

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

POSTAL RATE AND FEE CHANGES, 2001

Docket No. R2001-1

INITIAL BRIEF OF THE  
UNITED STATES POSTAL SERVICE

UNITED STATES POSTAL SERVICE

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March 4, 2002

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### Procedural History

On September 24, 2001, the United States Postal Service filed with the Postal Rate Commission ("Commission") the Request of the United States Postal Service for a Recommended Decision on Changes in Rates of Postage and Fees for Postal Services and Request for Expedition ("Request"). The Request was filed in accordance with 39 U.S.C. §§ 3622 and 3623.

The Request was based on cost, volume, and revenue projections using fiscal year ("FY") 2000 as a Base Year, and a Test Year running from October 1, 2002, through September 30, 2003.<sup>1</sup> The Postal Service proposed rate and fee increases for existing classes of mail and special services, and also proposed certain changes in the Domestic Mail Classification Schedule ("DMCS"). The Postal Service supported its request by the written direct testimonies of 40 witnesses (44 testimonies) and numerous other documents, including exhibits and workpapers, submitted pursuant to the Commission's Rules of Practice and Procedure. 39 C.F.R. §§ 3001.1 *et seq.*

The Postal Service stated its determination that, without increases in rates and fees, it would incur a substantial revenue deficiency in the test year, in contravention of 39 U.S.C. § 3621. The Postal Service estimated that at current rates, its test year revenues would total approximately \$70,583 million, and its total costs \$75,857 million, creating a test-year deficiency of some \$5,274 million. Included among the proposed rates was a rate of 37 cents for the first ounce of First-Class Mail, and maintaining 23 cents for the additional-ounce rate. As directed by the Board of Governors, the Postal

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<sup>1</sup> As in the past, however, the base period for volume forecasting consists of the most recent four quarters, in this instance 2000Q4-2001Q3.

Service requested that the Commission's consideration of its proposals be conducted with all possible expedition, consistent with the Commission's responsibilities and the requirements of due process.

By Order Nos. 1324 and 1325, issued on September 26, 2001, the Commission noticed the Postal Service's Request and designated the instant proceeding as Docket No. R2001-1. See 66 FR 50480 (October 3, 2001). The Commission gave interested parties until October 24, 2001, to intervene in the proceeding, and designated Shelley S. Dreifuss, Acting Director of the Office of the Consumer Advocate to represent the general public. Sixty-two parties have intervened in this proceeding.

On October 25, 2001, during the Docket No. R2001-1 Prehearing Conference, the Presiding Officer directed the participants to consider the possibilities for settlement. He noted the unforgettable and extraordinarily tragic terrorist attacks on the World Trade Center and the Pentagon on September 11<sup>th</sup> that threatened the nation's security, as well as the subsequent use of the mails in October to commit fatal and unsettling acts of biological terrorism. Chairman Omas asked all parties to reflect upon the potential that changed circumstances might have on the Postal Service's Request. The Presiding Officer also requested that all participants consider whether substantial Agreement on issues and objectives might permit a beneficial and expedited resolution of the proceeding. He asked the intervenors to consider his remarks, and asked the Postal Service to consult with them and report on whether a settlement might be possible. Docket No. R2001-1; Tr. 1/39-42.

The Postal Service,<sup>2</sup> the Office of the Consumer Advocate, and participating intervenors discussed the issues presented by this case at conferences on October 30, and November 16, 2001, to which all intervenors and the Office of the Consumer Advocate were invited. The Postal Service also consulted with intervenors individually and in smaller groups. As a result of these various meetings, a Stipulation and Agreement seeking to resolve all issues raised by the Postal Service's Request was circulated among the parties for consideration.<sup>3</sup>

The first set of scheduled evidentiary hearings, on the Postal Service's case, were held on December 13-19, 2001. A second set of hearings, which were abbreviated in light of the submission of the Stipulation and Agreement, were held on January 9-11, 2001.

During discovery, which was conducted prior to the submission of the Stipulation, Postal Service witnesses and the Postal Service itself responded to numerous written interrogatories, most of which were filed during the regular discovery period on the witnesses' testimonies, which ended on December 10, 2001. Responses to discovery requests to the Postal Service and its witnesses were generally provided within 14 days, as prescribed by the Commission's rules. The Presiding Officer issued 10 Presiding Officer's Information Requests, to which the Postal Service responded.

Meanwhile, on December 17, 2001, the Postal Service submitted a proposed

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<sup>2</sup> Not only through counsel, but also through the Postmaster General, the Chief Financial Officer, Chief Marketing Officer, and other management representatives.

<sup>3</sup> See, Motion of the United State Postal Service Submitting Second Revised Stipulation and Agreement and for the Establishment of a Preliminary Procedural Mechanism and Schedule (December 17, 2001).



Stipulation and Agreement in settlement of all issues in this case. This Stipulation was amended on December 26, 2001, January 17, 2001, and February 13, 2002. There are limited variations in rate designs between the Postal Service's Request and the rates in the Stipulation and Agreement.

The Stipulation and Agreement, as amended, proposes that the Commission recommend rates and classifications for approval by the Governors of the United States Postal Service that deviate in limited respects from the rates and classifications originally sought in the September 24<sup>th</sup> Request. The Agreement also enables the implementation of Docket No. R2001-1 rate and classification changes to occur as early as June 30, 2002, as compared to implementing the originally requested rates on September 30, 2002. It bears emphasizing that the Agreement also explicitly reflects the concurrence of the signatories that, for purposes of this proceeding, the Postal Service's Request, testimonies, and supporting documentation provide substantial record evidence sufficient to serve as the basis for the Postal Rate Commission's recommendations to the Governors. Stipulation and Agreement at ¶ 3. To-date, 56 of the 62 Docket No. R2001-1 intervenors have signed the Stipulation and Agreement.

In POR No. R2001-1/27, the Commission noticed the proposed Stipulation and Agreement and established procedures for participants to indicate opposition to any or all parts of the Stipulation. Only one participant, the American Postal Workers' Union, AFL-CIO ("APWU"), indicated opposition. The APWU stated it opposed "the rate design proposed for First-Class Mail because the proposed discounts exceed costs avoided." Notice of Opposition of the American Postal Workers Union, AFL-CIO, January 15, 2002, at 1. On January 30, 2002, the APWU filed APWU-T-1, testimony of Michael J.

Riley, in opposition to the proposed Stipulation and Agreement. On January 31, 2002, the Presiding Officer issued POR No. R2001-1/43, Presiding Officer's Ruling Establishing The Procedural Schedule For Consideration Of The Proposed Stipulation And Agreement.

On February 1, 2002, the Commission issued Notice of Inquiry ("NOI") No. 1, which concerned proposed DMCS changes. The Commission noted that the proposed Stipulation and Agreement of January 17, 2002 incorporated the Postal Service's proposal to eliminate from the DMCS the listings of combinations of special services that either must be used together, or may be used in conjunction with each other. The Commission stated that if the proposed Stipulation and Agreement were to form the basis of a recommended decision, it intended to retain the current special services combination listings, and not make changes to the DMCS that reduce the amount of information it contains. (NOI No. 1, at 3).

On February 13, 2002, the Postal Service withdrew, from its Request, and from the Stipulation and Agreement, the proposed changes to the DMCS addressed by the Commission in NOI No. 1. It submitted a third, revised Stipulation and Agreement that did not include these proposals, but made no other changes. No parties exercised their rights, embodied in the settlement, to withdraw as a result of these or any previous changes to the Stipulation and Agreement.

The Commission held hearings to receive the testimony of witness Riley on February 14, 2001, the parties having conducted discovery on him by February 7, 2001.

On February 20, five parties – the Postal Service through witness Moeller, the American Bankers Association and National Association of Presort Mailers through

witness Clifton, Keyspan through witness Bently, the Major Mailers Association through witnesses Bentley and Crider, and the National Association of Presort Mailers through witness Gillotte -- filed evidence. On February 26, 2002, the Commission held hearings on this surrebuttal evidence.

On February 28, 2002, through Presiding Officer's Ruling No. R2001-1/54, the Commission closed the evidentiary record "subject to transcript corrections filed by March 4, 2002."

The date for filing of briefs is set for March 4, 2002, with March 8, 2002, set as the date for filing reply briefs.

Pursuant to the Stipulation and Agreement, each signatory has reserved the right to withdraw from the Stipulation and Agreement under designated conditions. One condition is "[i]f the Commission fails to issue a Recommended Decision based on the Stipulation and Agreement by March 25, 2002." Stipulation and Agreement at (c). Other conditions include "[i]f the Commission adopts a Recommended Decision that deviates from the rates, fees, and classification changes set forth in Attachments A and B, as revised, appended to the Stipulation and Agreement, id. at (d); and if the Governors of the Postal Service fail to approve a Commission Recommended Decision adopting the rates, fees, and classification changes set forth in Attachments A and B, as revised, appended to this Stipulation and Agreement. Id. at (e).

I. The Commission Should Recommend the Nearly Unanimous Settlement Agreement.

A. Background

As noted above, the extraordinary circumstances created by the national events shortly before and following the filing of the Postal Service's Request led the Presiding Officer in this case to encourage settlement. During the Prehearing Conference on October 25, 2001, Chairman Omas stated:

I have often heard it said that there could never be a settlement in an omnibus rate case. There are too many conflicting interests, and too much money is at stake. But it seems to me that if there was ever a time when "business as usual" was not an attractive course of action, and when cooperative efforts to promptly resolve issues through settlement might be the right course of action, that time is now.

If history teaches us anything, it indicates that in nine or ten months the Commission will recommend higher postal rates. We don't know how high, and we don't know if one or another class of mail will avoid a significant portion of the increase proposed by the Postal Service.

I suggest that participants concerned with the justification for the request currently before the Commission consider the potential for new information that might justify higher rates. I also suggest that the Postal Service consider steps it could take to ease the impact of large increases and minimize disruption.

None of us want to be here in May arguing about this case, knowing that the Postal Service is at risk, and is preparing to file an additional request to make up for losses incurred while this docket was going forward. I urge all participants to recognize that extraordinary times warrant extraordinary acts.

Tr. 1/40-41.

Chairman Omas's wise counsel, combined with the economic and operating environment that gave rise to his advice, created the setting for the unusual success experienced by the Postal Service and other parties in their settlement efforts. Furthermore, while the importance of the Chairman's

leadership cannot be overemphasized, the current status of settlement owes an enormous debt to the ingenuity, cooperation, and willingness to compromise of the intervenors who participated in settlement. Counsel and industry officials representing a broad spectrum of participants made many constructive contributions. We acknowledge in particular the valuable efforts of the intervenors principally interested in First-Class Mail, Periodicals, and Standard Mail. Without their cooperative spirit and valuable input, the remarkable level of consensus supporting the settlement agreement in this case could never have been accomplished. In this regard, we note that not all of the changes imposed on the settlement as a result of compromise were welcome or popular with all of the participants. Nevertheless, they almost uniformly realized and accepted the overriding importance of the overall objectives and benefits, and were willing to subordinate their particular concerns to the more important goals suggested by Chairman Omas.

Acting as settlement coordinator, the Postal Service filed seven status reports describing the progress of the negotiations leading to the current state of the agreement embodied in the Stipulation and Agreement.<sup>1</sup> The evolution of

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<sup>1</sup> First Report of the United States Postal Service as Settlement Coordinator, Docket No. R2001-1 (Nov. 2, 2001); Second Report of the United States Postal Service as Settlement Coordinator, Docket No. R2001-1 (Nov. 9, 2001); Third Report of the United States Postal Service as Settlement Coordinator, Docket No. R2001-1 (Nov. 19, 2001); Fourth Report of the United States Postal Service as Settlement Coordinator, Docket No. R2001-1 (Nov. 30, 2001); Fifth Report of the United States Postal Service as Settlement Coordinator, Docket No. R2001-1 (Dec. 10, 2001); Sixth Report of the United States Postal Service as Settlement Coordinator, Docket No. R2001-1 (Jan. 4, 2002); Seventh Report of the United States Postal Service as Settlement Coordinator, Docket No. R2001-1 (Jan. 11, 2002).

that agreement is further chronicled in pleadings filed by the Postal Service submitting the Stipulation and Agreement at various stages of its development.<sup>2</sup> The Postal Service convened two general settlement conferences open to all intervenors.<sup>3</sup> At the second conference, the Postmaster General and the Postal Service's Chief Financial Officer addressed the participants and took an active part in the discussions. Numerous other discussions took place among the Postal Service and intervenors, individually and in smaller groups. Written communications apprising the participants of significant changes in the terms of the Stipulation and Agreement were sent to all parties of record in Docket No. R2001-1, regardless of their level of participation in the settlement negotiations.

#### B. The Stipulation and Agreement

The Postal Service's rate and classification proposals embodied in its Request filed September 24, 2001, provided the foundation for the substantive terms of the first draft of the Stipulation and Agreement. These were modified in four subsequent stages. As described more fully below, the first revisions involved changed proposals for worksharing and drop-ship discounts in First-

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<sup>2</sup> Motion of the United States Postal Service Submitting Stipulation and Agreement and for the Establishment of a Preliminary Procedural Mechanism and Schedule, Docket No. R2001-1 (Dec. 17, 2001)(Motion and First Stipulation and Agreement); Motion of the United States Postal Service Submitting Revised Stipulation and Agreement, Docket No. R2001-1 (Dec. 26, 2001)(Motion and Second Stipulation and Agreement); Motion of the United States Postal Service Submitting Second Revised Stipulation and Agreement, Docket No. R2001-1 (Jan. 17, 2002)(Motion and Third Stipulation and Agreement); Notice of the United States Postal Service Withdrawing Proposals and Submitting Revised Stipulation and Agreement, Docket No. R2001-1 (Feb. 13, 2002)(Notice and Fourth Stipulation and Agreement).

<sup>3</sup> The conferences were held on October 30 and November 16, 2001, at Postal Service Headquarters.

Class Mail, Periodicals, and Package Services.<sup>4</sup> In the second stage, the Postal Service established a new time perimeter for implementing rates that might be recommended as a result of settlement.<sup>5</sup> Originally, the Postal Service had taken the position that new rates and classifications would take effect no sooner than June 2, 2002. After a major compromise, the Stipulation and Agreement filed on December 26, 2001, established June 30, 2002, as the earliest implementation date. The second revision also changed proposals for Parcel Post intra- and inter-BMC rates. The third revision changed certain rates proposed for Standard ECR mail.<sup>6</sup> Finally, on February 13, 2002, the Postal Service submitted a fourth revision that withdrew from consideration proposals to alter the language of the Domestic Mail Classification Schedule (DMCS) regarding listings of Special Service combinations.<sup>7</sup>

The other terms and conditions embodied in the Stipulation and Agreement are similar in structure and content to settlement agreements offered in previous Commission proceedings.<sup>8</sup> The agreement expresses the fundamental principle that the Stipulation and Agreement represents a negotiated settlement of the Postal Service's Request for recommendations on rates, fees, and classifications, filed pursuant to 39 U.S.C. §§ 3622 and 3623. Apart from the substantive changes, other salient provisions include the following:

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<sup>4</sup> See Motion and First Stipulation and Agreement, filed December 17, 2001.

<sup>5</sup> See Motion and Second Stipulation and Agreement, filed December 26, 2001.

<sup>6</sup> See Motion and Third Stipulation and Agreement, filed January 17, 2002.

<sup>7</sup> See Notice and Fourth Stipulation and Agreement, filed February 13, 2002.

<sup>8</sup> Parties have proposed settlement agreements in two prior omnibus rate cases: Docket No. R74-1 and Docket No. R94-1. Several other settlements have been followed in mail classification cases. See footnote 14, *infra*.

- The parties agree that the testimony and documentation filed by the Postal Service in the docket provide substantial evidence for establishing the rates and fees proposed in the agreement, and that the changes accord with the policies embodied in title 39, United States Code.
- The parties agree not to file pleadings or testimony opposing the settlement or proposing changes other than those in the agreement.
- The parties agree that the force of the agreement will be broken if the Commission fails to recommend the settlement changes by March 25, 2002, or if the Governors fail to approve such recommendations.
- The parties agree that the force of the agreement will be broken if the Presiding Officer fails to establish a procedural mechanism and schedule governing settlement by January 31, 2002.
- The parties agree that any party, upon notice given, could withdraw from the agreement on February 4, 2002, if it concludes that its interests are no longer furthered by the agreement.
- The parties agree that the Stipulation and Agreement shall not constitute agreement with any ratemaking principle, approach, methodology, legal interpretation, or fact underlying the rate, fee, and classification proposals.
- The parties agree that the Stipulation and Agreement will apply only to Docket No. R2001-1 and does not create any precedent for any other proceeding.

C. The Commission Should Exercise Its Clear Authority to Recommend the Settlement Agreement Proposed in this Proceeding.

1. Applicable law and the Commission's rules and precedent obligate the Commission to consider settlement agreements.

The Commission long ago concluded that it bears an obligation to promote settlement where possible.<sup>9</sup> It derives this authority from the general requirement

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<sup>9</sup> In Docket No. MC73-1, the Commission stated:



in the Administrative Procedure Act (APA) to provide participants in its proceedings with “an opportunity for...the submission and consideration of...offers of settlement...when time, the nature of the proceeding, and the public interest permit...”<sup>10</sup> While courts have acknowledged that the APA does not dictate the manner or limits under which regulatory agencies must consider such settlement agreements,<sup>11</sup> the Commission has embraced the goal of settlement where applicable in its proceedings. The Commission’s procedural rules provide the opportunity for any participant to submit settlement offers and to conduct conferences for their consideration.<sup>12</sup>In its Opinion in Docket No. MC84-2, furthermore, the Commission stated:

Our rule requires us to allow the opportunity to reach settlement; its language literally permits parties to submit for our consideration a

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We are, like most other agencies, required by the Administrative Procedure Act to facilitate the settlement of cases...as a useful, convenient and fair means of disposing of complex cases. (*citing Southern Louisiana Area Rate Cases v. FPC*, 428 F.2d 407 (5<sup>th</sup> Cir. 1970); *cert. denied*, 400 U.S. 950 (1970)).

PRC Op. MC73-1, at 6 (Apr. 15, 1976).

<sup>10</sup> 5 U.S.C. § 554(c)(1). Section 554(c)(2) further provides that “to the extent that the parties are unable to so determine a controversy by consent, hearing and decision “ The policy justification for the APA’s requirement is explained in *Cities of Lexington, et al. V. FPC*, 295 F2d 109 (4<sup>th</sup> Cir. 1961)

<sup>11</sup> In *Pennsylvania Gas & Water Co.v. FPC*, 463 F.2d 1242, 1247 (DC Cir. 1972), the court observed the following with regard to the Federal Power Commission’s approval of a nonunanimous settlement agreement:

Section 554(c)...in itself is not decisive support for the Commission action here, as the [APA] merely provides for the “submission and consideration of facts, arguments, offers of settlement...when...the public interest permit[s].” Except as provided in § 554(c)(2), it does not spell out in what manner or by what procedure the Commission is to consider and *act* on the matter submitted, nor does it expressly require – or dispense with – the unanimous consent of all the participating parties in a multiparty proceeding.

<sup>12</sup> 39 C.F.R. § 3001.29 (2001).

nonunanimous settlement; and *Pennsylvania Gas*, construing similar language in the APA, shows that such a settlement is capable of adoption.<sup>13</sup>

The Commission's practice over thirty years has established an impressive record of considering and approving settlement agreements.<sup>14</sup>

2. The Commission may recommend nonunanimous settlement agreements based on its independent review of the record.

There is no requirement that settlement agreements be unanimous before they may form the basis of regulatory action.<sup>15</sup> The Commission has held that it

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<sup>13</sup> PRC Op. MC84-2, at 5 (Dec. 21, 1984). The Commission cited *Michigan Consolidated Gas Co. v. FPC*, 283 F.2d 204 (DC Cir. 1960), *cert. Denied sub nom Panhandle Eastern Pipeline Co. v. Michigan Consolidated Gas Co.*, 364 U.S. 913 (1960), and *Mobil Oil Corp. v. FPC*, 417 U.S. 283, 313-14 (1974) for the proposition that nonunanimous offers of settlement must be considered. PRC Op. MC84-2, at 5, n. 6. See also, PRC Op. MC79-4, at 3, 12-13 (Apr. 21, 1980). By far, the preponderance of federal judicial opinions reviewing settlement agreements arises out of litigation involving federal energy regulation (FERC and FPC). There is also significant caselaw at the state level involving utilities regulatory commissions. See, Stefan H. Krieger, *Problems for Captive Ratepayers in Nonunanimous Settlement of Public Utility Rate Cases*, 12 Yale J. on Reg. 257 (1995).

<sup>14</sup> The Commission has issued 17 Recommended Decisions adopting nonunanimous settlement agreements. See PRC Op. MC73-1 (Apr. 15, 1976); PRC Op. MC76-4 (Jan 12, 1977)(Concerning Zone-Rated Military Mail); PRC Op. MC76-4 (Jan. 12, 1977)(Concerning Mailings of Alaska Gold); PRC Op. MC 76-1 (Jan. 17, 1977)(Concerning the Elimination of Airmail from the Domestic Mail Classification Schedule); PRC Op. MC76-4 (Apr. 25, 1977)(Concerning Mailing of Maps and the Elimination of the Requirement that Special Rate Fourth Class Printed Educational Reference Charts Be Permanently Processed for Preservation); PRC Op MC76-1 (June 15, 1977)(Concerning Express Mail and Mailgram); PRC Op. MC79-4 (Apr. 21, 1980); PRC Op. MC84-2 (Dec. 21, 1984); PRC Op. MC91-2 (Nov. 22, 1991); PRC Op. MC 97-3 (Sept. 4, 1997); PRC Op. MC 97-4/C97-1 (Sept. 4, 1997); PRC Op. MC 99-1 (May 14, 1998); PRC Op. MC99-2 (July 14, 1999); PRC Op. MC99-4 (August 19, 1999); PRC Op. MC2000-1 (Feb. 3, 2000); PRC Op. MC 2001-1 (May 25, 2001); PRC Op. 2001-3 (Jan. 11, 2002). See also, Order Remanding Certified Settlement, Order No. 148, Docket No. MC76-4 (Jan 12, 1977).

<sup>15</sup> As the court stated in *Cities of Lexington, et.al v. FPC*,

may approve nonunanimous settlement agreements, pursuant to its rules, its obligation to consider offers of settlement under the APA, and its general responsibilities under the Postal Reorganization Act (Act).<sup>16</sup> In this regard, the Commission views its obligations under the Act as dictating its conduct in reviewing nonunanimous, and presumably unanimous settlement agreements.<sup>17</sup> The Commission has concluded that it may recommend settlement agreements, if it determines, based on the record as a whole, that they are supported by substantial evidence,<sup>18</sup> and that they conform to the substantive standards the Commission must apply in recommending rates and classifications under the Act. In Docket No. MC84-2, the Commission stated:

[T]he Commission encourages and welcomes settlement negotiations and settlement proposals. We do not believe, however, that a unanimous settlement proposal relieves this

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There is nothing in the Administrative Procedure Act which expressly requires unanimous consent of all the participating parties to an agreement of settlement; and to read such a contention into the statute in view of the countless state agencies, municipalities, and consumers who may be interested in an administrative proceeding would effectively destroy the settlement provision.

295 F2d 121.

<sup>16</sup> See PRC Op. MC84-2, at 4-6; PRC Op. MC79-4, at 3, 12-13; Order No. 148, Docket No. MC76-4, at 5-7. While the Commission acknowledges that the APA alone does not dictate its obligation to consider settlement offers on the merits (see PRC Op. MC84-2, at 4, and footnote 11, *supra*), it has concluded that its general obligations under the ratemaking scheme authorize it to adopt settlement offers as substantive proposals. *Cf. United Municipal Distributors Group v. FERC*, 732 F2d 202, 207, n.7 (DC Cir. 1984).

<sup>17</sup> All of the instances in which the Commission has adopted settlement agreements as its Recommended Decision appear to have involved nonunanimous agreements, in the sense that not all parties of record have been signatories to the proposed Stipulation and Agreement. See cases cited in footnote 14, *supra*. All of these settlement agreements, except one (Docket No. MC84-2), have been unopposed.

<sup>18</sup> Order No. 148, Docket No. MC76-4, at 5; PRC Op. MC73-1, at 7.

Commission of its statutory duty to recommend a classification schedule which is fair and equitable [citing 39 U.S.C. § 3623(c)(1)] and rates which recover the Postal Service's attributable and assignable costs of rendering that service. [citing 39 U.S.C. § 3622(b)(3)]

The Commission cannot discharge this responsibility unless it determines that the statutory criteria have been met. The Commission recognizes that, when it is considering a unanimous settlement, the record need not be as detailed as with contested proposals. [citing PRC Order No. 148, at 5-6] If parties with divergent interests can reach an agreement, there is a reasonable expectation that they have considered the statutory criteria for changing the mail classification schedule and establishing equitable rates. The Commission, however, has the duty to ascertain whether the record demonstrates that the statutory criteria are met by the proposed settlement.<sup>19</sup>

Furthermore, while the Commission has not yet adopted a settlement agreement in an omnibus rate proceeding, it has time and again reviewed nonunanimous agreements in mail classification proceedings, and adopted them as its Recommended Decision in the vast majority.<sup>20</sup>

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<sup>19</sup> PRC Op. MC84-2, at 12-13. (citing *Texas Eastern Transmission Corp. v. FPC*, 306 F2d 345, 354-57 (5<sup>th</sup> Cir. 1962), *cert. denied*, 375 US 941 (1963)).

<sup>20</sup> Stipulation and Agreements were offered for complete settlement in Docket Nos. R74-1 and R94-1. In both instances, the Commission concluded that it should not base its recommendations entirely on the agreements. Most recently, in Docket No. R94-1, the Commission concluded

that the record demonstrates a need to make significant revisions to the cost and revenue estimates to which the participants have stipulated. It also concludes that some significant revisions to the rates proposed by the Postal Service are required by the rate setting criteria enumerated in section 3622(b).

PRC Op. R94-1, at I-15. Unlike that case, where only two-thirds of the participants signed the Stipulation and Agreement, and several parties vigorously opposed objecting on a variety of issues, in the instant proceeding the vast majority of participants have agreed that the settlement proposals are supported by substantial evidence and conform to the policies of the Act. Furthermore, as we argue below, the settlement rates and classifications proposed in the instant

3. The Commission has afforded APWU a full opportunity to challenge the settlement proposals.

Notwithstanding the Commission's demonstrated predilection to afford parties objecting to settlement proposals the chance to challenge them in hearings, there is no categorical requirement that hearings be conducted.<sup>21</sup> In Docket No. MC84-2, the Commission considered a proposed nonunanimous Stipulation and Agreement supporting the Postal Service's Request that the Commission recommend elimination of E-COM from the DMCS. In that case, just as here, only one party, APWU, opposed. While APWU was permitted an opportunity to file a written opposition, no hearing was held. On brief, APWU argued that a nonunanimous settlement was not proper under the Commission's rules, and that an evidentiary hearing was necessary.<sup>22</sup> The Commission rejected both contentions. After reviewing relevant judicial opinions, the Commission considered each of APWU's substantive arguments and concluded that no hearing was required, basically because APWU had not raised an issue of material fact that needed to be explored in full hearings.<sup>23</sup>

In the instant proceeding, it would be possible to argue that APWU has again failed to challenge the factual basis of the settlement agreement sufficiently to require that it be given an opportunity to be heard through the full panoply of procedural rights normally exercised in an omnibus rate case. As discussed

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proceeding are fully supported on the record and do not conflict with any of the ratemaking criteria in the Act.

<sup>21</sup> See *New Orleans Public Service, Inc. v. FERC*, 659 F2d 509, 513 (5<sup>th</sup> Cir. 1981); *Rhode Island Consumers' Council v. FPC*, 504 F2d 203, 210 (DC Cir. 1974); *Pennsylvania Gas and Water Co. v. FPC*, 463 F2d 1250-51.

<sup>22</sup> PRC Op. MC84-2, at 3.

below, APWU's witness Riley repeatedly asserted reliance on the Postal Service's cost estimates, and he repeatedly emphasized that his testimony, rather, challenged the policy grounds for passing through avoided costs on which the proposed First-Class Mail presort and automation discounts were based. Notwithstanding the fact that his testimony suggested nonspecific differences of opinion regarding the accuracy of Postal Service costing,<sup>24</sup> we are confident that, even if his general observations were assumed to have some credibility, the Commission could easily conclude that the settlement agreement should be recommended, even assuming his vague factual allegations had some validity.<sup>25</sup>

In any event, in the instant proceeding, APWU has been given every opportunity to explore and assert its objection to the proposed settlement rates through discovery,<sup>26</sup> the filing of written direct testimony, oral testimony in open hearings, and an opportunity to challenge surrebuttal witnesses at hearings. Clearly, the Commission has met, if not exceeded, its responsibilities under applicable law and its own precedent to give APWU a full opportunity to challenge the rate and classification proposals agreed upon by virtually every other participant in this proceeding.

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<sup>23</sup> *Id.* at 5-11.

<sup>24</sup> Witness Riley did not open a new issue of fact in his remarks regarding Postal Service costing. This issue was squarely in play on the Postal Service's direct case, yet APWU did nothing to pursue it through discovery or cross-examination.

<sup>25</sup> In *Pennsylvania Gas and Water Co. v. FPC*, the court compared reliance on a nonunanimous settlement agreement in the absence of material factual issues to disposition pursuant to summary judgment in court. 463 F2d 1246.

<sup>26</sup> It is worth noting that APWU did not file a single discovery request to the Postal Service during the period reserved for that purpose in the procedural schedule.

4. The Commission should reject APWU's objection.

As we discuss at length below, APWU's challenge to the settlement agreement falls far short of providing persuasive reasons to abandon the nearly unanimous settlement agreement. The Commission may easily conclude from an independent review of the record that the rates embodied in the Stipulation and Agreement are fully supported by substantial evidence on the record taken as a whole, including Postal Service written testimony, exhibits, prefiled documentation, discovery responses, and oral testimony, and that the proposals are entirely consistent with the policies and provisions of the Act. Intervenors have also provided support in rebuttal to APWU's limited challenge.

It is imperative, however, that the Commission fully analyze and address APWU's objection, just as it has scrupulously afforded APWU a fair opportunity to present it. It is very clear that procedural due process is not alone sufficient to overcome objections to an otherwise uncontested settlement agreement. The agency must provide a detailed, well-reasoned explanation of the justification for adopting a settlement agreement over the opposition of one or more of the parties to its proceeding.<sup>27</sup> In this regard, we are very confident that the Commission can and will reject APWU's challenge and approve the otherwise uncontested Stipulation and Agreement.

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<sup>27</sup> See *Noram Gas Transmission Co. v. FERC*, 148 F3d 1158, 1162-65 (DC Cir. 1998); *Southern California Edison Co. v. FERC*, 162 F3d 116, 118-20 (DC Cir. 1998); *Laclede Gas Co. v. FERC*, 997 F2d 936, 947 (DC Cir. 1993).

D. The Commission Should Recommend the Settlement in Its Entirety.

Notwithstanding the Commission's authority and responsibility to conduct an independent review of the settlement proposals embodied in the Stipulation and Agreement, the Commission should have no reservation about recommending the entire settlement agreement, without departing from any of the specific proposals. The merits of the proposals, and the record support, provide sufficient justification for the Commission to recommend the settlement agreement in its entirety. It would be unrealistic, however, for the Postal Service to contend that the settlement proposals and the Postal Service's evidence would be endorsed by all of the signatories, in the absence of the extraordinary circumstances surrounding this proceeding. Every omnibus rate case is normally vigorously contested, and the Postal Service's proposals, methodologies, and testimony are frequently controversial. Nor would it be realistic to believe that the Commission will be persuaded in every instance that the settlement proposals could not be improved by the Commission, if this were a normal proceeding.

Fortunately, neither applicable law nor the practical circumstances facing the Commission and the participants would require those conclusions. There are several sound legal and practical justifications for adopting the settlement proposals without sacrificing either legitimacy or credibility. In other words, in light of both the legal and factual contexts of this proceeding, and the record taken as a whole, a Recommended Decision that incorporated the entire agreement would be reasonable and warranted.



1. Adoption of the entire settlement proposal is fully justified.

Apart from the merits of the proposals and the record support for them, there are independent reasons that militate strongly in favor of accepting the settlement agreement. First, Chairman Omas identified a key element of the motivation for settling when he implied that expedition toward resolving the Postal Service's immediate financial crisis, and avoiding the rigors of a typical ten-month rate proceeding, were important considerations. In fact, the efficient and expeditious termination of the case lies at the heart of the Postal Service's financial incentive to settle, since only by concluding the case early would the Postal Service be in a position to realize the substantial benefit of early implementation. Early implementation would make possible an infusion of new revenues in the current fiscal year, when, in light of the economic slowdown, falling volumes, and acute investment needs, they are critically needed. Similarly, the prospect of evading the time, expense, and uncertainty of a typical rate case was undoubtedly an important consideration for many of the settlement signatories. In this regard, courts have frequently recognized the validity of avoiding litigation time and expense as a powerful justification supporting approval of nonunanimous settlements.<sup>28</sup>

It would be difficult to speculate whether failure by the Commission to recommend all of the settlement proposals would lead to further litigation in the instant proceeding, but that is possible. One of the key conditions binding the

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<sup>28</sup> See *Id. at 947*; *Arctic Slope Regional Corp. v. FERC*, 832 F2d 158, 166 (DC Cir. 1987), *cert. denied* 488 US 868 (1988); *Pennsylvania Gas and Water Co. v. FPC*, 463 F2d 1247.

signatories to accepting settlement is that the Commission must issue a Recommended Decision that does not deviate from the rates, fees, and classification changes embodied in the Stipulation and Agreement.<sup>29</sup> While departure from the settlement terms in a small way might not cause the Governors of the Postal Service to refuse to approve the Recommended Decision, there could be potential for even a small deviation to unravel the carefully constructed consensus underlying the agreement. The Governors might feel the need to return the matter for reconsideration. Participants who have already sacrificed their opportunities to advance their own proposals, or to challenge aspects of the Postal Service's proposed rates, might assert due process arguments in court or before the Commission, and seek to pursue their own objections to the substantive outcome through further litigation.

At its worst, this development could be a significant setback to the promise of more flexible approaches to rate and classification litigation in the future. Settlement efforts have been an increasingly important element of the Commission's practice in recent years. Betrayed expectations from settlement in a case as important as the instant docket would be a serious blow to the future value of settlement to resolve important Postal Service initiatives.

Second, the extraordinary level of support for settlement in this proceeding cannot be ignored. Never in thirty years of Commission practice has there been so strong a consensus for settlement, and never before in an omnibus rate case have we come this close to unanimity in a major settlement effort. In fact, as

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<sup>29</sup> Stipulation and Agreement, ¶ 11.7, at 4.

noted by Chairman Omas at the Prehearing Conference, previously settlement of an omnibus case was almost unthinkable.

Fifty-six participants have agreed to bind themselves by the settlement agreement.<sup>30</sup> Other than APWU, no party not signing has opposed. This represents a higher percentage of agreement than achieved in the past in many cases where the Postal Service's proposals were relatively non-controversial.

Admittedly, extreme conditions played a dominant role in inducing the current level of support. It might never happen again. Nevertheless, all parties involved in the settlement in this case have learned important lessons about cooperation and willingness to compromise that could easily carry over into the future.

We acknowledge that the level of support in a settlement agreement is not a dispositive factor in review of agency decisions approving nonunanimous settlements.<sup>31</sup> Nevertheless, the Commission is entitled to rely on the absence of opposition to a settlement, and on level of support, as justifications for its adoption.<sup>32</sup> In the instant case, perhaps more than any other in the past, it would be warranted in doing so.

Finally, and perhaps most importantly, the Commission would be justified in concluding that a strong public interest in settlement in this case militates

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<sup>30</sup> Apart from APWU, only five parties have declined to sign. These include another postal union (National Postal Mailhandlers Union), three individuals (Douglas Carlson, Brad Eickholt, and David Popkin), and only one mailer association (Association of Priority Mail Users).

<sup>31</sup> *Noram Gas Transmission Co. v. FERC*, 148 F3d 1164-65.

<sup>32</sup> *Laclede Gas Co. v. FERC*, 997 F2d 946.

persuasively in favor of recommending the Stipulation and Agreement.<sup>33</sup> Clearly the national crisis resulting from the airline and anthrax attacks, and their effects on the Postal Service and this proceeding, stood in the forefront of Chairman Omas's concerns when he suggested settlement. In this regard, we will admit that the effects of major events are often complex and difficult to assess immediately, and hindsight might or might not confirm the seriousness of the current situation. There can be no doubt, however, that the national crisis and the health of the Postal Service were important influences on the willingness of the participants to settle. The future of the Postal Service's financial condition, moreover, is still largely in doubt. To a large extent, the importance of settlement is influenced by the type of speculations discussed above regarding the consequences, should the Commission not recommend all of the settlement proposals. We firmly believe, however, that such speculative considerations can be relied upon to support settlement approval, and that the public interest favors settlement in this instance. We submit, furthermore, that the Commission could exercise its authority in the Act to rely on factors other than those specifically enumerated to support its decision in this regard.<sup>34</sup>

2. Adoption of the Stipulation and Agreement as the Commission's Recommended Decision will not create binding precedent.

The nonbinding effect of the principles and facts embodied in the settlement proposals stands as a cornerstone of the Stipulation and Agreement. The signatories have agreed that, with respect to one another, by adhering to the

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<sup>33</sup> See *Arctic Slope Regional Corp. v. FERC*, 832 F2d 163-64, 166.

settlement, (a) they will not be bound by, or be deemed to have agreed to, any ratemaking or legal principle, methodology, or fact underlying the agreement, and (b) the agreement will not control any future proceeding.<sup>35</sup> As far as the Commission is concerned, furthermore, judicial precedent has recognized that the status of an agency decision as founded on a settlement agreement strictly limits its use as precedent in future proceedings.<sup>36</sup> Neither any party, nor the Commission, should therefore have any reservations about a Recommended Decision based on the entirety of the proposals in the Stipulation and Agreement.

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<sup>34</sup> 39 U.S.C. § 3622(b)(9). *Cf. Tejas Power Corp., et al. v. FERC*, 908 F2d 998, 1003-04 (DC Cir. 1990).

<sup>35</sup> Stipulation and Agreement, ¶¶ 9-10, at 6-7.

<sup>36</sup> *Kelly v. FERC*, 96 F3d 1482, 1489-90 (DC Cir. 1996); *Office of Consumer's Counsel v. FERC*, 783 F2d 206 (DC Cir. 1986).

II. Commission Recommendation of the Settlement Agreement Would Be in Accord with the Postal Service's Revenue Requirement and Relevant Post-Filing Events.

Even in normal circumstances, ratemaking under a complicated and lengthy litigation process tends to suffer from a growing gap between assumptions and reality, as actual results overtake projections during the litigation. The Commission must confront this phenomenon in every omnibus postal rate case. Increasingly, it has responded to the perceived need to update the record for actual developments as they unfold during each case. In the current case, we are presented with an unprecedented opportunity to achieve a settlement, precisely because of the seemingly imponderable gulf between the Postal Service's revenue needs, as projected prior to September 11, and what its probable needs might be shown to be, if the record were updated to confront reality. The prospect of meeting its statutory duties regarding the Postal Service's revenue needs under these conditions surely must give the Commission cause for serious concern.

As noted above, participants in Docket No. R2001-1 face an unprecedented set of circumstances. As the case was being developed, the financial fortunes of the Postal Service appeared to be on much more tenuous ground than they had appeared to be at the comparable stage of the last two rate cases. The five years of positive net income that had occurred between Fiscal Years 1995 and 1999 were receding into the past. The loss incurred in FY 2000 was certain to be followed by a materially larger loss in FY 2001. Yet, even as the Board of Governors approved the filing of Docket No. R2001-1, on September 11, 2001, things were about to get much worse. The attacks on our country that occurred later that morning, with their tremendous subsequent impact on all

aspects of American life, were followed in the next month by use of the mail to transmit anthrax, with tragic consequences particularly affecting the Postal Service.

In practical terms, the normal ten-month ratemaking exercise is simply not equipped to respond to changes in circumstances of this nature and magnitude. As described above, following the suggestion of the Presiding Officer, the parties chose to respond by pursuing a negotiated settlement agreement. This portion of the brief explains why recommendation of the settlement agreement appropriately resolves the revenue requirement issues created by this set of circumstances.

In any effort to assess the future financial needs of the Postal Service, such as that which falls under the general heading of “revenue requirement” in the rate case environment, a wide variety of potential factors require attention. Probably most prominent on that list, however, are expected trends in mail volume. The close relationship between a rate case revenue requirement and the corresponding volume forecast is obvious, as volume is a primary driver of both costs and revenues. In terms of both theory and practice, obtaining a volume forecast is the first step in preparing the revenue requirement. For purposes of most efficiently discussing the financial background of the Postal Service’s filing and the settlement agreement, this portion of the brief presents a combined discussion of volume forecasting, and then the broader revenue requirement issues.

A. The Volume Forecasts Included with the Postal Service’s Filing Are Predicated on the Well-Established Forecasting Methodology Employed in Previous Cases.

To obtain its test year volume forecasts in this proceeding, the Postal Service relied upon familiar expert witnesses employing familiar forecasting procedures. As in

the last several cases, the Express Mail and Priority Mail volume forecasts are presented in the testimony of Dr. Musgrave (USPS-T-9). Likewise, the volume forecasts for all other subclasses are once again presented in the testimony of Dr. Tolley (USPS-T-7), based largely on the econometric demand analysis presented in the testimony of his associate, witness Thress (USPS-T-8). In each instance, test year forecasts are based primarily on a careful examination of the markets in which mail services are offered, the factors which have explained mail volume changes historically, and the best available information as to how those factors are expected to change going forward. Such a forecasting procedure has in the past generally proven highly accurate in providing mail volume forecasts over the typical rate case time horizon.

One feature of the Postal Service's forecasting presentation that was new in this case was the separate testimony of witness Bernstein (USPS-T-10) addressing the impact of technological diversion on the Postal Service. While that subject was certainly not ignored in previous proceedings, witness Bernstein's testimony was an important part of the increased effort to actually integrate the expected impact of technological diversion into the test year forecasts. Jointly, witnesses Thress, Tolley, and Bernstein included available and projected information on expenditures on Internet Service Providers and Internet advertising as additional components of their First-Class and Standard Mail demand analyses and forecasts. Mr. Bernstein's testimony, moreover, shows why technological diversion due to innovations such as the Internet is likely to be a growing concern for the foreseeable future.

While the forecasting witnesses provided hundreds of pages of context and discussion, the actual volume forecasts are essentially summarized on page 5-6 of Dr.



Tolley's testimony in his Table 1. For each mail category, three figures are provided – volume in the four most recent quarters for which actual information was available (denominated as the Base Year, 2000Q4-2001Q3), volume in the test year (GFY 2003) assuming current rates (denominated as TYBR), and volume in the test year assuming implementation on October 1, 2002 of the Postal Service's proposed rates (denominated as TYAR). Table 1 shows that at the time of filing, the Postal Service was generally expecting relatively modest volume growth between the base period and the test year. Total domestic mail over the entire period was expected to grow a mere 4 percent TYBR, and only 2 percent TYAR. First-Class letter growth was projected to be even weaker, 1.5 percent TYBR and 0.5 percent TYAR. On a TYAR basis, Package Services volume growth was anticipated to be roughly commensurate with First-Class letters, while Priority Mail was essentially flat, and Express Mail and Periodicals were expected to decline. On the other hand, Standard Mail was projected to grow over 7 percent TYBR, and over 5 percent TYAR. Given that the forecast period over which these growth levels were contemplated to occur is in excess of two years, however, these figures show growth that cannot be considered robust in comparison with historical averages over the last two decades.<sup>1</sup> Anticipation of relatively weak volume growth, therefore, was certainly one contributing factor to the financial backdrop against which the Postal Service's decision to file Docket No. R2000-1 was set. In his revenue requirement testimony, witness Tayman paints a fuller picture.

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<sup>1</sup> To the extent that the growth levels implicit in Dr. Tolley's Table 1 are somewhat confusing because they cover the period between 2000Q4:2001Q3 and 2003Q1:2003Q4, a clearer picture may be obtained from the volume factor exhibits attached to the rollforward testimony of witness Patelunas (USPS-T-12, Exhibit 12A,

B. The Revenue Requirement Testimony of Witness Tayman Compellingly Documents the Postal Service's Need for Additional Revenue

The testimony of witness William P. Tayman, USPS-T-6, provides the basis for the Postal Service's revenue requirement of \$75.9 billion before rates in the test year (FY 2003), including a reasonable contingency and prior years' losses recovery. With revenue at current rates estimated for the test year at \$70.6 billion, that would leave a revenue deficiency of approximately \$5.3 billion. *Id.* at 11, 75. The Postal Service's revenue requirement was prepared before the catastrophic events of September 11, 2001, and the subsequent anthrax attacks on the postal system. As witness Tayman testified:

[T]he Postal Service has suffered from service disruptions in the wake of the September 11th attacks and anthrax contamination and infections. At the same time, the Postal Service is implementing significant additional budget cuts in an effort to offset revenue losses relating to unplanned, sharp decreases in the volume of mail. And new processes are also being developed to address bio-terrorism threats and to enhance the safety and security of mail and employees.

Tr. 11-C/4783.

Even before consideration of those events and their effects on costs and revenues, the testimony described the precariousness of the Postal Service's financial condition that existed prior to September 11th. The testimony begins with a summary of the Postal Service's thirty-year financial experience. This history, according to witness Tayman, "demonstrated that the combined pressures of providing universal service as an establishment of the federal

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pages 15-18). Those pages show the year-by-year forecasted changes between FY 2000 and FY 2003 (TYBR and TYAR).

government and the increasingly competitive nature of the markets in which the Postal Service functions make the congressionally-mandated goal of break-even extremely difficult to achieve.” USPS-T-6, at 3. He pointed out that the Postal Service has enjoyed only two periods of sustained net incomes. The most recent one began with FY 1995 and continued through FY 1999. Witness Tayman traced this “temporary period of financial success” to “the absence of additional obligations to the Federal Government, coupled with the benefits of the 1992 restructuring and debt refinancing, extremely moderate increases in the cost of labor and other resources, and healthy volume and revenue growth....” *Id.* At the time his testimony was being prepared, witness Tayman stated that this period was ending “due largely to escalating labor and energy costs and weak revenue growth.” *Id.* at 3-4. Without a rate increase, equity would drop to a negative \$6.1 billion, the lowest level in Postal Service history. *Id.* at 5.

In response to these projections, the Postal Service was planning to keep FY 2002 expense growth (3.2 percent) to the second lowest rate since Postal Reorganization in 1971, and FY 2003 before rates expense growth (4.1 percent) to a rate lower than that achieved in eight out of the previous thirteen years. However, the projected revenue growth rate for FY 2003 before rates was among the lowest growth rates in the period since FY 1990. *Id.* at 6.

Witness Tayman specified several other factors that indicated a gloomy financial picture, even before September 11. One was the rapid acceleration in the increase in unit personnel costs, which represent three quarters of postal costs. At 11.1 percent in FYs 2000 and 2001, the increase in these costs was almost double the 6 percent

increase in rates implemented in FY 2001. Coupled with the stalling of revenue growth, this indicated a deterioration in the Postal Service's financial condition. This deterioration was reflected in the Postal Service's negative equity position and the need to borrow for operating purposes in FY 2000, the first such borrowing since 1976. *Id.* at 7-8.

With respect to outstanding debt, both in absolute terms and as a percentage of the statutory debt limit, witness Tayman indicated that the Postal Service's debt is steadily increasing and will be uncomfortably close to the statutory limit in FY 2002. According to witness Tayman: "The debt trend points to the conclusion that the Postal Service is operating at a greater risk of financial illiquidity than it has at any other time in its financial history, except for the mid-1970's when a billion dollar bailout from the U.S. Treasury was required to restore the Postal Service's financial health." *Id.* at 8-9. Several other standard financial indicators demonstrated that the Postal Service's financial condition was deteriorating. *Id.* at 8-10.

Witness Tayman testified that recent unfavorable financial trends had resulted in the Postal Service's freezing of the various capital and infrastructure programs as a stopgap measure. He testified, however, that this situation could not be allowed to continue, because of the Postal Service's universal service obligations, and its need to serve its continually growing customer base, and to support its retail, delivery and processing networks. Witness Tayman pointed out that "each year the Postal Service provides service to approximately 1.7 million new delivery points, which ...[t]he Postal Service is obligated to serve ... whether or not volume grows commensurately and generates revenue to fund network growth." *Id.* at 46.

As summarized by witness Tayman, “the Postal Service’s losses are growing rapidly, equity is negative, cash flows from operating activities are insufficient to satisfy the Postal Service’s capital needs, and debt is uncomfortably close to the Postal Service’s statutory limit.” *Id.* at 45. Witness Tayman reiterated that “[t]he Postal Service is not relying on rate increases alone to restore its financial health.” He pointed to “extremely strong productivity performance in FYs 2000 and 2001, ...aggressive cost savings programs in FYs 2002 and 2003, and continued limitations on capital spending” as other means being pursued to bring costs and revenues closer to equilibrium. *Id.* at 47.

As part of its plan to restore the Postal Service’s financial health, the Postal Service’s revenue requirement included a 3 percent provision for contingencies and a provision for recovery of prior years’ losses. As witness Tayman explained: “These strategies should result in adequate funding to support operations, even in the face of unanticipated contingencies, and are designed create the ability to restore equity and make necessary capital investments.” *Id.* at 47. In addition to resuming the capital program at appropriate levels, recovering prior years’ losses, which can only occur if the contingency provision is adequate, will assist in retiring debt and restoring the Postal Service’s financial health. *Id.*

Postal Service management and the Board of Governors viewed the three-percent contingency provision as “reasonable and as the minimum amount that is necessary to address inherent uncertainties relating to the Postal Service’s projected financial status in the test year.” *Id.* at 46. Witness Tayman explained that “it also better

reflects the risky financial standing of the Postal Service than the smaller contingencies in Docket Nos. R94-1, R97-1 and R2000-1.” *Id.*

As witness Tayman testified:

The Postal Service’s 3 percent test year contingency provision implies that the Postal Service’s overall revenue and expense projections which forecast from an FY 2000 base year to an FY 2003 test year, must be at least 99.5 percent accurate (a 0.5 percent per year variance on average each for revenue and expense) in order for the contingency not to be fully consumed by adverse variances. This is a very tough standard.

*Id.* at 49. Twenty pages of the testimony were dedicated to providing a significant and comprehensive explanation of and justification for the 3 percent contingency provision included in the Postal Service’s revenue requirement. *Id.* at 47-67.

As to the desirability of the overall rate increase, witness Tayman testified that:

without the proposed rate increase, the Postal Service cannot meet the Board of Governors’ policy on equity restoration. Continued, high levels of borrowing would be required and would add significantly to interest expense. Without the proposed rate increase, the already limited capital program would have to be pared down further, undercutting the Postal Service’s ability to serve its growing delivery network, to invest in infrastructure, and to invest in future productivity improvements.

Operating at a loss over multiple years, further deferring equity restoration, curtailing investments in infrastructure, and borrowing for operations are not viable financial strategies. In light of the increasing additional costs, which I discuss below, and my financial projections for the Test Year, I conclude that the only prudent course of action is to increase Postal Service revenues through a general increase in rates.

*Id.* at 11. Overall, Mr. Tayman’s testimony leaves no doubt that the Postal Service’s need for requested additional revenue has been fully justified.

C. Adoption of the Settlement Agreement is the Appropriate Response to Post-Filing Developments.

None of the repercussions of the terrorist attacks were, or were able to be, factored into consideration of the state of the Postal Service's finances and its revenue requirement. Between September 11, when the Board of Governors approved filing of the request, and September 24th, when the case was filed, witness Tayman noted that "the tragic events unfolding as this testimony is finalized will undoubtedly have economic consequences, the magnitude of which cannot be easily predicted" and he noted that "[t]hese events and their repercussions are certain to create an even higher level of economic uncertainty and fragility than existed just two weeks ago." *Id.* at 48. Following the anthrax attacks, witness Tayman stated that "[t]est year finances will be adversely impacted. " He explained that "[w]hile the impact will undoubtedly be severe, it is premature to say at this point how much worse the financial picture will be and how it will be addressed." Response of Witness Tayman to Interrogatory NAA/USPS-T6-7 (November 6, 2001). In response to another question, he noted that the Postal Service was "suffering sharply and immediately from a revenue slowdown, and has experienced little, if any, net palpable benefit from reduced inflation." Tr. 11-C/4577.

The revenue slowdown to which Mr. Tayman referred was the inevitable result of the major drop off in postal volumes that became even more abundantly obvious following the anthrax contamination in October. During subsequent hearings on his testimony, Dr. Tolley was able to give some perspective on the relative magnitude of the underlying volume decline. Dr. Tolley was called upon to attempt to quantify what he had characterized (Tr. 2/126) as actual mail volumes "substantially" below volumes

forecasted earlier. He explained that preliminary figures suggested a volume shortfall of five to six percent for the first quarter of the fiscal year. Tr. 2/143, 157-161.

These events and concerns provided the context in which settlement discussions were conducted. The successful results of those discussions reflect consensus about the need for implementation of new rates in advance of the beginning of the test year, to provide an infusion of revenue at a time of an unprecedented challenge for the postal system against the backdrop of serious economic uncertainty. Furthermore, no party challenged the revenue requirement implications of the settlement agreement. While the APWU may have offered some comment on the situation in the testimony of its witness Riley, the APWU challenge to the settlement was explicitly limited to the issue of proposed discounts exceeding avoided costs. Notice of Opposition of the American Postal Workers Union, AFL-CIO (Jan. 15, 2002).

Moreover, the widespread acceptance of the settlement concept reflects recognition of the serious drawbacks associated with any apparent alternative. For example, as noted by the Presiding Officer at the Prehearing Conference (Tr. 1/41), attempting to ignore post-filing events and fully litigating the case as filed would in all likelihood have created the need for the Postal Service to prepare and file a trailing request for yet higher new rates immediately upon completion of the instant case. Alternatively, attempting to incorporate reasonable updates into the proceeding may not have provided any more satisfactory result. In circumstances in which time is of the essence, comprehensive updating had the potential to seriously delay proceedings, rather than expedite them. That is particularly the case when, as here, the ability to acknowledge the existence of changed circumstances substantially precedes the ability



to identify exactly what those new circumstances are, or what their consequences for the future might be. In practical terms, little confidence could be expected that any hastily-assembled update would have been substantially less likely to be overtaken by subsequent events than the original filing. And, as the Presiding Officer also hinted, the prospect of updating can not be disassociated from the possibility of higher rates as a result.

The parties that have signed the settlement have agreed that the Postal Service's testimony and documentation provides the requisite evidentiary foundation for the settlement rates. Implicitly, that includes the Postal Service's volume forecasts and revenue requirement. In light of the overwhelming support for the settlement agreement, and in the absence of any explicit challenge to those portions of the settlement, the Commission should likewise rely on the Postal Service's volume forecasting methodology and revenue requirement to support recommendation of the settlement rates.

III. The Postal Service's Subclass Costing Presentations Provide An Appropriate Foundation for Recommendation of the Settlement Rates

The bedrock of postal ratemaking has been and remains the estimation of subclass costs. Section 3622(b)(3) requires each subclass to cover the costs caused by the provision of that service. Accurate subclass costing allows compliance with this requirement of the Act, improves forecasts of accrued costs in future periods, and creates a framework against which subclass revenues and the allocation of institutional costs resulting from the pricing process can be evaluated. Much of the Postal Service's evidentiary presentation in this proceeding, consisting of the testimony of numerous witnesses as well as extensive supporting documentation, is devoted to the development and explanation of appropriate subclass costs. This body of material constitutes a comprehensive foundation of cost information that, in conjunction with the pricing analyses addressed subsequently in this brief, supports the rates included in the Stipulation and Agreement.

The Postal Service's subclass costing presentation in this case closely parallels similar costing presentations made in numerous previous rate cases. It begins with the monumental amount of information collected and processed through the Postal Service's extensive data collection systems. That body of information is first used to estimate the costs for each subclass in the base year. Base year subclass costs, in turn, are then employed in the rollforward process to derive estimates of subclass costs in the test year. The testimonies and other documentation relating to each of these portions of the subclass costing process are described below.

### III-2

#### A. The Postal Service's Case Appropriately Rests Upon Extensive and Reliable Historical Information Provided by Its Well-Established Data Collection Systems.

Postal Service legacy data systems provide detailed cost, volume and characteristic information regarding mail in various mail categories. These ongoing data systems provide high quality information used to support business decisions made by the Postal Service on an ongoing basis, as well as rate and classification decisions made by the Commission and the Governors of the Postal Service.

The In-Office Cost System (IOCS) provides an accurate basis to distribute the in-office labor costs of various postal employees to mail categories. Testimony on the IOCS was presented by witness Shaw (USPS-T-1). He describes the IOCS sample design, data collection methodology, data validation, and types of IOCS estimates and their reliability. Substantial record evidence supports the continued use of IOCS data in this proceeding.

Similarly, the Transportation Cost System (TRACS) accurately distributes base year purchased mail transportation costs to mail categories. Information regarding TRACS was presented in the testimony of witness Xie (USPS-T-2). Dr. Xie identifies and explains the five TRACS subsystems: Highway, Freight Rail, Passenger Rail (AMTRAK), Commercial Air, and Network Air. For each of these, she covers design, types of estimates, and the estimates themselves and confidence limits. Substantial record evidence supports the continued use of TRACS data in this proceeding.

The Revenue, Pieces and Weight System (RPW) provides reliable measures of revenue, pieces and weight totals for the major mail categories in the base year.

Although RPW data obviously have many other applications in the ratemaking process, they are used in costing to distribute certain base year costs, and in the rollforward procedure as the base from which mail volume effects are projected. Testimony regarding RPW was provided in this case by witness Pafford (USPS-T-3), and witness Hunter (USPS-T-4). Witness Pafford explains the Domestic RPW System (DRPW), which, with four exceptions, consists of a continuous probability sampling of mail exiting the system. The four exceptions: registered, insured, Collect on Delivery (COD), and Certificates of Mailing (COM), are instead sampled continuously as they enter the system. Witness Hunter explains the Bulk RPW System (BRPW), which reconciles information collected from bulk mailing statements with revenue accounts. Witness Pafford describes the RPW Adjustment System (ARPW), which combines DRPW and BRPW results into final totals of revenue, pieces and weight. Finally, witnesses Pafford and Hunter also provide reliability measures for the RPW estimates of totals provided in their tables. The RPW measures have been continuously relied upon by the Commission and the Postal Service in omnibus ratemaking proceedings, and the record of this case supports their continued use.

As the testimony of Postal Service witness Harahush (USPS-T-5) demonstrates, the data produced by the City and Rural Carrier Cost Systems (CCCS and RCCS) provide a reliable basis for the distribution of volume variable carrier costs underlying the Postal Service's Request and the settlement agreement. Mr. Harahush describes each data system, the methods for data collection in each, and the uses to which the data are put. He also provides reliability measures for all major estimates. USPS-T-5 at 4-22. The CCCS and RCCS data have been continuously relied upon by the

Commission and the Postal Service in omnibus ratemaking proceedings, and the record of this case supports their continued use.

B. The Postal Service's Base Year Presentation Represents a Reasonable Allocation of Costs to Subclasses Based on Sound Economic Principles and Analysis.

Generally using the information provided by the above-described data collection systems, the base year for costing purposes employed in this proceeding was FY 2000, the most recent year for which an audited Cost and Revenue Analysis (CRA) report is available. In presenting its base year costs, the Postal Service seeks to address two distinct levels of subclass cost causation -- the causation of costs at the margin, and the incremental costs caused by provision of the entire volume of a particular subclass or service. This formulation of the subclass costing inquiry follows the economic structure presented by Prof. Panzar in his testimony (USPS-T-11) in Docket No. R97-1, and is consistent with the structure used by the Postal Service in that case and in Docket No. R2000-1. Such an explicit economic structure was most recently endorsed by the Governors of the Postal Service in their first Decision in Docket No. R2000-1, dated December 4, 2001.

In this proceeding, the causation of costs at the margin is reflected in the volume variable subclass costs estimates provided by witness Meehan in USPS-T-11. Incremental cost estimates, on the other hand, are presented by witness Kay in USPS-T-21. In their exhibits and workpapers, both of these witnesses provide subclass information for the cost segments and components into which postal costs are disaggregated. Their overall subclass results, by virtue of the cumulative process by which they are constructed, incorporate both the effects of the base year input data

generated by the relevant upstream data collection systems, and the conclusions reached by a substantial body of current and past research into the behavior of specific cost segments and components. As discussed next, in their testimonies in this proceeding, several witnesses sponsored those new analyses that caused the relatively modest changes in the Postal Service's base year costing methodologies.<sup>1</sup>

As in the last proceeding, witnesses Van-Ty-Smith and Bozzo present testimony on the appropriate treatment of mail processing costs. The testimony of witness Van-Ty-Smith (USPS-T-13) again documents the mechanics of the procedures by which cost pools are created for mail processing operations, and the relevant costs are then distributed to subclasses. It also documents other additional analyses of IOCS data that are the source of inputs into the base year subclass cost presentation, or into other cost studies. As indicated in her testimony, most of the procedures she employs are the same as those used in Docket No. R2000-1, and are merely updated to reflect base year input data. Also included, however, are several minor modifications which, although not conceptual changes, improve the application of the procedure to account for changes in operational reality. These include new treatment of special delivery messenger costs and International Service Center costs, splitting the BCS cost pool that was formerly for all barcode sorters into two cost pools for delivery barcode sorters and

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<sup>1</sup> One change mentioned explicitly in the testimony of witness Meehan and running through all of the Postal Service's subclass costing presentations in this case is the combination of the reported costs for several preferred mail categories. See USPS-T-11 at 4. As a result of the amendment of title 39 by Public Law 106-384, for certain preferred subclasses for which costs previously were reported separately, the costs have now been aggregated to allow consistency with application of the new statutory procedures.

all other barcode sorters, extending the treatment of certain costs associated with clocking in/out, and refining the premium pay procedures to better align that adjustment with its original purpose.

The testimony of witness Bozzo (USPS-T-14) again provides appropriate econometric estimates of the volume variabilities for a subset of the mail processing cost pools. Essentially, Dr. Bozzo's work represents an update of the analyses that he presented in his testimony in the last case. As well as incorporating more recent data, he has conformed his cost pools to those currently used by witness Van-Ty-Smith, corrected some technical errors identified near the end of Docket No. R2000-1, and implemented several minor refinements to his methodology. In addition to presenting the variabilities he has estimated, Dr. Bozzo's testimony also includes substantial explanation of why his methodology continues to be appropriate, notwithstanding criticism advanced in the last case by opposing parties and the Commission. He demonstrates why those criticisms are themselves without merit. (Along the same lines, the Postal Service's operations witness Kingsley likewise discusses some of the possible misinterpretations of her previous testimony with regard to the operational basis supporting a conclusion of volume variabilities less than 100 percent. In section III of her testimony, USPS-T-39, she provides specific examples of mail processing costs that are primarily driven by factors other than volume.)

Although the Postal Service's presentation on mail processing costs remained relatively unchanged compared with the last case, the same cannot be said for city carrier costs. In the last case, the Postal Service offered city carrier analyses based on an entirely new source of information regarding carrier operations. Because the

Commission rejected the fundamental utility of that information for ratemaking purposes, however, the Postal Service in this case abandoned any effort to rely upon it. Instead, as explained by Dr. Bradley in his testimony (USPS-T-16), the Postal Service in this case essentially adopted the “established” model of city carrier costing, as described by the Commission in Docket No. R2000-1. Thus, while this methodology represents some departure from the Postal Service’s most recent city carrier cost analysis, it is certainly not new to postal ratemaking. The Postal Service has employed this approach because the Commission has made clear its belief that the “established” model makes best use of the existing data. Dr. Bradley’s testimony, however, also included a thorough discussion of the principles that should guide future efforts to collect and analyze cost and operational information that will improve on the existing city carrier data and models. In addition, Dr. Bradley explained why the Postal Service continues to treat single subclass costs as incremental access costs.

The testimony of witness Smith (USPS-T-15) represents another instance in which the witness essentially updates his work from the last case. Mr. Smith, as he did in Docket No. R2000-1, develops inputs for the estimation by subclass of volume variable equipment and facility-related costs. His analysis in this respect includes certain costs from Cost Segments 11, 15, 16, 18, and 20. He also provides piggyback factors, and calculates labor and indirect mail processing costs by shape, by cost pool. In all of these endeavors, Mr. Smith uses methods similar to, or the same as, he used in Docket No. R2000-1.

The attribution and distribution of purchased transportation costs is an area in which very careful distinction must be made between the base year and periods



subsequent. In the base year (FY 2000, as noted above), the transportation services purchased by the Postal Service closely resembled the similar services purchased in previous years. As a consequence, in the base year, the Postal Service's treatment of purchased transportation costs is essentially the same as the treatment afforded such costs in the last rate case. Witness Pickett (USPS-T-17) sponsors a variety of analyses which provide some of the inputs for that treatment. Other transportation analyses, also based on methodologies unchanged from previous years, can be found in the base year workpapers of witness Meehan. While these base year purchased transportation costing procedures remained relatively constant, however, as discussed below, the contract with Fed Ex had material effects on the rollforward process and subclass costs in years subsequent to FY 2000.

C. The Postal Service's Test Year Subclass Cost Estimates Constitute an Appropriate Extension of Base Year Costs

In developing this case, as with previous cases, the Postal Service started with base year costs and used the rollforward process to estimate for the test year both total accrued costs and costs by subclass. Witness Patelunas was the rollforward witness, and the total accrued and subclass volume variable cost estimates presented in his testimony (USPS-T-12) are developed in a process that follows the very familiar pattern of previous pieces of rollforward testimony.<sup>2</sup> That is to say, various factors are applied to the base year costs in order to arrive at estimated test year costs. Those factors, which have remained unchanged for many years, are cost levels, mail volumes,

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<sup>2</sup> In the instance of incremental costs, witness Kay actually provides both base year and test year incremental costs. In providing her test year estimates, however, she relies extensively on the same inputs as those used by witness Patelunas.

nonvolume workload, additional workdays, cost reduction programs, and other programs. Also incorporated into the analysis are Workyear Mix Adjustments and Final Adjustments.<sup>3</sup> As is customary, witness Patelunas provided test year costs on both a before-rates (TYBR) and an after-rates (TYAR) basis.

One significant complication in the estimation of test year costs in this case was incorporation of the expected effects of implementation of the FedEx transportation contract late in FY 2001. As a result of this operational change, prior procedures employed by the Postal Service and the Commission to treat costs incurred under previous transportation arrangements are no longer applicable. Consequently, unlike virtually any other aspect of postal costing procedures, simple reliance on the status quo methodology was not and is not an option with respect to those costs affected by the new FedEx contract.

Therefore, in the only portion of its subclass costing presentation even remotely approaching a substantially new analysis, the Postal Service presented the testimony of several witnesses to explain the proposed treatment of the costs associated with the FedEx contract. Witness Spatola (USPS-T-20) provided background on the overall objectives of the new transportation agreement, as well as operational details of the day-turn and night-turn networks. Witness Takis (USPS-T-19) provided a theoretical analysis of the appropriate economic treatment (i.e., based on cost causality) of various costs associated with the new contract, including start-up fees, the day-time network,

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<sup>3</sup> Some of the Final Adjustments used by witness Patelunas come from witnesses Eggleston (USPS-T-25), Nieto (USPS-T-26), Kiefer (USPS-T-33), and Schenk (USPS-T-43).

the night-time network, third-party ground handling costs, several other miscellaneous costs, and the costs relating to termination for convenience of the previously-existing transportation arrangements supplanted by the new regime. For reasons fully explained in his testimony, in accord with the same economic theory which governs treatment of the current transportation costs, Mr. Takis concludes that certain of these costs should be treated as volume-variable, and others should be treated as institutional. Consistent with this testimony of witness Takis, witness Hatfield (USPS-T-18) calculates, explains, and documents the actual purchased transportation rollforward adjustments necessary to reflect the implementation of the FedEx agreement, and provides those to witness Patelunas for incorporation into his comprehensive rollforward presentation.<sup>4</sup>

Thus, in its case as filed, the Postal Service presented fully-integrated subclass costs estimates for the test year based on the best information available at the time of case preparation. As is often the case, those estimates reflected a wide variety of management plans and programs intended to improve the performance of the Postal Service moving into the future. Moreover, in both the before-rates and after-rates versions, the estimates were predicated, obviously, on the levels of mail volume

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<sup>4</sup> Somewhat related to the testimony of the witnesses addressing the consequences of the implementation of the FedEx agreement was the testimony of witness Cochrane (USPS-T-41). The purpose of his testimony was to describe past, current, and future Priority Mail operations. With respect to transportation, those operations were affected by the FedEx contract. With respect to other functions, however, they were much more affected by the termination of the previous PMPC agreement with Emery Worldwide. During FY 2001, the Postal Service resumed responsibility for handling the Priority Mail operations previously handled by Emery under the PMPC contract. In USPS-T-41, Mr. Cochrane walks through the anticipated evolution of all aspects of Priority Mail operations, in light of these and other operational developments.

anticipated under the current and proposed rate regimes. Witness Moeller, the rate policy witness (USPS-T-28), then used the test year cost estimates provided by witnesses Patelunas and Kay, in conjunction with the pricing criteria of the Act, to support the rate levels proposed by the Postal Service and presented in his testimony.

D. The Subclass Cost Estimates Filed with the Case Still Constitute a Viable Base to Support the Settlement Rates.

The above discussion summarizes the subclass costing presentation included with the Postal Service initial filing. Subsequent developments since then, however, merit some discussion as well. Specifically relevant to these matters are the external events that triggered the groundswell of support for the Chairman's suggestion of a negotiated settlement of the case, and the procedural consequences of such an agreement.

Starting with the well-known tragic occurrences of last fall, logic suggests that some of the fallout of those events is likely to have an impact on actual test year subclass costs. As noted in the earlier discussion of settlement and revenue requirement issues, for purposes of postal ratemaking, the most significant deviation between expectations that seemed reasonable in early September and expectations that seem more likely some months later would be in the area of anticipated mail volumes. The test year costs generated by the rollforward are predicated on forecasts of generally slight, but positive, changes in the levels of expected mail volume. Currently, however, expectations of slightly positive volume growth have been replaced by the stark reality of volume losses in the near term likely to be of a magnitude unprecedented in the history of the Postal Service. These will certainly have an effect

on overall subclass cost levels, as lower volumes presumptively generate lower total costs. Less clear, however, are any necessary changes in *unit* subclass costs. Mere changes in mail volume could leave unit subclass costs relatively unaffected.

Of course, other occurrences since the September filing beyond mere diminution in expected volumes are likely to influence test year subclass costs. Without any comprehensive updating exercise, however, it is difficult to speculate exactly what the effects of these factors might be. (Indeed, it is not even clear that all of the factors in play could readily be identified.) Broadly speaking, however, it seems reasonable to postulate that these factors will generally tend to affect the costs of all subclasses equally. For purposes of ratemaking, therefore, the relative unit subclass cost levels – which in many respects are the most important cost measures for setting rates – should retain most of their vitality. In this sense, the test year subclass cost estimates filed with the case by the Postal Service still provide an adequate foundation for Commission recommendation of the settlement agreement.

Obviously, of course, that conclusion is dramatically reinforced by the context of the settlement agreement in which these matters are being considered. The parties have recognized that the tremendous uncertainty generated by the events of last fall would have made comprehensive updating a daunting task, at best. Moreover, at a time when the Postal Service faces legitimate cash flows issues, attempting to conduct an update, or even trying to fully litigate the normal panoply of rate case issues (including subclass costing issues), would seem to have been counterproductive. The parties have therefore agreed to stipulate that the materials filed by the Postal Service provide substantial evidence for establishing the negotiated settlement rates. Implicitly,

that provision of the agreement encompasses the Postal Service's subclass costing presentation. (In fact, even the party that has opposed the settlement, the APWU, has not challenged reliance on the Postal Service's subclass cost estimates.)

The parties, of course, have made this agreement with the intent and the understanding that no aspect of the evidence that they have endorsed will be construed to have a precedential effect in subsequent proceedings. In other words, even though they have agreed that the Postal Service's costs are adequate to support the settlement rates, they expect that (under the assumption that the Commission adopts the settlement) any new methodologies upon which those costs are based and upon which the Postal Service intends to rely in the future would still have to be fully supported in the next case as if the settlement agreement had not occurred. The parties' opportunity to challenge those methodologies has merely been postponed, not abandoned. The Postal Service embraces this aspect of the settlement agreement, and recognizes that it constitutes a critical element of the compromise by which parties were able to move forward on this unprecedented attempt to accelerate fair and equitable resolution of the case.

Moreover, as noted in the course of the above discussion, even in the abstract, this particular case would have been a good candidate for substantially less controversy in the area of subclass costing than normally is the case. Primarily because of the extremely short time interval between the close of Docket No. R2000-1 and the commencement of preparations for Docket No. R2001-1, the Postal Service's costing presentation in this case was the least ambitious in years. The only truly novel proposal in subclass costing involved the FedEx contract, and what gave rise to that issue was

not a discretionary determination to modify the existing methodology, but a change in operations that rendered the primary application of the existing methodology obsolete. In addition, while the volume variability of mail processing probably remains a contentious issue, the Postal Service's testimony in this case did not rely on any new analytic procedures that would have materially expanded the parameters of that debate. City carrier issues, on the other hand, hardly even made it onto the radar screen. As a consequence of this relatively low profile, subclass costing issues overall received substantially less interest in discovery than they had in previous proceedings. These considerations provide further assurance that concerns about subclass costing matters should not hinder the Commission's ability to accept the proposed settlement agreement as the appropriate resolution of this case.

#### E. Summary

The Postal Service's filing included all of the material normally provided in support of the subclass cost estimates underlying proposed rates. Relatively modest changes in costing procedures were explained in testimony, and all methodologies were fully documented. Notwithstanding the change in circumstances since last fall, the parties, as part of a negotiated settlement, have agreed that the Commission should for purposes of this proceeding accept this material as adequate evidentiary support for the settlement rates. The Postal Service urges the Commission to do so, with the understanding that such action will have no effect on any entity's ability to contest the underlying costing issues in future proceedings.

- IV. The Settlement Rates And Classification Changes Are Supported By Substantial Record Evidence And Represent The Optimal Solution For The Postal Service, Participants, And The Commission.
- A. The Rate Levels Proposed By The Postal Service For Each Subclass Of Mail Reflect An Acceptable Application Of The Relevant Statutory Criteria.

In the two-tier postal ratemaking process established by Congress, pricing follows costing as the second tier. The cornerstone of the pricing exercise, the rate policy portion, is to apply the pricing criteria in 39 U.S.C. § 3622(b) to determine how much total revenue to seek from each subclass, in excess of the costs determined to be caused by that subclass during the first-tier costing process, to allow the Postal Service to achieve financial breakeven.<sup>1</sup>

In this docket, as in previous cases, the Postal Service has provided a rate policy witness to explain why the rate levels proposed for each subclass and service are in accord with the statutory factors that guide the pricing process. The rate policy witness in the instant case was Joseph Moeller.<sup>2</sup>

Careful review of witness Moeller's rate policy testimony (USPS-T-28) will reveal that his rate level proposals rest on evaluations of the statutory factors that are very similar to those employed by his predecessors. Nothing he has done constitutes a major departure from the types of analyses relied upon in the past by both the Postal

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<sup>1</sup> After rate policy issues are resolved and a target revenue has been set for each subclass, rate design is the subsequent pricing task necessary to determine how to split that revenue burden among the various rate categories and rate elements of the subclass.

<sup>2</sup> Docket No. R2001-1, Direct Testimony of Joseph Moeller On Behalf of United States Postal Service, USPS-T-28.



Service in developing its rate proposals, and by the Commission in recommending rates to the Governors.

The Postal Service has once again provided additional analyses with its filing in this case which enhance the Commission's ability to fulfill its statutory mission. The analyses produce comprehensive sets of incremental costs<sup>3</sup> and economically-efficient (or Ramsey-based) prices.<sup>4</sup> Taking account of these analyses, witness Moeller has proposed rate levels that meet all of the relevant statutory criteria in a reasonable and rational fashion.

To achieve the purposes of the Stipulation and Agreement, the parties in Docket No. R2001-1 have forged an unprecedented consensus to forgo the usual robust debate about institutional cost allocation. The settlement proposal includes deviations from the originally requested rate design for First-Class Mail, Periodicals, Standard Mail, and Package Services. Tr. 13/4966. Nevertheless, even the one opponent to settlement, the American Postal Workers Union, AFL-CIO, does not explicitly challenge witness Moeller's inter-subclass institutional cost allocations.<sup>5</sup> In his surrebuttal testimony, witness Moeller noted that the slight changes in rates embodied in the settlement proposal do not "materially alter the rate levels for the various subclasses, or

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<sup>3</sup> Docket No. R2001-1, Direct Testimony of Nancy Kay On Behalf of United States Postal Service, USPS-T-21.

<sup>4</sup> Docket No. R2001-1, Direct Testimony of Peter Bernstein On Behalf of United States Postal Service, USPS-T-10.

<sup>5</sup> However, APWU witness Riley did propose such high rate increases for some First-Class Mail rate categories as to imply an unspecified increase in the cost coverage for the subclass.

the relationships among them.” *Id.* at 4973. Even within First-Class Mail, the differences between the original and the stipulated rate design barely affect the implicit intra-class cost coverages for single-piece and workshare mail. *Id.* at 4973.

For purposes of Docket No. R2001-1, the settlement parties have agreed to accept witness Moeller’s institutional cost allocations as fair and equitable, and as otherwise demonstrating appropriate consideration of the ratemaking policies in section 3622(b) and elsewhere in the Postal Reorganization Act. These intervenors do so under the terms of the Stipulation and Agreement, without prejudice to their right to contest his analysis and results in future proceedings.

The cost coverages proposed by witness Moeller represent a fair and equitable allocation of institutional costs. He took into account the Commission’s Docket No. R2000-1 institutional cost distribution<sup>6</sup> and relevant statutory criteria. He analyzed each specific subclass and ensured that the requested institutional cost contributions of the various subclasses were fair and equitable in comparison to each other. The result of his analysis is an allocation of institutional costs which treats mailers and competitors fairly, takes into account the unique characteristics of each subclass, and allows the Postal Service to meet the needs of the mailing public. Accordingly, the Postal Service urges the Commission to rely on the proposals advanced by witness Moeller in developing its opinion and recommended decision.

B. The Express Mail Settlement Rates And Classification Changes Should Be Recommended.

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<sup>6</sup> As modified by the Governors of the Postal Service.

The Postal Service's proposed rates and classification changes for Express Mail, which are incorporated into the settlement agreement without amendment, are reasonable, well-founded, and consistent with prior Commission recommendations and all statutory criteria. Further, there is substantial evidence in the record to support this settlement as it relates to Express Mail.

As explained by witness Mayo (USPS-T-35), the Postal Service has proposed moderate rate adjustments averaging 9.4 percent. These adjustments are designed to meet the system-wide increase of 8.7 percent and range from 3.5 percent to 13.8 percent. Consistent with prior accepted rate design for Express Mail, witness Mayo initially designed the Post Office to Addressee rate, and rate differentials were applied across-the-board to arrive at the proposed Post Office to Post Office and Custom Designed rates. USPS-T-35 at 28. The proposed rates were designed to eliminate the current inconsistency from one Express Mail rate to another, and to promote a consistent flow. *Id.* The Express Mail settlement rates are accordingly supported by substantial record evidence.

Three classification changes were proposed. The first would tie the flat-rate envelope rate for Express Mail to the half-pound rate. Currently, the Express Mail flat rate is tied to the one-pound rate. Witness Mayo testified that by aligning the flat-rate with the lowest Express Mail rate (half pound), users of the flat-rate envelope would actually realize a savings. Furthermore, having to provide only one flat size envelope (currently there are separate flat-rate envelopes for Post Office to Post Office, and Post Office to Addressee) would avoid confusion over which envelope to use for lighter

weight shipments. USPS-T-35 at 24. She testified that the proposal would also enable the Postal Service to produce one less envelope, thereby benefiting both the customer and the Postal Service (Criterion 5). *Id.* Overall, the proposed classification change would promote a fair and equitable classification system for Express Mail (Criterion 1). *Id.* The classification change is thus in accord with the statutory criteria and should be recommended.

Witness Mayo testified in support of the second proposed classification change, which would reduce the level of insurance for Express Mail from \$500 to \$100. This change would bring the Postal Service in line with industry practice, given that other major providers limit liability to \$100 for their next day products. USPS-T-35 at 25. Additionally, the proposed change would more closely reflect the level of claims the Postal Service has experienced. For example, in FY 2000, Express Mail document reconstruction insurance claims averaged \$68. *Id.* The proposed change would not, however, prevent customers from purchasing additional insurance, if they elected to do so. The Postal Service has supplied compelling evidence in support of this proposal, and it merits recommendation by the Commission.

Finally, the Postal Service proposed to amend language in the Domestic Mail Classification Schedule (DMCS) related to Express Mail refunds.<sup>7</sup> The expanded list of limitations to the service guarantee was intended to address rare circumstances beyond the control of the Postal Service in which Express Mail customers would not be entitled

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<sup>7</sup> Through rulemaking, the Postal Service is proposing to limit the invocation of many of the new refund limitations to decisions made by Headquarters. See 67 Fed. Reg. 4562, 4578 (Jan. 30, 2002). This measure will further promote uniformity and consistency in

to a refund. Furthermore, the classification change was intended to standardize the guarantee among Express Mail products, which would enhance consistency and promote uniformity in product identity. USPS-T-35 at 27. Finally, the proposed refund limitations would be more consistent with service guarantees offered by other providers.

*Id.* In sum, the evidence underlying this proposal is compelling, and this change should be recommended.

C. The Priority Mail Rates and Classification Changes Proposed by Postal Service Witness Scherer, and Incorporated in the Settlement Agreement, are Fully Supported By Substantial Evidence.

In his written direct testimony, Postal Service witness Thomas M. Scherer (USPS-T-30) proposed a new schedule of Priority Mail rates designed to meet the cost contribution objectives established by witness Moeller. Under witness Scherer's proposal, the current one-pound rate for Priority Mail would increase from \$3.50 to \$3.85, and most other Priority Mail rates also would increase. The average proposed increase for Priority Mail as a whole is 13.5 percent. USPS-T-30 at 11.

Along with these rate changes, witness Scherer also proposed to alter the rate design for Priority Mail by introducing zoned rates for the currently unzoned 2 to 5 pound weight increments. In addition, Mr. Scherer proposed a classification change that would tie the rate for Priority Mail flat-rate envelopes to the one-pound Priority Mail rate, rather than to the two-pound rate. Finally, Mr. Scherer proposed new fees for on-call and scheduled Priority Mail, Express Mail and Parcel Post pick-ups. USPS-T-30 at 4.

(..continued)  
refund administration.

As discussed below, witness Scherer's testimony and interrogatory responses provide ample evidentiary support for each of his proposed changes. Because of their sound evidentiary basis, these proposals, which are incorporated into the settlement agreement now before the Commission, should be recommended in their entirety.

In designing his proposed rates, Mr. Scherer separately analyzed test-year-before-rates weight-related and non-weight-related costs for Priority Mail, with the non-weight-related costs forming the basis for a "per-piece rate element," and the weight-related costs forming the basis for a "per-pound rate element." USPS-T-30 at 10-15. Noting that Priority Mail has undergone a shift to a more transportation-intensive rate structure since Docket No. R2000-1, witness Scherer explained that this shift results in a greater percentage increase in the per-pound rate elements than in the per-piece element, thereby putting upward pressure on rates for relatively heavyweight pieces. In recognition of this, Mr. Scherer constrained the rate increases for heavier pieces, and made up the forgone revenue from the flat-rate envelope and from pounds 1 through 5 (by setting their rates above the levels implied by the per-piece and per-pound rate elements.) *Id.* at 16-17. See also Tr. 11/4449-50, 4463-64.

Witness Scherer also proposed to rezone rates in the weight increments from 2 to 5 pounds (affecting all weight-rated pieces over one pound, up to five pounds). He explained that the principal reason for the proposed rezoning would be to stem the erosion of mail volume in the close-in zones in the 2 to 5 pound weight increments. Mr. Scherer noted that, in contrast to the zoned rates charged by competitive parcel and document delivery companies, the Postal Service's rate design produces averaged

rates that are relatively less attractive to shippers in the near zones. USPS-T-30 at 18. Competition for this “short-haul” business lately also has become more intense for reasons other than the relative rates structures; for example, UPS now offers a guarantee of 1-, 2- or 3-day delivery to commercial addresses in the near zones, at published rates that are competitive with Priority Mail. *Id.* The net result of these circumstances is that Priority Mail volume between 2 and 5 pounds has become increasingly skewed toward the more costly long-haul traffic. This shift toward volume that is more costly to transport has placed downward pressure on the cost contribution provided by Priority Mail, and upward pressure on Priority Mail rates. *Id.* See also Tr. 11/4452.

In order to reverse these adverse trends, witness Scherer proposed that the Commission recommend the rezoning of Priority Mail rates between 2 and 5 pounds. This adjustment would lead to more cost-based, more competitive and more rational rates in the current marketplace conditions. USPS-T-30 at 17-20. See also Tr. 11/4450. Although this would mean a reversal of a rate design decision made twelve years ago in Docket No. R90-1, Mr. Scherer noted that the rationale that supported the original decision to unzone these Priority Mail rates no longer applies. The current unzoned structure no longer facilitates the use of collection boxes, because recent security concerns prohibit the use of collection boxes for stamped Priority Mail over 1 pound in weight. (While metered Priority Mail will be permitted to be deposited in collection boxes, metering technology will accommodate a zoned structure as easily as an unzoned one.) USPS-T-30 at 19. Furthermore, the industry standard is no longer

the unzoned rate structure that prevailed in Docket No. R90-1; the industry now prefers zoned rates.

In his analysis, witness Scherer also pointed out that the rezoned rate structure would harmonize with certain pricing criteria of the Postal Reorganization Act. For example, Section 3622(b)(2), which calls for consideration of the “the value of the mail service actually provided . . . including . . . mode of transportation,” would be served by a zoned structure which reflects the fact that short-haul Priority Mail tends to be transported by surface transportation, while longer-haul traffic is transported by air. In addition, Mr. Scherer noted that the Postal Service’s competitors offer alternatives to consumers at reasonable costs, even with zoned rate structures (a consideration reflected in Section 3622(b)(5)). *Id.* at 20.

Witness Scherer recognized that rezoning the rates for weight increments between 2 and 5 pounds would require some adjustment of the rate for flat rate envelopes, currently tied to the 2-pound rate. Rezoning would create a variety of distance-based rates for Priority Mail weighing up to 2 pounds (and for every other weight increment between 2 and 5 pounds). This change thus would raise the issue of which of these 2-pound rates, if any, should be applied to the Priority Mail flat rate envelope. After considering the available options, Mr. Scherer concluded that the best solution would be to tie the flat rate to the 1-pound rate for Priority Mail.

Several factors entered into this choice. First, tying to the 1-pound rate would eliminate the potential for flat-rate customers to overlook the possibility that a less costly weight-based Priority Mail rate might be available. By pegging the flat rate to the lowest



available rate, such potential for confusion would be eliminated. Second, tying the flat rate to the one-pound rate would eliminate the need for the Postal Service to produce separate Priority Mail courtesy envelopes for flat rate and for weight-rated documents. Third, extending economical use of the flat rate envelope to one pound and under would result in increased opportunities to deposit such envelopes in collection boxes. *Id.* at 22.

In proposing to tie the one-pound rate to the flat rate envelope, witness Scherer fully considered the possible volume and revenue shifts that might accompany the change, and took these shifts into account in proposing Priority Mail rates. *Id.* at 23-24. Mr. Scherer also evaluated the proposed rate design in light of the statutory criteria of Sections 3622 and 3623(c). *Id.* at 25-26.

Finally, Mr. Scherer provided analytical support for a change in the pickup fee applicable to Express Mail, Priority Mail and Parcel Post. Noting that the average cost per stop in the test year developed by witness Abdirahman is \$10.916 for scheduled pickups and \$12.366 for on-call service, Mr. Scherer developed a weighted-average cost based on the estimated number of pickup stops for Express Mail, Priority Mail and Parcel Post in the test year. This weighted-average cost, including contingency, came to \$12.43 per stop. In order to cover this cost, Mr. Scherer recommended setting the pickup fee at this figure rounded up to the nearest 25-cent interval, or \$12.50 per pickup stop. At this level, the fee would produce a cost coverage of 100.5 percent, a low cost coverage that is consistent with prior cost coverages, and reasonable in light of the recommended 22 percent increase in the fee. USPS-T-30 at 27.

In the settlement agreement now before the Commission, the rates and rate design proposed by witness Scherer are supported by the signatories. No participant has opposed these rates and classifications, and no alternative has been presented to the Commission. In light of the compelling evidentiary basis for witness Scherer's proposals, and the agreement of the parties that these proposed rates are in accord with the requirements of the Postal Reorganization Act, the Commission should recommend the settlement rates, which are supported by Mr. Scherer's testimony, without alteration.

D. The Standard Mail Settlement Rates And Classification Changes Should Be Recommended.

1. An overview of the Standard Mail subclass and overall rate changes.

As witnesses Hope (USPS-T-31) and Moeller (USPS-T-32) explained, Standard Mail primarily consists of advertising mail. Regular and Enhanced Carrier Route (ECR) are commercial subclasses, while Nonprofit and Nonprofit Enhanced Carrier Route (NECR) are nonprofit subclasses whose rates are set according to the formula set forth in 39 U.S.C. § 3626, as amended by Pub. L. No. 106-384, 114 Stat. 1460 (2000). The average overall rate changes for Standard Mail resulting from the settlement would not be significantly different from those in the Request, which are summarized in the table below.

SUMMARY OF RATE CHANGES FOR STANDARD MAIL SUBCLASSES <sup>8</sup>	
Regular	8.0%
ECR	6.2%
Nonprofit	6.7%
NECR	6.5%

USPS-T-31 at 1; USPS-T-32 at 4.

2. The record supports the Standard Mail settlement rates.

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<sup>8</sup> The minimal, and somewhat offsetting, changes embodied in the settlement rates could result in a slight increase in the percentage change for ECR of less than 1/10th of a percentage point.

With a few exceptions in the Enhanced Carrier Route (ECR) subclass, the Standard Mail settlement rates mirror those proposed by the Postal Service. As a result of settlement, the proposed reduction in the ECR pound rate was changed, from the proposed 4 cent reduction to a 2.8 cent reduction (*i.e.*, from 63.8 cents to 61.0 cents). By virtue of the rate design formula, the resulting settlement piece rate for pound-rated pieces was decreased relative to the proposal, but only slightly. The Request included rate decreases for some heavier-weight pieces. Many of those pieces would now experience rate increases instead of a net decrease, although the heaviest pieces would still receive slight decreases. Since the rate design formula is designed to generate a specified revenue requirement, the increase in the proposed pound rate and the accompanying decrease in the per-piece rate for pound-rated mail would offset each other, resulting in minimal change in revenue.

The settlement agreement also lowered the saturation letter rate by 0.1 cent. This results in a slight deviation from the Postal Service's proposal. The effect of the change is a slight increase in the effective passthrough for the shape differential at the saturation tier, as well as the passthrough between the high-density and saturation tiers for letters. Assuming constant TYAR volumes, the effect on revenue would be less than \$4 million.

The settlement also extended to the ECR subclass the adjustment for “heavy weight” letters between 3.3 and 3.5 ounces, originally proposed for Standard Regular Mail. Since the letter-nonletter differential is smaller in ECR than in Standard Regular, the revenue effect of extending this provision would be *de minimis*.

The net revenue effect of these rate and classification adjustments would be minimal. Due to the practical similarity between the Postal Service's proposal and the settlement, the Postal Service's testimony and supporting exhibits, library references, and workpapers provide substantial record support for the settlement proposal, as well as the other proposals carried over from the Postal Service's Request.

3. The settlement rates fairly balance multiple considerations.

The Standard Mail settlement rates serve multiple objectives. First, consistent with longstanding Commission precedent, the settlement rates continue to pass through to mailers, in the form of discounts, proportions of calculated cost savings resulting from worksharing undertaken by mailers, such as presortation and destination entry.

Second, the settlement rates are sensitive to the need to moderate the impact of price changes in individual categories, so that no single rate category would receive a disproportionately high rate increase. *See, e.g.*, USPS-T-31 at 2.

Third, the settlement rates facilitate the evolution of the Postal Service's automation program by maintaining incentives for letters with basic carrier route density to be entered as automation letters. USPS-T-31 at 23-24.

Fourth, the settlement rates balance the Commission's desire to recognize the effect of shape on cost, while maintaining simplicity of the rate structure. Towards this end, the settlement would maintain the surcharge on residual shaped pieces within Standard Mail nonletter categories. USPS-T-31 at 22, 36; USPS-T-32 at 9-10, 21.

Finally, the settlement rates more directly account for updated cost information. For instance, the ECR pound rate reduction accounts for witness Schenk's cost data,

suggesting that reducing the current pound rate would better align the implicit coverages between piece-rated and pound-rated pieces. USPS-T-31 at 11-21. In addition, cost data supplied by witness Miller (USPS-T-22) demonstrates that nonmachinable letters have measurably higher costs. These data provide convincing cost justification for the new nonmachinable surcharge for Standard Regular and Nonprofit letters.

4. The settlement letter and nonletter presort discounts in the Regular and Nonprofit subclasses fairly balance the considerations of recognizing the value of worksharing and impact of rate changes on mail.

In this proceeding, presort and automation discounts in the Regular and Nonprofit subclasses serve to recognize cost differentials, while minimizing rate swings on mailers.

- a. Measurement of the presort- and automation-related cost differences is detailed and accurate.

The Postal Service has undertaken to provide the Commission with detailed cost information that supports settlement discounts. The studies and analyses underlying the presort and automation discounts are comprehensive and accurate.

- i. Witness Miller presented presort and automation Standard Mail mail processing cost differentials for letters and flats.

Witness Miller's letter mail processing cost testimony (USPS-T-22) provided comprehensive and accurate total mail processing unit cost estimates, and worksharing

related savings estimates for the Standard Mail letters rate categories. A "hybrid" cost methodology was used as a basis for his analysis. USPS-T-22 at 8. This cost methodology is similar to that used for First-Class letters, with the exception that the cost benchmarks are different. The benchmarks used to measure the worksharing related savings estimates for the Standard Mail letters rate categories are other Standard Mail rate categories. USPS-T-22 at 23.

Witness Miller's testimony continued the use of detailed cost models, which formed the basis of the Commission's recommended letter discounts for Standard Mail in Docket Nos. R2000-1, R97-1, and MC95-1. As a consequence of the passage of Public Law No. 106-384, aggregate Standard Mail letters cost estimates are provided; separate cost estimates for the Standard Mail Regular and Standard Mail Nonprofit letters rate categories are no longer calculated. See Response of Witness Moeller to POIR No. 4, Question 2.

Each cost model consists of a mailflow spreadsheet and a cost spreadsheet. The mailflow spreadsheets determine the test year processing path that the mail pieces in each rate category must travel before being presented to the mail carriers. Witness Miller updated the mailflows with various inputs, including densities, accept and upgrade rates, and miscellaneous data that were used to estimate the volume of mail processed in each operation for a given rate category. USPS-T-22 at 10-15.

The cost spreadsheets calculated rate category model cost estimates using the mailflow spreadsheet volume estimates, marginal productivities, wage rates, piggyback factors, and premium pay factors. For the nonautomation rate categories, package

sorting costs were also included. USPS-T-22 at 15-16. In addition, the cost spreadsheets calculate the percentage of mail for each rate category that is processed in Delivery Point Sequence (DPS). Witness Schenk used these DPS percentages to develop delivery unit cost estimates by rate category. USPS-T-22 at 16.

Total test year mail processing unit cost estimates for each rate category were calculated by applying a series of Cost and Revenue Analysis (CRA) adjustment factors to the model cost estimates for each rate category. USPS-T-22 at 17. A subset of each total mail processing unit cost estimate, referred to as the "worksharing related" mail processing unit cost estimate, was calculated by applying the worksharing related CRA adjustment factors only to the model cost estimates for each rate category. USPS-T-22 at 17.

The worksharing related savings estimates by rate category were calculated to be the difference between the sum of the worksharing related mail processing unit cost estimate and the delivery unit cost estimate for the selected benchmark, and the sum of those same costs for a given rate category. USPS-T-22 at 17.

Witness Miller's flats mail processing testimony (USPS-T-24) provided comprehensive and accurate total mail processing unit cost estimates for the Standard Mail flats rate categories. A "hybrid" cost methodology was used as a basis for his analysis. USPS-T-24 at 5. This cost methodology is similar to that used for Standard Mail letters. The flats cost studies, however, have not historically included benchmark - rate category comparisons. Consequently, worksharing related savings estimates were not calculated for the Standard Mail flats rate categories.



Witness Miller's flats mail processing testimony continued the use of detailed cost models, which formed the basis of the Commission's recommended flats worksharing discounts for Standard Mail in Docket Nos. R2000-1, R97-1, and MC95-1. As a consequence of the passage of Public Law No. 106-384, aggregate Standard Mail flats cost estimates were provided. Separate cost estimates for the Standard Mail Regular and Standard Mail Nonprofit flats rate categories are no longer calculated.

Each cost model consists of a mailflow spreadsheet and a cost spreadsheet. The mailflow spreadsheets determine the test year processing path that the mail pieces in each rate category must travel, before being presented to the mail carriers. Witness Miller updated the mailflows with various inputs, including updated densities, accept rates, and coverage factors that are used to estimate the volume of mail processed in each operation for a given rate category. USPS-T-24 at 7-11.

The cost spreadsheets calculate rate category model cost estimates using the mailflow spreadsheet volume estimates, marginal productivities, wage rates, piggyback factors, premium pay factors, and package sorting costs. USPS-T-24 at 11-12.

Total test year mail processing unit cost estimates for each rate category were calculated by applying a series of Cost and Revenue Analysis (CRA) adjustment factors to the model cost estimates for each rate category. USPS-T-24 at 12.

The total test year mail processing unit cost estimates cannot necessarily be used to evaluate the value associated with prebarcoded flats mail pieces, due to the mail piece characteristics differences that exist between rate categories. Consequently, "presort adjusted" cost models were also developed. The presort adjusted cost models

used identical mail entry profiles for a nonautomation flats cost model at a given presort level and the corresponding automation flats cost model. The total test year presort-adjusted mail processing unit cost estimates were then calculated using a methodology similar to that described above. USPS-T-24 at 12-13.

Witness Miller's models are comprehensive and provide enhanced precision in the estimated worksharing-related mail processing savings for Standard Mail. Witness Miller's models and refinements provide solid support for the settlement rate discounts.

- ii. Witness Schenk provided accurate and comprehensive unit delivery costs, which were used in the calculation of worksharing discounts.

In this proceeding, witness Schenk provided unit delivery costs by rate category. The methodology she used is essentially the same as that used by witness Daniel in Docket No. R2000-1, and accepted by the Commission. As was done by witness Daniel, witness Schenk developed delivery unit costs from data produced by the IOCS, the CCS, the RCCS, and RPW data systems. The only refinements to witness Daniel's methodology were the modeling of more disaggregated rate categories, which were necessitated by the data needs of other witnesses, and the decision to no longer model Standard nonprofit costs separately. This study was also updated to incorporate base year and test year costs and volumes.

Witness Schenk's development of Standard Mail unit delivery costs is thorough, detailed, comprehensive, and provides a sound evidentiary basis for the settlement rates.

- b. The Regular and Nonprofit presort and automation discounts recognize the calculated cost savings while tempering the rate increases for individual rate categories.

The settlement rates maintain appropriate incentives for generating low cost mailstreams. In order to promote rate stability and minimize the effect of increases on mailers, presort and automation passthroughs were designed to maintain relative stability in discounts, based on their existing value. See USPS-T-32 at 12-13, 22-23. The settlement rates accordingly preserve incentives and avoid disruptions in established price signals that have formed the basis for mailers' investment in worksharing planning, infrastructure, and equipment to provide low cost mail to the Postal Service. Nevertheless, the rate design acknowledges and accounts for the cost differences resulting from the cost differentials, and prudently adjusts worksharing discounts in the direction suggested by their results. *Id.* at 12-14.

The presort passthroughs for the settlement rates were derived by use of the "presort tree" proposed by witness Mitchell in Docket No. R90-1 and thereafter adopted by the Commission. See USPS LR-J-132, WP1 at page BB. The presort tree applies passthrough percentages for each letter presort level and for each letter-nonletter differential. Using the presort tree, the shape differential at each presort tier, along with the letter presort passthroughs, determine the nonletter presort passthroughs.

For the Regular subclass, the presort passthroughs are 288 percent for letters and 82 percent for nonletters. USPS-T-32 at 12, 29. These presort passthroughs are reasonably designed to recognize the savings due to presort, while avoiding consequential effects on other categories due to the dynamics of the presort tree. For

Nonprofit, the presort passthroughs underlying the settlement discounts are 170 percent and 69 percent for letters and nonletters, respectively. USPS-T-32 at 21, 29.

The automation passthroughs promote stability and maintain appropriate rate relationships. For Regular, the letter automation passthroughs range between 76 percent and 130 percent. USPS-T-32 at 14, 16, 29. The Regular flat passthroughs are much higher but are aimed at preserving the discounts at their current level. USPS-T-32 at 16. For Nonprofit, the letter automation passthroughs range from 37 percent to 150 percent, and the flat passthroughs are 150 and 140 percent for Basic and 3/5-digit automation, respectively. USPS-T-32 at 23, 29. These passthroughs serve the dual purpose of mitigating the rate changes on individual categories and preserving a measure of rate stability. USPS-T-32 at 16. In addition, the high passthroughs for flats are intended to recognize the "long-term operational value" of machinability and barcoding. *Id.*

The Postal Service accordingly urges the Commission to recommend the Regular and Nonprofit presort and automation discounts.

5. The letter and nonletter density and automation discounts in the ECR and NECR subclasses fairly balance the considerations of degree of mailer preparation, rate incentives, simplicity, and impact of rate changes on mailers.

The settlement rates for ECR and NECR clearly have been carefully designed to further multiple objectives.

- a. Measurement of the presort-related cost differences should be adopted by the Commission.

- i. Witness Schenk calculated ECR and NECR mail processing cost estimates using the Commission's accepted approach.

Witness Schenk presented the mail processing cost estimates for all presort tiers of ECR mail by rate category and shape. USPS-T-43 at 8-9 and USPS-LR-J-59. The methodology she used is the same as that used by witness Daniel in USPS-LR-I-96. This study was updated to incorporate base year and test year costs and volumes. The resulting differences in mail processing costs across tiers, along with the differences in delivery costs, properly form the basis for witness Hope's rate design for carrier route categories. USPS LR-J-131. Witness Schenk's mail processing cost estimates and methodology for ECR accordingly provided evidentiary support for the carrier route settlement rates.

- ii. Witness Schenk provided unit delivery costs for ECR and NECR.

In this proceeding, witness Schenk provided unit delivery costs by rate category. The methodology she used is essentially the same as that used by witness Daniel in Docket No. R2000-1. As was done by witness Daniel, witness Schenk developed delivery unit costs from data produced by the IOCS, the CCS, the RCCS, and RPW data systems. The only refinement to witness Daniel's methodology was that ECR commercial and nonprofit costs were no longer modeled separately. This change resulted from the fact that ECR nonprofit mail is no longer separately identified in the corresponding data systems. This study was also updated to incorporate base year and test year costs and volumes.

Witness Schenk's development of ECR unit delivery costs was thorough, detailed, and comprehensive and provides substantial record support for the settlement.

- b. The shape passthroughs in ECR and NECR serve important operational objectives, recognize the cost differences between letters and nonletters, and help mitigate the impact on mailers.

The settlement rates rely upon the Commission's Docket No. R2000-1 rate design for the ECR and NECR subclasses. For both ECR and NECR subclasses, the basic tier passthrough is set at zero. As witness Hope explained, this measure is intended to maintain incentives for letters with carrier route density to remain in the Regular and Nonprofit Automation 5-digit categories. USPS-T-31 at 23-24, 37. This

would be consistent with the Commission's Recommended Decisions in Docket Nos. R2000-1 and R97-1, in which the Commission endorsed this rate design mechanism to further the Postal Service's letter automation program.

For the other density tiers, the settlement rates closely approximate the Postal Service's proposed rates. As a result of settlement, the saturation letter rate was lowered by 0.1 cent over the Postal Service's proposal. Although this change was not incorporated into the rate design formula, its effect would be a slight increase in the passthrough for the shape differential at the saturation tier, as well as the effective passthrough between the high-density and saturation tiers for letters. While the settlement discount exceeds the Postal Service's proposal by an additional tenth of a cent, the change in the discount arising from settlement responds to, and takes account of, the proposed classification change providing that high-density and automation letters meet automation criteria to facilitate the delivery point sequencing of this mail, where appropriate. See USPS-T-31 at 10 (acknowledging that the shape passthrough is adjusted due to the new automation requirements for high-density and saturation letters). Because these rates closely approximate the Postal Service's proposal, witness Hope's testimony and workpapers provide a means to evaluate the effective passthroughs underlying the settlement discounts in ECR and NECR, and provide substantial support for the proposals.

- c. The passthroughs for the ECR and NECR density discounts recognize the calculated cost savings.

The density discounts for the carrier route subclasses closely approximate the Postal Service's proposal. As explained above, lowering the saturation letter rate by 0.1 cent results in a slight deviation from the Postal Service's proposal. The effect of the change would be a slight increase in the effective passthrough for the shape differential at the saturation tier, as well as the passthrough between the high-density and saturation tiers for letters. If this had been an input, rather than an adjustment to the output, it could have affected other rates minimally through the rate design formula. Nevertheless, the overall effect of this change would be small. Consequently, because the settlement closely approximates the Postal Service's proposal, witness Hope's testimony provides adequate support for the carrier route rate design.

6. Revenue and rate design considerations underlie the pound rates for Regular, Nonprofit, and NECR.

The settlement pound rates for Regular, Nonprofit, and NECR are driven primarily by rate design and revenue considerations. The pound rate for the Regular subclass reflects a modest increase of 4 cents. Witness Moeller explained that the increase, which is below the subclass average, helps to recognize the reduced role of the pound rate as a proxy for shape change. USPS-T-32 at 10-11. The pound rate increase also helps to stem the consequent upward pressure on minimum per-piece rates that would otherwise be needed if a lower pound rate were chosen. *Id.* at 11. For Nonprofit, the settlement calls for a modest 3.4-cent increase, which is consistent with the overall subclass average increase. USPS-T-32 at 21. With respect to the Nonprofit ECR subclass, the *status quo* would be preserved. USPS-T-31 at 36.



7. The reduction in the ECR pound rate encompassed in the settlement is supported by overwhelming record evidence.

The record in this docket provides ample justification for a reduction in the ECR pound rate. The reduction, which was decreased from 4.0 cents in the Postal Service's proposal to 2.8 cents in the settlement, represents a mere 4.4 percent reduction. Several factors underlie the reduction in the ECR pound rate. First, cost information clearly indicates that a lower pound rate is justified. As witness Hope explained, a reduction in the ECR pound rate has the effect of narrowing the differential in implicit cost coverages between piece- and pound-rated pieces, thereby promoting intra-subclass equity. USPS-T-31 at 13. Second, witness Hope explained that the effect of a small decrease in the pound rate would have only a minimal impact on volume. USPS-T-31 at 17-20. Indeed, because the pound rate reduction in settlement is smaller than the Postal Service's proposal, even fewer pieces than the small proportion that witness Hope identified in her testimony would be eligible for a net reduction. Finally, as witness Hope explained, a pound rate reduction reflects a considered balancing of the (b)(4) criterion's references to the impact upon both mailers and competition. USPS-T-31 at 20-21.

In support of the reduction, witness Schenk presented the unit cost by shape and weight increment for ECR mail. USPS-T-43 at 7, USPS-LR-J-58. The methodology she used is the same as that used by witness Daniel in USPS-LR-I-92. This study was updated to incorporate base year and test year costs and volumes. Witness Schenk's methodology modeled commercial and nonprofit mail together, because nonprofit mail

is no longer identified separately in the underlying cost data. Witness Hope used the unit costs by aggregated weight increments to inform the pound rate for ECR mail. USPS-T-31 at 11-21. Witness Schenk's analysis, and the aggregate cost by weight estimates used by witness Hope, provide compelling cost support for the ECR pound rate reduction.

8. The increase in the residual shape surcharge is a reasonable step in the progression towards more cost-based rates.

The settlement provides for a five-cent increase in the residual shape surcharge for all Standard Mail subclasses. For Regular and Nonprofit, the surcharge would rise to 23 cents; for ECR and NECR, the surcharge would rise to 18 cents. These surcharges, which are supported by compelling record evidence, balance the need for improving contribution from residual shapes, while maintaining sensitivity to the effect on mailers. USPS-T-32 at 9-10. The 5-cent increase is quite modest, since it merely maintains the same percentage passthrough of the cost difference between parcels and flats. *Id.* To stem the effect of rate shock as a result of this docket, the shortfall between revenue and costs for residual shapes can be addressed in future proceedings, on a gradual basis.

The residual shape surcharge is supported by cost information prepared by witness Schenk. Specifically, she presented the cost difference between parcels and flats for Standard Mail. USPS-T-43 at 7-8 and USPS-LR-J-58. This cost difference was estimated using the same methodology used by witness Crum in USPS-T-27/R2000-1, Attachment F, and accepted by the Commission. PRC Op. R2000-1,

¶¶ 5387, 5389. This study was updated to incorporate base year and test year costs and volumes. The cost difference was appropriately used by witness Moeller in developing the Standard Regular rate design. USPS LR-J-132.

Based on witness Schenk's analysis, the adjusted test year cost difference between Standard Mail parcels and flats exceeds the surcharge by several multiples. See USPS LR-J-58, Tables 6 & 7. In sum, witness Schenk's analysis used an established methodology, and provided a reliable and solid record basis for the residual shape surcharges in the settlement.

9. The destination entry discounts encompassed in the settlement in Standard Mail continue to recognize the cost savings due to dropship.

Witness Mayes' analysis of destination entry costs (USPS-T-23) shows that the measured costs savings for destination entry have increased from the levels measured in Docket No. R2000-1. USPS-T-31 at 27-32. As part of the settlement, destination entry discounts are based on an 85 percent passthrough, which results in increased savings for all destination entry points. USPS-T-31 at 28. Witness Hope explained that a higher passthrough would drive up basic tier and other rate increases over 10 percent. *Id.* at 31. Thus, the destination entry discounts, which are based on 85 percent passthroughs, are reasonable and should be recommended by the Commission.

Witness Mayes (USPS-T-23) presented updated cost avoidances for Standard Mail dropshipping that support of the settlement destination entry discounts. For Standard Mail, the study updated the transportation and non-transportation cost avoidances for commercial and nonprofit combined, which were last presented in

Docket No. R2000-1 by witness Crum. Witness Mayes' analysis employed the same basic approach that witnesses Smith and Crum followed in Docket Nos. R97-1 and 2000-1. The study was based on established methodology and provides substantial record support for the settlement rates.

10. The Standard Mail nonprofit rate design incorporates changes to the Revenue Forgone Reform Act.

During the pendency of Docket No. R2000-1, Congress enacted legislation to amend 39 U.S.C. § 3626. The new legislation provides that the rates for nonprofit subclasses should be equal, as nearly as practicable, to 60 percent of the estimated average revenue per piece to be received from the most closely corresponding commercial counterpart. Rates in both Standard nonprofit subclasses meet the statutory requirements of generating an average revenue per piece as close as possible to 60 percent of the average revenue per piece from their respective commercial counterparts.

As witnesses Moeller and Hope explained, implementing the new legislation has led to some changes in the rate design. First, as a result of Public Law No. 106-384, separate costs for the commercial and nonprofit counterparts of Standard Mail subclasses are not maintained separately. USPS-T-32 at 6-7; USPS-T-31 at 9. Instead, a combined cost measure, which includes the cost of both Regular and Nonprofit, and another combined cost measure, which includes the combined cost of ECR and NECR, are provided. Witnesses Hope and Moeller explained that the volume variable costs for the commercial and nonprofit counterparts were estimated by applying the cost share of each subclass from Docket No. R2000-1, relative to the combined total costs of both commercial and nonprofit counterparts. In other words, the volume

variable cost for each combined grouping was split in proportion to the TYAR volume variable costs from the Docket No. R2000-1 proposal. The splitting of the costs is merely a placeholder to allow the formula to function and produce rates. While this methodology does not purport to unambiguously measure volume variable costs of these two subclasses of Standard Mail, it serves as a reasonable tool to facilitate the rate design equation methodology. The methodology accordingly provides substantial record support for the Standard Mail rate design.

11. The Standard Mail classification changes in the settlement comply with the statutory criteria.

Four classification changes for Standard Mail have been incorporated into the settlement. As explained more fully below, each complies with the statutory classification criteria in 39 USC § 3263 and merits adoption by the Commission.

The first classification change is a new 4-cent surcharge in Regular and a 2-cent surcharge in Nonprofit for nonmachinable presort letters. As witness Moeller explained, the surcharge for nonmachinable letters would better reflect the additional cost of handling letters that are not eligible for processing on automated equipment. USPS-T-32 at 2-3. The surcharge is supported by clear evidence of higher costs associated with nonmachinable letters. USPS LR-J-60 at 59.

Creation of the nonmachinable surcharge would advance fairness and equity by relieving the non-surcharged letters of the additional costs of the nonmachinable letters. USPS-T-32 at 2-3. Postal Service processing and efficiency would benefit to the extent that the surcharge would lead mailers to produce machinable pieces, or reconsider their requests for manual handling. *Id.* As explained by the Postal Service's

operations expert, witness Kingsley, this option would reduce bundle preparation costs, because these mail pieces would go to the letter automation equipment, instead of to a bundle sort or mail preparation operation. USPS-T-39 at 12-13. While witness Moeller observed that creation of the surcharge does add some complexity to the rate schedule, the advantages of the surcharge in recovering some of the added costs of processing would outweigh disadvantages posed by the added complexity. USPS-T-32 at 2-3. The Commission should accordingly recommend this classification change.

The second classification change in the settlement consists of the subdivision of the Automation Basic letters into two separate rate categories: Mixed AADC and AADC. AADC category letters would be presorted to designated automated area distribution centers, while Mixed AADC letters would represent a sort encompassing multiple automated area distribution centers. Witness Moeller explained that the proposed division of the basic tier better accounts for the higher cost characteristics of mixed AADC mail. USPS-T-32 at 3 (citing USPS-T-39 at 13).

Creation of the separate rate for AADC would enhance fairness and equity because mailers that were able to create AADC trays due to the density of their mailings would not have to shoulder the additional costs associated with Mixed-AADC trays. *Id.* at 3. Processing and efficiency would benefit to the extent mailers can merge mailings or take other steps to increase their ability to achieve the density for AADC trays. *Id.* Since the tray preparation tiers exist today, there would be little added complexity. This minor classification change is accordingly supported by substantial record evidence, and should be recommended by the Commission.

The third classification change consists of combining letter piece rates with the

pound rate for pound-rated flats for automation letters weighing in excess of 3.3 ounces but less than 3.5 ounces. As part of the settlement, this special rate combination was extended to include carrier route subclasses, since to qualify for letter rates in the basic automation, high-density, and saturation categories, mailers must meet automation requirements. For heavy automation letters, mailers will pay the applicable pound rate for the additional weight above 3.3 ounces. Because the level of volume affected and revenue involved is small, any effect on revenues and costs would be *de minimis*. See USPS-T-32 at 4.

Witness Moeller explained that this new rate adjustment for automation letters promotes fairness by permitting Standard Mail letters to avoid the substantial rate increase for letter-shaped pieces exceeding 3.3 ounces. *Id.* at 4-5. Under the current schedule, once a letter exceeds the 3.3 ounce maximum weight, the piece becomes subject to substantially higher rates for pound-rated presort nonletters. Witnesses Moeller and Kingsley also explained that this proposal is advantageous to the Postal Service, because letter processing is more cost-effective than manual letter or automated flat processing. While there is added complexity to the rate structure, mailers who would take advantage of this proposed option should be familiar with the complexity of the current structure, and should be willing to accept the added complexity, in exchange for the rate relief offered by the proposal. The record accordingly demonstrates that this classification change is in accord with the statutory criteria. The Commission should recommend this classification change.

The fourth classification change in the settlement consists of new automation requirements for ECR and NECR High Density and Saturation letters. Specifically, letters in these categories must bear delivery point (*i.e.*, 11-digit) barcodes and meet other Postal Service requirements for automation compatibility. Witness Hope

explained that this measure would promote fairness and equity by applying uniform automation criteria to ECR letter rates in these tiers, resulting in a more logical rate relationship with the nonletter rates. USPS-T-31 at 9-10. The proposed classification change is desirable from the perspective of mailers and the Postal Service, because it will allow more flexibility and options in mail processing and delivery, and increased reliability, because barcoded pieces will allow automation equipment to “catch” carrier assignment updates, including new routes, earlier than would be otherwise be possible.

*Id.* The operations rationale for this proposal is reiterated in the testimony of witness Kingsley. USPS-T-39 at 11-12. The record accordingly provides compelling justification for this classification change.

E. The Commission Should Recommend the Periodicals Outside County and Within County Settlement Rates and Classification Changes.

Witness Taufique (USPS-T-34) presented the Postal Service’s rate and classification proposals for the Periodicals Outside County and Within County subclasses. The proposed rate increases would average 10.4 percent for Outside County, and 1.7 percent for Within County. USPS-T-34 at 2-3. These moderate increases reflect the cost coverages provided by witness Moeller, as discussed above.

Witness Taufique also proposed classification changes that would establish a new dropship discount for mail entered at a destination ADC facility, and a per piece pallet discount. He justified these proposals by considering operational factors and the statutory classification criteria. USPS-T-34 at 9-11, 16-17. He proposed to limit the dropship discounts to mail



entered at the destination facility.<sup>9</sup> Witness Koroma (USPS-T-44) proposed making permanent the experimental Ride-Along classification, and proposed a rate of 12.4 cents per piece. He explained his rate design, as well as the rationale for making the classification permanent. USPS-T-44 at 6-11, 15-17. All of these changes have been included in the Stipulation and Agreement. They are supported by substantial record evidence, and should be recommended.

The Periodicals rates proposed by the Postal Service have been adjusted in the Stipulation and Agreement. The original Postal Service proposal sought to provide dropship incentives by providing dropship discounts from the uniform editorial pound rate for editorial pounds entered at destinating facilities (DU, SCF, ADC). The negotiated rate structure for the settlement rates instead provides a dropship pallet discount on the piece side of the rate schedule. The Nonadvertising dropship pound rates for Outside County (including Science of Agriculture) would thus be set at a uniform \$0.193, instead of varying rates (ranging from \$0.158 to \$0.203) depending on destination entry level. These changes would have little effect on the overall cost coverage for the Outside County subclass.<sup>10</sup>

Since virtually all dropship volume is palletized (USPS-T-34 at 17), the dropship pallet discount can be justified as an alternative means to pass through some of the dropship cost savings underlying the original proposal. The original Postal Service proposal provided a discount worth \$22.2 million for dropshipped editorial pounds, based on a 50 percent passthrough of the transportation and non-transportation cost savings estimated for advertising pounds that are dropshipped. USPS-T-34 at 7; LR-J-107, worksheet 'Pound Data\_Ed.' If a still

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<sup>9</sup> USPS-T-34 at 5. The destination SCF rate would apply to mail entered at other selected destination facilities if backhauling to the SCF is not required. Tr. 11-C/4506-08.

modest passthrough of 75 percent were used, the value of the editorial pound rate discount would be roughly equal to the value of the additional 1-cent dropship pallet discount on the volume of palletized and dropshipped pieces. Tr. 14/5658-59.

Additional support for this discount can be provided by examining the cost savings associated with palletization. As shown by witness Schenk (USPS-T-43), the cost savings for palletized pieces compared to pieces in sacks is 2.09 cents. USPS-T-43 at 6. These savings are based on “costs associated with unloading and moving palletized and sacked mail at the ‘destination’ facility.” Id. at 7. Thus, the savings would apply uniformly to all pallets, regardless of their entry point. The original pallet discount of 0.5 cent per piece was based on a small passthrough of this cost saving. An approximately 72 percent passthrough of the cost savings of 2.09 cents would lead to the total 1.5-cent discount for dropshipped, palletized pieces included in the settlement agreement. Tr. 14/5659. The application of a cumulative discount of 1.5 cents to dropshipped pallets versus 0.5 cent for all other pallets is therefore justified based on dropship savings, as well as the efficiency of unloading and handling pallets at the destination facility. The end result would be a proposed structure that provides lower piece rates to mail which requires the least postal handling. Tr. 14/5659-60.

During oral cross examination, witness Taufique confirmed that the settlement rates for Periodicals would achieve the public policy and economic efficiency objectives reflected in the statutory pricing criteria. Tr. 8/1323-25. In summary, while the Stipulation and Agreement rate structure is somewhat different than the structure originally proposed by the Postal Service, the settlement rates still accommodate the

(..continued)

<sup>10</sup> Compare USPS-T-34, at 2, with Tr. 14/5660.

goals of encouraging more dropshipping and efficient containerization of parcels, and are supported by substantial evidence in the record.

F. The Package Services Settlement Rates and Classification Changes Should Be Recommended.

Witness Kiefer (USPS-T-33) provided testimony in support of the Postal Service's proposed rates for Package Services. Each of the Package Services rate design proposals, and any changes arising from settlement, are discussed separately below.

1. Parcel Post

The rates developed by witness Kiefer, specifically those for the Parcel Select categories, have been revised somewhat as a result of the settlement agreement. The rates originally proposed represented an average increase of 6.5 percent, with a corresponding cost coverage of 116 percent.<sup>11</sup> USPS-T-33 at 6. On average, Inter-BMC Parcel Post rates would increase 17.2 percent, Intra-BMC rates would increase 18.1 percent, and Parcel Select rates would increase 4.8 percent. Within Parcel Select, average DBMC rates would change by 9.6 percent, DSCF rates -1.2 percent and DDU rates -3.1 percent.<sup>12</sup> *Id.*

Under the settlement rates, modest decreases originally proposed in Parcel Post rates have been eliminated, so that no change from the current DDU rates is now

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<sup>11</sup> Measured using the same volume mix before and after the rate change, the rate increase is 10.0 percent. This calculation incorporates the migration of nonmachinable parcels from DBMC to DSCF in response to the new 3-Digit DSCF rate. *Id.*

<sup>12</sup> The rate changes for DBMC and DSCF were adjusted to remove the impacts of a proposed classification change that would permit mailers to enter nonmachinable parcels at DSCFs if presorted to 3-digit ZIP Codes. *Id.*

included in the settlement package.<sup>13</sup> For DSCF, rate cells that were proposed to decrease have been retained at current rates, and rates cells that were proposed to increase remain as proposed.<sup>14</sup> The additional revenue generated by these changes has been applied to moderate some of the proposed increases in DBMC. The net effect of these changes in Parcel Select is small — a reduction in revenue of approximately \$6.1 million, based on static volume analysis, out of test year after rates Parcel Post volume of \$1,202,568,000. This represents a decrease of approximately 1/2 of one percent, and therefore has no significant effect on the cost coverage for Parcel Post or overall postal finances. Accordingly, witness Kiefer's testimony provides adequate record support for the settlement rates.

Witness Kiefer provided support for three other changes in Parcel Post: a new three-digit nonmachinable DSCF rate, a separate one-pound rate for all Parcel Post rate categories, and no-fee Delivery Confirmation for Parcel Select, including elimination of the Delivery Confirmation retail (or manual) option for Parcel Select. USPS-T-33 at 14-15. The one-pound rate enables customers who mail light-weight merchandise with a Parcel Post option that better reflects the cost of those pieces. The no-fee Delivery Confirmation for Parcel Select reflects the needs of that market. In addition, the new nonmachinable DSCF discount introduces new worksharing options for the more difficult to handle parcels. The operational benefits of that proposal are described by witness

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<sup>13</sup> The sole exception is the newly de-averaged one-pound rate. Currently, one-pound DDU pieces pay the two-pound rate. Under both the original and settlement proposals, DDU pieces up to one pound in weight will pay a separate, lower rate.

<sup>14</sup> The rate for DSCF pieces weighing up to one pound will decrease due to de-averaging the existing zero-to-two-pound rate.

Kingsley. USPS-T-39 at 21-22.

In developing Parcel Post rates, Witness Kiefer relied on several estimates developed by witness Eggleston (USPS-T-25).

In summary, the Parcel Post changes continue the efforts of the Postal Service and the Commission to provide value-added products for Parcel Post and encourage worksharing. The Parcel Post settlement rates are supported by record evidence and merit recommendation by the Commission.

## 2. Bound Printed Matter

The rates developed by witness Kiefer for Bound Printed Matter (BPM) represent an average increase of 9.1 percent, yielding a cost coverage of 128 percent. USPS-T-33, at 7. They are incorporated into the settlement and are supported and their development fully explained in witness Kiefer's testimony and supporting documentation. Witness Eggleston (USPS-T-25) provided witness Kiefer with the estimated cost differences that are reflected in his rate design. USPS-T-33, at 30-31.

In Docket No. R2000-1, the Postal Service introduced new DBMC, DSCF, and DDU discounts to better reflect the cost of handling that mail and to promote additional dropshipping. At the same time, the cost differences were not fully reflected in the rates the Postal Service proposed or the rates recommended by the Commission in order to mitigate the impact on the affected customers. Instead, a more gradual path was chosen, which anticipated future movement to greater passthroughs of those cost differences. The settlement rates in this docket represent a step along that path.

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The Postal Service proposed two classification changes for BPM: separate rates for BPM flats and parcels/irregular pieces, based on delivery cost savings for flats, and a new barcode discount for automatable flats. These are incorporated into the settlement package and fully supported in witness Kiefer's testimony. *Id.* at 30-32. Additional operational background is also provided in the testimony of witness Kingsley. USPS-T-39 at 19.

### 3. Media Mail and Library Mail

The Postal Service has proposed to increase Media Mail rates by 4.0 percent and Library Mail rates by 3.3 percent, with a cost coverage of 115 percent for the consolidated Media Mail-Library Mail product. The Postal Service has also proposed to replace the existing BMC Presort level with a Basic Presort level, and to eliminate the requirement for separate 500 piece mailings to be eligible for both levels of presort discounts. Under the Postal Service's proposal, single mailings of 300 properly prepared and entered Media Mail pieces or Library Mail pieces will be eligible to take advantage of both discounts. USPS-T-33, at 7. Each of these proposals is incorporated into the settlement package and is supported in the testimony and documentation presented by witness Kiefer. *Id.* at 40-41.

The Postal Service believes that these changes are advantageous for several reasons. First, the lower minimums will allow more Media Mail and Library Mail customers to participate in the worksharing program. In addition, the changes will allow preparation requirements that are more appropriate for the shape of the mailpiece.

It is worth noting that the percentage rate increases for both of these

classifications are not spread equally across all rate cells. Rather, they are designed to reflect updated cost avoidances, along with the impact of weight on costs. As a result, items weighing one pound will bear slightly larger increases than average, and heavier items will tend to have smaller increases. In addition, presorted items, particularly those presorted to five-digit ZIP Codes, may have larger than average increases. In sum, the Media Mail and Library Mail settlement rates are supported on the record and merit recommendation.

G. The Special Services Settlement Fees And Classification Changes Should Be Recommended.

The Postal Service's special services provide an array of options for customers of all of the classes of mail. Several Postal Service witnesses developed special service cost analyses, and pricing witnesses Susan W. Mayo (USPS-T-36), Samuel J. Koroma (USPS-T-37), and Kirk T. Kaneer (USPS-T-38) designed the fees, and proposed many classification changes. As demonstrated by these witnesses, the Postal Service's special service classification and fee proposals satisfy the statutory classification and pricing criteria, and meet the needs of customers. Therefore, all of the Postal Service's classification and fee proposals should be recommended by the Commission.

Extensive cost studies provided a solid foundation for the Postal Service's proposals. Witness Patelunas (USPS-T-12) summarized volume variable costs for those special services included in the Postal Service's CRA reports.<sup>15</sup> These costs were used for overall cost coverage analyses for each of those special services. In addition, these costs, along with corresponding volumes, were used for fee design for certified mail, collect-on-delivery, money orders, and registered mail.

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<sup>15</sup> These special services include certified mail, collect-on-delivery, insurance, money orders, post office box and caller service, registered mail, special handling, and stamped envelopes. USPS-T-12, WP-F, Table E.

Witness Nieto developed costs for proposed enhancements to certified mail and registered mail, in order to provide a final adjustment to the costs for these services. USPS-T-26 at 12-13; LR-J-135, worksheet D-1. Witness Abdirahman provided additional cost analysis to estimate unnumbered and base numbered insurance costs, as well as bulk insurance cost savings. USPS-T-42; LR-J-69 at D-1 to D-3. Witness Mayo analyzed the indemnity costs for insurance. Exhibit USPS-36A.

For post office box and caller service, witness Kaneer allocated CRA post office box costs by box size and ZIP Code. USPS-T-38 at 16-22. This is a continuation of the work initiated by the Postal Service and endorsed by the Commission in Docket No. R2000-1. PRC Op., R2000-1, Vol. 1, at 538-40. Witness Abdirahman provided costs for caller service and reserved numbers. USPS-T-42; LR-J-69 at A1-A5. He also provided costs for post office box key duplication and lock changes. USPS-T-42; LR-J-69 at H1-H2. For stamped envelopes, he developed costs for each type of envelope. USPS-T-42; LR-J-69, Section B.

Where CRA data were not available, special service cost studies were used by the pricing witnesses for both cost coverage and fee design purposes. Three Postal Service witnesses prepared these special service cost studies. Witness Eggleston presented the cost study for bulk parcel return service. USPS-T-25 at 31-35. Witness Abdirahman presented cost studies for address correction service, certificates of mailing, mailing list services, money order inquiries, on-site meter service, Periodicals applications, permits, restricted delivery, and stamped cards. USPS-T-42; LR-J-69, section A. Witness Miller presented cost studies for business reply mail, and the annual permit and accounting fees. USPS-T-22 at 36-41.

Witness Nieto presented cost studies for Delivery Confirmation, Signature Confirmation, and return receipts, including costs for the newly proposed electronic



return receipt. USPS-T-26; LR-J-135. She also sponsored library reference J-136, which presented estimated volume adjustments in support of Test Year After Rates volumes for certified mail and return receipts presented by witness Tolley (USPS-T-7), and return receipts and Signature Confirmation volumes presented by witness Mayo (USPS-T-36). Witness Nieto used market research results presented by witness Rothschild (USPS-T-27; LR-J-121) to develop the volume adjustments.

Postal Service witnesses Mayo, Koroma, and Kaneer used sound professional judgment to develop fees and fee designs for the special services. Witness Mayo presented pricing proposals for the annual accounting fees, business reply mail, certified mail, Delivery Confirmation, insurance, return receipts, Signature Confirmation, stamped cards, and stamped envelopes. USPS-T-36.

Witness Mayo also proposed and testified in support of several classification changes for these special services, including enhancements for certified mail, Delivery Confirmation, and return receipts. For certified mail, she proposed access to delivery information without the need to purchase return receipt service. USPS-T-36 at 29-30. She proposed to extend Delivery Confirmation and Signature Confirmation to parcel-shaped mail in the Letters and Sealed Parcels subclass of First-Class Mail. *Id.* at 37-38. Based on the operational reasons presented by witness Kingsley, witness Mayo also proposed to limit Delivery Confirmation and Signature Confirmation to parcel-shaped Package Services mail. USPS-T-39 at 8, 19, 27-28; Tr. 9/2143-45, 2151-55; USPS-T-36 at 38. Finally, witness Mayo proposed a new electronic return receipt, which would provide delivery information and a copy of the recipient's signature by secure Email. USPS-T-36 at 57-58.

Witness Mayo also proposed the elimination from the DMCS of the listings of available combinations of special services with each other. She noted that the current

DMCS does not fully reflect the special service combinations allowed by the Postal Service, and that the public is informed about these combinations through the Domestic Mail Manual. *Id.* at 87. In Notice of Inquiry No. 1, the Commission expressed reservations about the effect on its jurisdiction over special services that would result from the Postal Service's proposal, as well as concern that removing the lists of combinations would deprive the public of useful information.<sup>16</sup> In response, the Postal Service decided to withdraw the proposals, and revise the Stipulation and Agreement accordingly. The Postal Service expressed its continued support for the proposals, but believed they should be addressed in a future case.<sup>17</sup>

Witness Koroma proposed and testified in support of fee changes for the following special services: address changes for election boards, address correction, bulk parcel return service (BPRS), carrier sequencing of address cards, certificates of mailing, collect on delivery (COD), correction of mailing lists, money orders, on-site meter service, Periodicals application fees, permit fees, registered mail, restricted delivery, and ZIP Coding of mailing lists. USPS-T-37. His testimony also proposed classification changes for money orders, on-site meter service, and registered mail. For money orders, the proposal would increase the value limit to \$1,000, and create two pricing tiers. *Id.* at 41-42; Tr. 11-B/4236-37, 4241. For on-site meter service, the change would clarify when the fee for checking in or out of service applies to Secured postage meters. USPS-T-37 at 44, 47-48. For registered mail, witness Koroma proposed to provide access to delivery information, without the need to purchase return receipt service. *Id.* at 60-61.

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<sup>16</sup> Notice of Inquiry No. 1 Concerning Proposed DMCS Changes (February 1, 2002), at 1-3.

<sup>17</sup> Notice of the United States Postal Service Withdrawing Proposals and Submitting Revised Stipulation and Agreement (February 13, 2002).

Witness Kaneer presented and supported the Postal Service's proposals for Post Office Box and Caller Service. These included an additional fee group within the post office box fee structure. This fee group would be the first group to include both city and non-city carrier offices, and would be needed to avoid undue fee impact during the transition to a more cost-based fee structure. USPS-T-38 at 13, 33. Witness Kaneer also presented proposals for Special Handling and Parcel Airlift (PAL), and justified fee increases for these services comparable to the systemwide average increase. *Id.* at 35-43.

V. The Postal Rate Commission Should Recommend The First-Class Mail Rate And Classification Changes Reflected In The Stipulation And Agreement

Unique circumstances have brought the parties in Docket No. R2001-1 to an unprecedented level of agreement regarding the resolution of the myriad of issues raised by the Postal Service's Request for rate and classification changes. The Postal Service proposed changes in all First-Class Mail rates except the single-piece additional-ounce rate. Also, the Postal Service proposed several minor classification changes. The February 13, 2002, Stipulation and Agreement makes four small adjustments in the requested First-Class Mail rates and incorporates all of the requested classification changes.

The one area of contention among the parties in this proceeding has been in the area of First-Class Mail rate design.<sup>1</sup> The American Postal Workers Union, AFL-CIO ("APWU") has expressed opposition to the Stipulation and Agreement. APWU's objection to the Agreement, discussed in greater detail below, is based upon its assertion that, taking the Postal Service's First-Class Mail workshare cost avoidance estimates as a given, the Commission should not recommend workshare discounts that exceed those cost avoidance estimates.

For the reasons explained below, the Postal Rate Commission should conclude that substantial record evidence exists to support the First-Class Mail rate and classification proposals reflected in the February 13, 2002, Stipulation and Agreement. Concurrently, the Commission should decline to adopt the alternative rate design

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<sup>1</sup> None of the requested First-Class Mail classification changes was modified by the Stipulation and Agreement or contested by any party.

proposals of the one settlement opponent. Accordingly, the Commission should issue an opinion and recommendation that the Governors approve the First-Class Mail rate and classification changes identified in the Stipulation and Agreement.

A. There Is Substantial Record Evidence to Support the Stipulated First-Class Mail Rate and Classification Changes

Before addressing APWU's objections to the First-Class Mail rate design in the Stipulation and Agreement, the Postal Service will summarize the First-Class Mail settlement rates and the evidentiary foundation that supports them.

As discussed above in Sections II and III above, the Postal Service's estimates of volume-variable cost for the various subclasses of mail and special services, and its requested revenue requirement are not disputed in this proceeding. Based upon the Postal Service's estimates of volume-variable costs, witness Moeller (USPS-T-28) developed a foundation for rate design by proposing cost coverages<sup>2</sup> for each subclass of mail. There was no challenge to the Postal Service's proposed allocations of institutional costs among the various subclasses and special services,<sup>3</sup> except to the extent that APWU's alternative rate design discussed below in Section VI.B. sought to materially change the revenues generated by First-Class Mail and, therefore, implicitly alter its cost coverage.<sup>4</sup>

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<sup>2</sup> The ratio of the revenue for a subclass or special service to its volume-variable costs.

<sup>3</sup> In accordance with the Stipulation and Agreement at ¶13.

<sup>4</sup> See Tr. 12/4898-99.

As is reflected in the direct testimony of Postal Service rate policy witness Moeller (USPS-T-28), discussed above in Section V.A., each subclass was accorded an independent application and weighting of the appropriate pricing policy considerations in 39 U.S.C. § 3622(b). The final step in the ratemaking process for any subclass is the design of rates which will generate sufficient revenue to ensure that the ratio of per-piece revenue to per-piece volume-variable cost equals the prescribed cost coverage for the subclass. The revenue burden for each mail subclass must be spread across all rate categories and distinct rate elements in that subclass in a fair and equitable manner.

Accepting the First-Class Mail revenue target implied by witness Moeller's proposed First-Class Mail cost coverage, the mission of Postal Service witness Maura Robinson (USPS-T-29) was to take into account the ratemaking policies of the Postal Reorganization Act and to design First-Class Mail rates that would generate revenues sufficient to meet witness Moeller's cost coverage goal. The Postal Service's Request reflects the First-Class Mail rates that resulted from witness Robinson's performance of this exercise. When comparing the requested First-Class Mail rates to the rates in the Stipulation and Agreement ("settlement rates"), the Commission will notice very minor changes in First-Class Mail rate design that were a product of the discussions among the parties that led to the filing of the Stipulation and Agreement.<sup>5</sup> The evidentiary and

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<sup>5</sup> As is discussed in further detail below, the Stipulation and Agreement proposes that the requested discount for two workshare rate categories – Automation 3-Digit Presort Letters and Automation 5-Digit Presort Letters – be increased by 0.2 cents per piece more than was originally requested. In addition, the Stipulation and Agreement proposes that the discount for the single-piece Qualified Business Reply Mail rate category not be reduced, as originally requested by the Postal Service.

policy foundation underlying the requested rates also supports the settlement rates.

The basis for the requested rates is summarized below, followed by an explanation of why the settlement rates also are in harmony with the ratemaking policies of the Act.

1. The Postal Service's requested First-Class Mail rate design provides a foundation for the settlement rates

On behalf of the Postal Service, witness Maura Robinson (USPS-T-29) designed rates and classifications for the two First-Class Mail subclasses at issue here: Letters and Sealed Parcels ("Letters") and Cards. The First-Class Mail rates requested by the Postal Service and discussed here are depicted at pages 5 through 8 of Attachment B of the Docket No. R2001-1 Request of the United States Postal Service For A Recommended Decision On Changes In Rates Of Postage And Fees For Postal Services (September 24, 2001) and at pages 2 through 4 of USPS-T-29. See *also* Attachment USPS-29A. Witness Robinson's specific rate design and classification change proposals are summarized and discussed below.<sup>6</sup>

For the First-Class Mail Letters subclass, she proposed an average rate increase of 8.2 percent. For the Cards subclass, she proposed an average rate increase of 9.7 percent. USPS-T-29 at 4. Her proposed rate increases for the Letters and Cards

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<sup>6</sup> All of witness Robinson's proposed classification changes in the Letters and Cards subclasses are discussed below. They are incorporated into the Stipulation and Agreement and no party presented testimony opposing any of them. A review of her testimony (USPS-T-29) should lead the Commission to conclude that each proposed change meets the applicable criteria in section 3623(c).

subclasses were designed to meet the 212.0 percent and 158.7 percent cost coverages for Letters and Cards, respectively, proposed by witness Moeller at Exhibit USPS-28B.<sup>7</sup>

For the Single-Piece and Nonautomation Presort categories of First-Class Mail, witness Robinson proposed the following changes:

The current rate for the first ounce of a basic First-Class Mail piece should be increased from 34 cents to 37 cents.

Witness Robinson proposed that the 3-cent rate differential from the basic rate for Qualified Business Reply Mail (“QBRM”) letters be reduced to 2.5 cents, resulting in the QBRM rate increasing from 31 to 34.5 cents.

She proposed that the current 1.8-cent rate differential from the basic rate for Nonautomation Presort letters should be preserved, which would result in a Nonautomation Presort letter rate of 35.2 cents.

Witness Robinson advocated that the 23-cent additional-ounce rate should be preserved for single-piece letters. This would widen the current 11-cent degression to 14 cents from the first-ounce rate. She proposed a half-cent reduction in the Nonautomation Presort additional-ounce letter rate from 23 cents to 22.5 cents.

She also proposed that the current 13-ounce weight limit for First-Class Mail remain in place.

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<sup>7</sup> A significant factor in witness Robinson’s First-Class Mail rate design was the vast set of differences between the implicit cost coverages for the single-piece component of the Letters and Cards subclasses (176.1 percent and 112.7 percent, respectively) and the workshared component of those same subclasses (294.1 percent and 335.3 percent, respectively) shown in Exhibit USPS-28B (as revised 1/11-02). See USPS-T-29 at 12 and Tr. 7/1608-11.



Witness Robinson proposed that the current 11-cent surcharge for nonstandard-size single pieces weighing one ounce or less should be increased to 12 cents. In addition, she requested that the current 5-cent nonstandard surcharge for Nonautomation Presort pieces weighing one ounce or less be increased to 5.5 cents.<sup>8</sup>

For all properly presorted pieces weighing above two ounces, witness Robinson proposed a reduction of the current 4.6-cent additional incremental discount to 4.1 cents.

She proposed that the current basic rate for stamped cards and post cards be increased from 21 to 23 cents. Her proposal that the rate differential from the basic rate for Nonautomation Presort cards be the same as it is for letters (1.8 cents) would result in a 21.2-cent rate for such cards. She also proposed that the current 18-cent rate for automation-compatible QBRM cards be increased to 20.5 cents, reflecting a half-cent reduction in the current 3-cent discount.

For the Automation categories of First-Class Mail, witness Robinson proposed the following rate and classification changes:

She advocated that the current Basic Automation rate category be reclassified as two separate categories: Mixed AADC Presort and AADC Presort, each with a separate rate. This reclassification would result in a Mixed AADC rate of 30.9 cents and an AADC rate of 30.1 cents.

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<sup>8</sup> Her proposals that both surcharges be assessed to apply to a broader category of “nonmachinable” letters and be appropriately re-named were incorporated into the Stipulation and Agreement and were not controverted on the record. These changes would better describe the surcharged pieces and better relate them to similar items in other mail classes.

Witness Robinson also requested the same reclassification and de-averaging for the current Basic Automation card category, resulting in a Mixed AADC card rate of 19.4 cents and an AADC card rate of 18.7 cents.

She proposed that the incremental differential (from the AADC Presort rate) for 3-Digit presorted letters be 0.7 cents, resulting in a cumulative discount for such letters of 7.6 cents and a rate of 29.4 cents. She advocated that the incremental differential (from the AADC Presort rate) for 3-Digit presorted cards be 0.4 cents, resulting in a cumulative discount for such cards of 4.7 cents and a rate of 18.3 cents.

Witness Robinson proposed that the current 1.4-cent incremental rate differential (from the 3-Digit rate) for the first ounce of a 5-Digit presorted letter be retained, resulting in a cumulative discount for such letters of 9.0 cents and a rate of 28.0 cents. She requested that the current 0.7-cent incremental rate differential (from the 3-Digit rate) for 5-Digit presorted cards be retained, resulting in a cumulative discount for cards of 5.4 cents and a rate of 17.6 cents.

For the first ounce of Automation Carrier Route letters, witness Robinson proposed that the current incremental discount be reduced from 1.0 cents to 0.5 cents, resulting in a cumulative discount for such letters of 9.5 cents and a rate of 27.5 cents. She proposed that the current 1.1-cent incremental rate differential for Automation Carrier Route cards be reduced to 0.6 cents, resulting in a cumulative discount for such cards of 6.0 cents and a rate of 17.0 cents.

Witness Robinson also requested reclassification and de-averaging for the current Basic Automation Flats category, resulting in a Mixed ADC Presort Flats rate of 34.1 cents and an ADC Presort Flats rate of 33.3 cents.

For the Automation 3-Digit Presort Flats category, witness Robinson advocated a 1.1-cent incremental rate differential from the ADC Presort rate, resulting in a cumulative discount for 3-Digit Presort Flats of 4.8 cents and a rate of 32.2 cents. For the Automation 5-Digit Presort Flats category, she proposed a retention of the current 2.0-cent incremental rate differential (from the 3-Digit Flats category), resulting in a cumulative discount of 6.8 cents for Automation 5-Digit Flats and a rate of 30.2 cents.

For all pieces weighing above two ounces, she proposed a reduction of the current heavy-piece deduction from 4.6 cents to 4.1 cents.

Witness Robinson advocated that the current 23.0-cent additional-ounce rate for all categories of Automation rate First-Class Mail be reduced by 0.5 cents to 22.5 cents.

Finally, witness Robinson proposed that the preparation requirements for First-Class Mail cards listed in Domestic Mail Classification Schedule be changed. USPS-T-29 at 30.

With the exception of the proposal that the current categories for Basic Automation Letters, Flats and Cards be split into two separate rate categories,<sup>9</sup> the proposal that the Nonstandard Surcharge be re-defined to include a broader definition of nonmachinable letters, the proposed deletion of the specific Cards preparation requirements, witness Robinson proposed no other changes in the Domestic Mail Classification Schedule conditions of eligibility for the current categories of First-Class Mail. As indicated earlier, none of these First-Class Mail classifications changes has been disputed.

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<sup>9</sup> Which also affects Mailing Online, as indicated at Tr. 7/1582-83.

2. The Commission should recommend the First-Class Mail single-piece rates proposed by the Postal Service.
  - a. The proposed 37-cent basic rate is fair and equitable.

Postal Service witness Robinson proposed a 37-cent rate for the first-ounce of single piece First-Class Mail. This rate, in combination with the various rate differentials (based upon such factors as weight, prebarcoding, presorting, machinability and size) in the Postal Service's Request would allow the Postal Service to achieve the revenue requirement in a manner consistent with the policies of the Act. While the proposed, three-cent increase in the basic First-Class Mail rate from 34 to 37 cents is larger than recent increases, it was necessary to meet the revenue requirement of the Postal Service in this proceeding.

As explained by witness Robinson (USPS-T-29 at 14), in light of the revenue requirement requested in this proceeding, several factors combine to reinforce the fairness and equity of the proposed three-cent increase. Any alternatives provide unfair and inequitable allocations of institutional costs. As witness Robinson testified, too high a First-Class Mail rate increase "would unfairly relieve other mail classes of their fair share of the institutional cost burden." *Id.*<sup>10</sup> Conversely, too low a First-Class Mail rate increase would place too high an institutional cost burden on other mail classes. The Postal Service proposed that the integer constraint for rates widely used by the general public should continue to be applied for administrative ease and public convenience. *Id.*

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<sup>10</sup> The same would be true of First-Class Mail intra-subclass rate relationships as well, if a basic rate higher than 37 cents were proposed.

- b. The Commission should recommend the remaining single-piece rates as modified by the settlement agreement.
  - i. The Qualified Business Reply Mail discount should be retained.

Qualified Business Reply Mail (“QBRM”) receives a postage discount in recognition of the costs avoided by the Postal Service because of automation-compatible mail piece design. Witness Robinson proposed that the postage discount be reduced from 3.0 cents to 2.5 cents, in recognition of the reduction in estimated Postal Service avoided costs for QBRM. USPS-T-29 at 14-15. While this rate proposal is reasonable, the settlement rates increase the QBRM discount to 3.0 cents, the current level. As discussed below, in the context of settlement, given the unique circumstances of this case, the Postal Service believes this adjustment to be reasonable and consistent with the policy goal outlined by witness Robinson.

- ii. The current additional-ounce rate for single-piece letters should be retained.

The additional ounce rate is charged for every ounce (or fraction thereof) above the first-ounce in weight of a single-piece First-Class Mail piece. In her testimony, witness Robinson proposed that this rate remain 23 cents. Given that 12 percent of the Postal Service’s total revenue accrues from the single-piece, additional ounce rate, this proposal is consistent with the revenue requirements of the Postal Service. In addition, ease-of-use is maintained for the general public by the continued adherence to the Postal Service’s long-standing policy of whole-cent increments for rates used by the general public. USPS-T-29 at 15-16. In this case, for the first time, the Postal Service

is proposing a different, lower, additional ounce rate for workshared First-Class Mail. That proposal is discussed below in section VI.A.4.b.ii.

- iii. The proposed nonmachinable surcharge for single-piece letters should be recommended.

The current nonstandard surcharge applicable to one-ounce single-piece First-Class Mail letters is proposed to be renamed the “nonmachinable surcharge” and to increase from 11 cents to 12 cents. The Postal Service is proposing to expand the application of the current nonstandard surcharge so that it extends to mail that is, by definition, nonmachinable or the subject of a request for manual processing. As a result, the surcharge is proposed to be renamed the “nonmachinable surcharge,” in recognition of the expansion of the mail characteristics to which the surcharge would apply. Nonmachinable mail<sup>11</sup> increases the Postal Service’s letter mail processing costs by forcing processing to manual operations. Similarly, manual processing requests also increase mail processing costs. USPS-T-39 at 10. The proposed nonmachinable surcharge for single-piece First-Class Mail letters does not fully pass through the additional costs to the Postal Service of nonmachinable mail. Witness Robinson mitigated the potential increase out of concern for the impact on mailers. USPS-T-29 at 18. The proposed classification change is fair and equitable, as it requires mailers to pay rates that recognize some of the higher costs associated with nonmachinable and

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<sup>11</sup> As discussed by witness Kingsley, nonmachinable letter mail includes pieces that are polybagged or polywrapped, have clasps, strings, buttons or similar closures, are nonrectangular, contain rigid or odd-shaped items such as pens or pencils or have other characteristics that make them nonmachinable. USPS-T-39 at 9-10.

manual-request mail. In addition, the extension of the surcharge recognizes the high value of service received by mailers who request manual processing. USPS-T-29 at 17.

3. The starting point for design of workshare category rates was witness Miller's cost analysis.

The primary inputs to witness Robinson's workshare rate design were the Postal Service's estimates of costs associated with the various First-Class Mail rate categories.

- a. Witness Miller has modified the Commission's Docket No. R2000-1 methodology.

Postal Service witness Michael W. Miller (USPS-T-22) presented a refined version of the Commission-approved "hybrid" cost methodology that was used to develop worksharing related savings estimates for the First-Class Mail presort letters and cards rate categories in Docket No. R2000-1.<sup>12</sup> USPS-T-22 at 8. This methodology relied on both Cost and Revenue Analysis (CRA) mail processing unit cost data, developed by witness Smith (USPS-T-15), and engineering cost models created by witness Miller.

The CRA mail processing unit cost estimates are dis-aggregated into 54 cost pools that represent specific tasks. USPS-T-22 at 8. Witness Miller relied on the Commission-approved cost pool classifications from Docket No. R2000-1, with two exceptions.<sup>13</sup> Consequently, the classification was changed in this docket. See USPS-

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<sup>12</sup> However, unlike the Commission's Docket No. R2000-1 analysis, witness Miller's analysis relies on the Postal Service's volume variability methodology.

<sup>13</sup> Witness Miller re-classified the "1SUPPF1" and the "1SUPPF4" cost pools as "non-worksharing related fixed." These cost pools represent tasks related to union activities, Quality of Working Life (QWL) programs, travel time for training, and general administrative activities. They are not directly related to the presorting and prebarcoding of letters and cards. USPS-T-22 at 9-10.

T-22 at 9-10. In addition, these cost pools are not tally-based cost pools. The distribution key used to estimate these costs is the subclass share of mail processing and window service costs.<sup>14</sup> In Docket No. R2000-1, the Commission opined that avoided window service costs should not be included in the worksharing related savings estimates.<sup>15</sup> This provides an additional reason why these cost pools should be excluded.

In cases where the mail processing unit cost estimates are not available at the rate category level, witness Miller used engineering cost models to de-average an available CRA mail processing unit cost category (e.g., First-Class Mail presort letters). Witness Miller's cost models consisted of two spreadsheets: a mailflow spreadsheet and a cost spreadsheet. The mailflow spreadsheet determined the test year processing path that the mail pieces in each rate category must travel before being presented to the mail carriers. Witness Miller updated the mailflows with various inputs, including densities, accept and upgrade rates, and miscellaneous data that are used to estimate the volume of mail processed in each operation for a given rate category. USPS-T-22 at 10-15. The cost spreadsheet calculated rate category model cost estimates using the mailflow spreadsheet volume estimates, marginal productivities, wage rates, piggyback factors, and premium pay factors. For the Nonautomation rate category, package sorting costs are also included. See USPS-T-22 at 15-16.<sup>16</sup>

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<sup>14</sup> See Docket No. R2001-1, Tr. 14/5647.

<sup>15</sup> PRC Op. R2000-1, at V-241, ¶5092.

<sup>16</sup> In addition, the cost spreadsheets calculate the percentage of mail for each rate category that is processed in Delivery Point Sequence (DPS). Witness Schenk



Total test year mail processing unit cost estimates for each rate category were calculated by applying a series of CRA adjustment factors to the model cost estimates for each rate category. See USPS-T-22 at 17. A subset of each total mail processing unit cost estimate, referred to as the "worksharing related" mail processing unit cost estimate, was calculated by applying the worksharing related CRA adjustment factors only to the model cost estimates for each rate category. See USPS-T-22 at 17.

The worksharing related savings estimates by rate category are calculated to be the difference between the sum of the worksharing related mail processing unit cost estimate and delivery unit cost estimate for the selected benchmark, and the sum of those same cost estimates for a given rate category. See USPS-T-22 at 17.

b. Benchmark issues should be laid to rest.

In order to develop these savings estimates, it is first necessary to establish the proper benchmark. The Postal Service shares the Commission's view that Bulk Metered Mail (BMM) is the appropriate benchmark when developing worksharing related savings estimates for the First-Class Mail presort letters rate categories. PRC Op. R2000-1, at V-241, ¶5089.

The In-Plant Survey conducted by witness Miller should lay to rest any controversy regarding the existence of BMM. See USPS LR J-155. From the survey, it was apparent that BMM letters came from one of two sources: (1) mailers that were not participating in the worksharing program, and (2) presort bureaus. See USPS-T-22 at 19. In the latter case, BMM letters are typically the "residual" mail volume that presort

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(USPS-T-43) used these DPS percentages to develop delivery unit cost estimates by rate category.

bureaus, for whatever reason, are unable to presort and/or prebarcode.<sup>17</sup> In fact, NAPM witness Gillotte implied that presort bureaus also receive BMM letters from their customers when he stated that "not all mail processed by presort bureaus is in fact BMM." Docket No. R2001-1, Tr. 13/5031. His testimony supports the Commission's view that a benchmark should be viewed as a "two way street." The BMM letters benchmark should represent not only the mail most likely to convert to worksharing rate categories, but also the category to which current worksharing mail would most likely revert, were the costs to mailers of performing worksharing activities to exceed the discounts. PRC Op. R2000-1, at V-241, ¶5089. If a presort bureau stopped participating in the worksharing program, the customers that had submitted their mailings to that bureau as BMM letters would likely submit their mailings to the Postal Service as BMM letters.

c. Appropriate proxies were utilized.

Postal Service cost data collection systems are not extensive enough to permit isolation of the mail processing unit costs for BMM letters. Consequently, a proxy must be used. Witness Miller used the CRA mail processing unit cost estimate for all First-Class single-piece metered letters as a proxy for BMM letters. USPS-T-22 at 20. This is the identical proxy relied upon by the Commission in Docket No. R2000-1.<sup>18</sup>

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<sup>17</sup> Witness Miller even provided copies of a presort bureau's postage statements from three such "residual" mailings. Tr. 14/5512-5516. He provided notes that were taken during field observations he conducted at three plants in which he personally confirmed the existence of BMM. *Id.* at 5505-07, 5517. During one of those visits he also photocopied sample BMM mail pieces. *Id.* at 5509-11.

<sup>18</sup> Docket No. R2000-1, PRC LR-12.

However, the Commission made one modification to the BMM letters mail processing unit cost estimate in Docket No. R2000-1, that witness Miller did not make in this docket. The Commission reduced the "1CANCMMP" cost pool by two-thirds of its value. PRC Op. R2000-1, at V-241, ¶5090. Witness Miller made no such adjustment. See USPS-T-22 at 20.

Postal Service cost data collection systems also are not extensive enough to isolate the in-office delivery unit costs for BMM letters. Consequently, a proxy must again be used. Back in Docket No. R2000-1, witness Miller used the aggregate Nonautomation Presort letters delivery unit cost estimate as the proxy for BMM letters.<sup>19</sup> The Commission's Docket No. R2000-1 opinion relied on that same delivery unit cost proxy.<sup>20</sup>

In the current docket, witness Miller de-averaged the Nonautomation Presort letters rate category into eight cost components based on the machinability and presort level of the mail pieces. Docket No. R2001-1, USPS-T-22 at 34. This analysis was conducted to support the Nonmachinable Surcharge proposal and resulted in a more expansive data set from which to select a BMM letters delivery unit cost proxy. After careful review, witness Miller selected the delivery unit cost estimate for Nonautomation machinable mixed AADC presort letters as the proxy for BMM letters. USPS-T-22 at 20.<sup>21</sup>

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<sup>19</sup> Docket No. R2000-1, USPS-T-24 at 13.

<sup>20</sup> Docket No. R2000-1, PRC LR-12.

<sup>21</sup> It is not surprising that the delivery unit cost estimate for this refined proxy differs from the delivery unit cost estimate used in Docket No. R2000-1. A high

The fact that there may be a cost difference between two delivery unit cost estimates does not, by itself, mean that one estimate is the best proxy for BMM letters. However, witness Miller's explanation makes it clear that the delivery unit cost estimate for Nonautomation machinable mixed AADC presort letters is the better proxy for BMM letters.

d. Flats costs have been expertly estimated.

Witness Miller's (USPS-T-24) flats mail processing testimony, described above in Section V.C.4.A.I., provided the starting point for witness Robinson's First-Class Mail flats rate design.

e. The updated nonstandard surcharge costs analysis supports the proposed nonmachinable surcharge.

Witness Miller's nonstandard surcharge cost study is contained in USPS LR J-60. It consists of an update of the cost study relied upon in Docket No. R2000-1. See Docket No. R2000-1, PRC LR-12. Witness Miller's study supports the Postal Service's proposal to expand the surcharge to apply to nonmachinable pieces. The study analyzes cost differences of various sub-components of the Nonautomation Presort

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percentage (25 percent) of First-Class Nonautomation Presort letters are nonmachinable and must be processed manually through the entire postal network. See USPS-T-22 at 34. In contrast, BMM letters are non-presorted, non-barcoded, machinable mail pieces with machine-printed, OCR-readable addresses that are entered in bulk, properly faced and trayed. See Docket No. R2001-1, Tr. 14/5592. Nonautomation machinable mixed AADC presort letters are also non-presorted, non-barcoded, machinable mail pieces with machine-printed, OCR-readable addresses that are entered in bulk, properly faced and trayed. In addition, BMM letters and Nonautomation Presort letters follow the same processing paths (Tr. 14/5586) and have virtually identical Delivery Point Sequence (DPS) percentages. Tr. 7/1378-1379.

First-Class Mail stream, disaggregated by machinability and presort level. Its methodology and results are not contested in this proceeding.

f. Witness Miller has refined the QBRM cost analysis.

Witness Miller (USPS-T-22 at 26-27) presented a refined version of his Docket No. R97-1 "exact piece comparison" cost methodology that was used to support the initiation of Qualified Business Reply Mail (QBRM) letter and card discounts.<sup>22</sup> In that docket, witness Miller estimated the worksharing related savings to be the difference between a First-Class Mail handwritten reply mail piece benchmark and a First-Class Mail preapproved, prebarcoded reply mail piece. The analysis was limited to the inclusion of costs up to the point where each mail piece received its first barcoded sortation on a Bar Code Sorter (BCS). In other words, the cost difference between the mail pieces was primarily driven by the additional costs required to apply a barcode to the handwritten reply mail piece.<sup>23</sup>

The Docket No. R2000-1 QBRM cost study presented by Postal Service witness Campbell attempted a more expansive analysis that included costs up to and including the incoming secondary operations.<sup>24</sup> In the current docket, witness Miller addressed the problems with witness Campbell's analysis and excluded the incoming secondary costs.<sup>25</sup> After further review, witness Miller determined that an analysis similar to that conducted in Docket No. R97-1 would be more appropriate. Consequently, he revised

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<sup>22</sup> Docket No. R97-1, USPS-T-23.

<sup>23</sup> Docket No. R97-1, USPS-T-23 at 2-3.

<sup>24</sup> Docket No. R2000-1, USPS-T-29 at 38-40.

<sup>25</sup> Docket No. R2001-1, USPS-T-22 at 27.

the QBRM cost study.<sup>26</sup> Witness Miller provided mail flow diagrams for both a handwritten reply mail piece and a QBRM mail piece<sup>27</sup> and explained his rationale for supporting a more limited analysis:

Mail volume dictates mail flow. . . . Consequently, a high volume post office box mail recipient would likely have their mail finalized in the same number of piece handlings, whether the mail piece entered a given facility as a prebarcoded reply mail piece or a handwritten reply mail piece. The only difference would be the extra RBCS-related processing steps required to apply a barcode to the handwritten mail piece.

Tr. 14/5470. Witness Miller calculated the worksharing related savings estimate for QBRM letters and cards to be 1.647 cents.<sup>28</sup> This figure represented nearly a 60 percent reduction from the worksharing related savings estimate originally calculated in Docket No. R97-1.

Witness Miller applied the Bulk Metered Mail (BMM) letters CRA adjustment factor to both the handwritten reply mail piece and QBRM mail piece model cost estimates before he calculated the worksharing related savings estimate. He explained that he used this CRA adjustment factor because both mail categories are also subsets of the First-Class Mail single-piece rate category, as is BMM letters. Tr. 14/5443. In fact, this CRA adjustment factor is likely high because the BMM letters cost model is being reconciled to a CRA mail processing unit cost estimate that represents all metered letters.<sup>29</sup> Unlike BMM letters, metered letters are not necessarily machinable,<sup>30</sup>

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<sup>26</sup> Docket No. R2001-1, Tr. 7/5539.

<sup>27</sup> Docket No. R2001-1, Tr. 14/5471.

<sup>28</sup> See Docket No. R2001-1, USPS-T-22 at 27.

<sup>29</sup> See Docket No. R2001-1, USPS-T-22 at 20.

<sup>30</sup> See Docket No. R2001-1, Tr. 14/5535.

are often entered in packages ("bundles"),<sup>31</sup> and can contain handwritten addresses.<sup>32</sup>

Witness Miller further explained that his method was sound, given that QBRM mail pieces and automation presort mail pieces have distinct characteristics. Tr. 14/5444.

The Postal Service supports the use of the handwritten reply mail piece benchmark in the QBRM analysis, but it is a generous benchmark indeed. If QBRM mail recipients did not provide QBRM mail pieces to their customers, it is possible that those customers would use a machine printed reply mail piece or Courtesy Reply Mail (CRM) piece as an alternative, both of which cost less to process than a handwritten reply mail piece.

g. Witness Miller's analysis of cards cost avoidance is proper.

Unlike the First-Class presort letters rate categories, the First-Class presort card categories do not have a formal non-presort benchmark. Consequently, the worksharing related savings estimates are calculated using other rate categories as benchmarks. Witness Miller calculated First-Class presort card mail processing unit cost estimates using card/letter cost ratios that have been adjusted for mail mix differences. USPS-T-22 at 21-22. The worksharing related savings calculations were then performed using the methods described above.

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<sup>31</sup> See USPS-T-22 at 20.

<sup>32</sup> See Docket No. R2001-1, Tr. 14/5595.

4. Witness Robinson's proposed rate design reflected appropriate consideration of relevant pricing factors
  - a. The workshare letters rate design follows Commission precedent.

Consistent with the cost coverages proposed by witness Moeller (USPS-T-28), witness Robinson (USPS-T-29) developed First-Class Mail rates that reflect a careful analysis and balancing of many – often conflicting -- rate design goals. Overall, the goal of the worksharing program has been to “control the costs of mail processing and delivery functions . . . in order to provide mail services at a reasonable price.” Tr. 7/1460. This goal has been met through the institution of worksharing discounts providing rate incentives for mailer preparation and sortation of First-Class Mail pieces meeting the requirements of the Postal Service. In this case, as in prior Postal Service requests and Postal Rate Commission recommended decisions, workshared First-Class Mail discounts were designed by taking into consideration estimates of cost avoidance. The Postal Service and the Postal Rate Commission have considered that worksharing discounts generally should be based on the costs that the worksharing activity avoids. USPS-T-29 at 10. However, as witness Moeller observed:

in past cases, the Commission has considered a variety of other factors in its determination of the appropriate passthroughs for various workshare discounts. The result has sometimes been passthroughs either significantly above or significantly below estimated cost avoidances, in circumstances where the Commission considered this to be warranted.

A review of prior Commission decisions indicates that the Commission has considered such factors as large changes in the results of cost avoidance studies, concern about the impact on rate changes on mailers, concern over the impact of reductions in workshare discounts on the automation program and concern with appropriate rate relationships.



Witness Robinson followed this approach in her rate design in this case. Clearly, witness Robinson did not limit her analysis to a mechanistic application of passthroughs to the avoided cost estimates provided to her by witness Miller. As her testimony indicates, she considered “the importance of mailer barcoding and presortation in overall postal operations” and that, “overall, automated letters are a low cost, high contribution mail stream.” USPS-T-28 at 20-21. In addition, she also considered “the impact [of the proposed rate changes] on . . . customers whose efforts have played a part in the success of [the] automation program”<sup>33</sup> (*Id.* at 12) and “the resulting rate relationships and the degree of rate complexity” Tr. 7/1519. Following this evaluation, witness Robinson determined that 0.5-cent increases in the workshare discounts<sup>34</sup> were appropriate and met the Postal Service’s policy goals and the statutory ratemaking criteria. USPS-T-29 at 20-21.

Passthroughs greater than 100 percent, such as those proposed by witness Robinson, are not unprecedented in postal rate design. The Commission has recognized that such passthroughs may be necessary under appropriate circumstances to avoid rate shock in adversely affected rate categories and to avoid unduly high increases for certain rate categories within a subclass. PRC Op. R2000-1 at 331, ¶¶5372; and 349-50, ¶¶5412. Accordingly, witness Robinson’s rate design was consistent with the ratemaking policies of the Postal Reorganization Act and Commission precedent.

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<sup>33</sup> USPS-T-29 at 12; see also Tr. 7/1509.

<sup>34</sup> Resulting in passthroughs of 115 to 121 percent of avoided cost estimates, respectively, based on the cost avoidance estimates initially presented in USPS-T-22.

c. The design of the other rate elements also is appropriate.

i. The nonmachinable surcharge

Other workshare letter rate elements proposed by witness Robinson are also reasonable and reflect the Postal Service's policy goals and the statutory ratemaking criteria. The nonmachinable surcharge, an expansion and associated renaming of the current nonstandard surcharge, is proposed to increase 0.5 cents, to 5.5 cents. The surcharge is based on the Postal Service's additional costs for processing a nonmachinable piece (or a piece for which manual processing is requested) and is designed to provide an incentive for mailers to prepare machinable mail pieces. USPS-T-29 at 24. As witness Robinson notes, the nonmachinable surcharge does not recover all of the additional processing costs associated with nonmachinability. This rate design decision was made as a result of her "concern for the impact on customers not currently paying the surcharge who would pay the surcharge under the expanded definition." Tr. 7/1563. Such an approach has been a consistent feature in the determination of the amount of the surcharge since its inception in Docket No. MC78-1.

ii. The additional-ounce rate for workshare letters

Witness Robinson's rate design for the workshare additional-ounce rate considered many of the factors outlined in the discussion of the workshare discounts discussed above. She proposed a 22.5 cents workshare additional-ounce rate – which is 0.5 cents lower than the corresponding single-piece additional ounce rate. This proposal is based, in part, on the cost data presented by Postal Service witness Schenk (USPS-T-43) in USPS-LR-J-58. Those data indicate that a workshare additional-ounce costs somewhat less than a single-piece additional ounce. Witness Robinson

considered that the underlying factors resulting in the relatively high implicit cost coverage for workshared First-Class Mail suggested that some mitigation of the workshare additional ounce rate was appropriate. USPS-T-29 at 25. As discussed below, the decision to establish a lower additional-ounce rate for workshared letters provides a foundation for the Postal Service's long-term strategy regarding the heavy-piece discount.

iii. The proposed heavy-piece workshare discount reduction

The Postal Service's rate design proposed that the heavy-piece discount applied to all workshared mail weighing more than two ounces be reduced 0.5 cents, from 4.6 cents to 4.1 cents. Witness Robinson's proposal to reduce this discount supports the Postal Service's longer-term policy goal of "eliminating the Heavy Piece discount . . . and incorporating any observed cost differentials between single-piece and presorted mail into the additional-ounce rate for presorted Letters." USPS-T-29 at 26. While elimination of the heavy-piece discount is a longer-term goal, witness Robinson's evaluation suggested that a consideration of the potential "significant disruption for some mailers" warranted a gradual phase-out of this discount. *Id.*

c. The Cards rate design reflected in the Stipulation and Agreement should be recommended by the Commission.

In its Request, the Postal Service proposed a two-cent increase in the single-piece card rate from 21 cents to 23 cents. This increase is consistent with the 158.7 percent Cards subclass cost coverage proposed by witness Moeller. Exhibit USPS-28B. However, as witness Robinson noted, the ratio of revenue to costs for single-piece cards is very low – only 112.7 percent – which might suggest that a greater

increase was warranted; but, concern over the potential impact on the single-piece card mailer suggested that a larger rate increase was not appropriate. The Postal Service proposes single-piece rates in whole-cents “for administrative ease and to avoid unnecessary complexity for the general mailing public.” USPS-T-29 at 26-27. In this proposal, coincidentally, the proposed single-piece postcard rate and the single-piece additional ounce rate are the same. While this result does not reflect a rate objective of the Postal Service, it will increase ease-of-use for the general public. USPS-T-29 at 27.

Like Qualified Business Reply Mail letter recipients, QBRM postcard recipients qualify for a postage discount in recognition of the automation-compatibility of their mail pieces. In recognition of a reduction in the estimated cost avoidance for QBRM mail pieces measured by witness Miller (USPS-T-22 at 27), witness Robinson proposed that the current 3.0-cent discount be reduced to 2.5 cents. USPS-T-29 at 27. While this proposal was reasonable, as for QBRM letters and cards, the settlement rates propose that the QBRM discount stay at the current 3.0 cent level. As discussed below, in the context of settlement, given the unique circumstances of this case, the Postal Service believes this adjustment to be reasonable and consistent with the policy goals outlined by witness Robinson.

The Postal Service proposed a 2.2 cent increase in the Nonautomation Presort card rate. Implementation of this increase would restore the parity between the Nonautomation Presort letter and card rates.<sup>35</sup> Consistent with past proposals, the

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<sup>35</sup> As a result of the Governors’ Docket No. R2000-1 Modification, the discount for Nonautomation Presort cards is currently greater than the discount for Nonautomation Presort letters.

Postal Service used the Nonautomation Presort letter cost avoidance as the best available proxy for Nonautomation Presort cards. USPS-T-29 at 28. For Automation Presort cards, the Postal Service proposed an increase of 0.5 cents in the discounts. This proposal was based on a balancing of numerous factors including: the cost coverage target proposed by witness Moeller, the high relative contribution of workshared cards, concern over potential disruptive effects on mailers, and the relative importance of mailer barcoding in overall postal operations. USPS-T-29 at 29. In addition, consistent with its classification proposals for Letters subclass, the Postal Service proposed a deaveraging of the current Basic Automation tier into Mixed-AADC and AADC tiers. This recognizes the cost differential for mail processing and will provide an incentive for mailers to consolidate mailings and increase the level of sortation of Automation rate cards presented to the Postal Service. USPS-T-29 at 29. The Postal Service is also proposing a classification change that deletes specific cards preparation requirements currently listed in Domestic Mail Classification Schedule section 222.2. As witness Robinson noted, “[s]ome of these requirements are outdated and do not conform to current card processing requirements.” USPS-T-29 at 30. These changes are expected to have a minimal impact on customers. Neither card subclass classification change is opposed by any intervenor and, therefore, both should be recommended by the Commission.

5. The settlement rates deviate minimally from the Request and also reflect balanced consideration of relevant rate design criteria

As noted above, discussions among the Postal Service and all intervenors resulted in First-Class Mail settlement rates that differ slightly from the rates initially

proposed by the Postal Service. Specifically in First-Class Mail, the settlement proposal seeks to expand the Automation 3-Digit and 5-Digit Presort letters discounts to a level 0.2 cents greater than originally requested by the Postal Service; and it proposes that the Qualified Business Reply Mail letter and card discounts be 0.5 cents greater than originally requested. Tr. 13/4967.

The settlement rates reflect recognition of the need for “everyone connected with this process – to be statesman-like and to work together to proactively meet the serious challenges facing the postal system.” See Tr. 1/42. As expressed by witness Moeller (Tr. 13/4968), the settlement rates also demonstrate the Postal Service’s concurrence with the Commission’s long-standing admonition that no party should consider its set of proposed rates to be “so `right’ that any deviation from it would produce rates which would be unlawfully unfair or inequitable.” See PRC Op. R87-1 at 360, ¶4001.

Witness Robinson proposed First-Class Mail rate and classification changes that are consistent with sound public policy and postal rate-making precedent. As she observed on cross-examination:

[r]ate design is not a mechanical process of passing through 100 percent of cost avoidances. . . . [I]t . . . is a judgmental assessment of the various factors surrounding the rate category, the discount, looking at a number of different things.

Tr. 7/1611-12. The Postal Service’s decision to revise the proposed 3-Digit, and 5-Digit Automation rates and the QBRM rate for the purposes of pursuing settlement still results in rates that are reasonable and consistent with the rate making objectives set out by witness Robinson in her testimony. Tr. 7/1614 -17. The Postal Service was faced with determining whether additional FY 2002 revenue of approximately \$1 billion,

as a result of earlier implementation of the Docket No. R2001-1 rates, was desirable and would allow it better meet its pressing financial obligations. The Postal Service balanced that objective against the pursuit of later implementation of its original rate design. Under the unique circumstances of this case, the Postal Service considered that the public interest could more immediately and best be served by the results that were attainable through settlement. Tr. 13/4978, 5009-11. See also, Section II, above, for an overview of the context in which settlement arose.

There is no pretense on the part of Postal Service witnesses Robinson or Moeller that only the originally requested First-Class Mail rate design would meet the criteria of the Act. Even under the unique circumstances of this proceeding, the Postal Service has presented substantial record evidence that reflects strict adherence to the fundamental principles of institutional cost allocation in postal rate design. The Postal Service has demonstrated how the First-Class Mail rates it originally requested comport with the ratemaking policies of the Act. The Postal Service also has explained how incorporation of the very minor First-Class Mail rate design changes in the Stipulation and Agreement have a relatively insignificant impact on its overall revenue requirement, as well as the relative contributions to that revenue requirement to be made by the single-piece and worksharing portions of the First-Class Mail stream. Tr. 13/4973. As witness Moeller further explained, the rate design differences between the Request, on the one hand, and the Stipulation and Agreement, on the other, are so small as to allow the Commission to conclude that the rates in the Stipulation and Agreement comply with policies of the Act no less well than the rates originally sought by the Postal Service. See Tr. 13/4991.

When combined with witness Moeller's surrebuttal testimony (USPS-SRT-1; Tr. 13/4961 *et seq.*), the above-referenced direct testimony of the Postal Service provides substantial evidence that the proposed settlement rates, fees and classifications share the same solid foundation as the Postal Service's Request, and also comprise a comprehensive, integrated and harmonious rate and classification schedule that should be recommended to the Governors.

B. The Commission Should Reject the Rate Design Proposed by American Postal Workers Union, AFL-CIO, Witness Riley

The record in this proceeding demonstrates that the First-Class Mail settlement rates ensure that the Postal Service's revenue requirement will be met in a manner that is fair and equitable to mailers and competition. These settlement rates are consistent with the public interest. Nevertheless, APWU objects to the Postal Service's First-Class Mail rate design -- as requested and as modified by the settlement agreement. As demonstrated below, the principal criticisms of APWU witness Riley are insufficient to support any deviation from the First-Class Mail rates in the Stipulation and Agreement.

1. APWU's myopic focus on workshare rate percentage passthroughs ignores relevant rate design considerations

On behalf of APWU, witness Michael Riley testified that the Commission should recommend First-Class Mail workshare discounts that reflect the passthrough of somewhere between 80 to 100 percent of the cost avoidance estimated by Postal



Service witness Miller (USPS-T-22).<sup>36</sup> Witness Riley emphasized that the passthroughs in the rate design should be closer to 80 percent than to 100 percent. Tr. 12/4846.

He offered several reasons for preferring this approach to rate design. First, he concluded that Postal Service witness Miller (USPS-T-22) has overstated First-Class Mail worksharing related cost avoidance. How does Mr. Riley know this? Because, in his view, witness Miller has not attempted to estimate “actual” cost avoidance, but instead, has presented the Commission with “should” estimates of worksharing cost avoidance.<sup>37</sup> And what makes witness Miller’s cost estimates “should” costs, instead of “actual” costs? Witness Riley proclaimed the Postal Service’s estimates of worksharing cost avoidance to be overstated, because those estimates supposedly do not take into account the “the added costs of mail presented at a category for which it does not qualify.” Tr. 12/4882. He presents no empirical cost or mailstream quality analysis to refute witness Miller’s cost estimates. Mr. Riley offered only his judgment, which, it turns out, is based upon his recollection of undocumented discussions at an August

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<sup>36</sup> Direct Testimony of Michael J. Riley On Behalf Of American Postal Workers Union, AFL-CIO, (APWU-T-1; Tr. 12/4840 *et seq.*).

<sup>37</sup> Tr. 12/4849-50. Never mind that witness Miller’s cost models are rooted in the CRA and, to the greatest extent currently practicable, incorporate nationwide aggregate productivities, and accept and upgrade rates from actual mail processing operations through which flow actual mail, imperfections and all. To the extent that mail piece imperfections cause automation rejects and higher reliance on less efficient sorting alternatives, such phenomena are reflected in the mail flow reject rates and productivities in witness Miller’s cost models.

2001 Mailers Technical Advisory Committee meeting regarding the currently evolving MERLIN mail piece quality assurance technology.<sup>38</sup>

Another reason Mr. Riley wants the First-Class Mail rate discounts to be close to 80 percent of the measured cost avoidance is to improve the overall finances of the Postal Service and to help the Postal Service recover from its dire financial straits. Tr. 12/4847. He criticized the ratemaking process as a failure. In his view, the ratemaking process that “has consistently resulted in worse financial results than . . . the law and good management require.” Tr. 12/4847-48. However, he did not offer any analysis of how, or any estimate of the degree to which the ratemaking process -- isolated from all other influences on postal finances and revenues -- has contributed to the Postal Service’s historical or current financial status. He provided no analysis of the impact of his preferred First-Class Mail rate design, or similar reductions in workshare discounts in other classes, on test year volumes or revenues. Nor did he explain why, in the context of the current proceeding, all else equal, mail should be subjected to higher percentage rate increases, solely because it is prepared for entry into the mail stream in a manner that reduces postal mail processing costs.<sup>39</sup>

Also absent from Mr. Riley’s testimony is any analysis of the impact that his proposal would have on affected workshare mailers. His testimony presented no discussion or comparison of the relative percentage rate increases implied by his

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<sup>38</sup> Tr. 12/4849-50. The technical implementation standards for which, apparently, are still under development. Tr. 13/5036, 5079-81.

<sup>39</sup> Assuming dire postal finances, it seems that the ratemaking criteria should be applied to ensure that all mail fairly and equitably shares in shouldering the cost of operating the postal system, without there being an additional “tax” on workshared mail.

proposal for the various First-Class Mail rate categories. When asked to state the percentage rate increases for each First-Class Mail rate category implied by his rate design approach, he dismissed the question as making “no sense[.]” Tr. 12/4896.

When one examines the percentage rate increases implied by Mr. Riley’s preferred 80 percent passthrough, it becomes apparent that the resulting percentage rate increase for the worksharing letters rate categories typically would be at least twice as high as the percentage increase proposed for single-piece First-Class Mail letters. See Tr. 13/5389. For workshare cards, the percentage increases would typically approach, if not exceed, 2.5 times the percentage increase proposed for single-piece cards. *Id.*

APWU may argue that the only meaningful comparison of percentage rate changes would be an analysis of such changes over a longer period of time. During cross-examination of witness Moeller, referencing USPS LR J-90, APWU attempted to make such a point, comparing the percentage rate increases between single-piece letters and 5-Digit Presort letters between the years 1991 and 2001. See Tr. 13/5002-06. However, as demonstrated by witness Moeller, the value of such an exercise is meaningless, when one fails to isolate the impact of the rather significant redesign of the workshare mail categories resulting from Docket No. MC95-1. *Id.* at 5004-06.

When one actually compares the percentage rate increases for the two rate categories since reclassification, APWU’s suggestion that single-piece mail has experienced a larger rate increase withers away. Beginning with the rates implemented as a result of Docket No. MC95-1, the single-piece rate has increased by 6.3 percent (from 32 cents to 34 cents) vs. 7.1 percent (from 23.8 cents to 25.5 cents) for 5-Digit Presort.

Substituting the settlement rates for the current rates, the increases are 15.6 percent for single-piece and 16.8 percent for 5-Digit. See USPS LR J-90 at 1-2.

Another failing of witness Riley's proposed rate design is that, in the absence of the application of some judgment, the mechanistic application of a preferred passthrough percentage for all workshare rate categories could lead to anomalous rate design. At either an 80 or a 100 percent passthrough, APWU witness Riley proposed no differential between the rates for Automation 5-Digit Presort and Carrier Route letters and cards. Tr. 12/4865-68.<sup>40</sup> Moreover, witness Riley's rigid approach would result in no discounts for flats presorted to the Mixed ADC, ADC, or 3-Digit Presort levels. *Id.* at 4865, 4867. If anything, his testimony reinforces the need to apply some judgment in considering factors other than workshare passthroughs to develop a rational and fair set of rates, as has been proposed by witness Robinson and incorporated into the terms of the Stipulation and Agreement.

Finally, witness Riley proposed that worksharing rates should be judged on the basis of whether:

[e]ach piece of . . . discounted mail . . . contribute[s] at least as much absolute dollar contribution as a each piece of comparable non-discounted mail. . . .  
[T]he Postal Service should have the exact same absolute contribution from the mailing of one First-Class letter, regardless of how it is presented.

Tr. 12/4852. In the absence of any cost data sufficiently disaggregated to permit such an analysis, he suggested that workshare discount passthroughs be kept close to his preferred 80 percent proposal. The Postal Service observes that whether or not such

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<sup>40</sup> Nor does his approach suggest a rate differential between 5-Digit Presort letters and 5-Digit Presort flats. Tr. 12/4865, 4867.

cost data can even be developed remains to be seen. However, the Commission's approach to rate design in this proceeding should not be hamstrung by the absence of data that have not been developed for purposes of this proceeding. In the meantime, the Commission should continue to rely on the factors identified in the testimony of Postal Service witness Robinson (USPS-T-29).

There are no data available with which to precisely perform Mr. Riley's comparable piece test. However, witness Moeller has observed that – if equal unit contribution were the preferred goal – the only available cost data would show that, at least in the aggregate, workshare letters make a slightly greater Test-Year-After-Rates unit contribution to institutional costs than single-piece letters -- either at the originally requested rates or at the settlement rates. Tr. 13/4974-75. The rates implied by Mr. Riley's preferred 80 percent passthrough would drive the unit contribution figures for workshare and single-piece further apart, contrary to the objectives of his own equal contribution objective. *Id.* at 4975.<sup>41</sup>

2. APWU neglects important factors in its opposition to the proposed workshared additional-ounce rate

Moving on to the issue of the additional-ounce rate, Mr. Riley rejected the proposed establishment of a lower additional-ounce rate for the First-Class Mail workshare rate categories. Tr. 12/4861-62. He quibbled with the timing of the proposed divergence in the single-piece and workshare additional ounce rates, and the degree to which current data justify the proposed divergence. Tr. 12/4862. In his view, the

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<sup>41</sup> The parameters of Mr. Riley's rule are sufficiently vague that postal experts such as witnesses Moeller and ABA&NAPM witness Clifton cannot agree on what it means. *Compare*, Tr. 13/4974-75 and 5287-91.

estimated cost difference between single-piece and workshare additional ounces is not sufficiently meaningful to warrant a rate differential now. *Id.*

The First-Class Mail additional-ounce cost studies that have evolved in the last several omnibus proceedings, on an aggregate basis, provide an indication that the additional-ounce rates for single-piece and workshare First-Class Mail could diverge, if no overriding policy consideration suggested that they remain merged. The additional-ounce rate has never been strictly tied to a measure of additional-ounce costs deemed to be precise on an ounce increment-by-ounce increment level. Witness Riley's aversion to a change in additional-ounce rate design overlooks the degree to which First-Class Mail additional-ounce rates have been adjusted historically by both the Postal Service and the Commission on a judgmental basis in the rate design process to meet the overall revenue target implied by the First-Class Mail cost coverage. Accordingly, his views should be given little weight.

3. APWU provides no compelling basis for rejecting the QBRM settlement rates

Mr. Riley also argued that the proposed retention of the current 3.0-cent QBRM discount as part of the Stipulation and Agreement is an excessive violation of sound business practice. Tr. 12/4863. On the one hand, he criticized the Postal Service's final, corrected QBRM cost avoidance estimate as too uncertain to be reliable. *Id.* At the same time, he urged the Commission to rely upon an initial erroneous miscalculation of the cost avoidance. He testified that, rather than accept the final corrected estimate as a basis for rate design, he would prefer to use the initial erroneous miscalculation, because it is a lower number, because the process of revision

causes him to be uncertain about the cost avoidance estimate. *Id.* at 4927. He even conceded to being indifferent to whether the lower estimate was erroneous or the result of a typographical error. *Id.* Apparently, the fact that the lowest number is the lowest number is a sufficient basis for preferring it. One might have assumed that, if Mr. Riley were so uncertain about the reliability of the underlying QBRM cost avoidances estimate, he might have approved the proposal in the Stipulation and Agreement to maintain the current 3.0-cent QBRM discount until such time as he was presented with a cost avoidance estimate he deemed sufficiently reliable.

At its core, witness Riley's testimony reflects a fundamental misunderstanding of the ratemaking process. Its purpose is not to maximize postal revenues by making choices that "generate the most revenue for the Postal Service." Tr. 12/4849. Because of the breakeven constraint in section 3621, ratemaking is a zero-sum game. Arbitrarily slashing all workshare passthroughs to 80 percent in that context merely transfers institutional cost burden from one mailer to another, which has volume and revenue consequences about which Mr. Riley provides no meaningful guidance.

- C. The Postal Rate Commission Should Not Rely on the Surrebuttal Testimony Presented by the Intervenors
  - 1. The settlement parties have agreed to support the Postal Service's case

Orderly and procedurally fair settlement of Commission proceedings should be encouraged. It promotes efficient use of the scarce resources of all who appear before the Commission, as well as the limited resources of the Commission itself. The unprecedented level of harmony among diverse interests that has been achieved during

Docket No. R2001-1 may be due to unique circumstances that we all hope are never repeated. Nevertheless, the manner in which this proceeding is resolved may make possible similar cooperative efforts under similar, if less urgent, circumstances.

Whether that can be a legacy of Docket No. R2001-1 depends, in part, on the perception that parties have of the manner in which the Commission has managed the litigation of this docket.

The Commission is to be commended for managing this docket from the outset in a manner that encouraged the parties to search for common ground and to reduce the usual myriad of contested issues. The Commission's efforts have borne fruit, bringing this proceeding to this stage three months earlier than usual, with the contested issues reduced to a single one. This has created an opportunity for the Postal Service to obtain significant financial relief from the impact of the events of September 11, 2001, and acts of bio-terrorism in October, 2001, much earlier than otherwise would have been possible. The positive impact of the Commission's leadership at a time of crisis and uncertainty cannot be overstated.

The Postal Service contends that the testimony it has sponsored in this proceeding provides substantial record evidence to support three conclusions: (a) that the settlement rates are in accordance with the ratemaking criteria of the Postal Reorganization Act, (b) that these rates should be recommended to the Governors for approval, and (c) the alternative First-Class Mail rate design proposed by APWU witness Riley should be rejected.



Accordingly, the Postal Service considers that it is not necessary for the Commission to rely on any of the surrebuttal testimony of intervenor witnesses supporting settlement to reach these conclusions.

Presumably, in response to the assertion by witness Riley that the Postal Service has overstated workshare cost avoidance (Tr. 12/4849-50) , four intervenors that support the settlement – American Bankers Association and National Association of Presort Mailers, KeySpan, Major Mailers Association and National Association of Presort Mailers -- filed testimony purporting to refute that claim. In doing so, these parties also suggest that the workshare cost avoidance estimates provided by witness Miller may be understated. There are several reasons why the Commission should not rely on this intervenor testimony in establishing a basis for the settlement rates.

2. The Commission should not rely on testimony seeking to expand the scope of mail preparation activity included in workshare cost avoidance estimates

National Association of Presort Mailers witness Gillotte (NAPM-SRT-T-1; Tr. 13/5035-36) and Major Mailers Association witness Crider (MMA-SRT-2; Tr. 13/5101) both urged the Commission to expand the definition of worksharing cost avoidance to include consideration of workshare mailer participation on the Postal Service's Move Update program. Identical proposals were rejected in the past two omnibus proceedings. PRC Op. R2000-1 at 242, ¶¶5093; PRC Op. R97-1 at 295, ¶¶5100. These witnesses provide no compelling basis for a reversal from the Commission's earlier pronouncements.

Witness Gillotte argued that the correlation between presort industry capital investment on postal capital investment should be analyzed. He testified that the Postal

Service avoids maintenance, supply, and transportation fleet costs because of the work performed by presort bureaus. He argued that mailers should be compensated for upgrading mail to automation-compatible status, for educating their customers and otherwise relieving the burdens of postal customer representatives and mailpiece design analysts, for the distribution of mailpiece trays provided by the Postal Service, and the reduction of window service and loading dock costs. Tr. 13/5029-35.

In Docket No. R2000-1, the Commission reiterated that it was inappropriate to consider avoided window service costs in measuring workshare cost avoidance. PRC Op. R2000-1 at 242, ¶5094. Witness Gillotte provided no compelling basis for expanding the definition of worksharing to include consideration of these other factors.

Witness Crider testified that worksharing rate incentives do not reflect costs avoided as a result of mailers voluntarily participating in pilot programs such as *PostalOne!*. However, witness Crider acknowledged that some of the mail preparation activities listed at Tr. 13/5102 are not required in order to qualify for current discounts. Tr. 13/5146-48. Innovation in mail processing often could not occur without the cooperation of the mailing community described in Mr. Crider's testimony. However, there is insufficient information on this record to allow a conclusion that the mail preparation activities described by witness Crider merit consideration in determining adjustments to current rates or classifications.

In any event, testimony by settlement parties seeking an expansion of the definition of worksharing cost avoidance, contrary to the testimony of the Postal Service, should not be relied upon by the Commission.

3. The Commission should not rely on settlement parties' workshare cost avoidance estimates that conflict with the Postal Service's testimony.

ABA&NAPM witness Clifton (ABA&NAPM-SRT-T-1; Tr. 13/5269 *et seq.*) and MMA witness Bentley (MMA-SRT-1; Tr. 13/5156 *et seq.*) both offered an analysis of First-Class Mail costs to refute Mr. Riley's assertion that the Postal Service's estimates of workshare cost avoidance may be overstated. Their estimates of workshare cost avoidance conflicted with those of Postal Service witness Miller. The Commission should not rely on the testimonies of witnesses Clifton and Bentley for the reasons stated below.

The Postal Service considers that, to varying degrees, each of these intervenor testimonies raises questions as to whether they are consistent with the Stipulation and Agreement. Accordingly, before determining whether to rely on any of these intervenor surrebuttal testimonies, the Commission should carefully examine each to determine whether there are portions<sup>42</sup> that should not be relied upon, because they are inconsistent with the terms of the Stipulation and Agreement.

The Stipulation and Agreement in this proceeding explicitly states that each of the signatories agrees that:

[f]or purposes of this proceeding only, . . . taken in their entirety, the Request, testimony, and materials filed on behalf of the Postal Service in this docket provide substantial evidence for establishing rates and fees, as . . . set forth in Attachment B to the Postal Services Request, as revised, and for establishing the classification changes set forth in Attachment A to the Request, as revised.

Stipulation and Agreement (as revised February 13, 2002), ¶3.

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<sup>42</sup> Identified in the various APWU motions to strike filed on February 25, 2002.

To the extent that settlement parties have challenged, rejected or criticized the Postal Service's worksharing rate category and QBRM cost avoidance estimates and the underlying analysis, the Commission should avoid reliance on any portion of such testimony and should do so explicitly.

CONCLUSION

For the reasons stated above, the rates for postal services, fees for special services, and the modifications of the domestic mail classification schedule contained in the Stipulation and Agreement are supported by the evidentiary record and are in accord with the applicable provisions of the Postal Reorganization Act.

WHEREFORE, the Postal Service requests that the Postal Rate Commission recommend under 39 U.S.C. § 3624(d) the rates and fees and changes in the domestic mail classification schedule contained in the Stipulation and Agreement.

Respectfully submitted,

UNITED STATES POSTAL SERVICE

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## **CERTIFICATE OF SERVICE**

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

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