

**BEFORE THE  
POSTAL RATE COMMISSION**

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**Docket No. R2005-1**

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**POSTAL RATE AND FEE CHANGES, 2005**

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**INITIAL BRIEF  
OF  
THE DIRECT MARKETING ASSOCIATION, INC.**

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**INTRODUCTION**

The Direct Marketing Association, Inc. (“The DMA”) respectfully submits this brief in support of the proposal filed by the U.S. Postal Service in this proceeding.

This case is unusual in several important respects. It is the first time that the Postal Service has filed a case under the Postal Reorganization Act of 1970 (the “Act”) in which the additional revenue it seeks under section 3621 of the Act has been so “lean;” it includes a provision for contingencies of zero percent, which is unprecedented. It is the first time that the additional revenue can be attributed to a specific Congressional mandate. It is only the second time that the Postal Service has proposed that additional revenue be borne by all mailers equally, through an across-the-board (“ATB”) increase.

Moreover, and perhaps most importantly, the USPS proposal has attracted unusually broad support from the entire mailing community and other interested parties. The extent of this support is entitled to be given great weight by the Commission.

In its recent Order 1443 in Docket No. MC2004-3,<sup>1</sup> the Commission explicitly recognized the value of settlements, stating :

“The Commission agrees with the Governors that the level of support a settlement proposal receives is an important factor for the Commission to weigh.”<sup>2</sup>

The Commission went on to say:

“ . . . however, Commission responsibilities are prescribed by law and the number of signatories to an agreement does not surmount either a violation of statute or inconsistency with the evidentiary record.”<sup>3</sup>

As will be demonstrated below, the Postal Service’s proposal in this case is consistent both with the requirements of the Act and with the evidence of record. Moreover, it reflects excellent, pragmatic judgment on the part of the Postal Service and should be recommended favorably by the Commission.

**I. The USPS Proposal is Fully Supported by the Evidence of Record.**

As a preliminary matter, it should be noted that the second cautionary point noted by the Commission in its Order 1443 should be of no concern in this case, because the Postal Service has provided extensive testimony that is more than adequate to meet the “substantial evidence of record” requirement.

**II. The USPS Proposal Is Consistent with the Requirements of the Act.**

**A. The Act Gives the Commission Substantial Leeway to Make Reasonable Judgments on Costing and Pricing Issues.**

The statutory scheme created by the Act relies heavily upon the judgment of the Commission, which is often referred to in the legislative history and subsequent judicial opinions

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<sup>1</sup> PRC Order No. 1443, Docket No. MC2004-3 (August 23, 2005) at 14-20.

<sup>2</sup> *Id.*, at 18.

<sup>3</sup> *Id.*

as the “expert Rate Commission.”<sup>4</sup> Consistent with this basic approach, the Act actually places rather few specific strictures on the Commission. The most important statutory requirement is the one contained in section 3622(b)(3) of the Act, which refers to “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 . . . .” Even here, however, the Commission has substantial flexibility. As the Supreme Court stated,

“The statute requires attribution of any cost for which the source can be identified, but it leaves to the Commissioners, in the first instance, to decide which methods provide reasonable assurance that costs are the result of providing one class of service.”<sup>5</sup>

This “reasonable assurance” standard gives the Commission substantial leeway to determine the methodologies to be used in determining the costs that must be borne by each subclass, the ultimate goal being generally to assure that one subclass does not cross-subsidize another.

A reasonableness standard also applies to the second most important “requirement,” the requirement that applies to the pricing process, *i.e.*, the “requirement that each class of mail or type of mail service bear . . . that portion of all other costs of the Postal Service reasonably assignable to such class or type.”<sup>6</sup> It is by now well-established that this pricing process involves large doses of judgment, as well, with the Commission going through a process in which it weighs a large number of factors to determine the rates, and attendant “cost coverages,” for each subclass.

Especially in light of the Commission’s substantial flexibility concerning the application of the statutory provisions in both the costing and pricing portions of the postal rate-making

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<sup>4</sup> *E.g.*, Nat’l Ass’n of Greeting Card Publishers v. USPS, 462 U.S. 810, 833 (“NAGCP IV”).

<sup>5</sup> *Id.* (emphasis supplied).

<sup>6</sup> 39 U.S.C. §3622(b)(3) (emphasis supplied).

process, The DMA does not perceive any statutory requirement that would impede the Commission from recommending favorably the Postal Service's proposal in this case.

B. Pre-Existing Rate Relationships are a Recognized Basis for Rate Recommendations.

As will be discussed in more detail below, an ATB rate increase is essentially a rate surcharge; it maintains the pre-existing rate relationships while providing additional revenues to the Postal Service.

In its most recent Opinion and Recommended Decision in an omnibus rate case, Docket No. R2001-1, the Commission confirmed that pre-existing rates form a valid basis for considering a rate proposal:

“ . . . the Commission believes that existing costing methods and rate relationships, as well as the Commission's recent rate recommendations, are particularly useful alternative benchmarks for conducting its analysis here.”<sup>7</sup>

In its Opinion and Recommended Decision in Docket No. R94-1, in which it considered a USPS proposal to increase rates using an ATB approach, the Commission confirmed that the pre-existing rate relationships were “presumptively reasonable,”<sup>8</sup> but it declined to approve the ATB approach based on its finding that attributable costs had changed markedly over the four years since the previous rate case. As the Commission stated,

“ . . . the Postal Service's across-the-board approach incorporates drastic departures from the pricing recommendations upon which the pre-existing Docket No. R90-1 rates were based. Most notably, First-Class letters would be required to make a contribution to institutional costs significantly higher than the systemwide average, contrary to the Commission's recommendations in Docket No. R90-1 and earlier proceedings. . . . By contrast all other non-preferred subclasses would have a lower markup than was recommended in Docket No. R90-1.

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<sup>7</sup> PRC Op. R2001-1 (March 22, 2002) para. 2024.

<sup>8</sup> PRC Op. R94-1 (November 30, 1994) para.4008.

“ . . . Indeed, attributable costs have changed such that any uniform increase of Docket No. R90-1 rates would appreciably alter inter-subclass markup relationships recommended in that case, as a mathematical inevitability.”<sup>9</sup>

The Commission’s determination that costs had changed so much that an ATB increase would result in inappropriately large disparities in markup relationships was, of course, a matter of pricing judgment limited to the specific facts of that case. It was not mandated by any statutory requirement.

The relevant test is a matter of Commission policy, not a matter of statutory mandate, and the Commission stated this policy quite well in Docket No. R2001-1:

“ . . . the agreed-upon rates should be held to a standard of reasonable consistency with past ratemaking practices, as illustrated in pre-existing rates and rate relationships.”<sup>10</sup>

Under this test, there should be a strong presumption in this case in favor of a proposal that both maintains pre-existing rate relationships because it is equal across-the-board and is supported by virtually all of the mailers and other intervenors. Thus, the Commission should view with a particularly critical eye any arguments to the contrary.

The relevant question, therefore, is whether the evidence and arguments made by the only party to have actively opposed the Postal Service proposal, Valpak, have enough merit to warrant the Commission rendering something other than a wholly favorable recommendation. The remainder of this brief will be addressed to this question, *i.e.*, whether the Commission should give significant weight to any of the arguments made by Valpak and recommend rates different in any respect from those proposed by the Postal Service.

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<sup>9</sup> *Id.*, at paras. 4006-07 (emphasis in original).

<sup>10</sup> *Id.*, at para. 2025.

### **III. The Postal Service's Additional Revenue Needs have been Caused by the Escrow Requirement Mandated by Congress.**

Relevant to this question is the character of the additional revenues that the Postal Service needs. For example, if the additional revenue needs were caused by events directly related to one or more identifiable classes of mail, it might be reasonable for the Commission to inquire whether the bulk of the additional revenue should come from the classes in question. However, where, as here, the additional revenue is needed because of an event that affects the entire Postal Service across-the-board, then an across-the-board rate increase makes good common sense.

In this case, the Postal Service has estimated that it will need an additional \$3.1 billion of revenues to “break even” in the test year,<sup>11</sup> and it attributes this need to a Congressional mandate that has become known as the “escrow requirement.”<sup>12</sup>

The fact that the additional revenue needs are virtually the same size as the cost of the escrow is partially coincidental, but not wholly. It is coincidental to the extent that during the test year the Postal estimates it would break even, were it not for the escrow requirement. It is not coincidental to the extent that the Postal Service has made an effort to keep the revenue requirement to that level and has, for example, refrained from requesting a provision for contingencies.

Coincidence or not, the equivalency between the escrow requirement and the additional revenue the Postal Service needs to break even in the test year simplifies the analysis significantly: the Postal Service is asking only for additional revenues large enough to cover the escrow requirement.

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<sup>11</sup> See 39 U.S.C. §3621.

<sup>12</sup> See generally, Testimony of USPS witness PMG Potter, USPS-T-1, at 2-4.

A. The Costs of the Escrow are Institutional Costs.

The record leaves no doubt that the escrow costs are to be treated as an “operating expense”<sup>13</sup> and that these costs should be treated as “institutional,” that is, they should not be identified as having been caused by any particular class or subclass of mail.<sup>14</sup>

B. There is a Clear Causal Link between the Projected TYAR Revenues Needs and the Congressionally Mandated Escrow Requirement.

The causal connection between the costs of the escrow and an act of Congress is clear and undisputed.<sup>15</sup> Valpak witness Mitchell attempts to split hairs when he claims that, nevertheless, it is not possible logically to identify a specific cause for the deficit that the Postal Service projects for the Test Year.<sup>16</sup>

Witness Mitchell argues that any deficit cannot be said to have been caused by any single factor, because a deficit is the sum of many factors, including management decisions, overall revenue levels, overall cost levels, and many others. During cross-examination, however, Mr. Mitchell was forced to modify his testimony significantly. He acknowledged that in their daily lives human beings regularly discriminate among a large number of preconditions to any given event and isolate a “proximate” cause to which responsibility for the event is assigned.<sup>17</sup> It happens in legal proceedings; it happens in daily life; and it happens in postal rate cases.<sup>18</sup>

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<sup>13</sup> USPS-T-1 at 4; VP-T-1 at 7.

<sup>14</sup> *E.g.*, USPS-T-10, Exhibit USPS-10H, page C-24; Tr. 9/5395 (Valpak witness Mitchell: “I agree that the escrow costs are not volume variable and should not be attributed.”); *see also* Tr. 9/5428-29.

<sup>15</sup> USPS witness Potter, USPS-T-1 at 3-4; USPS witness Kiefer, USPS-RT-1 at 5-7.

<sup>16</sup> VP-T-1 at 10-11, Tr. 9/5276-77.

<sup>17</sup> Tr. 9/5399-5400.

<sup>18</sup> *See generally* Tr. 9/5432-5447.

In the case of the \$3.1 billion of additional test-year revenue needed by the Postal Service, a single cause is clear: the Congressional mandate to fund the retirement escrow. Yes, if USPS revenues were higher, or if USPS costs were lower, the Postal Service might have enough money to fund the escrow without a rate increase. However, it is Mr. Mitchell who is being illogical when he asserts that the USPS revenues needs in this case are not “caused” by Congress. The causal connection between the two is simply too direct, too immediate, too “proximate” to be ignored as a valid basis for “logical” decision-making. There is no doubt that the escrow costs of \$3.1 billion are caused by Congress and that increasing USPS revenues to cover these costs will have the effect of eliminating the deficit. It is more than reasonable, therefore, for the Commission to act based on the proposition that Congress was the proximate cause of all the additional revenue the USPS estimates it will need in the test year.

#### **IV. An Across-the-Board Increase is Inherently Fair.**

The circumstances of this case are unprecedented. This is the first time since the passage of the Act in 1970 that the Postal Service needs to increase its revenue solely because of a specific act of Congress. To meet these needs the Postal Service has proposed an across-the-board increase similar to a special assessment<sup>19</sup> or a surcharge by the airlines to cover rising fuel costs.<sup>20</sup> Even Valpak witness Mitchell admitted that an equal-percentage increase would be “economically rational” in circumstances such as these.<sup>21</sup>

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<sup>19</sup> *E.g.*, Tr. 9/5411.

<sup>20</sup> *E.g.*, Tr. 9/5401-02.

<sup>21</sup> Tr. 9/5402; *see also* Tr. 9/5447-49.

The fairness inherent in the USPS proposal is clear: everyone is being asked to bear the same percentage increases.<sup>22</sup> In fact, the inherent fairness of this proposal is virtually unassailable, *ceteribus paribus*, (“all other things being equal”).<sup>23</sup>

In the typical omnibus postal rate case, of course, all other things are not equal. Typically, the Postal Service’s estimated revenue needs cannot be identified as being caused by a single factor; rather the revenue needs are the product of a large number of causes, including broad economic trends, mail volume trends, USPS costs, the results of USPS labor negotiations, postal productivity, and many more. The Commission, having heard detailed testimony on the costs attributable to each subclass and on the pricing factors as they apply to each subclass, discriminates among the subclasses and allocates to each unequal portions of USPS institutional costs. These unequal allocations are viewed as being “fair and equitable” not because they are equal, but because they are deemed appropriate in light of the various statutory pricing factors as they apply to the (complex) evidence of record.

In this case, the critical question is the reverse: whether there are any valid reasons to conclude that an ATB increase would be unfair, *i.e.*, whether there is any reason to conclude that the apparent fairness of an ATB increase is merely superficial.

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<sup>22</sup> *E.g.*, USPS-T-1 at 5. The fairness of an ATB increase is far easier to appreciate than increases of substantially different sizes, which are superficially discriminatory and which have to be separately justified in order to meet relevant tests of non-discrimination.

<sup>23</sup> Valpak witness Mitchell, of course, does assail the fairness of an ATB increase. VP-T-1 at 12-15. He does so, however, not because he questions the fundamental notion that equal increases are inherently fair, but because he believes “fair” postal rates must be based on current costs. VP-T-1 at 12-13 (“But it is a strange notion of fairness that neglects all current costs and builds on outdated cost and rate relationships.”); *see also* Tr. 9/5409-5410. This point, *i.e.*, that the rates paid by his client Valpak are unfairly high, is central to his testimony (*see, e.g.*, Tr. 9/5406) and are addressed in section VI of this brief, *infra*.

There is no such reason. In fact, there are several reasons in addition to fundamental fairness to conclude that an ATB increase is the most appropriate result in this case. First, the Commission is well aware that a multitude of costing issues, which are typically litigated in great detail in postal rate cases, have not been investigated by the parties in this case. Thus, it is reasonable to expect that the cost data available on this record contains weaknesses that remain unexposed for lack of detailed analysis. Should the parties be criticized for failing to dig deeply into the cost data and its sources? Perhaps. However, in light of the Postal Service's declared desire to expedite this case, a better result would be for the Commission to appreciate the good faith being exercised in this regard, and it certainly should not penalize parties for their cooperation.<sup>24</sup>

Second, the parties have exercised similar restraint on the pricing side. Here, the typical arguments do not relate primarily to the validity of USPS-produced data; they relate to various economic factors that affect the demand for each of the subclasses and to the other statutory pricing factors. The record is extremely lean in this area, as well. As a result, if the Commission were to deviate from an ATB approach, it would have to engage in a full-blown pricing analysis without the benefit of presentations by the parties on all the relevant pricing factors.

Third, these "surcharged rates" are expected to be in effect for only a short period of time. The Postal Service has announced that it expects to file another omnibus rate case in the early months of 2006 and that this case will open up a broad range of costing, pricing and rate

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<sup>24</sup> Any contrary result would entail serious consequences for the way in which future rate cases are litigated. For example, even if a party were in full support of the Postal Service's proposal, it would be forced into a position of having to litigate fully the broad range of costing issues, not merely those that had been raised by an objecting party such as Valpak. As a result, the Commission and other parties would have to spend substantial time and effort developing the record on issues that otherwise would probably never arise.

design issues.<sup>25</sup> Thus, any problems that may lie hidden beneath the surface of an ATB rate increase will persist for no longer than approximately one year.<sup>26</sup>

## **V. The Commission Should Give Great Weight to the Settlement Agreement.**

Valpak witness Mitchell asserts that the Commission should give little weight to the fact the Postal Service tailored its rate proposal with the hope of achieving wide support and thereby expediting this proceeding.<sup>27</sup> Even if Mr. Mitchell's argument had merit -- and The DMA doubts that it does<sup>28</sup> -- the Postal Service's success in achieving wide support could not be more pertinent to the proper exercise of the Commission's rate-making responsibilities.

### **A. A Broad Settlement Is Strong Evidence of Fairness.**

The primary statutory standard for the establishment of postal rates is that they be "fair and equitable."<sup>29</sup> There can be no evidence of the fairness of the USPS-proposed rates more compelling than the breadth of the support this proposal has attracted, as evidenced by the number of parties that have signed the Settlement Agreement. As the Commission well knows, these parties are usually at loggerheads when it comes to postal rate increases. Their signing of the Settlement Agreement clearly indicates their concurrence with the Postal Service that an ATB increase is the fairest under the current circumstances.<sup>30</sup>

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<sup>25</sup> *E.g.*, Tr. 9/5405-06.

<sup>26</sup> Witness Mitchell's concerns in this respect are not well-founded. *E.g.*, Tr. 9/5410.

<sup>27</sup> VP-T-1 at 15-17.

<sup>28</sup> The desirability of expediting postal rate cases was recognized by Congress and is expressly set forth in 39 U.S.C. §3624(b). *See also* 39 U.S.C. 3641. The desirability of limiting testimony was expressly recognized by Congress, also. 39 U.S.C. §3624(b)(4).

<sup>29</sup> 39 U.S.C. §101(d).

<sup>30</sup> Valpak witness Mitchell errs in two respects when he objects to PMG Potter's identifying the likelihood of achieving settlement as a valid reason for recommending an ATB increase. VP-T-1 at 15-17. First, expedition is a valid goal under the Act, and there can be no question that a case (continued...)

Do these parties agree that the rates that they would pay under the USPS proposal are those that they should be paying? Of course not. It would be very surprising indeed if a poll of these parties revealed even one that thought its rates were not too high. Why, then, have they supported the USPS proposal? Because they agree that this case presents unusual circumstances and that an ATB rate increase is the fairest way to get the Postal Service the additional revenue it needs.

The virtual unanimity of this position should be given great weight by the Commission as it considers the record. It is evidence far more convincing than written or oral testimony could ever be of the fairness of the USPS-proposed rates.

B. Impact on Future Settlements.

There is an additional issue related to the Settlement Agreement that the Commission should consider: if this broadly supported Settlement Agreement is not given substantial weight by the Commission, will there ever be a case in the future in which settlement will be possible?

Every intervenor who signed the Settlement Agreement refrained from presenting the Commission with its views on a wide variety of issues, and some of these views are held quite strongly. Each one did so, content to “hold its tongue” until the next rate case, but conscious of the risk it was taking. Each party understood that it might be giving its adversaries and competitors an advantage. Each party refrained from engaging in discovery, from presenting testimony, from building a record, from briefing issues, and from exercising its due process rights generally, with the full understanding that it was taking a risk of some unknown magnitude

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that can be settled even in part can be brought to conclusion more expeditiously than a case that must be fully litigated. Second, and more importantly, Mr. Potter correctly perceived that many interested parties would share the USPS view that an ATB increase was fair and appropriate. The number of signatories to the Settlement Agreement speaks volumes.

that the Commission would recommend in this case rates different from the Settlement Agreement rates. If the Commission fails to give substantial weight to the Settlement Agreement in this case, the lesson will be clear: a party that fails to litigate its positions actively in a PRC case does so only at great peril. This lesson will change the risk/reward analysis each party will make in future cases, substantially reducing and perhaps completely eliminating the possibility of settlement.

**VI. The Commission Should Give Little Weight to Valpak’s Complaint that the ATB Rates Do Not Adequately Reflect Current Costs.**

As has been demonstrated above, ATB increases are fair, “*ceteris paribus.*” Thus, those who would oppose them have a burden to demonstrate that all other things are not, in fact, equal, *i.e.*, that there are factors that make this apparent fairness merely superficial or illusory. This is the burden that Valpak has attempted to shoulder. Valpak has argued that the rates it pays are not based on accurate, current estimates of costs<sup>31</sup> and that, therefore, it is entitled to a rate increase lower than that borne by all others.<sup>32</sup> As shall be demonstrated below, Valpak has simply failed to meet that burden.

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<sup>31</sup> *E.g.*, Tr. 9/5409-10; 5451-51.

<sup>32</sup> It is important, in this connection, to keep in mind the dual role played by “costs” in the postal rate-making scheme. On the one hand, “costs” play a legal role: the Act mandates that each subclass of mail cover its own “attributable” costs; the purpose of this requirement is to assure that no subclass is cross-subsidized by any other subclass(es). On the other hand, “costs” play an economic role: they form the foundation upon which rates are determined. As has been explored on the record of numerous PRC dockets over the past three decades, principles of regulatory rate-making recognize the economic benefits of setting rates using marginal costs as the foundation and then setting rates using principles known as “Ramsey pricing,” “value-of-service pricing,” or “demand pricing.” In his testimony in this case, witness Mitchell is discussing costs in the latter context. Under the Act, demand pricing principles are only one of the factors that the Commission is required to take into account. Therefore, witness Mitchell is in a realm where expert judgment is the most important single factor.

For the sake of argument, we will accept Valpak's assertion that postal operations and other cost-causative factors have changed significantly since the turn of the millennium and that, therefore, current postal rates are not based on current postal costs. We will also accept, for the sake of argument, that the costs of the subclasses of mail utilized by Valpak have decreased in this period of time relative to the costs of other subclasses.

Even given these assumptions, we would note that Valpak's rates would not necessarily be different if the Commission were to reconsider the pricing issue today, based on current costs. As Valpak well knows, postal rate-making is a complicated process in which consideration of underlying attributable costs is only the first step. The process of pricing and rate design is imbued with multiple and complex judgments based on a wide variety of factors as they apply to all the subclasses and rate elements of the overall USPS rate structure.<sup>33</sup> If Valpak were to gain something in the costing process, it might easily lose an equivalent amount in the rest of the rate-making process.

Let us assume, again, however, that Valpak's rates would be lower if the Commission were to reconsider fully the pricing issue today, based on current costs. At its core, Valpak's argument is simply that it is unwilling to wait for the rate relief to which it believes itself entitled. It wants rate relief, and it wants it now. Why is Valpak being so apparently greedy? At the core of Valpak's position is its fear that ATB rates will be in effect substantially longer than the one year that the Postal Service is projecting. Furthermore, and perhaps of more concern to Valpak, Valpak believes that the rate relief to which it believes itself to be entitled is so large that

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<sup>33</sup> Tr. 9/5430-31.

the Commission is not likely to grant it in a single rate case.<sup>34</sup> Thus, Valpak seeks to persuade the Commission to begin the process of adjusting rates (in Valpak's favor) in this proceeding.

There are a number of flaws in Valpak's argument. First, it assumes that the Commission must base every rate decision on current, accurate, updated costs. To the contrary, many have been the times when the Commission has issued rate recommendations based on costs that it recognizes are less-than-optimal, but that it relies upon as being the best reasonably available at the time.

Second, it assumes that the Commission will be constrained for some reason from recommending rates in the next rate case that it determines to be fair on the basis of the record in that case. To the contrary, experience has shown that the Commission is perfectly capable of making rate adjustments of substantial size if it determines that they are warranted.

Third, it assumes its underlying premise, *i.e.*, that the applicable cost relationships have changed significantly in Valpak's favor. In fact, the size of the relevant cost figures is a hotly contested issue on this record.

Fourth, and most importantly, Valpak conveniently "forgets" that the Commission, in order to grant relief to Valpak, would be required to through a full-blown pricing analysis of every class and subclass, which would open a veritable Pandora's Box.<sup>35</sup> The Commission would be guilty of the most blatant form of discrimination if it were to lower Valpak's rates without investigating whether other rates should be modified, as well. At the very least, the Commission would have to decide which other subclasses would be forced to bear the revenue burden that was being removed from Valpak. Especially based on the record available to it, the

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<sup>34</sup> Tr. 9/5406.

<sup>35</sup> See Tr. 9/5453-57.

Commission would be ill-advised to conduct such as analysis simply to give Valpak some rate relief for a period of time that is not likely to last more than one year.

### **CONCLUSION**

For the reasons stated above, The DMA respectfully urges the Commission to issue a recommended decision approving the rate increases proposed by the Postal Service and supported by the many intervenors that have signed the Settlement Agreement.

Respectfully submitted,

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