Nelson. Both proposals have merit.

⁵ The special study showed that a significant portion of the volume on Roadrailleurs consists of Periodicals mail. See USPS-LR-I-433.

E. The Postal Service Has Provided Appropriate Test Year Estimates of Advertising Costs by Product.

In its brief, UPS criticizes the Postal Service's treatment of advertising costs, and urges the Commission to use FY98-based information to estimate test year advertising costs by product, even if it otherwise bases its recommendations on FY99-based data. UPS Brief at 26-27. That suggestion should be rejected.

As explained in the March 13, 2000 notice of revisions to the testimony, workpapers, and library reference of witness Kay, the Postal Service, when preparing the FY 1999 CRA, began to use a more comprehensive approach to the analysis of advertising costs. The improved procedures allowed better allocation of advertising costs to specific products and groups of products, in those instances in which such allocations are appropriate. When questions arose about the BY 1998 advertising cost allocations reflected in witness Kay's testimony as filed, the Postal Service decided to do a supplemental analysis of FY 1998 advertising costs, using the new procedures developed for the FY 1999 CRA. When the revised FY 1998 proportions of advertising expenditures by product were applied to the level of test year advertising expenses projected at the time, \$270 million, the results included the test year advertising costs by product quoted in the UPS Brief at 26. The Postal Service and UPS are apparently in agreement that those are the best estimates available for those three products if FY98-based data are used.

In response to Order No. 1294, witness Kay on July 7, 2000, filed supplemental testimony (USPS-ST-45) in which she presented FY99-based estimates of test year advertising costs, based on the information she had been provided by the Postal

Service. The procedures used to derive these estimates were the same as those used to derive the FY98-based estimates presented in her revised direct testimony. For the historical base period, she presented in LR-I-407 comparable information to that provided in her revised LR-I-150.¹ In the Order 1294 update process, however, those FY 1999 proportions were applied to a reduced projected test year advertising budget of \$160 million.

As explained in response to a UPS inquiry, the budget reduction for FY 2001 advertising is part of postal management's overall efforts to reach financial planning targets. Tr. 46B/20989. The joint effect of the overall budget reduction, and changes between FY 1998 and FY 1999 in the reported level of advertising for specific products, reduced, for purposes of response to Order No. 1294, the estimated test year advertising for the three products of apparent interest to UPS -- Priority Mail, Express Mail, and Parcel Post. Not surprisingly, UPS wishes to avoid this particular result of the update process, even though UPS elsewhere strongly urges the Commission to use actual FY 1999 data "to the maximum extent possible." UPS Brief at 11-12. This self-serving "pick and choose" approach should be rejected. USPS-RT-1 at 1 (Strasser).

The Postal Service has taken the position that the circumstances of this case require the Commission to rely on FY98-based data. See Part I of the Postal Service Initial Brief (Sept. 13, 2000). That approach would result in the use of the FY98-based test year advertising cost estimates favored by UPS. Although the Postal Service believes that those estimates have been superceded, given the fact that the advertising

¹ Compare revised pages 5 and 5A of LR-I-150 with the Fy99data.xls file in the Support Materials folder of USPS-LR-I-407.

function will not be funded at the higher level initially assumed, the Postal Service recognizes that consistency would require that they be treated like all of the other FY98-based estimates. If the Commission uses an FY98-based approach to develop its recommendations, the test year advertising cost estimates from witness Kay's revised direct testimony are the appropriate estimates to use.

In the event, however, that the Commission otherwise uses FY99-based data, it should use the FY99-based advertising cost estimates presented in witness Kay's supplemental testimony. The criticisms of those estimates advanced by UPS are without merit. UPS claims that the changes observed moving between the FY98-based and FY99-based results demonstrate the "arbitrariness" of the Postal Service's procedures, and that the Postal Service "has provided no information whatever to indicate that the Test Year advertising costs for Express Mail and Parcel Post will decline to zero or almost zero." UPS Brief at 27.

In fact, however, the Postal Service has provided the best possible information to indicate that advertising costs for Express Mail and Parcel Post will decline "to zero or almost zero." That information is the actual levels of advertising expenditures in the most recent historical year, presented in LR-I-407, which plainly show that there was no advertising reported for Express Mail in FY 1999, and well under \$1 million reported for Parcel Post. Given the lack of any better basis to predict how future advertising budgets will be allocated, that information provides the most reasonable basis to anticipate test year advertising levels for those two products.

UPS itself demonstrates why these changes are not "arbitrary." UPS states that:

Common sense establishes that the bulk of the Postal Service's advertising efforts focuses on its competitive products, especially Priority Mail.

UPS Brief at 27. What UPS would erroneously characterize as "arbitrary" is nothing more than a reflection of the fact that product managers have chosen to shift advertising funds away from Parcel Post and Express Mail, and focus instead on Priority Mail. As shown by a comparison of library references I-150 and I-407, while EPS managers in FY 1998 allocated their advertising efforts 79 percent to Priority Mail, 20 percent to Parcel Post, and 1 percent to Express Mail, a similar analysis of Media and Production expenses in FY 1999 showed that they devoted 99 percent to Priority Mail, 1 percent to Parcel Post, and none to Express Mail.² There is nothing arbitrary about these actions; they simply reflect the responsible officials' efforts to deal with marketplace reality. UPS itself call the focus on Priority Mail nothing less than "common sense." On the other hand, the allegation that the FY99-based estimates "almost certainly understate the likely Test Year advertising costs attributable to [competitive] classes" (UPS Brief at 27) is directly contrary to that reality, and should be ignored.³

² The breakout of EPS expenses for FY 1999 was indeed based on actual experience in FY 1999. The note in the Fy99data.xls file in LR-I-407 which suggests that the advertising agency based the shares on an analysis of FY 1998 expenses is a typo, and simply reflects a failure to update the source note correctly when the FY 1999 spreadsheet was developed, using the FY 1998 spreadsheet as a template.

³ On a more general note, UPS "wonders" why all advertising costs are not allocated to so-called competitive services, since all "monopoly" users have little choice but to use the Postal Service. UPS Brief at 27, note 13. In case UPS has not noticed, the Postal Service has no "monopoly" on how individuals choose to communicate with

In conclusion, the Commission needs to be consistent. It should use test year advertising cost estimates that are consistent with the rest of the data upon which its recommendations are based. The transparently-biased proposal by UPS to treat the advertising estimates differently from all other cost estimates should be rejected.

their friends and families, has no "monopoly" on how businesses and individuals choose to exchange financial information and payments, and has no "monopoly" on how advertisers choose to reach their intended audience. Once again, UPS is not prepared to allow reality to interfere with its version of the facts.

V. THE PARTIES THAT CHALLENGE THE POSTAL SERVICE OFFER NO SOUND REASONS FOR THE COMMISSION NOT TO ADOPT THE RATE LEVELS PROPOSED BY WITNESS MAYES

In section VI of its Initial Brief, the Postal Service explained why the rate level proposals of witness Mayes (USPS-T-32) should be recommended by the Commission to the Governors for approval and why various intervenor proposals should be rejected. The Initial Briefs filed by various parties take issue with the Postal Service's proposed rate levels and with the proposals of other intervenors. The soundness and validity of witness Mayes' institutional cost allocations were amply addressed in our Initial Brief. Below, in this section of its Reply Brief, the Postal Service refutes some of arguments raised by parties who challenge witness Mayes' application of the statutory pricing criteria in § 3622(b) to allocate institutional costs among the various subclasses. It is not the purpose of this Reply Brief to respond to each and every intervenor, as many of the arguments that the Postal Service could make have been ably presented by others for the Commission's consideration. Omission in this Reply Brief of discussion of any issues addressed in the Briefs of other parties should not be construed as any indication that the Postal Service necessarily agrees with the views and positions expressed by those parties.

A. GCA Fails In Its Challenge to the Postal Service's Consideration of Demand Factors and Ramsey Pricing.

In the portion of its brief regarding the respective roles of demand and cultural value within the pricing process, GCA offers two major themes which are incorrect. The first erroneous theme is that the cultural value of greeting cards to recipients cannot be reflected in the sender's demand curve. The second erroneous theme, somewhat

broader in scope, is that Ramsey pricing as applied by witness Bernstein is technically flawed. Both of these arguments are without merit, as will be shown below.

To begin, however, it may be useful to identify matters which are not in contention. In Docket No. R97-1, at page 346 of its Opinion, the Commission indicated that it is appropriate to reflect due consideration in pricing of the cultural value of greeting cards. In this case, the Postal Service's pricing witness testified that she did apply ECSI considerations (criterion 8) to First-Class letters, in accord with the Commission's views in recent proceedings. USPS-T-32 at 22-23. She specifically considered the cultural value of letters to recipients (Tr. 11/4344), and she did not advocate any change to previous Commission evaluations of the ECSI value of letters (Tr. 11/4256-57).

While the GCA brief speaks of "a fuller and more effective" application of the ECSI criterion to First-Class Mail (GCA Brief at 7, 37), it is unclear how GCA believes that should translate into First-Class rates in this proceeding. GCA appears not to argue that the proposed single-cent increase in the single-piece letter rate should be rejected on the grounds of ECSI. In the context of the accepted whole-integer constraint and a proposed one-cent increase, unless ECSI considerations were to be claimed to exclude single-piece letters from *any* rate increase (a claim GCA appears not to make), what would be the implications of a "fuller" application of ECSI, based on the cultural value of greeting cards? In any event, there seems to be consensus that some consideration of ECSI is appropriate for First-Class letters, the Postal Service's witness has applied such consideration, and GCA appears not to challenge the resulting proposed rate.

Another item that is not (or should not be) in contention is that Ramsey prices are not claimed to reflect all of the pricing criteria of the Act. Mr. Bernstein is quite explicit in noting that the Act requires consideration of concerns beyond those relating to economic efficiency. USPS-T-41 at 108. He makes no pretense of having adjusted his Ramsey prices to reflect ECSI values for First-Class Mail. Tr. 6/2195. No place on this record (or elsewhere, for that matter) is it suggested that once Ramsey prices are available, no further consideration of criterion 8 would be required. Criterion 8 is a factor designed to distinguish between subclasses based on content and is subjective by nature, whereas the basic Ramsey model is *not* designed to make content-based distinctions and is objective by nature.^{1/} From this rather rudimentary point, however, GCA proceeds to the first of its above-identified erroneous assertions.

1. Cultural value to recipients can be, and is, reflected in the demand curve for postal delivery of greeting cards.

Specifically, GCA argues that cultural value to recipients cannot be reflected in the mailer's demand curve. GCA Brief at 17-18.^{2/} In support of this view, GCA claims that "witness Erickson has shown that senders often do not know, or do not fully know, what value the greeting cards they mail will have to the recipients." *Id.* at 17. It may be

^{1/} Mr. Bernstein, however, injected a very relevant point in this regard when he noted that it is tautologically true that "[a]ny reflection of ECSI values in Ramsey-type prices, *or for that matter any other type of prices*, is by its very nature some kind of quantification of those values." Tr. 6/2194 (emphasis added).

^{2/} In stating the point in this fashion, GCA is at least retreating from the broader (and hence even more erroneous) position taken by the Hallmark brief in the last case, to the effect that it is "untenable" to suggest that value of mail to the recipient (without specific limitation to cultural value) is taken into account in the sender's purchasing decisions. See the Initial Brief of Hallmark Cards, Inc., Docket No. R97-1 at 9-12, 15-18, and the Postal Service Reply Brief, Docket No. R97-1, at IV-28 - IV-29.

true that Dr. Erickson ultimately did express that opinion, but only in discussions which occurred *after* GCA elevated the alleged importance of the distinction between senders and recipients. There is an abundance of evidence in the record which contradicts that opinion, consisting entirely of earlier statements made by Dr. Erickson in this case and the last. The abrupt shift in his views is demonstrable.

For example, when directly requested in written cross-examination to confirm that consumers can reasonably be expected to take the cultural value of greeting cards into account when deciding whether to send such a card, Dr. Erickson refused:

It is unlikely that all or even most consumers are fully aware of even the most accessible and immediate social value of greeting cards. Without being present when greeting cards are received, it is difficult for senders to know exactly what the recipient does with the card. What the recipient does with a greeting card is, I believe, an indicator of the kinds and degrees of value greeting cards hold for a particular recipient. . . .

Tr. 34/16468.

Yet in his direct testimony in Docket No. R97-1, which he reaffirmed in this case, he made no mention of any such difficulties regarding the ability of senders to anticipate what recipients would do with the cards:

For example, we found that some greeting cards are put out on display after they are received. This makes their content available for view and comment by other friends and family members. **This possibility was taken into account and talked about by people who bought cards. They sometimes bought cards "more carefully," they said, because they knew that their cards would not just be viewed and decoded by the recipient alone.**

Tr. 34/16488 (emphasis added). Also from his Docket No. R97-1 testimony:

The survey verifies the extent to which Americans agree that greeting cards help them celebrate holidays and special occasions-- important cultural features in any society. **It shows that senders expect their cards to be displayed for other to see.**

Tr. 34/16489 (emphasis added).

Moreover, similar statements appear in his direct testimony in this case:

We found that greeting cards and letters are not simply consumed when they are read. They are displayed, passed around, and presented as material evidence of family social connections. **This will come as no surprise to any American with a refrigerator capable of holding a magnet.**

Tr. 34/16448-49, 16490 (emphasis added). Also from his direct testimony:

The point is that the cultural value of greeting cards includes their display. This fact was mentioned in my earlier testimony in Docket No. R97-1 because we learned that greeting cards were often passed around for other family and friends to read. **And the survey demonstrated that it is the expectation of senders that recipients of greeting cards will put them on display for a time.**

Id. (emphasis added).

Moreover, Dr. Erickson's earlier statements about senders' awareness of factors which relate to cultural value extend to more than just their expectations of what the recipients will do with the card:

The life course of greeting cards includes people shopping for them and reflecting on how the card "fits" the cultural values surrounding their relationship in which the card participates. ... Cards stand for relationships and they are social actors, mediators in those relationships. We know this to be true because of the way shoppers talk about the decisions they make about cards. They evaluate the artistic content of the card for its relationship to the shopper's understanding of the taste, the likes, the dislikes, and the personality of the recipient. The history of the relationship enters in, as cards are bought not only to reflect the recipient's favorite colors or artistic taste but to reflect the experiences that the purchaser and the recipient share.

Tr. 34/16492-93 (emphasis added).

There are at least two noteworthy aspects of these statements. First, unlike Dr. Erickson's more recent statements, in which he has chosen to emphasize the potential ignorance of senders regarding cultural value, these statements clearly illustrate a high

level of cognizance of the very social and symbolic factors which Dr. Erickson has stated are indicative of cultural value.^{3/} Second, and perhaps of even greater importance, is the fact that Dr. Erickson himself chose to draw conclusions about cultural value directly from research which, at least initially, was limited exclusively to discussions with shoppers (i.e., persons in their role as "senders" of cards). Tr. 34/16495.

If there were any actual validity to the view that senders can be only partially aware of the factors which determine cultural value (GCA Brief at 11, 17), the validity of Dr. Erickson's original research methodology would be open to very serious question. In reality, however, as even Dr. Erickson concedes (Tr. 34/16466-67), the same individuals tend to be both senders and recipients of cards. The strained suggestion that there is a material difference between the cultural value of greeting cards evaluated from the perspective of senders, and the cultural value of the same cards evaluated from the perspective of the recipients, is little more than a transparent *post hoc* rationalization. As Dr. Erickson's own testimony (as quoted above) confirms, consumers are very much aware of the cultural value of greeting card exchanges when they go to the card shop and decide whether or not to send a card, and the selections they make are chosen with the "the taste, the likes, the dislikes, and the personality of the recipient" firmly in mind.

^{3/} To be fair, even Dr. Erickson's more recent statements (e.g., Tr. 34/16468, 16491, 16516) are not to the effect that senders are *totally* unaware of the cultural value of the cards they are sending. Nevertheless, the point is that the reservations he expresses now regarding the limitations of senders to appreciate cultural value are reservations that simply were not present when he provided his earlier testimony and, in fact, are in many respects contradicted by that testimony.

Witness Bernstein describes in economic terms what is essentially the same consumer decisionmaking process as that described in cultural terms by the above testimony of Dr. Erickson. Tr. 6/2180. The end result of that process is that the value to recipients is included in the sender's demand curve for mail. As Mr. Bernstein explains, the sender will implicitly consider three things in deciding whether it is worth sending a card through the mail: the time it takes, the price of the card, and the price of postage.^{4/} *Id.* Weighed against these three things -- the total costs, so to speak, of sending the card -- is the mailer's view of the value of the card to the recipient. *Id.* Just as Dr. Erickson describes the importance to the sender of finding the "right" card for the recipient to "fit" the relationship (Tr. 34/16445-46), so Mr. Bernstein confirms that it is the value to the recipient which motivates the sender. And when a one-cent postage increase increases the total cost of sending the card by one cent, the mailer must reassess whether the value to the recipient will still exceed the total costs. Thus, as Mr. Bernstein indicates, what defines the demand curve for greeting card postal delivery as the price of postage changes is the aggregate effect of card mailers making this series of cost/benefit determinations, based implicitly on the mailer's view of the value of the card to the recipient. *Id.*

The economic perspective provided by witness Bernstein is fully in accord with intuition and common sense. People send cards because they hope and expect that the

^{4/} GCA insists on continuing to misstate Mr. Bernstein's testimony in this regard by claiming that "the Postal Service simplistically suggests that the one way to measure the value of greeting cards to recipients is price." GCA Brief at 11. In fact, Mr. Bernstein explicitly identified three items which relate to the value of the greeting card -- two objective price components, and the mailer's more subjective evaluation of the worth of his or her own time and effort.

recipients will enjoy them. They balance that expected enjoyment against the total costs of sending a card. If card prices increase, or postage increases, or the more convenient card shop closes, such factors may affect their decision to send the card or not. Conversely, if expectations regarding the value to the recipient change, that also may affect the potential sender's motivation to send the card. An aunt may be far less inclined to bother with a birthday card for her nephew on his 17th birthday or his 27th birthday than she was on his 7th birthday. All of those factors are implicitly taken into account in deriving the demand curve for the postal delivery of greeting cards.

These factors include the ones that Dr. Erickson, as an anthropologist, has identified as contributing to "cultural value," whether or not ordinary people in their own minds think of them as such. As he so eloquently explains, they *know* which cards are likely to be shared with others and displayed, they *know* which cards are most likely to appeal to each particular recipient, and they *know* that the exchange of greeting cards is part of the social fabric that holds families and relationships together. It is for these reasons that they send cards, and it is against the backdrop of these factors that they react to postal rate increases in the manner exhibited in the senders' demand curve for postal delivery of cards.^{5/} Contrary to GCA's erroneous assertion, the cultural value of

^{5/} At one point, Dr. Erickson claims that "elements of culture have a reality beyond that which is known by members of a culture," that "many features of culture exist outside of daily consciousness awareness," and that these conditions prevent him from agreeing that consumers are "quite cognizant" of the cultural value of greeting cards. Tr. 34/16468. With all due respect to the anthropological profession, is there some magic/ritual about why people buy greeting cards that only the shaman/ anthropologist can divine? If that is so, once again Dr. Erickson has a major methodological problem, as the vast majority of what he purports to know about the cultural value of greeting cards comes from 1) talking to purchasers in card shops, and 2) interviewing consumers over the telephone. He may be correct in the sense that individual people

greeting cards is reflected in that demand curve.

In fact, Dr. Erickson himself ultimately acknowledged this point during oral cross-examination. For example, he agreed that groups that place that highest cultural value on greeting cards are least likely to buy fewer cards if the price of postage increases. Tr. 34/16509. And later, when asked if a mere one-penny increase were likely to cause reduced card exchange among low-income people, a group he identified as placing more cultural value on cards, he suggested that even such a small increase can matter to such people, because the pennies "add up." Tr. 34/16513. He was then asked, if that were the case and such people did curtail their greeting card mailing in response to a postage one-cent increase, whether the effect would show up in the demand for mail delivery, as measured by own-price elasticity. He responded:

That's a good question for an economist, and I think, from what I have read, it does show up.

Id. Therefore, despite the fact that he is not an economist, Dr. Erickson's testimony correctly indicates that cultural value is reflected in the demand curve.^{6/} And Mr.

are not necessarily cognizant of the entire forest, but they certainly can see the trees, and it is the aggregate result of how individual consumers view individual trees which shows up in the aggregate demand curve. More fundamentally, if elements of cultural value are "outside of daily consciousness awareness" of people when they send cards, they are equally "outside of daily consciousness awareness" of the same people when they receive cards. Criterion 8, after all, refers to cultural value to recipients, not to anthropologists.

^{6/} GCA at one point in its brief grossly distorts other testimony of Dr. Erickson regarding the relationship between cultural value and price elasticities:

Dr. Erickson first provides an anthropological perspective to shed light on the cultural value of greeting cards that are received in the mail. He notes that in this context arguments about price elasticity of goods are meaningless. ... (Tr. 34/16435-36).

Bernstein, who is an economist, confirms that conclusion and fully explains why that is the case.

What is the significance of the fact that cultural value is reflected in the demand curve for mail? As stated at the beginning of this discussion, it does *not* suggest that increased attention to demand-based factors in pricing, whether in the context of a Ramsey model or otherwise, would obviate the need to separately give due consideration to ECSI factors in order to properly apply criterion 8. It does suggest, however, that GCA's attempts to create an artificial world in which economic factors

GCA Brief at 11. When one examines the pages cited, however, Dr. Erickson's testimony actually appears as follows:

It is an anthropological truism that for most of human history, and perhaps, for most humans in recent times, arguments about price elasticity of goods are meaningless. This is because the appearance of money economies is a recent phenomenon. The arrival of money is tied to the development of complex forms of social organization, to state societies such as those that produce Postal Services and Postal Rate Commissions. For most people and for most of human history, reciprocal exchange in which value cannot be measured by price has been the mainstay of human economic systems. Most people for most of human history have not used price to assess value.

Tr. 34/16435-36.

Dr. Erickson's testimony clearly indicates the only context in which he asserts that "arguments about price elasticity of goods are meaningless." It is in the context of historical periods and cultures in which people function without the use of money as the medium of exchange -- i.e., non-money economies. Dr. Erickson's testimony is equally clear that our current stage of social and economic development, in which a money economy flourishes, constitutes an entirely different context, a "recent phenomenon" which he is attempting to place in contrast with the non-money economies he describes initially. The contemporary exchange by mail of the greeting cards about which Dr. Erickson testifies is obviously part and parcel of our modern money economy. Therefore, in no sense does Dr. Erickson suggest that "arguments about price elasticity of goods are meaningless" in the context of "the cultural value of greeting cards that are received in the mail," and representations in the GCA brief to the contrary are misleading.

operate in certain contexts, but can safely be assumed not to operate in others, should be rejected. Economic analysis is the exploration of trade-offs, and those trade-offs occur whether we choose to recognize them or not. As witness Bernstein stated:

A person can choose between buying a puppy and buying a kitten without much regard for the cost of either pet. Still, economists would argue that in choosing one over the other, the person is weighing marginal costs and marginal benefits and therefore, their decision is governed by and expressible in economic terms.

Tr. 6/2262. In recommending postal rates, it is important for the Commission to keep in mind that there are economic consequences to all of their decisions, and that no tool which allows them to better understand those consequences should be ignored merely because of lofty rhetoric to the effect that there is more to the world than dollars and cents. For better or worse, as even Dr. Erickson agreed (Tr. 34/16496), the Commission is limited to recommending postal rates in dollars and cents.

Witness Bernstein summarized it all quite well when asked if he would agree that many ECSI values are not reasonably quantifiable, to which he responded:

I believe that many ECSI values are not *objectively* quantifiable. However, to the extent that consideration of ECSI values leads to changes in postal rates, the impact of that change on postal volumes, revenues, costs, net revenues, and consumer surplus is quantifiable.

Tr. 6/2193 (emphasis in original). Of the two points made in this statement, it is the second -- which is exactly the point that GCA is attempting to obfuscate -- that is the far more important, because it applies with equal force not only to rate adjustments based on ECSI, but also to the rate consequences of *any* pricing consideration, objective or subjective.

2. The flaws in witness Bernstein's Ramsey analysis that GCA claims to have identified are illusory.

GCA claims to identify certain technical flaws in Mr. Bernstein's Ramsey presentation. GCA Brief at 16-24. Rather than actually casting doubt on his methodology, however, these arguments merely confirm the inability of GCA to grasp fundamental economic concepts.

GCA begins its discussion by misstating the record with respect to the relationship between witness Bernstein's Ramsey-based rates and the rates actually proposed by the Postal Service in this proceeding. GCA claims that the proposals of witness Mayes "are not very different from [witness Bernstein's]." GCA Brief at 16. The alleged support for this erroneous statement is that "Mr. Bernstein calculates that his Ramsey prices produce about \$14 million more 'consumer surplus' than her prices (Tr. 6/2289)." On that page of the record, however, the \$14 million figure is clearly labeled as the result of a comparison between the Postal Service's proposed rates and the R97-1 Index rates. Tr. 6/2289. This comparison is completely distinct from a comparison between the Postal Service's proposed rates and witness Bernstein's Ramsey-based rates, and offers absolutely no support for GCA's claim that Ramsey rates and the proposed rates of witness Mayes "are not very different."^{7/}

^{7/} In footnote 11 accompanying this portion of the text of page 16 of the GCA Brief, the further statement is made that "[w]hile claiming this small increase in 'consumer surplus,' Mr. Bernstein indicates a decline in consumer surplus for First-Class letters of over 1.7 billion dollars." No citation is provided for the \$1.7 billion figure. However, if one looks at the Table accompanying the response from which the \$14 million dollar figure was extracted, appearing two pages (Tr. 6/2291) behind the transcript page cited in the GCA Brief, the reported change in consumer surplus for First-Class letters is \$1.177 billion, not \$1.7 billion.

The discussion of externalities in the GCA brief is likewise flawed. It states:

Ramsey pricing will not work if significant externalities exist. An externality is a cost or benefit incurred or received by a non-buyer or non-seller as a result of the transaction being priced (here, the purchase of a stamp). The cultural value of a greeting card to the recipient is an example.

GCA Brief at 18 (emphasis in original). This line of argument is identical to one made in the last case by Hallmark, and the response must be the same:

Having erroneously postulated that value to a recipient is excluded entirely from conventional demand analysis, Hallmark proceeds to suggest that such value should be considered as an "externality." Hallmark Brief at 11, 17-18, 36. Once again, this manifests a fundamental misunderstanding of economics. An "externality" has been defined as follows:

An externality is an unintended consequence of a course of action that incidentally has beneficial or detrimental effects upon third parties, from whom the generator of the externalities cannot collect adequate compensation if the externalities are beneficial, or to whom compensation for damages will not automatically be paid by the generator if they are detrimental.

Baumol and Sidak, *Toward Competition in Local Telephony*, 1994, at 29,n.7. Clearly, the value to the recipient of a greeting card is not an "unintended consequence" that "incidentally" benefits the recipient. Even if one wants to use what appears to be Hallmark's more generic definition of an externality -- an effect on others who are not parties to the transaction -- it makes no sense to suppose that B is not a party to the transaction of sending a card from A to B. The Hallmark brief in this regard is hopelessly garbled.

Postal Service Reply Brief, Docket No. R97-1, at IV-29 -30. One case later, the same mistaken claim is repeated, still with no citation to support the definition provided of the basic concept, and still with no coherent basis to suggest why anyone would suppose that B is not a party to the transaction of sending a card from A to B. As witness Bernstein testified, "[m]ail services are a joint activity between the sender and the recipient, and the decision to use the mail reflects consideration of the value to both

parties." Tr. 6/2179. GCA's allegation about externalities is a complete red herring.

Another recycled argument contained in the GCA Brief involves the accusation of "demand rationing." The brief states:

Despite formally acknowledging the need for careful consideration of all the statutory ratemaking factors, the Postal Service has ignored or minimized the non-cost factors and has focused on a demand-rationing approach which reflects economic concepts that form only a part of the complex set of criteria Congress established for postal rates, and which fails to reflect the Postal Service's statutory mandate to foster and not ration the people's correspondence and to recognize the value of mail to recipients as well as senders.

GCA Brief at 10, also see 18-19. Once again, the Postal Service's reply from the last case demonstrates the absurdity of this argument:

Another theme of the Hallmark brief which is simply wrongheaded is the perverse claim that demand pricing somehow involves a "rationing" of demand that other forms of pricing do not. Hallmark Brief at 20-26. The fact that the prices which are set for any product, by any means, act to "ration" the demand for that product is an economic fact of life. If we reject Ramsey pricing and ignore demand factors in setting rates, the rationing effect does not go away. Demand is "selectively suppressed" by the relative rate levels set, no matter what means are chosen to do so.* The implication that demand rationing will go away if we merely banish Ramsey pricing surely constitutes one of the more struthious attitudes exhibited in this docket.

* To support its argument, Hallmark claims that Congress wanted postal rate schedules that would foster *more* postal communications, not "ration" the demand. Hallmark Brief at 21. In fact, although Ramsey pricing does not maximize postal volumes (Tr. 10/5110) -- it instead minimizes the aggregate burden on consumers -- witness Bernstein's comparison between Ramsey prices and the illustrative rates developed on the basis of the R94-1 markup indices clearly shows a substantial increase in volume when Ramsey prices are applied. USPS-T-31 at 54-56, 67. As he discusses at 56, the increase in total mail volume is one reflection of the benefits to mailers from Ramsey pricing. Ironically, Hallmark appears to be totally oblivious to these facts in its baseless arguments on demand rationing.

Postal Service Reply Brief, Docket No. R97-1, at IV-31 -32.^{8/}

GCA's claims about the alleged inadequacy of witness Bernstein's marginal cost data are similarly baseless. GCA Brief at 19-20. Mr. Bernstein testified that the cost and volume data he uses are the same as those used by all other witnesses. Tr. 6/2198. He cited both expert testimony and published articles to support his use of cost data which, of necessity, have their origins in the Postal Service's accounting information. Tr. 6/2253, 2276. GCA cites no testimony which purports to criticize Mr. Bernstein in this regard, and its arguments on brief should be afforded no weight.

The situation with respect to price elasticities is even more egregious. GCA criticizes the use of a constant elasticity function, apparently being of the opinion that constant elasticities cannot exist. GCA Brief at 20-22. Once again, the confusion contained in this section of the brief is manifest. We start with the following passage:

Here, however, witness Bernstein would use constant elasticities even though the price changes that would be occasioned by Ramsey pricing would cause the demand curve of each customer to shift and elasticities to change. The use of constant elasticities has major flaws, stemming from the difficulty or impossibility of accurately predicting demand elasticity after substantial price shifts of and among postal products, and from the mathematical necessity that the elasticity will change when the demand curve relocates in response to a price change.

GCA Brief at 20 (citations omitted). These statements confuse movement along a demand curve, which occurs when prices change, with shifts in the demand curve, which are unrelated to changes in price. See Tr. 6/2271, 2340. The demand curve

^{8/} Moreover, in addition to their other flaws, the claims made in above-quoted portion of page 10 of the GCA brief are particularly inapposite in view of the fact that the Postal Service's pricing witness expressly acknowledged that the ultimate conclusions she drew from her consideration of the pricing criteria of Act were not significantly affected by her review of Mr. Bernstein's Ramsey-based rates. USPS-T-32 at 19.

does not relocate in response to a price change -- the quantity demanded simply changes in response to movement up or down the curve. This fundamental confusion appears to contribute to GCA's unfounded accusations.

An additional possibility is that GCA simply fails to comprehend the mathematics of a constant elasticity function. After presenting a supposedly relevant equation (without citation to any testimony in this proceeding) and making arguments based on manipulation of that equation, GCA concludes:

Because of this mathematical fact, witness Bernstein could not explain how the slope of the curve could not change as the demand curve was relocated. (Tr. 6/2363-65). Because the slope, which determines the elasticity, must change when the demand curve moves -- signaling, e.g., a decline in volume -- the use of constant elasticities is wrong in principle.

GCA Brief at 21. First of all, the scope of this claim is rather stupefying -- a whole host of economists over several generations who thought that they could use a constant elasticity function apparently did not know what they were doing, including, apparently, Prof. Tolley and those at the Commission who accepted his work. Needless to say, GCA cites not one shred of evidence from this proceeding or elsewhere to support this more global claim. Instead, it cites witness Bernstein (who merely uses the elasticities estimated by witnesses Thress and Musgrave -- Tr. 6/2196-97, 2203, 2270) and claims that he was unable to explain "how the slope of the curve could not change as the demand curve was relocated."

The irony of this accusation is extreme, because at the pages cited, Tr. 6/2363-65, witness Bernstein explained exactly what GCA now claims that he could not explain. He was asked by counsel for the OCA if he could prove mathematically that it is possible for a constant elasticity curve to shift and still have the same elasticity. Tr.

6/2364. Despite an offer to allow him seven days to provide this proof, he provided it on the spot. At the completion of his explanation, OCA counsel (who happens to have a PhD. in economics) opined that, indeed, he had proven his point in less than seven days. Tr. 6/2365. That explanation was provided on the record on April 17th. If GCA was inclined to challenge the validity of that explanation, it was incumbent upon GCA to do so in testimony on May 22nd. Having forgone that opportunity, GCA is wasting everybody's time by trying to suggest in testimony-by-brief that universally accepted economic procedures (i.e., constant elasticity functions) are mathematic impossibilities.^{9/}

Lastly, GCA makes several miscellaneous allegations regarding Mr. Bernstein's application of Ramsey pricing principles, all of which lack merit. For example, Mr. Bernstein is faulted for failing to take into account in his Ramsey models that the own price elasticity for First-Class mail is, at least in GCA's view, "distorted" by the Private Express Statutes. GCA Brief at 22-23. In fact, however, that role would not necessarily fall to Mr. Bernstein and his models even were the Postal Service to put greater reliance

^{9/} Along the same vein, GCA states:

Witness Bernstein's myopia regarding how demand might change as prices increase in the magnitudes his Ramsey prices would call for is reflected in his apparent inability to consider what the actual effects of cross-elasticity would be for rate differentials of the magnitude shown in his Table 11.

GCA Brief at 22. This statement is accompanied by a footnote, which contains only some extracts from the witness's Table 11, and no other citation. The Postal Service has no idea as to the portion of the record to which this statement is intended to relate. Consequently, given the complete lack of context in which to try to interpret the accusation of, if nothing else, "myopia," the Postal Service is unable to respond, and respectfully suggests that this argument be ignored.

on those models in developing its rate proposals. As witness Mayes testified, any adjustments deemed necessary on that account could be performed later in the pricing process, when applying the other criteria of the Act. Tr. 11/4252-53, 4260. GCA also alleges that Ramsey pricing would allocate the costs of inefficiency to captive customers. GCA Brief at 23-24. Mr. Bernstein, however, specifically refused to confirm that assertion. Tr. 6/2191-92. Moreover, it is at least theoretically possible that inefficient costs would be allocated to specific non-captive products. In fact, Dr. Haldi's testimony on behalf of ANM, flawed as it is, nonetheless includes exactly that (in his case erroneous) assertion. The ultimate response, however, is that no pricing system will resolve the problem of inefficiently-incurred costs, and any alleged need to address that type of problem in other contexts provides no cogent basis to challenge the many other benefits of having Ramsey-based prices available to assist in the pricing process.

In summary, GCA purports to identify many shortcomings in both the theory and the application of Ramsey pricing. None of those withstand critical scrutiny. Witness Bernstein's testimony provides useful guidance on the appropriate role of demand elasticities and consumer surplus as tools to aid in the development of prices which satisfy all of the policies of the Act, including the promotion of economic efficiency.

B. UPS Fails To Establish a Valid Basis For Its Extraordinary Rate Level Proposals For Priority Mail and Express Mail

1. UPS's arguments about the appropriate cost coverage for Priority Mail are based on interpretations of the statutory pricing criteria that are flatly contradicted by the Commission and the courts.

UPS argues that the cost coverage for Priority Mail should be at least as high as that for First-Class Mail. UPS Brief at 43-56. This, of course, is the exact same

argument that UPS made to the court of appeals following Docket No. R97-1, and that argument was resoundingly rejected by the court. *UPS v US Postal Service*, 184 F3d 827, 843-45 (DC Cir 1999). It should again be rejected by the Commission.

UPS faults the Postal Service for placing considerable emphasis in its consideration of the value-of-service criterion on economic value of service, i.e., own price elasticity of demand. UPS Brief at 44. It cites the testimony of its own witness, Dr. Sappington, for the proposition that the Commission should not place undue reliance on "this very imperfect measure of value." *Id.* While one could cite to any number of instances in which the Commission has, in fact, placed substantial reliance on price elasticities in addressing criterion 2 (see Tr. 31/15582-88), there is no need to go any further than the court's summarization of the Commission's evaluation of that factor in the last case:

The Commission cited testimony that Priority Mail has a high "intrinsic value of service," which might justify a higher share of institutional costs, but also noted that it has a "high own-price elasticity," meaning that rate increases might drive away customers despite the high intrinsic value, therefore calling for a lower markup. PRC Op. R97-1 at 359. . . . Based on its perception of the value of Priority Mail service and of the deleterious effect a price increase might have, the Commission concluded that a "reduction in the proportional contribution by Priority Mail is not unreasonable," especially since even the lower markup the Commission recommended led to a rate increase for Priority Mail that exceeded the systemwide average. *Id.* at 362.

UPS, 184 F3d at 844. Over the challenges of UPS, the court endorsed the Commission's evaluation of the statutory criteria, including the determination that the application of (b)(2) was "decisive" in concluding that a lower Priority Mail cost coverage was appropriate. *Id.* at 844-45. Implicitly if not explicitly, the court very clearly endorsed reliance on own-price elasticity as one important aspect of value of service

consideration. In this docket, as witness Mayes noted, the estimated own price elasticity of Priority Mail has increased (in absolute value) since Docket No. R97-1, albeit very modestly, from -0.77 to -0.82. USPS-T-32 at 26.

To evaluate "incremental" value of service, UPS chooses to favor reliance on qualitative comparison of service quality with that of competitors over quantitative examination of demand elasticity. UPS Brief at 45. UPS asserts that "Priority Mail generally provides good value when compared to its competitors." *Id.* It is interesting to compare that view with very recently published reports of an alleged statement by UPS in response to stories of discussion between the Postal Service and FedEx. UPS is alleged to have stated:

The Postal Service has recognized deficiencies in delivery service, time in transit, package tracking and guarantees, all of which today's customers demand and expect. In short, why would anyone pay FedEx prices for postal service?

Business Mailers Review, Vol. 21, No. 19 (Sept. 18, 2000) at 2. Although those statements do not on their face address Priority Mail specifically, if accurate, they do suggest a quite different assessment than the one offered on brief by UPS of how shippers could be expected to view the merits of the Postal Service package services, including Priority Mail, relative to competitors. In fact, they sound much more like an endorsement of the assessment of Priority Mail's service quality, relative to competitors, offered on behalf of Priority Mail customers on the record in this proceeding (Tr. 25/11519-27, Haldi).

UPS, of course, puts special emphasis on the intrinsic value of Priority Mail, especially as compared with First-Class Mail. UPS Brief at 46-51. As noted by the

court as quoted above, however, the Commission has already acknowledged the high intrinsic value of Priority Mail. Much ink has been spilled in the case over the correct interpretation and significance of delivery performance figures. Like the Commission, however, witness Mayes has also acknowledged the fairly high intrinsic value of Priority Mail. USPS-T-32 at 26. Since that circumstance has already been taken account of, further consideration does not change the overall evaluation of Priority Mail, or possibly justify the cost coverage (and the percentage rate increase) that UPS seeks to impose.

Moreover, conspicuously absent from the substantial discussion in the UPS brief on the intrinsic value of Priority Mail service is any mention of Express Mail. Even Dr. Sappington did not disagree that Express Mail has the highest intrinsic value of service of any subclass (Tr. 31/15572-73), which necessarily implies that, as common sense would suggest, Priority Mail has a lower intrinsic value than Express Mail. Under the UPS theory, this would further suggest that Priority Mail should have a lower cost coverage than Express Mail. Yet in the Commission's Recommended Decision in Docket No. R97-1, that was not the case at all. Under the Commission's costing, its recommended markup for Express Mail was 114 percent, while that for Priority Mail was 166 percent.

Interestingly, a similar relationship holds in witness Mayes' testimony when coverage comparisons are made on the basis of incremental costs, rather than volume variable. As she discusses, in both subclasses, a material amount of product specific costs makes it worthwhile to examine cost coverages relative to both cost measures. She notes that relative to incremental costs, her cost coverage for Priority Mail is 163 percent, while that for Express is 148 percent. USPS-T-32 at 25, 29. Thus, purely on

the basis of a comparison of relative intrinsic value between Priority and Express Mail, the cost coverage for Priority Mail proposed by the Postal Service could be argued to already be overstated. Given the overwhelming importance that UPS purports to place on intrinsic value, and its claim that (b)(2) “primarily contemplates a comparison of Priority Mail’s service features with the features of other Postal Service products” (UPS Brief at 46), its abject failure to present anything resembling a balanced consideration in this regard is typified by its failure to even mention the service features of Express Mail relative to Priority Mail.

Returning to the subject of own price elasticity, UPS suggests that elasticity is best considered in the context of the availability of alternatives, factor 5, rather than in the context of value of service, factor 2. UPS Brief at 45. In that context, UPS claims that a high own price elasticity generally indicates that customers have readily available alternatives and thus require less protection from the Commission. *Id.* As indicated above, this reflects a distorted view of factor 2, with respect to which the Commission has long maintained that elasticity is a critical indicator of economic value of service. Moreover, it also reflects a distorted view of factor 5. As the court held in rejecting similar arguments from UPS in the R97-1 appeal:

As to § 3622(b)(5), the Commission has consistently, and reasonably, held that it authorizes a reduction in rates to maintain the position of the Postal Service as a competitor in the mail delivery industry.

UPS, 184 F3d at 845. The court gave similar short shrift to the claims made by UPS regarding factor 4, effect on mailers and competitors, which parallel those advanced once again in the UPS brief at pages 52-54. Just as the court found in that case, “UPS’s reading of the statutory provisions it invokes is unduly narrow.” *Id.* Its reading

has not improved with age.

In the appeal from the Governors' approval of the recommended Priority Mail rates in the last case, the court endorsed the reduction in the relative Priority Mail cost coverage in light of the fact that even the lower coverage led to rate increases that exceeded the systemwide average. *Id.* at 844. In this case, the Priority Mail rate increase proposed by the Postal Service is substantially in excess of the systemwide average, nearly triple the rate of inflation, and almost five times that proposed for First-Class letters. Moreover, the systemwide average in this case is already considerably higher than that recommended in Docket No. R97-1, and this would be the second case in a row in which the Priority Mail increase would exceed both the systemwide average and the First-Class increase by a wide margin. The Postal Service appropriately took all of these factors into account (USPS-T-32 at 25-28) in proposing its Priority Mail rate levels. UPS, in contrast, seeks to overturn well-established precedent regarding the application of the pricing factors of the Act, in pursuit of crippling rate increases that are designed solely to further its own competitive interests. Its argument that the cost coverage for Priority Mail should be set equal to that of First-Class Mail should be rejected by the Commission, just as it was rejected by the court of appeals in the last case.

2. UPS's proposal on Brief for a 13 percent increase in Express Mail rates is unsupported on the record and should be rejected.

In its brief, UPS urges the Commission to recommend an increase in Express Mail rates of 13 percent (17 percent if FY99-based data are used). UPS Brief at 65-66. UPS claims that this is "based" on "the Postal Service's proposed cost coverage." Such

a claim is sheer nonsense. The 13 percent figure is, in fact, simply the mechanistic output of witness Luciani's manipulation of a mishmash of Postal Service proposed rates, Commission version costs, and UPS cost adjustments.

What witness Luciani started with in Table 7 (Tr. 25/11792) was the implicit cost coverage of the Postal Service's rate proposal when evaluated against the PRC version of costs, shown at 149 percent.^{10/} His next step, however, was to recalculate the implicit cost coverage (181 percent) after incorporating all of UPS' proposed costing adjustments. (For reasons discussed elsewhere, most of those adjustments are erroneous, but for purposes of Mr. Luciani's testimony, their cumulative effect was to reduce the UPS estimate of Express Mail attributable costs by almost 20 percent.) While there is nothing inherently wrong with calculating an implicit number in this fashion, there is plenty wrong with representing that number (whether expressed as a markup, a cost coverage, a markup ratio, or a cost coverage ratio) as in any sense the Postal Service's proposal. Specifically, witness Mayes never addressed, much less endorsed, that share of institutional costs for Express Mail under the totally different cost base employed by witness Luciani.

Witness Luciani apparently then uses that *revised* markup figure in calculating a markup index, which he misleadingly characterizes (and UPS continues to misleadingly

^{10/} In and of itself, that step is highly questionable, because witness Mayes does her evaluation of the pricing criteria in the context of the Postal Service's proposed rates, and her cost coverage conclusions do not necessarily translate directly into the different context of the PRC version of costs. As explained earlier, however, witness Mayes did acknowledge the relevance of product specific costs for Express Mail, and did evaluate her proposed rates against incremental costs as a result. The resulting incremental cost coverage (148 percent, USPS-T-32 at 29) is quite close to the 149 percent shown by witness Luciani as implicit in the PRC version.

characterize) as "the Postal Service's proposed markup ratio." In Table 8 on the same page of his testimony, he then ratchets up the 181 percent cost coverage to 197 percent. It is only through this convoluted procedure that witness Luciani can succeed in proposing to take a *reduction* in estimated Express Mail attributable costs, purport to apply some neutral version of the Postal Service's evaluation of an appropriate contribution, and come up with an huge *increase* in the resulting percentage rate increase -- from 4 percent proposed by witness Mayes to the 13 percent shown in witness Luciani's Table 8.

That percentage rate increase is unsupported by any witness on the record. No witness addressed the pricing criteria of the Act and concluded that they could be met by Express Mail prices resulting from a 13 percent rate increase. Obviously, UPS had the opportunity to have Dr. Sappington, who did his best to offer pricing support for UPS's Priority Mail and Parcel Post proposals, undertake this burden. For whatever reasons, he did not. Witness Luciani, on the other hand, disavows any intent to address the pricing criteria, testifying that his calculation of the rate increase "was performed for illustrative purposes to assist the Commission in its considerations of the UPS recommended costing changes." Tr. 25/11901. The Commission should give no weight to UPS's unsupported arguments on brief to raise Express Mail rates by 13 percent.

C. NNA's Arguments To Boost the ECR Cost Coverage Must Be Rejected

1. NAA's obsession with the comparisons between First-Class Mail and ECR completely ignores more relevant comparisons between ECR and Regular.

In its Initial Brief, NAA states that the "unit contributions should serve as a larger factor in determining institutional costs," NAA Initial Brief at 28, and points to "gaping disparities" in the unit contribution between First-Class Mail and ECR mail. NAA points to witness Tye's comparisons of the unit contribution between ECR and First-Class Mail as evidence of the need to raise ECR rates beyond those proposed by the Postal Service. NAA Initial Brief at 29. These observations are, however, thoroughly discredited by the fact that witness Tye's analysis focuses exclusively on the unit contributions of First-Class and ECR, and completely ignores a more relevant comparison between Regular and ECR. Indeed, witness Tye deliberately avoided having to address this comparison by simply stating that he had "not determined optimal rates for Standard (A) Regular." Tr. 30/14817. Witness Tye's attempt to shield himself from this comparison is completely unavailing, and thoroughly discredits his testimony. As VP-CW witness Haldi correctly shows, a unit contribution analysis would favor a *reduction* in the institutional cost burden on ECR. Tr. 32/15792.

Witness Haldi shows that the unit contribution of ECR exceeds that of Regular by 2.6 cents in the base year. This disparity is projected to grow to more than 4 cents in FY 2000. Tr. 32/15796-97. These figures prompt witness Haldi to advocate in favor of a progressively lower unit contribution of ECR relative to Regular subclass mail. Tr. 32/15807. If the Commission insists upon conducting unit contribution comparisons, then witness Haldi's analysis is highly persuasive. USPS-T-32 at 39. Nevertheless, for

purposes of this proceeding, witness Mayes acknowledges that, but for the need to avoid shifting the institutional cost burden borne by ECR to other subclasses, the Postal Service would have proposed to reduce ECR rates beyond those actually proposed. USPS-T-32 at 39.

It is important to bear in mind, moreover, that the Regular/ECR unit cost comparison that witness Haldi presents is far more enlightening than the First-Class/ECR comparison. Quite simply, Regular and ECR are far more similar than is First-Class to ECR. As witness Haldi explains, both ECR and Regular have "comparable content, insofar as the vast majority of volume in each subclass consists of advertising mail." Tr. 32/15800. In addition, "[b]oth subclasses have the same service standards and the same priorities." Tr. 32/15800. By way of contrast, the content of First-Class Mail is far more valuable: a large component of the subclass consists of correspondence, including statements of account and transactions. Additionally, unlike Regular and ECR, which are both deferrable, First-Class Mail is subject to preferred service standards. Thus, contrary to witness Tye's contention, ECR and First-Class are hardly similar. *Cf.* Tr. 30/14844. Indeed, witness Tye's attempt to identify the comparable characteristics between First-Class and ECR crumbles, because the similarities he cites are more pronounced when either ECR and Regular, or Regular and First-Class Mail, are compared. Specifically, in comparing ECR and First-Class Mail, witness Tye identified the "substantial volume" in ECR and First-Class, the "substantial volumes of letters and flats" in the two subclasses, and the merging of ECR letters in DPS processing, as evidence of the similarity between the

subclasses. Tr. 30/14844. In the first two categories, Regular is far more similar to ECR, as shown in the table below.

Subclass	Volume	Percent Nonletters
First-Class Mail Letters and Sealed Parcels	97 Billion	6%
Regular	39 Billion	40%
ECR	33 Billion	62%

Source: Volumes: 1999 RPW; Percent Nonletters: USPS LR-I-166, WP 1 at 1; USPS LR-I-91, section 1 at 9, section 2 at 9.

Furthermore, in terms of DPS processing, ECR is far less similar to First-Class Mail than is Regular. The presort and automation categories in Regular subclass mail mirror to a large degree those in the First-Class Mail rate schedule. Furthermore, unlike Regular and First-Class Mail, which are processed to delivery sequence on automation in great proportions, USPS LR-I-95, ECR mail is generally intended to bypass entirely mail processing operations, and be given directly to carriers. Thus, ECR differs greatly from First-Class Mail in terms of DPS processing. In sum, witness Tye's attempt to show the similarities between First-Class Mail and ECR is without merit, and his particular unit contribution analysis is thoroughly undermined by the greater degree of similarity between Regular and ECR.

2. NAA's implication that increasing the ECR markup is the "straightforward" method to address the rate relationship between 5-digit automation and ECR Basic letters is self-serving and unjustified.

On Brief, NAA contends that the Postal Service did not consider the "straightforward" possibility of raising the ECR coverage to give sufficient "head room" for the desired rate relationship between 5-digit automation and ECR Basic letters. NAA Initial Brief at 31. NAA attempts to latch onto the objective of maintaining

Automation 5-digit rates lower than ECR basic tier letters as a pretext for proposing an even higher ECR markup to force the rate relationship, regardless of what direction is suggested by the pricing criteria. ECR Basic letters represent 17 percent of the ECR TYAR volume. Using a blunt tool such as the markup on ECR to create a desirable rate relationship for less than 17 percent of ECR volume (USPS-VR-I-166, WP1 at 3) is an extreme measure. NAA's "straightforward" solution cannot be recommended, in any event, because it fails to meet the objectives of the statutory pricing criteria. Increasing rates for all ECR mail in order to achieve a desired relationship for 17 percent of ECR mail is patently unfair and inequitable to the remaining 83 percent of ECR mail. Not surprisingly, NAA does not recommend an alternative means of achieving the relationship: reducing the markup for Regular in order to lower the 5-digit automation rate.^{11/} However, such a "straightforward" solution does not seem any less desirable than the alternative of increasing the ECR coverage.

No party proposes that the current 5-digit automation/ECR Basic letter rate relationship be discontinued; and the relationship can, and should, be maintained without resorting to increased, or decreased, markups on the affected subclasses.

Thus, NAA's rationale for increasing the ECR markup must be rejected.

3. Contrary to NAA's hyperbole, the Postal Service has not abandoned any of its analysis in support of the proposed ECR cost coverage.

In its brief, NAA also alleges that the Postal Service has abandoned its only objective rationale for reducing the ECR contribution. NAA Brief at 31-32. The Postal

^{11/} 5-digit automation letters represent only 16 percent of the TYAR Regular volume. USPS-LR-166, WP1 at 3.

Service has done no such thing. First of all, in the interrogatory response cited (Tr. 11/4322), witness Mayes emphasized that percentage rate increases and cost coverages must be evaluated for all subclasses taken together, and that changes in any one subclass cannot be viewed in isolation. She in no way implied that the change in own price elasticities for the two subclasses she proceeded to discuss constituted "the only objective rationale" for the ECR cost coverage which she proposed.

Obviously, the proposed percentage rate increases (between Docket Nos. R97-1 and R2000-1) changed as well, and those are, beyond cavil, "objective." Witness Mayes also stated that the "higher measured elasticities would result in more substantial reductions in volume for these two subclasses [Standard A Regular and Standard A ECR] in response to increases in rates than would have been the case in R97-1." That statement is also beyond dispute, and has not been qualified by anything subsequent.

NAA wishes to attach substantial significance to the fact that the elasticity estimates appear to have changed very largely as the result of an improved model specification, rather than as a reflection of an underlying change in demand. NAA Brief at 31-32. This fact, however, is irrelevant. Consider a lump sum cost-of-living allowance that is required to be set based on the measured difference in the cost of living in two locations. Assume the current allowance is set at X, based on price comparisons made three years before, and that every price on every good in the two locations has risen by the exact same absolute amount over the three year period. Now, assume that the old market basket used to measure aggregate cost of living in the two locations is found to be suboptimal, and an improved new market basket of goods is used instead, with the result that the calculated allowance falls to .5X. The

fact that the change in the allowance is solely the result of the change in the market basket, and not the result of actual price level changes over time between the two locations, is irrelevant. Notwithstanding the inevitable complaints from those intended to benefit from the allowance, and who expected the allowance to stay at X as it would have if based on the old market basket, the best available estimate of the *current* cost of living difference between the two locations, which is what the allowance is intended to address, is .5X.

The exact same rationale pertains to the measured price elasticities in this docket. For example, whereas the own price elasticity of ECR in Docket No. R97-1 was approximately 2.5 times the price elasticity of First-Class Mail letters, the elasticity of ECR in Docket No. R2000-1 is approximately 3.5 times that of First-Class Mail letters. Regardless of whether the observed change in price elasticity (i.e., R97 ECR versus R2000 ECR) was the result of structural change in demand over time or an improved ability to measure demand, it is only the currently-estimated relative levels of demand which are relevant for use in this proceeding. That is the information that witness Mayes applied on page 38 of her direct testimony, comparing the elasticities of ECR with those of First-Class Mail letters and Standard A Regular, to reach the conclusion that ECR has a "relatively low economic value of service."

The most fundamental flaw in NAA's argument, however, concerns not the relevant facts, but the premise. NAA presumes that any rationale that would justify the reduction of the ECR cost coverage would necessarily involve a change in circumstances. In the interrogatory response which NAA cites (Tr. 11/4322), witness Mayes was asked *only* to identify changes in circumstances. The logical flaw, however,

is that if the ECR cost coverage were too high initially (i.e., as set in Docket No. R97-1), absolutely no change in circumstances would be necessary to justify a lower cost coverage. NAA's Brief does not cite where in the record it asked witness Mayes to identify the factors that would justify a lower cost coverage; it cites only where she was asked to identify changes in circumstances. In her testimony, witness Mayes evaluated all the factors and concluded that, were it not for the below average rate increase implicit in her proposal for this subclass, a lower cost coverage would have been appropriate. USPS-T-32 at 38-39. See also Tr. 11/4324-29. Her assessment is neither more nor less objective than any other comprehensive assessment of the pricing criteria of the Act. The Postal Service has abandoned neither her evaluation of those factors, nor her conclusion.

D. The Proposals For Lower Cost Coverages For Bound Printed Matter Lack Evidentiary Support

In its Initial Brief at VI-29-34, the Postal Service explained why the 105 percent Bound Printed Matter cost coverage proposal of Association of American Publishers (AAP) witness Siwek should be rejected in favor of the 118 percent cost coverage proposal of witness Mayes. Much of the basis for AAP's claim for an even lower cost coverage than proposed by the Postal Service is the assertion that the Bound Printed Matter subclass is now heavily dominated by books. AAP contends that the degree to which books are present in the subclass should influence the Commission toward an extraordinary application of pricing criterion (b)(8), which calls for consideration of the educational, cultural, scientific, and informational (ECSI) value of matter within a

subclass. At page 6 of its Brief, AAP argues that "the crucial point in this case is that the latest data available show that books now do predominate the BPM subclass." In support of this proposition, AAP points to a Postal Service interrogatory response and cross-examination of witness Mayes as supporting the conclusion that 63.7 percent of the subclass now consists of books. See Tr. 9/3595-98 and Tr. 11/4466, respectively. The Commission will observe that AAP is rather selective in the data it cites. The Household Diary Study data referenced above in Tr. Vol. 9 reflect the percentage of books recorded by households as having been received among their bound printed matter pieces. It does not purport to represent the percentage of books in the Bound Printed Matter mail stream as a whole. The 63.7 percent figure was for 1998 only. A cursory review of Tr. 9/3596 makes clear that the percentage of books in Bound Printed Matter reported by households fluctuates considerably -- ranging between 41.9 percent and 63.7 percent during the period from 1994 to 1998. The same data show that, for the 1994 to 1998 period as a whole, the percentage of books in BPM received by households is just under 51 percent.

Furthermore, review of the above referenced cross-examination of witness Mayes reveals that she was referring to RPW data which indicated that books comprised approximately 52 percent of the Bound Printed Matter subclass. This figure is remarkably consistent with the Household Diary Study average for the 1994-1998. Neither of these figures suggests an overwhelming domination of the subclass by books. Contrary to the assertions of AAP, these data provide no basis for the application of ECSI to any degree greater than warranted in recent cases.

At page 26 of its Brief, Mail Order Association of America (MOAA) argues that the Commission should recommend a 101 percent cost coverage for Bound Printed Matter, considerably lower than the 118 percent cost coverage proposed by Postal Service witness Mayes. MOAA argues that this lower cost coverage can be achieved by giving greater effect to § 3622(b)(8). MOAA criticizes witness Mayes' application of § 3622(b)(8) to Bound Printed Matter, arguing: (a) that she did not give sufficient consideration to the ECSI value within the Bound Printed Matter subclass; and (b) that Bound Printed Matter is entitled to as much ECSI consideration as Periodicals. MOAA Brief at 23-24. Citing Tr. 11/4483, MOAA characterizes Ms. Mayes' determination not to accord Bound Printed Matter as much ECSI consideration as Periodicals as being "premised solely upon the fact that 'advertising is an integral part of the mail piece in [P]eriodicals.'" Understandably, MOAA made no effort to draw attention to her testimony that she gave less ECSI consideration to Bound Printed matter than to Periodicals, "in keeping with Commission precedent." Tr. 11/4482. Nor did it highlight her testimony that she "did not intend . . . to shift the ECSI value consideration . . . beyond what the Commission has done in the past." Tr. 11/4484. MOAA's proposed 101 percent cost coverage is supported by argument at pages 22-25 of its Brief. However, the MOAA argument lacks support in the evidentiary record. The proposed 101 percent cost coverage was not advanced by any witness in this proceeding. It springs forth for the first time in the MOAA Brief. In the interest of due process, the MOAA proposal must be summarily dismissed, since the parties have had no opportunity to examine or test it adversarially.

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Both AAP and MOAA fail to demonstrate that the ECSI content of Bound Printed Matter has changes since the Commission's Docket No. R97-1 evaluation.

VI. THE PROPOSED RATE DESIGNS OF THE POSTAL SERVICE ADHERE TO THE POLICIES OF THE ACT IN SUCH A MANNER AS TO RENDER ALTERNATIVE PROPOSALS INFERIOR.

A. The Intervenor First-Class Mail Rate Design Proposals Should be Rejected

Various parties have proposed alternatives or modifications to the rates design and classification proposals of Postal Service witness Fronk. In section VII.A of its Initial Brief, the Postal Service explained why each these proposals should be rejected. Below, the Postal Service responds to some of the arguments advanced by those parties in their Initial Briefs.

1. The OCA proposal to freeze the basic First-Class Mail rate should be rejected.

At pages VI-12-13 and VII-11-12 of its Initial Brief, the Postal Service explained the justification for its proposal to increase the basic First-Class Mail rate from 33 to 34 cents. Those arguments will not be repeated here. The OCA Brief raises a number of arguments addressed in the Postal Service's Initial Brief. Several other OCA arguments are addressed below.

At page 157 of its Brief, the OCA argues that the Commission should maintain the current 33-cent rate as a means of "slowing diversion to electronic communications and bill paying" However, the OCA cites no record evidence that a rate freeze would have any effect on the the diversion of current First-Class Mail to electronic media.

At page 153, the OCA argues that there is no cost basis to increase the First-Class Mail 33-cent letter rate. As the Postal Service pointed out at page VII-31 of its Initial Brief, this faulty conclusion reflects a lack of understanding of the significance of the First-Class letter mail mix change from higher-cost single-piece letters to lower-cost

workshared letters. Despite the decline in the unit cost for the aggregate category of First-Class Mail letters, the single-piece and the workshared letter subcategories experienced an increase in unit costs. As witness O'Hara testified during cross-examination by the OCA:

I did a calculation some time back looking at ...the unit cost for workshared and single piece mail using the PRC methodology in the R97 decision. You have to go way back in the appendix and add up all across the cost segments to do that, and compare that with the unit cost using the same PRC methodology projected for 2001, that is the test year in this case, compared to the test year in the last case, and both the single piece unit cost had gone up and the workshared unit cost had gone up notwithstanding the fact that the average for the subclass as a whole goes down.

As I recall, the number was around 2 percent plus for single piece and 4 percent plus for workshared.

Tr. 46E/22013-14. The OCA should do the math and accept the consequences.

2. The intervenor arguments favoring their respective single-piece de-averaging proposals are not persuasive.

In this proceeding, the Commission is faced with a flurry of proposals to de-average the basic rate charged to stamped and metered single-piece First-Class Mail. The OCA proposes that stamped Courtesy Envelope Mail (CEM) receive a 3-cent discount. ABA&NAPM proposes that "P" Rate Mail -- stamped or metered single-piece mail deposited with a presort bureau (and presumably prebarcoded by the bureau)¹ -- be given a 2-cent discount. There would apparently be no barrier to accumulating the CEM and "P" Rate discounts. E-Stamp and Stamps.com propose 4-cent discounts for single-piece mail pieces on which the delivery addresses is barcoded and certified via PC

¹ Putting aside that a significant proportion of such mail, particularly courtesy reply envelopes, already are.

Postage address hygiene software. Stamps.com proposes a 3-cent discount for similar pieces on which the delivery address and barcode are printed on a PC Postage label affixed to the mail piece. There appears to be no barrier to these PC Postage discounts being awarded in addition to the "P" Rate discount. Pitney Bowes proposes that single-piece mail on which the postage is affixed by either a "traditional" postage meter or a PC Postage meter qualify for a 1-cent discount. This discount would be separate and apart from any discount for which such mail could otherwise also qualify on the basis of its status as CEM, "P" Rate Mail, or by virtue of having a PC Postage-generated address and barcode.

This combination of proposals confirms the complication inherent in de-averaging the stamped and metered First-Class Mail stream and provides a stark picture of the complexity which would result in the single-piece First-Class Mail rate schedule that is used by the general mailing public, if any combination of these proposals was implemented. In its Initial Brief, the Postal Service explained why, on the record in this proceeding, the Commission should reject each of the various intervenor de-averaging proposals. Below, the Postal Service responds to some of the arguments advanced by some of the proponents in their respective Briefs.

- a. The arguments in favor of a metered mail rate category wither under scrutiny.
 - i. Pitney Bowes misreads the Postal Reorganization Act.

Pitney Bowes argues that "section 3622(b)(3) . . . specifically dictates that mailers should not be burdened with costs that they do not cause the Postal Service to incur."

Pitney Bowes also argues that the Commission has implemented § 3622(b)(3) "by the

creation of discounts." Pitney Bowes Brief at 5. Section 3622(b)(3) dictates that costs caused by a subclass of mail should be attributed to that subclass for the purpose of ensuring that there is no cross-subsidy between subclasses. See *NAGCP v. U.S. Postal Service*, 462 U.S. at 810, 828 (1983). Contrary to the assertion of Pitney Bowes, the Commission has implemented § 3622(b)(3) by exercising its authority to ensure that the attributable or volume variable costs of each subclass are charged to the appropriate subclass.

In attributing costs to each subclass, the Postal Service and the Commission are required by subsection 3622(b)(6) to consider "the degree of preparation of mail for delivery into the postal system performed by the mailer and its effect upon reducing costs to the Postal Service." As the Commission opined in Docket No. MC95-1:

As for the degree of preparation performed by mailers . . . , that has been reflected in the extensive system of workshare discounts . . . [which] constitute a major innovation in rate design developed since the passage of the Act.

When the Postal Reorganization Act became law in 1970, workshare discounts were not available. In both second and third-class, mailers were required to perform certain workshare activities; however, there was no direct rate recognition of them. To some degree, it can be assumed that Congress realized that mailers had to engage in mail preparation in order to qualify for second- and third-class rates and that it took that fact into account when it set rates for those classes. It indicated its concern with mailer worksharing by including § 3622(b)(6) in the Act.

PRC Op. MC95-1, at III-50-51, ¶3134.

Within every subclass, it is the case that not every mail piece is identical or incurs identical costs. Methods of mail entry, processing and delivery can vary for mail types within an existing subclass. The same is often true for mail within a particular rate category. As a consequence, not every mail piece within a subclass or rate category incurs all costs that are incurred by all other mail within that subclass or category. The

rates for all subclasses and rate categories reflect a degree of averaging of costs of relatively similar mail pieces. Some single-piece First-Class Mail pieces are entered at post offices, some are picked up by carriers on their routes, some are deposited in collection boxes. Some pieces are metered, some are stamped. Stamps and metered postage can be obtained in a variety of ways other than at a post office window. A wide array of single-piece First-Class Mail piece characteristics affect the manner in which the pieces are accepted, whether they need cancellation, whether they are routed to an Optical Character Reader, or to a Barcode Sorter, or whether they are manually processed. Some pieces are delivered to street addresses, some are delivered to post office boxes. Each of these differences results in different patterns of cost incurrence. Within the First-Class Mail letters subclass, postage is affixed by stamps, meters, and permit imprint. Whatever can be said of subsections (b)(3) and (b)(6) of § 3622, neither requires that a rate differential be established for each of these distinctions.

- ii. Pitney Bowes overlooks pertinent Commission opinions.

At page 5 of its Brief, Pitney Bowes provides a cryptic summary of the Commission's approach to the establishment of worksharing discounts. Meaning to cite page IV-97 of the Commission's Docket No. MC95-1 opinion, Pitney Bowes argues that "the Commission has insisted that discounts must, on an exact piece comparison basis, reflect only the costs that the Postal Service 'actually saves.'" Pitney Bowes Brief at 5. Pitney Bowes also cites page 384 of the Commission's Docket No. R97-1 opinion. There, in ¶5374, the Commission reviewed its Docket No. MC95-1 approach to determining "the kinds of costs that should be included in the avoidable cost calculation

used for setting rate differentials within a subclass." In reference to bulk prebarcoded and presorted First-Class Mail, the Commission emphasized that "the worksharing cost should be restricted to mail processing and delivery cost." PRC Op. R97-1, Vol. 1, at 384, ¶5374. Generally, postage on this mail is affixed by meter or permit imprint. The Commission has previously determined that "stamp avoidance" costs should not serve as a basis for measuring worksharing cost differences for bulk entered First-Class Mail.² Fairness and equity require the same result with respect to single-piece First-Class Mail.

At page 7 of its Brief, Pitney Bowes argues that without a meter discount, "it is not possible to conclude that the single-piece First-Class Mail rate schedule is either fair or equitable." Metering technology and permit imprint predate the Postal Reorganization Act by five decades. No rate schedule implemented under chapter 36 of the Act has included a rate differential based on the application of meter technology to affix postage. According to Pitney Bowes, each of the rate schedules implemented under chapter 36 has violated the Act. Such an argument strains credulity.

Also at page 7, Pitney Bowes argues that Postal Service rebuttal witness Miller failed to explain why a meter discount could not be limited to single-piece First-Class Mail. The Postal Service reads witness Miller's testimony as questioning whether such a discount could be limited to single-piece mail, since other portions of the First-Class Mail stream to which stamps can be affixed currently use meters and permit imprint and, arguably, avoid generating stamp-related costs as well. Tr. 45/19667-69.

Pitney Bowes argues that single-piece First-Class Mail:

² See PRC Op. R77-1, Vol. 1, at 258-259.

is the only category in which it is possible to compare the cost of a stamped mail piece with one in which postage has been evidenced through metering technology. The rates of other . . . First-Class categories already reflect the exclusion of attributable stamp production and distribution costs because stamps . . . are not in practice used by mailers in . . . those categories.

Pitney Bowes Brief at 10. This only raises the question of whether it is fair to exclude other metered and permit imprint mail types (which could bear stamps) from a meter discount.

- iii. A push-up effect on basic rate for stamped single-piece First-Class Mail would be inevitable.

At page 2 of its Brief, Pitney Bowes argues that "the lion's share of attributable transaction costs of collecting revenues from stamps is assigned to the First-Class single-piece mail category." At page 3, Pitney Bowes argues that de-averaging will not place "undue burden on mailers who do not qualify for the discount." Therein lies a contradiction. If, as Pitney Bowes argues, the lion's share of attributable stamp costs are in First-Class Mail, it stands to reason that unhitching these costs from metered mail will eventually result in attribution of those costs to stamped single-piece First-Class Mail, not to other mail classes.

Pitney Bowes witness Haldi estimates that there will be 53.2 billion letters, flats and IPP's in the test year before rates, of which 23.8 billion will be metered. Tr. 29/13940. He also estimates 2.4 billion cards in the test year before rates, of which 0.7 billion will be metered. *Id.* at 13942. And he assumes that another 4.954 billion pieces will convert from stamps to metering. *Id.* at 13911. Thus, according to Dr. Haldi, there will be 26.1 billion non-metered single First-Class Mail pieces in the test year if his

proposal is adopted.³ And if one takes Dr. Haldi's estimated \$156.5 million in lost contribution resulting from adoption of his proposal (*id.* at 13913) and divides it by the volume of non-metered single-piece First-Class Mail (*id.* at 13937), one gets 0.60 cents per piece (\$156.5 million ÷ 26.1 billion pieces = 0.60 cents). Thus, contrary to the claim at page 15 of the Pitney Bowes Brief, adoption of the meter discount proposal could very easily result in Aunt Minnie's rates going up higher than they otherwise would. Were this to occur, it would be impossible for the Commission to concur that a meter discount "enable[d] the Postal Service to better serve all users of its 'core product' -- unpresorted First-Class Mail." Pitney Bowes Brief at 4. Unless, of course, one equates "better service" with "higher rates."

iv. Dr. Staisey's repudiation of witness Heisler's market research was thorough.

At page 11 of its Brief, Pitney Bowes characterizes the rebuttal testimony of Postal Service witness Staisey (Tr. 45/19915 *et seq.*) as follows:

Most revealing is what Dr. Staisey has omitted from her criticism. She does not criticize the basic survey design, the manner in which it was carried out, the qualifying conditions imposed, or the use of a 'generic product' description in the survey questionnaire.

Pitney Bowes appears to be in denial concerning the substance of Dr. Staisey's testimony. In her critique of witness Heisler's testimony, she describes questionnaire bias and methodological flaws concerning sample size. Tr. 45/19921-19927. These criticisms go to the heart of witness Heisler's basic survey design.

On pages 11-12 of its Brief, Pitney Bowes attempts to dismiss witness Staisey's

³ (53.2 billion + 2.4 billion) minus (23.8 billion + 0.7 billion + 5.0 billion) = 26.1 billion.

concerns about whether customers understood the “burdens” of a PC postage device by stating that interviews were only completed with those who have a computer, Internet access, and a specific type of printer. But basic technological literacy does not equate with a rudimentary understanding of a PC postage product – whether one has to be on-line during use, whether addresses always need to be cleansed, net savings from use, and the like.

At page 13 of its Brief, Pitney Bowes asserts that “[a] low coefficient of variation is inherent in all intent surveys, including those that the Commission has relied upon in prior cases.” Without focusing on the statistical merits of this statement, it misses the point of Dr. Staisey’s testimony on this issue. As Dr. Staisey testified, “Normally, a small sample size leads to large coefficients of variation, an important criteria in evaluating statistical results.” Tr. 45/19926. In response to an interrogatory asking for coefficients of variation, witness Heisler chose not to provide them, instead responding with upper and lower bounds. Tr. 23/10622. Witness Staisey points out that such upper and lower bounds have no statistical meaning, making it impossible to directly test the link between small sample size and a large coefficient of variation. Tr. 45/19926.

v. Pitney Bowes distorts the testimony of Postal Service witnesses.

At the top of page 6 of its Brief, citing Tr. 45/19665, Pitney Bowes argues that the Postal Service “conceded” the validity of the cost estimate underlying its proposed meter discount. This is a misrepresentation of the record. As the Commission can clearly observe by reviewing the cited passage, the rebuttal testimony of Postal Service witness Miller merely summarizes the cost testimony of Pitney Bowes witness Haldi. Mr. Miller

makes no concession about the validity of Dr. Haldi's cost analysis.

Again, at page 16, Pitney Bowes argues that, at Tr. 10/4793, Postal Service witness Fronk "confirmed" the assessment that more widespread use of meters may promote more use of the mails. In its haste to bring a snippet of Fronk's testimony to the Commission's attention, Pitney Bowes neglected to mention witness Fronk's rather significant qualification that he has "no evidence that it actually does so." Tr. 10/4793.

- vi. Mr. Carlson's support for a meter discount conflicts with his opposition to PC Postage discounts.

At pages 23-24 of his Brief, Mr. Carlson weighs in on the issue of whether the *Commission should recommend a single-piece First-Class Mail meter discount*. However, the basis for Mr. Carlson's support of a meter discount is at odds with his opposition to discounts based on application of a delivery address and barcode by means of PC Postage technology. The thrust of Mr. Carlson's opposition to PC Postage discounts is that mailers would be required to pay fees to third-party PC Postage vendors in order to employ the technology through which their mail could qualify for such discounts. But, if the Postal Service is not mistaken, the use of postage meters -- either "traditional" or the PC Postage variety -- is not free. Users of postage meters pay fees to vendors as well.

Moreover, since the Pitney Bowes meter discount also would apply to mail pieces on which postage was affixed by PC Postage meters, as well as "traditional" meters, Mr. Carlson may wish to reconsider his support for the Pitney Bowes proposal altogether.

b. The OCA's arguments in support of CEM are without merit

i. The OCA is at odds with its own witness.

At page 172 of its Brief, the OCA argues that Courtesy Envelope Mail (CEM) has an implicit cost coverage approaching 1000 percent. While the OCA Brief focuses great attention on Tr. 21/9198-202 as a basis for measuring the volume-variable costs and the implied institutional cost contribution of a CEM rate category, it is telling that the OCA witness who proposed CEM keeps her distance from those figures and, instead, relies upon the more plausible cost avoidance estimate for QBRM provided by Postal Service witness Campbell as her basis for proposing a CEM rate differential. See Tr. 23/10736.

ii. The OCA's postcard analogy is misguided.

Postal Service witness Miller testified that the Postal Service, whose consignment stamp program is pretty much limited to the basic First-Class Mail stamp, could face complaints in a CEM environment, if CEM stamps were not as widely distributed as basic stamps among nonpostal retail outlets. Tr. 45/19653. At pages 176 of its Brief, the OCA argues that since the same limitation on availability of postcard stamps at non-postal retail outlets currently affects postcards, and there are no complaints about the unavailability of postcard stamps at non-postal retail outlets, there is no basis for being concerned that customers will complain about the absence of non-postal access to CEM stamps.⁴ On this point, the OCA cannot see the forest for the trees. It is precisely

⁴ The OCA argues that it is inconsistent for the Postal Service to oppose CEM on the ground that it would add complexity to the rate schedule, when the Postal Service has "no problem with having a subclass of postcards which is significantly smaller in volume than CEM would be." OCA Brief at 176. The Postal Service's testimony was not that an additional line in the rate schedule would make it overly complex. It remains the Postal Service's view that administration and enforcement of a

because of the intrinsic differences between postcard and courtesy reply mail that the situations are not analogous.

Household mailer use of postcards is a relatively rare phenomenon in relation to the sending of basic First-Class Mail letters.⁵ Thus, consistent with common-sense, the availability of basic letter rate stamps is more ubiquitous than it is for postcard stamps which, in the ordinary course of mailing, stamp-using customers rarely use. And when typical household customers need these “other” stamps,⁶ they get them at a post office. CEM or no CEM, postcard mailing transactions will remain relatively rare. On the other hand, in a CEM environment, the overwhelming majority of single-piece First-Class Mail transactions – the approximately 90 percent consisting of the mailing of one-ounce letters – would be split into two large pools: non-CEM and CEM. As witness Miller testifies (Tr. 45/19657), it would take a significantly more complex stamp distribution scheme than presently exists to ensure that there would be quantities of non-CEM and CEM available in postal and non-postal retail outlets. What benefit there currently is to customers in being able to avoid postal window transactions to purchase stamps for all of their basic transactions (the 90 percent consisting of mailing unitary rate 1-ounce letters) would be undermined by virtue of the fact that many would be required to either return to post offices to buy all of their stamps (to purchase non-CEM and CEM basic

CEM would rate would add an undesirable level of complexity to the conduct of basic postal transactions.

⁵ As seen by a comparison of volumes of TYBR single-piece First-Class Mail letters (53.2 billion) and cards (2.4 billion) estimated by Postal Service witness Tolley. USPS-T-6, at 59, 79.

⁶ For example, an additional-ounce stamp.

stamps) or split their purchases between postal (for CEM) and non-postal outlets (for non-CEM) to obtain basic stamps.

The existence of a postcard subclass and postcard rates that differ from those for letters is well-established.⁷ The fact that the public can handle rate differences between cards and letters may well have more to do with the longstanding, relatively extreme differences between cards and letters, which provide a basis for understanding the relatively large letter/card rate differential. Whether the more subtle differences between types of letters would produce the same level of understanding is an open question. If there were two rates which generally applied to all letters in the single-piece letter mail stream and the physical distinctions between those letters are not extreme,⁸ and daily rate application determinations had to be made in distinguishing CEM-eligible letters from non-CEM eligible letters, the likelihood of confusion and misapplication of postage increases substantially.

At page 176 of its Brief, the OCA challenges the Postal Service's opposition to CEM by arguing that it is inconsistent for the Postal Service to administer QBRM, on the one hand, but declare that CEM would add intolerable complexity. The OCA argues: "QBRM, more complex than CEM because it requires counting each piece, poses no

⁷ If the OCA considers that cards are an appropriate subject for examination in determining whether to de-average single-piece letter rates on the basis of whether a letter is mailed in a Courtesy Envelope, then, for sake of consistency, the OCA should be advocating the abandonment of the uniform basic rate for single-piece postcards, despite the fact household mailers benefit from a grouping that includes both high-cost and low-cost pieces.

⁸ Particularly between non-CEM courtesy reply envelopes and CEM, or simply if a CEM stamp came to be known as a "bill payment" stamp and people applied it on the basis of the content of the envelope.

complexity problem for witness Miller.” Again, the OCA misses a fundamental distinction. Relatively few in number to the 120,000,000 households which would have to deal with CEM, QBRM recipients pay directly, in the form of a combination of fees for the counting, rating and billing “complexity” which is undertaken by the Postal Service.⁹ Thus, the cost to the Postal Service associated with administration and enforcement of QBRM postage is paid for by the QBRM recipient.

In contrast to QBRM, the Postal Service would have to spend (at least) \$122 million for CEM administrative and enforcement costs to distribute (as much as) \$180 million in benefit to the users of CEM. In other words, the OCA is encouraging the Commission to recommend that the Postal Service spend at least a dollar per household per year to distribute as much as \$1.50 in benefit to each household per year.¹⁰ When the alternative is to avoid the \$122 million expenditure and spread the cost savings generated by courtesy reply envelopes among all First-Class Mail users to keep everyone's rates down, the Postal Service considers the choice to be an easy one.

At pages 178-179 of its Brief, the OCA argues that the revenue loss associated with CEM would be trivial, that there would be virtually no shortpaid mail. However, in support of this argument, the OCA focuses on data which show the rate of underpayment when mailers are not faced with any degree of complexity other than

⁹ The up-front complexity of administering two different basic single-piece First-Class Mail rate denominations does not compare to the seamless integration of the QBRM accounting function in postage due units in the postal system.

¹⁰ Perhaps, to “level the playing field” and eliminate a major distinction between QBRM and CEM, the OCA would want the Commission to charge a “CEM administration fee” to the producers of qualifying courtesy envelopes to cover the administrative and enforcement costs associated with CEM.

determining whether they have a stamp bearing the applicable unitary rate. Those data show that when application of postage is a "no-brainer," relatively few pieces are shortpaid. However, when customers are faced with complexity as slight as the application of additional-ounce postage, the shortpaid rate rises exponentially. What percentage of shortpaid mail would there be in a CEM environment? No one can say for certain. It is not reasonable to expect the shortpaid percentage in a CEM environment to be as low as it is when there is no rate complexity involved. The percentage of shortpaid mail which results from mailer's failure to affix additional-ounce postage suggests that the rate of short payment is related to the degree of complexity faced by the mailer. That complexity is increased substantially when mailers, instead of simply affixing "a stamp" to a letter, have to determine "which stamp" denomination should be affixed to which letter.

iii. Shrill distortions are no substitute for the truth

Witness Miller expressed concern about public confusion over which rate would apply to which letters and the resulting misapplication of postage. Tr. 45/19658. The OCA's Brief is so shrill that it twists these expressions of concern into accusations that the general public "are uneducable -- or worse; they are larcenous." OCA Brief at 175.

The OCA argues that "the Postal Service seems to think that individual mailers are willing to . . . [misapply postage]. No one making a bill payment would do anything of the sort." *Id.* First, the obvious reason why the OCA provides no record citation for what "the Postal Service seems to think" is because there is no record basis for the OCA's characterization. Similarly, the OCA can point to no record basis for the assertion that "[n]o one making a bill payment would do anything of the sort." It is not a sacrilege

for the Postal Service to assert, or the OCA to concede, or the Commission to conclude that postal customers can make honest mistakes.

- iv. The OCA and the Postal Service agree that something about CEM does not make sense.

At page 180 of its Brief, the OCA argues that it "makes no sense" for the Postal Service to engage in activity to enforce the proper application of CEM postage, since the cost of that activity is likely to exceed the revenue collected on short paid mail which would result from a misapplication of CEM postage.¹¹

First, it is the Postal Service -- not the OCA and, with all due respect, not the Commission -- which is charged with the responsibility of enforcing the proper application of postage. The testimony of witness Miller explains -- in a CEM environment -- why CEM-specific enforcement would be necessary, how it would be approached, and what it would cost. Tr. 45/19658-60. On these issues, the Postal Service must be accorded deference. What does not make sense, as explained by witness Miller at Tr. 45/19661, would be for the Postal Service to establish a rate category which would put it in the position of having to implement necessary enforcement measures that were likely to either offset or exceed the benefit that the category was intended to confer.

Rather than continue to recommend a classification which generates problems which have repeatedly caused the Governors to decline to approve it, the Commission

¹¹ Adhering to this philosophy, the OCA would have the Chief Postal Inspector ignore the value of deterrence and perform a narrowly-focused cost benefit analysis to determine whether the Postal Inspection Service should bother to enforce any of the civil and criminal statutes under its jurisdiction. After all, the cost of enforcement could exceed any funds recovered. So, why bother, right?

should reject the latest revival of the OCA's CEM proposal and give the parties an interval in which to clear the air and explore alternative opportunities to improve the First-Class Mail rate structure in a manner which does not generate the intractable problems associated with CEM.

- c. The record simply does not support a PC Postage discount.

The Initial Briefs of Stamps.com and E-Stamp raise a number of issues, most of which have been addressed in the Postal Service's Initial Brief at VII-54-64. Several issues in each of these parties' Briefs merit a response below.

- i. There are significant differences between PC Postage and QBRM.

At page 1 of its Brief, Stamps.com alleges that there are no differences in mail characteristics between a PC Postage mail piece and a QBRM piece. Stamps.com goes on to say, that with the exception of the Facing Identification Mark (FIM), the mail pieces are identical. *Id.* at 8. The Postal Service has provided substantial evidence that there are material differences between PC Postage mail and QBRM. At Tr. 14/5910-13, Postal Service witness Campbell explained that PC Postage mail pieces can exceed the very strict automation-compatibility, size and weight limitations that a QBRM piece must meet. He also indicated that PC Postage pieces produced by affixing labels will not contain a FIM. He also demonstrated that PC Postage address labels containing a Postnet barcode can be affixed to mail pieces so that the barcode is outside the read zone of postal automation equipment.

Stamps.com correctly summarized the testimony of Postal Service witness Miller that "little to no" mail processing cost savings are associated with PC Postage Mail. Tr.

45/19675. This conclusion is inescapable because machine printed letter mail is routed to AFCS bins 5 and 6, along with PC Postage mail. This combined mail is processed on an MLOCR-ISS, where a high percentage of that mail is also likely to be realized, thus bypassing the RCR/RBCS. See Tr. 45/19674. The only cost difference between machine-printed mail and PC Postage mail would be associated with the difference in the percentages that do not get barcoded by the MLOCR-ISS and, therefore, have to be processed through the RCR/RBCS.

Stamps.com argues that “[l]iterally, with the flick of a switch or the push of a button on the AFCS, a USPS plant manager could process PC Postage mail as FIM C.” Stamps.com Brief at 27. It is true that the AFCS operator control panel can be used to establish the correct sortation bin for each FIM type. USPS LR-I-154 at 60-61. However, even if FIM D mail were routed to bins 1 and 2 (along with prebarcoded CRM FIM A and QBRM FIM C mail), the number of processing steps for PC Postage mail, and therefore mail processing costs, would be roughly the same as if it had been routed to bins 5 and 6. Tr. 45/19675.

- ii. The handwritten benchmark was appropriately applied to QBRM, but is not applicable to PC Postage.

Again, Stamps.com attempted to link PC Postage mail to QBRM by arguing that the same benchmark that was employed for QBRM, a handwritten mail piece, should somehow apply to PC Postage. Stamps.com reached this conclusion on the basis of three assertions: (1) if QBRM did not exist, such mail would revert to courtesy reply mail (CRM) (Stamps.com Brief at 9); (2) the term “handwritten” is really a misnomer— it essentially is a “stand-in for any type of address that does not bear a FIM code and

POSTNET barcode" (*id.* at 11); and (3) the use of the "handwritten address benchmark is appropriate to maximize the benefit USPS gains from the adoption of PC Postage technology" (*id.*).

To support the first assertion, Stamps.com mischaracterized the testimony of Postal Service witness Fronk. During cross-examination, witness Fronk acknowledged that, in the absence of QBRM, some QBRM recipients could provide courtesy reply mail (CRM) pieces. Tr. 12/4933-34. He agreed that if, in the absence of QBRM, a business enclosed a CRM piece, such a piece would likely have preprinted addresses (instead of a space for the sender to hand-write the recipient's address). *Id.* However, the record is devoid of any evidence that, in the absence of QBRM, QBRM recipients would revert, whether totally or in large part, to providing CRM. In all likelihood, if a business did not provide a QBRM mail piece (or any reply mail piece) to a household customer, that customer would have to rely on a handwritten mail piece or an alternative to the mails (e.g., 1-800 phone numbers) to establish contact with the business. Tr. 45/19885.

Second, in declaring that "handwritten" now means something other than "handwritten," Stamps.com's Brief repudiates its own witness and abandons all reason. According to Stamps.com Brief, "*nouveau* handwritten" mail is now all single-piece First-Class Mail that does not have a FIM or a POSTNET barcode. Bulk metered mail: no FIM, no barcode – presto! Handwritten! Typewritten or PC-generated mail: no FIM or barcode – change-o! Handwritten!

The absurdity of this redefinition of "handwritten" mail aside, the expansion of the term "handwritten" to include relatively "clean" bulk metered mail and other typewritten or machine-printed mail suggests that the conversion of mail to the PC Postage format may

not have as dramatic an effect on mail processing cost savings as suggested by Stamps.com's witnesses.

Moreover, the Stamps.com Brief makes abundantly clear at pages 12-13, that the original "actually handwritten" benchmark was selected for PC Postage Mail, not because this is the source of mail converting to PC Postage, but because using that benchmark "produces a level of discount that would motivate mailers to undertake the preparations required by PC Postage. . . . Too small a discount will not maximize the overall benefits of PC Postage." See Tr. 10/10540. Apparently, it was determined that "too small" a cost avoidance would result if one measured the impact of the change in *nouveau* "handwritten" mail to PC Postage mail. It is no wonder that the "actually handwritten" benchmark selected was the one that would generate the largest estimate of avoided cost.

Finally, Stamps.com asserts, "It is estimated that about one-third to 50 percent of mail that converts to PC Postage would have had a *handwritten address*." Stamps.com Brief at 10 (emphasis added). Is Stamps.com now referring to "actually handwritten" mail or to the redefined "*nouveau* handwritten"? In either case, Stamps.com undertook no efforts to estimate the percentage of pre-IBIP mail pieces that were "handwritten." Tr. 23/10528. Further, if one considers that business generate more mail pieces than individuals (Tr. 23/10530), and considers the composition of Stamps.com's customer base (see Stamps.com-LR-4, filed under Protective Conditions), one could conclude that the true percentage of pre-IBIP mail pieces that were "actually handwritten" is less than one-third.

Ultimately, the objective of postal rate design is a much more complicated task

than simply finding ways to artificially inflate discounts so that they will induce maximum conversion to a favored rate category. As nearly as practical, discounts should reflect an accurate estimate of actual cost avoidance. Stamps.com's analysis falls short of this objective.

- iii. Dr. Staisey correctly concluded that the Lawton survey methodology was flawed and its results unreliable.

On pages VII-55-57 of its Initial Brief, the Postal Service explains why Stamps.com witness Lawton's marketing research is so flawed that its results are unreliable

Not only is witness Lawton's survey flawed, but some of the alleged "results" alluded to in the hearing room do not appear to have been provided to the Commission or the parties for scrutiny. Specifically, the Postal Service is unable to verify the existence of raw data supposedly provided in connection with Ms. Lawton's testimony concerning the decrease in post office visits survey respondents claimed to experience as a result of using PC Postage. In its Brief at 12, Stamps.com cites Tr. 23/10367, which stated (in passing) "Stamps.com customers . . . use the local Post Office less (an estimated 1,000,000 fewer visits each month)." However, when the Postal Service asked witness Lawton to provide the raw data associated with the survey results, she responded "[t]he entire survey was provided in Stamps.com –LR-2, as well as the supporting data for the answers to each question relied upon in my testimony." Tr. 46/20641. Stamps.com then attempted to discredit Dr. Staisey's testimony by implying that she did not thoroughly review the raw data supplied by Stamps.com. Tr. 45/19995-98. The Postal Service's repeated examinations of Stamps.com-LR-2 have turned up no such raw data. The Postal Service defers to the Commission's judgment concerning

whether such data were ever provided and, if they were not, what inferences should be drawn.

- iv. If implemented, the proposed discount would result in a decrease in postal revenue.

At page 31 of its Brief, Stamps.com alleged “. . . the 4 cent discount proposed by Heselton is revenue neutral and will not de-average rates.” Clearly any discounted postal rate that does not correspond to an equal decrease in cost would have a negative impact on revenue. As explained in the testimony of Postal Service rebuttal witness Miller, Stamps.com has failed to accurately quantify the cost savings associated with PC Postage. And even if there were potential PC Postage cost savings, the level of savings would be substantially less than the proposed four-cent discount. Tr. 45/19671-73. *See also* Postal Service Brief at VII-54-64.

- v. E-Stamp's arguments do not justify the implementation of a PC Postage discount.

In its Brief, E-Stamp advanced arguments similar to those made by Stamps.com. While many of the parallel arguments have been properly addressed either in the Postal Service's Initial Brief or in the sections above, there are several issues that merit rejoinder.

- (a) The methodologies used to determine PC Postage cost avoidance are flawed and must be rejected.

In support of witness Jones' "preferred business model" objective of PC Postage discounts large enough to offset PC Postage user fees (Tr. 29/13714-15), witness Prescott employed costing methodologies that are suspect at best. The inherent flaws

in E-Stamp's approach to measuring cost avoidance make it doubtful that its savings estimates are even remotely accurate.

For example, E-Stamp continues to use nonsensical terms such as "nonautomation presort bulk metered mail (BMM)." E-Stamp Brief at 5. The nonautomation presort rate category is not related to BMM. The Postal Service tried to correct the many terminology errors found in witness Prescott's testimony through the discovery process, but witness Prescott, in every instance, refused to budge. Tr. 29/13785-13786.

Another example can be found in the update to witness Prescott's Table 1. E-Stamp Brief at 7. The figures used in that table were taken from Postal Service LR-I-481. However, the data that were used at page 7 of the E-Stamp Brief were Base Year 1999 data, not Test Year 2001 data. Like all worksharing related savings estimates, the estimates found in witness Prescott's original testimony were Test Year figures. Therefore, Table 1 in E-Stamp's Brief is not a true "update" at all.

The second cost methodology that witness Prescott used to calculate a savings estimate was found in Table 2 of his testimony. Tr. 29/13763. Table 2, however, was not updated to incorporate Test Year data that were developed using Base Year 1999. E-Stamp claims "Mr. Miller failed to update his Appendix 1 to FY 1999 so it is not possible to update Mr. Prescott's Table 2, which is based on Mr. Miller's Appendix 1." E-Stamp Brief at 8. This claim is not true. Witness Miller's updated cost figures can be found in Postal Service LR-I-477. The Commission will observe that had witness Prescott's Table 2 been updated using the Test Year costs found in LR-I-477, the worksharing related savings estimate would have been less than the 4-cent discount

proposed by witness Jones.

In his rebuttal testimony, witness Miller pointed out that both cost methodologies used by witness Prescott contain cost comparisons between mail types that exhibit different mail characteristics. Tr. 45/19671-19673. E-Stamp attempts to cloud this issue by stating: "Mr. Miller's own testimony describes a mail processing difference between nonautomation presort mail and basic automation of 5.183 cents per piece." E-Stamp Brief at 11. In reality, Mr. Miller's direct testimony did not attempt to calculate any savings estimates between these two rate categories. The cost benchmark that both rate categories were compared to in his testimony was Bulk Metered Mail (BMM) letters. USPS-T-24. Appendix I at I-1.

E-Stamp also attempts to confuse this issue by criticizing witness Miller's use of the term "vast." E-Stamp Brief at 11. In order to clarify his point, witness Miller explained that the model cost for a Manual Presort letter was 9.675 cents, while the model cost for an Automation Basic Presort letter was 4.093 cents. In ratemaking terms, a cost difference of 5.582 cents is "vast," indeed. The crux of witness Miller's testimony was that the cumulative effect of the mail characteristics differences between nonautomation presort letters and automation presort letters makes witness Prescott's reliance on such a cost comparison problematic. Nonautomation presort mail pieces are only machinable 25% of the time, can incur package sorting costs, can weigh up to 13 ounces, and are presorted to different levels. On the other hand, automation presort letters must be machinable, can not be entered in packages, are limited to 3.3 ounces, and are more finely presorted. It is reasonable to conclude that the cost impact of these mail characteristics would result in an estimate that does not truly isolate the

worksharing related savings associated with a barcode.

E-Stamp further claims that witness Miller's concerns regarding the mail characteristics differences between nonautomation presort letters and automation presort letters do not apply to witness Prescott's second cost estimate.

Mr. Miller did have to concede that, while he had previously criticized Prescott's first methodology because it compared an actual CRA category, presorted nonautomated, and the combined categories of basic, three digit and five digit presort automated, Prescott's second methodology compares the automation presort to nonautomation presort. So that previously leveled criticism, even if it were valid, is inapplicable to this methodology.

E-Stamp Brief at 14.

Again, E-Stamp uses the incorrect terminology here. The second methodology used by witness Prescott compares the costs for a Nonautomation Presort letter to the costs for an "Automation Basic Presort" letter, not an "Automation Presort" letter. In addition, witness Miller's criticism is still valid. The mail characteristics differences pertaining to the level of presortation may not apply in this instance, but the differences related to machinability, the use of packaging, and weight do apply. As such, it is again reasonable to conclude that the cost impact of these mail characteristics would result in an estimate that does not truly isolate the worksharing related savings associated with a barcode.

Further, E-Stamp vainly tries to cite Postal Service Bulletin 22044 (August 12, 199) as proof that PC Postage mail generates the cost savings estimated by witness Prescott. E-Stamp Brief at 10-11. Issued at the time that the PC Postage program was inaugurated, the Postal Bulletin states: "PC postage products provide time savings, increased efficiency, reduced costs, and enhanced security for both

customers and the Postal Service.” Does the Bulletin describe or quantify any time savings, increased efficiencies, or cost reductions? Are the cost reductions for customers or the Postal Service? Are mail processing cost reductions described? Lest there not be any doubt, the Postal Service possesses no studies that estimate any such time savings, increased efficiencies, or cost reductions.

Moreover, it is interesting to note that after the apparent flaws in Prescott methodology were revealed, E-Stamp attempted to shift the blame for such shortcomings to the Postal Service. E-Stamp Brief at 15. The Postal Service has no responsibility for conducting cost studies for E-Stamp or any other intervenor that proposes a rate discount. The burden is, and should be, on the interested party to justify the proposed discount.

(b) E-Stamp failed in trying to rehabilitate witness Boggs’ testimony.

On Brief, E-Stamp, like Stamps.com, unsuccessfully attempts to discredit Dr. Staisey’s testimony. E-Stamp alleges that, when questioned about the low response rate to witness Boggs’ survey, Dr. Staisey offered “no corroboration from other authority that her judgment” was correct. E-Stamp Brief at 18. However, that is a mischaracterization of Dr. Staisey’s testimony. She clearly stated that her conclusion about the response rate “would be [a] generally-held opinion by anyone with expertise in survey research.” Tr. 45/19945.

E-Stamp further attempts to put an incorrect slant on Dr. Staisey’s testimony. E-Stamp argues that, when asked what facts were at issue, Dr. Staisey “was unable to come up with any other than the fact that a survey was taken and that there was a

16.5 percent response." E-Stamp Brief at 19. If the Commission wants a clear and succinct description of the factual issues as they relate to witness Boggs' market research, it need only read Dr. Staisey's testimony at pages 16-19 (Tr. 45/19931-34).

E-Stamp attempts to deflect the significance of examining actual year 2000 PC Postage results as a means of evaluating the quality of the assumptions underlying witness Boggs' forecasts by conceding that "hindsight is 20/20." E-Stamp Brief at 19. However, if witness Boggs' projection for year 2000 is so far off the mark, how can the Commission have any confidence in his projections for future years?

Finally, the Commission should disregard the assertion that Dr. Staisey's professional judgment was somehow tainted by the fact that she was employed by the Postal Service as a consultant. E-Stamp Brief at 20. Clearly, if a contractual relationship alone were presumed to detract from the credibility of expert witnesses in Commission proceedings, then the testimony of witness Boggs, as a consultant for E-Stamp, would be discredited on that basis alone as well. Further, Dr. Staisey's testimony is supported by factual data provided by the Postal Service (Tr. 45/20013), and confidential information supplied by PC Postage vendors (Tr. 47/22378-85, 22387).

(c) The Postal Service supports PC Postage technology.

The allegation at page 1 of the E-Stamp Brief that "not a single penny has been spent by the Postal Service to promote" PC Postage is simply unfounded. Postal Service witness Gordon testified that not only has the Postal Service spent

"one penny" to promote PC Postage (Tr. 45/20032), but it has conducted a number of programs aimed at increasing public awareness of PC Postage (Tr. 45/20031). However, the marketing responsibility of PC Postage, like that of any other privately produced postal evidencing system, depends in great measure on the vendors.

Barely a year old, PC Postage technology shows great promise. Witness Gordon testified that the Postal Service looks forward to working with all of the PC Postage vendors to develop the technology to its fullest potential. Tr. 45/20020. Whether the technology can provide a basis for further de-averaging of the single-piece First-Class Mail rate is a question that merits further study.

- d. Other intervenor single-piece proposals should be rejected.
- i. Mr. Popkin's proposed EXFC-based rate differential should be summarily rejected.

At page 14 of his Brief, Mr. Popkin makes broad-brush allegations about the extent of isolated "special arrangements" taken to improve First-Class Mail service performance in two of 85 performance cluster included in the Postal Service's External First-Class Mail (EXFC) service performance measurement system. Based on two isolated examples, Mr. Popkin proposes that the Commission de-average the First-Class Mail rate structure on the basis of whether mail is deposited in one of the 85 performance clusters covered by the EXFC system.¹² Alternatively, he proposes that the Postal Service should provide "equal service to all residents in the United States by extending the EXFC areas countrywide."

¹² The proposed 34-cent rate would apply in such zones; the current 33-cent rate would apply to mail deposited elsewhere.

This proposal should be summarily dismissed. Mr. Popkin argues that “[i]f the mailers in the non-EXFC areas are receiving a lower and less costly level of service, they should pay less than those in EXFC areas.” Popkin Brief at 14. But he points to no cost data to support such a rate differential. Nor does he provide a basis for evaluating the operational or administrative feasibility of such a rate scheme. He provides no evidence of a difference in the value of service of EXFC-entered mail vs. non-EXFC-entered mail. Nor does he articulate how any of the other § 3622(b) criteria would support such a differential.

Mr. Popkin also seems to confuse the extension of the EXFC measurement system with either the provision (or improvement) of First-Class Mail service. The size and scope of the EXFC program are matters reserved to the discretion of postal management and outside the scope of this proceeding. In any event, as current EXFC scores make abundantly clear, the presence of EXFC among the 85 performance clusters does not “equalize” service performance among the affected delivery service areas. There is no basis for assuming that a comprehensive extension of EXFC nationwide would have such an effect.

Mr. Popkin’s proposal is reminiscent of an earlier proposal rejected by the Commission. See PRC Op. R87-1, Vol. 1, at 435, 437.

- ii. There is no basis for Mr. Carlson’s proposal to “freeze” the basic postcard rate at its current level.

The Postal Service has proposed a one-cent increase in the basic postcard rate from 20 to 21 cents. For the reasons explained below, Mr. Carlson’s arguments in opposition to this penny increase should be dismissed.

Citing ¶6004 of the Commission's Docket No. R97-1 opinion, Mr. Carlson argues that mail processing costs are lower for the stamped card subset of the card subclass. Carlson Brief at 23.¹³ However, he points to no Docket No. R2000-1 record evidence to quantify any such difference.¹⁴

At page 20 of his Brief, Mr. Carlson cites the Commission's policy¹⁵ of maintaining a relatively inexpensive postal category that can be widely used by the general public, businesses, and organizations. However, he fails to articulate any basis for concluding that the rate proposed by the Postal Service would undermine the accomplishment of that objective.

Mr. Carlson argues that § 3622(b)(2) should be applied to freeze the postcard rate. He points to the Commission's application of that pricing criterion in Docket No. R97-1 and argues that FY 1998/1999 External First-Class (EXFC) data¹⁶ should be used as a basis for concluding that, all else aside, the value of service for cards is so inferior to that for letters that the card/letter rate differential should be increased. Carlson Brief at 20-21. However, there are no data which indicate what the difference in service performance for cards and letters may have been before 1998.

¹³ Mr. Carlson neglects to mention that the Commission also concluded that "there is considerable uncertainty as to the extent of any difference in processing costs between stamped cards and postal cards." PRC Op. R97-1, Vol. 1 at 594, ¶6004.

¹⁴ Mr. Popkin makes the same claim in his Brief at 9, where he states that "the cost of processing stamped cards is far less than that for post cards." He, too, provides no record support for his assertion.

¹⁵ PRC Op. R97-1, Vol. 1 at 349, ¶5269.

¹⁶ Which show slightly superior delivery performance for letters, compared to cards.

Accordingly, it is impossible to determine whether the 1998/1999 EXFC data referred to by Mr. Carlson reflect a change in relative service performance since the time of the Commission's Docket No. R97-1 evaluation. In the absence of a benchmark from which to draw a comparison, it is impossible to conclude, as part of the complex application of factors considered under § 3622(b)(2), that the 1998/1999 data, by themselves, reflect any change in letter/card service performance sufficient to warrant a change in the letter/card rate differential. In fact, the very data relied upon by Mr. Carlson show the service performance differential narrowing from 5.3 percent in 1998 to 4.3 percent in 1999.

- e. The OCA has failed to provide a basis for modifying the nonstandard surcharge.

In support of its offensive against the application of the nonstandard surcharge to low aspect ratio one-ounce First-Class Mail pieces, the Oca makes a number of arguments, most of which have been refuted in the Initial brief of the Postal Service at VII-82-85. Below, the Postal Service responds to several arguments in the OCA Brief.

At page 191 of its Brief, the OCA argues that "the revenue and cost associated with low aspect ratio letters are so small that the Postal Service is essentially unconcerned with what (if any) surcharge should be imposed on such mail." To the contrary, the testimony of witness Fronk (USPS-T-33 at 28-30) demonstrates that the objective of the nonstandard surcharge is not to recover all possible costs related to the nonstandard nature of such pieces directly from their senders, but to continue the long-standing policy of ensuring that a sufficient level of

such costs are directly recovered as to provide an incentive to avoid non-standardization and to maximize mail processing efficiency.

The OCA argues that "it is clear from the evidence in this proceeding that low aspect ratio letters are being routinely processed and sorted to carrier walk sequence on automation." OCA Brief at 187. In addition, the OCA asserts that "[t]he evidence in this proceeding supports this conclusion that low aspect ratio letter mail is being processed successfully on automated equipment." OCA Brief at 191. The Postal Service has never suggested that it was impossible for such letters to successfully processed on automation to some degree. The OCA, however, can point to no evidence of the degree to which low aspect ratio pieces are successfully processed. Neither witness Miller nor witness Callow provided any such analysis. Although the OCA Brief makes every effort to elevate Dr. Haldi's Docket No. R97-1 10-piece experiment to the Olympic heights, that experiment only proves that some pieces can get barcodes applied. It does not establish the degree to which any of those pieces were processed successfully on automation, much less walk sequenced.¹⁷

The OCA tries to have it both ways here. On the one hand, it criticizes the Postal Service for applying the surcharge to low aspect ratio letters that the OCA claims are "routinely processed." On the other hand, the OCA laments the absence of evidence indicating the degree to which low aspect ratio letters are successfully processed in today's automation environment. OCA Brief at 189. If the OCA does not have evidence of the extent to which low aspect ratio letters are successfully

¹⁷ As witness Callow stated himself, the results from this study were not "statistically valid." Tr. 22/10215.

processed on automation, it cannot simultaneously claim that such letters are routinely processed successfully through delivery point sequencing.

In fact, the Postal Service has repeatedly conceded that some letters can be successfully processed through some automation operations. USPS-T-24 at 20. Tr. 45/19678. Some low aspect ratio letters were also successfully processed through some mechanized operations in the original Tracor-Jitco studies relied upon by the Commission in Docket No. MC73-1. As witness Miller explained, "If low aspect ratio letters were a problem in a low-speed mechanized environment, why would they possibly be easier to process in a high-speed automated environment? Witness Callow's unsupported claim defies logic." Tr. 45/19679. The OCA Brief is conspicuously silent on this matter.

As confirmed by witness Callow, the cost study sponsored by the OCA definitively proved that nonstandard letters do, in fact, cost more to process. Tr. 22/10217. Rather than address this fact, the OCA continues to criticize witness Miller's original cost study because it assumed that nonstandard letters were processed manually. OCA Brief at 194. However, the OCA fails to mention that witness Miller updated that cost study in his rebuttal testimony using witness Callow's "most likely" cost figure. Tr. 45/19692. The cost results from that study were still significantly higher than the 11-cent surcharge proposed by witness Fronk. USPS-T-33 at 27.

- f. The ABA&NAPM and MMA criticisms miss several key points.
 - i. Major Mailers Association is wrong about the benchmark.

At pages 18 and 19 of its Brief,¹⁸ MMA makes a series of assertions about the bulk metered benchmark which are just plain incorrect.

For instance, MMA characterizes the Postal Service's bulk metered mail benchmark piece as "a nonprebarcoded, nonpresorted, automation compatible mail that meets all the prerequisite design and the mail preparation regulations that current First-Class Mail Automation mail must meet, including Move Update and reply mail requirements." MMA Brief at 18. However, MMA can provide no citation to such an exaggerated description ever having been provided by anyone.

On the same page, MMA argues that using MML [metered mail letters] rather than BMM [bulk metered mail] as the benchmark simply recognizes that the mail preparation costs are also avoided by worksharing efforts of presort mailers." But this is not so. The only difference between MML and BMM costs is the fact that witness Miller set the "1CANCMMMP" cost pool to zero. This cost pool contains the costs for cancellation and the meter belt operation and has nothing to do with "mail preparation" activities related to sleeving, banding/strapping, and labeling of trays.

¹⁸ On September 14, 2000, MMA filed what it characterized as "corrected pages" to its September 13th Brief. These "corrected pages" include an entire two-page chapter IV added to the end of the Brief. These two pages are described in a facsimile message to the Postal Service as having been "omitted from the filed version." Neither the September 14th filing nor the facsimile message suggests that the "omission" was a typographical error, that it resulted from a printing production error, or that it was otherwise inadvertent.

At page 18, of its Brief, MMA asserts that there are no reliable data demonstrating that bulk metered mail exists. And at page 19, MMA describes the testimony of witness Bentley as indicating that it is illogical to assume that mailers would forego worksharing discounts but still voluntarily prepare their mailings in the same manner as presort mailers. Neither Mr. Bentley nor the MMA Brief points to any Postal Service testimony that mailers would prepare their mail exactly as presorters do in the absence of workshare discounts. However, common sense informs the Commission that mailers who prepare metered mail in bulk have to orient and face those pieces in order to affix a meter indicium. MMA would have the Commission believe that these mailers “un-tray” and “un-face” their mail after metering it and before taking it to the post office. Now, that is illogical.

No matter how hard they try, ABA&NAPM and MMA cannot “wish away” bulk metered mail, and have no basis for persuading the Commission to adopt a different, more “discount-friendly” benchmark. The rebuttal testimony of witness Miller (Tr. 45/19696-97) -- which relies on current MODS data, his own survey of mail processing managers at over 100 mail processing plants, and his own direct field observations -- confirms that bulk metered mail is alive and well. It continues to serve as the appropriate benchmark from which to measure worksharing cost avoidance.

- ii. MMA and ABA&NAPM are mistaken about the implications of using the bulk metered mail benchmark.

MMA argues that “in the final analysis, the choice of a benchmark has no effect whatsoever on the outcome of Mr. Miller’s workshare cost analysis. MMA Brief

at 17. This statement is misleading. Had witness Miller used a metered mail letter benchmark (as did witnesses Bentley and Clifton), his savings results would not have changed because he classified the one affected cost pool (1CANCMMP) as "non-worksharing related." Witnesses Bentley and Clifton, however, classified this cost pool as "worksharing related." As a result, the use of a bulk metered mail benchmark, rather than a metered mail letter benchmark, does affect their savings estimates.

At page 8 of their Brief, ABA&NAPM argue that if MMA witness Bentley had used the bulk metered mail benchmark in his analysis, it would only have reduced his cost avoidance measurements by 0.3 cents per piece, "which would result in a level which still fully supports the ABA&NAPM proposed discounts." However, this also is not the case. Had Mr. Bentley used the bulk metered benchmark, his PRC-version-based Automation Basic unit cost avoidance estimate would have shrunk by 0.5 cents to 6.4 cents per piece, which is less than the 6.6-cent discount proposed by ABA&NAPM witness Clifton.

- iii. ABA&NAPM miss a fundamental point about the potential impact of the Move Update requirements.

At pages 15-16 of their Brief, ABA&NAPM argue that the Move Update requirements¹⁹ reduce forwarding and return costs for such mail in relation to single-piece First-Class Mail. At page 16, AMA&NAPM assert that "the worst culprit for mail forwarding and return costs would be the very mail which Mr. Miller uses as a

¹⁹ Imposed upon the automation-based workshare categories of First-Class Mail letters as a result of Docket No. MC95-1.

benchmark to measure cost avoidance . . . bulk metered mail."²⁰ However, if ABA&NAPM believe in the benchmark/rate category method of measuring cost avoidance, then they should appreciate that any cost differences related to return and forwarding are included in witness Miller's cost avoidance estimates by virtue of the fact that the affected cost pools ("bcs", "mani", and "cfs") were classified as "worksharing related."

²⁰ First, it is encouraging that ABA&NAPM have finally conceded the existence of bulk metered mail, even if only for the purposes of disparaging it. However, the basis for the assertion that bulk metered mail has the highest rate of forwarding and return among First-Class Mail pieces is a mystery.

- B. The change to the Priority Mail flat rate proposed on brief by Mr. Carlson and Mr. Popkin must be rejected.

The Postal Service has covered the salient issues regarding Priority Mail rate design in its initial brief. However, because two parties chose to introduce wholly new proposals on brief, additional comments on these proposals are warranted.

Intervenors Douglas F. Carlson and David B. Popkin, on brief, argue that the Commission should recommend a classification change that would set the rate applicable to Priority Mail flat-rate envelopes equal to the proposed one-pound Priority Mail rate, rather than the two-pound rate, as in the current rate schedule. Carlson Brief at 1-9, Popkin Brief at 12-13, Popkin Initial Brief Filed Under Protective Conditions (Popkin Sealed Brief) at 1. Mr. Popkin argues that applying the two pound rate to flat-rate pieces weighing under a pound would create a rate anomaly, would cause mailer confusion, and would result in the Postal Service committing "fraud" against customers who might not realize that use of a flat-rate envelope might not be the lowest-cost Priority Mail option available. Popkin Brief at 12-13. Mr. Popkin also argues that knowledgeable postal customers might be inclined to use Postal Service-supplied mailing supplies in such a way as to impose greater costs on the Postal Service. Popkin Sealed Brief at 1. Mr. Carlson, in a brief that in many respects resembles testimony, advances a variety of arguments in support of applying the proposed one-pound rate to Priority Mail flat-rate envelopes. Among these are the assertions that the proposal would enable mailers using flat-rate envelopes to benefit from weight-averaging, and that there would be only minimal upward pressure on the one-pound rate. Carlson Brief at 1-5. Mr. Carlson also asserts that the convenience afforded by

the flat-rate envelope is of little value to mailers, and thus does not justify the higher, two-pound rate, and that customer confusion will result if his proposal is not adopted. *Id.* at 6-8.

Since these intervenors did not file their proposals¹ as testimony during the normal course of this proceeding, many of the unsupported assertions made in their briefs have not been examined on the record of this case. Furthermore, no party has had the opportunity to submit responsive testimony on the negative aspects of the change sought by these intervenors. These procedural inadequacies militate strongly against serious consideration of the classification change sought.

Beyond these procedural defects, however, it can readily be seen that, for several reasons, the Commission should not recommend the rate sought by Mr. Carlson and Mr. Popkin.

In response to Presiding Officer's Information Request No. 5, Question 7, Postal Service witness Robinson explained that the flat-rate envelope rate was set equal to the two-pound Priority Mail rate, in part to avoid upward pressure on the one-pound rate. Tr. 46-D/21792-3. *See also* Tr. 7/2874. In his brief, Mr. Carlson acknowledges that "[i]f the Commission applies the one-pound rate to flat-rate envelopes, some customers surely will migrate from weight-rated Priority Mail in their own packaging to the flat-rate

¹ Mr. Carlson implies that the burden is on the Postal Service to justify retention of the existing two-pound rate for the flat-rate envelope. Carlson Brief at 1. On the contrary, it is clear that Mr. Carlson and Mr. Popkin are the sole proponents of their suggested classification change to apply a new one-pound rate as the flat-rate envelope rate. As the proponents of this change, the burden is theirs to carry, and theirs is the need for substantial record evidence. Unfortunately, they chose not to present testimony on this issue.

envelope."² Carlson Brief at 2. Having made this start, however, Mr. Carlson proceeds, without convincing record evidence, to discount this acknowledged potential for diversion of volume, and its attendant effects on the weight-based Priority Mail rate structure. *Id.* at 2-5.

Contrary to Mr. Carlson's assertions, a careful review shows that the potential for "push up" on the one-pound rate, if that rate were applied to the flat-rate envelope, cannot be ignored. If the one-pound rate were to be applied to the flat-rate envelope, current flat-rate envelope customers presumably would continue to have a financial incentive to use the flat-rate envelope. In addition, all customers mailing Priority Mail pieces weighing between one and two pounds and not using the flat-rate envelope would have a new financial incentive to use the flat-rate envelope.³

As described in witness Robinson's testimony, Priority Mail rates are based on an allocation of costs to rate cells which includes a "per-pound" rate element. If the average weight of a rate cell changes, the costs allocated to that rate cell also will change.⁴ USPS-T-34 at 11-12. Therefore, to evaluate the potential effect on rates of

² Even this observation can be accepted only with qualification. It is clear that the customers that could potentially migrate from weight-rated Priority Mail to the flat-rate envelope would include not only those that use "their own packaging" but, potentially, those who use other Postal Service-provided packaging materials.

³ It is possible that some customers that mail pieces weighing more than two pounds that do not currently use the flat-rate envelope may decide to use the flat-rate envelope if the rate were the one-pound rate rather than the two-pound rate. However, because this behavior cannot be quantified, these customers will not be included in the following calculation. See Response to DFC/USPS-T34-17 (April 13, 2000).

⁴ Calculating the average weight for the flat-rate envelope, as well as the one-pound and two pound rate cells, was clearly required to design rates given the Postal Service's proposal to differentiate the one-pound and two-pound rates. See USPS-T-

the Carlson-Popkin proposed rate cell for "one-pound weight-rated Priority Mail and flat rate envelope," one must determine what the average weight for the cell would be. This requires a careful analysis of potential migration to the flat-rate envelope under the assumption that the Carlson-Popkin proposal were accepted. However, owing to the fact that these parties chose to present their proposal only on brief, there is no such analysis on the record, nor is there even any evidence that would permit an adequate analysis to be performed.

From the record evidence that exists, the upper bound on the weight of the Carlson-Popkin proposed rate cell "one-pound weight-rated Priority Mail and flat-rate envelope" arguably can be estimated at 1.05 pounds.⁵ If this estimate is correct, the

34, Attachment C.

⁵The upper bound for the weight of the Carlson-Popkin "one-pound and flat-rate envelope" rate cell is calculated assuming that ALL weight-rated Priority Mail weighing between 16.001 and 32.000 ounces migrates to the flat-rate envelope. This calculation must be based on the TYBR volume and average weight data *without* the impact of the Docket No. R2000-1 Postal Service-proposed one-pound rate:

		Volume TYBR (a)	Average Weight (pounds) (b)	Total Weight (pounds) (c)
(1)	Flat-rate Envelope	156,451,596	0.64	100,685,403
(2)	Weight Rated (.001- to 1-Pounds)	380,237,162	0.72	272,084,556
(3)	Weight Rated (1- to 2-Pounds)	493,746,619	1.43	708,272,204
(4)=(1)+ (2)+(3)	Total	1,030,435,377		1,081,042,162
(5)=(4c)/ (4a)		Average Weight (pounds)		1.05

Source: USPS-T-34, Attachment B, pages 3-5

Carlson/Popkin proposal can be expected to increase the weight used to calculate the one-pound rate by up to 0.41 pounds (or 63 percent above the weight of 0.64 pounds that underlies witness Robinson's proposed one-pound Priority Mail rate.)⁶ See USPS-T-34, Attachment C at 3. The testimonial brief filed by witness Carlson clearly does not adequately deal with the potential increase in average weight per piece in the lowest Priority Mail rate cell, and the increase in test-year costs that would go along with it.

One might object that it is not clear that all weight-rated pieces weighing between one and two pounds will migrate to the flat-rate envelope. However, this consideration simply highlights the need to examine classification proposals such as this on the evidentiary record. There simply is no record evidence to show what proportion of Priority Mail pieces will migrate to the flat-rate envelope if the rate incentive inherent in the Carlson-Popkin proposal is introduced. Even Mr. Carlson appears to believe that the upward pressure could be as much as 2.25 ounces (0.14 pounds or 22% above witness Robinson's assumed weight of 0.64 pounds for one-pound pieces) or perhaps 0.91 ounces (0.06 pounds or 9% above witness Robinson's assumed weight of 0.64 pounds).⁷ Carlson Brief at 5. There is not a sufficient basis on this record to estimate

⁶ It is an arithmetic coincidence that the average weight of a flat-rate envelope calculated prior to the consideration of the Postal Service's Docket No. R2000-1 one-pound rate proposal (as shown in USPS-T-34, Attachment B) equals the average weight of a one-pound, weight-rated Priority Mail piece assuming the Postal Service's proposed rate design (shown in USPS-T-34, Attachment C).

⁷ The "per-pound" rate element for Priority Mail ranges from 0.415064 (Zones L,1,2,3) to 1.270998 (Zone 8). USPS-T-34, Attachment G at 3. Clearly, if the average weight of a "one-pound and flat-rate envelope piece" under the Carlson-Popkin proposal increased, a significant rate increase for that rate, and possibly others, may be necessary.

the potential impact on Priority Mail test year volumes and costs of the Carlson/Popkin proposal.

It is not enough to suggest, as does Mr. Carlson, that "if upward pressure on the one-pound rate does occur, the one-pound rate should be raised in a future rate case." Carlson Brief at 5. The Commission is charged with recommending rates that conform to the requirements of the Postal Reorganization Act, not rates that may fall short of those requirements when recommended, but can be "fixed" in the future. Along these same lines, neither Mr. Carlson nor Mr. Popkin have discussed the decreased revenue that would result from lowering the flat rate from the two-pound rate to the one-pound rate. Clearly, this decreased revenue must be made up if the target cost coverage is to be achieved and the revenue requirement met. There is insufficient consideration of this important issue on the present record.

Mr. Carlson's failure to support his proposal with persuasive record evidence on the issue of diversion does not end with the omissions noted above. The Postal Service also does not concede the validity of Mr. Carlson's unsupported assertions that "flat-rate envelopes are useful only for documents and other matter that does not require padded protection," and "[f]lat rate envelopes do not hold more than an average of 22.89 ounces." Carlson Brief at 3. These are empirical questions, and, despite Mr. Carlson's attempts to posit an answer to them through pure reasoning and assumptions regarding the behavior of customers, can only be answered by empirical data. Unfortunately, the record again is devoid of the necessary information.

Mr. Carlson also argues incorrectly that the flat-rate envelope provides little additional value of service because "security restrictions on the deposit of mail in

collection boxes have destroyed most of the value that may have been associated with the flat-rate aspect of flat-rate envelopes". Carlson Brief at 7.

Mr. Carlson's arguments regarding the allegedly low value to customers of the flat-rate envelope are similarly unsupported. For example, Mr. Carlson asserts that Priority Mail bearing adhesive stamps must be brought to the retail window.⁸ Carlson Brief at 6. This conclusion is easily refuted. As DMM 54 D100.2.6 notes, "[s]uch mail may be presented by a sender known to the postal carrier at the sender's residence or place of business." In these circumstances, it is not inconceivable that there could be value of service for a mailer (perhaps running a home-based, small business) who can tender a flat-rate envelope with adhesive postage stamps to his or her letter carrier without needing to weigh the Priority Mail piece. Tr. 46-D/21792-3.

Mr. Carlson similarly asserts that a customer who uses a postage meter would receive no additional value of service from the flat-rate envelope. Carlson Brief at 6. This is based on the unsupported statement that "customers who have postage meters are likely also to have [postage] scales," and therefore, would either not need to use the flat-rate envelope because they could weigh all mailpieces. Carlson Brief at 6. There is absolutely no record evidence correlating the use of postage meters with the possession of postage scales. In fact, the value of service for flat-rate envelope customers using postage meters may be even greater than for customers using adhesive stamps because these customers do not face additional restrictions on use of

⁸ In any event, note that, depending on the Postal Quarter, only about 8.5 to 10 percent of Priority Mail bears adhesive stamps. See USPS-LR-I-170, ODIS Quarterly Statistics Reports, (FY98-99) Table 13.

collection boxes. “. . . [Metered] Priority Mail (in a weight category for which rates do not vary by zone) . . . may be deposited in any street collection box or such other place where mail is accepted. . . .” DMM 54 P030.5.4.

Mr. Popkin's argument regarding the alleged upward pressure on Priority Mail rates assuming that customers would choose more expensive Postal Service-provided packaging materials to save 40 cents if the flat-rate envelope rate was not the lowest Priority Mail rate is similarly unsupported by record evidence. Popkin Sealed Brief at 1. No evidence exists on this record that would indicate what packaging would be employed by mailers in response to a one-pound-rate flat-rate envelope. Furthermore, Mr. Popkin's assertion regarding customer reactions ignores the Postal Service's intention to offer a “non-flat-rate” envelope for weight-rated Priority Mail pieces with similar characteristics to the current Priority Mail flat-rate envelope. Tr. 7/2872.

Given the lack of substantial record evidence supporting their proposal, and the inadequate opportunity for scrutiny regarding it, the change proposed by Mr. Carlson and Mr. Popkin must be rejected.

C. The Periodicals Mail Rates and Rate Design Should Incorporate Record Developments.

1. Lower Periodical rates can be recommended based on a large downward adjustment in Periodicals costs, but that adjustment should not be as large as the Periodicals mailers propose.
 - a. The Periodicals mailers have argued for many test year cost reductions that are supported by the Postal Service and some that are not.

The Periodicals mailers¹ present a number of test year cost reductions totaling \$218 million. Periodicals Mailers Brief at 19. Although the Postal Service agreed in its initial brief that a large downward adjustment in Periodicals cost was warranted, based in part on test year cost reductions,² the Postal Service does not agree with all of the cost reductions identified by the Periodicals mailers. In addition, the Postal Service believes that 1998, not 1999, is the appropriate base year in this case, and thus some of the savings identified by the Periodicals mailers would be applicable *only if* the Commission determines to use FY 1999 as the base year.

- i. The Postal Service and the Periodicals mailers are in agreement on certain cost reductions.

The two cost reductions where there is complete agreement between the Postal Service and the Periodicals mailers are the Line-of-Travel Requirement (\$23 million), and the Memorandum of Understanding on Vertical Flats Casing (\$7 million), whether

¹ Alliance of Nonprofit Mailers, American Business Media, Coalition of Religious Press Associations, Dow Jones & Company, Inc. Magazine Publishers of America, Inc. National Newspaper Association, The McGraw-Hill Companies, Inc. Time Warner, Inc.

²

There are Base Year 1998 costing methodology changes that would reduce Periodicals costs as well, and these are discussed in more detail in section b. below.

either 1998 or 1999 is used as the base year. There is another cost reduction area where there is near complete agreement and that is the savings from changes in other Periodicals mail preparation requirements involving (a) mandatory compliance with the L001 option, (b) elimination of carrier route skin sacks, and (c) allowing barcoded and non-barcoded bundles in the same sack for approximate test year cost savings of \$15 million. The \$15 million, while agreed to in the context of Base Year 1998, was treated slightly differently in the Order No. 1294 update materials, which used FY 1999 as the base year.³

Also, the Periodicals mailers have urged that if the Commission uses FY 1998 as the base year, then "it should include a cost reduction program in FY 1999 that reduces test year Periodicals transportation costs by \$11 million." Periodicals Mailers Brief at 10. This is not a true cost reduction program in the traditional sense since the \$11 million reflects the amount by which actual FY 1999 costs were lower than projected FY 1999 costs, presumably based, in part, on "the Postal Service's commitment to keeping surface mail off of air transport." Tr. 46C/20956. Nonetheless, for purposes of this case, the Commission may wish to somehow reflect this \$11 million favorable variance for Periodicals, if 1998 is used as the base year. If FY 1999 is used as the base year,

³ As stated in the Postal Service's response to MPA/USPS-70, "[t]he amount of cost savings for Periodicals for the implementation of new mail preparation standards related to "Carrier Route Sacks, L001, and Combining Automation and Nonautomation Flats in Sacks and on 5-Digit Pallets" that is included in the Postal Service's July 7 update is \$9.211 million. This figure differs from the \$14,885 million savings shown in USPS-LR-I-332 because it does not include piggybacks. The difference between the \$9.211 million and the \$14.885 million would be included in the other cost reductions and in the PESSA redistribution in the rollforward." Tr. 46-C/20872-76.

no adjustment is warranted, as acknowledged by the Periodicals mailers. Periodicals Mailers Brief at 10.

Finally, the Periodicals Mailers have urged that if FY 1999 is used as the base year, then a final adjustment, reducing Periodicals test year after rates costs by \$39 million, would be appropriate. Periodicals Mailers Brief at 18. As the Postal Service stated in its initial brief, it "does not necessarily endorse the methodologies by which those estimates have been calculated," but "would not challenge their utilization in this case if FY 1999-based costs were to be used." Postal Service Brief at I-23-24.

- ii. The Postal Service and the Periodicals mailers are in partial agreement on other cost reductions.

The Periodicals mailers include a number of cost reduction items from the Order No. 1294 update, but do not make clear whether they think these cost reductions should apply regardless of whether 1998 or 1999 is the base year. If the Periodicals mailers are implying that these cost reductions can be used with a 1998 base year, they are wrong. Although the Postal Service is opposed to using the results of the Order No. 1294 update, rather than its case based on a 1998 base year, if data from the update are used, *all* data from the update must be used, not selected pieces. It would not be proper to reflect only cost reductions arising from the update, without also reflecting the additional expenses contained in the update.

Thus, for example, the Periodicals mailers desire to incorporate what they term "[b]reakthrough productivity in highway transportation" for a savings of \$ 12 million.

The Postal Service agrees that breakthrough productivity savings should be recognized, but only if FY 1999 is used as the base year.⁴

The Periodicals mailers also project \$47 million in test year cost savings for various mail processing enhancements involving (a) increased flat sorting productivity, (b) better AFSM 100 performance, and (c) addition of OCRs and automatic feeders to the FSM 1000. See Periodicals Mailers Brief at 10. The support cited for this conclusion is the Postal Service's response to MPA/USPS-70. Tr. 46-C/20872-75. Apparently, some confusion was engendered by both the question and the response.

The responses to subparts e) and f) are repeated here:

- e) The amount of cost savings for Periodicals (above the savings included in the original filing) for "Equipment and Productivity Enhancements" that is included in the Postal Service's July 7 update is \$6.266 million. These savings are in mail processing and they can be found on page 10 of USPS-LR-I-408 under the distribution key headings: 1461, 1458 and 1462.
- f) Please refer to page 2 of USPS-LR-I-408, midway down the page to the section showing the distribution key "1448." Five mail processing programs (Flat Mail OCR, Accelerate FSM Buy Into 2001, Additional AFSM to upper bound, Improve FSM and Increase manual flat productivity) are combined because they share a common distribution key 1448 (sorting to flat cases). The sum of the five programs, \$250.532 million, is distributed on distribution key 1448 and this is shown on page 10 of USPS-LR-I-408 under the column headed 1448 – the Periodicals portion of the savings is \$40.904 million.

As stated in the response to subpart e), the \$6.266 million cost savings for Periodicals is "above the savings in the original filing." The figures in the response to subpart f) are for total cost savings, including cost savings in the original filing. The

⁴ There appears to be some inconsistency in the Periodicals mailers tallying up of their cost reduction totals. Base Year 1998 can not be used for the air transportation savings simultaneously with Base Year 1999 for the breakthrough productivity highway transportation cost savings.

Periodicals \$40.904 million portion of the \$250.532 million total in subpart f) is thus not above the savings in the original filing. To determine the amount above the savings in the original filing, a comparison can be made between the cost reductions distributed with key 1448 in the original filing, witness Kashani, USPS-T-14, Appendix A, and the Order No. 1294 update, USPS-LR-I-408. Witness Kashani's Appendix A, page 36, shows a total cost reduction of \$218.993 million and a Periodicals cost reduction of \$35.561 using distribution key 1448. The last page of USPS-LR-I-408 shows a total cost reduction of \$250.532 million and a Periodicals cost reduction of \$40.902 million using distribution key 1448. The difference is \$31.539 million for the total cost reduction (\$250 million - \$218 million) and \$5.341 million for the Periodicals cost reduction (\$40 million - \$35 million).

Thus, the correct method for calculating the savings is to add \$6.182 (reflected in witness Degen's rebuttal testimony, Tr.38/17330) plus \$5.341 (as referenced above), for a total of \$11.523 million, rather than the \$47 million claimed by the Periodicals Mailers. The \$5.341 and the \$11.523 total, however, would actually both be lower amounts because, as recommended by the Postal Service in its initial brief, "the \$200 million field reserve inadvertently omitted from witness Patelunas's update [should] be incorporated into the subclass cost estimates." Postal Service Brief at I-19. Of course, the additional amount (\$5.431 million as reduced by a proportionate amount of the \$200 million field reserve) is only relevant if FY 1999 is used as the base year.

The Postal Service and the Periodicals mailers are also in partial agreement on test year cost savings for bundle breakage; both agree that there will be significant savings, but disagree on the exact amount. The Postal Service's estimate of \$15

million in test year bundle breakage cost savings⁵ is based upon an assumption of 25 percent reduction in bundle breakage in the test year, whereas the Periodicals mailers estimate of \$21 million was based upon an assumption of 50 percent reduction in bundle breakage in the test year and another assumption that no pieces from broken bundles will be keyed on the SPBS in the test year. As the Postal Service indicated in its initial brief, it is of the view that the Periodicals mailers assumptions "are overly optimistic, whereas its assumptions are more firmly grounded in operational reality." Postal Service Brief at Vii-141, n.2.

- iii. The Postal Service and the Periodicals mailers are in disagreement on other cost reductions.

There are certain cost reductions proposed by the Periodicals mailers, with which the Postal Service is in total disagreement. They are for cost savings which will not materialize.

The Periodicals mailers allege that the Postal Service had understated cost savings from AFSM 100 deployment by approximately \$24 million in the test year. Periodicals Mailers Brief at 14. The \$24 million estimate apparently was derived using certain FY 1999 sorting productivities. See Tr. 38/17190. Earlier, the Periodicals

⁵ The \$15 million was stated in the context of Base Year 1998, and like certain mail preparation changes, discussed above, was treated slightly differently in the Order No. 1294 update materials, which used FY 1999 as the base year. As stated in the Postal Service's response to MPA/USPS-70, "The amount of savings for Periodicals for expected reductions in bundle breakage and improvements in bundle recovery that is included in the Postal Service's July 7 update is \$10.323 million. This figure differs from the \$15 million savings shown in the response to MPA/USPS-ST42-10 because it does not include piggybacks. The difference between the \$10.323 million and \$15 million would be included in other cost reductions and in the PESSA redistribution in the rollforward." Tr. 46C/20873.

mailers had estimated the Postal Service's understatement of cost savings to be \$28 million in the test year. See Tr. 24/11278. Whatever the amount, it represents savings that will not be realized, as discussed in the Postal Service's initial brief. See Postal Service Brief at II-26-28.

The Periodicals mailers also assert that Periodicals test year costs should be reduced by \$3 million "to take into account the obvious fact that when cost reduction programs reduce direct labor costs, they also reduce supervisory requirements." Periodicals Mailers Brief at 17 (citation omitted). As the Postal Service fully explained in its initial brief, however, the analysis leading to this conclusion is flawed. See Postal Service Brief at II-26-28.

The final area of disagreement is over the purported \$16 million in test year rail transportation cost savings advanced by the Periodicals mailers. Periodicals Mailers Brief at 14-16. The Postal Service's disagreement that these proposed savings are real was fully discussed in its initial brief (Postal Service Brief at V-144-48) and is highlighted again in the discussion of transportation costs in this reply brief.

- b. The Periodicals mailers have argued for many base year costing methodology changes that are supported by the Postal Service and some that are not.

The Postal Service's agreement in its initial brief that a large downward adjustment in Periodicals cost was warranted, was based in part on a number of base year costing methodology changes that the Postal Service believes constitute either improvements in, or reasonable alternatives to, those contained in the Postal Service's

direct case.⁶ There are some costing methodology changes proposed by the Periodicals mailers, however, which the Postal Service does not support.

- i. The Postal Service and the Periodicals mailers are in agreement on certain costing methodology changes.

The Postal Service and the Periodicals mailers are in full agreement that a change should be made to the rural carrier mail shape adjustment using a full year of volume data from the rural carrier cost system, for an estimated base year reduction in Periodicals cost of about \$17 million. The two parties also agree that the variability for loop dismount costs should be set at zero. The Postal Service estimates that this would reduce Periodicals base year costs by about \$45 million.⁷

The Postal Service and the Periodicals mailers also are in accord on two revised transportation distribution keys – one for Roadrailleurs, resulting in a reduction in base year Periodicals costs of approximately \$2 million and another for rail empty equipment, resulting in around \$5 million in reduced Periodicals costs in the base year. For a more detailed discussion of these revised distribution keys, see Postal Service Brief at V-150-51 and the section on transportation costs in this reply brief.

- ii. The Postal Service and the Periodicals mailers are in partial agreement on other costing methodology changes.

Both the Postal Service and the Periodicals mailers are in general agreement on the concept of broader distributions of both mixed mail and allied “not handling” costs,

⁶ It should be noted that all of the base year costing methodology changes discussed in this section are derived using Base Year 1998, not FY 1999.

⁷ The Postal Service originally said that this would reduce Periodicals costs by approximately \$46 million. See Postal Service Brief at VII-143. The \$45 million is a more accurate estimate.

but differ on how broad these distributions should be and on how they should be implemented. The Postal Service can support a broader distribution of mixed mail costs beyond what was contained in its direct case so long as item and container information is not discarded, which would result in an approximate base year Periodicals cost reduction of around \$17 million. However, it cannot support the even broader distribution which is the preferred alternative of the Periodicals mailers, nor can it support a modification, using IOCS question 19 information, of its own broader distribution described immediately above, as proposed by the Periodicals Mailers. See Periodicals Mailers Brief at 24. The Postal Service also proposed a broader distribution of allied "not handling" costs in its direct case, although for different reasons than the Periodicals mailers. Moreover, the Postal Service stands by its original proposal in this regard and disagrees with the Periodicals mailers suggestion to use IOCS question 19 information. For a more detailed discussion of the agreements and disagreements between the Postal Service and other parties on mail processing cost distribution issues, please see Postal Service Brief at V-61-69 and the mail processing cost distribution section of this reply brief.

The Postal Service fully supports use of the new route-level regressions for load time variability sponsored by witness Baron. The Periodicals mailers support is conditional – their preferred outcome is to have the Commission reject witness Raymond's Engineered Standards Study, but they support witness Baron's new load time variabilities if the Commission declines to reject the Raymond study. The new load time variabilities would reduce Periodicals base year costs by approximately \$50

million. The validity of the Raymond study is addressed in the Postal Service's initial brief. See Postal Service Brief at V-70-80.

- iii. The Postal Service and the Periodicals mailers are in disagreement on one costing methodology change.

The Postal Service and the Periodicals mailers are in complete disagreement on highway transportation variabilities. The Postal Service has sponsored Dr. Bradley's variabilities, which are based on established precedent and sound econometrics. The Periodicals mailers have presented alternative variabilities based on MPA witness Nelson's econometric work. The substantial theoretical and implementation errors in Mr. Nelson's work are fully analyzed in the Postal Service's initial brief (Postal Service Brief at V-120-27) as well as in the transportation cost section of this reply brief.

- c. The Periodicals rates should reflect the cost reduction and costing methodology changes agreed upon by the Postal Service and Periodicals mailers.

Subsequent record developments in identifying further cost reductions and costing methodology changes should be reflected in the rates ultimately recommended for Periodicals mail. The Postal Service believes that the rates appropriately should reflect those cost reductions and costing methodology changes where there is full agreement between the Postal Service and the Periodicals mailers, as described above. Where there is partial agreement or no agreement, then the Postal Service asserts that its proposals, and not those of the Periodicals mailers, are the ones that should be reflected in the rates. As indicated in the Postal Service's initial brief, it is the Postal Service's belief that incorporation of these changes should provide the

Commission an opportunity to recommend an average rate increase for Periodicals of less than 10 percent. Postal Service Brief at VII-144.

2. The Periodicals mailers claim that the Postal Service's flats mail processing cost model is deficient is unfounded.

On brief, the Periodicals mailers claim that "Yacobucci's model is deficient" because it relies "on essentially worthless data on bundle breakage frequency rather than on far superior data that was subsequently collected." Periodicals Mailers Brief at 62. The Periodicals mailers criticize the use of an average bundle breakage rate and propose that the models be changed to incorporate deaveraged bundle breakage rates for sacks and pallets. The record demonstrates that the use of an average figure is reasonable and does not indict the model. Specifically, witness Yacobucci explains that the average bundle breakage rate "would be close to averaging the MTAC data." Tr. 5/1510. Further, the average bundle breakage rate does not "introduce new non-presortation-related bias into cost differences between rate categories." Tr. 5/1441. Hence, the Postal Service's flats mail processing cost model is not deficient because of its treatment of bundle breakage.

3. The Commission should recommend the formation of an Outside County subclass.

CRPA and CPA argue that it may not be in the public interest to merge Nonprofit and Classroom periodicals into the same subclass as Regular periodicals. CRPA Brief at 9; CPA Brief at 7-8. CRPA attributes the rate anomalies to an "irrational cost system." CRPA Brief at 8. However, witness Taufique explains that these rate anomalies are not based on irrational costs. Instead, rate anomalies persist because of a low Periodicals markup, the mechanism of 'half the regular mark-up' providing lower

rates for preferred subclasses, and higher discounts for Regular publications, compared to preferred publications. USPS-T-38 at 2; Tr. 17/6960, 6968-69. Given the current low markup proposed for Periodicals by the Postal Service the anomaly issue will only be exacerbated, absent a merger of subclasses. USPS-T-38 at 3. A permanent solution to avoid these type of anomalies, if the legislative change is enacted, is to develop rates for all Outside County periodicals jointly, and recognize the preferred mailers by providing a discount on total postage (except for the postage paid on advertising pounds). The Postal Service believes that an Outside County subclass needs to be created to prevent rate anomalies, and to provide more stable cost estimates. USPS-T-38 at 4-5.

4. Watchtower's "Trial Brief" should have been filed as testimony, and cannot be fully analyzed at this late time in the proceeding.

On September 13, 2000, Watchtower Bible and Tract Society of New York, Inc. (Watchtower) filed a "trial brief" proposing that Periodicals Nonprofit letter rates should either be kept at current rates, or increased between 3.0 and 4.7 percent. While the Postal Service is concerned about large rate increases for letter mailers, the lack of testimony filed by Watchtower has made it difficult for the Postal Service to respond.⁸ Given the proposed merger of the Regular, Nonprofit, and Classroom subclasses, rate increases for Nonprofit letters would be based on overall changes for the new Outside County subclass. The impacts of the changes proposed in Watchtower's brief are therefore hard to analyze. The Postal Service opposes Watchtower's request to "make

⁸ The Postal Service also has been unable to confirm hard copy service of this brief.

a 15 minute verbal presentation before the Commission." Watchtower Brief at 8. The Commission has already concluded several rounds of hearings during this proceeding, and oral argument is not appropriate on issues for which testimony is lacking.

- D. The Postal Service's Proposed Standard Mail Rate Design Is Balanced, Fair, And Sound, And Has Received Widespread Support From Standard Mail Users.

Relatively few challenges to the Standard Mail rate design have been advanced by participants. Challenges and alternatives to the proposed rate design have been few and very narrowly focused upon the following subject matter areas: (i) opposition to the ECR pound rate by NAA, VP-CW, and AAPS, (ii) parcel mailers' opposition to the proposed residual shape surcharge, (iii) adjustments to passthroughs for destination entry categories, and (iv) challenges to the cost basis underlying the letter/flat differential in ECR.

The bulk of the Postal Service's proposed rate design proposals, however, remains uncontroverted after having been thoroughly tested on the record. Intervenors have expressed praise and extended endorsements for various proposals. *E.g.*, PSA Initial Brief at 37 (supporting Standard Mail parcel barcode discount); MOAA et al. Initial Brief at 40 (supporting Standard Mail ECR and Regular rate design); Postcom et al. Initial Brief at 5 (supporting automation rates proposed by the Postal Service). On all of these positions and proposals, the Postal Service would invite the Commission's attention to the full discussion of Standard Mail (A) issues found in its Initial Brief. USPS Initial Brief at VII-149-207. Not all of the arguments in opposition to the Postal Service's proposals merit discussion in this Reply Brief. Below, the Postal Service responds to the principal arguments raised by the opponents on brief. In doing so, the

Postal Service puts to rest the notion that any of the challenges raised by the opponents merit recommendation by the Commission.

1. The proposed pound rate for ECR is eminently reasonable and is supported by reliable cost data.

The proposed reduction in the ECR pound rate has received strong support from Standard Mail users, including SMC, AISOP, and MOAA et al. SMC Initial Brief at 9-56; MOAA et al. Initial Brief at 1-40; AISOP Initial Brief at 3-13, 17-24. Only NAA, VP-CW, and AAPS oppose the proposed reduction in the pound rate on brief. AAPS Initial Brief at 1-11; VP-CW Initial Brief at 20-56; NAA Initial Brief at 6-24. The Postal Service refers the Commission to its Initial Brief at VII-170-83, as well as to the initial briefs of SMC, AISOP, and MOAA et al., for a discussion of the convincing record support favoring adoption of the proposed rate, as well as to the arguments made on brief thoroughly discrediting the opposition. In this brief, the Postal Service simply undertakes to address some of the principal themes raised in the opponents' initial briefs.

- a. The opponents misuse and misinterpret criterion (b)(4).

On brief, AAPS and NAA contend that the Postal Service has failed to meet its "burden" with respect to criterion (b)(4) of the ratemaking criteria. AAPS Initial Brief at 8; NAA Initial Brief at 7, 9-10. The record is clearly to the contrary. Not only did the Postal Service give due consideration to the (b)(4) criterion, but it has amply

demonstrated that the proposal satisfies the requirement.

First, however, it is important to point out that the intervenors incorrectly interpret criterion (b)(4) to apply to the microscopic evaluation of a *rate element* within ECR. Such a focused application of the criterion has no basis in judicial precedent. Rather, the (b)(4) criterion has been examined in the context of *cost coverages* of subclasses considered as a whole. See *Direct Marketing Association Inc. v. United States Postal Service*, 778 F.2d 96, 105 (2d Cir. 1985) (holding that the Commission properly exercised its discretion in evaluating the (b)(4) criterion in the context of cost coverage, and only secondarily in the context of unit contribution). The pound rate is not the sole determinant of the rate for ECR pound-rated pieces; rather, it is merely one rate element among a myriad of rates in the ECR subclass.¹ It is thus inappropriate to focus exclusively on the pound rate for purposes of the (b)(4) analysis. Rather, the cost coverage of the subclass as a whole should be the primary tool for evaluating the proposal's satisfaction with the (b)(4) criterion.

In any event, the Postal Service appropriately considered the (b)(4) criterion in conformance with the Act. Specifically, witness Mayes acknowledged that the "very high cost coverage of the ECR subclass" in excess of 200 percent provided ample

¹ Taken to its logical extreme, NAA's and AAPS's argument that each rate element must be examined for consistency with criterion (b)(4) would require that the Commission no longer tolerate a situation in which the Standard Mail (A) surcharge for residual shapes fails to provide adequate revenue to cover the costs of these pieces. Surely, the Commission is not prepared to embrace such an interpretation of the (b)(4) criterion, for to do so would be inconsistent with its Docket No. R97-1 recommendation of "below cost" rates for residual shapes, PRC Op. R97-1 § 5487, for which there clearly is

support for her finding that the rate change "does not result in unfair competition for [postal] competitors." USPS-T-32 at 38. In addition, as explained in the Postal Service's Initial Brief, witness Moeller went so far as to deliberately recognize the concerns of alternative providers in determining the appropriate level of the reduction. USPS Initial Brief at VII-179-80. Witness Moeller's analysis of implicit cost coverages of pound- versus piece-rated pieces further confirms that there is absolutely no risk of a below cost situation for pound-rated ECR pieces, as their implicit cost coverage under current rates exceeds that of piece-rated pieces, and the their implicit coverages would be not only equal, but also very high under the proposal. USPS-T-35 at 21.

The opponents also misinterpret the (b)(4) criterion's reference to competitors. NAA Initial Brief at 7, 11; AAPS Initial Brief at 7-8. Contrary to the opponents' arguments, the criterion does not protect specific nonpostal competitors from postal rate increases; rather, the (b)(4) criterion is intended to protect *competition*. Cf. *Direct Marketing Association Inc. v. United States Postal Service*, 778 F.2d 96, 106 (2d Cir. 1985) ("*DMA*"). In *DMA*, the predecessor to AAPS, the Council of Non-Postal Media (CNPM), challenged the Governors' approval of the Commission's recommended cost coverage for bulk rate regular (BRR) pursuant to Docket No. R84-1. CNPM argued that the Commission, in recommending rates for BRR, inadequately addressed the impact of BRR rates upon private-sector competitors of the Postal Service. The Second Circuit Court of Appeals rejected CNPM's argument, and concluded that the Commission had

(..continued)
competition.

properly addressed the effect on competition. *DMA*, 778 F.2d at 106. In so doing, the court held that the Commission's evaluation of "rate increases" under subsection (b)(4) is limited to arguments on the effect on competition in a general sense, without regard to particular competitors:

In evaluating competition-related arguments under subsection (b)(4), it must be remembered that the PRC's task is to protect competition, not particular competitors. *Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc.*, 429 U.S. 477, 488, 50 L. Ed. 2d 701, 97 S. Ct. 690 (1977).

DMA, 778 F.2d at 106. The opponents' focus on the effect of the rate change on alternative delivery carriers is accordingly misplaced. The appropriate focus of the analysis should be how the proposal affects competition, and as discussed below, the proposal clearly furthers this objective.

The record beyond question shows the proposal satisfies the judicially established interpretation of (b)(4). As witness O'Hara convincingly explains in his testimony, the (b)(4) criterion is satisfied, because the Postal Service's proposed reduction in the pound rate will cause competition in advertising markets to flourish:

the NAA and AAPS testimony is diametrically opposed to the proliferation of choice--and ultimately of competition--in advertising markets. In effect, NAA and AAPS would have the Commission maintain ECR rates for heavier weight pieces at levels far in excess of the relationship suggested by their costs. This necessarily implies that a more affordable alternative, in the form of a more attractive rate for heavier weight ECR mail, would be denied to mailers for the sake of the protectionist self-interest of NAA's and AAPS's members, thereby restricting choice and *reducing* competition. Simply put, the 3622(b)(4) requirement that the Commission consider the effect on competition weighs in favor of the Postal Service's proposal, for it will enable competition to flourish in the market for high circulation advertising, to the benefit of advertisers.

Tr. 46E/21937. This is echoed in Advo witness Crowder's testimony:

because it is an improvement that more closely aligns rate structure with cost structure, the USPS rate proposal will benefit all advertisers and consumers. It will make the print advertising distribution market more competitive by forcing its private distribution competitors to become more efficient and innovative. It will encourage delivery innovation and efficiency, enhance investment and entry into the retail and service markets, increase useful information to consumers, and reduce consumer prices for retail products and services. It will encourage allocative, productive, and dynamic efficiencies in the national economy.

Tr. 44/19385. Thus, contrary to the opponents' contentions on brief, the interests of criterion (b)(4) will clearly be furthered by adoption of the Postal Service's proposal.

By contrast, the course suggested by the opponents, which consists of either maintaining the rate at its current level or raising it to a higher level, would contravene the policy embodied in criterion (b)(4). By urging the Commission to recommend artificially high rates in order to protect a select group of individual businesses from the effects of cost-based rates, the opponents effectively seek to erect protectionist barriers that will ultimately result in reduced competition.

Tr. 46E/21937. Thus, the goals that NAA and AAPS seek to achieve, i.e., protectionism of a select industry, reduction of choice, and deprivation of an affordable alternative for heavier weight advertising matter, are clearly contrary to those embodied in criterion (b)(4). The opponents' arguments must therefore be rejected.

- b. The opponents rely heavily upon the SAI research, but it does not further their argument.

In AAPS's Initial Brief, and in AAPS's and NAA's Joint Brief Under Seal, the opponents point to the SAI report as evidence that the proposal will result in commercial harm to alternative delivery. AAPS Initial Brief at 5; Joint Brief at 3-5. Yet the SAI report should give the opponents little comfort; indeed, its findings suggest that the alternative delivery's challenges have little to do with postal competition.

First, however, it is essential that the SAI report be understood in its proper context. The report is not intended to supply the participants, or the Commission, with a market research suitable for ratemaking analysis. The study is not designed to satisfy the requirements for market research under the Commission's Rules of Practice. **[Insert Sentence A from Sealed Portion of Reply Brief]** The study was not sponsored by a witness, nor was cross-examination conducted on the study methodology or results. Thus, any findings of the study must be given proper weight given the study's limitations in these respects.

Other factors suggest that there are additional limitations in the utility of the research. The report was completed more than two years ago, and its findings may be outdated or superseded by changes in the market. For

instance, the report would not reflect the more current market assessments offered by industry witnesses in this docket, including witnesses Buckel, Merriman, Smith, Baro, Bradpiece, Giuliano, and Harding. For example, SMC witness Guiliano explained that the alternative delivery companies owned by his firm did not respond to SAI requests for information. Tr. 44/19065-66. In addition, the report does not reflect the 1999 postal rate increase for Standard Mail (A), which resulted in an increase in ECR rates. This is particularly important, because the study predates the implementation of the surcharge for Standard Mail (A) residual shapes. USPS LR-I-268 at 32. **[Insert Sentence B from Sealed Portion of Reply Brief here]** In sum, the opponents are remiss in placing excessive reliance in the study's findings.

Turning to the findings in the report itself, it is evident that very little of the reported decline in alternative delivery volumes has anything to do with postal rates. **[Insert Sentences C from Sealed Portion of Reply Brief here]**.

In summary, the SAI study provides no basis for the opponents' apparent conclusion that the pound rate reduction is a major determinant of the alternative delivery industry's future.² The opponents accordingly misplace reliance upon the

² Even AAPS admits on brief that the alternative delivery industry is facing stresses from sources external to postal competition:

[t]he record shows that it is faced with high costs and a scarcity of unskilled labor while battling the constant problem of convincing skeptical advertisers that alternate delivery can be trusted (Tr. 19146).

report's assessment of the state of the alternative delivery industry. If anything, a fair reading of the report confirms the widely accepted view, identified as an "adverse inference" in MOAA et al.'s Initial Brief, that the prices of alternative delivery are well below those of the Postal Service. See USPS LR-I-268 at 10, 16, 26, 32.

- c. NAA's preposterous belief that the Postal Service is conspiring on behalf of the federal government to muzzle the press by proposing a lower pound rate cannot be taken seriously.

On brief, NAA states that under the Constitution, the federal government cannot "try to drive revenue out of the pages of newspapers." NAA Initial Brief at 4. Putting aside the dubious legal proposition that the Constitution actually provides guidance as to whether the Postal Service can propose a cost-based rate for weight, it is unnecessarily provocative for NAA to even so much as suggest that the Postal Service has any interest in muzzling the press. The record, moreover, is clearly to the contrary. The Postal Service routinely proposes extremely low markups for Periodicals, thereby enabling mail with editorial value, such as newspapers, to flourish. As witness O'Hara notes, it is the higher markups on subclasses such as ECR that enables Periodicals to bear a small institutional cost burden. Tr. 46E/21992-93. Also, to the extent NAA seeks to draw into its argument the revenues of newspapers, the record clearly shows

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AAPS Initial Brief at 5. These problems, if accurate, are problems of the industry's own making or external to postal competition, and advertising mailers should not suffer for them in the form of the protectionist ratemaking policy that NAA and AAPS advocate here.

that newspapers in particular will be benefited by the proposed rate change.

Specifically, the Postal Service has proposed a rate decrease (the only decrease proposed) for the category of ECR mail used by the newspaper industry for distribution of their TMC products. Tr. 46E/21940. Also, despite NAA's high-flying rhetorical argument regarding the newspapers' role as "watchdog over all levels of government", NAA Initial Brief at 2, NAA also admits that its industry is engaged in big business. Witness Wilson admits that newspapers "must produce profit margins that the market demands." Tr. 44/19151. In sum, the newspaper industry is hardly in a position to claim that the proposal is a conspiracy against its financial interests, let alone the dissemination of editorial content.

- d. Intervenor claims that witness Daniel's IOCS-based cost estimates are statistically unreliable rest on unsupported allegations and are contradicted by substantial record evidence.
- i. The intervenors' claim that witness Daniel has not addressed the Commission's request for a comprehensive analysis of the impact of weight on cost is contradicted by abundant refinements and improvements to the study design.

On brief, ABA&NAPM, NAA, and VP-CW claim that witness Daniel has essentially repeated past studies of the effect of weight on cost without providing a more comprehensive analysis upon which the Commission has insisted. ABA&NAPM Initial Brief at 25; NAA Initial Brief at 12; VP-CW Initial Brief at 54. These criticisms are unfounded. Witness Daniel's testimony provides a clear and comprehensive roadmap

of the methodology used to distribute cost to weight increment. She further expanded the scope of the study to include multiple subclasses, *i.e.*, First-Class Single Piece; First Class Presort; Periodicals Regular and Nonprofit; and Standard Mail (A) Regular, ECR, Nonprofit, and NECR, as well as each shape, *i.e.*, letter, flat, or parcel, within those subclasses. USPS-T-28 at 3-10. Witness Daniel further explains that the study represents an improvement over prior studies because it uses the MODS-based CRA approach—*i.e.*, by cost pool, subclass, and activity code³—for distributing mixed-mail tallies where weight is not known. USPS-T-28 at 5. The study also presents results by half-ounce increments, thereby enabling witness Moeller to analyze results below and above the Standard Mail (A) breakpoints, which fall between the third and fourth ounce increments. Witness Daniel also addressed criticisms regarding the distribution of city carrier costs by using a weight-based distribution key to allocate elemental load costs, thereby providing an estimate that approaches the upper bound of the relationship of weight to cost. USPS-T-28 at 8; Tr. 19/19478-80.

The opponents further criticize witness Daniel's study for not isolating for the effect of weight on cost. ABA&NAPM Initial Brief at 25; NAA Initial Brief at 15; VP-CW Initial Brief at 20. The opponents' criticism is in vain, however, for the cost estimates produced by witness Daniel do not require the complete isolation of weight-related costs upon which the opponents improperly insist. Tr. 44/19370. The objective upon which the opponents insist is, moreover, unattainable, for no study could ever

³ IOCS activity codes indicate characteristics such as shape, presort, automation

completely isolate for the effect of weight on cost, whether such a study relies on IOCS data or consists of an "engineering study" to which VP-CW seem to be enamored. VP-CW Initial Brief at 55-56. It seems quite likely that, in the privacy of their own offices, the opponents appreciate this, yet publicly, they erect this hurdle knowing full well that it cannot be overcome. By contrast, witness Daniel offers a credible explanation of the difficulties presented by such an analysis:

Isolating the effect of weight on cost is very difficult because weight is rarely the only characteristic that varies between different mail pieces. The shape, origin/destination combination, cube, and level of presorting and dropshipping of mail can affect the cost of mail. In general, shape changes from mostly letters to mostly flats and parcels as weight increases. Cube also tends to be proportional to weight, especially for paper-based products like letters and flats. Origin and destination pairs may be different for pieces of various weights. Other cost drivers such as the level of presorting, customer barcoding, dropshipping, and mail preparation vary across weight increments. Some volume data exist to quantify the mix of different shapes and worksharing levels at each ounce increment and are presented in USPS LR-I-102. However, data do not exist to control for differences in origin/destination combinations or mail preparation. Thus, while it is possible to analyze the data for guidance in rate design, it is difficult, if not impossible, to isolate precisely the impact of weight on costs or identify the exact unit cost of each ounce increment for three of the major classes of mail.

USPS-T-28 at 3. Witness Daniel controls for, or provides data to control for, a number of these factors, namely, shape, presorting, dropshipping, and prebarcoding. USPS-LR-91, -92, -93 (shape); Tr. 4/1209-20 (presorting, dropshipping for ECR), Tr. 4/1263-66 (presorting and prebarcoding for First-Class Mail). Not isolating for the effect of weight on cost would not be cured by

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compatibility for sampled mailpieces.

conducting an engineering study, as VP-CW insist, since an engineering study would not be able to control in any meaningful and realistic way the multiple characteristics that influence cost. Such a study would, moreover, suffer from the far greater criticism that it lacks representativeness of the myriad mail makeup and operational combinations that are captured by IOCS.

- ii. No record evidence supports ABA&NAPM's claim that the GVF approach to measuring standard errors is inappropriate.

ABA&NAPM's criticisms of witness Bozzo's use of the Generalized Variance Formula (GVF) approach to estimate the coefficients of variation (cv's) of the weight cost study estimates amount to nothing more than bare, unsupported allegation. Without citation to any supporting record evidence, ABA&NAPM claim on brief that "[i]f variances of the sample data are high but the mean of the data is also (erroneously) high one can produce low c.v.'s . . . The GVC [sic] measure of statistical significance used by Ramage and supported by Bozzo is not valid in the presence of bad data. . . ." ABA&NAPM Initial Brief at 22 n.38. ABA&NAPM offer no citation to the record to support this claim, and it does not withstand scrutiny. Contrary to ABA&NAPM's bare allegation, witness Bozzo provides a convincing and reasonable justification for the use of the GVF. Tr. 44/19472; Tr. 44/19491-93. As stated in section III.B of the Postal Service's Initial Brief, the GVF is an improved variance reporting methodology that allows participants to more readily evaluate sampling error for a wide range of potential

cost estimates. Tr. 4/1116-17 (Ramage). It is not used to hide alleged data problems.

Dr. Bozzo explains that, based on his "extensive experience producing measures" of the sampling variation of IOCS-based cost estimates, the "generalized variance function approach . . . is highly accurate in predicting . . . the results of the bootstrap," which represents the other appropriate method for computing the variances. Tr. 44/19491-2. ABA&NAPM offer no record evidence refuting this conclusion.

Furthermore, ABA&NAPM's argument is premised on the unproven assertion that certain of witness Daniel's finely detailed cost estimates are biased. Dr. Bozzo's testimony contravenes this belief, however. He explains that even though some of the finely detailed cost estimates cited by ABA&NAPM "may be subject to considerable sampling variation," it does not follow from the presence of random error in an estimate, however large, that the estimate is necessarily biased. Tr. 44/19488. However, even in the event that there were bias in witness Daniel's estimates, the result described by ABA&NAPM would not, in general, even represent an error. As Professor Greene notes, it is possible that a biased estimator may have lower variance than an unbiased estimator. Tr. 46E/22129-30. In any event, the cv will correctly reflect the relative sampling error.

The fundamental problem with ABA&NAPM's position is that Dr. Clifton computed cv's by a grossly erroneous method that greatly exaggerated the IOCS sampling error. Dr. Clifton's work was effectively put to rest by Dr. Bozzo, who provided correct estimates of relative sampling error for the IOCS cost estimates used by

witnesses Fronk and Moeller, thereby demonstrating that those cost estimates are statistically reliable. Tr. 44/21943-45. In addition, it is particularly far-fetched for ABA&NAPM to suggest that the cost estimate for 7-to-8 ounce First-Class Presort letters,⁴ would materially bias the total cost of First-Class presort above one ounce, since it represents less than 0.1 percent of total additional ounce cost. See USPS-LR-I-91. Accordingly, ABA&NAPM's argument should be rejected on the additional ground that it fails on its merits.

- iii. The intervenors' efforts to cherry-pick witness Daniel's detailed data for "anomalies" pointedly avoid discussion of the reasonable and reliable cost estimates actually used by witnesses Fronk and Moeller.

The intervenors' claims of anomalous results in witness Daniel's cost estimates are misplaced. The intervenors invariably cite to supposed "anomalies" in witness Daniel's detailed data. See ABA&NAPM Initial Brief at 21-22 & n.38 (referencing costs for 0-1/2 ounce increment for First-Class presort parcels; 8-9 ounce presort letters); NAA Initial Brief at 16 (referencing various Standard Mail (A) weight increments for commercial and Nonprofit ECR costs by shape); VP-CW Initial Brief at 51-52 (listing unweighted counts of weight increments exhibiting "anomalies"). The opponents conveniently omit from their discussion, however, the fact that the categories upon which they focus represent very small fractions of the far larger mail categories

⁴ On page 22 n.38 of their Initial Brief, ABA&NAPM misreport this cost estimate as

considered by witnesses Fronk and Moeller in the rate design. The combined volume for First-Class presort parcels between 0 and 0.5 ounce, and for First-Class presort letters between 7 and 8 ounces is 88,440 pieces out of the First-Class presort total volume of 47,047,898,126 pieces. See USPS-LR-I-91. Likewise, Nonprofit ECR parcels represent only 0.07 percent of Nonprofit ECR volume (2.101 million pieces out of 2.907 billion). See USPS-LR-I-92.

More importantly, the fundamental misstatement in the intervenors' criticism is quite simply that they "slic[e] the data too thinly." Cf. Tr. 44/1969 (Bozzo). It should be no great surprise that if disaggregating sample data sufficiently, there will not be too many observations in some tabulation cells.⁵ The point made by Dr. Bozzo is that the data may be appropriately "thin" for low-cost mail categories. Witness Bozzo explains:

relatively small volume (and/or low-cost) mail categories should generate relatively few tallies given the overall sample size. For small mail categories, the data are appropriately thin—the few tallies correctly reflect

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belonging to the 8-to-9 ounce weight increment. Cf. USPS-LR-I-91.

⁵ A simple example will illustrate this "problem." Consider a hypothetical sample where the characteristic of interest is dichotomous (0 or 1 outcome) and we wish to estimate the proportion of the population in various tabulation cells that have this characteristic. Suppose the characteristic of interest is independent the poststratification variables and that the underlying true proportion for the tabulation cells is constant, $p_i = p_j = .5$. If the tabulation cells are sufficiently small, so that there are only 3 observations in the tabulation cell, then the only possible proportion estimates for the tabulation cell would be: 0.0, .3333, .6667, and 1.0 (and the c.v. for the cell would be quite large). Of all tabulation cells of size $n_i = 3$, approximately half would have *unlikely estimates* (estimates of 0.0 or 1.0) and a critic might be found to assert that these estimates are highly unlikely and due to a "thin data" problem. However, once the data are sufficiently aggregated (so that the sample size of tabulation cells is large enough to produce relatively small c.v.'s for the cell), the proportion estimate for that cell will begin to approach the underlying true proportion ($p = 0.5$) with high probability.

the relatively small costs incurred by the associated mail category. Thus, the problem, if there even is one, would not be the data thinness, *per se*, but rather the effect it has on the relative standard errors of some narrowly-defined weight increments. The solution, when large increases in sample size are impractical (as is the case here), is to limit the reliance upon individual point estimates that are subject to large sampling variation. This is exactly what witnesses Fronk and Moeller do by using relatively large aggregates over weight increments.

Tr. 44/19471-2 (footnote omitted). Witness Bozzo explains that Postal Service witnesses Fronk and Moeller use IOCS cost estimates appropriately and responsibly. Their testimonies are based on IOCS data sufficiently aggregated over weight increments, so that the resulting cost estimates do not suffer from excessive sampling variation.

In essence, the intervenors would have the Commission reject the weight study on the basis of the results of a handful of select data points representing individually irrelevant weight increments. These criticisms miss the point. Witness Daniel's cost study is not used for the purpose of determining the cost of a given subclass, shape, and weight increment. Rather, witnesses Fronk and Moeller use aggregated results that encompass multiple weight increments in their rate design analyses. USPS-T-35 at 21; USPS-T-32 at 24-25. Thus, pointing to anomalous results in single weight increments does nothing to detract from the reliability of the far larger categories for which witness Daniel supplies costs to witnesses Fronk and Moeller. In the case of ECR, since no changes are proposed to the minimum-per-piece rate structure, and since that particular rate structure has a uniform pound rate above the breakpoint,

witness Moeller's use of aggregated data for the entire weight range for pound-rated pieces is appropriate when proposing the pound rate

Furthermore, in some cases, the so-called "anomalies" are not necessarily anomalies at all. For instance, NAA describes as "unlikely" the result that ECR letters weighing less than 3.5 ounces have lower unit costs than Nonprofit ECR flats in the same weight category. NAA Initial Brief at 15-16. That letter-shape pieces should cost less to process and deliver than non-letters is, in fact, the expected outcome (absent differences in dropshipment levels)—reflected in shape-based rate differentials in the Standard Mail (A) piece rates. See, e.g., USPS LR-I-166, Moeller WP 1 at 18. Another example is VP-CW's attempt to demonstrate "rampant" anomalies in witness Daniel's detailed data by counting weight increments with negative marginal cost differences. VP-CW Initial Brief at 50-52. Negative marginal cost differences between weight increments are only anomalous if the true difference is not negative. However, there is ample reason to expect there to be some negative marginal cost differences between weight increments. In her direct testimony, witness Daniel observed that the need to handle "flimsy" lightweight flats in higher cost manual operations explains a consistent pattern across subclasses of "u-shaped" flats costs by weight increment. USPS-T-28 at 12-13.⁶ VP-CW's own witness, Dr. Haldi, reinforces witness Daniel's testimony when he admits that he would "not necessarily" expect the weight-cost relationship for flat-

⁶ A similar argument applies to parcel shape pieces, which must weigh at least six or eight ounces to be machinable, depending on the mailpiece characteristics. See DMM C050.

shape pieces to be monotonic, since lightweight flats tend not to be automation compatible. Tr. 32/15932. Thus, VP-CW fails to establish that the relationships it describes represent anomalies. Rather, the record offers compelling and reasonable explanations for the absence of a monotonic relationship in witness Daniel's cost data by weight increment.

- iv. The supposed "anomaly" VP-CW claim witness Bozzo "pointedly does not discuss" in the 2.5-to-3-ounce weight increment for Standard Mail (A) ECR letters results from an error in witness Haldi's "link relatives" table.

VP-CW contend on brief that Dr. Bozzo "pointedly ignores the anomaly between 2.5 and 3.0 ounces in the half ounce letter data shown in witness Haldi's Table B-3." VP-CW Initial Brief at 50. Specifically, VP-CW imply that Dr. Bozzo inappropriately characterized the import of claimed anomalies by deliberately ignoring an anomaly in a lower half-ounce increment. In fact, the error is witness Haldi's. Dr. Haldi's Table B-3 incorrectly transcribes the Standard Mail (A) ECR letter costs for the 1.5-to-2 and 2-to-2.5 ounce increments from USPS-LR-I-92. The result is that the "anomaly" cited by VP-CW is a byproduct of an apparent transcription error. Contrary to Dr. Haldi's erroneous testimony, the actual marginal cost difference between the 2.5-to-3.0 ounce increment is positive, and the first "anomaly" is in the weight increment discussed by Dr. Bozzo. See USPS-LR-I-92. The errors are shown in bold in the table below.

**Transcription errors in Haldi's "link relatives" table for ECR letters
[Weight Increments with Haldi transcription errors in bold]**

Weight Increment (oz.)	Haldi Total Cost	LR-I-92 Total Cost	Haldi Unit Cost	LR-I-92 Unit Cost
0-0.5	321,077	321,077	.053	.053
0.5-1	287,252	287,252	.071	.071
1-1.5	96,270	95,270	.080	.079
1.5-2	68,973	55,973	.108	.088
2-2.5	66,806	55,305	.113	.093
2.5-3	48,576	48,575	.110	.110
3-3.5	22,493	22,493	.150	.150
3.5-4	8,800	8,800	.202	.052

Sources: Tr. 32/15847 (Haldi, VP-CW-T-1 at B-25); USPS LR-I-92, Section 2.

- v. VP-CW's arguments distort Dr. Bozzo's testimony on the reliability of IOCS for the distribution of cost to subclass and weight increment and fail to rehabilitate Dr. Haldi's blanket criticisms of the use of IOCS data.

VP-CW claim on brief that "witness Bozzo's rebuttal misunderstands or misrepresents some of witness Haldi's observations" regarding the applicability of IOCS for developing costs by weight increment. VP-CW Initial Brief at 46. VP-CW, however, fail to point to any specific "misunderstandings" or "misrepresentations," but rather offer a blanket claim that Dr. Bozzo "does not [address] the concern raised by witness Haldi—that the allocation of such costs by weight increment is inaccurate, and subject to systemic bias." VP-CW Initial Brief at 49. The record is clearly to the contrary.

In particular, Dr. Bozzo demonstrates that the main predicates of Dr. Haldi's critique of the use of IOCS are unsubstantiated, inconsistent with the IOCS sample

design, and inapplicable to the MODS-based cost distribution system. VP-CW claim that direct piece-handling tallies "show little relationship between weight and cost." VP-CW Initial Brief at 47. This claim is unsubstantiated. When asked to support the basis of this claim, Dr. Haldi stated that he had "not performed any analysis of direct tallies." Tr. 32/15930. In fact, as Dr. Bozzo shows, the IOCS sample design ensures that the direct tallies will show whatever cost-weight relationship obtains for the activities they represent. Tr. 44/19466-67. To the extent heavier weight pieces require more time (and hence cost) to handle, there will be relatively more tallies of such pieces in both the direct and mixed-mail observations. *Id.*

Dr. Bozzo's observation that Dr. Haldi's criticisms of the weight distribution do not apply to the MODS-based method is directly responsive to Dr. Haldi's testimony. Tr. 44/19465-66. Dr. Bozzo's criticism of Dr. Haldi on mixed-mail and not-handling tally distribution issues is not that the issues raised by Dr. Haldi could not be problematic. Dr. Bozzo notes that some of the problems identified by Dr. Haldi were present in the now-abandoned LIOCATT methodology for distributing mail processing volume-variable costs to subclass. Tr. 44/19469. However, those problems with the LIOCATT system were remedied with the MODS-based cost distribution system. The real issue identified and addressed by Dr. Bozzo is that that Dr. Haldi's central criticisms presuppose that mixed-mail and not-handling costs from bulk operations handling operations are distributed using piece handling tallies. VP-CW Initial Brief at 47. Such criticisms are inapplicable to the MODS-based method. As Dr. Bozzo shows, the MODS-based

method simply does not engage in those kinds of cross-operation distributions. Tr. 44/19467-68. In this instance, too, Dr. Haldi was unable to provide any examples of how tallies from "non-weight driven functions" are used to develop the distribution keys for mail processing volume-variable cost. Tr. 32/15926. Incredibly, Dr. Haldi attempts to suggest that he "did not need to perform such an analysis when preparing [his] testimony." *Id.* It is absurd for Dr. Haldi to suggest that he need not analyze the Postal Service's actual cost distribution methods in order to cast doubt upon their validity. In fact, Dr. Bozzo shows that the MODS-based system is not merely, as VP-CW put it, "less presumptuous." VP-CW Initial Brief at 47. Rather, it avoids the specific presumptions that Dr. Haldi contends would lead a cost distribution system to mask the underlying cost-weight relationship. Dr. Bozzo notes that to use the IOCS data appropriately, "the Postal Service's methods, by design, do not distribute mixed-mail tallies from one type of handling activity on direct mail tallies from a completely different type of handling activity, contrary to Dr. Haldi's criticism" Tr. 44/19467. Dr. Haldi simply failed to conduct the review of the Postal Service's methods before criticizing their validity, which thoroughly undermines the credibility of his criticisms. His criticisms should accordingly be rejected.

Dr. Haldi's remaining arguments degenerate to the shopworn arguments that IOCS was not designed to measure costs by weight increment, and that the presence of mixed-mail and not-handling tallies in the IOCS data set renders the analysis unreliable. VP-CW Initial Brief at 46, 49. Subclass is an important, but far from the only

relevant characteristic of handled mail sampled in IOCS. As Dr. Bozzo indicated, the overwhelming majority of direct tallies have information on both the subclass and weight increment of the sampled piece. Tr. 44/19502-03.⁷ Therefore, there is not materially less data on weight increment than there is on subclass. To the extent that the presence of mixed-mail and not-handling tally data are a problem for measuring cost by weight increment, they should likewise be a problem for measuring cost by subclass. Dr. Haldi's apparent objection, however, is in essence that the same data and methods that are unobjectionable for measuring cost by subclass are somehow grossly inappropriate when extended to weight increment, another observable (and observed) characteristic of the sampled mail. Tr. 32/15834. As Dr. Bozzo demonstrates, the "direct" tallies embody the appropriate weight relationships for mail processing activities, and the MODS-based method ensures those relationships are appropriately extended to the mixed-mail tallies. Cf. Tr. 44/19504-10. Thus, the methods can be reliably extended to measure cost by weight.

VP-CW's claim that there is no information with which to infer weight for mixed-mail tallies is likewise incorrect. As noted above, shape is not the only information available for tallies without weight information and other mixed-mail tallies. USPS-T-28 at 5. Dr. Bozzo further discusses how information, such as shape, can be used to infer the weight distribution of mixed-mail observations. USPS-RT-18 at 4-5; Tr. 44/19467-

⁷ Witness Daniel's tabulations of direct tallies by weight increment further shows that Dr. Bozzo's figure of ten percent direct tallies with no weight data is conservatively high. See Tr. 4/1342-44.

68; Tr. 44/19504-10; see *also* USPS-T-16 at 69-71, 73-74; Docket No. R97-1, USPS-T-12. The point is not that the weight of the specific pieces is known, any more than the specific subclasses are known in mixed-mail. Rather, by using the available mixed-mail information appropriately, biases in cost distribution can be avoided. Accordingly, the distribution keys are statistically reliable.

Dr. Haldi's arguments about the applicability of IOCS are inconsistent with the IOCS sample design and rely on a mischaracterization of the methods by which the IOCS data are analyzed. Therefore, they are, as Dr. Bozzo states, "not legitimate grounds for rejecting witness Daniel's distribution of mail processing costs to weight increment." Tr. 44/19469.

- e. VP-CW's theory that certain rate elements should be modified in order to offset deficiencies in the administration of other rate elements is more applicable in the context of the pound rate.

VP-CW contend that the proposed destination entry discounts should be increased in order to mitigate an alleged shortcoming of the presort discounts. VP-CW Initial Brief at 13-14. The thrust of the argument is that the presort discounts do not recognize weight-related cost savings since they are *per-piece* discounts. Witness Haldi recommends, therefore, increasing the destination entry discounts, which are based on weight, as a means of mitigating the lack of weight-related savings in the presort discounts. Tr. 32/15769. Although VP-CW's theory is of little use in determining the destination entry passthrough for reasons described in the Postal

Service Initial Brief, USPS Initial Brief at VII-200-01, the theory may have greater applicability to the proposed pound rate. To the extent one rate element can be used to offset shortcomings in other rate elements (such as a per-piece discount ignoring weight-related savings), there is little doubt that the Postal Service's proposed pound rate offers such a mechanism. The Standard Mail rate design is complicated in that it includes discounts (and surcharges) for shape, automation discounts, presort discounts, density discounts, and destination entry discounts. If, as witness Haldi suggests, these discounts do not perfectly capture the savings related to each worksharing discount or rate differential, then the pound rate, as determined by witness Moeller using net revenue and costs for pieces above and below the breakpoint weight, serves as a balancing mechanism.

2. The criticisms put forth by the parties concerning the residual shape surcharge do not detract from the reasonable, conservative nature of the proposed surcharge.
 - a. Intervenor criticisms of the level of the proposed increase for pieces subject to the residual shape surcharge are exaggerated and offer misleading analyses concerning the effect of the increases on mailers.

On brief, PSA, RIAA, and DMC exaggerate the extent of the proposed increase for pieces subject to the surcharge by emphasizing the increase in the *surcharge itself* rather than the effective increase on the *postage* for the pieces subject to the surcharge. Specifically, PSA states that the 80 percent increase contravenes criterion

4 of the rate criteria of section 3622(b). PSA Brief at 36. DMC complain that surcharge increases from 50 to 80 percent "have entirely ignored the adverse impact of the *proposed increases on Standard A parcel shippers.*" DMC Initial Brief at 32 n.29. RIAA, on the other hand, has its math wrong, in that it complains about a 180% increase. This is obviously a miscalculation. The increase in the surcharge for the Regular and Nonprofit subclasses is proposed at 80 percent, not 180 percent; for ECR and NECR, the surcharge is proposed to increase by 50 percent.

These observations, whether correctly calculated or not, are highly misleading. In fact, the increases for most residual shaped pieces will be much lower. The surcharge is only one of the rate elements that determine the postage for a given piece; consequently, an increase in the surcharge does not equate to the rate change that an individual piece will experience. The record clearly shows that the proposed rate increase for lightweight (0-3.3 ounces) Regular parcels would be much lower than 80 percent, as shown in the table below.

Standard Mail (A) Regular rate category	Current nonletter piece rate	Current piece rate w/surcharge	USPS Proposed nonletter piece rate	USPS Proposed piece rate w/surcharge	Percentage increase w/surcharge
Basic	\$0.304	\$0.404	\$0.311	\$0.491	21.5%
Basic DBMC	\$0.288	\$0.388	\$0.294	\$0.474	22.2%
Basic DSCF	\$0.283	\$0.383	\$0.289	\$0.469	22.5%
3/5 Digit	\$0.240	\$0.340	\$0.258	\$0.438	28.8%
3/5 Digit DBMC	\$0.224	\$0.324	\$0.241	\$0.421	29.9%
3/5 Digit DSCF	\$0.219	\$0.319	\$0.236	\$0.416	30.4%

Tr. 10/3843. As shown in the table above, the percentage rate changes range from 21.5 percent to 30.4 percent, not 80 percent (or 180 percent). Tr. 10/3843. The percentage increases in this table would apply to only 12 percent of Regular subclass parcels. See USPS LR-I-92 at 13-14. The percentage increases would be *lower* for parcels weighing over 3.3 ounces, Tr. 10/3844, since for these pieces the surcharge represents a smaller portion of the total postage. Indeed, 88 percent of Regular parcels exceed 3.5 ounces, USPS LR-I-92 at 13-14. Therefore, the *vast majority* of Regular

subclass parcels would be subject to increases *smaller* than those shown in the table above.

The intervenors are also wrong to suggest that the Postal Service has "ignored" the adverse impact upon mailers. DMC Initial Brief at 32, n.29. Contrary to the intervenors' claims, witness Moeller clearly indicates that the passthrough, and the surcharge, were limited in order to moderate the impact on mailers. USPS-T-28 at 7. Indeed, given that the gap between the costs of flats and parcels has widened, witness Moeller opines that an even higher rate would have been proposed were it not for the Postal Service's consideration of the effect on mailers. USPS-T-35 at 7; Tr. 10/3845. In sum, contrary to the intervenors' claims, the record is clear that the Postal Service gave thoughtful consideration to the effect of the increases on mailers.

- b. RIAA misunderstands the proposal and fails to provide evidentiary support for an alternative proposal of its own.

On brief, RIAA contends that the Postal Service's proposed residual shape surcharge embodies a "one size fits all" approach by perpetuating an alleged "adherence to a single or uniform surcharge." RIAA Brief at 4. RIAA misapprehends the Postal Service's proposal in this docket. The Postal Service has not simply proposed a single surcharge applicable to all four Standard Mail (A) subclasses. Rather, the proposal applies sensible pricing analysis to justify different treatment for carrier route and noncarrier route mail. Tr. 10/3937; see also USPS Initial Brief at VII-188-89. Two levels of surcharge have been proposed: 18 cents for Regular and

Nonprofit, and 15 cents for ECR and NECR. USPS Initial Brief at VII-188. Although the 3-cent difference in the Postal Service's 18-cent and 15-cent proposed surcharges is driven by the availability of the proposed parcel barcode discount for Regular and Nonprofit, and not by subclass-specific costs, the proposed surcharges are amply supported by substantial record evidence.

Putting aside RIAA's misunderstanding of the proposal, RIAA's preferred approach of cost-based, subclass-specific surcharges would do nothing to mitigate the increase of the surcharge in any of the subclasses. As shown by witness Crum, the FY98 estimated loss per parcel for the Regular subclass was 29 cents. Over all four subclasses, the average loss was 33 cents. Tr. 8/3399. The Regular subclass accounts for ninety percent of Standard Mail (A) parcel volume, so the overall, average cost figure is dominated by the Regular subclass. *Id.* The proposed surcharge is therefore warranted by the shortfall in the Regular subclass alone. An 18-cent subclass-specific surcharge for the Regular subclass could just as easily be justified on the record if the underlying Regular subclass costs were considered in isolation. Such a surcharge could be defended using a 32-percent passthrough of the cost differential for the Regular subclass, which is merely 4.5 percentage points greater than the four-subclass average of 27.5 percent. USPS-T-28 at 7. Furthermore, witness Moeller makes clear that a much higher surcharge level would have been proposed were it not for consideration of the effect on mailers. USPS-T-35 at 7. The other Standard Mail (A) subclasses would fare no better under a subclass-specific proposal. These subclasses

suffer from even greater shortfalls, so if anything, larger surcharges would likely have resulted if the costs of these subclasses were considered separately. Tr. 8/3399.

RIAA, moreover, fails to offer evidentiary support in favor of an alternative proposal. RIAA simply observes on brief that if a passthrough of 27.5 percent were applied to each subclass cost differential individually, the surcharge in Regular would be 15 cents, and in ECR it would be 18 cents. RIAA Brief at 5. Yet RIAA never offered the Commission or the participants an opportunity to evaluate a subclass-specific set of surcharges of its own.⁸ RIAA's observation regarding the passthrough offers no compelling theoretical basis for reducing the proposed surcharge for the Regular subclass. Ratemaking is not a strict mathematical exercise of applying a given passthrough to a cost difference, and there is nothing sacrosanct about the 27.5 percent passthrough. Rather, a variety of factors inform the level of the surcharge, including the impact upon mailers, the revenue and cost relationship of residual shapes, the availability of the 3-cent parcel barcode discount, and inter-subclass relationships. USPS-T-35 at 6-8, 23-24; Tr. 10/3934-35, 3937. Thus, applying a fixed passthrough to subclass-specific costs does not provide a basis for lowering the surcharge for any Standard Mail (A) subclass.

- c. Intervenor criticisms that that the Postal Service does not recognize revenues are contrary to record evidence and

⁸ RIAA merely contends that the surcharge should be 13 cents, thereby essentially preserving the *status quo* for barcoded Regular parcels. Yet there is no evidentiary support for this proposal, or for RIAA's claim that its proposal would not "improperly burden other rate categories in the Standard (A) Regular commercial subclass"

sensible business practice.

Intervenor claims that the Postal Service has not considered revenues of residual shapes are unfounded. Specifically, PSA states that "[t]he Postal Service has failed to take into account the demonstrably greater revenues per piece raised by parcels. . . ." PSA Brief at 35. Similarly, DMC state that "[t]he Postal Service focuses on costs and ignores revenue." DMC Initial Brief at 10; see also RIAA Initial Brief at 9.

As discussed in the Postal Service's Initial Brief, these charges are without merit. Both Postal Service witnesses Crum and Moeller discuss the cost/revenue relationship, and their data show that Regular parcels are money-losers, with an implicit cost coverage of 83 percent. USPS Initial Brief at VII-191 (citing USPS-T-27, Attachment F, Tables 6.1-6.3; USPS-T-35 at 7). In addition, witness Moeller acknowledges the heavier weight of parcels, and hence greater revenue via the pound rate, in his support for lowering the pound rate in the Regular subclass, a proposal which helps mitigate the impact of the surcharge for Regular subclass parcel shippers. USPS-T-35 at 8. Simply put, the Postal Service is not trying to "obscure" the "true" relationship between parcels and flats, as PSA contends. PSA Brief at 35. In fact, the Postal Service welcomes such examination of the cost-revenue relationship since, if anything, these data support a surcharge level higher than the proposed rates. It was concern over the below-cost nature of parcels that instigated the residual shape surcharge, and the intervenors can point to no data on the record to suggest that, even at the proposed level, the surcharge would cause residual shapes to cover their costs.

DMC suggest that the Postal Service is remiss in proposing a surcharge that might result in some loss of Standard Mail (A) parcel volume. DMC Initial Brief at 31. To the contrary, it would be remiss to not be concerned about segments of its business in which costs exceed the rates. As the Postal Service argued in its Initial Brief, it "defies logic and common sense for the Commission and the Postal Service to turn a blind eye to the fact that Standard Mail (A) parcels are a money-losing proposition for the Postal Service." USPS Initial Brief at 190-91. "Sensible business practice alone militates in favor of remedial measures to stem the losses engendered by handling these residual shapes." *Id.*

- d. RIAA's contention that the level of the per-piece surcharge should be affected by the fact that FY99 data show more-than-expected total revenue from the surcharge is wholly without merit.

On brief, RIAA notes, correctly, that FY99 data appear to suggest that more pieces are paying the surcharge than was anticipated at the time of the filing. RIAA Brief at 10-11. Even if one were to conclude that using the FY99 data in projecting the test year revenue from the surcharge is appropriate, RIAA's proposed solution for distributing these "found revenues", RIAA Brief at 11, is absurd. To the extent there is to be greater total revenue from the surcharge in the test year, RIAA seems to suggest that this revenue be used to reduce the surcharge. RIAA Brief at 13. The surcharge is based on a per-piece cost difference (or cost-revenue differential, if one prefers to view it that way) in the test year. Regardless of how many pieces were estimated to be

subject to the surcharge in the test year, the per-piece cost differential is entirely unaffected by any change in the number of pieces paying the surcharge. The level of the per-piece surcharge should accordingly be unaffected by a higher revenue projection. If the rate design were to anticipate a greater volume of pieces paying the surcharge, this would result in a change in the net "leakage" due to discounts and surcharges in the rate design formula. USPS-LR-I-166, WP 1 at 14 and 17. The "found money" would not be "pocketed" by the Postal Service, but would accrue back to the subclass as a whole, not to individual rate categories. The Commission should accordingly ignore RIAA's contention that the FY99 data regarding volume of pieces paying the surcharge should have an impact on the level of the per-piece surcharge itself.

- e. The change in definition of automation flats does not support RIAA's argument that the surcharge should be reduced.

RIAA states that the Commission should "be very chary" before recommending the increase in the surcharge. RIAA Brief at 15. Specifically, RIAA cites witness Crum's acknowledgement that the change in the automation flat definition in terms of thickness could cause uncertainty regarding how parcels and flats were classified in 1999 due to the deployment of FSM 1000s. RIAA Initial Brief at 14. No record evidence supports RIAA's argument. As even PSA acknowledges in its brief, the change in the definition of automation flats was implemented in FY1999, so it "does not infect the Base Year data." PSA Initial Brief at 26. It is the Base Year costs upon which

the surcharge is ultimately based, and although similar FY1999 data are not available, there is no reason to suspect that the advent of the FSM1000 has reduced the cost differential.⁹ In fact, the record establishes that the migration of parcels to the automation flat category would likely increase the differential between flats and parcels. Tr. 46D/21495. Thus, while the definitional change in automation flats may make it more difficult to ascertain the differential, that change does not affect the cost differences presented in this proceeding, and even if the change were incorporated into a cost estimate, it would likely cause a widening of the differential. Therefore, RIAA's suggestion that the definitional change casts doubt on the validity of the proposed surcharge is not supported by record evidence.

- f. The intervenors provide no basis for setting aside the solid, convincing evidence of shape-related cost differentials.

On brief, DMC and PSA raise several challenges to the cost data underlying the proposed residual surcharge. As discussed more thoroughly below, each of these arguments is either unsubstantiated or contrary to record evidence.

First, the intervenors' general criticism of the variation in the cost data supporting the surcharge does not withstand scrutiny. The opponents focus primarily on the 26-percent variation between 1996 and 1998, and argue that this increase in the differential undermines the credibility of the cost data. For instance, DMC suggest that the "51 percent increase" in costs between Base Year 1996 and Base Year 1998, as well as

⁹ Incidentally, since the record establishes that these pieces are still handled as parcels

variation in parcel costs over a ten year period, provide a basis to challenge the accuracy of the cost data. DMC Initial Brief at 12-23; see also PSA Initial Brief at 36. These criticisms are, however, refuted on the record. Specifically, witness Crum presented unadjusted Bulk Standard Mail (A) parcel unit cost data for each of the years he has carefully analyzed. Those data show marked consistency in the cost differences between parcels and flats for each year from 1993 through 1996. Tr. 8/3430. Contrary to the opponents' allegations, the record supplies a reasonable explanation for much of the difference between FY 96 and FY 98. In particular, witness Crum shows that by using consistent methodologies for volume variabilities, the cost increase between 1996 and 1998 is actually far less than that claimed by the opponents on brief. Tr. 8/8420.

In a related argument, DMC overstate the significance of witness Smith's response to Presiding Officer's Information Request No. 4. DMC Initial Brief at 13-21.¹⁰ Specifically, DMC suggest that there have been clear cost trends and that Standard Mail (A) parcel costs are "totally out of control." DMC Initial Brief at 17. The record is to the contrary. DMC conveniently ignore the fact that the response to POIR No. 4 makes clear that many changes occurred over the time period witness Smith reviewed, and, despite the best efforts to provide as consistent a time series as possible, a large

(..continued)

(USPS-T-15, page 17), there should be minimal, if any, change in their unit costs.

¹⁰ In his response to POIR No. 4, witness Smith provided shape-specific mail processing and city carrier in-office costs for a number of subclasses for the period from FY 89 to FY 99, with adjustments to account for changes in methodology. Tr.

number of those changes simply could not be controlled for in the analysis. For instance, witness Smith states that "the true magnitude of changes over time will not be accurately captured by these costs, given the various discontinuities associated with the underlying data, and the inadequacies of the LIOCATT based costs." Tr. 46D/21812. Further, the Postal Service's response to discovery by DMC related to Presiding Officer's Ruling No. R2000-1/45 dispels any notion that the changes noted by DMC are significant. Specifically, the Postal Service explained that there was a simple correction made between 1995 and 1996 that accounted for much of the cost change in Standard Mail (A) parcels originally noted by DMC. Tr. 46C/20792-97. This obvious and simple methodological correction accounts for most of the claimed dramatic cost increases for Standard Mail (A) parcels here. Finally, when this is combined with the removal of DMC's misleading use on brief of a three-year moving average, the dramatic cost trends all but completely disappear. Thus, DMC's claims regarding Standard Mail (A) parcels have been shown on the record to be clearly overblown and inaccurate.

Second, DMC's objection to the use of the In-Office Cost System for estimating Standard Mail (A) parcel costs is easily discredited. Specifically, DMC state that use of IOCS is problematic for Standard Mail (A) parcels because the volume is allegedly too low. DMC Initial Brief at 24. This criticism, however, does nothing to cast doubt upon the accuracy of the cost figures in this docket. Although the volume of Standard Mail (A) parcels may be low in comparison to the many billions of Standard Mail (A) letters

(..continued)
46D/21807.

and flats, the absolute volume of Standard Mail (A) parcels is quite high, thereby dispelling any possible claim that use of IOCS data is subject to high degrees of variation due to small sample size. Indeed, the 904 million Standard Mail (A) parcel pieces substantially exceeds the entire volumes of numerous subclasses, including Express Mail, Classroom Publications, Parcel Post, Bound Printed Matter, Special Standard, and Library Mail. Cf. USPS-T-27, Attachment F, Tables 1 & 2. Surely, if the Commission is prepared to rely on IOCS data to estimate the costs of Express Mail and Parcel Post, then it must likewise find the use of the data suitable for use in measuring the costs of Standard Mail (A) parcels. Thus, IOCS data do not constitute an unsuitably small sample from which to estimate the costs of Standard Mail (A) parcels. DMC, moreover, failed to supply any testimony sponsoring a superior, alternative means of estimating the costs of Standard Mail (A) parcels. DMC's complaint regarding the total volume of Standard Mail (A) parcels is accordingly without merit.

Third, no credence should be given to DMC's contention that the Postal Service does not have good information regarding the relative costs of Standard Mail (A) machinable and nonmachinable parcels. DMC Initial Brief at 27. Presumably, DMC raises this argument on brief in order to cast doubt on the application of the proposed level of the surcharge to nonmachinable Standard Mail (A) parcels. This argument, however, is unavailing, as evidence from prior dockets dispels the notion that machinable parcels are clearly less costly than nonmachinable parcels. Specifically, in Docket No. MC97-2, the Postal Service filed a study that measured the relative costs of

machinable and nonmachinable parcels. Docket No. MC97-2, USPS LR-PCR-50.¹¹ The results of the study suggest that nonmachinable Standard Mail (A) parcels cost *slightly less* than machinable parcels,¹² contrary to the implicit contention underlying DMC's argument here. Thus, cost data from prior dockets dispel the proposition that the surcharge should be deliberately targeted at nonmachinable parcels, and DMC's criticism therefore does not provide a basis for departing from the proposed rate design.

Finally, DMC complain that the effect of weight on parcel costs is unknown. DMC Initial Brief at 27. These criticisms were, however, addressed in Docket No. R97-1, and effectively rebutted in the Postal Service's Initial Brief at VII-192-93.

3. The Commission should not recommend increases in destination entry discounts beyond those proposed by the Postal Service.

A few members of the mailing community, including Postcom, et al., MOAA, and VP-CW favor an increase in the destination entry passthrough. VP-CW favor a minimum 85 percent passthrough, while Postcom et al. and MOAA favor raising the proposed passthroughs from approximately 75 percent to 100 percent. Postcom et al., Initial Brief at 2-4; MOAA Initial Brief at 21-22; VP-CW, Initial Brief at 13-14. As thoroughly discussed in the Postal Service's Initial Brief, multiple factors underlie the Postal Service's proposed passthroughs. See Postal Service Brief at VII-197-201.

¹¹ Witness Crum further withstood oral cross-examination on and explained the complexities of the impact of machinability on Standard Mail (A) parcel costs in Docket No. R97-1, Tr. 5/2369-71.

¹² This is presumably due to differences between machinable and nonmachinable parcels with respect to other cost driving characteristics.

Witness Moeller identifies the increase in the basic rates as a reason for moderating the passthroughs for destination entry. USPS-T-35 at 15. Witness Moeller also identified concerns about over-rewarding destination entry, Tr. 10/3958, Tr. 10/3855, as well as the fact that higher passthroughs would not necessarily send more appropriate price signals, in support of the proposed destination entry passthroughs. Thus, the factors cited in support of the Postal Service's proposed passthroughs clearly outweigh those raised by the intervenors. The Postal Service urges that the Commission adopt its proposed passthroughs for the destination entry discounts.

4. VP-CW's proposed adjustment to the letter-flat differential is fatally flawed and cannot be recommended.

The Postal Service refers the Commission to its Initial Brief, as well as to the initial briefs of SMC and MOAA, for a discussion of the convincing record support favoring rejection of witness Haldi's proposed 0.29 cent adjustment to the ECR letter-flat differential. See Postal Service Brief at VII-200-04; MOAA Initial Brief at 17-19; SMC Initial Brief at 56-57. On brief, VP-CW cling to the claim that an alleged miscalculation arises in the "inconsistency between the definition of letter and nonletter" under the RPW and the IOCS. VP-CW Initial Brief at 14-19. Yet VP-CW apparently forget that their own witness explicitly abandoned this belief in written discovery. Tr. 32/15865. Specifically, witness Haldi admitted to a misunderstanding of the source of the relevant volumes for determining the unit cost of letters. USPS Initial Brief at VII-203. As the Postal Service explained in its Initial Brief, there is no such mismatch

between costs and volumes because the volume data used to unitize the cost are derived from PERMIT data, which are shape-based, not RPW data, which are based on rate categories. See USPS Initial Brief at VII-202-03. VP-CW's criticism on brief rests entirely on the premise that RPW is the source of volume used in the calculation. VP-CW Initial Brief at 17, 18. Thus, VP-CW's criticism on brief of MOAA et al. witness Prescott's testimony and SMC witness Crowder's testimony is--to put it simply--flat out wrong. The record is clearly to the contrary, and thus VP-CW's attempt to discredit witness Crowder's and Prescott's analyses crumbles. No credence should be given to VP-CW's argument on brief that there is a mismatch in the Postal Service's use of cost and volume data.

As the Postal Service explained in its Initial Brief, both the numerator and denominator used in the calculation of the unit costs for letters and flats are consistent. In particular, both are based on DMM shape, as opposed to revenue category. USPS Initial Brief at VII-202-03. Thus, in the Postal Service's calculations, the unit cost of letters includes all letter shapes in all weight Standard Mail (A) increments; similarly, the unit cost of flats includes all flats *shapes* in all Standard Mail (A) increments. Tr. 46C/21006-08. Witness Crowder accounts for this by providing rate category-defined unit costs for letters and flats, *i.e.*, letter-*rated* pieces and flat-*rated* pieces (both piece- and pound-rated). Tr. 44/19405. Witness Crowder shows that the differential between letter-*rated* pieces and flat-*rated* pieces is several multiples smaller than the differential calculated by witness Haldi, thereby completely defeating the need for an adjustment.

USPS Initial Brief at 204.

Witness Crowder's calculation includes costs due to weight, and therefore a passthrough less than 100 percent of the cost difference is preferable in order to better isolate for the impact on shape. See Tr. 44/19407. Ideally, the cost for letters and the cost of flats used to determine the letter and flat differential would be limited to letter and flat pieces subject to the minimum-per-piece rate, *i.e.*, letters and flats below the breakpoint.¹³ This is because the letter-nonletter rate differential applies to piece-rated letters and flats, *i.e.*, pieces up to the breakpoint. The fact that the unit cost for letters includes a small portion of letters over the breakpoint weight is overwhelmed by the fact that the nonletter costs include a much larger portion (relative to letters) of nonletters over the breakpoint. USPS LR-I-92 at 9. Consequently, there is no need not adjust the letter-nonletter cost differentials, and the Commission should recommend the passthroughs as proposed by the Postal Service.

¹³ The differential between the unit cost of piece-rated ECR letters and piece-rated ECR nonletters adjusting for dropshipment can be calculated from data on the record. One would need to subtract the costs of flats adjusted for dropshipment at Tr. 4/1210 less than 3.0 or 3.5 ounces, and the cost of letters below 3.0 or 3.5 ounces adjusted for dropshipment which, as specified in the response, can be calculated using the same analysis.

E. Package Services

1. Parcel Post

Despite the various criticisms put forward by UPS in its Brief, the rates designed by Witness Plunkett are reasonable and supported by evidence on the record.

Moreover, his rate design is consistent with past practice and will benefit all mailers.

- a. UPS's proposal to reduce the passthrough for the DDU rate should not be substituted for the Postal Service's passthrough which is economically sound and consistent with past practice.

UPS argues that the passthrough for the DDU rate should be reduced. UPS Brief at 84-86. However, economic theory and past postal practice stipulate that the passthrough of worksharing activities ought to be as close as practicable to the cost savings measured for that activity. In Docket No. R97-1, the Commission passed through nearly 100 percent of the DDU cost avoidance. Witness Plunkett followed this precedent by proposing an 80 percent passthrough – the effective passthrough that results implicitly from the rate constraints that he had to impose after starting off using 100 percent of the cost savings. UPS witness Luciani's proposal to reduce the passthrough for DDU to 50 percent is flawed, and was adequately rebutted by witnesses Glick (Tr. 41/18083-84) and Haldi (Tr. 44/19542-46).

- b. The Commission should not heed UPS's opposition to simplification for Package Services mailers in the form of a consistent minimum weight.

UPS opposes the Postal Service's proposal to reduce the minimum weight for Parcel Post. Nevertheless, it is a simple proposal designed to make mail shipments easier for Parcel Post mailers with merchandise of varying weights. Furthermore, it would make all Package Services subclasses similar with respect to the weight

minimum. It does not require the burdensome and unnecessary analysis that UPS argues should have been done. UPS Brief at 89-92.

- c. UPS is incorrect in arguing that the final adjustment double counts DSCF savings.

UPS contends in its brief that Parcel Post final adjustments double-count Parcel Post DSCF cost savings. UPS Brief at 41-42. However, UPS's argument ignores witness Luciani's own testimony. Witness Luciani testified that he does not believe that DBMC would be dropped at the DSCF because, unless it was sorted to 5-digits, it would need to be transported back to the DSCF and not be eligible for the DBMC rate. In addition, witness Luciani testified that the 7.11 percent used by witness Eggleston to estimate the percent of DBMC dropped at the DSCF was not the percent of DBMC dropped at the DSCF, but rather the Docket No. R97-1 estimate of how much DSCF would exist after the rate was put into effect. Witness Luciani discredits the idea that DBMC is dropped at the destination SCF, but then UPS bases its argument on the assumption that 7.11 percent of DBMC is dropped at the destination SCF.

UPS cannot have it both ways. The matter should be resolved as recommended in our initial brief at VII-113-14.

- d. UPS's exclusion of sack shake-out costs is incorrect.

UPS argues that the 2.1 cents, associated with sack shake-out, should be excluded from the DDU cost avoidance. UPS Brief at 80-81. UPS claims that since the Postal Service did not provide DDU-specific entry profiles there is no proof that parcels do not arrive in sacks. However, both witness Clark and witness Wittnebel testified that the majority of CTC and Amazon.com's DDU parcels are not entered in sacks, and that,

when they are, the sacks are dumped by the mailers and not by postal personnel. Tr. 41/18045, 18138-39.

UPS then argues that the 2.1 cents should still be excluded, even if sack shake-out is avoided, because the Postal Service has to move the parcels from the dock to the sack sorting area. UPS Brief at 81. UPS appears to be grasping at straws. First, it puts the cost of moving the parcels to the sorting area in terms of cost per container, failing to account that a container could hold 50 to 100 parcels. UPS also fails to mention that using its questionable cost estimate of 50 cents per container, the cost per parcel would only be one-half to one cent ($\$0.50/100$ and $\$0.50/50$).

Second, and more importantly, the DDU cost avoidance model does *not* assume that DDU parcels avoid the movement from the dock to the parcel sorting area. This parcels need to be moved regardless of how the parcels arrive at the DDU. Surely UPS does not contend that parcels brought to the DDU by the Postal Service move themselves from the dock to the parcel sorting area. The costs associated with moving parcels from the dock to the sort area is not included in the mail processing model, and therefore is contained in the fixed CRA adjustment factor. USPS-T-26, Attachment A. Not only is the fixed CRA adjustment factor not applied to the DDU cost avoidance, even if it had been, it would cancel itself out because it would need to be applied to both DDU and DBMC, the rate category in which DDU is compared.

Third, since DSCF and DDU are relatively new rate categories, witness Eggleston did not apply the proportional CRA adjustment factor to the worksharing cost savings estimate. USPS-T-26, at 11. She testified that since these are relatively new rate categories, there was not enough time to collect significant data. In other words, she

realized that some of her assumptions might not be fully accurate. Assuming the appropriate proportional CRA adjustment factor for DDU is the one used for the rest of Parcel Post, 1.154,¹ the estimated cost savings would be 84.2 cents ($73.0 * 1.154$). This is 11.2 cents higher than the DDU cost savings proposed by witness Eggleston in this case. USPS-T-26, Attachment J. Therefore, even if sack shake-out and unloading costs are not avoided one hundred percent of the time, the cost savings estimate presented by witness Eggleston is still appropriate.

- e. UPS's allocation of Alaska Air costs to DSCF and DDU is inappropriate.

UPS contends that the Postal Service should allocate Alaska Air costs to DSCF and DDU. UPS Brief at 83-84. UPS insists that since DSCF and DDU incur Alaska Air costs, these costs need to be allocated to those rate categories. UPS simply does not understand or does not want to understand the Parcel Post cost model. Witness Eggleston testified that, given a 1998 base year and how the costs were treated in the roll-forward, the test-year before rates have not been adjusted for the existence of DSCF and DDU rate categories. Therefore, total Parcel Post transportation costs were allocated to the rate categories that existed: inter-BMC, intra-BMC and DBMC. Then, and this seems to be the step UPS either unknowingly or knowingly ignores, DSCF and DDU costs were estimated using proxies. Therefore, no costs were allocated to DSCF and DDU. And since the Alaska adjustment results in Alaska air costs being incurred the same as any other costs, it does not matter that DSCF and DDU were estimated using DBMC as a proxy. In other words, the same costs would be allocated to DSCF

¹ USPS-T-26, Attachment A, p. 1.

and DDU whether they were incurred in Alaska or any other area in the continental United States. See Postal Service Initial Brief at VII-116-17.

UPS tries to back up its argument by saying the Postal Service did allocate Alaska air costs to DSCF and DDU when the models were updated with FY 1999 data. UPS Brief at 84. This is not true. Witness Eggleston explained that she had to use proxies for DSCF and DDU because of the 1998 base year. She also testified that she would not use proxies if the base year were changed to FY 1999. Tr. 13/5202.

- f. FGFSAs argument that non-zone related costs in the Parcel Post transportation model are not valid is incorrect.

In her Parcel Post transportation model, witness Eggleston separated costs into zone-related (ZR) and non-zone related (NZR), but FGFSAs argues in its brief that there is no validity to the NZR concept. FGFSAs Brief at 13. FGFSAs completely misunderstands the terms ZR and NZR as used in the Parcel Post transportation model. Witness Eggleston clearly stated that her model cannot be interpreted to mean that transportation costs do not increase with distance. Zone-related refers to those transportation legs that distance traveled, and therefore costs incurred, increase with zone. Non-zone related refers to those transportation legs that distance traveled, and therefore costs incurred, do not necessarily increase with zone. USPS-T-26, at 19-20; Tr. 13/5143, 5146. Witness Eggleston's cost allocations are logical, and the Commission used the same approach in Docket No. R97-1.

2. Bound Printed Matter.

a. Three levels of dropship discounts should be recommended.

AAP states that their members that utilize dropship discounts will "only be able" to dropship to DBMCs and not to DSCFs or DDUs. AAP Brief at 1. Even if an individual book mailer lacks the volume dropship more deeply, a consolidation industry is developing that could assist them in taking advantage of deeper dropship. AAP has not provided evidence that no AAP members can dropship beyond the DBMC, and it is contrary to anecdotal comments received by the Postal Service from book mailers. The Postal Service could potentially have presented contradictory evidence had this claim been made before the Brief. In fact, AAP contradicts themselves later in their brief by making the much more reasonable and accurate comment that "book mailers are less likely to dropship mail directly to the DSCF or DDU." AAP Brief at 21. The blanket statement above is unsupported by any record evidence and must be wholly disregarded.

AAP also claims that the Postal Service discounts are "based on a flawed cost-study." AAP Brief at 2. In fact, AAP has presented no evidence that the cost study is flawed other than speculation. Their criticisms are limited to the volumes upon which unit cost savings are based and not the cost savings themselves, which are unblemished on the record. They have provided no alternative estimate of the cost savings. Finally, they have provided no evidence that even if any of their speculative claims are correct that this would *lower* as oppose to increase the estimated transportation or non-transportation cost savings due to dropshipping Bound Printed Matter.

MOAA proposes even deeper DDU discounts. The Postal Service recognizes that deeper discounts may better reflect the measured cost avoidances and encourage more dropshipping. However, as indicated throughout the Postal Service's proposal, these goals should be considered in light of the impact on other customers and the need to provide the appropriate cost coverage for the subclass. The Postal Service's proposal reflects a reasonable balance of these multiple goals. Nevertheless, other rate designs may meet these goals as well.

b. The BPM Mail Characteristics Study is sound.

AAP alleges technical flaws in the BPM Mail Characteristics Study, but fails to show any significant impact even if such flaws exist. AAP does not quantify the net impact of the survey's imperfections, and does not provide any credible evidence that the alleged flaws are material: that they compromise the Survey results in such a way that the results are no longer reasonable to use for the purpose at hand.

For example, AAP tries to attack the BPM Mail Characteristics Study by saying that it "was conducted by Christensen Associates with minimal oversight from the Postal Service". AAP Brief at 15. The record shows otherwise. Postal employees were the ones who actually filled out the survey forms, and witness Crum was fully involved in managing the study from beginning to end. Postal Service Initial Brief at VII-121. Beyond the full involvement of the Postal Service in this study, Christensen Associates is an experienced and valued contractor with an 18 year history of producing studies supporting rates and discounts in numerous Commission proceedings. Between 1994 and 1998 they assisted with eight previous mail characteristics studies including Standard Mail (A), Periodicals, and First-Class Mail. Each of these presented more

complicated issues than the BPM mail characteristics study they assisted with in this docket. While this may have been the first study of Bound Printed Matter's entry profile, it is one in a long series of cooperative mail characteristics studies produced by the Postal Service and Christensen Associates. *E.g.*, Docket No. R97-1, USPS-LR-H-105, H-185, and H-195.

AAP attempts to discredit the BPM Mail Characteristics Study based on the study's treatment of a small fraction (3.8 percent) of total BPM volume, and the problems with calculating standard errors based on only one observation from stratum three. They also express concern that sample observations were taken in 1999 and inflated to 1998 stratum totals. AAP maintains that because of these "infirmities" the study should be ignored in these proceedings. AAP brief at 17-21. The fundamental issue here is not whether or not these issues exist; they almost always do in statistical studies. The issue before the Commission is whether known sources of error were dealt with in a reasonable manner, and if the existence of these issues have a significant impact on the resulting estimates. The record shows the methodology employed in the BPM Mail Characteristics Study effectively deals with each of these issues and provides an accurate measurement of the current entry profile of BPM.

With respect to AAP's timing issue, Mr. Degen shows that regardless of whether 1998 or 1999 strata volumes are used to inflate the sample there is little impact on the measured entry profile of BPM. Tr. 38/17346-47. This fact suggests that the behavior of the majority of BPM customers is stable over time and any bias is insignificant.

The standard errors reported for the BPM Mail Characteristics Study are a conservative estimate of the variability of the population. Tr. 38/17347-48. Because

there is only one stratum three observation, the bootstrap estimate of stratum 3's variance is zero. Therefore, standard bootstrap estimates of the variance will understate the true variance. The collapsing of strata two and three results in variance estimates that are larger than the true variance, thereby providing conservative estimates for the confidence intervals.

AAP maintains that because the strata weights for offices that accept a small portion of national BPM volume are subject to measurement error, the study should be ignored in these proceedings. The measurement error comes from the fact that the Postal Service does not have a census of every piece of mail deposited by its customers. Because of this, stratum four volumes must be estimated, and thus bias is introduced. However if gains in precision from a stratified sample design are large, the introduction of a small bias is acceptable. The only way for there not to be bias is to abandon these precision gains. AAP claims that Mr. Degen "severely mischaracterizes Mr. Siwek's testimony" and claims that "Mr. Siwek's testimony identified potential sources of bias and sought to improve the estimation procedures". AAP Brief at 18. Mr. Siwek offers no such improvements in his testimony. The suggested "improvements" first appear in AAP's initial brief. Mr. Siwek's testimony simply states the BPM study is infirm because stratum four's volume was measured with error.

The sample in LR-I-109 makes use of four sample strata. The weights used to average the means of these strata are based on the proportion that each stratum represents in the total annual volume of pieces. Nevertheless, the annual volume assigned to strata four is not the actual volume but rather an estimate based on strata four's volume and strata three's ratio of revenue per piece. As a result, strata four's volume, and hence the total population volume is measured with error. Instead of the true stratum populations, the report used estimated weights that bias the estimate of the population mean.

Tr. 30/14578. Mr. Degen correctly points out that the only way to eliminate this "infirmity" does indeed imply the need to abandon a stratified random sample as there is no way to measure the volume of the stratum four offices without error. Mr. Degen also shows that the bias associated with this measurement error is insignificant and eliminating this source of bias by using an unstratified sample would result in unreliable estimates. Tr. 38/17346-47.

As AAP demonstrates, only an absurdly large measurement error would produce any measurable impact on the resulting estimates. AAP's argument that Table 3 of Mr. Degen's testimony "actually shows that measurement error in strata 4 introduce a systematic bias in the Postal Services estimate of DDU mail" (AAP brief at 20) is more a function of the fact that only one decimal point is reported in Table 3 than of any actual bias. The 9.1 percent increase in "DDU-Destinating BMC Service Area" when stratum four's revenue per piece is assumed to be 25 percent larger than the base scenario is calculated as $(1.2\% - 1.1\%) / 1.1\%$. The true values for these cells are 1.1447% and 1.1541% respectively. Thus, the actual increase in "DDU-Destinating BMC Service Territory" is 0.82 percent, not 9.1 percent. Similar calculations for "DDU mail" reduce the percentage change from 4.2 percent to 3.5 percent. Both estimates are well within the confidence estimates of the original estimates.

Thus, AAP has not established any significant problems with the Mail Characteristics Survey. If there were such flaws, however, they would render AAP's DBMC discount proposal invalid also. Accepting AAP's arguments would result in rejection of all dropship discount proposals, including AAP's. This would be an unwarranted response to insignificant imperfections that can seldom be eliminated in

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real world analyses. The Postal Service's Mail Characteristics Survey remains the best data available, and can be relied upon for ratemaking purposes.

VII. CRITICISMS OF THE POSTAL SERVICE'S SPECIAL SERVICES PROPOSALS ARE UNFOUNDED, AND ALTERNATIVE PROPOSALS MUST BE REJECTED.

The Postal Service presented the basis for many of its special service proposals in its initial brief. Postal Service Brief, Section VIII. The Postal Service responds to arguments raised on brief by the intervenors and the OCA below.¹

A. CSA's Approach to Bulk Parcel Return Service Is Mistaken.

The Postal Service provided a detailed analysis of the CSA position in its initial brief, and that discussion will not be repeated. But CSA has presented several additional arguments and misstatements, as discussed below.

1. The original BPRS fee was established based on a systemwide average cost coverage.

CSA claims a lack of agreement on the attributable costs or BPRS cost coverage in the settlement discussions conducted prior to Docket No. MC97-4, which established BPRS. CSA Brief at 9. However, the settlement agreement filed in that docket, and signed by CSA, established the testimonies of Postal Service witnesses Pham and Adra as the record basis for a Commission recommendation. Witness Pham presented a cost study calculating a unit attributable cost of \$1.119. Witness Adra explained that the \$1.75 fee the Postal Service proposed was based on the cost estimates developed by witness Pham, and that "using witness Pham's \$1.12 per piece cost estimate, the

¹ With respect to certified mail, permit fees, registered mail, return receipts, and return receipts for merchandise, Mr. Popkin complains that the increases are greater than the average increase proposed in this proceeding. Popkin Brief at 1, 4, 5, and 15. The proposal for each of these services reflect different costs, and is justified individually in the testimony of witness Mayo (USPS-T-39).

flat fee of \$1.75 yields a cost coverage of 156 percent."² Furthermore, witness Adra's testimony specifically considered the appropriateness of the fee with respect to other cost coverages:

The proposed fees and fee levels were selected with the existing cost coverages and rate structures of related services in mind. At these fees, the cost coverage for BPRS is 156 percent. This cost coverage level is close to the systemwide cost coverage

Docket No. MC97-4, USPS-T-1, at 16. In preparing its recommended decision, moreover, the Commission conducted an independent review of the testimonies of witnesses Pham and Adra, along with the statutory classification and pricing criteria. PRC Op., MC97-4, at 10. The status quo is a level close to the systemwide cost coverage.

The Postal Service does not endorse the use of systemwide average cost coverages per se, but does believe that a fair application of the pricing criteria to BPRS supports a cost coverage near the systemwide average. BPRS provides high value to both the sender and recipient, and provides a cost-effective foundation for business mailers to send customers parcels in circumstances in which customers may want to return a substantial proportion of the parcels.

2. CSA's selective use of FY 1999 data should be rejected.

CSA purports to update the BPRS cost analysis to incorporate FY 1999 data. CSA selects certain costs with minor increases and decreases (e.g. collection costs, transportation costs), but rejects the 20 percent increase in mail processing cost. CSA

² Testimony of Mohammad Adra on Behalf of United States Postal Service, Docket No. MC97-4, USPS-T-2, at 13, cited by the Commission at PRC Op, MC97-4, at 5.

Brief at 4-5. Selective updating of model costs is not an acceptable approach for incorporating FY 1999 data, since it allows intervenors to construct cost analyses in any manner desired. Therefore, CSA must either accept the FY 1998 base year, as the Postal Service prefers, or fully update the costs to the FY 1999 base year.

3. BPRS is a special service, rather than a Standard Mail (A) subclass.

CSA argues that BPRS is Standard Mail (A) since it is required to have a Standard Mail (A) class of mail endorsement. CSA Brief at 11-12. The CSA brief provides an example of a return label which includes this endorsement. CSA Brief at 12. CSA does not point out that the same label indicates in two places that the label is actually a "Bulk Parcel Return Service" piece. Moreover, as discussed in the Postal Service's initial brief, BPRS clearly is a special service, rather than a subclass, providing much more than processing and delivery of mail.

CSA incorrectly argues that BPRS meets all the requirements of Standard Mail (A). *Id.* Unlike Standard Mail (A), BPRS pieces are entered into the mailstream singly through the retail counter or the collection system, and are not postage prepaid. Moreover, BPRS parcels are not entered in bulk, are not presorted, and are not processed in bulk. Tr. 23/10675, 10706, 10713-15.

- B. KeySpan's Advocacy in Support of Lower QBRM Per-piece Fees Crosses the Line.

1. The Commission should not rely on extra-record material described by KeySpan.

Beginning on line 9 of page 24 and ending on line 5 off page 26, KeySpan's Brief spins an argument based on factual assertions which are not a part of the evidentiary record and which have previously been excluded from the record by the Presiding

Officer. During the cross-examination of rebuttal witness Campbell, KeySpan sought to enter into the record two documents containing these same factual assertions. In each instance, the documents were not allowed into the record. Tr. 39/17600-05. The Postal Service trusts that the Commission is fully aware of its obligation to avoid relying on materials which are in evidence, particularly matters specifically excluded by the Presiding Officer.

2. The comparison to nonletter-size weight averaging is misleading.

In support of its alternative Qualified Business Reply Mail fee cost analysis, KeySpan's Brief resorts to mischaracterization and distortion of the record evidence. At the heart of KeySpan's machinations is a desire to persuade the Commission to de-average the per-piece fees for QBRM in such a manner that the very highest-volume QBRM recipients pay much lower fees than those proposed by the Postal Service. Below, the Postal Service explains why the KeySpan Brief provides very little guidance in resolving the issues in this case.

For instance, at pages 5-6 of its Brief, KeySpan contrasts Postal Service witness Campbell's (USPS-T-29) 0.57-cent average unit cost estimate for nonletter-size BRM weight averaging with his 2.00-cent average unit cost estimate for QBRM per-piece counting. The purpose of the comparison is to suggest something counter-intuitive about the figures. However, the comparison is misleading. The figures make sense for a very simple reason. The first figure reflects the average cost for weight averaging, the less expensive of two alternative methods of counting nonletter-size pieces. The other method, manual counting is much more labor intensive and generates significantly higher costs, as reflected in the current and proposed fees for non-advance deposit BRM. USPS-LR-I-160, Section B, page 4. If a weighted average of the two figures

were developed, for the purpose of determining the average per-piece cost nonletter-size BRM counting, it would be much higher than 0.57 cents, and closer to the 7.42-cent figure shown in USPS-T-29 at 21 (Table 1).

The 2.00-cent unit cost estimate for QBRM counting reflects the average unit cost of counting letter-size QBRM pieces, based on a mix of five different counting methods (manual, special counting machines, weight averaging, end-of-run bin counts, and BRMAS). These counting methods vary in cost, with BRMAS being the least expensive and manual counting being the most expensive.

An "apples-to-apples" comparison would be one which contrasted the cost of weight averaging for nonletter-size BRM with the cost of weight averaging applied to QBRM letters. KeySpan's "apples-to-cornucopia" comparison is pointless, unless one considers misleading the Commission to be a worthwhile objective.

3. Increases in automated mail processing do not automatically result in increased opportunity to utilize BRMAS.

The principal difference between the testimonies of Postal Service witness Campbell (USPS-T-29) and KeySpan witness Bentley (KE-T-1; Tr. 29/13980 *et seq.*) are their estimates of the degree to which various methods are employed to count QBRM. Witness Campbell relies upon the percentages estimated for each method by the Docket No. R97-1 Business Reply Mail Practices Study. A survey of the 70+ highest-volume QBRM accounts indicates that the estimate that 14 percent of QBRM is counted on BRMAS is too low, meaning that his 2.00-cent average unit counting cost estimate for QBRM is too high. See Postal Service Initial Brief at VIII-21. Witness Bentley estimates that QBRM BRMAS counting percentage to be approximately 52 percent. Tr. 29/14029. There are a number of mistaken assumptions which lead to

witness Bentley's miscalculation. They are described at pages VIII-24-25 of the Postal Service's Initial Brief. Because witness Bentley's estimated BRMAS percentage is too high, his average unit cost estimates for counting high and low volume QBRM are too low.

One of KeySpan's criticisms of witness Campbell is based upon the assertion that he has not taken into account the increased utilization of BRMAS implied by the testimony of Postal Service witness Kingsley. At page 15 of its Brief, KeySpan points to the testimony of Postal Service witness Kingsley and asserts that more automation is applied to First-Class Mail (and by definition, QBRM), meaning that there is a much higher percentage of QBRM accounting performed on BRMAS than previously estimated. This argument combines a misreading of witness Kingsley's testimony with an unfounded leap to an unrelated conclusion.

Witness Kingsley testified that a higher percentage of letter mail was receiving automated processing. Tr. 14/6204. Her statement was not specific to First-Class Mail, but to automation-compatible letter mail in general, which includes a large proportion of Standard (A) Mail. Moreover, it was restricted to mail processing, and did not extend to ancillary operations, such as QBRM accounting. As witness Campbell has explained, despite the advent of automated mail processing, there are many reasons why BRMAS utilization does not come close to approaching levels projected a decade ago.

Foremost among these is the fact that the BRMAS accounting window and the Delivery Point Sequencing window are open concurrently and DPS has preferential access to automated equipment, often shifting BRMAS-eligible QBRM to less efficient counting methods. Tr. 14/5927. By implication, witness Kingsley's statement supports witness Campbell's testimony. The Postal Service is utilizing its automated equipment to do

more automated mail processing, cutting down on opportunities to run BRMAS. Thus, witness Kingsley's testimony provides no basis for witness Bentley's inflated estimate of BRMAS utilization.

4. KeySpan does not fully understand the costing approach.

The discussion at pages 31-33 of the KeySpan Brief concerning the so-called "Premium Sortation Myth" reflects further misunderstanding of witness Campbell's costing analysis.

At page 33 of its Brief, KeySpan asserts that "Mr. Campbell's . . . study design first uses a 951 PPH productivity factor for manual counting that combines counting and sorting functions. . . ." Witness Campbell's rebuttal testimony explains that the Commission has relied upon the Docket No. R90-1 testimony of Postal Service witness Pham (USPS-T-23) for over a decade, including the 951 PPH productivity factor. Tr. 39/17498-500. Next, at page 32, KeySpan alleges that witness Campbell's study "deducts some, but not all, of the sortation costs." During cross-examination, witness Campbell explained that "41.6 percent of BRM pieces^[3] . . . are sorted on automation to a large degree, but then receive the finest depth of sortation [to customer account] manually in the Postage Due Unit." Tr. 14/6102-03. It is this volume of BRM that receives an extra sortation to the customer account, a sortation that is incremental to BRM.⁴ In order to avoid charging the customer twice for an incoming secondary operation, witness Campbell subtracts out the cost of an incoming secondary for an

³ See BRM Practices Study, USPS LR-H-179, page 21.

⁴ Also referred to as a "premium" sortation by witness Campbell. Tr. 14/6156. The premium sortation occurs solely due to the fact that these pieces are BRM. If these were not BRM pieces, they would normally receive an incoming secondary sortation equivalent to that received by an automation compatible mail piece.

automation-compatible mail piece⁵ only for these 41.6 percent of BRM pieces. The remaining 58.4 percent of BRM are sorted to customer account on a barcode sorter or other method, do not receive a premium sortation, and therefore, are never double charged.

5. KeySpan has only itself to blame for its unsupported assumptions.

Another significant reason for witness Bentley's inflated BRMAS counting percentage is his unsupported inclusion of 56,000,000 pieces of QBRM from one particular high-volume customers as all high-volume QBRM. Rather than concede error, the KeySpan Brief, at page 17, n. 18, tries to blame the Postal Service for witness Bentley's assumption that this mail was all in one high-volume account. As is clear from the record, without knowing the use to which the data would be put, the Postal Service provided what KeySpan requested – the total QBRM volume for a particular customer known by both parties not to be

recorded in the Postal Service's Corporate Business Customer Information System (CBCIS) database. See Tr. 39/17587-88. The Postal Service "withheld" nothing and is not responsible for any assumptions made by witness Bentley.⁶

6. KeySpan's brief misrepresents the nature of CBCIS.

At page 19 of its Brief, KeySpan identifies CBCIS as the source of data reflecting the counting method for 241 million "high-volume" account QBRM letters. And at page 28 of its Brief, KeySpan criticizes the Postal Service for disregarding "recent actual

⁵ The cost of an Automation Basic Presort incoming secondary operation for First-Class letters is used as a proxy. See USPS LR-I-160, Section B, page 2.

⁶ KeySpan's counsel and witness apparently have opposing views on the matter: See KE-T-1, at 16: "Mr. Campbell is to be commended for his diligence in obtaining this important information at such a late stage in this proceeding."

information from . . . CBCIS . . . that directly refute the BRM Practices Study . . . witness [Campbell] relied upon to determine the percentage of QBRM counted by the various counting methods."

To be clear, nearly half of the counting percentage data provided by witness Campbell in response to KE/USPS-T29-49 (Tr. 14/6030) came directly from the BRM Practices Study data. Those data, combined with the results of his telephone survey, provide the counting methods data reflected in that response for the top 70+ high volume QBRM accounts. CBCIS only served the purpose of identifying most of the QBRM recipients, by volume which should have been included among the top 70+ customers. There are no data in CBCIS concerning accounting methods employed. Therefore, it cannot be intelligently claimed that CBCIS contains counting methods data at all, much less counting methods data which refute the BRM Practices Study data.

KeySpan's criticism of the BRM Practices Study in its Brief might be a bit more muted if the Brief reflected the realization that the BRM Practices Study -- and not CBCIS-- provides a large portion of the data provided in response to KE/USPS-T29-49 and relied upon by both witnesses Campbell and Bentley to estimate QBRM counting method percentages.

Table 4 at page 29 of the KeySpan Brief purports to juxtapose percentages for the various QBRM counting methods supposedly derived from alternative "Data Sources" identified as -- the "BRM Practices Study" and the "CBCIS Data System." The counting method percentages identified as coming from the BRM Practices Study indisputably come from that study. However, as explained above, CBCIS contains no counting methods data. It only provides BRM customer volumes. KeySpan witness

Bentley takes those volumes and makes a number of assumptions and judgments⁷ to derive the counting percentages that KeySpan misrepresents in its Brief as issuing from the "CBCIS Data System." Granted, characterizing an estimate as the output of an official postal data system may give it more credibility, but it is disingenuous to cite a postal data system as the source of an estimate when the estimate is transparently a judgmentally-derived product of KeySpan's witness. The Table would not be misleading if it substituted "Witness Bentley's Estimates" wherever it reads "CBCIS Data System." The rebuttal testimony of witness Campbell (Tr. 39/17494 *et seq.*) explains why witness Bentley's estimates are unreliable.

7. Contradictory approaches to volume-variability analysis: KeySpan vs. MMA.

At page 39 of its Brief, KeySpan rebukes Postal Service witness Campbell for relying on the assumption that the manual productivity for "counting and sorting QBRM was 100% variable with volume" because such an assumption is a "poorly disguised, opportunistic attempt to artificially inflate QBRM costs" KeySpan Brief at 39. Coincidentally, the Initial Brief of Major Mailers Association asserts that "important methodological changes proposed by the Service . . . that labor costs do not vary 100 percent with volume" result in the "assignment of an excessive portion of institutional costs to First-Class Mail." MMA Brief at 12. MMA goes on to argue that such an approach would "artificially reduce workshare cost savings and mask the traditional yardsticks used by the Commission to judge the fairness of proposed rates." *Id.* The Postal Service has addressed the issue of volume variability analysis extensively on the

⁷ Which are addressed at pages 9-13 of the rebuttal testimony of Postal Service witness Campbell (Tr. 39/17504-08) and the Postal Service's Initial Brief at 24-25.

record of this proceeding and on Brief. The Postal Service is anxious to see which of the result-oriented approaches to volume variability analysis carries the day: KeySpan's or MMA's.

C. *The Postal Service's Proposed Certified Mail and Return Receipt Fees Are Justified Despite Intervenor Criticisms of Cost Analyses and the Quality of Service.*

Once again intervenors Carlson and Popkin argue for lower certified mail and return receipt fees, reflecting their dissatisfaction with the underlying cost analyses, and the quality of service. However, the Postal Service's proposal is based on low cost coverages that take account of many of their concerns. The Postal Service's proposals should be recommended.

1. Intervenor concerns about costs are mistaken.

Mr. Carlson is skeptical that "costs for certified mail . . . have risen 50 percent since Docket No. R97-1." Carlson Brief at 11. However, the Postal Service has explained that much of the cost increase for certified mail results from improved costing analyses for certified mail, rather than actual cost increases. Postal Service Initial Brief at VIII-27-28. In particular, much of the increase is based on a new estimate of incremental costs for certified mail. Witness Kay explains that incremental costs are 18.9 percent higher than volume variable costs, because of the behavior of carrier costs. USPS-T-23 at 17-19. Because of these costs, the fee increase for certified mail is required simply to cover costs. The fee is not based on the level of service. Contrary to the complaints of Mr. Carlson and Mr. Popkin, witness Davis' cost study for return receipt is reliable and represents the best available cost data. The Commission should rely on this cost study in recommending fees for return receipt service. Return receipt service consists of two types: (1) requested at time of mailing and (2) requested after

mailing. DMM S915.1.1. It is noteworthy that while Mr. Carlson and Mr. Popkin criticize the Postal Service for the increase in the cost of the former, they are silent on the 66 percent decrease in the cost of the latter.

In addressing the cost study for return receipt at time of mailing, Mr. Carlson and Mr. Popkin raise two concerns: (1) the validity of data from the clearing clerk review study and (2) the study's assumption of proper handling of return receipts. These two concerns should be put into proper context. First, Mr. Carlson and Mr. Popkin fail to recognize that the cost increase for this service is due mostly to factors *other than* the updated productivity data from the clearing clerk review survey. In fact, the cost increase is due to a combination of updated cost inputs, including increased wage rates and piggyback factors for carriers and clerks for various activities *other than* clearing clerk review. Tr. 14/5782-84. Second, while witness Davis responded to some 55 interrogatories from Mr. Carlson related to the clearing clerk review survey, Mr. Carlson's initial brief largely ignores numerous explanations put forth by Mr. Davis in defense of the study. Lastly, for all their interrogatories and criticism regarding the cost study, Mr. Carlson and Mr. Popkin fail to offer an alternative cost study.

The first claim, that the clearing clerk review study is "sorely deficient" (Carlson Brief at 10), is unwarranted. As witness Davis has explained in previous interrogatory responses, the study utilized a randomly selected sample of small, medium, and large offices; each Area Office in the nation was represented in the sample; and the survey data include the review of 8,918 return receipts. Tr. 14/5814-5815, 5819, 5868-70. Furthermore, witness Davis has explained in previous interrogatory responses that because of aggregate reporting of data by facilities, one cannot meaningfully evaluate the dispersion (e.g., standard errors, confidence intervals) of data for return receipts

reviewed. Tr. 14/5868-5869, 5872. If Mr. Carlson and Mr. Popkin somehow believe that meaningful measures of dispersion can be calculated, than it is curious why neither has provided any such calculations in this proceeding, especially since the Postal Service provided the raw data in an MS Excel file upon request. Tr. 14/5860. All that these intervenors claim is that statistical measures are missing, not that they would show deficiencies in the study.

Mr. Carlson and Mr. Popkin unfairly criticize the raw data because several of the facilities did not provide exact counts, but instead provided approximate counts. Carlson Brief at 17-18; Popkin Brief at 3. Given that the surveys were completed by accountable mail clerks (who regularly perform the review process) at selected facilities, the inclusion of approximate counts results in a more complete and informative study. Tr. 14/5824-26, 5831, 5873. That a given facility, facing budget constraints *and* demands to move the mail as quickly as possible, may report approximate counts instead of fully precise measurements over an extended period of time should not dismiss that facility's reported data per se. Tr. 14/5824-25.

The second claim, that the cost study assumes proper processing of return receipts, is misguided and carried too far. Mr. Carlson states that in a number of cases, improper processing of return receipts results in a total unit cost of \$0.196. Carlson Brief at 18. However, that total omits the significant category of window acceptance costs. *Furthermore, it should not be inferred from Mr. Carlson's initial brief that* improper return receipt processing necessarily means that all delivery costs have been avoided. The Inspection Service report shows that special procedures for certified mail/return receipt service are in place. For example, the Inspection Service audit report shows that for one site, which Mr. Carlson singles out (Carlson Brief at 18),

clerks still prepare manifests, scan the PS Forms 3811, remove PS Forms 3811 from the envelopes, and then hand stamp these forms to show date of delivery. USPS-LR-I-200 at 19. The costs for such processing are significant. Finally, Mr. Carlson argues that "[c]ost data for return receipt must be discounted by the extent to which postal facilities improperly process return receipts." Carlson Brief at 11. But data collection for the return receipt cost study would pick up costs as they actually occurred. In that respect, a new study would find higher costs to the extent improper methods are corrected.

Mr. Popkin's comment that "the cost data has not been properly documented" is incorrect. Popkin Brief at 4. Extra efforts have been made to provide a greater detail of documentation of cost data than has been provided in previous rate cases. USPS-LR-I-108 is rich with documentation of cost data. The Postal Service has provided additional documentation in responses to interrogatories. See *e.g.*, Tr. 14/5796-99, 5812-13, 5860.

2. The concerns about service quality are overstated, and do not require any change to the Postal Service's proposals.

Intervenors Carlson and Popkin allege that they have revealed serious deficiencies in return receipt service. Carlson Brief at 5; Popkin Brief at 6. Providing fees with only a minimal cost coverage may actually discourage such service improvements, however, since attention might be diverted to products with higher contributions.

Mr. Carlson limits the value of return receipt service to four "distinguishing characteristics." Carlson Brief at 12; also see Popkin Brief at 3-4. These four characteristics are the Postal Service acting as a disinterested party, retaining

possession of the piece until it is signed, the recipient not being allowed to open the piece until after signing for it, and the Postal Service mailing the receipt back within one day after delivery. Id. But return receipt's value is not so limited. As witness Plunkett explained in Docket No. R97-1, in many cases the customer is satisfied with learning that an article has been delivered, even if some of the above characteristics were not satisfied. Tr. 49/17119-20.

Mr. Carlson criticizes the lack of training for the check-off box. Carlson Brief at 14, 16. While Headquarters has not conducted any training, training may have been done at the local level, through field communications or stand-up talks. See Tr. 14/5478, 5508, 5531. Moreover, Mr. Carlson ignores the inclusion of two boxes, rather than the single box promised in Docket No. R97-1.⁸ The check-off system has been implemented as two boxes, asking the carrier to check "Yes" if the address is different or "No" if not. Tr. 14/5477, 5529. Two boxes provide greater assurance that the carrier actually is completing the form, and responds to earlier criticisms by Mr. Carlson and Mr. Popkin that a single check-off box, left unchecked, would provide ambiguous information.

Mr. Carlson claims that the Postal Service's retail displays on accountable mail services "sought to deceive more customers into purchasing these services," and that the Postal Service is "aggressively encouraging customers, via lobby advertising, to use certified mail and return receipt to mail their tax returns." Carlson Brief at 15, 16. But the Postal Service has explained that the purpose of those displays was simply to educate customers about the variety of accountable mail services at a time when

⁸ In Docket No. R97-1, witness Plunkett alluded to a "check-off box to indicate that the current address is correct." Docket No. R97-1, USPS-T-40 at 14.

customers typically ask a lot of questions about which service would meet their needs.⁹ Moreover, based on volume trends, customers seem to be getting what they desire from return receipt service as currently provided. Tr. 49/17124-25. In this regard, federal law endorses certified mail as one means of providing delivery to the IRS, and it is the postmark, rather than the return receipt, which is critical in legal disputes. 26 U.S.C. § 7502.

The focus of intervenor attention has been on the delivery practices at IRS service centers, and other large organizations. It should not be forgotten that, in general, return receipts are signed for at the time of delivery. However, obtaining signatures on each return receipt before delivery is not always practical when many return receipts are delivered at one time. Perhaps employees could be added, but staffing increases for return receipt processing would tend to raise return receipt fees even more substantially.

The Postal Service believes that its practices for delivery of return receipt mail to large organizations is efficient, and meets customer needs in most instances. Tr. 32/17124-25. The Postal Service continues to serve as an independent third party in such cases, by requiring the signature of a manifest, and maintaining a record of delivery. The IRS should indicate a correct date on the return receipt, given its signing of the manifest and its procedures for separating return receipts by date of delivery.¹⁰

⁹ Tr. 46D/21435, 21438. Similarly, the Inspection Service has determined that customers are often confused about the definitions of registered, certified, and insured, and thus do not always select the appropriate service for their needs. USPS-LR-I-200 at 3.

¹⁰ Tr. 49/17170-71.

Moreover, the process of allowing large organizations to sign for receipt of all certified mail at the time of delivery, and then complete the return receipt cards later, may be at least temporarily necessary in order to avoid even more problematic delivery delays. During Docket No. R97-1 witness Plunkett warned that a large recipient of return receipts like the IRS might just refuse the mail if required to sign each return receipt at the time of delivery. Tr. 49/17173. Witness Plunkett testified that the Postal Service and the IRS "have developed a system that allows for normal operations to take place at IRS service centers but that still provides a safeguard to ensure that return receipt customers are getting the correct date on their return receipts." Tr. 49/17171.

Mr. Carlson argues that the problems with delivery of certified and return-receipt service identified in the Inspection Service report "decimate the core value of these services." But in response to the Inspection Service audit, management stated that the problems would be resolved.

John Dorsey, Manager of Special Services, Don Leonard, Delivery Policies and Programs, and Jim Buie, Engineering, are addressing the issues discussed with the purpose of designing systems and procedures to enable the Postal Service to comply with existing requirements while improving automated handling of large volume of Certified Mail.

LR-I-200 at 22. Thus, there is more evidence than in prior cases that these problems are being addressed by management, and a fee should be set high enough to cover costs for the level of service demanded by customers like Mr. Carlson and Mr. Popkin.

Mr. Carlson claims that lower cost coverages for certified mail and return receipt services will provide a monetary incentive for the Postal Service to correct problems

with the delivery of certified and return-receipt mail. Carlson Brief at 11. While the Postal Service is concerned about all aspects of service, postal management may have a reduced financial incentive to focus resources on a particular product for which fees do not provide a significant contribution above costs. Moreover, having an Inspection Service report presented to management pointing out service problems is likely to have already had an impact on management more than the indirect signal of a low fee resulting from a rate case. Mr. Carlson notes that "the Inspection Service audit found that revenues received from certified mail are adequate to pay for the resources needed to handle this mail. USPS-LR-I-200 at 23." Carlson Brief at 16, n. 5. But the lower fees Mr. Carlson pushes would jeopardize those revenues.

Mr. Carlson acknowledges that witness Mayo proposes a lower cost coverage for return receipt because of its service problems. Carlson Brief at 16. In fact, she proposes a very low 116 percent cost coverage.¹¹ USPS-T-39 at 131. This cost coverage is below the cost coverage established in prior dockets, and is barely adequate to reflect the intrinsic value of return receipt service.¹² Mr. Carlson fails to specify exactly how much below that cost coverage he believes that the cost coverage should fall. But witness Mayo's proposal fully reflects the service problems of which Mr. Carlson and Mr. Popkin complain. Finally, value of service is just one of the nine pricing criteria. Fees and cost coverages should not be based solely on any one criterion, but rather on a balance of all applicable criteria.

¹¹ Mr. Carlson and Mr. Popkin's brief do not even acknowledge the low cost coverage proposed by the Postal Service. They just provide supporting arguments for the Postal Service's low proposed cost coverage. Carlson Brief at 10-16; Popkin Brief at 2-4.

¹² In Docket No. MC96-3 the Commission agreed with the Postal Service that return receipt service has a high value. PRC Op., MC96-3, at 111.

3. The Postal Service's certified mail proposal reflects the available alternatives.

Intervenor Popkin claims the only alternative to certified mail is to use an expedited service. Popkin Brief at 5. However, market research presented in Docket No. MC96-3 demonstrated that there are many available alternatives to certified mail, mostly non-Postal Service alternatives, and that customers often find these alternatives to be more convenient than certified mail. Docket No. MC96-3, USPS-LR-110, at 20-21. The Postal Service is also introducing alternatives by adding Delivery Confirmation and Signature Confirmation. The information available from these postal alternatives could provide what current certified mail customers are seeking at a lower price than certified mail. Especially given the availability of alternatives, the Postal Service is not "taking advantage of the public" by charging a fee just high enough to cover incremental costs.

4. The Postal Service's proposal for return receipt for merchandise is consistent with the proposals for certified mail and return receipt service.

Mr. Carlson and Mr. Popkin argue that the combined certified mail and return receipt fee should be no more than the return receipt for merchandise (RRM) fee. Carlson Brief at 19; Popkin Brief at 4. However, unlike the certified mail and return receipt fees, the RRM fee reflects a very low markup of only 101 percent, chosen to mitigate the fee increase resulting from the higher costs identified in witness Davis' updated cost study. USPS-T-39 at 131, 135. Moreover, RRM is designed for parcel-shaped mail, while certified mail/return receipt is generally used for letters. The delivery cost for return receipt for merchandise may be lower than for certified mail plus return receipt service because the delivery deviation cost is absorbed by the large host

mailpiece itself, not by the requirement for a signature. Tr. 14/5791-92. In this regard, RRM costs are based on additional certified mail costs over and above the costs for delivery of Priority Mail. USPS-LR-108 at 52-55. Some RRM delivery costs might be absorbed in the costs for Priority Mail delivery, similar to the absorption discussed in witness Davis' rebuttal testimony (USPS-RT-21) concerning Delivery Confirmation. Tr. 39/17428-29. Finally, return receipt for merchandise provides an option for customer waiver of the signature requirement for return receipt for merchandise. Tr. 14/5792.

D. Certificate of Mailing Service Is Higher Cost than Delivery Confirmation.

Mr. Popkin argues that the fee for certificate of mailing service should be no higher than the proposed retail fee for Delivery Confirmation. But he incorrectly assumes that providing a certificate of mailing is the same as providing a mailing receipt under retail Delivery Confirmation service. Popkin Brief at 6. In fact, several operational distinctions between the two result in higher costs for certificate of mailing service.

First, window acceptance is a more costly function for certificate of mailing service, because all articles receiving certificate of mailing service incur a window transaction. With Delivery Confirmation, on the other hand, data show that 22.6 percent of volume for the retail option bypass window acceptance; thus, for these pieces, *no* mailing receipt is provided. Tr. 14/5793-94.

Second, because Delivery Confirmation is a much higher-volume service, window clerks are more familiar with, and thus more efficient, at providing this service than at providing certificate of mailing service, which is not commonly requested. Third, Delivery Confirmation is a new, technology-driven service which exhibits greater cost efficiencies than does certificate of mailing service. *Id.*

E. The OCA's Proposal on Delivery Confirmation Does Not Require Commission Action.

The OCA repeats witness Collins' recommendation from her testimony that the no-charge status for provision of electronic Delivery Confirmation to bulk Priority Mail users be extended to individuals. OCA Brief at 213. However, witness Collins understood that individual customers already have access to the no-fee electronic Delivery Confirmation option, via third-party providers. She modified her recommendation to changes in the Postal Service's website to make this option available one more way. Tr. 29/14254. Thus, her testimony appears directed at the Postal Service, rather than a classification or fee change requiring Commission involvement.

F. The OCA's Criticisms of the Postal Service's Insurance Proposal Should Be Rejected.

The Office of the Consumer Advocate argues that "the Postal Service has failed to support the proposed insurance fee increases". OCA Brief at 208. The OCA's contention is misplaced for one simple reason: the Postal Service has proposed an increase in insured mail fees in response to substantially higher cost estimates for the service than in Docket No. R97-1.

Witness Davis' corrected cost study for deaveraging insured mail costs still results in a significant cost increase in the costs for unnumbered insurance since Docket No. R97-1. The increase in the costs for insurance are due in part to several witnesses' enhanced methodologies, which result in higher variability factors for insured mail. Tr. 14/5889. The higher variability factors translate into higher volume variable insurance costs as reported in the Postal Service's Cost and Revenue Analysis report.

Finally, the OCA argues that the incremental fee rate for insured mail should not be increased. The OCA's position appears to be based on the mistaken conclusion that the Postal Service has *no* understanding of costs by fee increment. OCA Brief at 210. While the Postal Service may not have separated *all* costs by fee increment, the Postal Service has provided a detailed indemnity analysis that supplements general cost data presented in both the Cost and Revenue Analysis and cost studies performed by witnesses Davis and Kay. Tr. 39/17657. Moreover, there is no evidence to suggest that non-indemnity costs vary by fee increment. Therefore, the OCA's argument that incremental insurance fees remain unchanged should not be accepted.

On brief, for the first time, the OCA proposes an unnumbered insurance fee of \$1.05. OCA Brief at 209. This proposal is arrived at by reducing witness Mayo's proposed unnumbered insurance fee of \$1.35 by \$0.30, resulting essentially in a full "pass-through" of witness Davis' cost correction of \$0.31. This reduces the unnumbered fee too much.

The OCA recognizes correctly that witness Mayo was constrained to mark up the unnumbered costs well below the average for the insurance service as a whole. Tr. 39/17659-60. By mitigating the unnumbered insurance fee, witness Mayo acted in a responsible manner based on an understanding of the insurance market and the potential effect on customers. The \$1.35 was a reasonable and balanced compromise between rising costs and the effect of a proposed fee increase on the customer.¹³ Witness Mayo clearly stated in rebuttal testimony that if the correct cost information was

¹³ If witness Mayo had marked up the original cost of \$1.26 by the average cost coverage of 138.4 percent, the proposed fee would have been \$1.74. Tr. 39/17659-60. Witness Mayo therefore mitigated the potential fee approximately 44 percent. $[(\$1.74 - \$1.35) / (\$1.74 - \$0.85)]$.

available when initially proposing the fee, she would have proposed a lower fee. But witness Mayo also stated that she would not have proposed a fee resulting in a cost coverage as low as 104.5 percent. *Id.*

The OCA's new proposal applies this low cost coverage as if nothing has changed. But witness Davis' correction reduced the cost of unnumbered insurance by 25 percent.¹⁴ Therefore, substantial mitigation is no longer necessary. Any reduction of the unnumbered insurance fee must recognize that witness Mayo's fee proposal was mitigated, and should increase the cost coverage for this category to a level more consistent with the overall insurance service cost coverage and more reflective of the value of service provided.

The OCA provides no record support for their proposal to modify the insurance increments over \$1000. OCA Brief at 211. This recommendation should be rejected. In addition to the problems discussed in the Postal Service's initial brief, at VIII-33, witness Mayo provides sound reasons for not pursuing this type of change. First, Postal Service competitors all assess insurance fees based on \$100 increments. Tr. 39/17659. Second, introducing a different structure would be confusing to the customer and increase the difficulty of price comparisons. *Id.* Third, the expansion of the increments would result in a customer being charged for excess insurance when the value of their package is in the lower portion of the increment. *Id.* While the Postal Service may consider some form of insurance service fee restructuring in future cases, the OCA's new, irresponsible, and unsupported suggestion should be rejected.

¹⁴ $(\$1.26 - \$0.95) / \$1.26 = 25\%$.

G. The OCA Attacks on the Postal Service's Money Order Proposal Are Mistaken.

The OCA notes "USPS witness Mayo concedes that 'money orders are used by individuals with modest incomes.' Tr. 39/17668." OCA Brief at 203. The OCA does not give the whole sentence, which gives witness Mayo's statement an entirely new meaning. Witness Mayo stated "Although I have stated that money orders are used by individuals with modest incomes, the point I was trying to make in my testimony was that there is a growing number of money order customers who are not low income individuals." Tr. 39/17668-69. The changing user base supports a higher cost coverage and witness Mayo's proposed fee increases.

The OCA's criticism of witness Mayo's comparison of the proposed money order fee with the fee charged 24 years ago should be ignored. OCA Brief at 205. The fact that witness Mayo's proposal would raise the fee to no higher than it was 24 years ago is telling, since no inflation factors are used. The OCA's argument that the 13-cent First-Class Mail rate of 24 years ago should be revived misses the point. *Id.* Especially in times of inflation, customers are unlikely to be unduly harmed by a small fee increase when the resulting fee is no higher than the fee was 24 years ago.

The OCA attacks witness Mayo for her statement that "[p]ostal money orders should be of an extremely high value to domestically-stationed military personnel away from their own financial institutions due to the abundance of post office throughout the United States and its territories." Tr. 39/17670. Witness Mayo is referring to one way the APO/FPO money orders provide high value. When servicepersons are on temporary duty in an overseas or remote location, or on a ship, they can use APO/FPO money orders to send money home, with the recipient able to cash it at any post office.

As Chairman Gleiman points out, this feature also makes the APO/FPO money order attractive to personnel permanently stationed overseas. Tr. 39/17747.

Ignoring the possibility that domestically-stationed military personnel can be temporarily stationed away from the U.S., the OCA confidently argues that “[c]ontrary to witness Mayo’s assertion, domestically-stationed military personnel do not qualify for the lower APO/FPO money order fee.” OCA Brief at 208. Even for domestically stationed personnel, APO/FPO money orders may be available. The DMM regulations are focused on the military facilities authorized to sell money orders, rather than the individuals allowed to purchase APO/FPO money orders. Moreover, the OCA’s own statement that APO/FPO money orders are sold at “offshore, remote, or overseas duty stations” does not exclude remote locations in the United States, or domestically-controlled waters. OCA Brief at 207.

H. The Commission Should Recommend The Post Office Box Fees Requested By The Postal Service.

The Commission is faced with only one record-based alternative for post office box fees and fee groups – those proposed by Witnesses Mayo and Kaneer. New fees and classifications will facilitate a transition to more cost-homogenous fee groups. USPS-T-40 at 10. The proposed classifications are based on the existing fee groups and estimates of economic space cost, thereby better meeting the requirements of the Act.

Mr. Popkin is the only participant in this docket who has filed a brief regarding the Postal Service’s post office box proposals. However, his argument that the Postal Service’s proposal should be denied is lacks logical and scientific support. Mr. Popkin

plainly misunderstands the cost heterogeneity problem of the existing fee groups. At page 2 of his Initial Brief,¹⁵ he states:

While there is a distinction between present Fee Groups A/B/C vs. Fee Group D [Fee groups A/B/C have city delivery service while Fee Group D has rural or HCR delivery without having city delivery], there is no category difference between Fee Groups A, B, and C. They are all city delivery offices and the only distinction is apparently one of cost.

The Postal Service in this docket and together with the OCA in Docket No. R97-1 have maintained that the costs underlying existing fee groups largely overlap, i.e. that they are cost *heterogeneous* (USPS-T-40 at 3). In other words, the facilities within existing fee groups are not primarily distinguished by differences in their space costs (see, Exhibit USPS-40C at 1, revised March 31, 2000).

Mr. Popkin amply illustrates his misunderstanding by mischaracterizing Witness Kaneer's testimony (USPS-T-40 at 13) when he asserts: "The cost groups have become increasingly cost homogeneous". Witness Kaneer actually testified prospectively, not retrospectively, stating: "Over time, the cost groups can become increasingly cost homogeneous." Mr. Popkin also contradicts himself on page two of his Initial Brief by claiming first that, "[t]he proposed fee group will depend on two factors – the cost per square foot and the present Fee Group for the box." He then ignores the distinct fee groups to argue that fee groups A/B/C do not differ. This is nonsense.

Mr. Popkin wrongly claims that the facility in Englewood Cliffs, New Jersey was arbitrarily assigned to Fee Group B2 "as a result of the last case." Popkin Initial Brief at

¹⁵ References to the Popkin Initial Brief in the discussion of post office box fees are to his separate brief filed under protective conditions.

2. The choice of Englewood Cliffs as a transfer site was not arbitrary (Tr.2/5731). It is a matter of record that Englewood Cliffs was chosen according to a set of criteria which were presented in testimony before the Commission (see Docket No. R97-1, USPS-RT-19, Exhibit C, page 2). Moreover, while the conceptual foundation for location-based realignment was set forth in Docket No. R97-1, the realignment of Englewood Cliffs occurred between omnibus cases.¹⁶ The fact that Englewood Cliffs is now better aligned in the post office box fee groups than it would have been without the test realignment is no barrier to the new fee groups themselves. Any faster realignment now will simply mean less continued realignment later on. The potential for fee shock mitigation is reflected fully in its assignment to Fee Group B2.

Mr. Popkin also does not understand the reasons for using ZIP Codes as the unit of cost observation and pricing. At page 2 he states:

The assignment of ZIP Codes is based on mail processing needs and it is not related to the cost of the facilities or the relationship between the subordinate office and its main facility.

However, ZIP Codes were selected as the unit of observation for space cost and for pricing due primarily to administrative concerns and customer ease of use. At this time, using ZIP Codes is an uncomplicated way to promulgate cost-based fees, internally and externally, to postal facilities and box customers.

Mr. Popkin's claimed observations regarding the cost estimates reflect a surface level understanding or less; as such, they are uniformly non-meritorious. Witness Yezer provided detailed support for his analysis and explained the scientific validity of

¹⁶ The Commission encouraged the Postal Service to proceed. PRC Op., R97-1, Vol. 1 at 566.

his research. Mr. Popkin's assessments are not scientifically based and he has not submitted a single statistically valid analysis of the data he questions. Thus, his statements are without merit and cannot be relied upon to draw any scientifically valid conclusions whatsoever.

Mr. Popkin identifies a number of situations that he believes indicate the use of inaccurate data. Popkin Brief at 3. The Postal Service recognizes that the facilities data originated from the FY 1998 Facility Profile, a paper based effort, and it is possible that the data are not all inclusive. Tr. 47/22414. But perfect data are not required to propose a fee structure that better aligns post office box costs and fees. Tr. 47/2410. In addition, changes will have occurred in the interim period between the time of filing and planned implementation. Tr. 47/22408. In any event, implementation efforts are being developed to identify facility omissions, and to identify and appropriately assign a fee group to all ZIP Codes having post office boxes. Tr. 47/22410.

I. Mr. Popkin's Arguments on Registered Mail Should Be Rejected.

In Docket No. MC96-3 the Commission recommended the elimination of the no-insurance option for registered mail with declared values between \$ 100.01 and \$25,000 as a reasonable way to avoid customer confusion concerning the level of insurance provided as a part of the service. PRC Op., MC96-3, at 126. The Commission further recommended in Docket No. R97-1 that registered mail with a value of \$0.01 to \$100 should be covered by postal insurance to ensure that the service met the reasonable customer expectation that "their registered mail is insured." PRC Op., R97-1, at 570-571.

Mr. Popkin objects to these changes. Popkin Brief at 5. This issue was argued and resolved in the previously cited dockets. Mr. Popkin provides no basis for reconsideration of the Commission's previous recommendations.

Mr. Popkin, citing the Inspection Service Area Coordination Audit Report on Special Services dated May 18, 1999 (USPS-LR-200), argues that registered mail is treated as ordinary First-Class Mail, and therefore, fee increases should not be increased until the service is improved. Popkin Brief at 5-6. Mr. Popkin ignores the fact that the Inspection Service report addresses only the Northeast Area and, even in that Area, substantial senior management attention and staff effort has been directed towards correcting any deficiencies.

The Inspection Service report identifies certain security concerns, staffing deficiencies, and procedural noncompliance in the Northeast Area. But the report also describes the actions taken by senior management to institute the Registered Mail Improvement Program (RMIP), and that this program has had a very positive effect by reducing losses in the areas where implemented. LR-I-200 at 16. Additionally, the Inspection Service report identifies actions taken by the Northeast Area to implement and evaluate RMIP at the Pittsfield Post Office and to reroute registered mail away from the Hub & Spoke Project (HASP) sites. Id. At 17. A fair reading of the Inspection Service report does not support Mr. Popkin's conclusion concerning the handling of registered mail, and he has provided no record evidence to support the contention that the procedural discrepancies identified in the Northeast Area are common to other areas. Therefore, the Commission should place no weight on Mr. Popkin's recommendation that registered mail fees should not be increased.

J. Attacks on the Postal Service's Stamped Card Fee Proposal Ignore Previous Commission Determinations.

Mr. Carlson argues that the stamped card special service fee should be held at one-cent "because stamped cards unfairly subsidize the larger cards subclass."

Carlson Brief at 20. But any argument about the overall costs for stamped and other cards should be directed at the First-Class Mail rate design. The stamped card special service fee is designed to cover just the printing and manufacturing costs for stamped cards, rather than the processing and delivery costs covered by the postage rate. As Mr. Carlson appears to recognize, the special service costs for stamped cards are 1.4 cents per card, so the current one-cent fee is inadequate. USPS-T-29 at 31; Carlson Brief at 20. Different processing and/or delivery costs for stamped cards versus other cards has not been shown on this record.¹⁷ But even if such cost differentials could be shown, the Postal Service's proposal to increase the special service fee to two cents is fully justified.

Mr. Carlson and Mr. Popkin oppose the Postal Service's stamped card special service fee proposal. Carlson Brief at 2. Their opposition is based on a belief that the fee would discourage use of what they assert is a less costly product.

Mr. Popkin argues that the stamped card fee is inconsistent with the statutory prohibition against selling postal cards for more or less than their face value. Popkin Brief at 7-8. In Docket No. R97-1, the Presiding Officer explained the errors in Mr.

¹⁷ Mr. Carlson bases his conclusion on a Docket No. R97-1 finding, but there is no evidence to support this finding in the record of this proceeding. Mr. Popkin cites no basis for his claim that "the cost of processing stamped cards is far less than that for post cards." Popkin Brief at 9.

Popkin's analysis in Presiding Officer's Ruling No. R97-1/31, which denied Mr. Popkin's motion to dismiss the Postal Service's request for a stamped card fee.

K. Mr. Popkin's Criticisms of the Postal Service's Stamped Envelope Proposal Should be Dismissed.

Once again, Mr. Popkin challenges the shipping and handling charge used by the Philatelic Fulfillment Service Center. Popkin Brief at 14. The Commission determined that this charge was a permissible philatelic charge, even when applied to the purchase of personalized stamped envelopes, in Docket No. C95-1.

CONCLUSION


For the reasons stated above, the rates for postal services, fees for special services, and the modifications of the domestic mail classification schedule proposed or endorsed by the United States Postal Service are supported by the evidentiary record and are in accord with the applicable provisions of the Postal Reorganization Act.

WHEREFORE, the Postal Service requests that the Postal Rate Commission recommend under 39 U.S.C. § 3624(d) the rates and fees and changes in the Domestic Mail Classification Schedule requested by the Postal Service in this Docket.

Respectfully submitted,

UNITED STATES POSTAL SERVICE

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Chief Counsel, Ratemaking



Anthony F. Alverno



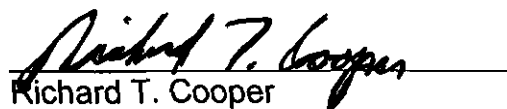
Susan M. Duchek



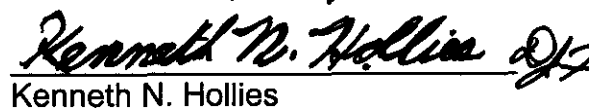
Eric P. Koetting



Scott L. Reiter



Richard T. Cooper



Kenneth N. Hollies



Joseph K. Moore




David H. Rubin



Michael T. Tidwell

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.


Daniel J. Fouchéaux, Jr.

475 L'Enfant Plaza West, S.W.
Washington, D.C. 20260-1137
September 22, 2000

