

VP-T-1

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

POSTAL RATE AND FEE CHANGES, 2005 )

Docket No. R2005-1

Direct Testimony of  
ROBERT W. MITCHELL

Concerning  
STANDARD ENHANCED CARRIER ROUTE MAIL

On Behalf of  
VALPAK DIRECT MARKETING SYSTEMS, INC. AND  
VALPAK DEALERS' ASSOCIATION, INC.

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**Direct Testimony**  
**Of**  
**Robert W. Mitchell**

**AUTOBIOGRAPHICAL SKETCH**

My name is Robert W. Mitchell. I am a consultant on issues relating to postal rates. From 1992 until my retirement in 2002, I worked as Special Assistant to the Postal Rate Commission and, before that, as Special Assistant to the Chairman. From 1975 to 1992, I was a Cost Systems Analyst, a Planning Officer, an Assistant to the Assistant Postmaster General of Rates and Classifications, Manager of the Primary Rates Branch in the Office of Rates, and a Principal Economist at the United States Postal Service. I have worked on a wide range of rate issues, from costing to rate administration to rate design to regulatory policy. I have represented the Commission and the Postal Service to mailers and various postal groups. I was the Postal Service's witness on Periodicals and Standard mail rates (then second class and third class) in Dockets No. R87-1 and R90-1, and testified on behalf of the Postal Service in four other dockets. I have also been a consultant on rates to the nations of Dominica and The Gambia.

1           Prior to joining the Postal Service, I was an Assistant Professor of  
2 Business at the University of Wisconsin-Milwaukee, teaching Economic Theory  
3 and Managerial Economics. I have a Bachelor of Science in Mechanical  
4 Engineering from the University of Cincinnati and an M. A. in Economics from  
5 Case Western Reserve University. While at Case, I passed my written and oral  
6 comprehensive examinations for the Ph.D. in Economics, with major areas in  
7 Economic Theory, Econometrics, and Industrial Economics.

8           I have written a number of articles and published papers, primarily on  
9 economic issues relating to postal rates, including: "Postal Worksharing:  
10 Welfare, Technical Efficiency, and Pareto Optimality," in *Emerging Competition*  
11 *In Postal and Delivery Services* (1999), and "Preparing the Postal Service's Rate  
12 Structures for Competition: A Study of How the United States Postal Service  
13 Might Adjust to Increased Competitive Pressure," in *Future Directions in Postal*  
14 *Reform* (2001).

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**I. PURPOSE OF TESTIMONY**

The context surrounding this case is important. Competitive pressures have been increasing. Volume growth has been stagnant and Congress is considering legislative changes. The Postal Service’s success in increasing its productivity is projected to yield a cumulative net income by the end of FY 2005 of approximately \$2.5 billion (Tr. 3/83). Not inconsistent with this success, an operating deficit approximating \$3 billion is projected for FY 2006. To remedy this deficit, as allowed by law, the Postal Service has directed attention to one specific expense element, a Congressionally required escrow payment of \$3.1 billion that is coincidentally almost equal to the projected deficit, and proposed an across-the-board rate increase of 5.4 percent, arguing that the rate increase should be thought of as the fairest way to cover that one expense. In effect, the Postal Service is suggesting that each mailer should visualize approximately 5 percent of his total postage bill as being funneled into an escrow account.

The rates being proposed build on the rates of Docket No. R2001-1, which were pursuant to a non-unanimous settlement agreement, and therefore on the now-out-of-date costs of FY 2000. No improvements in the efficiency of the rate structure are being proposed, despite substantial investment since 1999 by the Postal Service and mailers in what have been called “product redesign” initiatives. And, despite the Postmaster General’s statement that a more traditional case will come “on the heels” of this one (Tr. 2/80), no one really

1 knows how long any rates recommended will remain in effect. Funding issues  
2 central to the legislation being considered make such uncertainty unavoidable  
3 (see, e.g., H.R. 22 and S. 662). Moreover, that same legislation may change the  
4 way the Postal Service is regulated and may lead to structures such as price  
5 caps. If price caps were to be based on the rates recommended in this case,  
6 instead of on the rates emanating from a more-traditional next case, the tie to FY  
7 2000 costs (which were not the result of full Commission deliberation, due to the  
8 settlement) could lie behind the rates for some time.

9 Under these circumstances, it seems unwise as well as unfair to proceed  
10 in a way that virtually neglects all current cost relationships and builds without  
11 review on rates built on now-badly-out-of-date costs. Moreover, the ratesetting  
12 scheme outlined in the Postal Reorganization Act of 1970 does not align well  
13 with an across-the-board approach. Accordingly, this testimony has the following  
14 purposes.

15 1. To explain that this case is no different from any other omnibus postal  
16 ratemaking case and, accordingly, that it should be considered under  
17 conventional Commission rules pursuant to the **Postal Reorganization**  
18 **Act**. Its across-the-board character should be rejected.

19 2. To explain that the markup on the Enhanced Carrier Route (“ECR”)  
20 Standard subclass should be selected through an independent application

1 of the non-cost factors in the Act and that the markup on ECR costs  
2 should be reduced.

3 3. To make specific proposals concerning the rate design for ECR  
4 Standard mail. Because it is not apparent that suitable costs and cost  
5 avoidances are available on the record, specific rates will not be  
6 proposed.

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## II. POLICY CONSIDERATIONS

### 1. The Instant Case Is No Different from Any Other Case and the Same Rules Should Apply.

The Postal Reorganization Act of 1970 (hereinafter the “Act”) provides

that:

From time to time the Postal Service shall request the Postal Rate Commission to submit a recommended decision on changes in a rate or rates of postage or in a fee or fees for postal services if the Postal Service determines that such changes would be in the public interest and in accordance with the policies of this title. [39 U.S.C. section 3622(a).]

One of those policies is that “rates and fees shall be . . . sufficient to enable the Postal Service . . . to maintain . . . the development of postal services of the kind and quality adapted to the needs of the United States,” and another is that “rates and fees shall provide sufficient revenues so that the total estimated income and appropriations to the Postal Service will equal as nearly as practicable **total estimated costs** of the Postal Service.” (*Ibid.*, section 3621, emphasis added.)

The Act goes on to explain that:

“**total estimated costs**” shall include (without limitation) **operating expenses**, depreciation on capital facilities and equipment, debt service (including interest, amortization of debt discount and expense, and provision for sinking funds or other retirements of obligations to the extent that such provision exceeds applicable depreciation charges), and a reasonable provision for contingencies. [*Ibid.*, emphasis added.]

1           The Postal Service has filed an omnibus case. The Commission’s Rules  
2 of Practice and Procedure (39 CFR 3001) require that the revenue/cost balance  
3 and all rate/cost relationships be established by focusing on a prospective test  
4 year, presumably one representative of the period during which the rates will be  
5 in effect.

6           Postmaster General Potter, appearing as a policy witness (USPS-T-1),  
7 explains that “[t]he Postal Service’s decision to seek changes in postal rates and  
8 fees at this time represents a policy judgment about the most reasonable,  
9 practical and effective way to meet a currently unavoidable financial obligation  
10 [explained subsequently to be the \$3.1 billion escrow payment] in Fiscal Year  
11 2006.” USPS-T-1 at 2, ll. 3-6. Additionally, he explains that “Public Law 108-18  
12 **declares** that the escrow [payment] shall be considered as an **operating**  
13 **expense** of the Postal Service.” *Ibid.* at 4, ll. 17-18, emphasis added.

14           Therefore, as an operating expense, the escrow payment is a component  
15 of the Postal Service’s “total estimated costs,” which the Act specifies shall be  
16 covered by rates and fees set according to its policies. I am not aware of any  
17 basis under the Act for treating this operating expense as any different from any  
18 other operating expense. Indeed, by using the terminology of the Postal  
19 Reorganization Act, Congress has “declare[d]” that it is no different.<sup>1</sup>

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<sup>1</sup> Treatment of the escrow expense as an operating expense was confirmed by witness Tayman on oral cross-examination when he said: “By statute, it’s defined as an operating expense.” Tr. 2/221, ll. 8-9.

1           Witness Potter states that “Congress provided no guidance on how the  
2 obligation to fund the escrow account should be allocated among the various  
3 mail classes and services.” *Ibid.*, p. 4, l. 23 through p. 5, l. 1. That action by  
4 Congress is easily explained. Congress had already put in place a scheme for  
5 meeting “operating expenses,” and in P.L. 108-18 it categorized the escrow  
6 expenses using the same words. Had Congress intended that one particular  
7 operating expense should be met in a manner different from other operating  
8 expenses, it would have needed to create a separate set of guidelines. In  
9 addition, it would have had to explain how the two sets of guidelines align with  
10 each other, and how various layers of rates should build on each other.<sup>2</sup>

11           Witness Potter explains at page 4 (ll. 11-14) that “[t]he Postal Service,  
12 thus, finds itself in the peculiar situation of being required to ensure that its  
13 revenues in FY 2006 are sufficient to cover not only actual operational expenses  
14 but also an additional \$3.1 billion to be put in escrow.” Actually, it is not  
15 “peculiar” for the Postal Service to face the requirement to break even, given that  
16 Congress specifically required that the escrow payment be treated as an  
17 operating expense. After all, one would be hard pressed to argue that this case

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<sup>2</sup>           The conundrum established by having two separate ratesetting procedures would be mind boggling. One can’t help but think of intervening parties arguing about which cost is of which kind and of accountants establishing some variation of last-in, first-out procedures for adjusting rates when a particular expense is removed or when one expense grows more rapidly than another, or even when total estimated expenses are 30 percent of one kind and 70 percent of another.

1 would have been filed in the face of an operating surplus in FY 2006 large  
2 enough to cover the escrow payment.<sup>3</sup>

3 In line with the presumption that the reason for this case being filed is a  
4 projected deficit, Postal Service witness Tayman (USPS-T-6) develops in  
5 considerable detail a financial projection for FY 2006. After many pages, he  
6 says: “The Postal Service’s total revenue deficiency in the Test Year [FY 2006]  
7 at present rates would be approximately \$3.0 billion. Changes in postal rates  
8 and fees proposed in this filing will eliminate the deficiency . . . .” USPS-T-6 at  
9 54, ll. 2-4.

10 Except for the Postal Service’s unusual decision to propose a contingency  
11 level of zero, it seems purely coincidental that the deficit of \$3 billion in the Test  
12 Year is approximately equal to the escrow payment of \$3.1 billion. But it makes  
13 no difference. Whether the deficit is 30 percent, 100 percent, or 300 percent of  
14 one component or another of Postal Service expenses, including the \$3.1 billion  
15 escrow payment, the deficit must be addressed, and addressed according to the  
16 requirements of the Act.

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<sup>3</sup> In response to VP/USPS-T27-9 (Tr. 3/426-428), witness Robinson refers to “the reality that, if the escrow obligation did not exist, the Postal Service would not have requested any changes in rates and fees.” I take this to mean: given that the Test Year deficit is \$3 billion, a reduction of approximately \$3 billion in any cost category, including the escrow, would have allowed the filing to be avoided. There would seem also to be a reality that: (1) if the escrow **did** exist and there were **no** deficit in the Test Year, a case **would not** be filed; and (2) if the escrow **did not** exist and there **were** a meaningful deficit in the Test Year, a case **would** be filed. The first of these two realities was essentially confirmed by witness Robinson on oral cross examination. See Tr. 3/495, l. 24 through 3/496, l. 1.

1    **2.    As a Matter of Logic, Identifiable Causes for Deficits Do Not Exist.**

2           Generally, one would not expect any logical basis for assigning  
3   responsibility for a deficit. Deficits exist in the aggregate and are residual in  
4   nature. To see this, assume a **base** year with three products and profits of \$300.  
5   Each product makes a contribution equal to its revenue minus its cost. By the  
6   end of the **next** year, suppose the contribution from product No. 1 increases  
7   \$1,000, that from product No. 2 decreases \$1,200, and that from product No. 3  
8   decreases \$500. The new net position involves a deficit of \$400. Is it possible  
9   to assign responsibility for the deficit?

10           What happened during the year is not in dispute. In fact, it is understood  
11   clearly. But one cannot say that the responsibility for the deficit lies in a certain  
12   place. If the contribution from product No. 3 had not declined, there would not  
13   be a deficit; there would be a surplus instead. Does this make product No. 3 the  
14   culprit, even though the decline in the contribution from product No. 2 is much  
15   larger? And do the relative levels of contributions from the three products make  
16   any difference? Suppose inquiry showed that product No. 2 made a contribution  
17   of \$1,800 in the base year and \$600 in the next year; would anyone then want to  
18   argue that product No. 2 caused the deficit? It would be just as logical to argue  
19   that product No. 1 caused the deficit because its contribution should have  
20   increased \$1,400 instead of just \$1,000.

1           Suppose further analysis is done and it is found that product No. 2 pays  
2 an annual licensing fee of approximately \$400. It has paid this fee throughout its  
3 existence, and the fee continues. Would it be logical to argue that the licensing  
4 fee is responsible for the deficit? It is certainly true that if the licensing fee were  
5 removed, there would be no deficit. It is even possible that the licencing fee was  
6 established by a court, in a decision with which the firm totally disagrees. The  
7 escrow payment is much like the licensing fee.

8           What is the conclusion? No logical basis supports a conclusion that the  
9 deficit projected for FY 2006 is caused more by the escrow payment than by any  
10 other expense component, and any relation between their sizes is purely  
11 coincidental.

12 **3.     The Across-the-board Approach Should Be Rejected.**

13           Faced with a deficit in FY 2006 and the coincidence that its size is roughly  
14 the same as that of the escrow payment, the Postal Service has taken two  
15 positions: (1) that the deficit is due to the escrow (discussed above), and  
16 (2) that the best way to fund the deficit is through an across-the-board (“ATB”)  
17 rate increase. The question of the best way to eliminate a deficit must be guided  
18 by the Act. Alternative guidance does not exist.

19           Witness Potter provides two justifications for the ATB approach. The first  
20 is: “This approach is reasonable and fair under the circumstances because it  
21 generally seeks to require that mailers pay the same percentage increase over

1 and above the rates and fees they are paying now.” USPS-T-1, II. 12-14. But  
2 this reasoning is nothing more than a tautology, and it could be applied to any  
3 deficit, regardless of the developments leading to it. No real weight can be  
4 attached to an argument that the ATB approach is fair because it is ATB.

5 Other Postal Service witnesses echo witness Potter. Witness Robinson  
6 (USPS-T-27) refers to witness Potter as having “determined that a very  
7 reasonable approach to fulfilling the escrow obligation [is] on a *pro rata* basis  
8 through an across-the-board rate increase.” USPS-T-27 at 7, II. 14-16. She also  
9 refers to the ATB approach as equitable. *Ibid.* at 8, I. 16. Then, in discussing the  
10 ratemaking criteria in the Act, she says: “The Postal Service’s proposals in this  
11 case have fairness and equity as their most fundamental objectives.” *Ibid.* at 11,  
12 II. 14-16. Witness Taufique (USPS-T-28) refers to witnesses Potter and  
13 Robinson as saying that the ATB approach “reflects an effort to take the existing  
14 rate and fee schedules and to spread the burden of the \$3.1 billion FY 2006  
15 escrow obligation equitably.” USPS-T-28 at 2, II. 7-8.

16 One can’t help concluding that some notion of fairness has been elevated  
17 above all other considerations. Then, as a check, a perfunctory review of a  
18 range of other factors has been taken to show that the results fall within an  
19 acceptable range.<sup>4</sup> But it is a strange notion of fairness that neglects all current

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<sup>4</sup> The Commission has been presented with such reviews before. In Docket No. R90-1, the Commission observed: “Witness Lyons does not attempt to evaluate the relative levels of the cost coverages he supports, as the Commission does (continued...) ”

1 costs and builds on outdated cost and rate relationships,<sup>5</sup> even relationships that

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<sup>4</sup> (...continued)

in developing rates. He merely finds that the cost coverage levels he suggests seem reasonable to him.” *Op. & Rec. Dec.*, Docket No. R90-1, pp. IV-6-7, ¶ 4018, footnote omitted. Further on, in the same opinion, the Commission said: “In sum, we find witness Quick’s criticisms persuasive insofar as they show Lyons’ largely formalistic invocation of the Act’s criteria support widely varying rate results. . . . It appears that he has done no more than judge whether certain rate levels might be compatible with the pricing policies of the Act, rather than applying those factors consistently to develop a schedule which fairly apportions institutional costs among the classes and subclasses of mail.” *Ibid.*, p. IV-9, ¶ 4028.

<sup>5</sup> In Docket No. R2000-1, the Commission evaluated a Postal Service request predicated on costs that were just one year older than were available at the time. Specifically, it was faced with relying on FY 1998 costs after FY 1999 costs became available. It required the Postal Service to update the costs. In assessing the results, the Commission said:

The recommended rates reflect more recent actual operating results, and thus are **fairer** to both mailers and affected private businesses. Additionally, the update provided the Postal Service with the opportunity to correct earlier longer-range projections, identifying both underestimates and overestimates. The Service acknowledged that it should experience lower costs to process flat-shaped mail than it initially projected. The rates recommended by the Commission reflect these reductions. The Service also identified several recent events, such as increasing fuel prices, that should increase its overall revenue needs. The rates recommended by the Commission also take account of these cost increases. [*Op. & Rec. Dec.*, Docket No. R2000-1, p. iii, emphasis added.]

In Docket No R94-1, which was also filed as an AτB case, the Commission said: “Without such evidence [that an AτB approach will actually tend to further reclassification], there is no classification-related reason for freezing existing inter-class rate relationships, and the across-the-board proposal does not override the need to insure a balanced application of the other factors in the Act, including questions of **fairness and equity**.” *Op. & Rec. Dec.*, *Ibid.*, p. I-5, ¶ 1016, emphasis added.

Concerns of these kinds, all hinging on issues of fairness, suggest that the AτB case’s neglect of current costs is not inherently fair, and certainly not as fair as could be.  
(continued...)

1 were the result of a settlement. Making matters worse is that both the prior  
2 settlement and this case should rise to the challenge of being steps along a path  
3 to a better future, and no one should be content with anything less than full  
4 review and consideration. This is a high standard, but it is neither unfair nor  
5 unreasonable. In fact, it is perfectly in order. These issues will be discussed  
6 further below.

7           Notions of fairness are well known to exist to a considerable degree in the  
8 eye of the beholder, and it is not uncommon for discerning observers to  
9 disagree. In my opinion, however, the beginning point for considerations of  
10 fairness should be review and recognition of current costs, which the Postal  
11 Service's ATB proposal circumvents entirely.<sup>6</sup> In this regard, the Commission  
12 has explained:

13           The Commission begins the rate design process  
14           assuming equal implicit markups. This is a neutral  
15           starting position which seems to be implied by  
16           § 3622(b)(1), a **fair and equitable** schedule. It is  
17           consistent with the Commission's general policies that  
18           the rates for each rate category be above cost; that  
19           **rates reflect the costs developed in the record**;  
20           and that rate design results in identifiable  
21           relationships between rate categories. Equal implicit  
22           markups, however, are only a starting place, and  
23           often may not be practical or appropriate. [*Op. &*

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<sup>5</sup> (...continued)

<sup>6</sup> I agree with the Commission's observation that "[a]ttempting to keep rate increases for all subclasses equal would make the exacting determination of cost causality meaningless." *Op. & Rec. Dec.*, Docket No. R90-1, p. IV-35, ¶ 4109.

1                    *Rec. Dec.*, Docket No. R2000-1, p. 390, ¶ 5533,  
2                    emphasis added.]

3                    The Postal Service's notion of fairness does not stand up to review. It is  
4 inconsistent with previous Commission practice, just as it is out of line with the  
5 ratesetting guidance in the Act. It constitutes an inadequate justification for an  
6 ATB proposal.

7                    Witness Potter's second justification for an ATB approach is more  
8 pragmatic. He says:

9                    One compelling justification for this approach is the  
10                    likelihood that it will enhance the prospect for  
11                    settlement of issues in this proceeding, permit a more  
12                    expeditious conclusion, and allow the Postal Service  
13                    to begin early in calendar year 2006 to generate the  
14                    additional revenues necessary to meet the obligation.  
15                    [USPS-T-1 at 5, ll. 15-18.]

16                    On oral cross-examination, he addressed this same issue, saying:

17                    It was a policy decision that was made by the  
18                    governors to file this case, to do it in an across-the-  
19                    board manner so we could expedite it so that we  
20                    would not harm the finances of the Postal Service  
21                    going forward. It's as simple as that. [Tr. 2/89, ll. 20-  
22                    24.]

23                    My view of settlements has been somewhat different, as follows. First,  
24 the Postal Service proposes a set of rates, according to Commission rules and  
25 the policies of the Act. Then interested parties review that proposal. If the  
26 parties believe that the proposal is fully justified and that it does not present  
27 problems, they can sign a settlement. But adopting a particular rate approach in  
28 hopes of facilitating a settlement, rather than according to the requirements of

1 the Act, simply is not appropriate ratemaking. Put another way, increasing the  
2 likelihood of achieving a settlement is not one of the non-cost factors in the Act.  
3 And arguments that the Postal Service has a financial interest in implementing  
4 rates a month or so sooner lack merit. The Postal Service has had full control  
5 over the timing of this case and it has known of the escrow requirement since  
6 P.L. 108-18 was enacted on April 23, 2003.<sup>7</sup> Borrowing options are available to  
7 allow flexibility and to smooth things out over time. Neither a desire for a  
8 settlement nor a hurry to realize increased revenue is a credible justification for  
9 an ATB approach.

10 One more issue relating to the justification for a settlement needs to be  
11 addressed. Although the Commission must make the final recommendation,  
12 both the Postal Service and the Commission are impartial reviewers in the sense  
13 that they themselves are not users of specific categories of rates. On the other  
14 hand, intervening parties generally do use specific categories of rates and  
15 generally do stand to gain if the rates of those categories are reduced. They are  
16 not, therefore, impartial reviewers. Intervenors inquire into the bases of the  
17 proposed rates in hopes of being able to show that their rates should be lower.  
18 In pursuing this interest, however, they know that the Commission is the final  
19 reviewer and that the Commission will not give weight to bad arguments.

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<sup>7</sup> It is true that extensive preparation is needed to file a well-supported rate case and that these preparations take time. But the analyses needed in support of such a case are no different from those that should be available on an on-going basis in any well-managed firm, public or private.

1           Focusing on settlement as a goal in such a situation introduces a dynamic  
2 that may be out of line with appropriate ratemaking. It is altogether possible that  
3 the Postal Service, in negotiating with intervening parties, who may represent the  
4 interests of some mailers to the neglect of others, will find that it can achieve  
5 settlement by proposing rates that it cannot justify as most appropriate, in hopes  
6 that the Commission will do little more than certify that the rates in the settlement  
7 are within a range allowed by law instead of being the best for the nation. The  
8 incentives of such a dynamic are unacceptable and should not be allowed to  
9 dictate the nation's postal rates and fees.

10 **4.     AtB Fails as a Special Assessment.**

11           In places, the Postal Service's proposal makes the AtB proposal sound  
12 like some kind of special assessment. Witness Robinson argues that the escrow  
13 expense "is unrelated to the provision of postal services," is "independent of the  
14 volume and mix of mail," and that were it not for the escrow expense, the Postal  
15 Service "would not . . . be proposing changes in rates and fees" at this time.  
16 USPS-T-27 at 6 (ll. 22-23), 7 (l. 8-9), and 6 (ll. 20-21). She even goes on to  
17 recount that "some commentators have observed [that] the \$3.1 billion escrow  
18 burden is not unlike a 'tax' that has been placed on the Postal Service and,  
19 ultimately, on its customers." *Ibid.* at 6, l. 24 through 7, l.1.

20           Special assessments are not uncommon, such as in a special tax to help  
21 pay for a much-needed road, or for a war, although even here there is often a

1 concern that ability to pay should be considered or that equal sacrifices should  
2 be made.<sup>8</sup> There can also be attention to benefits received. But in all such  
3 cases, consideration is given at the same time to what will happen when the road  
4 is built or the war is over. More specifically, a plan is put in place to remove the  
5 special assessment when the need has been met.

6 The Postal Service has not presented any plan to remove the ATB  
7 increase when some change is made in what can be done with the escrow  
8 funds. In fact, it is clear without question that no such plan is feasible and that if  
9 the ATB increase is implemented, the next rate increase will be built on top of the  
10 ATB rates. The ATB rates, then, if implemented, will effectively generate a  
11 **platform** on which future rates will be built, and could therefore have an effect  
12 for some not inconsequential period of time.<sup>9</sup> It is evident on its face that two  
13 sets of best future rates cannot exist and that future rates built on an ATB

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<sup>8</sup> A few years ago, my church began a building program. The slogan was “equal sacrifice.” It could have, but did not, suggest that everyone permanently increase their giving by 30 percent. In any case, as discussed further in the text, the extra giving, which took the form of pledges, was understood to be for a certain term only.

<sup>9</sup> The establishment of just such a platform, or base, was emphasized by witness Potter on oral cross examination, when he said: “The narrow need is the escrow account and the notion that we build that funding into our base . . . . Again, the policy decision that was made by the board of governors was to pursue an across-the-board increase with a very narrow purpose: to build funding into our rates such that it covered the escrow account.” Tr. 2/79, ll. 8-18. In a similar response at Tr. 2/74, ll. 2-9, he said: “. . . , let me just state that we’re dealing with this escrow, and we’re trying to get the escrow built into the base – assume no legislative change occurred. You would want that built into your base going forward, okay, the \$3.1 billion, and you can see from Witness Tayman’s testimony that that rises going forward.” Witness Tayman also referred to getting the escrow into the Postal Service’s “base prices.” Tr. 2/231, l. 23.

1 platform would be different from future rates built on a more traditional platform.  
2 Therein lies the inconsistency – an ATB case does not fit well with a process  
3 that focuses on generating the most appropriate rates. Quoting witness  
4 Robinson: “this docket is in contrast to the approach to rate and fee levels  
5 usually taken.” *Ibid.* at 3, ll. 9-10.

6 **5. An ATB Approach Is Inconsistent with the General Ratemaking**  
7 **Scheme of the Act.**

8 The ratemaking scheme under the Act has both static and dynamic  
9 aspects. The ATB approach is consistent with neither.

10 At first reading, the Act may be thought to present a static process. The  
11 Postal Service shows a need for revenues and files a proposal with the  
12 Commission. The proposal contains a full justification for all rates therein. This  
13 process requires the Postal Service to present and discuss all bases for the rates  
14 proposed. It must be transparent with all of its policy positions. Following the  
15 filing, the Commission and interested parties examine the case, explore  
16 alternatives, and have an opportunity to supplement the record with information  
17 and analysis that might be helpful to the Commission. In the end, the  
18 Commission makes a recommendation based on the Act, its judgment, and the  
19 record developed.

20 In my view, the Commission recommends the set of rates that it believes  
21 to be best aligned with the policies of the Act and that is, under those policies,

1 best for the nation. It may be that a large number of sets of rates could be  
2 viewed as lying within a range that is legal, but I believe it demeans the Act to  
3 argue that the Commission should be satisfied if it does nothing more than  
4 assure the nation that it has found one of those sets. More than this should be  
5 expected of the Commission and the ratesetting process.

6 An appropriate Commission process has two central aspects: (1) to  
7 examine current costs critically and (2) to select markups carefully. As carried  
8 out in a number of omnibus cases, this process is quite involved. It generally  
9 includes complex analyses to develop estimates of costs and then detailed  
10 workpapers that begin with the costs and show all steps leading to the proposed  
11 rates. The nature of the steps varies, but common elements include recognizing  
12 transportation costs, determining how these costs vary with distance, separating  
13 piece-oriented costs from those those that are pound-oriented, laying out cost  
14 differences associated with such things as piece shape, piece weight, kind of  
15 containerization, and machinability, and paying special attention to cost  
16 differences and avoidances associated with preparation activities such as  
17 presorting, prebarcoding, and dropshipping. In the case of many of these cost  
18 differences, specific consideration is given to trends in the costs over time and to  
19 the proportions of differences that should be passed through into rate  
20 differentials.

1           Virtually none of these steps have been taken in this case.<sup>10</sup> The Board of  
2   Governors of the Postal Service appears to have decided in favor of an ATB  
3   approach before looking at any of the cost elements. Furthermore, none of the  
4   usual workpapers are presented, not even on an after-the-fact basis. More  
5   specifically, the transportation costs are not examined, the range of cost  
6   differences is not displayed or discussed, and the passthroughs<sup>11</sup> are given no  
7   attention at all.

8           It would be a coincidence of monumental unlikelihood for the full scheme  
9   outlined in the Act to collapse into a simple ATB proposal. But finding out  
10   whether or not it does requires attention to all of the steps just outlined, and the

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<sup>10</sup>           In Question 3(b) of POIR No. 4, the Commission asked about the effects on mailers, competitors, and overall economic efficiency of building in Parcel Select on rates that are now understood to be out of alignment with the cube-weight relationships. In response, witness Robinson explains that “the escrow requirement does not vary depending on cube-weight relationships.” Tr. 3/471. She fails completely to acknowledge the fact that if the current rates are misaligned with costs, then any rates that build proportionately on them will be misaligned as well. She even argues that if a customer received a “lower-than-average rate increase,” that customer “effectively . . . would have borne [proportionately] less of the escrow burden.” To allocate certain portions of revenue to certain fixed costs is to engage in an unacceptable practice that is normally referred to as restricted institutional costing. One of the problems of such tracing can easily be seen by considering the situation of a subclass like Periodicals, where the proposed coverage is less than 105.4 percent. If 5 percent or so of its revenue were allocated to the escrow, its rates would have to be viewed as below cost.

<sup>11</sup>           In rate case parlance, “passthroughs” are understood to be the proportion of relevant cost differences that are passed through into rate differentials or discounts. The passthroughs are normally expressed on a percentage basis and can be less than, equal to, or greater than 100 percent of the cost difference.

1 Postal Service has circumvented those steps.<sup>12</sup> The Postal Service simply has  
2 not justified its proposal.

3 **6. This Case Is More Troublesome Dynamically than Statically.**

4 The analysis above is primarily static. But once the notion of a rate  
5 platform is introduced, on which future rates will be built, the importance of the  
6 process through which rates play themselves out over time becomes clear.

7 The key to the dynamic impact of a particular omnibus rate docket lies in  
8 the importance of considering the **effects** of the increases on mailers and other  
9 parties. Indeed, the Act specifically requires that consideration be given to “the  
10 effect of rate increases upon the general public, business mail users, and  
11 enterprises in the private sector of the economy engaged in the delivery of mail  
12 matter other than letters.” 39 U.S.C. section 3622(b)(4).

13 It is perfectly obvious that if an ATB increase is implemented instead of an  
14 increase that varies in size among rate categories, the increases required in the

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<sup>12</sup> In its *Opinion and Recommended Decision* in the Docket No. R94-1 ATB case, the Commission said:

The Postal Service’s across-the-board filing is inconsistent with cost-based ratemaking. The request ignores changing differences in costs between the classes of mail, includes no analysis of changing cost patterns within subclasses; and would result in substantial changes in the allocation of institutional costs among the subclasses of mail. The Service’s rate proposal ignores changes in attributable costs. [*Op. & Rec. Dec., Ibid.*, p. I-5, ¶ 1017.]

These concerns apply with equal strength to the instant case.

1 **next** case to reach a meritorious rate position will be for some categories larger  
2 than otherwise would be the case, and thus that an ATB case will lead in all  
3 likelihood to arguments of rate shock in the next case, which might keep the  
4 meritorious position from being reached.<sup>13</sup> Therefore, the nation would be  
5 expected to be worse off. Such a result cannot be considered a consistent  
6 application of the provisions in the Act.

7 No suggestion is being made that rates recommended in a normal rate  
8 case would never turn out to involve proportionate increases in some collections  
9 of rates, possibly including entire subclasses. One can make the case, in fact,  
10 that if a set of markup indexes is approximately maintained and neither relative  
11 costs nor a range of relevant exogenous factors change, the natural outcome of  
12 a normal rate process would be expected to have an ATB character.

13 But even if exogenous factors are taken to change slowly, it is perfectly  
14 clear that relative costs are in a state of flux, perhaps as a natural outcome of  
15 business activity. The Postal Service is and has been tightening its operations  
16 and increasing its productivity. New equipment and new technologies are being  
17 introduced. Also, mailers are changing the way their mail is prepared, a factor  
18 identified in the Act as important. See 39 U.S.C. section 3622(b)(6). Under

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<sup>13</sup> Mailers receiving lower-than-appropriate rate increases in an ATB case could receive tempered rates in the next case, at a cost to other mailers, but they would not likely be asked to make catch-up payments. In a related situation in Docket No. R90-1, the Commission said: "We must recommend test year rates which are fair and equitable for test year mailers; they should not, and are not, designed to provide a 'catch-up' for past decisions." *Op. & Rec. Dec.*, Docket No. R90-1, p. IV-35, ¶ 4112.

1 these conditions, there is no justification for presuming that an ATB approach is  
2 in line with the Act and good ratesetting principles, certainly not without careful  
3 examination, which is absent from this case.

4 **7. A Quantitative Showing that an ATB Case Is Generally Inconsistent**  
5 **with the Rate-setting Scheme under the Act.**

6 Using a relatively simple model, it is easy to show that an ATB case is  
7 generally inconsistent with the rate setting process prescribed by the Act, and  
8 that such a case leads to suboptimal rates and undue effects on mailers.

9 To create a reference or base position, assume three normal rate cases.  
10 Each case is fully litigated and the Commission makes recommendations on  
11 each record. Three products are adequate to make the point. In the first rate  
12 case, the Commission selects a rate for the first product of A (cents per piece).  
13 The rates for the second and third products may be expressed as proportions of  
14 A, therefore being  $\alpha_2A$  and  $\alpha_3A$ , where the proportions  $\alpha_2$  and  $\alpha_3$  can be less  
15 than, equal to, or greater than 1. In the second and third rate cases, the rates for  
16 the first product are B and C, with the rates for the second and third products  
17 similarly expressed as proportions. The following rates therefore are  
18 recommended:

		<u>Product 1</u>	<u>Product 2</u>	<u>Product 3</u>
1				
2	Case 1	A	$\alpha_2 A$	$\alpha_3 A$
3	Case 2	B	$\beta_2 B$	$\beta_3 B$
4	Case 3	C	$\delta_2 C$	$\delta_3 C$

5 This reference position is perfectly general. The Commission considers fully the  
6 evidence in each case and decides on a best recommendation. The effects on  
7 mailers are also considered. When the rate for Product 1 is considered in Case  
8 2, the difference B - A is considered. Importantly, this difference is the difference  
9 between two rates that are both set in perfectly general rate cases, conducted  
10 under Commission rules and the Act.

11 Now consider a first case that is normal, as above, a second case that  
12 uses an ATB approach, and a third case that attempts to return to normality.

13 Assuming the ATB proportion is  $\kappa$ , get:

		<u>Product 1</u>	<u>Product 2</u>	<u>Product 3</u>
14				
15	Case 1*	A	$\alpha_2 A$	$\alpha_3 A$
16	Case 2*	$\kappa A$	$\kappa \alpha_2 A$	$\kappa \alpha_3 A$
17	Case 3*	C	$\delta_2 C$	$\delta_3 C$

18 Case 1\* is the baseline and is identical to Case 1. Case 2\* is an ATB case and  
19 is not the same as Case 2. Case 3\* shows the rates that Commission would

1 prefer to recommend in Case 3\*, *i.e.*, the rates that it finds meritorious and best  
 2 for the nation under the circumstances at the time of Case 3\*, absent any  
 3 tempering to reduce effects. These rates may or may not be in line with a set of  
 4 preferred markup indexes. They are the rates that would result from a string of  
 5 perfectly normal rate cases, and are therefore identical to Case 3. One might  
 6 say that the rates in Case 3\* are the rates that the Commission would like to get  
 7 back to, after an ATB interruption, and that it **must** get back to if the ATB  
 8 interruption is not to distort natural rate paths.

9 For Product 1, the effect of the rate increases on mailers in Case 3\* is  
 10  $C - \kappa A$ , and in Case 3 it was  $C - B$ . The **excess** effect on mailers of Case 3\* is  
 11  $(C - \kappa A) - (C - B)$ , which reduces to  $B - \kappa A$ . Calculated in this way, the excess  
 12 effects of the rate increases on mailers using the three products become:

13	<u>Excess effect</u>	<u>Which reduces to</u>	
14	Product 1	$(C - \kappa A) - (C - B)$	$B - \kappa A$
15	Product 2	$(\delta_2 C - \kappa \alpha_2 A) - (\delta_2 C - \beta_2 B)$	$\beta_2 B - \kappa \alpha_2 A$
16	Product 3	$(\delta_3 C - \kappa \alpha_3 A) - (\delta_3 C - \beta_3 B)$	$\beta_3 B - \kappa \alpha_3 A$

17 In order for the excess effects on mailers to be zero, each expression in  
 18 the final column above must be zero. From Product 1, if  $B - \kappa A = 0$ , then B must  
 19 equal  $\kappa A$ , which requires that  $B/A = \kappa$ . Similarly, from Product 2, it is required

1 that  $B/A = \kappa\alpha_2/\beta_2$ , and from Product 3,  $B/A$  must =  $\kappa\alpha_3/\beta_3$ . The only way all three  
2 excess effects can be zero is if  $\alpha_2/\beta_2 = 1$  and  $\alpha_3/\beta_3 = 1$ .

3           Given the reality that relative costs change over time, due to changing  
4 technologies and other factors, it is clear that these conditions generally would  
5 not be met. Therefore, the excess effect of returning to normalcy after an ATB  
6 case is non-zero. Faced with a non-zero excess effects on mailers, the  
7 Commission would in all likelihood consider tempering the rate increases and  
8 recommending a set of rates in Case 3\* that is different from  $C$ ,  $\delta_2C$ , and  $\delta_3C$ .  
9 That is, the preferred set of rates would not be recommended in Case 3\* and the  
10 nation would be worse off. It being unreasonable that the same Act could  
11 sanction a set of rates in one case that would prevent a best set of rates in the  
12 next case, it follows that an ATB case is inconsistent with the Act.

13           Using simple figures selected to keep the math easy, an example of  
14 **excess effects** was presented to witness Robinson during oral

1

**Figure 1**

2

**Alternative Rate Scenarios, Illustrating Excess Effect on Mailers**

3	Rate	Case		Product 1	% Δ		Product 2	% Δ
4	Case	Type		Rate-cents			Rate-cents	
5	Case 1	Baseline		20			50	
6	Case 2	ATB 20%		24	20%		60	20%
7	Case 3	Conventional w/o Factor 4		32	33.3%		63	5%
8	Alternate	Conventional		25	25%		56	12%
9	Case 2							
10	Alternate	Conventional		32	28%		63	12.5%
11	Case 3							

12 cross-examination. As presented in Figure 1, the example involves two products  
 13 with base rates of 20 cents and 50 cents, and an ATB case that increases these  
 14 rates by 20 percent, to 24 cents and 60 cents. Then a few years later, it is  
 15 assumed that a conventional case is filed (Case 3), which recognizes then-  
 16 current costs. Now suppose that the Commission in conventional Case 3 case  
 17 examines the then-current costs and the then-current market conditions, and  
 18 considers all of the non-cost factors in the Act, except factor No. 4 (39 U.S.C.

1 section 3622(b)(4)), having to do with the effects of any rate increases, and  
2 arrives at candidate rates of 32 cents and 63 cents. But then the Commission  
3 notices that these rates would involve increases from the ATB rates of 33.3  
4 percent and 5 percent, respectively, and becomes concerned about the effects  
5 on mailers.

6 If the Commission alters the candidate rates in the conventional Case 3,  
7 and recommends rates of, say, 29 cents and 67 cents, it will have **deviated** from  
8 the most appropriate set of rates, because of consideration of effects. Assuming  
9 the underlying costs and market conditions changed in a well-behaved way over  
10 the time periods in question, this deviation could have been avoided by  
11 recommending in Case 2, shown as Alternate Case 2, the rates of, say, 25 cents  
12 and 56 cents. From a platform of these alternate rates, the desired rates of 32  
13 cents and 63 cents would have been achievable, with a relatively smooth pattern  
14 of rates over time. It may be viewed as unfortunate that Product 1 has such a  
15 strong upward trend in its rates, but the ATB case is clearly unfair to Product 2.

16 The point is that an ATB case can disrupt normal rate trends and cause  
17 excess effects on mailers, as in the increase of 33.3 percent in Case 3. Witness  
18 Robinson's response to the example was, variously: "You're proposing a  
19 situation that I find very hard to understand", "you're imposing an order on the  
20 consideration of the criteria", and "I think the premise is fundamentally flawed in  
21 how the costing criteria and the other criteria of the act interact." Tr. 3/501 (ll. 12-  
22 13), 502 (ll. 4-5), and 508 (ll. 20-22), respectively. But the example is illustrative

1 of a fundamental problem. No one would expect the Commission to be able to  
2 consider the effects of rates on mailers until they have candidate rates to  
3 consider. It is clear that an ATB case not only can result in disruptive rate  
4 patterns and excess effects on mailers in future cases, but also can prevent  
5 meritorious rate positions from being reached.

6 **8. This Case Presents Other Dynamic Difficulties.**

7 Progress in rates over time requires changes. Given this, any procedure  
8 that slows the development and implementation of optimal rates or makes them  
9 more difficult to attain is suspect on its face.

10 Numerous changes in rate design have occurred in virtually every  
11 subclass of mail. One example is second class, now referred to as Periodicals.  
12 At the time of reorganization in 1970, mail sent as second class was charged by  
13 the pound; piece rates did not exist. This sent terrible signals to mailers. It said:  
14 If you double the weight of your periodical, we will double your postage, even  
15 though our costs do not anywhere near double. One could argue that such a  
16 rate structure penalized mailers for adding weight, even though they had done  
17 nothing wrong. That is not what the Postal Service is here for.

18 In the first rate case (Docket No. R71-1), the Commission recommended  
19 piece rates for second class, to go with the pound rates. Over time, the reliance  
20 on piece rates increased. In Docket No. R84-1, 55 percent of Periodicals  
21 revenue was obtained from the piece rates. This was increased to 60 percent in

1 Docket No. R87-1. Along the way, presort discounts, prebarcode discounts,  
2 additional dropship discounts, and pallet discounts were introduced. One would  
3 be hard pressed to argue that these changes were not improvements or that the  
4 rates of Periodicals are not more efficient today. And, obviously, the  
5 Commission would not have recommended the changes if it did not think the  
6 changes were best under the Act.

7 It should be noted that the effects of these changes in the structure of  
8 Periodicals rates were not small. When, following Docket No. R84-1, the  
9 proportion of revenue from the piece rates was increased, the piece rate for  
10 basic presort increased 75.7 percent, the piece rate for 3/5-digit presort  
11 increased 77.8 percent, and the piece rate for carrier route presort increased  
12 77.3 percent. See USPS-LR-K-73, Domestic Mail Rate History. There were, of  
13 course, associated reductions in the pound rates. Nevertheless, the effects on  
14 mailers were pronounced, with some mailers affected much more than others.<sup>14</sup>

15 Rate improvements such as those implemented for Periodicals must await  
16 the occasion of the Postal Service filing an omnibus rate case, unless the  
17 Commission begins a mail classification case on its own volition,<sup>15</sup> which has

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<sup>14</sup> Effects on mailers must be accepted if changes of import are to be made. In regard to the structural changes in third class in Docket No. R90-1, the Commission said: "Even so, the percentage point spread between the lowest and highest percentage rate changes is about the same as the Service's spread – about 40 percentage points." *Op. & Rec. Dec.*, Docket No. R90-1, p. V-246, ¶ 5971.

<sup>15</sup> Except in response to a complaint from a mailer, the Commission cannot begin a rate case, even when underlying cost relationships change. Remedies,  
(continued...)

1 turned out to be a very weak authority, or the Postal Service files special cases,  
2 which has, in my opinion, happened too infrequently. And even then, if, as a  
3 result of timidity and excessive tempering, baby steps are taken toward improved  
4 positions, progress can be very slow, which suggests, I contend, that the nation  
5 on the whole is worse off for it. All this suggests that an opportunity to make  
6 improvements should not be lost, which will occur if an ATB increase is  
7 implemented.

8 Admittedly, a release of all ATB constraints in this case will not bring forth  
9 into the record a bevy of classification improvements. But it is well known that  
10 the Postal Service is considering what have been called “product redesign”  
11 changes for the case after this one, and a decision to recognize costs more  
12 completely in this case will in all likelihood make it easier to proceed with product  
13 redesign in that next case.<sup>16</sup> Conversely, an ATB approach in this case will in all  
14 likelihood make product redesign more difficult and less effective. The  
15 Commission should not recommend the ATB rates.

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<sup>15</sup> (...continued)

therefore, must await a filing by the Postal Service. The fact that the Commission does not have this authority could be viewed as a weakness in the Act, because, as witness Robinson explained in response to Question 3(b) of POIR No. 4, “these changes [in the underlying cost relationships], in and of themselves, do not necessarily result in a Postal Service request to change rates and fees.” Tr. 3/470.

<sup>16</sup> The logical basis for this statement can be spelled out very simply. The changes made in any “product redesign” initiative are likely to improve the alignment of rates and costs, and fuller recognition of costs (including updating) in this case is likely to decrease the distance between the initiative rates and the then-existent rates.

1 Another aspect of making changes over time is that sometimes they are  
2 made incrementally. Using Periodicals again as an example, piece rates were  
3 introduced in Docket No. R71-1, were increased in Docket No. R84-1, and were  
4 increased again in Docket No. R87-1. As a practical matter, decades can pass  
5 before desired rate positions are reached. Again, opportunities to make  
6 improvements should not be lost.

7 **9. The Pace of Change in Standard Mail Has Been Anemic.**

8 A number of changes were made to Standard mail (then third class) in  
9 Docket No. R90-1, including a letter/flat differential, dropship discounts, and  
10 saturation rates. In order to help make these changes smoothly, a number of  
11 passthroughs were deliberately set at low levels and the passthroughs for some  
12 already-existing discounts were actually reduced. There was every expectation  
13 on the part of the Postal Service that steps would be taken in the next rate case  
14 to recognize costs more fully, increase passthroughs, and improve the signals  
15 sent to mailers.

16 But Docket No. R94-1 was filed as an ATB case, and even though the  
17 Commission rejected its ATB foundation, many ATB aspects could not be  
18 avoided. Docket No. MC95-1, the reclassification case, made structural  
19 changes, but was contribution neutral. Docket No. R97-1, then, a full seven  
20 years after the changes in Docket No. R90-1, was the first normal post-R90-1  
21 case. Docket No. R2000-1 was also normal, except that the base year was

1 updated during the case, and it is not clear that the Postal Service's case was  
2 fully updated.<sup>17</sup> Docket No. R2001-1 was settled, and thus did not receive the  
3 benefit of what I would call full Commission deliberation. My point is that from  
4 Docket No. R90-1 to date, a period of approximately 15 years, there have been  
5 only two normal rate cases, one of which involved a difficult cost update, and one  
6 contribution-neutral reclassification case. Progress is occurring very slowly.

7       The fact that progress is occurring slowly should be a cause for concern.  
8 Observers, including the Postal Service itself, are quick to point out that  
9 technology is advancing rapidly, mailer capabilities are improving, competitive  
10 pressures are increasing, alternatives to the mail are proliferating, and that to be  
11 effective, organizations must focus on doing whatever it takes to meet customer  
12 needs. One hears arguments that business-like behavior is required and that the  
13 Postal Service's financial position will deteriorate if it cannot be more responsive  
14 to all that is going on. Rate improvements should be a key part of this dynamic,  
15 and the opportunity presented by this case should not be lost.

16       The instant case should be reviewed fully. All costs should be updated  
17 and examined. Changes should be made where found appropriate. Handling  
18 this case as such would be in line with the common cry for a series of small,

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<sup>17</sup> The basis for this statement is that the Postal Service did not revise its request when it updated its costs. It seems difficult to believe that a full case based on newer costs would be the same as one based on earlier costs.

1 predictable rate adjustments instead of large-but-infrequent ones. Sitting back  
2 and waiting for some future opportunity is not justified.

3 **10. Summary.**

4 As witness Potter explains, Congress has declared that the escrow  
5 requirement is an operating expense of the Postal Service and has provided no  
6 special guidance on how it should be covered. Therefore, the expense qualifies  
7 fully as one that should be met according to Commission rules, implementing  
8 the Act.

9 Witness Tayman projects a deficit for Fiscal Year 2006 that it is, merely by  
10 coincidence, approximately equal to the escrow payment. Accordingly, this case  
11 has been filed to meet that deficit. But no logic suggests that the deficit is  
12 caused in any meaningful way by the escrow. In fact, it is clear that if some  
13 other Postal Service expense had been projected to be \$3 billion lower, no deficit  
14 would exist and no case would have been filed. Since this would occur despite  
15 the escrow, it cannot be said that the escrow caused the deficit.

16 The Postal Service elevates non-cost factor No. 1 (39 U.S.C. section  
17 3622(b)(1)) to a position of undue priority, and then argues that an AtB approach  
18 is the fairest way to fund the deficit. But this requires a notion of fairness that  
19 neglects all current costs and builds solely on out-of-date cost and rate  
20 relationships, many of which have changed. Such a notion cannot truly be  
21 viewed as fair. The AtB approach fails also as a special assessment, because

1 no procedure exists for withdrawing it when the need has been met. And  
2 perhaps the most egregious characteristic of an A+B approach is that it creates a  
3 new rate platform, built on old cost relationships, in such a way that updating  
4 costs in the future will almost undoubtedly entail more burdensome effects on  
5 mailers than would otherwise be the case, and that might well slow progress  
6 toward more efficient rates.

1       **III. ECR COST COVERAGE IS TOO HIGH AND SHOULD BE REDUCED**

2       **1. An Independent Application of the Non-cost Factors in the Act Is**  
3       **Required.**

4           The starting point for selecting an appropriate cost coverage is that a  
5 subclass must receive an independent application of the non-cost factors in the  
6 Act. The Commission has said:

7                       Since the late 1970s the Commission has followed  
8                       the practice of establishing only subclasses of mail  
9                       having “unique characteristics . . . which would  
10                      warrant an independent application of all of the §  
11                      3622(b) ratemaking criteria to [the] category.” [*Op. &*  
12                      *Rec. Dec.*, Docket No. MC95-1, pp. III-7-8, ¶ 3019  
13                      quoting *Op. & Rec. Dec.*, Docket No. R77-1 at 247,  
14                      brackets in original.]

15       In that docket, in reference to a proposed subclass in First Class, the  
16 Commission stated: “If presorted first-class constitutes a ‘class of mail’ or ‘type  
17 of service’ for purposes of [section 3622(b)], it follows that the rate adopted **must**  
18 be based on an independent application of the § 3622(b) factors.” *Op. & Rec.*  
19 *Dec.*, Docket No. R77-1, p. 241, fn. 1, emphasis added.

20           The Postal Service agrees with this approach. In this case, witness  
21 Robinson was asked whether “the Postal Service sees elevating the cost  
22 coverage of the ECR subclass as one way to help achieve a rate for ECR Basic  
23 letters that is higher than the rate for Regular prebarcoded 5-digit letters.” She  
24 responded:

25                       No. The selection of cost coverages for the Standard  
26                       Mail ECR subclass is based on the application of the

1 nine pricing criteria of Title 39, section 3622(b). While  
2 the relative coverages of the subclasses has some  
3 effect on the prices within the subclasses, this  
4 particular rate relationship has not driven the  
5 selection of either the cost coverages for Standard  
6 Mail ECR or for Standard Mail Regular in this docket  
7 or in previous dockets. [Response to VP/USPS-T28-  
8 21(c), redirected from witness Taufique, Tr. 3/464.]

9 Therefore, the cost coverage for ECR should depend on how the non-cost  
10 factors are applied, with the understanding that financial breakeven is required.  
11 Accordingly, the level of the coverage should not depend on its historical levels,  
12 except that the effect of rate increases on mailers should be considered. Such  
13 consideration, however, would be short-term in nature. That is, effects might be  
14 reduced by achieving a desired coverage in several steps instead of one, but  
15 attention to effects should not prevent eventual achievement of an appropriate  
16 result.<sup>18</sup>

17 **2. The Goals of the Reclassification Case Suggest that the Current**  
18 **Coverage of ECR Is Too High.**

19 The focus of the Docket No. MC95-1 reclassification case was on whether  
20 the proposed ECR grouping warranted an independent application of the non-  
21 cost factors of the Act. Speaking broadly, the Commission said:

22 The “subclass issue” is paramount in this docket.  
23 The Reorganization Act speaks only of “classes.”

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<sup>18</sup> 39 U.S.C. section 3622(b)(4) refers to the “effect of rate increases,” not to the effect of rate levels. Therefore, one could not say that the effect of a rate level is too great.

1                    See for example, 39 U.S.C. § 3623, and the function  
2                    of mail classification is to create mail groupings which  
3                    allow, and even help, the Postal Service to charge fair  
4                    and equitable rates. The significant role of  
5                    “subclasses” has evolved through Commission  
6                    decisions – they have become integral to ratemaking  
7                    in accordance with the Act. Courts have confirmed  
8                    that such classification distinctions exist for the  
9                    purpose of ratemaking. [*Op. & Rec. Dec.*, Docket No.  
10                    MC95-1, pp. III-6-7, ¶ 3017.]

11                    In response to a Postal Service argument that additional subclasses are  
12                    needed to help reflect costs and demand and to promote its automation strategy,  
13                    the Commission said: “The Commission concludes, based on this record, that  
14                    the only benefit of disaggregating subclasses further would be the ability to  
15                    reflect differences in demand or other non-cost factors of the Act in separate  
16                    markups.” *Ibid.*, p. IV-115, ¶ 4253.

17                    On the question of the subclass proposal in First Class, the Commission  
18                    said: “Proponents of the Postal Service’s proposed subclass structure for First-  
19                    Class Mail have failed to show that the proposed structure better warrants  
20                    independent application of the § 3622(b) ratemaking criteria than that which  
21                    exists today.” *Ibid.*, p. I-5, ¶ 1011. In regard to a similar proposal in Docket No.  
22                    R97-1, the Commission said: “The critical factors to be considered are ‘whether  
23                    the cost characteristics and market demand characteristics of presorted First-  
24                    Class [Mail] are sufficiently different to warrant independent evaluation under the  
25                    § 3622(b) factors.’” *Op. & Rec. Dec.*, Docket No. R97-1, p. 605, ¶ 6518,  
26                    brackets in original, quoting *Op. & Rec. Dec.*, Docket No. R80-1, p. 273, ¶ 0686.

1 The Commission explained:

2 In the past, a showing of cost and demand  
3 differences has been important for concluding that  
4 independent application of all of the § 3622(b)  
5 ratemaking criteria is warranted. . . . The market-  
6 demand characteristics test reflects the need to  
7 classify mail for purposes of assigning institutional  
8 costs, particularly to take into account “the value of  
9 mail service actually provided each class or type of  
10 mail service to both the sender and the recipient . . . .”  
11 39 U.S.C. § 3622(b)(2). [*Op. & Rec. Dec.*, Docket  
12 No. MC95-1, p. I-3.]

13 In reference to its decision to recommend ECR as a separate subclass,  
14 the Commission said: “Quantitative and qualitative evidence in the record **does**  
15 support a finding that there are market differences between carrier route and  
16 noncarrier route Standard Mail.” *Ibid.*, p. I-7, ¶ 1017, emphasis added. “The  
17 Commission is satisfied that the proposed Enhanced Carrier Route subclass **has**  
18 distinct demand characteristics which indicate differences in value to senders.”  
19 *Ibid.*, p. III-46, ¶ 3121, emphasis added. And: “With the exception of the  
20 proposed Standard Enhanced Carrier Route subclass, there is not sufficient  
21 evidence on this record for the Commission to find that the subclasses proposed  
22 exhibit different demand characteristics. They do **not** consist of different  
23 products which serve different markets.” *Ibid.*, p. I-4, ¶ 1009, emphasis added.<sup>19</sup>

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<sup>19</sup> One of the Postal Service’s proposals was to separate now Regular Standard into an automation and a non-automation subclass. The Commission said: “While there are differences in costs between the proposed Automation and Regular Standard Mail, there is not substantial evidence of demand differences between them. Hence, the Commission cannot recommend separate subclasses for these categories.” (continued...)

1 Similarly: “there is sufficient evidence on the record for the Commission to  
2 conclude that carrier route and noncarrier route Bulk Rate Regular mail **are**  
3 distinct markets.” *Ibid.*, p. V-189, ¶ 5459, emphasis added. Relating this issue  
4 to economic efficiency, the Commission said:

5           the own-price elasticities and other demand  
6           characteristics of carrier route and noncarrier route  
7           mailers are sufficiently different so that separate rates  
8           and discounts for carrier route and noncarrier route  
9           mail should improve the equity and economic  
10          efficiency of the postal rate structure. [*Ibid.*, p. V-189,  
11          ¶ 5460.]

12           It is clear that the Commission’s decision hinged strongly on non-cost  
13 factor (b)(2) of section 3622, and therefore on value of service and associated  
14 demand measures. In the first sentence of its summary, the Commission said:  
15 “In this case, the Postal Service proposes ‘market-based classes’ of mail . . . .”  
16 *Ibid.*, p. i. Very little role was played by other factors.<sup>20</sup> Since it is clear that the  
17 value of service is lower for ECR than for most other subclasses, and particularly  
18 lower than the average value of service for the former third class, it is clear that

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<sup>19</sup>           (...continued)  
*Op & Rec. Dec.*, Docket No. MC95-1, p. V-161, ¶ 5385.

<sup>20</sup>           It was clear throughout the case that a subclass would allow costs (factor (b)(3)) to be recognized, but that costs could also be recognized without a separate subclass. Some attention was given to the fairness of the proposals, without apparent effect, except in Periodicals and First Class. At one point the Commission explained: “To be fair, rates should not only reflect direct and indirect attributable costs, but also the ‘noncost’ factors set forth in the ratemaking section of the Act, § 3622.” *Op. & Rec. Dec.*, Docket No. MC95-1, p. III-22, ¶ 3056. Also, the Postal Service indicated that it faced stronger competitive pressures in ECR than in Regular Standard. *Ibid.*, USPS-T-18 at 5.

1 the cost coverage for ECR should have declined. This was implied by the  
2 reasoning in the reclassification case. As will be discussed further below, the  
3 cost coverage has not declined.

4 The expectation of a lower cost coverage for ECR has also been part of  
5 the Postal Service's position. In policy testimony in Docket No. MC95-1, under  
6 the heading of "Efficient Mail Pays Disproportionate Contribution," Postal Service  
7 witness McBride said: "Exactly the same situation occurs in bulk regular third  
8 class, where the efficient carrier route category has a cost coverage 94  
9 percentage points higher than the other category." Docket No. MC95-1, USPS-  
10 T-1 at 16-17. Similarly, Postal Service witness Moeller, the rate design witness  
11 for the proposed new subclasses of Automation, Regular, and ECR Standard  
12 (only the latter two of which the Commission recommended), when asked about  
13 the cost coverage that should apply to ECR, absent tempering to lessen the  
14 effects of the rate changes on mailers, said:

15 . . . if we were starting from a situation where the  
16 coverages for the three subclasses were equal, a  
17 **somewhat lower coverage for Enhanced Carrier**  
18 **Route relative to the combined coverage for the**  
19 **three new subclasses could be supported.** Even  
20 with the waiver of the constraint of avoiding major rate  
21 relationship changes, I have insufficient information to  
22 speculate as to how much lower of a coverage could  
23 be supported, but in the situation you describe it  
24 could be as little as 10 percent. [Docket No. MC95-1,  
25 response to OCA/USPS-T18-18, Tr. 2/4275-6,  
26 emphasis added.]

1           The Postal Service has continued to take the position that the coverage  
2 on ECR should be lower. In Docket No. R97-1, Postal Service witness O'Hara  
3 said: "This [percentage rate increase for ECR] is somewhat below the system-  
4 wide average increase, reflecting a desire to lower the very high cost coverage of  
5 this subclass." Docket No. R97-1, USPS-T-30 at 34, ll. 20-21. In Docket No.  
6 R2000-1, Postal Service witness Mayes, in regard again to the percentage rate  
7 increase for ECR, said: "This is somewhat below the system average increase,  
8 **reflecting a desire to lower the very high cost coverage of this subclass.**"  
9 Docket No. R2000-1, USPS-T-32 at 38, ll. 6-8, emphasis added. Most recently,  
10 in Docket No. R2001-1, in support of the cost coverages proposed for ECR,  
11 witness Moeller said:

12                     The Postal Service is proposing a cost coverage of  
13                     217.8 percent over volume variable costs for the  
14                     ECR/NECR subclass, which results in a 6.2 percent  
15                     average rate increase for ECR, and a 6.5 percent  
16                     increase for NECR. These are somewhat below the  
17                     system average increase, **reflecting a desire to**  
18                     **lower the very high cost coverage for this**  
19                     **subclass.** [Docket No. R2001-1, USPS-T-28 at 36, ll.  
20                     15-19, emphasis added.]

21           In the instant docket, witness Robinson (USPS-T-27) was asked if she  
22 would agree that if the cost coverage of ECR is not reduced over some period of  
23 time following its creation, then the creation of ECR as a separate subclass will  
24 have failed to achieve more equitable rates and to reflect market characteristics.  
25 She declined to agree, and added, in part, two observations.

1           First, she said: “The Enhanced Carrier Route subclass provides options  
2 for customers mailing geographically targeted advertising that are not available in  
3 the Standard Regular subclass.” Response to VP/USPS-T27-5 (Tr. 3/406).  
4 Since ECR and Regular were cut from and included in the former third class, and  
5 since all of the features of ECR were or would have been part of third class, this  
6 response is accurate but deceptive. When asked on oral cross-examination  
7 what she meant by this, she said: “There are pricing structures that allow high-  
8 density advertising mail to be provided as a product for customers to use.” Tr.  
9 3/510, ll. 17-19. The fact is that there are no pricing structures in ECR that were  
10 not or would not have been part of third class.

11           Second, she said: “By creating a separate ECR subclass, market and  
12 demand differences were recognized not only in the rate structure, but also to a  
13 greater extent in the classification structure.” Response to VP/USPS-T27-5 (Tr.  
14 3/406). On oral cross examination, she was asked how market and demand  
15 differences have been recognized in the classification structure. Her response  
16 did not address classification structures. See Tr. 3/510-11.

17           Aside from the institution of the residual shape surcharge, the line-of-  
18 travel requirement on preparation, the requirement for high density and  
19 saturation letters to be prebarcoded, and the provision for automation letters  
20 weighing from 3.3 to 3.5 ounces (which was provided as well to Regular mailers),  
21 there have been no changes in the classification structure of ECR, and all of  
22 these could have and in all likelihood would have been made in the same way if

1 ECR were still part of third class. The cost coverage has not been reduced, and  
2 I find no basis for the argument that market or demand differences have been  
3 recognized.

4 **3. Rates for ECR Mail Are Higher Now than They Would Be If No**  
5 **Separate Subclass Had Been Created for It.**

6 Third-class mail, now called Standard mail, underwent a major  
7 restructuring in Docket No. R90-1. At that time, the letter/flat differential was  
8 introduced and was implemented at a 50 percent passthrough of the cost  
9 difference. Also, dropship discounts were introduced. They were proposed at a  
10 passthrough of 75 percent, and implemented at a slightly higher level due to  
11 revised costs. In order to help accommodate these changes and to temper their  
12 effects on mailers, passthroughs on some of the already-existing presort  
13 discounts were reduced. Then in Docket No. MC95-1, just five years later,  
14 reclassification occurred and third class was split into Regular Standard and  
15 ECR Standard. If reclassification had not occurred, it seems clear that rates for  
16 the former third class would have moved toward passthroughs of 100 percent (in  
17 the case of some passthroughs that were reduced, back towards 100 percent), in  
18 line with oft-expressed preferences of the Commission and the Postal Service for

1 full recognition of cost differences in rates and for sending appropriate (efficiency  
2 improving) signals to mailers.<sup>21</sup>

3 Even given reclassification, the rates in Standard mail recognize cost  
4 differences among the various rate categories in substantial degree. To the  
5 extent to which 100 percent of the cost differences are passed through into  
6 rates, the outcome is that the various categories have approximately the same  
7 per-piece contribution to fixed costs.

8 The expectation of reasonably uniform per-piece contribution levels allows  
9 a check to be made. Specifically, if ECR had not been made into a separate  
10 subclass and the cost differences among the categories in third class had been  
11 fully recognized, as I believe they would have been, then the average **per-piece**  
12 contribution for the categories now in ECR Standard would be approximately the  
13 same as the average per-piece contribution of the categories now in Regular  
14 Standard.

15 Note that this expectation holds despite the well-understood phenomenon  
16 that workshared pieces within a subclass have a higher implicit **percentage** cost  
17 coverage than non-workshared pieces. That is, the average percentage

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<sup>21</sup> Note that Docket No. R94-1, which occurred between the restructuring in Docket No. R90-1 and the reclassification in Docket No. MC95-1, cannot be used as an indicator of the course that post-R90-1 rates would have taken, because it was filed as an AtB case. It is true that the Commission rejected the AtB approach and sought to recognize costs more fully, but this was done only in limited degree, due to an absence of cost information. In most cases, the rates within subclasses were increased a uniform amount, but not the proposed AtB amount. This means that the rates going into reclassification were not those that would have resulted from full Commission consideration in Docket No. R94-1.

1 contribution of the pieces now in ECR Standard would be higher than the  
 2 average **percentage** contribution of the pieces now in Regular Standard, but the  
 3 average **per-piece** contribution would not.

4 Figure 2 shows the results of performing this check under three sets of

5 **Figure 2**

6 **Unit Contribution of Standard Mail Subclasses**

	<b>Average Contribution in Cents per Piece</b>		
<b>Item/Basis</b>	<b>FY 2004</b>	<b>TYBR</b>	<b>TYAR</b>
	<b>(1)</b>	<b>(2)</b>	<b>(3)</b>
<b>Regular</b>	<b>6.46</b>	<b>6.18</b>	<b>7.24</b>
<b>ECR</b>	<b>9.06</b>	<b>8.65</b>	<b>9.52</b>
<b>Difference: ECR-Regular</b>	<b>2.60</b>	<b>2.47</b>	<b>2.28</b>

7  
 8  
 9  
 10  
 11  
 12  
 13 Source: Based on volumes and revenues (w/o fees) from USPST28Aspreadsheets.xls  
 14 in USPS-LR-K-115; FY 2004 costs from Docket No. IM2005-1\_CRA-PRC-2004.pdf filed  
 15 3/15/05 with PRC and FY 2006 TYAR and TYBR costs from  
 16 R2005.FY2006BRC\_DRpt.PRC.AMX.xls and R2005.FY2006ARC\_DRpt.PRC.AMX.xls  
 17 in USPS-LR-K-95.

18 conditions, FY 2004 base year, test year before rates (TYBR), and test year after  
 19 rates (TYAR). In the test year before rates, column 2, which is a projection  
 20 under the assumption of no rate changes, the per-piece contribution of Regular  
 21 Standard is 6.18 cents and of ECR Standard is a whopping 8.65 cents, for a  
 22 difference of 2.47 cents. A similar result is shown in the other columns.

23 Since the per-piece contribution of ECR is, on average, substantially  
 24 higher than the per-piece contribution of Regular, ECR flunks the test and we

1 can say that the rates for the categories in ECR would in all likelihood be lower if  
2 ECR had never been made into a subclass. It is true that this is a relatively  
3 rough test. But the difference (2.47 cents TYBR) is not by any means small.

4         The interpretation of this check is not that a difference in the per-piece  
5 contribution of zero is ideal. A difference of zero would mean only that the rates  
6 for ECR are approximately equal to what they would be if no separate subclass  
7 for it had been created. But a primary reason for creating the ECR subclass was  
8 to allow recognition of differences in the ECR and non-ECR markets, which, as  
9 will be argued below, should have caused the rates to be lower than they  
10 otherwise would have been and the per-piece contribution of ECR to be lower  
11 than the per-piece contribution of Regular. In other words, the difference in per-  
12 piece contribution, shown in the figure to be approximately 2.47 cents, is  
13 **positive**, and it **should be, to some degree, negative**.

14 **4. A Quantitative Showing that ECR Rates Would Be Lower without the**  
15 **Creation of a Separate Subclass.**

16         The conclusion just discussed, that the now-ECR categories would have  
17 lower rates if the ECR subclass had not been created, can be shown  
18 quantitatively. Again, the estimation process is not exact, and does require  
19 assumptions, but the results are not equivocal.

20         I developed rates based on the following assumptions: (1) The revenue  
21 requirement for the combined subclass is equal to the sum of the revenue

1 requirements proposed by the Postal Service for Regular Standard and ECR  
2 Standard. (2) Rates as proposed by the Postal Service are assumed for the  
3 non-machinable letter surcharges, the residual shape surcharges, the barcode  
4 discount for qualifying residual-shape-surcharge pieces, and all four pound rates.  
5 (3) The average revenue-per-piece levels for the two nonprofit categories are  
6 separately set at 60 percent of those of the corresponding commercial  
7 categories, to the extent allowed by conventional rounding practices, before  
8 fees.<sup>22</sup> (4) Dropship savings are updated and Commission costs are used, and  
9 the passthroughs for them are at the levels recommended by the Commission in  
10 Docket No. R2001-1. (5) With three exceptions, explained further below, a 100  
11 percent passthrough is used on all avoidances and cost differences shown in the  
12 presort tree, including between such categories as 3/5-digit letters and basic  
13 carrier route letters, which are now in separate subclasses. (6) Adjustments for  
14 the negotiated service agreements are handled the same as in the Postal  
15 Service's proposal. (7) For cost differences, shown in the presort tree, I used  
16 Commission costs for mail processing and Postal Service costs for delivery. The  
17 latter seems reasonable given the anomalous costs that appear to result from  
18 updating the Commission's delivery coststhe update of PRC-LR-7 from Docket  
19 No. R2001-1, as provided by the Postal Service.

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<sup>22</sup> The term "commercial" is sometimes used to help refer to either the for-profit category of Regular Standard or the for-profit category of ECR Standard. Officially, there are no names for these categories, and the identifiers available are more confusing than helpful. When necessary for reasons of balance, "commercial" will be capitalized.

1 Under the preceding assumptions, the rates are revenue neutral for the  
2 combination of ECR Standard and Regular Standard, as proposed by the Postal  
3 Service, AtB. In Docket No. R2001-1, based on USPS costing, 15 passthroughs  
4 were selected in the combined commercial category. These are shown, but not  
5 confirmed, in the Postal Service response to VP/USPS-T28-48, redirected from  
6 witness Taufique (Tr. 8/\_\_\_\_). Seven of these were equal to 100 percent; two  
7 were over 100 percent; and six were below 100 percent. Three of those below  
8 100 percent (for mixed AADC automation, 3-digit automation, and basic ECR  
9 automation) have been preserved, based on a presumption that their levels were  
10 selected because the costs of the host category included non-machinable mail.  
11 One could note that it is unlikely that all passthroughs except these three would  
12 exactly equal 100 percent sans the ECR subclass. It is the case that in any  
13 particular rate proceeding, each passthrough would be examined, along with  
14 trends, and might be adjusted for various reasons. As a rough estimate,  
15 however, the assumption is undoubtedly indicative.

16 The results for the commercial categories now in ECR are shown in  
17 Figure 3. Column E contains results for the joint subclass and, for reference  
18 purposes, column G shows the AtB rates proposed by the Postal Service in this  
19 case. The basic ECR letter rate is 16.7 cents, a full 3.7 cents below the  
20 proposed rate of 20.4 cents. In all cases, rates in the joint subclass are  
21 substantially lower, except for the pound rate, which was constrained by  
22 assumption.

1

Figure 3

2

## Rates For Now-ECR Categories If No Subclass Had Been Created

<b>Now-ECR Categories</b>					
<b>Built as Though No ECR Subclass Had Been Created</b>					
				<b>Hypothetical Combined Subclass Rates</b>	<b>USPS Proposed Rates (reference)</b>
<b>Minimum per-piece Rates, cents/pc</b>					
Letter Piece Rates					
	Basic ECR			16.7	20.4
	Automation ECR			13.3	18.0
	High Density ECR			13.5	17.3
	Saturation ECR			13.2	16.0
Non-Letter Piece Rates				17.3	20.4
	Basic ECR			14.0	17.8
	High Density ECR			13.6	16.9
	Saturation ECR				
Destination Entry Discounts, per piece					
	DBMC			2.3	2.2
	DSCF			3.0	2.7
	DDU			3.7	3.3
<b>Pound-rated Pieces, cents/lb &amp; cents/pc</b>					
Pound Rate				64.3	64.3
Per-piece Add Ons					
	Basic ECR			4.0	7.2
	High Density ECR			0.7	4.5
	Saturation ECR			0.3	3.6
Destination Entry Discounts, per pound					
	DBMC			11.3	10.5
	DSCF			14.7	13.2
	DDU			17.7	16.6

1           These results confirm the expectation implied by considering the per-  
2 piece contributions. ECR rates are approximately 25 percent higher than they  
3 would be if no ECR subclass had been created. Using a modified set of  
4 passthroughs or avoidances would not change this conclusion. It is decidedly  
5 pronounced.

6 **5.     Specific Consideration of the Non-cost Factors in the Act for ECR**  
7 **Mail.**

8           As discussed above, cost coverages for the subclasses should result from  
9 an independent application of the non-cost factors in the Act, within a breakeven  
10 framework. When the Commission did this for third class, before reclassification,  
11 it said: “Similarly, we have consistently found that third-class bulk regular,  
12 another subclass which is largely subject to the statutory monopoly, should also  
13 bear an approximately average markup.” *Op. & Rec. Dec.*, Docket No. R90-1, p.  
14 IV-8, ¶ 4022. In short, the Commission laid the various characteristics of third  
15 class and its markets against the non-cost factors in the Act and reached a  
16 conclusion that its cost coverage should be 146.2 percent, which was a markup  
17 index of 0.927. *Ibid.*, App. G, Schedule 3, pp. 1-2.

18           It is important to note that this cost coverage of 146.2 percent was  
19 selected by focusing on the combination of what is now Commercial Regular and  
20 Commercial ECR, not including any influence from the nonprofit categories.  
21 Nonprofit third class at the time was a separate subclass and had a legislated

1 cost coverage approximating 100 percent, with its calculated contribution (to  
2 fixed costs) paid by Congress in the form of an appropriation. If lower rates for  
3 the then-nonprofit subclass had been financed in the same way that they are  
4 now, and the commercial categories were to have had the same implicit markup  
5 that they actually did (so as to leave them unaffected by the financing  
6 arrangement for nonprofit), the cost coverage for the joint (nonprofit and regular)  
7 third-class subclass would have had to be lower than 146.2 percent.

8 The important question becomes: If the application of the non-cost  
9 factors to the mail in Commercial Regular Standard and Commercial ECR  
10 Standard together led to a cost coverage of 146.2 percent, what coverages  
11 should a similar application of the non-cost factors yield when applied separately  
12 to Regular and ECR, allowing for the presence of the Nonprofit categories?<sup>23</sup>  
13 The decision to make ECR into a separate subclass, which by definition warrants  
14 an independent application of the non-cost factors, makes this the appropriate  
15 question, and one that must be answered.

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<sup>23</sup> A similar question was asked by the Commission when it selected cost coverages for single piece and bulk third class in Docket No. R90-1, the two both being subclasses of third class. The Commission said: "Theoretically, there may be little reason to differentiate between single piece and bulk third class when establishing relative markups, however the rate design problems of single piece have effectively insulated it from being assessed a systematically developed contribution toward institutional costs." Op. & Rec. Dec., Docket No. R90-1, p. IV-31, ¶ 4101. This reasoning, to the extent to which it applies, suggests that the markups on Regular Standard and ECR Standard should be similar in magnitude.

1           Using X to stand for each of the non-cost factors,<sup>24</sup> this question can be  
2   stated another way. If non-cost factor X, when applied to the former third class,  
3   was part of a deliberation process that led to a cost coverage of 146.2 percent,  
4   what cost coverages are implied by applying factor X separately and  
5   independently to the now-Regular and the now-ECR subclasses, with the  
6   understanding that the average revenue-per-piece of the Nonprofit categories  
7   must be equal as nearly as practicable to 60 percent of that of their  
8   corresponding commercial categories? Since Congress made it clear that it did  
9   not intend for the burden of supporting the Nonprofit rates to fall on their host  
10   commercial categories only, but rather on the Postal Service overall,<sup>25</sup> it is clear  
11   that if the **implicit** coverages for the commercial categories of Regular and ECR  
12   were both to be 146.2 percent, the coverages on the joint (Commercial and  
13   Nonprofit) categories would necessarily be below 146.2 percent.

14           In addition to selecting cost coverages that do not place the burden of the  
15   Nonprofit rates on the host category, it needs also to be kept in mind that the

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<sup>24</sup>           Note that factor No. 3 of section 3622, "the requirement that each class of mail or type of mail service bear the direct and indirect postal costs attributable to that class or type plus that portion of all other costs of the Postal Service reasonably assignable to such class or type," is not a non-cost factor.

<sup>25</sup>           Section 2 of S. 2686, which led to P.L. 106-384, 114 Stat. 1460, Oct. 2000, was a transitional provision that said: "In any proceeding in which rates are to be established under chapter 36 of title 39, United States Code, for mail matter under former sections 4452(b) and (c) of that title, pending as of the date of enactment of section 1 of this Act, the estimated reduction in postal revenue from such mail matter caused by the enactment of section 3626(a)(6)(A) of that title, if any, shall be treated as a reasonably assignable cost of the Postal Service under section 3622(b)(3) of that title."

1 resulting rate levels for the Nonprofit categories are determined just as much by  
2 these cost coverages as the rates of the accompanying commercial category.  
3 That is, since the per-piece revenue for the Nonprofits is fixed at 60 percent of  
4 the per-piece revenue for the corresponding commercial category, the higher the  
5 rates for the commercial categories, the higher the rates for the Nonprofit  
6 categories. Therefore, to elevate the coverages (and the rates) on the combined  
7 categories unnecessarily would be to elevate the implicit coverages (and the  
8 rates) on the Nonprofit categories. To do this would seem to negate the  
9 provision Congress made for the Nonprofits. The need to watch out for the  
10 Nonprofits, therefore, puts added pressure on the process of selecting  
11 coverages.

12 In the sections below, each non-cost factor will be discussed. Attention  
13 focuses on the proportionate (expressed as a percentage) cost coverage, which  
14 is directly related through the systemwide cost coverage to the markup index.<sup>26</sup>

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<sup>26</sup> The Commission has agreed that the cost coverages and the associated markup indexes are the appropriate focus. It has said: "We conclude that it continues to be most appropriate to distribute the relative burden of recovery of institutional costs on the basis of coincident application of the policy factors of the Act, with reference to the markup index." *Op. & Rec. Dec.*, Docket No. R90-1, p. IV-17, ¶ 4052. Also: "We measure relative burdens with a markup index, which compares the markup for each subclass with the systemwide average markup. . . . We find this measure particularly valuable because it allows us to compare relative burdens from case to case, while case to case comparisons of cost coverages or unit contributions are made misleading by variations in the amount of total attributable dollars involved." *Ibid.*, p. IV-4, ¶ 4011. Within the context of a given case, of course, there is no difference between relative cost coverages and relative markup indexes.

1 This is the appropriate focus, rather than some other measure such as the per-  
2 piece contribution.<sup>27</sup>

3 **Non-Cost Factor No. 1:**  
4 **The establishment and maintenance of a**  
5 **fair and equitable schedule**

6 The question is: would any notion of fairness, when applied to ECR,  
7 suggest in any direct way that its cost coverage should be higher than the 146.2  
8 percent (or the associated markup index of 0.927) that was suited to third class  
9 as a whole? Several observations may be made.

10 First, the fact that the reduced revenue from Nonprofit mail makes the  
11 rates for the Commercial mail higher for any given cost coverage for the ECR  
12 subclass suggests that the cost coverage for the subclass should be lower than  
13 the 146.2-percent figure. If an influence in this direction were not allowed, it  
14 would imply that the full burden of providing the lower Nonprofit rates should be  
15 borne by the Commercial mailers, which, as discussed above, was not the intent  
16 of Congress.

17 Fairness is often taken to mean that costs are recognized in appropriate  
18 ways, lending support to attributable costs and markups as important reference

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<sup>27</sup> Another candidate measure is the markup fraction, which is the absolute per-piece markup relative to the rate. For example, if the rate is 8 cents and the cost is 5 cents, the per-piece markup is 3 cents and the markup fraction is  $3/8 = 0.375$ . This measure will always be equal to or less than 1.0. Its lack of use in Commission proceedings is probably because its relative levels are closely related to those of the more-common cost coverage.

1 points and to interests in what are often called **cost based rates**.<sup>28</sup> The  
2 Commission noted this and extended it in Docket No. MC95-1 when it said:

3 To be fair, rates should not only reflect direct and  
4 indirect attributable costs, but also the “noncost”  
5 factors set forth in the ratemaking section of the Act,  
6 § 3622. A major reason for establishing separate  
7 subclasses is to allow rates to be set to reflect  
8 significant distinctions in the applicability of one or  
9 more of the noncost statutory criteria. [*Op. & Rec.*  
10 *Dec.*, Docket No. MC95-1, p. III-22, ¶ 3056.]

11 In addition, national policy issues can be associated with fairness. The  
12 Postal Service has been established to provide services to mailers and the  
13 American people. The presumption is that by aggregating mail from all sources  
14 and having one carrier, a low-cost, highly efficient operation can be achieved,  
15 and these low costs can allow correspondingly low rates. Partly through the help  
16 of extensive preparation of mail by mailers, an issue discussed further under  
17 non-cost factor No. 6 below, low costs have been achieved in the ECR subclass  
18 to a considerable degree. ECR’s costs are low and the resources drawn from  
19 the nation to provide the service are minimal. Benefits from this achievement  
20 can be realized only if the low-cost mailstream is made available to mailers at  
21 reasonable rates. An excessive cost coverage subverts this process, unfairly,  
22 and prevents the benefits from being received.

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<sup>28</sup> When rates are not cost based, it is often the case that inefficient signals are sent to mailers. One might argue, for example, that it is unfair to local mailers to maintain a uniform nationwide rate, as this would force them to help finance transportation for long-haul mailers that could arrange easily to print and enter their mail much closer to its destination. This is one of the reasons dropship discounts were introduced in third class in Docket No. R90-1.

1 Finally, as stated above, notions of fairness are often viewed as  
2 reflections of the thought process of the beholder. For example, in Docket No.  
3 R90-1, the Commission said: “The Commission is a collegial body with five  
4 members, each of whom has a separate, distinct view of what is fair and what is  
5 equitable. These five views become balanced as rate recommendations are  
6 being developed.” *Op. & Rec. Dec.*, Docket No. R90-1, p. IV-39, ¶ 4124.

7 I find no basis for concluding that considerations of fairness and equity  
8 argue for a cost coverage on ECR that is higher than the coverage on the former  
9 third class, or even higher than the average for all mail. In the same docket,  
10 quoting its own opinion in Docket No. MC78-2, the Commission said:

11 it is our view that in the exercise of our classification  
12 responsibilities pursuant to § 3623, the requirement of  
13 a “fair and equitable classification system for all mail”  
14 compels us to strive for a classification structure  
15 which permits the establishment of cost-based rates.  
16 [*Ibid.*, p. V-56, ¶ 5124.]

17 One reason for creating ECR was to improve the cost-based nature of the  
18 rates. That purpose should not be overridden by an excessive markup.

19 **Non-Cost Factor No. 2:**  
20 **The value of the mail service actually provided each**  
21 **class or type of mail service to both the sender and the**  
22 **recipient, including but not limited to the collection,**  
23 **mode of transportation, and priority of delivery**

24 Mailers receive value from using the mail. We know, for example, that a  
25 mailer spending a million dollars on postage must be receiving more than a  
26 million dollars of value, or he would not enter the mail. But as applied to the

1 question of how far to raise rates above costs, which **is** the question faced when  
2 cost coverages are selected, the question is how much value beyond the one  
3 million dollars is available to be drawn upon. Mailers spending a million dollars  
4 on postage could be getting, say, 8 or 9 million dollars in value. The realization  
5 of such high values is the hope when the service is provided. The nation is  
6 certainly better off when a value of 8 or 9 million dollars is received than when a  
7 value of, say, 1.5 million is received. On the other hand, mailers spending a  
8 million dollars on postage could be receiving a value of only 1.5 million dollars. A  
9 circumstance such as this would not suggest that the service should be  
10 withdrawn, but it would be clear that little value exists to draw on in increasing  
11 rates above costs.

12           If there is a substantial amount of value to draw on, the cost coverage can  
13 be elevated and volume will diminish only a little. If volume diminishes only a  
14 little, the reduction in value received will also be small, although more of the  
15 value will be paid out in postage. Alternatively, if only a small amount of value is  
16 available to be drawn on, then an elevation in the cost coverage will reduce the  
17 volume substantially, and the reduction in value received will also be substantial.  
18 The importance of recognizing value to mailers when selecting markups is to  
19 reduce the occurrence of the large losses in value that result from large volume  
20 reductions.

21           The measure of the sensitivity of volume to price increases, and therefore  
22 of value to price increases, is the own-price elasticity of quantity demanded.

1 Acknowledging this measure, the Commission said: “Large differences in own-  
2 price elasticities are clearly important evidence supporting separate treatment  
3 under § 3622(b)(2).” *Op. & Rec. Dec.*, Docket No. MC95-1, p. III-45, ¶ 3120.

4 Measures of elasticity are developed by the Postal Service as part of the  
5 volume forecasting process. In this docket, Postal Service witness Thress  
6 (USPS-T-7) estimates the own-price elasticity of Commercial ECR to be -1.093  
7 and of Commercial Regular to be -0.267, both of which categories were part of  
8 the former third class. USPS-T-7 at 9. This means that when rates for third  
9 class were increased, a substantial amount of value was lost by now-ECR  
10 mailers and a much smaller amount was lost by now-Regular mailers. In Docket  
11 No. R2001-1, these two elasticities were estimated to be, in order, -0.770 and -  
12 0.390. That is, the own-price elasticity of Commercial ECR is now estimated to  
13 be 41.9 percent **higher** than it was in the previous docket, and the corresponding  
14 own-price elasticity of Commercial Regular is now estimated to be 31.2 percent  
15 **lower**. See responses of witness Thress to VP/USPS-T7-1-2, Tr. 3/325-26. The  
16 importance of recognizing value has increased.

17 An elasticity of -1.093 is substantial. It means that if there is a rate  
18 increase of 10 percent, the volume will decline 10.93 percent, *ceteris paribus*,  
19 and therefore that total revenue will actually decrease. Total revenue less cost,  
20 however, which is the contribution obtained from the subclass, will increase as  
21 long as the elasticity, in absolute value, is less than the price divided by the per-  
22 piece markup. For Commercial ECR, this critical level (with its actual sign) is

1 about -1.88. Therefore, despite the volume loss, which is substantial, an  
2 increase in price will increase net revenue. But the amount by which net  
3 revenue will increase is not large and the elasticity is not so very far from the  
4 level where even this would not occur.

5 The elasticity measures vary among the subclasses of mail. In general,  
6 the elasticity of Commercial ECR (at -1.093) is relatively high (in terms of the  
7 response to a rate change) and the elasticity of Commercial Regular (at -0.267)  
8 is relatively low. The difference is due to a number of factors, including the  
9 importance attached to sending or receiving the piece, closeness of substitutes,  
10 preferences of the users, and response rates of recipients (the later applying  
11 primarily to advertising materials). The measure does reflect, then, the value to  
12 recipients.

13 In past proceedings, some attention has been focused on what are called  
14 **intrinsic** indicators of value. These relate to such things as deferability, speed  
15 of service, whether air transportation is used, whether delivery is guaranteed on  
16 a certain day, options available for acceptance or postage payment, whether the  
17 piece is sealed against inspection, and whether forwarding service is provided.  
18 For the most part, these are **characteristics of the product or service offered**.  
19 Whether and to what extent these characteristics are valued by senders or  
20 recipients is another matter. A product can have a long list of characteristics and

1 not be valued highly.<sup>29</sup> In the end, identifying a product's characteristics may  
2 highlight its features and facilitate clear thinking about the value mailers **might**  
3 place on the product, but the ultimate – and only relevant – question is whether  
4 the value is actually there. The test for this is the decisions users make in the  
5 market, which is reflected in the elasticity measures.

6         One reason for creating the ECR subclass was to facilitate recognition of  
7 its market characteristics. The measure of this that received primary attention  
8 was its high elasticity. It is apparent that the value available to draw on in the  
9 case of ECR Standard is considerably lower than the value available in the case  
10 of Regular Standard or of most other subclasses. To the extent that recognition  
11 is given to this low reservoir of value, a lower-than-average and lower-than-the-  
12 former-third-class cost coverage is suggested.

13         In the recognition of value, the Commission has noted that much of the  
14 inelasticity in First Class is due to restrictions against private carriage and to the

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<sup>29</sup>         Suppose a product is defined by a certain list of **characteristics** and, accordingly, has a certain cost. Suppose further that the price is set equal to this cost and that, say, 5 billion pieces are purchased, for a total postage bill of \$1 billion. The fact that mailers are willing to spend \$1 billion on this product is certainly evidence that they find much value in it (in the sense that \$1 billion is a lot of money on any basis), and certainly the decision to purchase 5 billion pieces is a reflection of the product's characteristics. In fact, we know that the value being received must be something in excess of \$1 billion. But knowing this and understanding the product's characteristics tells us nothing about (i) how far the value being received is above \$1 billion, (ii) how rapidly the volume will drop off when the price is increased, and, accordingly (iii) how much value is available to draw on in increasing the price. If the volume falls off substantially when the price is increased, the attempt to obtain more revenue will largely fail due to the disappearance of the volume, and the value received by mailers from purchasing the product will decline substantially as well.

1 requirement that some materials, if mailed, **must** be sent First Class. It has  
2 considered it therefore somewhat unfair to elevate the markup of First Class on  
3 the basis of elasticity, even though it is clear that considerable value exists. In  
4 Docket No. R90-1, for example, the Commission said: “Specifically, we find that  
5 it would violate the principles of postal ratemaking as set forth in the Postal  
6 Reorganization Act to set First-Class rates to produce a markup index  
7 significantly higher than average.” *Op. & Rec. Dec.*, Docket No. R90-1, p. IV-19,  
8 ¶ 4059. For related reasons, the Commission has declined to recommend a low  
9 markup to Standard mail, based on its low value. In the same docket, it said:  
10 “Similarly, we have consistently found that third-class bulk regular, another  
11 subclass which is largely subject to the statutory monopoly, should also bear an  
12 approximately average markup.” *Ibid.*, p. IV-8, ¶ 4022.

13         Accepting the preference for not lowering the markup on third-class mail,  
14 and recognizing that Commercial ECR is more elastic than Commercial Regular,  
15 the question in regard to value should be whether the markup on Commercial  
16 ECR should be both lower than the systemwide average markup and lower than  
17 the markup on Commercial Regular. Even if this question is answered by a  
18 Commission preference for applying its “approximately average markup” to both  
19 ECR and Regular, the current markup on ECR, 226.4 percent in the test year at  
20 the proposed rates, is too high, by a wide margin. See USPS-LR-K-114, revised  
21 June 10, 2005. If the markup on ECR is not lowered, then ECR is thereby

1 prevented from having its market characteristics recognized appropriately, which  
2 was a primary purpose of making it a separate subclass.

3 **Non-Cost Factor No. 4:**  
4 **The effect of rate increases upon the general public, business**  
5 **mail users, and enterprises in the private sector of the economy**  
6 **engaged in the delivery of mail matter other than letters**  
7

8 If a meritorious rate position has been identified and the rate increase  
9 required to get there is unusually large, concern over the **effect** of the rate  
10 increase might cause the coverage to be reduced, in order to ease the  
11 adjustment burden. Any such reduction, however, would normally be expected  
12 to be temporary. The Commission might decide to get to the desired rate  
13 position in two or three steps instead of one, but it would not reject the  
14 meritorious position. The concern here is over rate shock, not over rate level.

15 But in considering whether cost coverages are too high, a concern over  
16 the effect of rate **increases** does not arise. Instead, the question that arises is  
17 over the effect of rate **decreases**, which this non-cost factor does not expressly  
18 address.

19 Nevertheless, despite its specific focus on rate increases, this factor has  
20 sometimes been interpreted to raise the question of whether a rate is so low that  
21 it competes unfairly with “enterprises in the private sector of the economy  
22 engaged in the delivery of mail matter other than letters.” Insofar as the  
23 restrictions on private carriage are concerned, letters are addressed pieces

1 having no more than 24 pages. Pieces without addresses can be carried  
2 privately, as can pieces with over 24 pages.

3         These definitions mean that addresses can be removed from saturation  
4 pieces and they can then be delivered by private enterprises, along with the  
5 over-24-page pieces. But private enterprises still cannot use the mailbox. That  
6 is, they are permitted to take the pieces to the delivery points, and leave them on  
7 door knobs or in front yards, but not in mailboxes. Under these conditions, I  
8 contend that it is not only unfair to mailers but also poor national policy to elevate  
9 ECR rates, for both Commercial and Nonprofit mailers, whether the pieces can  
10 be delivered privately or not, in order to attempt to make it profitable for private  
11 enterprises to be successful in attracting a portion of the ECR mailstream.

12         The situation faced by private delivery enterprises is perplexing at best.  
13 Delivery operations tend to have fixed costs as an inherent characteristic, which  
14 is another way of saying that their costs do not vary substantially with volume  
15 and that scale economies can be realized by attracting additional volume. To be  
16 effective, these operations need to attract substantial volumes per delivery point.  
17 But the situation they face is that only a portion of the ECR volume can be  
18 carried privately and, since many mailers and recipients would prefer the use of  
19 the mailbox, their method of delivery is considered inferior. Therefore, even  
20 under the best of circumstances, they have difficulty attracting volume. Many  
21 private delivery operators have said to me: If only I could use the mailbox, I  
22 could attract more volume and I would be running a successful operation.

1           Given this situation that they face, private operators tend to have relatively  
2 high costs, which might be overcome in some degree by payment of relatively  
3 low wages. On the other hand, mailers have available in the form of the Postal  
4 Service a low-cost delivery service that is able to use the mailbox and that should  
5 be able to meet their needs effectively. Under these conditions it is not  
6 appropriate to elevate the ECR rates to attempt to make the private operators  
7 successful anyhow. Doing this simply increases mailer costs, reduces volume,  
8 and accordingly reduces the value that mailers could receive. It also keeps the  
9 Postal Service from providing exactly the service that it was established to  
10 provide.

11           The Commission has taken the position many times that competition  
12 should be protected, but not competitors.<sup>30</sup> Placing an average markup on ECR,  
13 especially given that the wages (including fringe benefits) paid by the Postal  
14 Service are undoubtedly higher than those of private operators, would protect  
15 competition adequately. I contend that it is not good ratesetting to use an effect-  
16 on-competitor argument to elevate the coverage on ECR under these conditions.  
17 If there were interest in encouraging private competition, the mailbox rule could  
18 be changed instead.

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<sup>30</sup> See Docket No. R2000-1, where the Commission said: “The Commission’s role is to protect competition, not competitors. *Direct Marketing Association, Inc. v. United States Postal Service*, 778 F.2d 96, 106 (2<sup>nd</sup> Cir. 1985).” *Op. & Rec. Dec.*, *ibid.*, p. 473, ¶ 5788.

1 **Non-Cost Factor No. 5:**  
2 **The available alternative means of sending and receiving**  
3 **letters and other mail matter at reasonable costs**

4 When this factor was applied to the former third class, it was in effect  
5 applied to ECR and Regular Standard jointly. Now that they are two separate  
6 subclasses, the factor must be applied separately, and the proportions of the  
7 included mail that can be carried privately differ.

8 As discussed above, some letters and other mail matter in ECR can be  
9 carried by private competitors if the addresses are removed or if the pieces have  
10 over 24 pages. Another alternative is to send materials privately under the  
11 urgent letter exception, which would not be expected for advertising matter. But  
12 most materials in ECR cannot be sent privately. The Private Express Statutes  
13 require that if they are sent, they must be sent through the Postal Service.  
14 Therefore, most ECR mailers have no alternatives. This conclusion applies with  
15 even more force to Nonprofit mailers.

16 In the case of Regular Standard, however, the mail tends to be targeted  
17 and removing the addresses is not an option. Therefore, it may be that Regular  
18 mailers have fewer options than ECR mailers, or at least that a smaller  
19 proportion of the included volume has a private delivery option. For this reason,  
20 one could argue that an appropriate markup on ECR might be somewhat higher  
21 than the markup on Regular. This position, however, is based on averages and  
22 not on any notion of fairness to the mailers in ECR who have no options. In any

1 case, it is difficult to see that this factor would contribute to the markup on ECR  
2 being **substantially** higher than the markup on Regular.

3 Considerations rooted in this factor are often expanded to include  
4 **alternatives** to sending and receiving physically, such as when information  
5 equivalent to that contained in letters and other mail matter is transmitted  
6 electronically, despite the fact that this non-cost factor refers specifically to  
7 “sending and receiving letters and other mail matter.” For example, a mailer  
8 sending advertising or other promotional material in one of the Standard  
9 subclasses could consider a similar promotion using television, radio,  
10 newspapers, or the Internet.<sup>31</sup> Viewed in this way, it is clear that Standard  
11 mailers do have alternatives. And, since ECR mailers are more likely to be  
12 interested in reaching broad geographic areas, and thus are more likely to find  
13 some of the broader media like television suitable, one could argue that ECR  
14 mailers might have more alternatives than Regular mailers, perhaps contributing  
15 to the higher elasticity and lower value of service of the former relative to the  
16 latter.

17 If ECR mailers have more alternatives than mailers in other subclasses or  
18 than Regular mailers, the position could be taken that an elevation in their rates  
19 would not leave them in the lurch, despite the lower value available to be drawn

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<sup>31</sup> As another example, one restaurant that I frequent sends me coupons by e-mail. It is clear beyond question that my propensity to eat there again is influenced by the coupons received. In fact, if I fail to use the coupons, my wife takes the position that I have wasted money.

1 on through increased rates. And, at the same time, it is important to compete  
2 fairly with these other media. But it is also important not to disadvantage the  
3 mail option. The Postal Service exists to serve mailer needs effectively and a  
4 high rate prevents that from occurring, thereby limiting the value and benefits  
5 that are achievable.

6 On balance, arguments relating to the availability of alternatives, exclusive  
7 of considerations relating to value, and arguments about how to compete fairly  
8 with providers of alternatives, could be taken to suggest a markup at or near the  
9 average level, and perhaps a slightly higher markup for ECR than for Regular,  
10 but would not support, even apart from the influence of other factors, the  
11 exceedingly high markup on ECR that would exist under the Postal Service's  
12 proposal.

13 **Non-Cost Factor No. 6:**  
14 **The degree of preparation of mail for delivery into the**  
15 **postal system performed by the mailer and its effect**  
16 **upon reducing costs to the Postal Service**

17 An important element of an effective postal system involves mailers and  
18 the Postal Service working together. Sometimes this is done through rate  
19 arrangements commonly referred to as involving worksharing, with an associated  
20 outcome of achieving technical efficiency in the mailstream and lowest combined  
21 costs, and sometimes through an elementary process of deaveraging and  
22 recognizing costs in rates, which can increase the competitiveness of the Postal  
23 Service in fair ways, while allowing mailer needs to be met. Mailer responses to

1 signals sent through rates aligned with notions of worksharing and appropriate  
2 cost recognition often result in additional preparation of the mail, an activity that  
3 this non-cost factor suggests should be recognized in rates.

4 ECR mailers engage in preparation activities in greater degree than any  
5 other subclass. They presort, they barcode, they prepare mail in line-of-travel  
6 sequence, and they dropship. In addition, some practices that are a natural part  
7 of their operations tend to result in low postal costs, such as container usage,  
8 acceptance processes, and postage payment procedures. Also important is that  
9 their density, which may be thought of as the number of pieces per carrier route,  
10 and their bulk nature helps to translate their activities into low costs. As a result,  
11 the Postal Service's costs for ECR mail are notably low – especially saturation  
12 mail.

13 When costs are low, a normal outcome of the competitive process is low  
14 rates. This allows benefits of the low costs to be realized. It makes no sense at  
15 all for the presence of low costs to be used as a basis for elevating rates to an  
16 extreme degree. Such a practice removes from mailers the reasonable option to  
17 use a low-cost mailstream that is a prime example of the kind of service that a  
18 national postal service should provide. Also, an elevation of rates on this basis  
19 runs counter to this non-cost factor, which requires that preparation activities be  
20 recognized. This factor, even on a *ceteris paribus* basis, cannot be used as a  
21 basis supporting a markup on ECR at anywhere near the current level. At the  
22 most, it should support a markup at or below the median, at least as far as

1 subclass coverage goes. This does not mean it is unimportant in supporting  
2 much of the rate design within the subclass.

3 **Non-Cost Factors Nos. 7 through 9:**

4 **Simplicity of structure for the entire schedule and simple,**  
5 **identifiable relationships between the rates or fees charged**  
6 **the various classes of mail for postal services;**

7 **The educational, cultural, scientific, and informational value**  
8 **to the recipient of mail matter; and**

9 **Such other factors as the Commission deems appropriate**

10 Issues relating to simplicity of structure (factor No. 7) do not bear on the  
11 markup for either ECR Standard or Regular Standard. Similarly, questions  
12 relating to the educational, cultural, scientific, and informational value (commonly  
13 referred to as ECSI value) of the mail matter involved do not play a role. ECSI  
14 value is recognized for Periodicals and Media Mail (the latter primarily because  
15 of the books contained therein). It does not have an influence on ECR, except  
16 for the extent to which, in line with breakeven, the markup on all subclasses must  
17 be elevated somewhat to cover the lower rates for the subclasses receiving ECSI  
18 recognition.

19 The Commission has the authority to consider such other factors as it  
20 deems appropriate (factor No. 9), but it has never used references to this factor  
21 to influence the markups for ECR Standard or Regular Standard mail. In fact,  
22 the Commission has made relatively little use of this factor for any purpose.  
23 Three references to this factor are noteworthy.

1 In regard to the reclassification proposals of the Postal Service and factor

2 No. 9, the Commission said:

3 No other factor involved in the process of allocating  
4 institutional costs requires separate mention.  
5 Consideration of the eight specific factors leads to the  
6 conclusion that only one of the subclasses proposed  
7 by the Postal Service will improve the ability of rates  
8 to reflect the statutory ratemaking criteria. [*Op. &*  
9 *Rec. Dec.*, Docket No. MC95-1, p. III-53, ¶ 3141.]

10 In the same docket, the Commission mentioned the “other factors”

11 provision in section 3623(c)(6), saying: “The major ‘other factor’ which the

12 Commission has taken into consideration in this docket is whether the proposed

13 subclass structure will facilitate the application of the statutory ratemaking

14 criteria.” *Ibid.*, p. III-41, ¶ 3110. It concluded that it did for ECR.

15 Finally, in Docket No. R94-1, another case filed as ATB, the Commission

16 said:

17 In evaluating all of the arguments for and against the  
18 proposed across-the-board rate increase, the  
19 Commission has focused on its obligations under the  
20 Act. The Postal Service suggests that section  
21 3622(b)(9) allows the Commission to determine that  
22 the importance of facilitating [the] reclassification  
23 [case to come] outweighs the considerations codified  
24 in other statutory criteria. The Commission has  
25 carefully considered this proposition, but before  
26 accepting it the Commission must judge whether  
27 there is sufficient evidence to support the conclusion  
28 that an across-the-board approach will actually tend  
29 to further reclassification. Although a number of  
30 parties support the Postal Service’s request, there is  
31 no empirical evidence in the record to suggest that  
32 mailers will be less receptive to reforms of product  
33 lines if rate increases for existing subclasses are not

1 identical. [*Op. & Rec. Dec.*, Docket No. R94-1, pp. I-  
2 4-5, ¶ 1015, footnote omitted.]

3  
4 Other parts of my testimony deal with whether a justification has been  
5 presented for an AtB approach, under or apart from non-cost factor No. 9. But I  
6 have found no basis for non-cost factor No. 9 being used to influence the markup  
7 of the former third class or of ECR.

8 **6. The Legacy of ECP Should Not Be Continued in High Markups.**

9 Many differences among rates within subclasses have been set according  
10 to the efficient component pricing (“ECP”) rule. The Commission explains:

11 The theory [the ECP rule] requires the discount to be  
12 100 percent of the cost savings. The Commission  
13 tries to achieve 100 percent passthrough of the  
14 worksharing savings, but again it frequently may  
15 depart from this standard for a variety of reasons.  
16 [*Op. & Rec. Dec.*, Docket No. R2000-1, p. 390, ¶  
17 5535.]

18 When the rule is followed, pieces moving from one rate category to another tend  
19 to keep their same absolute per-piece contributions to fixed costs; and to the  
20 extent to which all important cost differences among mailings are recognized in  
21 rates, all pieces within the subclass tend to have the same per-piece  
22 contribution. When the per-piece contributions are equal, the percentage  
23 contributions are not. Specifically, workshared pieces will tend to have much  
24 higher percentage contributions than non-workshared pieces. This phenomenon  
25 is well recognized in rate proceedings. Examples are easy to construct.

1           Suppose a subclass is composed of equal volumes of two kinds of pieces,  
2 presorted and not presorted. Suppose further that the presorted pieces cost 6  
3 cents to process and deliver, and the non-presorted pieces cost 10 cents. If the  
4 rate difference is set equal to the 4-cent cost difference, the presort rate might be  
5 11 cents and the non-presort rate might be 15 cents. Under these conditions,  
6 the average per-piece revenue is 13 cents and the average per-piece cost is 8  
7 cents. The cost coverage of the subclass, then, is  $13/8 = 162.5$  percent. Each  
8 of the pieces, presort and non-presort, make a per-piece contribution of 5 cents  
9 (11 - 6 and 15 - 10). But the implicit percentage markup of the presorted pieces  
10 is 11 divided by 6, which is 183.3 percent. This result does not imply an error in  
11 any of the ratesetting steps.

12           Prior to reclassification, third class fit this example. The implicit  
13 percentage cost coverage of the most highly workshared pieces, taken category  
14 by category or as a group, was much higher than the percentage cost coverage  
15 of the subclass as a whole; and since ECR is composed of the most highly  
16 workshared pieces, the implicit coverage of ECR was very high.

17           Actual figures show exactly such relationships. Coming out of  
18 reclassification, which was contribution neutral, the coverage of Regular  
19 Standard was estimated to be 134.6 percent and the coverage of ECR Standard

1 to be 218.1 percent. The joint coverage, however, was 159.9 percent.<sup>32</sup> *Op. &*  
2 *Rec. Dec.*, Docket No. MC95-1, App. F.

3           These relationships and relative levels were consistent with what would be  
4 expected under the efficient component pricing rule for recognizing worksharing  
5 **within a subclass**. But the outcome of the reclassification case was to separate  
6 third class into two subclasses, which would warrant an independent application  
7 of the non-cost factors to obtain cost coverages. The ECP rule does not apply  
8 between subclasses. The appropriate way to recognize costs in rates was quite  
9 different after reclassification. Reclassification recognized that different markets  
10 and different mailers were involved. In effect, Regular Standard and ECR  
11 Standard became separate products.

12           Under these conditions, there is no justification for continuing the relative  
13 cost coverages of Regular and ECR, case after case after case, much as though  
14 they were worksharing categories. In response to the possibility of doing just  
15 that for the proposed split of Regular into two subclasses, the Commission said:

16           The alternative of creating separate subclasses and  
17 considering the issue of lowest combined cost when  
18 selecting the associated markups is not a rational  
19 alternative. Selecting the markups in such a  
20 constrained way provides rates that are no different  
21 from those that result from offering worksharing  
22 discounts through rate categories. . . . One has to  
23 question the logic of creating subclasses and then

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<sup>32</sup>           These figures do not include the Nonprofit subclasses, which were the subject of a separate reclassification proceeding. As explained earlier in the text, the inclusion of the Nonprofit categories should have caused the cost coverages to decline.

1                   constraining the outcome in accordance with a result  
2                   that would be obtained without creating the  
3                   subclasses. [*Op. & Rec. Dec.*, Docket No. MC95-1,  
4                   pp. V-161-62, ¶ 5388.]

5                   The pattern must be broken. The link between the two subclasses is  
6                   gone. It is time to apply the non-cost factors in the Act separately. When this is  
7                   done, as explained herein, it becomes clear that the appropriate coverage for  
8                   ECR should be much lower than it is. The position is not taken that the required  
9                   reduction should necessarily be made in one step, but it should be undertaken  
10                  and it should begin now. Ten years have now passed. That is too long.

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**IV. SPECIFIC RATE DESIGN PROPOSALS**

As explained further by Valpak witness Haldi (VP-T-2), the costs of record in this case raise a number of questions and leave much to be desired. A case in point is the Commission version of the delivery costs, which appears to be little more than a rote reproduction of earlier spreadsheets and which depends on inputs that have now been changed. It is not clear that any principle or preference expressed by the Commission in the past argues against making a range of updates and improvements in these costs. See Postal Service responses to VP/USPS-2 (Tr. 8/\_\_\_\_) and VP/USPS-7 (Tr. 8/\_\_\_\_).

It is Important to note that the problems with these costs, and others, go to their basic structure and not just to a need for updates, which might do little more than change their general level. Consider, for example, the delivery cost for flats tendered to the Postal Service in 3/5-digit Regular bundles compared to the delivery cost for flats tendered in basic ECR bundles. The Postal Service agrees that any delivery cost difference between these two categories does not lie in street costs, obviously because the street costing system does not distinguish between them, so that the cost difference must be due to in-office activities. Response of witness Kelley to VP/USPS-T-16-6 (Tr. 7/2857-59).

When carriers receive these flats and begin the in-office casing activity, the 3/5-digit Regular flats are in groups prepared by the Postal Service in flats sorting operations and the basic ECR flats are in bundles prepared by the mailers. Aside from issues relating to piece uniformity, the only known difference

1 between receiving the flats in one way instead of the other is that the ECR flats  
2 are in line-of-travel (“LOT”) sequence and the Regular flats are not. A study  
3 done by the Postal Service in Docket No. R2000-1 showed that LOT preparation  
4 saves about 0.74 cents per flat, due to faster casing, a figure that may need  
5 updating for inflation. See Docket No. R2000-1, USPS-LR-I-307. Yet under  
6 Commission costing, the carrier cost for the 3/5-digit Regular flat is 11.184 cents  
7 (up 32.51 percent from Docket No. R2001-1) and for the basic ECR flat is 5.923  
8 cents (down 6.99 percent from Docket No. R2001-1). See June 17, 2005  
9 revision to USPS-LR-K-101 and Docket No. R2001-1, PRC-LR-7.

10 Corrected for LOT, the difference between these two costs, 4.521 cents,  
11 is far too large to be explained by any difference in the uniformity of the pieces.<sup>33</sup>  
12 When asked about this cost difference during oral cross examination, witness  
13 Kelley replied: “I just reiterate my response to 40(a). I just haven’t studied the  
14 issue and the different casing rates.” Tr. 7/2989, ll. 22-24. Just as disturbing as  
15 the difference between these two costs is the fact that one of them (the cost for  
16 3/5-digit-entered flats) **increased** 32.5 percent from Docket No. R2001-1 and the  
17 other (the cost for basic-ECR-entered flats) **decreased** 6.99 percent. These

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<sup>33</sup> To place this cost difference in perspective, it can be converted to seconds of time. If it is assumed for present purposes that the average wage of carriers is \$40,000 per year and that the average piggyback factor on carrier costs is 1.25, the cost difference of 4.521 cents equates to 6.77 seconds. The comparison then is that it takes a carrier 6.77 seconds **longer** to case a 3/5-digit Regular flat than it does a basic ECR flat. This kind of difference is quite beyond the pale. It is essentially equal to the 6.9 seconds of credit that rural carriers are allowed in toto for handling **either** the 3/5-digit flat or the carrier-route flat. See response of witness Lewis to VP/USPS-T-30-29, Tr. 6/2388.

1 changes are anomalous. Given the strong similarity in the processing received  
2 by the two pieces, one would expect the percentage increases to be similar in  
3 magnitude, whatever their absolute level and in whatever costing system they  
4 are developed. There is no excuse for not studying these issues and trying to  
5 figure out what is wrong.

6       If **Postal Service** versions of these same delivery costs are compared,  
7 the findings are somewhat less disturbing, but not out of the woods. The carrier  
8 cost for the Regular flats is 9.290 cents (up 11.77 percent from Docket No.  
9 R2001-1) and for the ECR flats is 6.143 cents (up 1.20 percent from Docket No.  
10 R2001-1). See response of the Postal Service to VP/USPS-T28-50, redirected  
11 from witness Taufique (Tr. 8/\_\_\_\_), for Docket No. R2005-1 costs, and response  
12 of the Postal Service to VP/USPS-T-28-48 (Tr. 8/\_\_\_\_), redirected from witness  
13 Taufique, for Docket No. R2001-1 costs. Even if one argued that the Postal  
14 Service version of these costs is an improved rendition, the difference in cost  
15 between the two categories (Regular and ECR) is suggestive of a serious  
16 problem, just as is the fact that the proportionate increase in one (at 11.77  
17 percent) is approximately ten times the proportionate increase in the other (at  
18 1.20 percent). Accordingly, the costs accepted by the Commission at the end of  
19 this case will undoubtedly be different from any available now.

20       Under these circumstances, I can make certain proposals concerning how  
21 ECR rates should be developed, but, lacking reliable costs, am not able to  
22 propose specific rates. These proposals are outlined in the following four

1 sections. The first two, dealing with cost coverage and the rate differential  
2 between letters and flats, are **critical**. They deal with key issues in rate design  
3 that I believe are out of line with accepted ratemaking principles. The second  
4 two deal with related issues, the most important being to move toward full  
5 recognition of a range of cost differences for the categories of the ECR subclass.

6 **1. Cost Coverage.**

7 For the reasons developed and explained in Section III, the cost coverage  
8 of ECR Standard should be reduced. I propose a reduction of 10 percentage  
9 points in this case, relative to the coverage proposed by the Postal Service, and  
10 10 additional points of coverage in each of the next two cases. At that time, cost  
11 coverage levels should be considered further.

12 A reduction of 10 percentage points in this case would give ECR mailers  
13 little if any rate increase. Accordingly, my recommendation would be to leave  
14 ECR rates unchanged. However, if the Commission finds that the record allows  
15 meaningful estimates of the costs of the rate categories in ECR, a new set of  
16 rates consistent with the 10-percentage-point reduction in coverage and the  
17 guidelines outlined below should be developed by the Commission.

1 **2. Letter/Flat Rate Differential.**

2 A key element in the development of ECR rates is the selection of a  
3 letter/flat rate differential.<sup>34</sup> At Commission costs, as presented by the Postal  
4 Service in this case, the cost difference on which this rate differential would be  
5 based is -0.540 cents, the negative sign suggesting that letters cost more to  
6 process and deliver than flats. See Cell G30 of 'Sheet 3' of file  
7 Cost\_Interrogatory-USPS2\_checked.xls, filed by the Postal Service as an  
8 attachment to its response to VP/USPS-T28-49, redirected from witness  
9 Taufique (Tr. 8/\_\_\_\_). As the presort-tree diagram in that response makes clear,  
10 all ECR rates depend in a critical way on the letter/flat rate differential selected.  
11 The fact that the difference is negative as presented is clearly anomalous,  
12 pointing again to the need for cost adjustments.<sup>35</sup>

13 In developing the rates that became those of the settlement of Docket No.  
14 R2001-1, the Postal Service's workpapers show a letter/flat cost difference of  
15 +0.251 cents, but a passthrough of zero percent. See response of the Postal  
16 Service to VP/USPS-T28-48, redirected from witness Taufique (Tr. 8/\_\_\_\_). It  
17 selected this passthrough for reasons associated with an interest in achieving a

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<sup>34</sup> The rates for pieces that do not qualify as letters or flats depend on both the letter/flat differential and the residual shape surcharge.

<sup>35</sup> The Postal Service response to VP/USPS-T28-49 (Tr. 8/\_\_\_\_) was not updated to reflect cost revisions provided in a June 17, 2005 errata to USPS-LR-K-101, which would change the cost in cell H28 to be 9.146 cents, which makes the cost difference equal to -1.909 cents, even more anomalous than before. Note that the revisions in the June 17 errata were not reflected in the Postal Service response to Question No. 3c of POIR No. 3, which has not been revised.

1 specific alignment of the basic ECR letter rate with the 5-digit automation letter  
2 rate in Regular, and that passthrough resulted in basic ECR letters having the  
3 same rates as basic ECR flats. Specifically, the letter and flat rate came out to  
4 be 19.4 cents, which compares with a rate for 5-digit automation letters in  
5 Regular of 19.0 cents, for a rate difference between them of 0.4 cents. A 100  
6 percent passthrough, given the cost difference of +0.251 cents, would have  
7 yielded a rate for basic ECR letters of 19.2 cents, still 0.2 cents above the rate  
8 for the 5-digit automation letters in Regular.

9           It is argued below that the rate for basic ECR letters should be decoupled  
10 from the rate for 5-digit automation letters in Regular. This should be done  
11 regardless of whether the basic ECR letter rates overlap with the 5-digit  
12 automation letter rates. Then, the passthrough on the letter flat cost difference  
13 should be set to a level of at least 100 percent.

14           The processing streams for letters and flats are generally separate, and  
15 are becoming even more so with the shift to delivery point sequencing. To a  
16 considerable extent, they are separate products. A shift by mailers from one to  
17 the other has cost implications, but it is not a matter of worksharing.<sup>36</sup> The Postal

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<sup>36</sup>           The absence of a worksharing distinction between letters and flats was recognized early on by the Commission when it referred to the rate difference as being “one based primarily on physical characteristics of the mail and not on traditional worksharing concepts.” *Op. & Rec. Dec.*, Docket No. R90-1, p. V-230, ¶ 5941. It also said: “We . . . note that the letter discounts we are recommending are not worksharing discounts in the sense this term is used on the record; however, our recognition of shape at the saturation level introduces the possibility that some mailers may decide to convert their mailings.” *Ibid.*, p. V-305, ¶ 6076. Mailers should not be restricted from

(continued...)

1 Service does not avoid any piece of work when a mailer shifts from a flat to a  
2 letter. Similarly, there is no piece of postal work that the mailer does if a flat is  
3 sent instead of a letter. Therefore, getting the lowest cost entity to do the work is  
4 not an issue. The mailer may look at rates to help decide which product to  
5 purchase, but this is exactly the kind of market decision made regularly among  
6 all products.

7 In the case of two separate products, costs need to be recognized and the  
8 markups need to be selected. No theory or body of analytical guidance suggests  
9 that two products, even though related, should have the same per-piece  
10 markups, and there is no reason why the rate differential should equal the cost  
11 difference. In fact, if a default solution exists, it would probably be one of equal  
12 percentage markups, although economic theory would suggest that this solution  
13 should be tempered if the cross elasticities are high. Accordingly, I believe the  
14 passthrough of the letter/flat cost difference should be over 100 percent, but  
15 certainly at least 100 percent.

16 Whether the passthrough of the letter/flat cost difference has an upper  
17 limit is open to question. If the elasticity of letters is higher than that of flats,  
18 which is not known to be the case, notions of economic efficiency would suggest  
19 that the passthrough could be greater than the subclass cost coverage, *i.e.*, the  
20 passthrough of the letter/flat cost difference could be over 156 percent for a

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<sup>36</sup> (...continued)  
choosing the products that suit them best, given appropriate rate differences.

1 subclass with a cost coverage of 156 percent. On the other hand, establishing  
2 equal implicit cost coverages on letters and flats would suggest a passthrough  
3 equal to the coverage of the subclass. This is an issue that should be  
4 considered further. But the upper-limit question does not need to be answered  
5 to know that the passthrough should be at least 100 percent. Simply put, no  
6 justification exists for requiring low-cost letters to bear the heavy per-piece  
7 contribution burden that is associated with low passthroughs.<sup>37</sup> Similarly, no  
8 justification exists for elevating the rates for letters so that the rates for flats can  
9 be lower.

10 **3. Decoupling the ECR Basic Letter Rate and the 5-digit Automation**  
11 **Letter Rate.**

12 In recent rate cases, the Postal Service has argued that to encourage an  
13 automated mailstream and to support its automation program, the rate for basic  
14 letters in ECR Standard should be higher than the rate for the 5-digit automation  
15 letters in Regular Standard. The concern seems to be that if the rate for basic  
16 letters in ECR is lower, automation mailers might move from Regular into ECR,  
17 and leave the barcode off. Alternatively, there could be an interest in giving ECR  
18 basic mailers an incentive to apply barcodes.

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<sup>37</sup> In Docket No. R90-1, the letter/flat differential was introduced with a passthrough of 50 percent. There was every expectation at the time that this would be increased further. The zero percent passthrough of Docket No. R2001-1 is at the wrong end of the spectrum.

1           On practical grounds, neither of these possibilities should be given weight.  
2 Regular mailers by their very nature cannot move to ECR. That is, Regular  
3 mailers must have at least 10 pieces per 5-digit area and ECR mailers must  
4 have at least 10 pieces per carrier route. The second requirement is an order of  
5 magnitude greater than the first. The essence of the reclassification case,  
6 Docket No. MC95-1, was that: (i) the 5-digit mailers are different in kind from the  
7 ECR mailers; (ii) the cross elasticity between the two is low;<sup>38</sup> (iii) the value of the  
8 service received by the two groups is different; and (iv) that the nature of the  
9 mailings is different. And, if one is interested in giving basic letters in ECR an  
10 incentive to barcode, it should be done in the ECR subclass, not by establishing  
11 a restrictive link to another subclass.

12           The problems with the linkage as it now exists are, however, even more  
13 fundamental than this. Regular Standard and ECR Standard are separate  
14 subclasses of mail. Their rates should be set through an independent  
15 application of the non-cost factors in the Act, along with accepted and defensible  
16 rate design procedures. If these steps, because of lower value of service, lower  
17 costs, recognition of mail preparation, or recognition of market characteristics,  
18 yield rates for basic letters in ECR that are lower than those for 5-digit  
19 automation letters in Regular, then the basic letters in ECR should be allowed to

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<sup>38</sup> See the Commission's discussion of Postal Service witness Tolley's conclusion that the cross elasticities between the two are low, *Op. & Rec. Dec.*, Docket No. MC95-1, pp. V-179-80, ¶ 5437.

1 have those rates. To elevate the rates for these letters artificially is to say to  
2 them: We understand that you would like your market characteristics and your  
3 low costs recognized in your rates, but we would rather give you higher rates  
4 (which, incidentally, will allow us to provide lower rates to flats) and thereby  
5 encourage you to abandon your subclass altogether and join a prebarcoded  
6 group of a different subclass. No justification exists for sending such a message.

7 Another difficulty, and an important one, is caused by the means used to  
8 keep the rate for the basic letters in ECR above the rate for the 5-digit  
9 automation letters in Regular. Specifically, zero percent of the cost difference  
10 between basic letters and basic flats in ECR is passed through into a rate  
11 differential. In other words, the rate for basic letters and basic flats in ECR are  
12 the same, even though their costs differ. The additional difficulty caused by this  
13 fix, as the presort tree makes clear, is that it not only elevates artificially the rate  
14 for basic letters in ECR, it also elevates artificially the rates for the high density  
15 letters and the saturation letters, as their rates are directly dependent on cost  
16 differences and discounts from the basic letter rate. This is decidedly unfair,  
17 particularly since both of these categories, high density and saturation, are  
18 required to apply barcodes and meet automation requirements.<sup>39</sup>

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<sup>39</sup> One other issue relating to the linkage with the 5-digit automation rate should be noted. The 5-digit automation discount in Regular Standard is based on a cost difference that relates not only to the placement of a barcode on the piece and meeting associated automation requirements but also to mailers changing their pieces from a non-machinable format to a machinable format. This change in format is not a worksharing change, but rather is related to the mailer choosing to purchase what is  
(continued...)

1 **4. Other Rate Design Proposals.**

2 Completing rate design for ECR requires attention to a number of  
3 additional issues. The following recommendations are made. (1) Once costs  
4 are developed, passthroughs of 100 percent should be selected, unless good  
5 reason exists to do otherwise.<sup>40</sup> (2) Increase (or decrease) the residual shape  
6 surcharge (“RSS”), the barcode discount for RSS pieces, and the pound rates by  
7 the same proportion as any increase (or decrease) in the rates of the subclass  
8 as a whole, much as in the Postal Service’s proposal. (3) Update the dropship  
9 cost avoidances and apply the same passthroughs as those recommended in  
10 Docket No. R2001-1. Test year avoidances are provided in the testimony of  
11 Postal Service witness Mayes, USPS-T-25. (4) Within limits allowed by normal  
12 rounding procedures, set the Nonprofit rates so that their average per-piece level  
13 is 60 percent of the corresponding per-piece level of their host category, as  
14 required by law, before the recognition of fees. This is easy to do and no reason  
15 has been offered to do otherwise. My experience has been that phrases like “as

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<sup>39</sup> (...continued)

essentially a different product. The cost avoidance recognized for the discount should be much smaller. When this is done, the rate for 5-digit automation letters will increase, making it even more apparent that a tie between the two rate categories is disruptive.

<sup>40</sup> Passthroughs of 100 percent are aligned with general Commission preferences. In Docket No. R90-1, for example, the Commission referred to: “align[ing] presort passthroughs with our longstanding cost and policy preferences [which] generally means that for established presort discount categories, we recommend full passthrough of associated savings.” *Op. & Rec. Dec., Ibid.*, p. V-159, ¶ 5806.

- 1 nearly as practicable” are always meant to allow the practicalities of rounding to
- 2 be accommodated, and nothing more.<sup>41</sup>

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<sup>41</sup> Whatever is done with rates, a small error in witness Taufique’s (USPS-T-28) revenue calculations should be corrected. The postage for automation letters weighing between 3.3 and 3.5 ounces (heavy letters) is calculated by applying the pound rates and the piece-rate-add-ons for pound-rated non-letters, and then subtracting the letter/flat rate differential. In other words, these rates are calculated from other rates. Witness Taufique developed his revenues by applying to the heavy-letter volumes a per-piece revenue figure developed by applying the 5.4 percent increase to the current per-piece revenue, and then rounding, which in some cases gives a different per-piece revenue than the postage that will actually be paid. See response to VP/USPS-T28-29, Tr. 3/659-60, the response to which seems to argue that the correction required is a small one.