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POSTAL RATE COMMISSION
OFFICE OF THE SECRETARY

**BEFORE THE
POSTAL RATE COMMISSION**

**EXPERIMENTAL SUSPENSION OF FEE FOR
MANUAL DELIVERY CONFIRMATION CATEGORY :**

**DOCKET NO. R2001-2
DOCKET NO. MC2001-2**

**DIRECT TESTIMONY
OF
LARRY F. DARBY
ON BEHALF OF
UNITED PARCEL SERVICE**

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1 **I. QUALIFICATIONS**

2 My name is Larry F. Darby. I head an economics consulting practice, Darby
3 Associates, in Washington, D.C. I received a Ph.D. in Economics from Indiana
4 University in 1970, where I specialized in price theory, industrial organization, and
5 regulation of business. I have been Assistant Professor of Economics at the Temple
6 University Graduate School of Business; Senior Economist in the Office of
7 Telecommunications Policy in the Executive Office of the President; Chief Economist
8 and Chief of the Common Carrier Bureau of the Federal Communications Commission;
9 Executive Director of the Motor Carrier Ratemaking Study Commission; and Vice-
10 President of Corporate Finance in the Lehman Brothers Investment Banking Group.

11 In addition to conducting my consulting practice, I am currently Professorial
12 Lecturer in Telecommunications at the Graduate School of The George Washington
13 University, where I now teach a course in Telecommunications Finance and am
14 scheduled in the Spring to teach the final course in applied research in the economics
15 sequence of the Telecommunications Masters Program. I am also Adjunct Professor of
16 Law at the New York Law School, where I will teach a course in the Economics of
17 Regulation. I have done research and studied rates and ratemaking processes under
18 transport and telecommunications regulation for much of my career and have written
19 numerous articles, reports, and advisory memoranda on those and closely related
20 subjects.

21 I have offered testimony to the Federal Communications Commission as its
22 principal advisor on common carrier rates, to Committees of both Houses of Congress,
23 to the Motor Carrier Ratemaking Study Commission (a temporary Joint Congressional

1 Commission established to examine the antitrust implications of motor carrier
2 ratemaking methods), and to state regulatory bodies.

3 **II. INTRODUCTION**

4 I have been asked by United Parcel Service to evaluate the proposal of the
5 United States Postal Service to suspend the fee for Manual Delivery Confirmation for
6 Priority Mail users for sixteen days in December 2001. The purpose of my testimony is
7 to explain the results of my evaluation in the specific context of (a) the experiment's
8 purposes, (b) its desired effects, and (c) the applicable statutory standards and Postal
9 Rate Commission precedent.

10 My testimony begins with a statement of the proposal and my understanding of
11 its rationale; proceeds to set forth the criteria for my evaluation of it; and then weighs
12 the proposal in terms of those criteria.

13 **III. THE PROPOSAL AND ITS RATIONALE**

14 The Postal Service has proposed an experiment under which it would offer a rate
15 reduction of 100% -- that is, service without charge -- for Manual Delivery Confirmation
16 to its Priority Mail customers for the period from December 1, 2001, to December 16,
17 2001. It has two primary objectives for giving away this costly and valuable service: to
18 obtain usable information about customer demand for the service by promoting it to
19 customers, and to smooth holiday demand for the service. The Postal Service claims
20 substantial benefits and minimal cost from the experiment.

1 **IV. TERMS OF REFERENCE FOR EVALUATING THE PROPOSAL**

2 My testimony is organized around four points of reference for evaluating the
3 proposed experiment. The first relates to the general purposes and effects of the
4 experiment. The last three relate to the evidence that must be adduced and evaluated
5 to determine the experiment's ability to pass specific statutory tests.

6 (1) Design of the experiment. The novelty of the proposal to give away a
7 valuable service as an experiment obliges the Commission to consider carefully
8 elements of the experiment's rationale in some detail. In particular, what questions are
9 intended to be answered, and what questions will in fact be answered, by the data
10 generated by the experiment? Are these data and answers useful in pursuit of lawful
11 Postal Service purposes? Are there better ways to get the desired information?
12 Finally, what are the full implications, beyond those addressed by the Postal Service, of
13 the experiment?

14 (2) Cost coverage. Section 3622(b)(3) of the Postal Reorganization Act
15 requires that "each class of mail or type of mail service bear the direct and indirect
16 postal costs attributable to that class or type plus that portion of all other costs of the
17 Postal Service reasonably assignable" to it. Accordingly, I will examine the information
18 provided by the Postal Service to evaluate its conclusions and claims about the extent
19 to which the experiment meets this applicable legal requirement.

20 (3) Competitive impact. Section 3622(b)(4) of the statute requires an
21 evaluation of the impact of the proposed experimental rate change "upon the general
22 public, business mail users, and enterprises in the private sector of the economy
23 engaged in the delivery of mail matter other than letters." The class of mail to which the

1 free value-added feature attaches, Priority Mail, is a substitute for comparable services
2 offered by firms in the private sector. Thus, the proposal raises questions about its
3 impact on competition and on the health of the competitive process.

4 (4) Other considerations. The Postal Service's testimony raises assorted
5 issues not falling clearly into these three categories. These issues include assertions
6 about the interpretation and relevance of practices by other firms in the economy and
7 certain other factual representations.

8 **V. THE EXPERIMENT WILL NOT PROVIDE USEFUL INFORMATION.**

9 The experiment is destined to fail to the extent that success requires it to achieve
10 substantially the purposes for which it was designed: to yield information about
11 customer demand relevant to lawful ratemaking; to shift usage in ways that will save
12 costs; or otherwise to deliver substantially the promises held out by the Postal Service.

13 The experiment is intended (1) to acquire, and is rationalized on the basis of
14 acquiring, data that will provide useful information about customer demand by
15 conveying information about the availability of the service, thereby promoting it to
16 customers, and (2) to smooth holiday demand for the service.

17 (a) Demand Data

18 Unfortunately, data from the experiment will convey almost no useful information
19 about customer demand, let alone information about demand in the range of lawful
20 rates. The experiment purports to test for information about the relationship between
21 rates and volume of usage. The relationship between price changes and changes in
22 quantity demanded (price elasticity of demand) is well known to ratemaking analysts. It
23 is well established in principle and from studies of demand that measures of price

1 elasticity have meaning for firm pricing behavior only when (a) price changes are
2 relatively small, and (b) changes in quantity are clearly attributable to the price change
3 and not to some other variable. Neither of these holds in the case of the proposed
4 experiment.

5 The Law of Demand holds that price and quantity are negatively related. When
6 price changes, quantity changes in the opposite direction: if prices go up, the quantity
7 purchased goes down; if prices go down, the quantity purchased goes up. While that
8 general relationship holds everywhere on a normal demand curve, like the one that
9 almost certainly applies to Manual Delivery Confirmation service, the relative
10 responsiveness of quantity changes to price changes is different for each initial price
11 level and for every different magnitude of price change.

12 Large price changes typically yield little useful information about the elasticity of
13 demand in the neighborhood of the initial price. An experiment raising or lowering price
14 -- say, by plus or minus 10-15% from the current level of \$0.40 -- would yield useful
15 information about pricing around the neighborhood of that price -- at, say, \$0.35.
16 However, lowering the current price to zero will convey no useful information about
17 consumer demand around the current price (or around any other price, for that matter),
18 since the overall effect of the larger price change conceals the specific impacts of
19 smaller changes. Giving away service for free will tell the Postal Service absolutely
20 nothing about the responsiveness of consumer behavior to neighborhood price
21 changes that are meant to be sustained for a longer period of time.

22 It is noteworthy in this context that the Postal Service has pending a request to
23 raise the present rate of \$0.40 for Manual Delivery Confirmation of Priority Mail by

1 12.5%, to \$0.45. The experiment will provide no credible information about the effect
2 of the proposed rate increase on consumer usage at that price.

3 A second problem with the experiment relates to the “noise level” created by
4 other demand factors. The change in quantity observable while giving away Manual
5 Delivery Confirmation at a zero price would not be a reliable indicator of the effect of the
6 price change alone, since other important influences on demand will likely be changing
7 over the same time interval.

8 For example, if allowed to go forward, the experiment will yield data about
9 quantity for Manual Delivery Confirmation at a zero price during the experimental
10 period. These data would be compared with price and quantity for the comparable
11 period last year. However, material changes in other factors driving demand are sure to
12 be changing, and perhaps substantially so, thereby rendering uncertain the implications
13 of the price change alone. Analysts of the effects of the price experiment must
14 calculate how much of the quantity change is attributable to reducing the price to zero,
15 and how much is attributable to other changes. The proposal provides no information
16 useful for answering this question. Economic principles and a large body of empirical
17 work on demand suggest that a number of other factors affecting demand will likely be
18 material and potentially too large to ignore. These include, but certainly are not limited
19 to, changes in the economy and expectations, changes in buying habits, gift-giving and
20 mailing patterns associated with changes in perceptions of security, and changes in the
21 prices of other closely related, substitutable or complementary services. The Postal
22 Service does not propose to do anything to examine the influence of these factors.
23 This problem of determining whether the price change is the cause of increased usage,

1 or whether the level of increased usage is due to any significant degree to other factors,
2 is similar to that suggested by the Postal Service itself in its response to Commissioner
3 Goldway's question on whether the Postal Service will be able to determine whether it
4 will actually save any costs as a result of shifting demand from one week to another.
5 See Response of Postal Service Witness O'Hara to Questions From Postal Rate
6 Commissioners Posed at the October 23, 2001 Hearing (filed October 26, 2001)
7 ("Response to Hearing Questions"), Response to Question 1.

8 The Postal Service's belated suggestion that it might scale back the experiment
9 does nothing to change this conclusion: No matter how large or small the geographic
10 scope of the experiment, giving away a service for free tells one nothing about how
11 much people will be willing to pay for a service, or about how much of the service they
12 will buy at a given price. In fact, restructuring the experiment to certain selected
13 geographic areas raises other questions that the Postal Service has not addressed,
14 such as whether demand in the areas selected is characteristic of demand nationwide,
15 and whether the costs of serving the additional volume in the limited geographic area
16 will remain constant or will increase on a unit basis when a different price change is
17 rolled out on a nationwide basis.

18 In sum, the experiment may generate data about consumer demand for Manual
19 Delivery Confirmation when its price is zero. However, that data will be ambiguous in
20 meaning and have little information content useful for any future pricing decisions.

21 A related goal of the experiment is to inform consumers about the service in
22 order to promote its use. Dr. O'Hara has observed that the experiment would introduce
23 Manual Delivery Confirmation to customers who might otherwise never try it, and that

1 more households and other infrequent users of Priority Mail would probably find Manual
2 Delivery Confirmation useful if they were familiar with it. USPS-T-1 at 2. These claims
3 are largely unexceptionable. At the same time, they amount to faint praise indeed,
4 since other methods would yield the same conclusion. The experiment will not provide
5 suitable data, nor does it reflect an intention to do so, to test the cost effectiveness of
6 giving the service away relative to other, possibly less expensive means of promotion.
7 Dr. O'Hara conjectures that offering Manual Delivery Confirmation without charge may
8 be more effective than other methods -- saturation mail or broadcast media -- as a
9 means "to build awareness." USPS-T-1 at 3. But then again, it may not. Considering
10 the substantial negative impact of the experiment -- a revenue loss alone of \$0.40 for
11 each transaction -- it is reasonable to suggest that the same "awareness" might well be
12 created through other, less objectionable means than giving away a valuable and costly
13 service for nothing. In any event, the experiment will not shed any light on the issue
14 without additional information and careful analysis of the effectiveness of alternatives,
15 none of which the Postal Service proposes to test.

16 Finally, there is a simple alternative solution to the lack of customer awareness
17 problem -- a test and solution that avoids the issues raised by giving the service away.
18 The clerk at the window could simply be instructed to ask customers if they would like to
19 purchase Manual Delivery Confirmation at the current rate. Point of sale
20 representatives in other retail sectors of the economy routinely provide information
21 about other services to customers at the time of the transaction.

1 (b) Smoothing Mailing Patterns

2 Dr. O'Hara indicates that another objective is "to learn more about . . . the extent
3 to which modest incentives will induce households to shift holiday mailing patterns"
4 USPS-T-1 at 3. The rate experiment -- a 100 percent reduction that takes the rate to
5 zero -- is inaptly described as conveying a "modest" price incentive. Indeed, the only
6 way to configure a less "modest" proposal would be to pay customers to try the service.
7 Moreover, as indicated above, measuring the change in volume (comparing volume for
8 the test period with that achieved for the same period last year) cannot dispose of the
9 question whether, and to what extent, the experimental rate change is the cause of any
10 shift in mailing patterns. Significant volume differences in different weeks might
11 reasonably be anticipated as a consequence of other factors -- the business cycle,
12 changes in consumer attitudes and behavior, changes in holiday patterns (e.g., the day
13 on which Christmas falls), and others.

14 Evidence on usage patterns shows clearly an uneven distribution of demand
15 during the weeks, and particularly the last few days, preceding Christmas day. This
16 pattern is described visually in Dr. O'Hara's Chart 1: Holiday Mailing Patterns (see Dr.
17 O'Hara Workpapers), and numerically in the table entitled "Daily Priority Volume Data:
18 Retail Window-Entered and PERMIT System" (USPS-T-1, Workpaper, page 3 of 4).

19 Dr. O'Hara asserts that the experiment would give customers an incentive to mail
20 packages before the very busiest week of the holiday season. He also claims benefits
21 from shifting the peak: "To the extent that customers respond to this incentive the
22 Postal Service may be able to reduce the need for clerk and carrier overtime and for
23 supplemental air transportation during the peak week." USPS-T-1 at 1 (emphasis

1 supplied). Again, as stated, this observation is unexceptionable. If customers shift the
2 time of usage and thereby smooth it out, peak costs might be reduced. While clearly
3 possible, however, the necessary conditions are not assured.

4 It is also worth noting that customers may ship late simply because they shop
5 late. The Postal Service has shown nothing to indicate that free Manual Delivery
6 Confirmation will affect a primary driver of volume during the last week before
7 Christmas.

8 First, the Postal Service offers no assessment of the costs of the peak, or, by
9 inference, the value available to it or to its customers of smoothing the peak, beyond
10 the observation that it would provide “opportunities” for “modest savings in clerk and
11 carrier overtime and in supplemental air transportation costs.” USPS-T-1 at 5
12 (emphasis supplied). Subsequently (at USPS-T-1, p. 10), Dr. O’Hara states, without
13 equivocation, that the Postal Service does not know what the costs of the peak are and
14 has not even attempted to estimate any cost savings. Thus, the Postal Service does
15 not attempt to estimate the value of a major alleged benefit of the experiment -- shifting
16 peak usage. In place of a suggestion of even a rough order of magnitude of the
17 benefits, the Postal Service simply begs this important question by citing the difficulty of
18 measuring it. Explaining why no cost savings or other benefits of shifting the peak are
19 estimated, Dr. O’Hara correctly states that the amount of potential cost savings is
20 contingent on how customers respond to the gift of free Manual Delivery Confirmation,
21 and he notes how difficult that is to estimate before the fact. USPS-T-1 at 10.

22 Again, this issue does not disappear by reducing the scale or scope of the
23 experiment. As Dr. O’Hara has observed, “Many factors other than the experiment will

1 have an effect on this year's usage of both overtime and supplemental air
2 transportation in comparison with last year." Response to Hearing Questions,
3 Response to Question 1. Dr. O'Hara forthrightly admits that "For this reason, any
4 estimate of savings will require numerous assumptions and approximations." Id. These
5 are accurate and candid statements. Thus, the Postal Service concedes that it will be
6 difficult even after the experiment is implemented to estimate any cost savings from it.
7 But surely, the Commission and the public are entitled to a reasonable estimate of the
8 benefits of such a drastic experiment designed to shift the peak in demand for Priority
9 Mail.

10 The difficulty of measuring the savings from whatever success the experiment
11 may yield in terms of shifting the peak should not be permitted to shroud the fact that
12 the Postal Service is proposing a drastic solution to what may very well be a modest
13 problem. The problem may be trivial for a couple of reasons. First, I call attention to
14 Dr. O'Hara's Chart 1 showing a frequency distribution for estimated Retail Priority Mail
15 volume during the period from November 24, 2000, to December 24, 2000. Volume on
16 four of the seven days during the pre-Christmas week -- Wednesday, Thursday, Friday,
17 and Saturday -- is less than the peak during the previous week. Volume on six days in
18 the second-last week preceding Christmas (i.e., the last week of the experiment) and
19 the average for six days in the prior week exceeded the volume during three days of the
20 "peak" Christmas week. Thus, the week before Christmas day, that is the week during
21 which demand is presumed to be excessive, is not the peak week.

1 There is, however, a clear daily peak in the week before Christmas day, but it is
2 notable that this peak exceeds the peak of the previous week on only two days --
3 Monday and Tuesday.

4 There are several important facts to take away from this. First, under the best of
5 circumstances that might follow from any Postal Service action to shift that peak, the
6 cost savings are likely to be very small, as well as subject to considerable measurement
7 error, since there is considerable chance that the experiment may simply shift the peak
8 to another day during an earlier week. In other words, there will be no net cost savings;
9 instead, peak costs will merely be incurred on a different, but earlier day. By giving
10 away the service during earlier times, the solution advanced in the proposed
11 experiment may simply create the very same problem, but with the peak occurring on
12 different days than would otherwise be the case. The Postal Service offers no evidence
13 or assurance that its solution will not simply make matters worse.

14 Uneven demand, usage peaks, and time of day/week/season congestion are not
15 unique to the Postal Service, even if its proposed solution is. Pricing changes as a
16 solution to similar problems in other industries seldom, if ever, involve simply giving
17 service away during off peak times. Instead, solutions in other sectors, unlike the
18 solution proposed here, quite frequently involve assigning the costs of the peak
19 ("congestion costs") to the cost causer, that is, the customers responsible for creating
20 the peak. Applying the well accepted principles of that solution to the problem
21 addressed here would require the Postal Service to estimate the costs of the peak,
22 which it has not done, and then to attribute those costs to the relevant service -- Manual
23 Delivery Confirmation.

1 **VI. THE EXPERIMENT PROPOSES A RATE BELOW**
2 **COST IN VIOLATION OF SECTION 3622(b)(3).**

3 The Delivery Confirmation service provides customers with information about the
4 date and time of day of delivery (or attempted delivery). Delivery Confirmation may be
5 by either mechanical or electronic means.

6 Like all postal services, Manual Delivery Confirmation service for Priority Mail
7 must cover its attributable costs as well as make a contribution to the Postal Service's
8 institutional costs. Since the proposed rate is zero, the Postal Service faces a
9 formidable barrier in meeting its responsibility to assure the Commission that the rate
10 meets the statutory standard for cost recovery. To document fully the financial impact
11 of the proposal, the Postal Service is obliged to show its cost effects.

12 In his original testimony, Dr. O'Hara concluded a very truncated analysis of cost
13 and revenue changes brought about by the experiment with the conclusion that ". . . the
14 cost coverages of both Priority Mail and the manual Delivery Confirmation for Priority
15 Mail would be reduced by only one-half percentage point." USPS-T-1 at 9. Not clearly
16 expressed, but suggested by the statement, is the impression that the experiment
17 passes the very clear test of cost coverage spelled out in Section 3622(b)(3) of the
18 Postal Reorganization Act. That impression is not correct, as I will demonstrate below
19 by walking through the details of Dr. O'Hara's analysis.

20 In his calculations of the cost and revenue impact of the experiment, Dr. O'Hara
21 starts with TYAR 2000 volumes, revenues, costs, and cost coverages for (a) Priority
22 Mail as a class, and (b) Manual Delivery Confirmation for Priority Mail paying the \$0.40

1 fee. As previously allowed (on a conditional basis) by the Commission,¹ he attributes
2 the cost of electronic Delivery Confirmation to Priority Mail, since the costs are already
3 included in and recovered by the base rate for Priority Mail.

4 Citing no economic basis and without any discussion, Dr. O'Hara then departs
5 from the Commission's established costing methodology and attributes the cost
6 associated with the non-electronic portion of Delivery Confirmation (\$0.346 per unit) to
7 Priority Mail rather than to Manual Delivery Confirmation. Dr. O'Hara gives no
8 explanation or rationalization for doing so. He merely states in a single sentence that
9 "with the experiment the cost for the non-electronic portion would similarly be
10 transferred to Priority Mail from Delivery Confirmation." USPS-T-1 at 9.

11 Dr. O'Hara thereby shifts the bulk of the economic costs caused by the
12 experiment from one service -- Manual Delivery Confirmation -- to another, Priority Mail.
13 Now you see it, now you don't, and now you see it again over there. The Postal
14 Service simply erases economic costs from one class of service and pencils them into
15 another type of service.

16 These are real economic costs that would not exist but for the experiment. They
17 are costs the Postal Service agrees are "caused by" the added Manual Delivery
18 Confirmation volume stimulated by the zero experimental price. See USPS-T-1,
19 Workpaper, page 2 of 4, in particular Part B, the line item entitled "Additional manual
20 DC usage due to experiment."

21 Such cost shifting is the very antithesis of the language and intent of Section
22 3622(b)(3). Moving costs in this way does not change the fact that new and significant

1. Docket No. R97-1, Opinion and Recommended Decision at 586, ¶ 5977.

1 costs will be caused by the Manual Delivery Confirmation service and magnified by the
2 zero experimental price. Because of this accounting sleight of hand, the costs caused
3 by the added volume stimulated by the experiment must be borne by other users, or by
4 "the Postal Service," according to Dr. O'Hara. USPS-T-1 at 9.

5 The amount of cost shifted is relatively straightforward to calculate, and I will do
6 so in the course of considering Dr. O'Hara's workpaper.

7 To calculate the cost of the experiment, Dr. O'Hara considers costs from four
8 sources -- actually, three costs and one source of foregone revenue. These are (a) the
9 revenue foregone by giving away service for which customers would, but for the
10 experiment, have been obliged to pay, (b) the Manual Delivery Confirmation costs of
11 informing consumers of the experiment, (c) the electronic costs of the additional Manual
12 Delivery Confirmation volume, and (d) the non-electronic costs of the additional Manual
13 Delivery Confirmation volume:

- 14 (1) The revenue foregone from usage pro rated from the prior year is
15 estimated at \$1,332,998 (prorated volume of 3,332,494 times \$0.40);
- 16 (2) The cost of informing customers of the experiment is estimated at
17 \$150,000, of which only \$75,000 (half) is attributed to Manual Delivery
18 Confirmation with the other half attributed to Priority Mail;
- 19 (3) It is assumed that additional usage of 19,069,868 units of Manual Delivery
20 Confirmation will be stimulated by the zero experimental price. The cost
21 of this additional usage has two parts -- the electronic portion of Manual
22 Delivery Confirmation costs, and the non-electronic portion. The
23 additional cost of the electronic segment is \$1,487,450 (that is,

1 19,069,868 times \$0.078, or the stimulated volume times the electronic
2 unit cost);

3 (4) The additional cost of the non-electronic segment is \$6,598,174 (that is,
4 19,069,868 times \$0.346, or the stimulated non-electronic volume times
5 the non-electronic unit cost);

6 (5) The full additional cost of the stimulated volume (electronic and non-
7 electronic) is \$8,085,624, or the added volume of 19,069,868 times
8 (\$0.078 + \$0.346).

9 These costs must be attributed. Dr. O'Hara correctly charges the experiment
10 with the foregone revenue from giving away a service that otherwise would have been
11 sold at \$0.40 per unit. Secondly, as noted, he attributes half the cost of informing
12 customers to the Manual Delivery Confirmation service and half to Priority Mail. Third,
13 following the precedent allowed previously by the Commission, he attributes the
14 electronic portion of the costs of the added Manual Delivery Confirmation volume
15 (\$1,487,450) to Priority Mail. Fourth, and contrary to the Commission's established
16 treatment, Dr. O'Hara attributes to Priority Mail the non-electronic portion of the costs of
17 the added Manual Delivery Confirmation volume resulting from the zero price
18 experiment (\$6,598,174).

19 By shifting to Priority Mail the additional non-electronic cost of the additional
20 Manual Delivery Confirmation volume stimulated and clearly caused by the zero price
21 experiment -- thereby excluding it from the calculation of the cost coverage ratio of the
22 Manual Delivery Confirmation service to which the experiment applies -- the Postal

1 Service is able to say that the service will generate a cost coverage of 115.1% for the
2 year. USPS-T-1, last line of Workpaper, page 2 of 4.

3 I recalculate below the cost caused by the experiment with one change from Dr.
4 O'Hara -- attribution to Manual Delivery Confirmation, where the Commission has said it
5 belongs, of the increase in the non-electronic portion of Manual Delivery Confirmation
6 cost resulting from the volume stimulation caused by the zero price experiment:

7	(a)	Lost revenue from foregone sales at \$0.40.....	\$1,332,998;
8	(b)	Half the cost of informing customers.....	\$ 75,000;
9	(c)	Non-electronic Manual Delivery Confirmation cost caused 10 by the experiment.....	\$6,598,174;
11	(d)	Total cost "caused by" the experiment to be borne by 12 Manual Delivery Confirmation.....	\$8,006,172.

13 The difference between these numbers and Dr. O'Hara's approach is in line item (c),
14 which I have attributed to Manual Delivery Confirmation, as required by Commission
15 precedent, and which Dr. O'Hara has attributed to Priority Mail. This is an economic
16 cost "caused" by the experiment and properly attributable to Manual Delivery
17 Confirmation. That contrasts with Dr. O'Hara's unexplained decision to depart from
18 Commission precedent and attribute it instead to Priority Mail.

19 Dr. O'Hara also inexplicably shifted \$1,153,043 (3,332,494 times \$0.346) of the
20 non-electronic component of the cost of Manual Delivery Confirmation to Priority Mail
21 and away from Manual Delivery Confirmation. This is the cost of the Manual Delivery
22 Confirmation transactions that would have taken place and that would have been borne
23 by the service in the absence of the experiment, but which, as a result only of the
24 proposed free offering, simply disappears as a Manual Delivery Confirmation cost and
25 then, supposedly, rematerializes as a cost of Priority Mail. On its face, the rationale

1 appears to be that the announcement of a price experiment for a service "causes" costs
2 to move from that service to another class of service to be recovered by other
3 customers.

4 The foregoing has accepted several assumptions by Dr. O'Hara whose basis is
5 not set forth or with which I do not necessarily agree -- the division of the cost of
6 informing users between Priority Mail and Manual Delivery Confirmation instead of
7 assigning all of the cost to Manual Delivery Confirmation, the assumption about how
8 much volume will be stimulated, and others. Even accepting these questionable
9 assumptions, the core difference in our estimates of the cost impact of the experiment
10 centers on the attribution of the non-electronic portion of the added cost of the Manual
11 Delivery Confirmation service stimulated by the experiment. I believe Dr. O'Hara's
12 treatment leads to a misallocation of economic cost, cross-subsidy, and a burden on
13 other postal users.

14 I conclude that the costs of the experiment, when properly recognized, will result
15 in a loss of at least \$5.2 million for the year and a cost coverage of only 79% for Manual
16 Delivery Confirmation service, in clear violation of the statute.

17 It is worthwhile to put these losses in a slightly different context. Using Dr.
18 O'Hara's estimated non-electronic cost of Manual Delivery Confirmation of around
19 \$0.35 and a current price of \$0.40, the contribution per transaction is around \$0.05. The
20 lost revenue (\$1.3 million) and the added cost (\$8.1 million) of the experiment combine
21 to a total cost of \$9.4 million. For this experiment to recoup its cost, the volume of
22 Manual Delivery Confirmation service for Priority Mail would have to increase by about

1 188 million units. Since current annual volume is in the range of 52 million units, this is
2 indeed a formidable requirement.

3 Finally, I note that Dr. O'Hara's analysis suggests that the total cost of Manual
4 Delivery Confirmation as recorded in the Postal Service's accounts will actually
5 decrease by \$1.15 million even though volume is assumed to increase by 19 million
6 transactions.

7 Once again, a reduction in the scale or scope of the experiment does not change
8 the basic underlying fact: the additional volume stimulated will be given away at less
9 than its attributable cost, and the cost coverage for Manual Delivery Confirmation will be
10 eroded below the level required by the statute. In fact, even assuming a "scaled-down"
11 cost of the experiment of only \$1,138,439 (see Response to Hearing Questions,
12 Response to Question 2), an additional 22.8 million Manual Delivery Confirmation
13 transactions would have to be generated after the experiment to pay for it. That
14 represents a volume increase of almost 44%, a volume increase that is highly unlikely,
15 to say the least.

16 **VII. THE PROPOSED RATE WOULD BE ANTICOMPETITIVE.**

17 Section 3622(b)(4) of the Postal Reorganization Act requires consideration of the
18 impact of the proposed rate "upon the general public, business mail users, and
19 enterprises in the private sector of the economy engaged in the delivery of mail matter
20 other than letters."

21 While the Commission has, and should have, no obligation to protect specific
22 competitors of the Postal Service from the rigors of healthy rivalry in the marketplace,
23 the statutory monopoly of the Postal Service over letter mail creates the familiar

1 opportunity for rates to embody cross subsidies from monopoly to competitive services.
2 To the extent that competitive services offered by the Postal Service do not cover
3 costs, appropriately defined and determined, the offering can be expected to harm the
4 competitive process that the Postal Reorganization Act and other laws are designed to
5 protect.

6 Dr. O'Hara characterizes the experimental gift of Manual Delivery Confirmation
7 service as consistent with similar practice elsewhere in the economy. USPS-T-1 at 13.

8 It is notable, though, that the specific example Dr. O'Hara cites is very different in
9 important ways from the instant case. Cable television operators and their program
10 suppliers sometimes offer premium channels to prospective customers for a limited
11 time free of charge. However, since the cost of that offer is not assured to be
12 recovered by other customers and any losses therefrom are assured to be borne by
13 private shareholders, managers have a clear and compelling incentive to make sure the
14 offer will have a positive financial impact. Moreover, it is also notable that, unlike with
15 the instant experiment, the cable offer is typically not extended to customers who are
16 already paying for the service.

17 A private firm would have strong incentives not to undertake the kind of
18 experiment offered here, given the degree of uncertainty present about the success of
19 the experiment or the potential for cost savings or improved customer service quality if
20 the experiment is successful.

21 Though the total costs of the experiment and their misallocation may be relatively
22 small in the context of a \$70 billion revenue stream, that is not an adequate defense for
23 the potentially anticompetitive impacts of a not demonstrably effective, poorly designed

1 pricing experiment that fails to cover its economic costs. Nor is the disclaimer of its
2 proponents with respect to anticompetitive intent (USPS-T-1 at 14) sufficient to offset its
3 anticompetitive impact. To the extent that a service offering fails to cover its economic
4 cost and for that reason diverts traffic from lower cost competitors unable to draw
5 support from a protected monopoly service, there will be a well-known deadweight
6 efficiency loss to the economy from resource misallocation.

7 The potential impact in the marketplace and on competition of the Commission's
8 decision on this proposal may be significant, notwithstanding the characterization by its
9 proponents of the small size of the revenues and costs projected to be involved. The
10 Commission with its decision here will send an important signal not only about its views
11 of this proposal, but also about Postal Service prospects for similar, future ones as well.

12 The decision here will have precedential value for consideration downstream of
13 proposals involving uncertain revenue, cost, and overall financial consequences in a
14 competitive environment. The proposal to take to zero the rate for a costly and
15 valuable service and thereby eliminate a lawful fee for a competitive service during the
16 heaviest mailing season of the year is a serious one, regardless of its relative scale in
17 the context of the overall size of the Postal Service.

18 In short, it is important for public policy purposes that the Commission get this
19 one right.

20

VIII. CONCLUSION

21 The proposed experiment's benefits are overstated and not measured. The
22 costs are understated. To the extent that this experiment does not cover the costs
23 caused by it, as opposed to a fictional accounting allocation of those costs, the offering

- 1 is clearly anticompetitive and will be a burden on monopoly ratepayers or users of other
- 2 services. The description of the proposal and its analysis offers vagueness, ambiguity,
- 3 and conjecture, where the gravity of the issues raised by it require care, precision, and
- 4 analytical rigor.