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

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

Docket No. R2001-1

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\_\_\_\_\_)  
POSTAL RATE, FEE AND CLASSIFICATION CHANGES, 2001)  
\_\_\_\_\_)  
\_\_\_\_\_)

SURREBUTTAL TESTIMONY OF  
JAMES A. CLIFTON  
ON BEHALF OF  
AMERICAN BANKERS ASSOCIATION  
NATIONAL ASSOCIATION OF PRESORT MAILERS

February 20, 2002

## EXECUTIVE SUMMARY

- APWU witness Riley opposes the settlement rates and discounts for First Class worksharing mail because he alleges they “pass through” more than 100% of avoided costs, but the weight of evidence using various measures of avoided costs indicates the settlement discounts pass through substantially less than 100% of avoided costs.
- Witness Riley uses USPS witness Miller’s “should cost” model estimates of cost avoidance, but he himself states a preference for use of actual CRA data in measuring cost avoidance, which data demonstrate forcefully that the settlement discounts are substantially less than 100% of avoided costs.
- Using basic and refined measures of cost avoidance relying on the Commission’s methodology from R2000-1, I also find cost avoidances associated with the proposed settlement rates pass through substantially less than 100% of costs avoided.
- Witness Riley’s proposed discounts would, contrary to his unsubstantiated assertions, send the wrong price signals to the market, while the proposed settlement rates and discounts, which are close to those supported by USPS rate witness Robinson, would send the correct price signals Witness Riley is concerned to send.
- Witness Riley’s “absolute dollar contribution” method for assigning mark-ups within the FCM letters subclass certainly would not send the correct price signals to the market that the witness intends, as my illustrative calculations using his method result in a 38 cent stamp and higher discounts than the settlement ones he rejects.
- Since both the CRA and PRC Methods of estimating cost avoidance show the settlement discounts on average passing through only about 80% of costs avoided, witness Riley with all the cost avoidance evidence before him should now be delighted at the settlement rates and discounts proposed as a way to help the Postal Service’s finances, because that pass through is near the lower bounds of his proposal to pass through between 80 to 100% of avoided costs.

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1 I. Autobiographical Sketch  
2  
3

4 My name is James A. Clifton. I am President of Washington Economics Consulting  
5 Group, Inc., (WECG). The firm is devoted to regulatory and economic policy analysis,  
6 litigation support, and industry analysis for housing and other sectors. In addition to my  
7 responsibilities at WECG, I serve as Vice President of Finance and Economics for the  
8 Manufactured Housing Institute.  
9

10 My prior professional experience includes three years with the U.S. Chamber of  
11 Commerce as a senior regulatory economist (1979 – 1983), three years as Republican  
12 Staff Director of the House Budget Committee (1983 – 1986), and four years as President  
13 of the Center for Industrial Competitiveness, a non-profit foundation (1986 – 1990). In  
14 the consulting arena, I was principal associate at Nathan Associates from 1990 – 1991, an  
15 academic affiliate of the Law and Economics Consulting Group from 1992 – 1995, and  
16 an independent consultant from 1987 – 1990 and 1996 – 1997.  
17

18 I have been visiting Associate Professor of Economics and Business at The Catholic  
19 University of America, from 1992 through 1997. My other academic experience includes  
20 Assistant Professor of Economics at the University of Maine-Orono (1975 – 1978), and  
21 Visiting Professor at Cambridge University during 1977.  
22

23 I received a B.A. in Economics from Cornell University in 1969 and a Ph.D. in  
24 Economics from the University of Wisconsin-Madison in 1975. At the latter institution, I  
25 was a Ford Foundation fellow. I have published occasional research in academic journals  
26 including the Cambridge Journal of Economics, Contributions to Political Economy,  
27 Business Economics, and the Journal of Economic Behavior and Organization. My early  
28 work on the theory of competition was selected for inclusion in The New Palgrave, a  
29 compendium of economic research drafted by the world's leading authorities.  
30

31 Before this Commission, I have testified on five previous occasions. In Docket No. R90-  
32 1, I presented direct testimony on behalf of McGraw-Hill, Inc. In the R94-1 rate case, I

1 presented rebuttal testimony on behalf of the American Bankers Association, and in  
2 MC95-1 I presented direct testimony on behalf of the Greeting Card Association. In  
3 R97-1, I presented direct testimony on behalf of the American Bankers Association,  
4 National Association Presort Mailers, Newspaper Association of America, and Edison  
5 Electric Institute. In R2000-1, I presented direct and supplemental testimony on behalf of  
6 the American Bankers Association and the National Association of Presort Mailers.

7  
8  
9 II. Purpose and Scope of Testimony

10  
11 This testimony is provided on behalf of the American Bankers Association (ABA) and  
12 the National Association of Presort Mailers (NAPM), who along with numerous other  
13 parties representing or interested in First Class Mailers, including, inter alia, the Postal  
14 Service, the Major Mailers Association, the Office of the Consumer Advocate at the  
15 Commission and the Greeting Card Association, support the settlement rates put forward  
16 by the parties to the "Amended Stipulation and Agreement" dated December 26, 2001.  
17 In support of such settlement, the purpose of this testimony is, to offer surrebuttal on  
18 behalf of ABA and NAPM to the testimony by Michael Riley which was filed on behalf  
19 the American Postal Workers Union (APWU-T-1), the only party to file testimony in  
20 opposition to the settlement.

21  
22 I supported Chairman Omas's early calls for settling this case, as did my clients, which  
23 included ABA, NAPM and GCA during the settlement negotiations. In support of my  
24 clients' desires to settle, I was actively involved in all public settlement conferences  
25 organized by the Postal Service, and in most of the private conferences involving First  
26 Class mailers which did lead to the settlement rates and terms to which my clients have  
27 agreed.

28  
29 In what follows I address below the two major points made by APWU witness Michael  
30 Riley, namely (1) raising First Class worksharing rates by as much as 22%, in the case of  
31 5 digit presort prebarcoded mail under the lower bound of Mr. Riley's proposed 80 to  
32 100% pass through of USPS witness Miller's extremely narrow measure of cost  
33 avoidance; (2) proposing in the future a uniform absolute mark-up in cents for First

1 Class discounted and non-discounted mail, a procedure that would have produced a 38  
 2 cent single piece stamp in this case. I conclude my testimony by addressing a number of  
 3 less central points made by the APWU witness that are clearly wrong.

4  
 5  
 6 III. Witness Riley's Proposed Discounts Beg the Question of What Is the Correct  
 7 Method for Estimating Cost Avoidance

8  
 9 A. Witness Riley's Preferred Method of Cost Avoidance, Actual  
 10 CRA Cost Differences, Are in Line With Settlement Discounts Even  
 11 at the Lower Bounds of Witness Riley's 80 to 100% Pass Through  
 12

13 Although APWU witness Riley relies in his testimony on the cost avoidance models of  
 14 USPS witness Miller in setting his proposed rates for First Class workshared mail, he also  
 15 argues at some length that these ““should cost” estimates which are provided to the  
 16 Postal Rate Commission in rate cases” are inaccurate.<sup>1</sup> (APWU-T-1, p. 10, lines 1-2).  
 17 Witness Riley then goes on to assert that as a result of the inaccuracy of the USPS cost  
 18 models, it is better to rely on actual costs as measured by the Cost and Revenue Analysis.  
 19 He states: “In this case, the CRA cost system will properly register the “actual” costs of  
 20 the mail. . . .” (APWU-T-1, p. 10, lines 9-10). Of course, actual CRA cost differences  
 21 register other types of inaccuracies in the USPS cost models as well, not just the one-  
 22 sided issue of barcode readability of mailer-entered mail that APWU witness Riley  
 23 dwells on. For example, the CRA should pick up costs associated with barcode un-  
 24 readability from USPS applied barcodes.

25  
 26 Nonetheless, I agree with witness Riley's acknowledgement that, as concerns what costs  
 27 avoided should be passed through in automation discounts, “I prefer more accurate costs  
 28 to less accurate costs if they are available” (Cross Examination of APWU witness Riley  
 29 Transcript Vol. 12 at page 4903, line18). I also agree with him that actual CRA data,

---

<sup>1</sup> Mr. Riley's belief is that actual CRA cost differences between discounted and non-discounted mail in First Class should reveal lower cost avoidances than the “special studies, which develop “should cost” estimates of cost avoided by pre-barcoding and pre-sorting” that are used in rate cases. (APWU-T-1, p. 10, lines 4-5). He believes that private sector mail processing facilities apply more un-readable barcodes than the USPS does, thus rendering “should cost” estimates of cost avoidance higher than the “actual” ones that should be revealed in actual CRA cost data.

though aggregated in the presort rate categories, has fewer actual and potential problems than “should cost” estimates like USPS witness Miller’s cost models.

In fact, the recent as well as long term trend in the CRA data base shows clearly that cost differences between First Class non-discounted mail and First Class discounted mail is higher than the cost models Mr. Riley critiques, and is increasing over time, contradicting another assertion made by the APWU witness that “[t]he costs avoided by pre-barcoding and pre-sorting mail are declining over time”. (APWU-T-1, p. 2, lines 20-21.)

Since 1997, when MLOCR readability of single piece mail was starting to realize its potential, the full cost difference between First Class discounted and nondiscounted mail has increased, as indicated in Table One below.

Table One

CRA Cost Differences Between Discounted and Non-Discounted First Class Mail

(in cents)

	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>
<u>Cost Difference in:</u>				
Total unit attributable Cost	12.04	12.42	13.00	14.06
Mail processing direct Labor cost	5.84	5.83	6.28	6.49
Delivery cost	0.79	1.06	1.09	1.43

Source: ABA&NAPM-SRT-1 WP1, Table1, Table 2, & Table3.

Further, the cost differences between discounted and non-discounted First Class mail for mail processing and delivery services combined, the two services that are “scored” for purposes of setting discounts, have also increased in recent years.

For the longer term, the trend line exercises in Figure 1, Figure 2, and Figure 3, make clear that, in witness Riley's own terms, "CRA actual costs" indicate increasing cost avoidance for the discounted mail. These trends are consistent with the increase in discounts proposed by the Commission in recent cases, recommended by the Postal Service in this case, and negotiated between the parties in the settlement of R2001-1.

Were I to adopt Mr. Riley's 80% - 100% pass through proposal for First Class worksharing discounts using his preferred method of estimating cost avoidance, namely the actual CRA cost differences, I could base discounts on the full CRA cost difference or the CRA cost difference for mail processing and delivery costs between discounted and non-discounted First Class mail. For BY2000, these would approximate discounts as follows:

Table Two

Base Year 2000 Discounts Using Witness Riley's Preferred CRA Approach  
(in cents)

<u>CRA Approach</u>	<u>Pass Through</u>	
	<u>100%</u>	<u>80%</u>
Full cost difference	14.06	11.25
MP + D	7.9	6.34

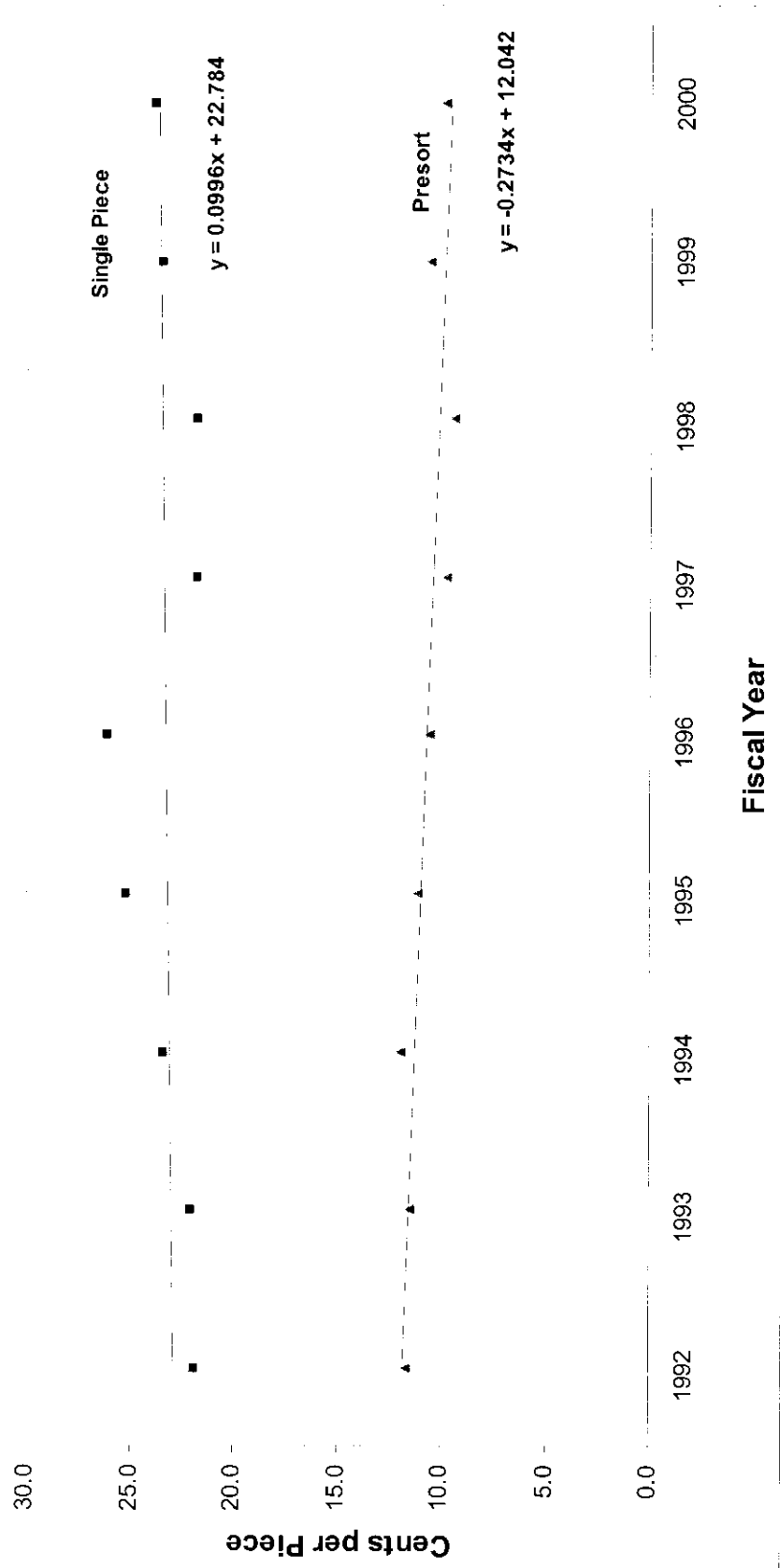
Source: ABA&NAPM\_SRT-1 WP1, Table 1 & Table 4.

These CRA-based discounts are an average across all rate categories for presorted or prebarcoded mail. Using the trends established in Figure 1 through Figure 3, TY2003 discounts utilizing APWU witness Riley's preferred actual CRA costs yields discounts as shown in Table Three.

1

**Figure 1**

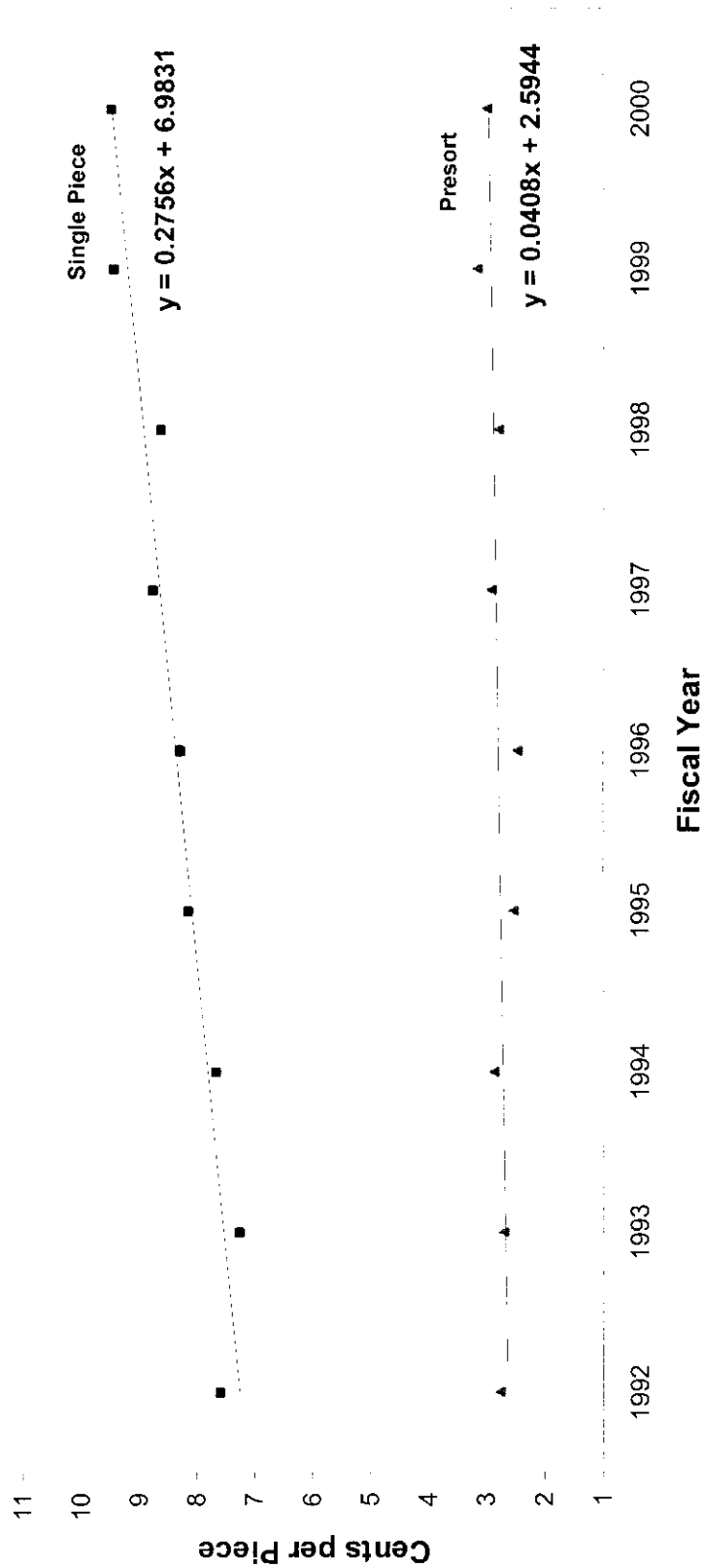
First-Class Total Unit Attributable Cost Differences are Increasing Between Single Piece and Presort



2

**Figure 2**

First-Class Mail Processing Unit Attributable Cost Differences are  
Increasing Between Single Piece and Presort  
(Direct Labor, Cost Segment 3.1)



**Figure 3**

First-Class Delivery Unit Attributable Cost Differences are  
Increasing Between Single Piece and Presort  
(Cost Segments 6, 7 & 10)

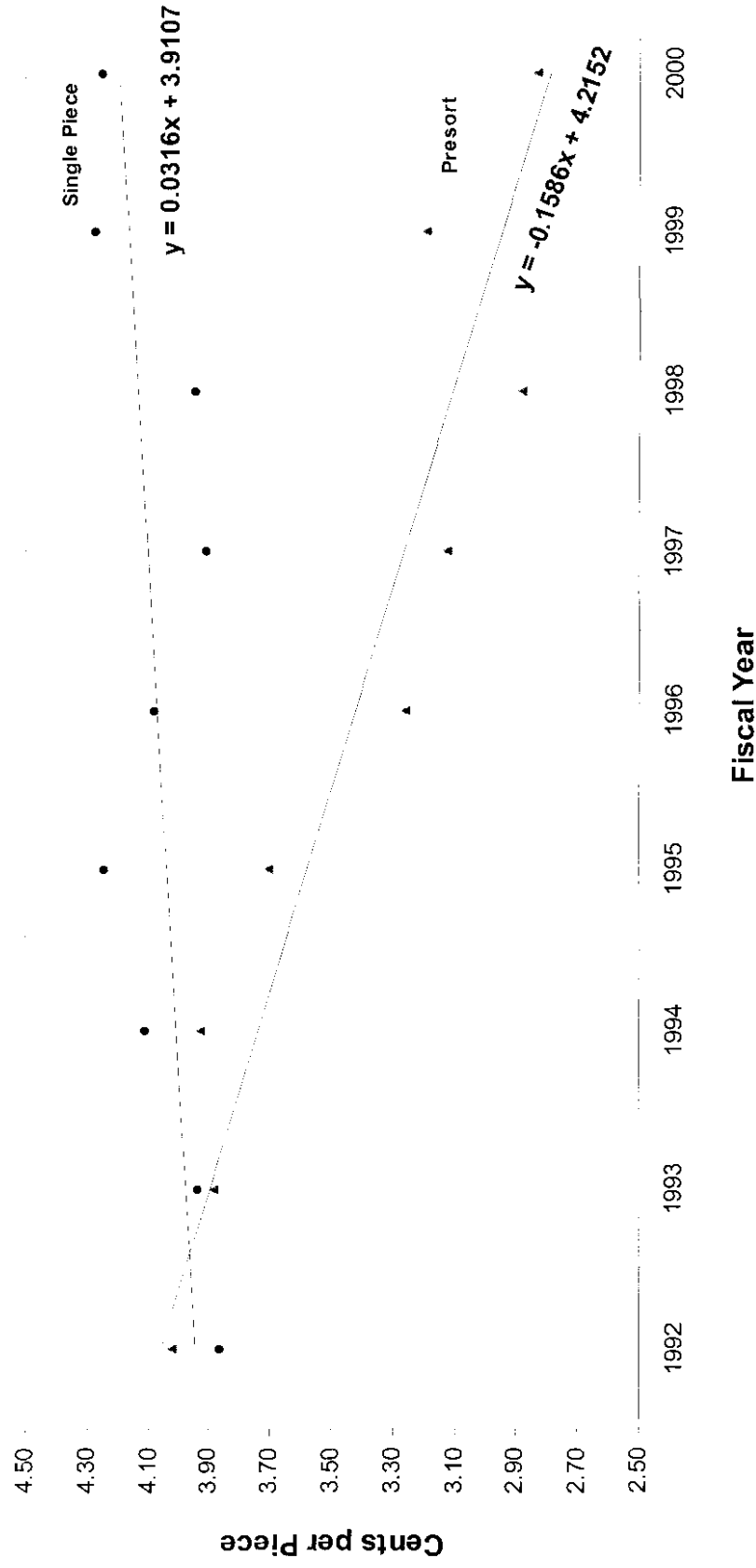


Table Three

Settlement Discounts Compared to TY2003 Discounts  
 Using Witness Riley's Preferred Approach Versus  
 Using USPS Witness Miller's "Should Cost"  
 Model Estimates  
 (in cents)

Pass Through

<u>CRA Approach</u>	<u>100%</u>	<u>80%</u>
Full cost difference	15.22	12.18
MP + D	9.18	7.35
<u>"Should Cost" Model</u>		
Automation mixed AADC	5.0	4.0
Automation AADC	5.9	4.7
3 Digit Presort	6.2	5.0
5 Digit Presort	7.4	5.9
<u>R2001-1 Settlement</u>		
Automation mixed AADC		6.1
Automation AADC		6.9
3 Digit Presort		7.8
5 Digit Presort		9.2

Source: ABA&NAPM-SRT-1 WP1, Table 1 & Table 4; USPS-T22;  
 "Amended Stipulation and Agreement" dated December 26, 2001.

Several conclusions can be drawn from Table Three. First, using APWU witness Riley's preferred "CRA Approach" method for calculating cost avoidance, the settlement discounts are within the range of 80% of the MP + D cost difference between discounted and non-discounted mail. Second, the settlement discounts are well under 100% of cost avoidance so measured.

Third, the discounts proposed by witness Riley using witness Miller's "should cost" model of cost avoidance are well below the discounts that emerge from using Mr. Riley's preferred CRA Approach (i.e., actual CRA cost difference method of cost avoidance).

1 Fourth, witness Riley's proposed discounts are extreme low ball estimates of cost  
2 avoidance whether one takes 80% or 100% of the CRA cost difference for mail  
3 processing and delivery between discounted and non-discounted First Class mail.  
4

5  
6 B. The PRC's Methodology of Cost Avoidance is in Line with  
7 Settlement Discounts Even at the Lower Bounds of Witness Riley's 80 to  
8 100 % Pass Through  
9

10 While APWU witness Riley's preferred measure of cost avoidance, actual CRA data, is  
11 not the method he uses to estimate discounts in his testimony, the year 2000 CRA is a  
12 matter of public record and may be taken judicial notice of by the Commission as it has  
13 in past cases. It could have been used to estimate cost avoidances, as I have done above,  
14 had witness Riley chosen to. Also available in R2001-1 are USPS Library References, in  
15 particular USPS LR J 84, setting forth the PRC versions of USPS witness Miller's  
16 modeled cost approach to cost avoidance. However, APWU witness Riley chose to  
17 submit testimony to the Commission using the USPS methodology which, as is well  
18 known, produces lower estimates of cost avoidance than the PRC methodology, and  
19 which has been repeatedly rejected by the Commission.  
20

21 In response to MMA/USPS-T22-76 in this case, the Postal Service confirmed that if the  
22 Commission were to use the same PRC methodology to estimate cost savings from  
23 worksharing in this case as it used in R2000-1, the TY2003 cost savings would be as  
24 shown in Table Four.  
25  
26  
27  
28  
29  
30  
31  
32

Table Four

TY2003 Cost Avoidance Using PRC Methodology from R2000-1

(in cents)

<u>Rate Category</u>	<u>Cost Savings Using PRC R2000-1 Method</u>	<u>Settlement Discounts</u>	<u>Pass through Percentage</u>
Mixed AADC	7.994	6.1	76%
AADC	9.076	6.9	76%
3-Digit	9.439	7.8	83%
5-Digit	10.711	9.2	86%

Source: R2001-1, MMA/USPS-T22-76.

The pass through percentages that result from looking at the cost avoidances in Table Four relative to the settlement discounts should make APWU witness Riley very happy for they are close to the lower bounds of his 80% to 100% pass through proposal. These less than full pass throughs of cost avoidance do not help private sector businesses also feeling the financial effects of recession; they mainly help the Postal Service.

Using the PRC methodology of cost avoidance, APWU witness Riley's proposed discounts, which are even less than the settlement discounts, would pass through only 50% of mixed AADC cost savings from worksharing, 52% of AADC worksharing related savings, 53% of 3-Digit cost savings and 55% of 5-Digit worksharing related cost savings. This would be a radical departure from current policy with respect to worksharing. Paradoxically, such drastic cuts in discounts as the pass through percentages imply, would not improve the Service's financial performance, for a large percentage of mailers would find their own financial situation untenable and would choose not to prebarcode and presort. The USPS would be overwhelmed by such entry into the system and unable to process such volumes.

C. My Refined PRC Measure of Cost Avoidance is in Line with Settlement Discounts Even at the Lower Bounds of Witness Riley's 80 to 100% Pass Through

I do not in this testimony attempt to address in any detail the latest evolution in USPS witness Miller's Olympic pursuit of constricting the definition of mail processing cost avoidance for First Class work shared letters to the point of reductio ad absurdum. I understand Mr. Richard Bentley, the surrebuttal witness for the Major Mailers Association will focus on Mr. Miller's methodology in R2001-1.

Much of the same criticisms I directed at Mr. Miller's testimony in R2000-1 (ABA&NAPM-T-1) apply equally here. Mr. Miller has created two more cost pools in this case; we are now up to 54 in the effort to "better isolate" true cost avoidance from worksharing. More stunning is his effort to break down the troublesome rate category of nonautomation presort letters into eight gradations, an effort which allows Mr. Miller to reduce by nearly two cents, compared to his R2000-1 method, the delivery unit costs for that hard to find bulk metered mail. Does anyone really believe that the delivery costs for bulk metered mail have actually changed by the difference between 5.942 cents (old Miller method adopted by Commission in R2000-1) and 4.083 cents (new Miller method), beyond what base year data and the roll forward models to test year tell us?

When last we left the issue of nonautomation presort in my Supplemental Testimony (ABA&NAPM-ST-2) in R2000-1, we were getting absolutely bizarre results for cost avoidance, as Commissioner LeBlanc noted at the time. One would have thought – drop the nonautomation presort proxy for BMM delivery unit costs of Mr. Miller, go out and measure BMM delivery costs directly if you can find any BMM.

Below, I present my refined version of cost avoidance using the PRC methodology. I adopt the same assignments of cost pools that I did in modifying the USPS methodology in R2000-1 in ABA&NAPM-T-1. Once again, the settlement discounts result in pass through percentages in the range of lower bound 80% level advocated by Mr. Riley.

Table Five

## Refined Cost Avoidance Measures Using PRC Method

(in cents)

<u>Rate Category</u>	<u>Worksharing Related Savings</u>	<u>Pass through Percentage at Settlement Discounts</u>
Mixed AADC	7.994	76%
AADC	9.147	75%
3-Digit	9.534	82%
5-Digit	10.887	85%

Source: ABA &amp; NAPM, SRT-1, WP 1, Table 20.

IV. Witness Riley's "Absolute Dollar Contribution" Method for Assigning Institutional Costs Between Discounted and Non-Discounted Mail Would Produce a 38 Cent Stamp or Worse if Limited to FCM Letters

In his testimony, APWU witness Riley asserts that the entire cost coverage methodology used to set postal rates at the class and subclass levels for decades is wrong. He states: "The primary focus should be on the absolute contribution per piece, not the percentage markup." (APWU-T-1, p. 2, lines 17-19.) Witness Riley asserts "[t]his is especially true for discounts offered within a subclass once the target coverage has been established." He attempts to clarify his proposed mark-up method, stating "[s]aid differently, in the worst case the Postal Service should have the exact same absolute contribution from the mailing of one First-Class letter, regardless of how it is presented."

In his testimony, witness Riley does not extend his concept to other subclasses of mail earning discounts, notably Standard A letter mail. Nor does he attempt to quantify this policy proposal. Presumably, APWU witness Riley believes such a mark-up would produce lower single piece rates in First Class and higher worksharing rates, i.e. lower discounts. As with his preference for actual CRA cost data to measure cost avoidance,

however, witness Riley's mark-up proposal appears to generate just the opposite results that he intends.

It is difficult to use Postal Service data to estimate rates emanating from Mr. Riley's proposal. What follows can best be described as illustrative rates were the Riley "absolute dollar contribution" mark-up proposal to be implemented.<sup>2</sup>

Table Six

TY2003 FCM Rates Using Uniform "Absolute Dollar Contribution" Mark-Up  
(in cents)

<u>Rate Category</u>	<u>Settlement Rates</u>	<u>Mark-Up</u>	<u>Implied Riley Rates From Uniform Mark-Up</u>
Single Piece	37.0	16.3	38.0
Mixed AADC	30.9	16.3	26.9
AADC	30.1	16.3	26.6
3-Digit	29.2	16.3	26.3
5-Digit	27.8	16.3	25.8

Source: ABA&NAPM-SRT-1, WP 1, Table 18.

What is striking in Table Six about the application of APWU witness Riley's mark-up proposal is that it results in higher single piece rates and lower workshared rates at a uniform mark-up of 16.3 cents, the amount that distributes the FCM letter subclass institutional costs of \$19.8 billions. The discounts implied are therefore greater under witness Riley's "absolute dollar contribution" method than under the traditional cost coverage method which he critiques. What accounts for these results?

<sup>2</sup> The data in Table Six as well as the data that follows are based on calculating volume variable costs that are explicit in some instances, such as single piece, and implicit in others, such as worksharing rate categories. We have to assume that the same cost coverage that applies to the presort category as a whole applies to each rate category. As a result, there is artificial compression between the worksharing rates because our method of backing out volume variable costs artificially reduces the differences in such costs between rate categories. In addition, it is harder to estimate any implied volume variable costs for flats. We do assume in this exercise that additional ounce rates and nonstandard rates stay the same as the settlement proposal, and we assume the same TY2003 revenue requirement as that in the USPS filing as revised.

1  
 2 First, the volume variable cost for FCM workshared letter mail is substantially below that  
 3 for single piece. Thus, we are adding a uniform 16.3 cents mark-up to a much lower cost  
 4 base, and the result is lower, not higher workshared rates. Second, the implied cost  
 5 coverage of First Class workshared mail is substantially greater at current and settlement  
 6 rates than it is for single piece mail. Thus, under the cost coverage mark-up convention in  
 7 the settlement rates (and discounts), each piece of workshared mail is already  
 8 contributing a disproportionate amount of the \$19.8 billion of USPS institutional costs  
 9 allocated to FCM letters and flats. APWU witness Riley's mark-up method actually  
 10 makes the mark-up per piece more proportionate than the current system, producing a 38  
 11 cent stamp and lower worksharing rates than those proposed in the settlement.

12  
 13 As with his discount proposals, APWU witness Riley's "absolute dollar contribution"  
 14 method for discounted and nondiscounted pieces within a subclass is targeted toward  
 15 First Class mail only. One could extend witness Riley's proposal to each piece of letter  
 16 mail, "regardless of how it is presented". (APWU-T-1, p. 12, line 17). Indeed, in his  
 17 response to MMA/APWU-T1-4, Mr. Riley provides a compelling reason why one should  
 18 apply his uniform mark-up across all mail if it is to be applied at all.

19  
 20 [I]t is important to note that in 1970 all letters in First-Class Mail were what is  
 21 now called single piece First-Class letters. . . . In addition, in 1970,  
 22 personalized information could not be sent in a Third-Class letter. Now  
 23 personalized information can be sent in a Standard Mail letter. For the single  
 24 piece First-Class letter rate category to maintain the volume it had in 1970 while  
 25 there has been a huge migration of business mail to other First Class letter rate  
 26 categories and to Standard Mail letters does not represent stagnation of single  
 27 piece First-Class letters.  
 28 (Response to MMA/APWU-T1-4)

29  
 30 The migration of First Class letters since 1970 into various worksharing rate categories in  
 31 Standard A and First-Class provides a good reason why Mr. Riley's mark-up proposal, if  
 32 applied at all, should be applied to all letter mail. Indeed, as the witness pointed out under  
 33 oral cross examination, he is not averse to extending his discount proposals beyond First-  
 34 Class, it was simply his client's desire to focus on First Class. (Cross Examination of

APWU witness Riley at Transcript Volume 12, p. 4921, line 8). I provide rate estimates below in Table Seven extending the “absolute dollar contribution” mark-up across all letter mail.

Table Seven

TY2003 FCM Rates Using Uniform “Absolute Dollar Contribution” Mark-Up  
Across All Letter Mail  
(in cents)

<u>Rate Category</u>	<u>Settlement Rates</u>	<u>Mark-Up</u>	<u>Implied Riley Rates From Uniform Mark-Up</u>
Single Piece	37.0	12.2	34.0
Mixed AADC	30.9	12.2	22.8
AADC	30.1	12.2	22.5
3-Digit	29.2	12.2	22.2
5-Digit	27.8	12.2	21.7

Source: ABA&NAPM-SRT-1, WP 1, Table 18.

What occurs among all the letter subclasses under APWU witness Riley’s uniform “absolute dollar contribution” mark-up method is that the institutional cost contribution for FCM letter mail drops from \$19.8 billion to \$14.8 billion, with most of the difference coming from Standard A mail. The uniform mark-up for the FCM letters subclass would as a result be less than it is in Table Six, namely, a 12.2 cents mark-up per piece.

One of the complications in trying to estimate the rate impact of APWU witness Riley’s uniform “absolute dollar contribution” mark-up method is the treatment of extra ounces. In the above two tables, I have included extra ounces in the calculation of pieces, though I have kept the extra ounce rate constant rather than adding the uniform mark-up for each extra ounce. One can interpret witness Riley’s proposal as being a uniform mark-up per piece of FCM letter mail regardless of how much it weighs. In Workpaper I, Table 19, I present the same information as in the two above tables. If limited to FCM, the Riley

proposal would lead to a 42 cent stamp. If extended to all letter mail it would lead to a 36 cent stamp and greater FCM workshare discounts than proposed in the settlement rates.

In summary, Mr. Riley's Absolute Dollar Contribution view of the world would result in higher FCM single piece rates relative to FCM workshare rates, if limited to FCM, and if applied across all letter mail would result in both lower FCM single piece and workshare rates.

V. Witness Riley's Suggestions About a 36 Cent Stamp Contradict His Ostensible Concern with the Postal Service's "Dire Financial Straits"

A. In the Context of Achieving Settlement, First Class Business Mailers Supported Efforts at Achieving A 36 Cent Stamp, but Ultimately Made a Substantial Concession in the Form of a 37 Cent Stamp

In many of my early settlement scenarios for First Class mailers under varying FY2002 volume loss assumptions below baseline, I thoroughly examined the possibility of a 36 cent stamp for this case. Both ABA and NAPM expressed support for one such model run, which entailed setting new postal rates at a uniform across the board percentage increase. This indicates that my clients were also interested in seeing whether, to quote Mr. Riley "a lower First Class Stamp of 36 cents might be possible." (APWU-T-1, page 2, lines 3-4).

In the final analysis all of the settlement parties, including those most interested in the single-piece FCM rate, such as the Office of the Consumer Advocate and the Greeting Card Association, joined the settlement with a 37 cent stamp. They did so with the full knowledge that First Class worksharing mailers had achieved a settlement based on minor 0.2 cent adjustments to the rates for 3 digit and 5 digit prebarcoded, presorted letter mail. Given the history of good faith settlement efforts by all First Class mailers in this case, I hope that the Commission will see through and reject APWU witness Riley's effort to drive a wedge between single piece and worksharing mailers in this case by raising the question of a 36 cent stamp. The mailing public, the OCA and the Postal Service all support this settlement.

B. Give Backs by FCM Business Mailers Since R2000-1 From July 1, 2001 Rate Increases Were One Context Leading to Settlement Rates Negotiated

First Class mailers generally and worksharing mailers in particular began this rate case in a substantially worse rate environment than the rates recommended by the Commission in R2000-1. The letters subclass in First Class began this rate case in a substantially worse rate environment than that afforded by the Postal Service to Standard A Mail following the unanimous modification vote of the Board of Governors of the USPS to raise certain rates above the Commission recommended level on July 1, 2001.

These rate “adjustments” as they were portrayed by the Postal Service in advertising the increases had a superficial appearance of effecting equitable treatment between various classes and subclasses. Worksharing discounts were cut by two tenths of a cent for First Class automation letters, by two tenths of a cent for Standard A ECR letters and by three tenths of a cent for Standard A Regular letters. However, the extra ounce rate for First Class letter, was raised from the Commission recommended rate of 21 cents to 23 cents for both single piece and workshared letters, a full two cents on nearly 22 billion extra ounces.

The effect of these unilaterally imposed rate increases was to raise the cost coverage for total First Class Mail from the Commission recommended 188.8% to 191.7%, a 2.9% increase, while the increase for Standard A mail was only 1.3%, from 150% to 151.3%. The revenue from FCM was increased by \$489 million (on a TY2001 basis) while the revenue from Standard A was increased by only \$71 million. In other words, First Class mailers began the settlement discussions with USPS in R2001-1 having just given USPS on July 1 almost \$500 million more at annualized rates than any regulatory rate making had mandated in R2000-1, and over \$400 million more than Standard A had contributed.

1 Of importance to the future of the rate making process, the First Class cost coverages  
2 resulting from the Postal Service's July 1, 2001 modification rate increases completely  
3 negated the lower cost coverages recommended by the Commission and restored the cost  
4 coverages for First Class to the nearly identical levels requested by the USPS in its  
5 (amended) rate filing. By July 1, 2001, for First Class Mail, the situation was as if there  
6 had been no adjudicated process at all of the Postal Service's proposed cost coverages in  
7 R2000-1.

8  
9 This is also part of the context in which First Class mailers were requested by Chairman  
10 Omas to sit down with the Postal Service and try to negotiate a settlement for a third rate  
11 increase in one year.

12  
13 C. The Major Context of Settlement in R2001-1: Added Revenue for USPS  
14 Above Its Request Net of Settlement Discounts for FCM  
15

16 APWU witness Riley asserts that the settlement rates between First Class worksharing  
17 mailers and the Postal Service makes the Service's financial problem worse. He states:  
18 "The Postal Service cannot afford to give away this revenue." (APWU-T-1, page 6, lines  
19 14-15). What give away? Discounts for First Class business mail were increased  
20 modestly in the settlement rates in return for worksharing mailers advancing hundreds of  
21 millions of dollars more in extra revenue to the Postal Service than contemplated in the  
22 case as filed. As was pointed out several times in settlement negotiations, it is not just the  
23 Postal Service, which has had financial problems recently as a result the U. S. economy  
24 being in recession since March of 2001. The businesses willing to give the Postal Service  
25 all this extra revenue beyond the USPS request have also suffered financially from the  
26 recession, and cannot afford to give away revenue either.

27  
28 During Oral cross examination of APWU witness Riley, Commissioner Goldway made  
29 the point that, while "the difference we're talking about is about \$100 million in revenue  
30 from the initial proposal to the settlement that the APWU is focusing on", the Postal  
31 Service under this settlement gets "about \$1.5 billion more than it might have gotten had  
32 we gone through the rate case as it was originally filed and rates were to have gone into

effect at the end of September”. (Tr., volume #12, 4946 at lines 1-2 and 4945 at lines 16-18.)

VI. In General, APWU Witness Riley’s “Policy-Oriented” Testimony Is Little More than A Set of Unsubstantiated Assertions Which Are Clearly Wrong

A. Witness Riley Does Not Understand the Context of the Settlement

In his direct testimony on behalf of the American Postal Workers Union (APWU), Michael Riley has testified against the settlement rates proposed for First Class workshared letter mail, and only against these particular discounted rates. Many of the positions taken by Mr. Riley in his testimony make it clear he is not familiar with either the fiscal realities of all parties underpinning the need for settlement or the detailed and technically complex settlement negotiations which, after some months, did produce a carefully balanced and near unanimous settlement of R2001-1. Below, I provide some context for that settlement before turning to the direct discussion of Mr. Riley’s “policy proposals”.

I believe strongly that settlement at the rates and terms in the Amended Stipulation and Agreement of December 26, 2001, is the best way to resolve the R2001-1 rate case. The DRI forecast used in the Postal Service’s original filing was from May of 2001. It was predicting a rebound in economic growth for the third quarter of 2001 from a sluggish second quarter. It was becoming known by the time of the Postal Service’s filing that that particular DRI forecast (and most other macro forecasts) was way off the mark. I had independent knowledge of the weakness of that particular DRI forecast as a result of using it and similar ones in June and July to forecast housing dynamics on a quarterly basis. By having to rely on what turned out to be a very poor forecast in its rate filing, the USPS over-estimated volume and revenue for PFY 2002 and the test year of 2003 in the case that it filed. This would have been true had the terrorist attacks of September 11<sup>th</sup> and the follow on anthrax attacks which disrupted postal services and risked the lives of

1 postal employees and others never happened. These latter events further compounded an  
2 already obsolete set of test year postal finances.

3  
4 WECG ran a set of PFY 2002 volume scenarios to examine what the implications were  
5 for our clients and for postal finances for the current fiscal year if USPS volumes, year  
6 over year, were 2%, 4% and 6% less than the Postal Service projected in its rate case  
7 filing. These scenarios were helpful to all First Class mail parties engaged in settlement  
8 discussions in helping us focus on the immediate revenue needs of the USPS so that  
9 postal services would not be further disrupted. While, of necessity, the settlement had to  
10 be framed as advancing the implementation date of TY2003 recommended rates as they  
11 emerged from the settlement, leading up to settlement nobody really knew what 2003 was  
12 going to look like. We still don't, though indications are the U. S. macro economy should  
13 be entering a recovery in the first half of this year which should strengthen considerably  
14 in the second half, just as the Postal Service's fiscal 2003 commences. I believe our focus  
15 on the current fiscal year needs helped in some small way to achieve settlement between  
16 the parties.

17  
18 In the scenarios run by WECG from the start of the settlement process, it was understood  
19 that First Class mailers were proposing to help the USPS's worsening financial situation  
20 by significantly advancing the date some level of higher rates were to take effect in 2002,  
21 as early as January. The billions of dollars in extra revenue generated for USPS from  
22 early implementation of higher rates was a hallmark of all settlement negotiations  
23 between First Class mailers and the Service from the start. This advance of extra revenue  
24 is the context in which First Class mailers asked for some consideration in the rates and  
25 discounts upon which they ultimately settled.

26  
27 B. Witness Riley Ignores a Decade's Worth of Mounting Evidence in Favor of a  
28 Lower Extra Ounce Rate for Presort Mail, Which Has Demonstrably Lower Costs  
29 Than Single Piece and a Stratospheric Cost Coverage  
30

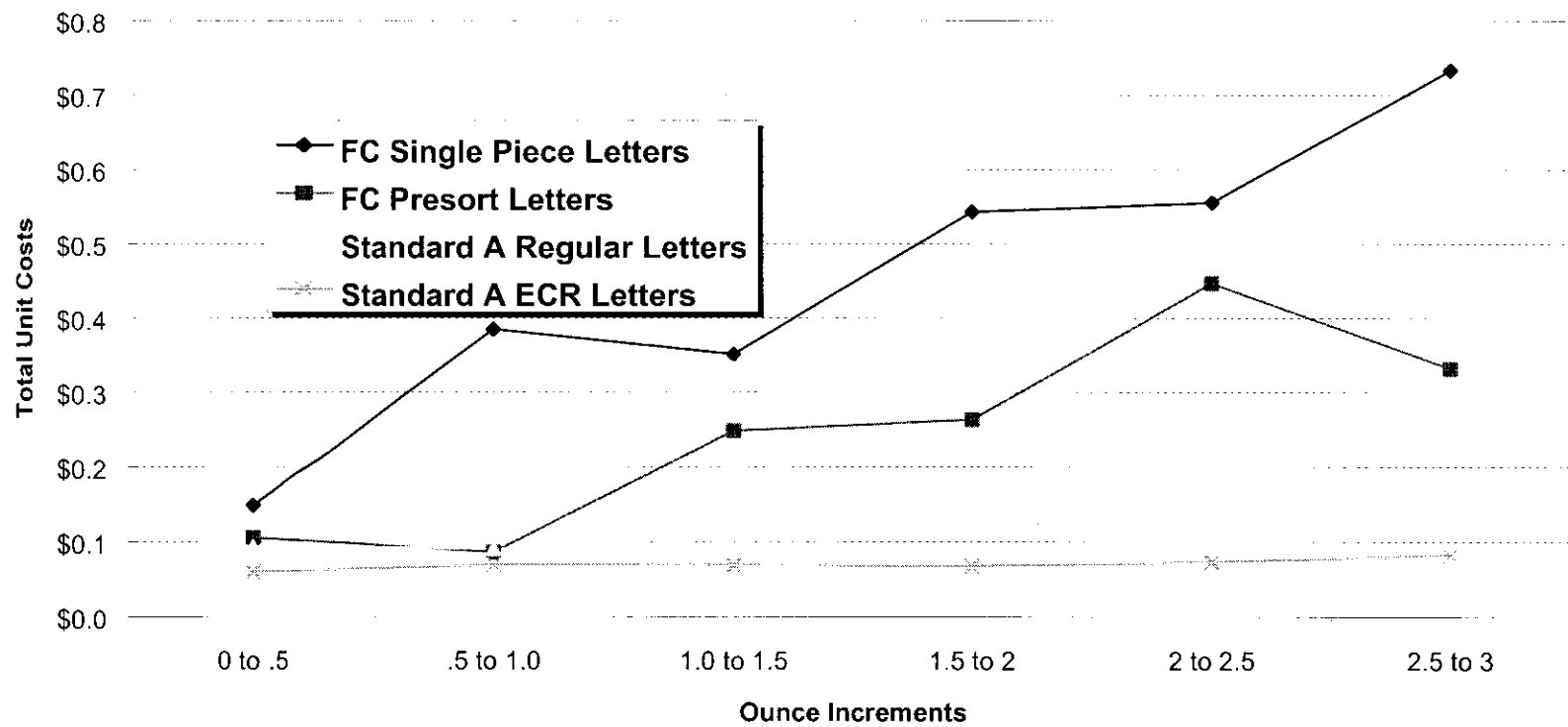
31 Over the past decade a number of parties have questioned whether the extra ounce rate

1 for First Class letter mail is cost based, or whether it is simply used by the Postal Service  
2 as a revenue source largely unrelated to costs that can be used at the whim and fancy of  
3 the service to generate substantial extra revenue beyond what its cost based rates can  
4 achieve. My views on the extra ounce issue can be found in ABA&NAA&NAPM-T-1 in  
5 R97-1 and ABA&NAPM-T-1 in R2000-1.

6  
7 For business mailers in First Class, such as banks and the monthly statements they send  
8 out including canceled checks, the extra ounce issue focuses on the first couple of extra  
9 ounces. Mr. Riley's cost and discount arguments ignore this reality. Within this range, the  
10 evidence from older cost studies and the latest one, as shown in Figure 4, indicates that  
11 the extra ounce costs for First Class presort are materially lower than for single piece.  
12 And, the cost studies for presort appear to be flawed, biased upwards in fact. As I have  
13 stated in previous testimony, the extra ounce cost studies for Standard A letter mail  
14 appear to offer a truer picture of what the extra ounce costs for First Class presort mail  
15 are than the erratic extra ounce data for First Class presort.

16  
17 In the recent past the Commission has given some consideration to reducing the extra  
18 ounce rate across all First Class letter mail on the basis of evidence submitted that mainly  
19 focuses on extra ounce workshared letter mail. This has been one of the few avenues  
20 available to the Commission, faced with the whole cent rounding convention for first  
21 ounce, First Class single piece mail, that it can use to reduce the cost coverage for the  
22 letters subclass of FCM. While I understand the Commission's goal, this is frankly not a  
23 very good way of addressing the rate issues of single piece mailers.

24  
25 On July 1, 2001, the Postal Service reversed the Commission's latest recommendation  
26 order on the FCM extra ounce rate, and raised that rate for both single piece and  
27 worksharing mailers from the PRC's recommended decision of 21 cents in R2000-1 to 23  
28 cents. Given the cost evidence for presort extra ounces, this was an especially egregious  
29 decision insofar as worksharing mailers were concerned, for their first ounce rates, unlike  
30 the single piece rate, were also raised.

**Figure 4****TY2003 Total Unit Costs By 0.5 Oz Weight Increments Up to 3 Oz**

1 The decision by the Postal Service in its R2001-1 rate case as filed, and in the settlement  
 2 rates supported by all First Class mail groups, not just worksharing mailers, has been to  
 3 recognize the lower extra ounce costs of First Class presort mail that I have addressed in  
 4 direct testimony in R97-1 and R2000-1.

5  
 6 C. Witness Riley's Claim Overstates and Exaggerates the Reality Concerning USPS  
 7 Finances Since Postal Reorganization  
 8

9 Witness Riley's testimony purports to focus on the immediate "dire financial straits" in  
 10 which the Postal Service finds itself since the onset of recession and the anthrax attacks  
 11 using the mail system to which hundreds of Postal Service employees were regrettably  
 12 exposed. However, as part of his evidence for slashing worksharing discounts in First  
 13 Class mail, Mr. Riley also cites an ostensible long run reality, namely that "the Postal  
 14 Service has never achieved a cumulative breakeven". (APWU-T-1, p. 7, lines 23-24). Mr.  
 15 Riley may be technically correct, but he seriously misses the forest for the trees.

16  
 17 Figure 5 and Figure 6 present, respectively, the long run comparison of USPS operating  
 18 revenues and operating costs and total revenue and total costs. Superimposed on these  
 19 cost and revenue comparisons is the annual level of Congressional appropriations for the  
 20 Postal Service. Since 1990, as seen in Figure 5, the Postal Service's operating revenue  
 21 has exceeded its operating expenses until very recently. Further, the dependence of the  
 22 Postal Service on tax dollars has fallen greatly to a de-minimus level relative to the  
 23 situation immediately following postal reorganization. For these reasons, Mr. Riley is  
 24 really too pessimistic in his financial assessment of USPS's long-term financial position.

25  
 26 As a recent GAO study points out, the major financial problem within USPS consists of  
 27 the growth of interest expense on deferred retirement liabilities. This has mushroomed  
 28 from about \$1.05 billion in 1990 to \$1.6 billion in 2001.<sup>3</sup> This one charge explains why  
 29 the total revenue and total cost dynamics of the Service have not performed as  
 30 consistently in the black since 1990 as have total operating revenue and total operating

---

<sup>3</sup> The deferred retirement cost of the Postal Service on which this interest charge is based was \$3 billion in 1975, \$21 billion in 1990 and \$32 billion in 2001.

1 cost dynamics. In this case, APWU witness Riley has mistaken a misleading tree as being  
2 the entire forest!

3

4 D. The Strange World of APWU Witness Riley's Economics

5

6 Woven throughout APWU witness Riley's testimony is a variety of economic assertions  
7 that appear so divorced from professional economic views that they simply cannot go left  
8 unchallenged, especially since witness Riley presents himself, in part, as an expert  
9 witness in economics, stating that he completed "all of the required course work for a  
10 PHD [i]n economics." (APWU-T-1, p. 4, lines 24-25).

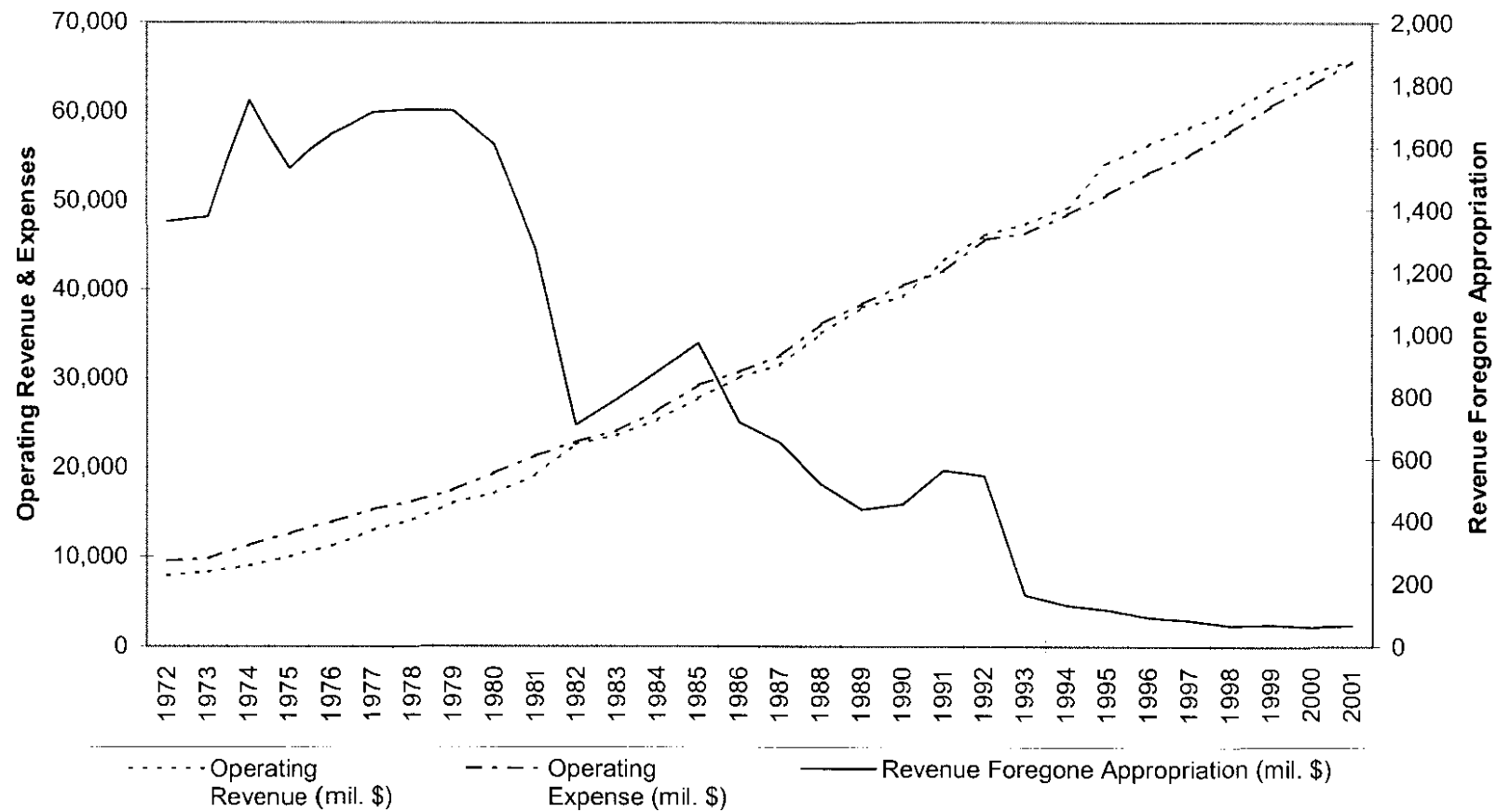
11

12 As is universally understood and acknowledged, except perhaps by Mr. Riley, USPS  
13 operations and rate making are not based on the concept of maximizing the rate of profit  
14 on equity, sales, capital or any other profit motive. USPS is a far more complex  
15 organization than corporate America, and USPS rate-making is not the same as pricing by  
16 Ford, Microsoft or, even UPS and FEDEX. Witness Riley goes to extremes in defending  
17 his policy proposals to slash FCM worksharing discounts, thereby raising worksharing  
18 rates, on the basis of using analogies between postal pricing and the requirements for  
19 sound finances in the for-profit corporate world.<sup>4</sup> Mr. Riley finally admits in response to  
20 ABA&NAPM/APOWU-T1-12 that the Postal Service is "an independent establishment  
21 of the executive branch of the Government of the United States governed by the Postal  
22 Reorganization Act as amended, not a "for profit" environment." (Tr. Volume 12 at page  
23 4893)

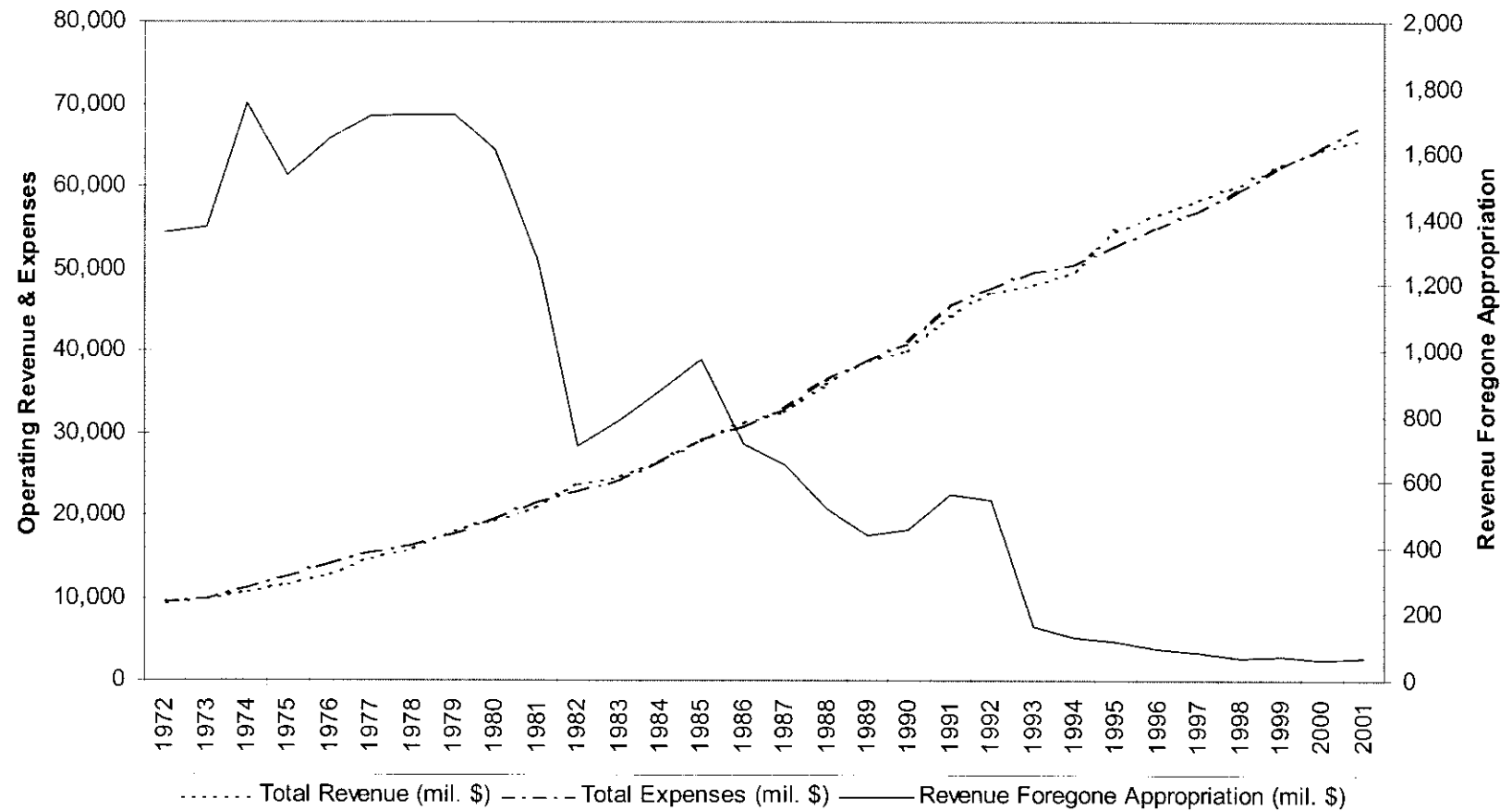
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<sup>4</sup>For example, he speaks of slashing discounts in the context of "a typical for-profit organization" on page 7, line 10, of his testimony. He speaks of the "Postal Service needs to have more profits" on page 8, lines 4-5.

**Figure 5**  
**USPS Operating Revenue, Operating Expenses**  
**And Revenue Foregone Appropriation**



**Figure 6**  
**USPS Total Operating Revenue, Total Operating Expenses**  
**And Revenue Foregone Appropriation**



1 However, even the competitive for-profit world would never adopt the pricing strategy  
2 Mr. Riley recommends: "I urge the Rate Commission, whenever it has a range of choices,  
3 to pick the one that will generate the most revenue for the Postal Service." (APWU-T1,  
4 page 9, lines 3-5). This statement so flies in the face of allocatively efficient pricing,  
5 marginal cost pricing, or of regulatory ratemaking that in the broad sense is supposed to  
6 replicate how a competitive market for the services it regulates would set prices, that I  
7 find it incredulous. There is some evidence that the USPS may act (inefficiently) as a  
8 volume maximizing institution, but its retrogression into a short run sales maximizing  
9 institution would simply put the Service in greater financial jeopardy than it is now in.  
10 Generating revenue is important to USPS's health but so to is controlling costs by  
11 boosting productivity, downsizing when and where appropriate, and by other means.

12  
13 While witness Riley in his testimony is full of for-profit corporate analogies as to how  
14 postal finances should operate, he clearly believes that only the Postal Service should  
15 realize a return on its investment in automation equipment. Evidently, the hundreds of  
16 presort bureaus and major mailers who risk capital, unlike USPS, when they have  
17 invested in automation equipment do not deserve a return on that investment. Or, they  
18 only deserve a return if USPS earns one first. Like witness Riley's related comments  
19 about the allegedly higher private sector costs associated with prebarcoding and  
20 presorting the mail relative to USPS costs, Mr. Riley's view of who is entitled to a return  
21 on automation investment suggests that he is completely out of touch with the highly  
22 competitive market environment for mail processing services.

23  
24 The discounts which Mr. Riley asserts are too high are simply a very imperfect proxy for  
25 the absence of direct price competition between the private sector and the Postal Service  
26 in automated mail processing, one in which monopoly power can unfortunately be  
27 exercised by e.g., less than 100% pass-throughs. Based on my experience and  
28 understanding of both private sector and USPS mail processing labor costs, which are  
29 certainly substantially more than those of the private sector, I am certain that total mail  
30 processing costs are lower in the private sector than they are within the Service up to the  
31 stage of delivery point barcode sortation. Were mail processing an unbundled postal

1 service, especially now that single piece letter mail is highly machine readable, volume  
 2 would flow quickly to the private sector and out of the USPS, particularly if the USPS  
 3 could no longer maintain a monopoly on collection mail.

4  
 5 VII. Conclusion: Witness Riley's Assertion that His Proposed Discounts Send the  
 6 "Correct Price Signals" Begs Two Questions

7  
 8 A. What Foundations Has Witness Riley Established as an Expert Economist as  
 9 to What a "Correct Price Signal" Is?  
 10

11 In this case, discussions surrounding the "pass through" percentages of FCM worksharing  
 12 discounts vis a vis one (and only one) measure of cost avoidance began first with USPS  
 13 witness Maura Robinson's testimony as the First Class rate witness, and second with  
 14 APWU witness Riley's testimony. I have a very different perspective on this issue than  
 15 either of the above witnesses, which I present in conclusion after reviewing the  
 16 discussion to date on pass-throughs.

17  
 18 USPS witness Robinson, an economic expert on postal pricing and rate design, supported  
 19 the rates and discounts in her testimony under all of the Title 39, Section 3622 (b)  
 20 criteria, acknowledging that she was passing through more than USPS witness Miller's  
 21 newest variation on minimizing cost avoidances. Other rate design considerations were  
 22 evidently more important to witness Robinson than that one measure of cost avoidance,  
 23 and in making her decision on rates and discounts, witness Robinson was no doubt aware  
 24 that the Commission has repeatedly rejected the Miller/Hatfield method(s) in its opinions  
 25 and recommended decisions in favor of more balanced approaches. Witness Robinson  
 26 believes, as do I, that the settlement rates, which are close to her recommended rates,  
 27 send the correct price signals to the market for all First Class mailers and are fully in  
 28 accordance with all the Title 39, section 3622 (b) rate design criteria.

29  
 30 APWU witness Riley, who is not an economic expert on postal pricing and rate design or  
 31 even a practicing economist by professional experience, opposes witness Robinson's  
 32 proposed discounts (and the settlement discounts) because, and only because, they  
 33 appear to pass through more than 100% of cost avoidance based on one, and only one,  
 34 extremely narrow measure of cost avoidance that in my judgment is thoroughly broken,

1 namely witness Miller's measure. Neither his blind adherence to Miller's narrow measure  
2 of cost avoidance, nor Riley's long ago course work in economics qualify witness Riley  
3 to assert the kind of radical discount changes he proposes.  
4

5 B. Beyond Pure Assertion, Where Is the Evidence That His Proposed Discounts  
6 Would Send "Correct Price Signals"?  
7

8 Using any other known means of measuring cost avoidance, whether actual CRA cost  
9 differences which Mr. Riley himself appears to prefer over witness Miller's "should cost"  
10 modeling or PRC volume variable cost assumptions, as I have shown, APWU witness  
11 Riley cannot argue that the settlement proposed rates and discounts are even close to  
12 100% of costs avoided, let alone more than 100%.  
13

14 He cannot argue, therefore, that the proposed worksharing rates and discounts send the  
15 wrong price signals to the market. On the contrary, it is witness Riley's proposed slashing  
16 of the discounts recommended by USPS witness Robinson that would clearly send the  
17 wrong price signals to the market: "Exit, exit, exit!" Any balanced view of cost avoidance  
18 suggests that witness Riley's proposed discounts would pass through only about 50% of  
19 avoided costs to the mailers doing all the mail processing work for 22 billion First Class  
20 pieces.  
21

22 APWU witness Riley's "absolute dollar contribution" method for allocating institutional  
23 costs and setting rates and discounts would not, based on my illustrative calculations,  
24 send anything like what Mr. Riley himself would view as correct pricing signals to the  
25 market. It would raise single piece rates and increase worksharing discounts.  
26

27 Much as the Commission's "Appendix F" methodology for estimating cost differences  
28 and setting discounts was broken by the R94-1 rate case (See my rebuttal testimony in  
29 that case, ABA-RT-1), the allegations made by both of the above witnesses that the USPS  
30 proposed worksharing rates entail setting discounts above 100% of cost avoidance is little  
31 more than a very large addition to the mounting evidence since the R97-1 rate case that  
32 the Postal Service's entire modeled cost approach to estimating cost avoidances is  
33 fundamentally, and irreparably, broken. Such a method, or anything resembling it, should

1 not even be allowed into evidence in the next rate case. It should die the same quiet death  
2 that the Appendix F methodology did in R94-1. That said, I do note that the costs in the  
3 record in this case, when subjected to a reasonable measure of cost avoidance as outlined  
4 in my testimony, do support the settlement FCM workshare rates.

5  
6 In this testimony, I have adopted largely the same, multi-faceted approach to measuring  
7 costs avoided as I did in R94-1. In that case, the Commission recognized that no single  
8 methodology has always dominated the measurement of costs avoided for the purposes of  
9 setting discounts for as long as they have been set by the Commission. In that case, the  
10 Commission also largely agreed with the reasons I set forth as to why its "Appendix F"  
11 methodology had become unreliable as a basis for setting discounts. The reasons why the  
12 Hatfield/Miller method of cost avoidance has become irreparably broken are different. I  
13 cannot go into detail here as it is beyond the scope of my testimony. I simply ask the  
14 Commission (and the Postal Service) to reflect on the following observations:

15  
16 (1) By the time the Service's own rate witness, in essence, has to ignore her own  
17 organization's method for determining avoided costs in admirably setting  
18 those rates and discounts, it is obvious that the method has no practical value  
19 anymore;

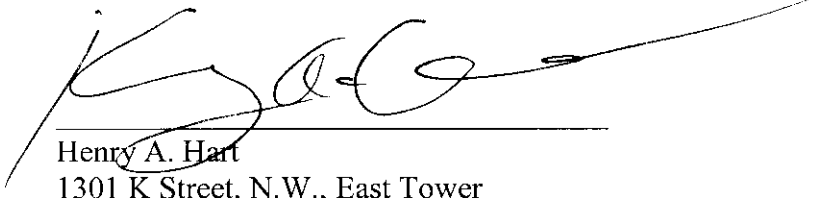
20 (2) By the time a recent former CFO of the Postal Service involved in R97-1  
21 himself acknowledges greater trust in "actual CRA costs" than USPS "should  
22 cost" models, it is obvious that the "should cost" method likely has little  
23 internal USPS credibility;

24 (3) By the time a mission oriented USPS witness, trying to minimize costs  
25 avoided, has to break out several more rate category model details from a  
26 "nonautomation presort" category which exhibited absolutely bizarre behavior  
27 in measured cost avoidance in the last rate case, it becomes a fundamentally  
28 irresponsible exercise that comes dangerously close to exercising monopoly  
29 power over the prices presort bureaus have to charge in the marketplace for  
30 mail processing.

1 I renew my call from the last case, and I trust APWU witness Riley would agree with me,  
2 that, short of unbundling the Service and pricing all mail processing services directly, the  
3 Commission should recommend in this case that the Postal Service develop direct CRA  
4 measurements by rate category of costs avoided in First Class Mail. It already does so for  
5 some rate categories, and it can certainly do so for all the major volume drivers with the  
6 CRA presort aggregate.

7  
8 CERTIFICATE OF SERVICE  
9

10 I hereby certify that I have this 20<sup>th</sup> day of February 2002, served the foregoing  
11 document upon all participants of record in this proceeding in accordance with section 12  
12 of the Rules of Practice.

13  
14  
15  
16  
17  
18  
19  
  
Henry A. Hart  
1301 K Street, N.W., East Tower  
Suite 1100  
Washington, DC 20005-3317