Postal Rate Commission
Submitted 9/26/2005 3:38 pm
Filing ID: 46912
Accepted 9/26/2005

UNITED STATES OF AMERICA
Before the
POSTAL RATE COMMISSION
WASHINGTON, D.C. 20268-0001

Postal Rate and Fee Changes, 2005) Docket No. R2005-1

Initial Brief

of

The Office of the Consumer Advocate

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September, 26 2005

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I. EXECUTIVE SUMMARY

The Office of the Consumer Advocate (OCA) is one of the few parties that did not sign the Stipulation and Agreement submitted by the Postal Service on July 22, 2005. OCA is strongly opposed to the Agreement because it urges the Commission to approve a rate increase that violates §3621 of title 39, as well as Public Law 108-18. The proposal to raise $3.1 billion to pay for the PL 108-18 escrow payment makes no adjustment to reflect the cumulative net income of $2.58 billion that the Postal Service estimates will be on hand at the end of FY 2005. This income is sufficient to fund most of the $3.1 billion payment. Even if rates were not raised at all, the Postal Service estimates a loss of only $303 million. This shortfall can be brought to zero by an across-the-board increase of approximately 0.8 percent. OCA urges the Commission to reject the proposal (and Stipulation and Agreement) to raise rates by 5.4 percent across-the-board, as it would leave the Postal Service with a net income of nearly $1.64 billion in the test year – a clear violation of §3621, which unambiguously requires that the Commission recommend rates that produce a breakeven position for the Postal Service.

In the event that legislation is enacted that relieves the Postal Service of the escrow payment or diverts the payment to pre-fund the retiree health benefits obligation, then the Postal Service's request for a $3.1 billion across-the-board increase must be rejected, as there is no evidence in the record to support such an increase.

The current accounting and data collection systems fail to provide the information needed to perform meaningful econometric analyses of Postal Service costs. The cost segments and components classification system is an artifact of a decades-old

accounting approach. Limiting marginal cost analysis to the cost segment boundaries prevents a deeper exploration of real sources and causes of costs for the classes and services. These limitations are particularly evident in the case of the mail processing attribution analysis submitted in the instant proceeding.

The Postal Service strings together a chain of assumptions concerning mail processing cost pools that, not only have never been verified, but which appear to be incorrect. A careful examination of the model presented by Postal Service witness Bozzo reveals that he purports to furnish the Commission estimates of the volume variability of mail processing *outputs*, but instead has only measured the variability of one of the *inputs* of mail processing, i.e., piece handlings/pieces fed. A correct understanding of the outputs of mail processing reveals that they are pieces sorted finely enough to be delivered (to an individual mail receptacle or a delivery office). No progress can be made in estimating the marginal costs of mail processing without the proper understanding of the relationship between the production process for sorting mail and the true output of this process.

The Postal Service presents a new study for the econometric analysis of the volume variability of City Carrier costs – the City Carrier Street Time Study (CCSTS). The study suffers from a wholly inadequate database that must culminate in rejection of all of the study's results. The primary shortcoming of the study was the decision to limit data collection to an extremely brief period of time, only 11 days, at the end of May 2002. This led to serious problems of heteroskedasticity and multicollinearity that are incapable of repair. In effect, only cross sectional analysis can be performed with data collected over so short a period of time. Panel data are completely lacking. Therefore,

no time series analysis can be performed. The brevity of the data collection period causes the study to fall far short of the standards articulated by the Commission in a succession of rate case opinions. The only way to salvage the study for use in a future proceeding is by utilizing several years of data available from the Postal Service's Delivery Operating Information System (DOIS) mainframe and archives. These data were furnished to OCA on September 22, 2005, in Library Reference USPS LR-K-152. OCA is optimistic that the breadth of these data will permit a meaningful econometric analysis.

An agreement reached between OCA and the Postal Service prior to the time established for the filing of participant direct cases resulted in OCA not filing evidence in the instant proceeding and the Postal Service making a commitment to post delivery information for several of its major services on its website, with notices to that effect placed in retail offices around the country. The classes of mail for which delivery times will be provided are: First Class, Priority Mail, Express Mail, and Package Services. The data systems that will supply the delivery data are External First Class Measurement system (EXFC); Priority End-to-End (PETE); the Product Tracking System (PTS); and the Delivery Confirmation system. Another provision of the OCA-Postal Service agreement is to establish a working group, chaired by the Postal Service, to study the possibility of having the Postal Service sell a non-denominated "forever" stamp. This group will meet regularly for a year, and eventually the results of the study will be published.

OCA is critical of the lack of data demonstrating the quality of service that the Postal Service provides to the public for classes and services that have been

purchased. OCA urges the Postal Service to establish new data collection systems to measure service performance for all classes and services and to file the data with the Commission. In order to fulfill its statutory role, the Commission must have essential performance information to consider when applying pricing factor 2 of the PRA, i.e., concerning "the value of the mail service actually provided . . . to both the sender and the recipient."

Finally, OCA proposes a price increase for Registered Mail that is a small fraction of the increase that the Postal Service proposes. The key to making possible a smaller increase in price is the recommendation to base Registered Mail's price on the costs produced by the Commission's attribution methodology, rather than the Postal Service's. The Postal Service's cost estimates produce a 70 percent fee increase, while the Commission's estimates can keep the Registered Mail fee increase to the same 0.8 percent OCA recommends for all classes and services. Although the cost coverage that results from a 0.8 percent fee increase is very small (only 0.1 percent), breakeven for this special service is achieved and so the §3622(b)(3) requirement is satisfied.

II. THE REVENUE REQUIREMENT PROPOSED BY THE POSTAL SERVICE VIOLATES THE PRA AND PL 108-18

B. The Requested Rate Increase of 5.4 Percent Would Produce Excess Revenues and Maintain A Cumulative Income Violating the Breakeven Directive of the PRA.

The requested rate increase would violate the breakeven requirement in the Postal Reorganization Act (PRA) because the Postal Service would maintain its cumulative income. If any rate increase is implemented at all in FY2006, it should be to recover, at most, a net earnings shortfall of only $303 million for an across-the-board rate increase of about 0.8 percent. Alternatively, a similar result can be achieved in the test year if the implementation date of the full 5.4 percent increase is deferred until August 15, 2006.[1] Even if no rate increase goes into effect in 2006, because of the uncertainties of profit and loss estimates, the Postal Service may break even within the meaning of the PRA or have such a small cumulative earnings shortfall that any necessary borrowing from the U.S. Treasury would be easily within statutory limitations. (Tayman, Tr. 2/201-2.)

By the end of this fiscal year, FY2005, with projected earnings of $1.68 billion, the total cumulative net income (retained earnings) as projected will be $2.58 billion.

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[1] OCA's preference is delay of the 5.4 percent rate increase until August 15, 2006 because, if the escrow payment is maintained, the new rates will better reflect the escrow payment requirement in FY2007. This, of course, is outside the Commission's control, but could have been incorporated into the settlement agreement. It is evident that the agreement filed on July 22, 2005, includes no such provision. This may be contrasted with the Stipulation and Agreement submitted by the parties in Docket No. R2001-1 on February 13, 2002. Paragraph 4 of that agreement set forth a commitment not to increase rates sooner than June 30, 2002. In the current proceeding, an increase of only 0.8 percent more nearly reflects the revenue requirements in the FY2006 test year after consideration of accumulated earnings.

Thus, the Postal Service does not need a $3.1 billion rate increase for FY2006 to maintain a cumulative breakeven posture.[2] Under current rates and without any rate increase, according to the evidence, the large accumulation of profits will fall to only a $303 million deficit by the end of FY2006. The proposed rate increase of 5.4 percent (or as adjusted for other error corrections) could be implemented late in the fourth quarter of FY2006, and produce the statutory breakeven condition for the test year. Thus, at the end of FY2006, the retained earnings would be reduced to approximately zero (breakeven), and meet the expressed intent of Congress in the Postal Reorganization Act.

Where, as now, there are positive retained earnings, we submit that the Postal Reorganization Act requires the Commission to recommend rates that move toward break even. It does not matter that, for all of FY2006, the Postal Service may have a loss of $2.88 billion,[3] because the rates will only be truing up the revenues and costs which have recently been unequal as demonstrated by the profits accumulated over the previous three years.[4]

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[2] Nor does the Postal Service even need in FY2006 the anticipated $1.94 billion it will gain if these rates become effective three months into the fiscal year, on January 1, 2006. Witness Tayman testified that, because the proposed rates would not become effective until the start of the second quarter of FY2006, the Postal Service will lose about $800 million of income in that year. Tayman, USPS-T-6, at 54.

[3] Exhibit USPS-6A Revised, Tr. 2/164.

[4] The Postal Service may be required to borrow funds to pay some of the $3.1 billion retirement amount, but its total debt would still be extremely low inasmuch as the Postal Service paid off all of its debt during October 2005 (Tr. 2/208, 141-2), down from over $11 billion as recently as the end of FY2002. (Tayman, USPS-T-6, Table 10, at page 15.)

1. Accumulated earnings must be taken into account in this proceeding

For the first time in its history, from the commencement of operations as the United States Postal Service on July 1, 1971, the Postal Service does not have a cumulative net loss. (Tayman, Exhibit USPS 6I Revised, Tr. 4/1123; 2/71-2, 76; OCA/USPS-T6-1c, Tr. 2/105-6.) Earnings of over $3 billion in each of the fiscal years 2003 and 2004 have eliminated past losses and resulted in an accumulation of retained earnings. The accumulated earnings of the Postal Service must be taken into account in determining the revenue requirement.

In the last three years since the current rates became effective June 30, 2002, the Postal Service has built up a reserve of retained earnings—that is, past profits have accumulated in an account conceptually similar to a retained earnings account. By the end of FY2004, the cumulative net income of the Postal Service was $900 million.[5] Projected earnings for fiscal year FY2005 are estimated to add an additional $1.64 billion of annual income to the total cumulative net income (retained earnings).[6] Thus, in its initial filing, the Postal Service revealed that it is likely to end FY2005 with a total cumulative net positive income of $2.54 billion.[7] Subsequently, witness Tayman revised his exhibit and added $36.4 million to the estimated cumulative net income at the end of FY2005 to correct errors in interest income and final adjustments. This increased the

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[5] Exhibit USPS 6I Revised at Tr. 4/1123.

[6] Exhibit USPS 6I.

[7] Ibid.

Postal Service's estimated FY2005 income to $1.680 billion and cumulative net income by the end of FY2005 to $2.577 billion.[8] These retained earnings of $2.577 billion must be used to offset most of the estimated test year deficit of $2.880 billion.[9]

Incidentally, the requested rate increase would also result in very large Postal Service equity. As the request originally filed demonstrated, if the rate increase is granted, the test year after rates net equity (not cumulative net income) would be, in millions, $5,686.659 ($5.687 billion). (Tayman-T1, Table 63, page 54.)[10] Subsequent revisions by witness Tayman of his Exhibit USPS 6I, resulted in a projected net equity position of the Postal Service at the end of FY2006, if the rates as requested go into effect, of a cumulative equity after rates of $5.723 billion.[11] This equity not only reflects the cumulative net earnings of the Postal Service, but also some billions of dollars of appropriations added by Congress since 1971 that have not been reflected in the revenue requirement.[12]

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[8] Exhibit USPS 6I Revised, Cumulative NI, 2005 Est. (Tr. 4/1123); Tr. 2/203. The Postal Service is to be commended for the accuracy of its estimate. The Financial & Operating Statements, report for August 2005, i.e. covering 11 months of the fiscal year, reports net income for August 2005 of $1.467.3 billion.

[9] Exhibit USPS 6A Revised, Tr. 2/164.

[10] The equity of the Postal Service is cumulative net income plus $3,033.924 millions of cash infusion provided by Congress over the years to mitigate past losses. This shown as the difference between the test year after rates Equity and Cumulative Net Income columns for FY 2005 and earlier. (Exhibits USPS 6I and USPS-6I Revised, Tr. 4/1123.)

[11] As noted above, the corrections to Tayman's Exhibit USPS-6I resulted in a $36.4 million increase in cumulative earnings which flows through to the following year. Tr. 2/203.

[12] Our contention here relates only to the issue of the cumulative net income. A further question may be at issue regarding the propriety of permitting equity build-up as a result of Congressional appropriations, inasmuch as §3621 of the Postal Reorganization Act includes appropriations along with total estimated income in calculating the amount of revenues that must equal as nearly as practicable total estimated costs. Much of those appropriations have never been accounted for in the revenue

Even if there were no rate increase in this case, but a $3.1 billion escrow payment into the U.S. Treasury at the end of FY2006, the Postal Service would have a relatively small retained earnings deficit of $303 million.[13] Therefore, in order to break even in the test year of this proceeding, FY2006, the Postal Service rates may be lawfully raised only to erase the cumulative $303 million deficit, a little over 0.8 percent.[14] On the other hand, the Postal Service's proposed rate increase of 5.4% would produce a huge cumulative income surplus of $2.577 billion– considerably more than the zero (or breakeven) condition specified by Congress in §3621 of title 39.

The effect of the Postal Service's request for an across-the-board 5.4% increase in rates producing $2.577 billion in cumulative income is, effectively, to ask mailers to pay in advance for potential deficits that may arise in years following the test year. This is a radical proposal in conflict with the PRA. Moreover, OCA believes that consumer mailers do not wish to pay in advance. There is no record evidence to support the proposition that mailers are in favor of, or are even neutral, about paying in advance for future cost increases. Rather, the logical assumption is that mailers prefer to have their rates increase only so much as overall costs warrant.

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requirement. Had they been recognized as revenue, they would have made their way to equity through net income. (Tr. 2/213-215.)

[13] The $303 million is the difference between the cumulative net income at the end of FY2005 of $2.577 billion (Exhibit USPS-6I revised) and Tayman's projected test year net loss of $2.880 billion. (Exhibit 6A Revised, Tr. 2/164 filed in response to OCA/USPS-T6-46.)

[14] This is discussed further in a later Subsection B in this Part II, below.

2. The Breakeven Requirement in §3621.

It is well established that §3621 of the Postal Reorganization Act requires total estimated income (plus appropriations) to equal as nearly as practicable total estimated costs—that is—breakeven. Because costs and revenues fluctuate from year to year between rate cases, year to year breakeven is not expected to be maintained, but when the Postal Service does file for a rate increase, the books should be evened-up unless there is a very good policy reason consistent with the Postal Reorganization Act for not doing so. The Commission said in Docket No. R76-1, "Indeed, the act is so structured as to make it clear that the Service was not to seek a profit." (Tr. 2/67 citing Op. R76-1 at 45.) The Postmaster General agrees, "The law says that we break even over time, and I believe in doing that." (Tr. 2/67.)

Even though the Postal Service totally ignored prior year accumulated net income in calculating the necessary rate increase in this rate filing, those past years' profits must be taken into account in this rate case to comply with the breakeven requirement. All losses or profits must be included in the revenue requirement unless there are exigent circumstances that preclude inclusion of the entire amount in the revenue requirement in a single rate case. The statutory requirement is thus to include the entire amount of cumulative income as revenue in calculating the revenue requirement.

3. Cumulative earnings are simply the reverse of past years' losses which the Commission has determined must be recovered by adjustment to the revenue requirement

The Commission has long since recognized the principle that past years' financial losses must be taken into account in the test year. The reverse of that theory is applicable to past years' profits. In other words, cumulative net income can be reflected in the revenue requirement by inserting a new line in the revenue requirement exhibit of witness Tayman.[15] The new line would be titled "Cumulative Net Income" in lieu of the "Recovery of Prior Year Losses" line item.[16] The evidence demonstrates that the amount of cumulative net income as of the end of FY2005. subject to any minor corrections and additions not included in witness Tayman's exhibits, is $2,577.158 million.[17]

Rate cases could be filed every year and, then, each year the rates would be adjusted to meet that year's expenses. But rate cases are not filed every year; instead they are filed about every three years. Profits or losses between test years are allowed to float up and down in the interim years between rate cases. If a large profit arises in the first year after a rate case, the first interim year, it may be eliminated in subsequent interim years. The same is true with losses. Losses in interim years accumulate between rate cases and measures are taken to recover those losses from prior years in the next rate case. Thus, the principle that losses may be recovered in the subsequent rate case is a long-established principle. That principle is based upon the statute and legislative history.

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15 Exhibit USPS 6A Revised, Tr. 2/164.

16 "Recovery of Prior Year Losses" line is a zero amount in this proceeding.

17 Exhibit 6I Revised, Tr. 2/1123.

Ever since the Commission's Opinion in Docket No. R76-1,[18] the statutory breakeven requirement has been applied to long-run cumulative losses. Thus, when the retained earnings were negative, steps were taken in each rate case to true-up that account so that, over time, the Postal Service would break even.

When providing for recovery of prior years' losses, the Commission has focused on the indicators of financial stability. The Postal Service's financial situation has previously been deemed less than satisfactory. Today, the financial situation is precisely the opposite and excellent; and retained earnings must be recognized in the revenue requirement. At the close of FY1987, the ratio of equity to assets was a "razor-thin" ratio of 0.01 (only $138 million of equity and $13.7 billion in assets).[19] Currently, as of the end of FY2005, witness Tayman estimates the equity will be $5.6 billion while Postal Service assets were over $26 billion as of July 2005 for a ratio of assets to equity of 0.215.[20] The ratio of equity to assets is now more than twenty-one times what it was in the 1970s and 1980s. Furthermore, today the Postal Service has no debt. In short, its financial position is much the opposite of that seen in the 1970s, 1980s and into the mid1990s. Thus, there are no extenuating financial circumstances that would warrant excluding retained earnings from the revenue requirement.

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[18] Opinion and Recommended Decision, Docket No. R76-1, at 15-51. See also, Opinion and Recommended Decision, Docket No. R87-1, at 17 discussing Docket No. R76-1.

[19] Opinion and Recommended Decision, Docket No. R87-1, at 23.

[20] Compare USPS Exhibit 6I Revised, Tr. 4/1123 with USPS Financial and Operating Statements, July 1, 2005 – July 31, 2005, Statement of Financial Position, at 10.

It has been suggested that the retained earnings might be worked down over a period of years in the same manner as prior years' losses have been worked off.[21] When the cumulative losses grew large, the Commission established the principle of amortizing past years' losses over a period of time by adding one-ninth of the total shortfall to the revenue requirement This was based on the recognition that all of the losses could not be taken into account in a single rate case because of rate shock. The rate impact would have been enormous and so a method was devised to amortize the losses over 9 years due to those extenuating circumstances. There is no potential for rate shock here. Simply delaying the rate increase or reducing the percentage of the rate increase will quickly work off the accumulated net income without rate shock. Thus, contrary to what has been suggested, it would be unreasonable (as without purpose) to work off the retained earnings over a period of years as was done for cumulative losses.

The Commission discussed the principles to be applied when considering prior years' losses in its Opinion in Docket No. R76-1. The Commission stated:

> The Postal Reorganization Act incorporates a different plan of organization. Instead of compensating in advance for the risk of loss (through allowing a profit), as is done in the regulation of a profit-making utility, we are directed to insure, as nearly as practicable, that the enterprise neither makes a profit nor suffers a loss. (Footnote: The statute does not authorize any rate of return to the Postal Service to compensate either for the use of the Government's capital or for the risk of losing that "investment.")[22]

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[21] Tr.2/76.

[22] Opinion and Recommended Decision, June 30, 1976, at 29.

Mathematically, recognizing cumulative earnings in the revenue requirement would be the reverse of the recovery of prior year losses. The amount of the retained earnings the Commission determines should be taken into account is simply applied as a negative number in the revenue requirement calculation as set out in line 27 of witness Tayman's Exhibit 6A. A line entitled "cumulative earnings" should be included as a line item offset to the revenue requirement. The record is clear as to the impact of such an adjustment. If the accumulated earnings of $2.577 billion estimated by witness Tayman at the end of FY2005 are correct, then the test year loss will be reduced to $303 million as discussed elsewhere in this brief. Applying the familiar Commission methodology, rates should be increased to provide only that amount of increased revenue.

Witness Tayman suggested it would be inappropriate to invert the treatment of past years' losses to work down cumulative net earnings. In support, he cites to the cost of land as a benefit to mailers that has not been included in the revenue requirement. He points out that since 1971 land investment has increased about $2.6 billion.[23]

The treatment of land has no bearing on a decision to reduce the revenue requirement by the cumulative net income. Land is not included in the revenue requirement because it is not depreciated. It is the only asset that is not depreciated.[24] Witness Tayman's exhibit summarizing the Postal Service's history of net income and

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[23] OCA/USPS-T6-17, Tr. 2/131.

[24] Tr. 2/217.

losses demonstrates that cumulative net losses totaled almost $2.8 billion as early as 1975 and cumulative net losses increased dramatically between 1990 and 1994, from just over $4 billion in 1990 to almost $9 billion in 1994.[25] The expenses for land clearly did not drive the profits and losses.

Even though the cost of land has not been included in the revenue requirement, the Postal Service has never attempted to recover the cost of land in the revenue requirement.[26] There has been no restriction on the purchase of land from the beginning of the Postal Service, and the Postal Service has purchased land as needed; nor has the Postal Service not been able to purchase land because land is not included in the revenue requirement.[27] Finally, the PRA does not make any special provision for allowing profits to build up in order to acquire land. The PRA's reference to surpluses in §2009, cited by witness Tayman, relates to the annual budget program and accounting analyses of annual deficits and surpluses arising in the short term.[28] Nothing in that section or in legislative history or in Commission opinions suggests that §2009 rises to override the clear and fundamental breakeven requirement of §3621. In fact, the legislative history of §3621 supports the opposite conclusion. Minor capital investments in excess of depreciation were specifically excluded from the PRA.[29]

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25 Exhibit USPS 6I Revised, Tr. 4/1123.

26 Tr. 2/218-9.

27 Ibid.

28 Tr. 2/220.

29 For a review of the legislative history of §3621, see Section 5, below.

There is, therefore, no impediment either in logic, accounting practice, or in the law that would prohibit simply reversing the methodology applied for years to recover past year losses to account for the cumulative net income in the revenue requirement.

4. The plain meaning of 39 U.S.C. §3621 is that Congress never granted the Postal Service the power to retain earnings.

Nowhere in §3621 may one find the slightest suggestion that Congress granted the Postal Service the power to retain earnings. Rather, in clear and unambiguous language,[30] Congress provided that, "Postal 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 . . . ." The phrase "total estimated income" contains no hint of an exception – *all* income is counted in determining the Postal Service's breakeven posture. In the exhibit summarizing net income and equity,[31] witness Tayman reports $2.58 billion of cumulative net income for the test year if the Commission approves the Postal Service's request for a 5.4 percent across-the-board increase in postal rates. The language used in the exhibit itself contains the plain statement that the amount in question is "income." As such, it undoubtedly is included as one of the sources of "total estimated income."

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[30] "It is elementary that the meaning of a statute must, in the first instance, be sought in the language in which the act is framed, and if that is plain . . . the sole function of the courts is to enforce it according to its terms." *Caminetti v. U.S.*, 242 U.S. 470 , 485 (1917).

[31] USPS-T-6, Exhibit 6I Revised, Tr. 4/1123.

5. A review of the legislative history of the PRA clearly demonstrates that Congress did not intend to give the Postal Service the power to retain earnings.

Given the plain meaning of §3621, it is not necessary (or even appropriate) to resort to the legislative history of the PRA. Nevertheless, the propriety of the "plain meaning" discussed above is reinforced by a review of legislative history. To be sure, there is scant explicit discussion in the *Kappel Commission Report* – or elsewhere in the legislative history of the PRA – whether it was advisable to give the Postal Service the power to retain earnings. However, one reference that OCA uncovered reveals that, while the issue was posed for "[p]ossible retention of earnings (over and above 'costs') . . . for contingencies, and for minor capital investment in excess of depreciation,"[32] the language finally adopted in 39 U.S.C. §3621 reflected a conscious choice by Congress to follow the recommendation for contingencies, i.e., "a reasonable provision for contingencies," but any amounts for "minor capital investment in excess of depreciation" were excluded from §3621. Under the well established principle of statutory construction: *expressio unius est exclusio alterius* ("all omissions should be understood as exclusions"),[33] it is clear that <u>the power to retain earnings was not delegated to the Postal Service by Congress</u>. The position espoused by the Postal Service in the instant proceeding – that the $3.1 billion escrow expense can be considered in isolation, without first applying as an offset existing available income, such as accumulated net

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[32] *Kappel Commission Report*, Annex I, Report of Price Waterhouse & Co. on "Financial Management in the Postal Service," findings transmitted on February 9, 1968, at 41.

[33] Sutherland Statutes and Statutory Construction, Vol. 2A §47:23 (2000).

income – is a violation of the unambiguous prescription of §3621 that all sources of income must be weighed against expenses.

6. This is not a “special” rate case as characterized by the Postal Service, but a rate case pursuant to §3621 guided by the breakeven requirement

The Postal Service has portrayed this rate case as a “special” rate case. It seeks to leave the impression that, because the impetus for this case is unusual and unique, it is justified in placing on hold the provisions of the PRA. The PRA makes no provision for “special” rate cases. Rate cases are filed only pursuant to §3621. The Postal Service points out Congress has directed that the escrow payment must be treated as an operational cost. OCA does not take issue with that conclusion. On the other hand, in P.L 108-18 Congress did not modify the provision of the PRA requiring that, in setting rates, costs must equate to revenues as nearly as practicable.

OCA does not agree that this rate case must be accorded special treatment by the Commission in a manner that would exceed the bounds of the authority conveyed by the PRA. The PRA does not provide for “special” rate cases. In each rate case the Commission’s duty under §3621 is to recommend rates so that total revenues equal as nearly as practicable total costs. The statute does not recognize any other result. The statute does list various impacts that the rates may have which are to be considered when establishing rates to recommend, but those impacts are all related to the allocation of costs or the propriety of classifications and services, they are not factors which may alter the fundamental equation described in and required by §3621 that total income and appropriations “shall” equal as nearly as practicable total costs.

Postal Service's witness Potter stated this case is special and that the Postal Service will soon file another case in the near future.[34] The suggestion is that accumulated net income will be handled in that case. (*Ibid.*) Unfortunately, the PRA requires the Commission to establish rates "as nearly as practicable" to break even. There is no question that the law requires breakeven. In fact, the Postmaster General understands the law requires a breakeven. Witness Potter stated, "The law says breakeven over time. I believe in doing that." (Tr. 2/67.) Thus, the Commission cannot merely ignore the accumulated earnings of the Postal Service as if they do not exist. The accumulated earnings must be considered in addressing the revenue requirement and in establishing rates by taking the earnings into account. The Commission must address the issue in each and every rate case.

Witness Tayman suggested the Postal Service management ought to have discretion in deciding the amount of earnings it may retain.[35] To a certain extent, the management does have that discretion. In fact, the Postal Service exercised that discretion in the year immediately prior to the year it filed this case when it already had retained earnings at the end of the year.[36] At that time, it exercised its discretion and did not file for a rate increase. OCA is not contending the Postal Service should have filed sooner than it did to avoid compiling any retained earnings. Rather, once having filed this rate case, the Commission's duty is to insure the revenues and costs are balanced.

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[34] Tr. 2/76; OCA/USPS-T1-2c (Tr. 2/55).

[35] Tr. 2/156.

[36] Exhibit USPS 6I Revised at Tr. 4/1123.

The idea that it is appropriate to begin building the escrow payments into the rates in this case, as suggested by witness Potter (Tr. 2/74) ignores the fact that such a procedure would be premature. Witness Potter's view that this case is special and the issue of accumulated earnings will be addressed in the next case is simply at odds with the long recognized statutory scheme. Section 3621, entitled "Authority to fix rates and classes," establishes the overall authority and duty of the Commission in rate cases to equate income with costs. The following section, §3622, entitled "Rates and fees" demands the Commission exercise its authority ("the Commission shall make a recommendation…in accordance with the policies of this title [*i.e., inter alia*, §3621] in accordance with nine enumerated factors.") Those factors may not be grounds for altering the fundamental equation required in §3621. Thus, while the Postal Service may be correct in asserting the circumstances of this case are unique, the applicable statutory law by which this Commission rules on rate proceedings does not provide for ignoring the fundamental rate equation. The unique or, at least, rare situation is being addressed in this proceeding by the Postal Service's request for a simple across-the-board rate increase. By not taking into account the actual current cost attributions, the Postal Service is asking for unique treatment of the escrow expenses. It does not follow that the Commission or the Postal Service may ignore the fundamental equation that revenues equate to costs.

The PRA does not provide for an *ad hoc* rate increase to recover a specific expense. The fact that this escrow payment may be separate and identifiable does not provide any greater flexibility to the Commission. There is no doubt that the Postal Service recognized the break even requirement when it determined the amount of its

rate request. It may be merely chance that the Postal Service's calculated test year shortfall is almost precisely the required escrow amount. Perhaps that similarity is why the Postal Service chose to approach the rate increase as one solely to meet the escrow payment. But, by tying the test year losses specifically to the escrow payment, a very tidy rate increase package was created to justify a quick and uncontested across-the-board omnibus rate case. But suppose the Postal Service test year had demonstrated a loss of only $2 billion rather than the approximately $3 billion loss before the rate increase. If the Postal Service had sought a $3 billion rate increase in the test year on the theory that the $3 billion escrow payment is a special cost, the result would have yielded a $1 billion windfall for the Postal Service. No one would have agreed to that, and all participants would have said that is outside the bounds of the statute because the rates would provide revenue exceeding total costs.

This case is no different than any other rate case in terms of establishing rates and fees providing sufficient income to recover total estimated costs. The Commission must not be misled by the simplistic idea that because the test year shortfall appears to be very nearly identical to the escrow payment, the Commission can easily, without more rigorous analysis of the total income of the Postal Service, approve a rate increase only to cover the escrow payment.

The Postal Service is not guaranteed a rate increase equal to the escrow payment or even the test year shortfall that is calculated in witness Tayman's revenue requirement. It is well settled that an increase of postage and fees must equate revenues with estimated costs, i.e. costs as estimated by the Commission. The across-the-board rate increase of 5.4 percent was provided as a guideline, not as the final

percentage increase the Commission must necessarily recommend. If the test year losses taking into account cumulative earnings are significantly less, then the Commission may follow the across-the-board approach, but the rate increase must be adjusted downward proportionately. OCA believes the amount of the rate increase must be reduced to recover, at most, a shortfall of $303 million.

7. PL 108-18 explicitly states that the savings arising from payments that the Postal Service was spared in 2003, 2004, and 2005 are to be used to maintain the lowest possible rates for mailers.

In enacting the Postal Civil Service Retirement System Funding Reform Act of 2003 (PL 108-18),[37] Congress intended to have the savings arising from relief from making payments into the CSRS fund for a three-year period (2003 - 2005) be used (among other things) to keep postal rates unchanged for years 2003 - 2005 and beyond. The Postal Service's decision to file a "Public Law 108-18" rate case flouts one of the chief purposes of the law – to use the savings to hold down the rates paid by mailers. After all, mailers were the source of the overpayments into the Civil Service Retirement Fund. It seems fitting for mailers to benefit from the measures enacted by Congress to keep the fund from ballooning further.

Congress' intentions are made explicit in two sections of PL 108-18. In section 3.a.2. (Disposition of Savings Accruing to the United States Postal Service), Congress provided that the Postal Service: "shall, to the extent that such savings are attributable

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[37] Enacted April 23, 2003.

to fiscal year 2005, *be used to continue holding postage rates unchanged* and to reduce the postal debt . . . ."[38]

Section 3.d.1. ("Sense of Congress") reinforces that expression of congressional intent:[39]

> It is the sense of the Congress that . . . the savings accruing to the Postal Service as a result of the enactment of this Act will be sufficient to allow the Postal Service to fulfill its commitment *to hold postage rates unchanged until at least 2006*.

The Senate recognized that the savings from spared payments in 2003-2005 would remain at the disposal of the Postal Service for years beyond 2005:[40] "[T]he benefits of this legislation will continue to be realized by the Postal Service for many years." Among these benefits was "keeping postal rates stable."[41]

The Congressional Budget Office observed that one of the chief aims of PL 108-18 was to "delay future rate increases," leading to the deferral of the next postal rate case to 2007.[42]

During OCA's written and oral cross-examination of witnesses Potter and Tayman, it became apparent that the Postal Service was carrying over savings arising from payments it was spared from making in 2004 and 2005 (and likely 2003) as net income in the test year of this proceeding. The Postal Service's failure to use the

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38 Emphasis added.

39 Emphasis added.

40 Senate Report No. 108-35 (April 8, 2003), at 4-5.

41 *Id*. at 5.

42 *Id*. at 9 and 13.

savings "to continue to hold[ ] postage rates unchanged" is a manifest violation of the directive of §3.a.2. and the sense of Congress in PL 108-18. Retaining a $2.58 billion accumulated net income[43] *and* imposing rate increases early in 2006 thwarts one of the chief aims of CSRS payment relief.

The Postmaster General agreed that at least a portion of the $1.64 billion of net income for FY 2005 was the result of not having to make a CSRS payment in 2005 by virtue of PL 108-18:[44]

> [Counsel]: Earlier, I think you agreed that, in large part, the $1.64 billion of net income for Fiscal Year 2005 resulted from being spared a CSRS payment in 2005. Correct?
>
> [General Potter]: Yes.

Likewise, Postal Service witness Tayman agreed that:[45]

> The positive cumulative net income at the end of FY 2004 is due in large part from the reduction in Civil Service Retirement System (CSRS) expense resulting from Public Law 108-18.

The 2004 accumulated net income is approximately $900 million.[46]

Witness Tayman also testified that: "The Postal Service currently has no operating debt and does not anticipate any at the end of FY 2005."[47] Thus, the income surplus that witness Tayman estimates going into the test year – $2.58 billion – cannot

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[43] Witness Tayman provided this corrected figure during cross-examination by OCA counsel. Tr. 2/203.

[44] Tr. 2/88.

[45] Id. at 106 (his response to interrogatory OCA/USPS-T6-1).

[46] Witness Tayman's Exhibit 6I.

[47] Tr. 2/129 (his response to interrogatory OCA/USPS-T6-15).

be used (at least at the outset) to reduce debt, which is another of Congress' chief objectives in PL 108-18. Since the PL 108-18 savings cannot be used to reduce debt (there being none to reduce), the savings should be applied to hold down postal rates.

During cross-examination, witness Tayman suggested that Congress intended to give the Postal Service the authority to generate and retain cumulative net income by enacting 39 U.S.C. §2009. Section 2009 requires the Postal Service to prepare a budget that is submitted to the Office of Management and Budget. The budget is a "business-type budget" or "plan of operations" that must include, among other things, "an analysis of surplus or deficit." The language of §2009 lends no support to the view that Congress intended to grant explicitly a power to the Postal Service to retain earnings. On the contrary, §2009, which is a subsection of Chapter 20 of the PRA addressing questions of "Finance," merely outlines the form and contents of the budget report to OMB and is plainly not intended to modify the ratemaking provisions of Chapter 36.[48]

In summary, the Postal Service's position, that it is empowered by Congress to submit a request for an omnibus increase in rates that would result in Commission approval of a test year accumulated net income of $2.58 billion, is in conflict with §3621

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[48] Of course, witness Tayman cannot be faulted for making this argument since he is a financial expert who does not profess to have legal expertise.

of the title 39, as well as with PL 108-18. Consequently, the Commission may lawfully approve an increase of only $303 million.[49]

8. A 5.4 percent rate increase in this case is not needed to avoid a prohibitively large rate increase in the next rate case.

The Postal Service indicated in its filing that this rate case is intended only to meet the immediate needs of FY2006 and that it intends to file a separate case in the "near future."[50] There has been some suggestion in this proceeding that the increase of 5.4 percent is needed to ameliorate the size of the future rate increases in the following rate case expected to be filed in FY2007. Thus, some have expressed concern about delays or reductions in the rate increases implemented in this case as exacerbating the size of the rate increases in the next rate case. However, that concern is misplaced for at least two reasons and therefore should not be of concern to the Commission and should not be a justification for recommending the proposed rate increase in this docket.

First, it has not been shown, if the cumulative earnings are taken into account here and the rate increase accordingly is minimal, that the next rate case will necessarily result in a large rate increase. Postal Service earnings have not dropped precipitously year to year. For instance, the earnings drops from year to year shown on

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[49] The method for collecting the $303 million revenue shortfall with a 0.8 percent across-the-board increase at the start of the 2nd quarter of the test year or a 5.4 percent rate increase on August 15, 2006 is discussed in Subsection B of this Part II, below.

[50] See OCA/USPS-T1-2c (Tr.2/55), response of witness Potter that an omnibus rate case will likely be filed in calendar year 2006. See also, Letter from Daniel J. Foucheaux, Jr., Chief Counsel, Ratemaking. To Parties of Record, Docket No. 2005-1, April 4, 2005, Attachment to Request.

Tayman's Exhibit 6I in years without rate increase have been in the $1 billion range and often less.

Even though the rates implemented in this case may be lower than anticipated, a recent Postal Service statement indicates the next rate increase will probably not be as high as originally estimated. The Postal Service has recently gone on record to state that the next rate case after this one will involve rate increases of mid-single digits. The Chairman of the Board of Governors of the Postal Service, James Miller, was recently reported to have stated that if no legislation is passed, the Governors anticipate an increase in 2007 in the "mid-single digits." (Statement released following the board's monthly meeting, see Postcom Bulletin, August 5, 2005 at 2.) In the context of past rate increases, that would neither be an enormous nor an abnormal rate increase. Even if the rates here are not increased as much as 5.4 percent in this docket, the impact of the next rate proceeding will not be out of line.

Second, in the interim between this case and the next rate case, several factors may further reduce the impact of the next rate increase request. For instance, earnings may remain high, year to year drop-off of earnings may not be more than about $1billion per year as in the past, or legislation reducing escrow costs may be passed.

Also, in the next rate case, as costs are reattributed and allocated in the traditional manner, rather than across-the-board, and brought more up-to-date in line with attributable costs, the overall impact of the next rate increase may be lessened on those mailers normally most concerned with the impact of a larger postage increase. Of course, the opposite may happen, but that is not certain. The impact may fall upon

those better able to handle larger changes in rates. At this time, the impact is unknown.

The Commission should proceed now in a way which conforms to the law without prejudging or trying to foresee the future. The Commission must deal with this case on this record and with the current accumulated earnings of the Postal Service rather than be concerned with a parade of potential future costs and potential rate hikes.

If Congress passes the proposed legislation after the Commission acts in this proceeding, and that looks very likely at this time, the Postal Service's escrow payment will be eliminated and replaced by payments into the Health Benefits Retirement Fund, thus probably reducing or even eliminating the need for a further rate increase in FY2007. Any concern that a rate increase lower than requested in this case will lead to undue hardship at a later time in the next rate case is not supported by the evidence, is misplaced and should be rejected.

C. If Retained Earnings are Considered in the Revenue Requirement, the Rate Increase Must Be Limited to No More than Approximately 0.8 Percent or, Alternatively, the 5.4 Rate Increase Could Be Deferred Until August 15, 2006.

If cumulative earnings are taken into account in the revenue requirement as required by the PRA, the rate increase must be no more than a 0.8 percent across-the-board. As indicated in the above section, the revenue shortfall for FY2006 will be about $303 million. In order to break even in the test year of this proceeding, FY2006, the Postal Service rates may be lawfully raised only a little over 0.8 percent, at most, to erase the cumulative $303 million deficit.

The record does not reflect the precise percentage drop from the proposed 5.4 percent increase in rates that would be necessary to return an additional $303 million in after rates dollars. However, merely assuming a proportional decrease in the total amount requested, the rate increase would amount to about 0.8 percent.

The 0.8 percent across-the-board rate increase to raise $303 million to achieve breakeven is calculated as follows: assuming implementation of an across-the board increase of 5.4 percent at the start of quarter 2, FY2006, new revenues of approximately $1.94 billion would be generated.[51] The required $303 million ÷ $1.94 billion = 15.6 percent. (We have used the implementation date as the start of quarter 2, FY2006 in the calculation rather than the start of the test year. If the reduced rate increase were assumed to start at the beginning of the fiscal year, but delayed for one quarter, the Postal Service would not recover all of the $303 million needed to breakeven.) Thus, the Postal Service needs 15.6 percent of the new revenues it is requesting in the current case. One may apply the 15.6 percent to the across-the-board figure of 5.4 percent to give a rough approximation of the across-the-board increase that is really necessary to achieve breakeven in FY2006: 0.156 x 5.4 percent = 0.844 percent. In fact, the increase should be even less than 0.8 percent because the volume impact of a relatively small rate increase of 0.8 percent is a small fraction of the dampening effect of a 5.4 percent increase.

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[51] Comparing the before and after rates revenue for the test year in witness Tayman's revised exhibit indicates an expected full year of new revenue of $2.583,653 billion ($72,917,720 – $70,334,067). Exhibit 6A Revised, Tr. 2/164. Nine months of new revenues with a 5.4 percent rate increase are calculated as $1.937,740 billion. This is three fourths of the full year's estimated revenues.

This increase is significantly less than the rate applied for and yet not only conforms to, but is required by, the statute. It also provides some slight rate increase. OCA submits an increase is better for the Postal Service than no increase at all, as it is a step that will moderate somewhat the next rate increase.

Alternatively, OCA does not object to meeting the minimal shortfall in another manner. The $303 million revenue deficiency could be raised by an across-the-board increase of the full 5.4 percent rate increase requested, but implemented later in the test year. OCA calculates that deferral of the 5.4 percent rate increase implementation date until about August 15 would provide sufficient revenue to cover the $303 million shortfall. This is determined as follows: a full year of a 5.4 percent increase would provide new revenue of $2,583.653 million. The $303 million shortfall is approximately 11.7 percent of that $2,583.653 million. Then, 11.7 percent of the year is 43 days (11.7 % x 365 days). Therefore, implementation of the 5.4 percent increase in rates 43 days prior to the September 30 end of the test year (rounded to mid month) should provide approximately $303 million needed to equate cumulative revenue with cumulative costs. Thus, an implementation date of August 15, 2006[52] would also bring into breakeven the cumulative net income by the end of the test year.

This alternative approach has the advantage to the Postal Service over the first alternative in that it raises the rates by the entire 5.4 percent requested so that rates are at a higher level going into FY2007 than if the percentage rate increase is reduced but

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[52] If the Governors made a binding commitment to postpone the rate increase to August 15, a recommended increase of 5.4 percent would appear to conform to §3621 and would also be consistent with the congressional intentions articulated in PL 108-18.

implemented over a longer period of time during FY2006. In either alternative, the breakeven requirement for the test year is honored.

III. ATTRIBUTABLE COSTS AFFECTED BY POSTAL REFORM LEGISLATION

A. Passage of Legislative Reform Proposals H.R. 22 and S. 662 Would Require Extensive Modification or Withdrawal and Refiling of the Rate Case.

9. For the test year FY2006, H.R. 22 and S. 662 would remove the underpinning of the proposed rate increase by eliminating the escrow fund payment and the consequent across-the-board institutional allocation.

The House passed postal reform legislation, H.R. 22, on July 26, 2005. The bill was placed on the Senate calendar the next day. The Senate very nearly considered S. 662 only a few days later on July 29, just prior to the August recess. Unanimous consent was needed to pass the legislation, but one senator placed a last minute hold on the legislation so that the matter was not considered for a Senate vote.[53] Reportedly, the vote would have led to passage of S. 662 as the White House, Senate Republican leadership and key sponsors had reached agreement on substance.[54] Thus, in the near future, enactment appears likely and more than a mere possibility before the final Commission ruling in this case.

If P.L. 108-18 is repealed and a retirement health fund is established and military retirement costs are returned to the treasury as provided for in H.R.22 (and S.662), then according to the USPS, additional costs for payments into the unfunded health benefits

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[53] As reported by "PostCom Bulletin," Number 31-05, August 5, 2005, at 2.

[54] Ibid.

fund in FY2006 would be significantly less than the $3.08 billion escrow payment now required by P.L. 108-18. The USPS stated that assuming $1.2 billion were paid into a new Retiree Health Care Fund, "it would be appropriate for the Postal Service to withdraw this case and file a new case."[55] However, the Postal Service may take the position that despite the elimination of the escrow payments, new costs justify continuing the rate case.[56]

In the event of final passage of the legislation now in the Senate, and already approved by the House, even if new costs are the same as the current estimated cost, the Commission will be required to order a complete recasting of the evidentiary support for any rate increase or, alternatively, encourage its withdrawal. Without the escrow payment, the rationale for an across-the-board rate increase will be eliminated and any rate increase must then be based upon updated cost attributions.

10. Payments into a retiree health benefits fund provided for by H.R. 22 and S. 662 must be treated as volume variable and attributable consistent with current treatment of health benefits expenses.

The proposed legislation would eliminate the proposed escrow payment that the Postal Service has treated as an institutional expense. However, the legislation in the version already approved by the House, and in the version now before the Senate, would require large Postal Service payments into a Retiree Health Benefits Fund. The

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[55] VP/USPS-T6-9(a)i (Tr. 2/189).

[56] Office of the Consumer Advocate Motion to Compel Responses to Interrogatories OCA/USPS-196-207, dated September 6, 2005, at 4.

amount of those payments is not clear although it is likely to be significantly different than the $3.01 billion anticipated for the escrow payment, in the FY2006 test year. More importantly, the payments into the Retiree Health Benefits Fund would not appropriately be deemed institutional costs but should be allocated as volume variable costs in the manner that other Postal Service labor costs are allocated. The Postal Service has stated in this record, "Annuitant health benefit costs are, and always have been, distributed to the same degree as all volume variable postal labor costs. This treatment is used because health care benefits for retirees are considered part of labor costs since we do not accrue costs for future health benefits of current employees."[57]

11. Passage of the legislation either as proposed, or as modified to include Postal Service obligation for military retiree benefits as proposed by the administration, would require, at a minimum, extensive modification and probably refiling of a Rate Case.

One of the most prominent features of H.R. 22 is to require a sizeable payment into a Retiree Health Benefits Fund, in lieu of the P.L. 108-18 escrow payment. The Postal Service itself acknowledges that the character of a P.L. 108-18 escrow payment, described by the Postal Service as a "tax" that is best treated as an institutional cost, is very different from a health benefits payment. Both the Postal Service and the Commission have long agreed that health benefits payments are volume variable to the same extent as the underlying labor costs are volume variable.

In view of the increasing likelihood that Congress will pass postal reform in the next few months, it may become important for the Commission to have available to it,

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[57] VP/USPS-T6-2 (Tr. 2/170).

when it formulates its decision, evidence that it must consider when it evaluates the "across-the-board" rate increase. Since the $3.1 billion escrow payment was viewed by the Postal Service as an institutional cost, while a retiree health benefits payment is mostly attributable to the same degree as the underlying labor costs are volume variable, the rates proposed by the Postal Service might very well be in violation of §3622(b)(3) in that some classes of mail might not even be covering their attributable costs. The OCA posed several interrogatories to the Postal Service to determine the impact of attributing Retiree Health Benefits Fund payments to the various classes of mail and whether, in that case, all classes of mail would cover their attributable costs. Although the Commission has denied the motion to compel responses to those interrogatories,[58] if reform legislation is passed, information of the type requested in the interrogatories would be required to determine the appropriate course of action by the Commission.

The record does not include even approximate Retiree Health Benefits Fund amounts required by the legislation to be paid by the Postal Service; nor does the record include the impact of attributing the Retiree Health Benefits Fund payments to the various classes of service in the manner that labor costs are attributed. Consequently, the Commission would need to require, at a minimum, extensive modification of the existing case, or more probably a withdrawal and refiling of a new rate case.

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[58] "Presiding Officer's Ruling Denying the Office of the Consumer Advocate Motion to Compel Responses to Interrogatories OCA/USPS-196-207," September 21, 2005.

IV. THE POSTAL SERVICE COSTING METHODOLOGY CANNOT MEASURE THE TRUE MARGINAL COSTS OF POSTAL PRODUCTS

Since before the first general rate case, the Postal Service has advocated using volume-variable cost as the base from which to begin setting rates.[59] During the 70s and 80s, the Postal Service presented the testimony of several esteemed economists asserting that (1) rates should be based on marginal cost and (2) the Postal Service's unit volume-variable costs were good approximations to marginal cost.[60] Since at least Docket No. R97-1, the Postal Service has argued that its volume-variable costs *are* marginal costs.[61] Witness Bradley so testifies in this proceeding.[62] Unfortunately, due to (1) the cost segment/component/pool structure of its data collecting and reporting, (2) its aversion to measuring volume variability directly, and (3) constant improvements in automation technology, the Postal Service cannot measure marginal costs.[63] As the *Data Quality Study* states:[64]

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[59] *See* Bureau of Finance and Administration, Post Office Dep't, Summary Report of Cost System Task Force on Incremental Costs, May 1970 (Docket No. R71-1, Exhibit 10).

[60] *See, e.g.,* Docket No. R84-1, Direct Testimony of William J. Baumol (USPS-T-5), November 10, 1983.

[61] *See, e.g.,* Docket No. R97-1, Direct Testimony of John C. Panzar (USPS-T-11), July 10, 1997; Rebuttal Testimony of Laurits R. Christiensen (USPS-RT-7), March 9, 1998.

[62] Tr. 11/6045, ll. 1-3 However, witness Bozzo has backed off somewhat, testifying that volume-variable cost is a "first-order approximation" to marginal cost. Direct Testimony of A. Thomas Bozzo (USPS-T-12), April 8, 2005, at 20, ll. 10-11. "First-order approximation" is mathematese for "close enough for government work."

[63] In mathematical terms, the Postal Service repeatedly invokes assumptions of "additivity," "separability," "proportionality," and temporal "stability" of cost functions in order to "prove" that its volume-variable costs are marginal costs. In fact, the Postal Service's unit volume-variable costs understate marginal costs.

> Two key assumptions implicit in the [Postal Service's costing methodology] should be noted. First, cost is additively separable . . . across cost components (where these cost components or pools are in the postal context costs related to transportation, mail processing and so forth). Second, it is assumed in this formulation that there is a single driver (such as Total Pieces Handled) for each cost component, although more complex multi-driver models could be analyzed in the same manner.

To these assumptions the *Study* adds that (1) the relationship between cost drivers and mail volume must be "linear homogeneous" (a proportionality assumption) and (2) technological conditions must remain unchanged until the next rate case (a stability assumption).[65]

Overall, the Postal Service's costing methodology, particularly in mail processing, places strong and unnecessary restrictions on the mail processing technology. It constrains the way that inputs are allowed to substitute for each other, in a way that is inconsistent with the observed substitution of automated for manual operations and later generation automation for earlier generation automation over the last decade. In addition, it only estimates one component of the relationship between cost and volume (the relationship between cost and cost drivers) while assuming away an equally important part of the relationship (the linkages between the cost drivers and volume). As a result, it is an inappropriate framework for the measurement of marginal cost.

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[64] A.T. Kearney Inc., Data Quality Study, Technical Report #1: Economic Analysis 73, April 16, 1999. Unfortunately, the "Summary Report" of the *Data Quality Study* ignored most of Technical Report #1 when it stated:

> The logic of the procedure used by the Postal Service to measure "unit volume-variable cost" (UVVC) is appropriate. In addition, it provides a reasonable estimate of marginal cost under the assumption that the operating procedures used by the Postal Service remain stable over the period for which marginal cost is to be estimated.

Id., Summary Report at 55.

[65] *Id.,* Technical Report #1 at 74-75.

A. The "Separability" Assumption Has Never Been Verified

In order for the Postal Service's costing methodology to produce marginal costs, it *must* be the case that cost pools are independent of each other. Postal Service witnesses acknowledge this.[66] Yet, as evidence contradicting the separability assumption accumulates, the Postal Service resists attempts to adjust attributable costs.

The possibility that the separability assumption is incorrect was implicitly raised in a paper commissioned by the OCA and presented at a conference in June 2002.[67] Stated simply, the Postal Service's costing methodology prohibits the level of volume (or the level of capital) in one cost pool from affecting the level of cost in another cost pool.[68] Worse, as the number of cost pools proliferates, the opportunity for "spillover effects" occurring and going undetected increases.[69]

Determining the existence, magnitude, and direction of spillover effects is an empirical problem. Yet the Postal Service continues to resist undertaking analyses that

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[66] *See, e.g.,* Tr. 5/1535, ll. 8-11 (Postal Service witness Bozzo).

[67] Mark J. Roberts, An Empirical Model of Labor Demand for Mail Sorting Operations, May 31, 2002. The conference was held June 20, 2002. See http://www.prc.gov/main.asp?Left=OCA.asp&Right=../OCA/OCAIndex.htm for the paper and a transcript of the conference.

[68] Stated mathematically, the Postal Service sets all cross-partial derivatives of cost in one pool with respect to volume or capital in any other pool equal to zero. This is a consequence of assuming additivity and separability of cost functions.

[69] If there are *n* cost pools, then creation of one more cost pool requires *n* more additivity assumptions. As the number of additivity assumptions grows, the probability that at least one will be violated also grows.

could identify and measure such effects. Witness Haldi has presented testimony showing how volume in one cost pool can affect cost in another pool.[70]

B. The "Proportionality" Assumption Has Never Been Verified

Several witnesses, in this and other cases, have attempted to show why it makes sense to assume that the relationship between a cost driver and the volumes of various classes is a constant. That is, a given piece volume always requires the same quantity of the cost driver in a given operation. This assumption of proportionality implies that the Postal Service uses a fixed-proportions production function—a form of production found mostly in textbooks.

For example, in a simplified model of production with one manual input and one automated input, the assumptions made by witness Bozzo imply that a mail processing plant needs a fixed number of units of the manual sorting input and fixed numbers of units of automated sorting inputs. This production function implies that there is no opportunity for substitution between the various inputs; they are always used in fixed proportions. This is not a realistic assumption to make. The trend over the last decade has been the substitution of automated operations for manual as well as the substitution of later generation automation (AFSM or DBCS) for earlier generations (FSM881 and FSM1000 or LSM and MPBCS). At the very minimum, this requires that the factors of proportionality vary over time and across plants with differences in the technologies in

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[70] Direct Testimony of Dr. John Haldi (VP-T-2), July 19, 2005.

place. But even this is a very restrictive assumption about how input substitution should be included in the production model.

The proportionality assumption places strong restrictions on the form of the production function for letter sorting, much stronger than the separability assumption. To be sure, this assumption does simplify the construction of marginal cost—but at too great a cost. It implies that the derivative of the driver with respect to volume is the factor of proportionality. This, in turn, is equivalent to assuming that the elasticities of the driver with respect to volume equal 1. Given this assumption, the marginal cost of changes in volume can be estimated without knowing the actual relationship between the cost driver and mail volume. However, it is not possible, given the Postal Service approach, to verify that the proportionality assumptions are appropriate. A more general model, such as the one developed in the Roberts paper, cited above, would estimate the relationship between volume and cost directly, making this restriction unnecessary.

V. THE COMMISSION SHOULD CONTINUE TO TREAT MAIL PROCESSING COSTS AS 100 PERCENT VOLUME VARIABLE

The Commission has not accepted the Postal Service's approach to estimating volume variability in mail processing in past cases. It should not accept it now. Not only is witness Bozzo's model of production overly restrictive, but he does not even use a proper measure of output of mail processing plants.

A. Witness Bozzo Has Not Estimated the Volume Variability of Mail Processing Costs

The model of production presented by witness Bozzo is a refinement of a basic model of labor demand that has been presented in rate cases since 1997. Unfortunately, the model of plant production that gives rise to the specific labor demand equations estimated in USPS-T-12 is never clearly spelled out. It is also complicated by the fact that the methodology used is both measuring marginal cost (implicitly) and allocating across rate classes of mail simultaneously. The assumptions made about the technology (cost drivers) and the assumptions made to allocate costs across rate classes (the distribution key) are so intertwined (USPS-T-12, section II.A.5) as to inhibit all but the most intrepid analyst.

The mail processing model used by witness Bozzo to estimate marginal cost makes two assumptions that are restrictive. The model disaggregates mail processing into separable stages and uses separate cost drivers, that are assumed to be proportional to volume, for each stage. These assumptions can provide some

simplification in the specification of the empirical labor demand equations, particularly when there are many inputs. But this simplification comes at the cost of mis-specifying the relationship between cost and mail volume. And, the number of inputs in mail sorting operations is fairly small. In letter sorting there are OCR, MPBCS, DBCS, and manual operations, while in flat sorting there are FSM881, FSM1000, AFSM, and manual. When the number of inputs is this small there is relatively little simplification provided by the separability assumption. Given the importance of quantifying the relationship between cost and mail volume as part of the postal rate setting process, it is important to avoid unnecessary restrictions and to justify the ones that are made.

1. The “separability” assumption is misleading

The basic idea underlying the Postal Service costing methodology is that mail processing consists of a number of distinct, independent steps that can be modeled and examined in isolation from the other processing steps in the plant (Tr. 5/1453-56). In addition, each processing step has a “cost driver” that is *unique to that operation*. Consider a simplified production process for letter sorting that depends on one manual labor input (M_L) and one automated operation, that itself depends on two inputs: labor (A_L) and capital (K_L). Witness Bozzo would assume that each sorting operation can be viewed as a stand-alone production process. In terms of a stylized model, this implies that capital and labor in automation can be aggregated into a distinct automation production step. Under this assumption, the production function for letter sorting can then be written as:

Assumption 1 (Separability): $L = L(M(M_L), A(A_L, K_L))$.

This implies that the production function for sorted letters (*L*) is separable into two aggregate inputs, a manual input *(M)* and an automation input *(A)*. Each of these aggregates is produced by combining a more disaggregated group of inputs that are specific to each operation. For example, the workhours and capital stock in the automated operation, A_L and K_L, are combined into the aggregate automation input *A*. This assumption about production restricts the substitution patterns among the inputs. Specifically, it implies that the marginal rate of substitution between labor and capital in automation is not affected by the amount of manual labor used. No Postal Service witness has shown this to be the case. In fact, no witness has shown an awareness that this is implied by the separability assumption.

This model implies that there are two layers of input substitution possible for the plant. In producing total output *L*, the plant can substitute between *M* and *A*, varying the mix of these aggregated manual and automated inputs. The plant can then substitute between the disaggregated inputs within each aggregate (for example, between A_L and K_L) to produce the desired level of the aggregate *(A).* The cost function associated with this production function has the form:

$$C = (C_M(WM_L, L), C_A(WA_L, K_L, L)).$$

This cost function has been divided into separate components, one for costs in the manual labor pool and one for costs in the automated labor pool. The manual labor cost pool will depend only on the level of output and the price of manual labor. The automated labor cost pool will depend on the level of output, price of automated labor, and the capital stock in the automated operation. But does this correspond to reality?

The Postal Service has never shown that separability actually applies to its production processes.

Finally, the labor demand equations for the two types of labor have the form:

workhours in automated operations: $A_L(WA_L, K_L, L)$

workhours in manual operations: $M_L(WM_L, L)$

where WM and WA are the wage rates for labor in manual and automated operations, respectively. The labor demand equation for manual hours does not depend on the level of capital in automation. If the production function is separable into distinct manual and automated steps, then the level of the capital stock determines the level of the labor in the automated operation, but not the level of manual labor. In general, if the production function is separable into multiple stages (*i.e.,* OCR, MPBCS, DBCS, and manual) then the labor demand in each stage is determined only by the level of plant output *L* and the capital stock *in the same stage*. For example, the capital stock in DBCS will determine the labor demand in the DBCS operation but not in any other operation. The labor demand equations under the separability assumption are different than the labor demand equations derived in a more general model. They are also more restrictive. In a general model, the capital stock in every sorting operation will enter as an argument in every labor demand equation, and that will reflect the more general pattern of input substitution allowed in such a model.[71]

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[71] An analogy that can help illustrate the implication of separability assumptions can be drawn from the production of a car. Suppose a car is composed of one engine, one body, and four tires. The production processes for engines, bodies, and tires are separable. This means, for example, that any change in factor prices, capital stocks, or technology for producing engines has no effect on the quantities of inputs used to make bodies or tires. In addition, the demand for labor in engine production depends only on the

The Postal Service methodology requires an additional set of assumptions. In each processing stage, there must be a unique "cost driver" that is related to the volume of mail but that is not the volume of mail. Rather, changes in the volume of mail lead to changes in the level of the driver, and this determines the labor use in each sorting operation. This cost driver is variously described as "an intermediate output" (USPS-T-12 at 19) or "value added" for the sorting operation (Tr. 5/1454).

While the USPS testimony never relates the cost driver to the form of the underlying production function, it appears that what they would like as the cost drivers for the manual and automated operations are simply the aggregate inputs *M* and *A* which are defined as part of the separability assumption on the production function. In order to reformulate the production model in terms of a set of cost drivers, the production process must be separable into stages that will correspond to the drivers. While separability may be appropriate in some production processes, the Postal Service has not explicitly identified, justified, or examined the implications of the separability assumptions that they make for mail processing.

2. The "proportionality" assumption is incorrect and unnecessary

The Postal Service's approach to estimating volume-variable costs in the Mail Processing operation raises two questions that the Service's witnesses have not yet addressed satisfactorily. Why are there so many cost pools, and why are piece

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factor prices of the other variable inputs in engine production, the capital stock in engine production, and the number of cars produced. The labor demand equations for these three stages of production can be modeled independently of any inputs used in the other stages. The Postal Service is not in the

handlings a cost driver? The answer to both questions is the same. Piece handlings in a narrowly defined sorting operation are proportional to piece volumes.

But being proportional to piece volumes should not be the sole criterion for choosing a cost driver. Granted, proportionality is a *necessary* condition for the Postal Service's costing methodology to produce marginal costs, but being proportional to piece volumes is nowhere near *sufficient.* It is also *necessary* that cost-driver data be available. But again, convenient availability of data is hardly *sufficient* reason for choosing a cost driver. Yet these appear to be the only reasons for creating so many cost pools and claiming that piece handlings are a measure of the output of a mail processing plant.

The Postal Service's costing methodology is intuitively attractive and understandable *so long as* one can view a cost driver as an intermediate output in a sequential production process.[72] Piece handlings, however, is not an intermediate output, as explained below in Section B. Cubic-foot-miles of transportation, however, is an excellent example of a cost driver. Transportation is valuable to the Postal Service because changing the physical location of mail pieces is a precondition to delivering them. A cubic-foot-mile of transportation between New York and Philadelphia puts mail pieces closer to their final delivery points. Not only that, the Service could sell its transportation capacity to someone else. In other words, a cubic-foot-mile of

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manufacturing industry. It is in the service industry. Whether separability actually applies to the Postal Service has never been established, and simply assuming it is unnecessary.

[72] Witness Bozzo equates the term "cost driver" with intermediate output. USPS-T-12 at 19, l. 4. See also Tr.5/1453-55.

transportation has objective value as both an input and as an output.[73] The Service's treatment of Transportation cost pools is intuitively understandable and economically sensible. But the treatment of Mail Processing is neither.

A general model of Mail Processing would use labor demand elasticities with respect to total volume of sorted pieces in order to calculate marginal cost. After all, the output of a mail processing plant *is* sorted pieces, so this is the output to use in measuring the labor demand elasticities. A general model does not rely on either separability or proportionality assumptions.

Witness Bozzo's model uses the elasticities with respect to cost drivers in each operation. The goal of witness Bozzo's model is to estimate these elasticities. The only reason that these elasticities can be used to measure the marginal cost of a sorted piece is because of the proportionality assumption. If the cost driver is proportional to piece volume, then, and only then, does the labor elasticity with respect to the cost driver equal the elasticity with respect to volume. Essentially, the proportionality assumption makes it possible to ignore the relationship between the volume of mail and the cost drivers when calculating marginal costs.

The cost of that assumption is an unrealistic restriction on the substitution among sorting stages in the plant. Witness Bozzo's empirical model does not attempt to estimate the production parameters that underlie the proportionality assumption. Since the goal of the model is to estimate marginal cost, it is not necessary to have estimates

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[73] Whether the Postal Service produces transportation capacity using its own vehicles and employees or contracts for it is irrelevant to this example. In principle, the Postal Service could produce all the transportation capacity it needed, and even sell some excess.

of those parameters, *so long as the proportionality assumption is imposed.* But this limits the usefulness of the empirical results as an overall description of mail processing technology. It is not possible to use the (not estimated) parameter estimates to learn about substitution between manual and automated inputs or between different generations of automated inputs. It is also not possible to learn about the relationship between the volume of mail in the plant and the levels of the cost drivers.

C. Witness Bozzo's Cost Drivers Are Not Intermediate Outputs

Witness Bozzo's method for measuring the intermediate output of a mail processing plant is not analogous to the transportation example. Worse, there is no reason (other than ready availability of data) to attempt to force the analysis of Mail Processing costs into the Transportation mold. The misguided effort to treat all postal operations like Transportation has produced some very peculiar results. Most important, piece handlings cannot be viewed as an intermediate output The true output of a plant is depth of sort.[74] This cannot be measured as or related to—directly or indirectly—an accumulation of piece handlings. Does the Postal Service pay bigger discounts for presorted mail if the mailer uses more piece handlings? Piece handlings *per se* have no value to the Postal Service.[75] What matters is sortation.

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[74] Depth of sort is defined below.

[75] Actually, the Postal Service could, in principle, sell piece handlings to a presorter. But doing so would be equivalent to renting the services of a piece of sorting equipment. Piece handlings is a measure of equipment utilization.

Piece handlings is a measure of effort—*i.e.,* of input—just like labor hours. The true difference between pieces in and pieces out of a plant (which, of course, is the same *number* of pieces) is a *quality* difference—the additional depth of sort achieved, not the number of handlings consumed. Depth of sort is a list of numbers, not a single number. For example, during a 24-hour period a plant might dispatch a million letters as follows: 250,000 to 3 digits, 100,000 to 5 digits, 150,000 to 9 digits, and 500,000 to DPS. This can be represented as [0, 250,000, 100,000, 150,000, 500,000], where it is understood that the first number is unsorted letters, the second number is letters sorted to 3 digits, etc.

But this list of numbers does not represent real output, because it almost certainly does not reflect how the letters were already sorted when they arrived at the plant. Only in the unlikely situation where the plant sorted nothing but collection mail would [0, 2.5, 1, 1.5, 5] (in hundred thousands) represent additional depth of sort or value added by the plant. Suppose the million pieces arrived at the plant looking like this: [4, 3, 2.5, 0, 0.5]. Then the additional depth of sort achieved by the plant can be thought of as the respective differences between the numbers in the two lists—*i.e.,* [(0-4), (2.5-3), (1-2.5), (1.5-0), (5-0.5)] = [-4, -0.5, -1.5, 1.5, 4.5]. This list of numbers says that the plant eliminated 400,000 unsorted letters, 50,000 3-digit letters, and 150,000 5-digit letters, while creating an additional 150,000 9-digit letters, and 450,000 DPS letters.

This list of numbers might be considered not fully informative. For example, it does not say where the DPS letters came from. Some of the DPS letters could have arrived as collection mail, some as 3-digit letters, and some as 5-digit letters. In order to

determine how much value the plant added, one might think it necessary to know how finely the plant sorted the arriving collection letters, 3-digit letters, and 5-digit letters. This would mean creating a list of numbers for *each* number in the arrival list. Thus, it might be the case that:

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4.0  =>  [0.0,  2.5,  0.2,  0.3,  1.0]
3.0  =>  [0.0,  0.0,  0.8,  0.2,  2.0]
2.5  =>  [0.0,  0.0,  0.0,  1.0,  1.5]
0.5  =>  [0.0,  0.0,  0.0,  0.0,  0.5]
_____________________________________

[0.0,  2.5,  1.0,  1.5,  5.0]
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It should be noted that there is an infinite number of possible ways to get from the example input to the example output. And we have not kept track of how many times a letter had to be sorted in order to get from, say, collection to DPS.

What this illustrates is that, when *measuring output*, it is the depth of sort, the difference between the sortation level of the arriving and destinating mail, that is important. How this sort is achieved, such as the number of piece handlings it took to sort it, should not be included in the measure of output. A higher number of piece handlings implies higher labor hours, which implies higher cost. But whether it takes three piece handlings or four piece handlings to convert a collection letter to a DPS letter does not alter the fact that a DPS letter is the same output no matter what collection of inputs produced it. And a list of outputs such as [0, 2.5, 1, 1.5, 5] is the same regardless of whether a plant required 30 piece handlings or 40 piece handlings to produce it. Yet witness Bozzo would count the 40 as higher output than the 30.

Suppose a delivery unit had to pay for the sorted mail it received from its local plant. Presumably, a delivery unit values depth of sort. After all, the more DPS mail

there is, the less there is to case. Would the unit be willing to pay the same for a given number of upstream piece handlings regardless of whether the pieces were in DPS order or in no order at all? And even if the delivery unit knew that all pieces were in DPS order, would it be willing to pay more for a dispatch that had used more piece handlings? The obvious answers to these questions establish that pieces handled is not an intermediate output like cubic-foot-miles. And if pieces handled is not an intermediate output, then what is the rationale for using it as a cost driver?

Witness Bozzo's so-called measure of output—total piece handlings/pieces fed—is actually an input. It measures the amount of effort required to produce a given output—essentially the same thing that labor hours measures. That is, the more piece handlings there are, the more labor hours there are. This is intuitively obvious to the casual observer of manual sorting. But it is also true for automated sorting. If a tray of letters requires two passes to be sorted, a clerk must feed it twice and a clerk must sweep it twice.

Treating piece handlings as an output leads to peculiar conclusions. If Plant A uses twice as many piece handlings as Plant B to produce a given depth of sort for a given list of pieces, such as [4, 3, 2.5, 0, 0.5], witness Bozzo's definition of output means that Plant A produced twice the output of Plant B. Yet the two plants started with the same number of pieces at the same depth of sort and ended with the same number of pieces at the same depth of sort. This logical contradiction invalidates witness Bozzo's use of piece handlings as a cost driver.

Other illogical examples can be created. Suppose that two plants each use three million piece handlings to sort one million letters. But Plant A produces an added depth

of sort of [-10, 4, 2, 3, 1] while Plant B produces [-10,1, 2, 3, 4]. The output of Plant B will require much less effort to finalize than that of Plant A. In other words, the output of B is greater (or more valuable to downstream facilities) than the output of A. Yet their outputs would be the same if one defines output as FHP or TPH/F.

Is it possible to measure or approximate output correctly? Perhaps. MODS contains both FHP and TPH/F volume data by operation by plant. One can think of FHP in an outgoing primary operation as mail that is unsorted when received at the plant. FHP in an incoming primary operation can be considered as having been sorted to 3 digits by another plant or by a presort mailer when received at the plant. FHP entering a DPS operation would most likely have been presorted to 5 digits. One can extract a fairly accurate input list from the FHP counts.

The output list is another story. One can reasonably assume that all 5-digit FHP (that is, first handling pieces entering DPS) become completely sorted to final destination in the plant. It doesn't matter whether the plant dispatches these pieces sorted to box section, unique 5s or 9s, or sorted to individual carrier delivery points. No other plant needs to touch them. Unfortunately, this is about as far as one can go with MODS data in identifying depth of sort for mail dispatched from a plant. If econometric analysis of mail processing costs is to be used at the Commission, the Postal Service will need to collect better data on plant output.

Overall, the Postal Service approach, which treats each processing step as producing a distinct output which is measured as TPF, leads to anomalies when trying to interpret the marginal cost of an additional letter, compare productivity across plants, or understand the effect of differences in capital among plants.

Even though TPF does not satisfy the requirements of a cost driver, a useful question to examine is: What information does TPF provide about the sorting technology? Or, how can information on TPF in each sorting operation be integrated into a coherent model of mail sorting? In his testimony, witness Bozzo (USPS-T-12 at 14) shows the relationship between TPF and the number of machine hours on the sorting equipment as:

Runtime = TPF / Throughput rate.

The throughput rate is a measure of the operating speed of a machine. Runtime is a measure of the number of machine hours required to process a given level of TPF on a piece of equipment.

This measure of machine hours used in the processing operation is exactly analogous to the number of workhours used in the operation. Each is a measure of the flow of services used in the operation—in one case from the capital stock and in the other case from the employees. Both are measures of inputs used in the operation. If the throughput rate is constant for a given type of technology used in a sorting operation, then the Runtime definition above shows that TPF in a sorting operation is proportional to the machine hours in the sorting operation. In other words, *TPF in a sorting operation is a measure of the capital input used in that operation.*

With this interpretation, we can see a second reason why TPF is not an acceptable measure of the cost driver in a sorting operation. It is not an independent measure of output of the sorting stage, but rather a measure of one of the *inputs* used to produce sorted letters in that operating stage.

It is now possible to interpret the output variabilities estimated by witness Bozzo. They are partial correlations (holding capital stocks and relative wages fixed) between the two *inputs*, labor hours and machine hours, in each sorting operation. These are, of course, related. A plant with more hours of use of its capital equipment will also have more hours of labor use. Witness Bozzo's variabilities are not, however, correlations between labor hours in the sorting operation and a measure of "output" in the sorting operation. The estimate of variability for the BCS/DBCS operation (USPS-T-12, Table 5), is 0.85. This says that an increase in the number of machine hours by one percent is associated with a 0.85-percent increase in the number of workhours. This implies something about the co-movement of the capital and labor services in the BCS operation, but it does not provide *any* information on the change in sorting output that would correspond to this input change. It is not a measure of volume variability. While not a satisfactory cost driver, TPF is a measure of capital input in a sorting operation and it should be possible to extend the production model to recognize the demand for capital inputs as well as labor inputs in production.

VI. THE COMMISSION SHOULD REJECT THE NEW CARRIER STREET-TIME STUDY

A. The City Carrier Street Time Study Has an Inauspicious History

The Postal Service makes a formal submission in this proceeding of a City Carrier Street Time Study (CCSTS) that was first presented pursuant to a recent revision to the Commission's Periodic Reporting Rule No. 102. The purpose of the rule is to have the Postal Service "provide the basic datasets that it uses to estimate unit product costs, and identify any new estimating technique it applies to those data to derive the unit cost estimates in the CRA."[76] The Commission found that having this information filed each year, rather than waiting for the Postal Service to provide it in a general rate case, should produce the following benefits:

- Litigant familiarity with new studies going into a rate case, which would lead to a reduction in discovery and shorter hearings.
- Faster evaluation of experiments and NSAs.
- Ability to evaluate costs, volumes, and revenues between rate cases.
- Increased ability of the Commission to initiate classification proceedings when cost shifts are observed.
- Increased ability of litigants to prepare alternative analyses that could be submitted in rate cases.

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[76] Order No. 1386, "Final Rule on Periodic Reporting Requirements," Docket No. RM2003-3, November 3, 2003, at 2-3.

Professor Michael Bradley made an oral presentation with Power Point slides on December 3, 2003. On May 25, 2004, the Postal Service filed some of the documentation and data from the study that were used to produce City Carrier delivery costs for the 2003 Cost and Revenue Analysis (CRA). A letter from the Postal Service's Chief Counsel, Ratemaking, Daniel Foucheaux, accompanied the materials. The letter contained two notable statements. The first was that the Postal Service had made an offer to provide background materials to the Commission and other parties expressing interest. The second was that the Postal Service had a "preference" to serve as the source of such materials; it requested that materials not be placed on the Internet or distributed publicly.

On June 22, 2004, the Secretary of the Commission, Steven Williams, wrote to Mr. Foucheaux that the Postal Service had not yet complied fully with the new periodic reporting requirements. He requested the balance of the materials still outstanding. Mr. Williams also explained that the Commission could not agree to the Postal Service's conditions of withholding the materials from the public, as this would undermine the spirit and intended operation of the new reporting requirements.

On September 8, 2004, the Postal Service's General Counsel, Mary Anne Gibbons, wrote to Mr. Williams that the Postal Service would not provide the balance of the materials requested because it was following "good business practice" and, implicitly, that the Commission lacked the authority to require the Postal Service to furnish, outside of a rate case, information that the Postal Service considered "commercially sensitive." The Postal Service objected to the conduct of an "independent study of postal cost behavior" and "indiscriminate[ ]" placement of the

materials on the Internet. Ms. Gibbons also noted that no one had taken up the Postal Service's offer of February 2004 to access the disputed materials in a non-public manner.

On December 2, 2004, OCA Director, Shelley Dreifuss, transmitted a request to Mr. Foucheaux to take advantage of the Postal Service's offer to provide CCSTS materials confidentially. Ms. Dreifuss made "an unqualified commitment not to post any of the information on the Commission's website or to disseminate it publicly via any other medium."

Mr. Foucheaux replied to the OCA letter on January 2, 2005, refusing OCA's request, and stating that OCA had gone beyond the requirements of the newly revised reporting rule. In an apparent reversal of its earlier position, Mr. Foucheaux stated that the Postal Service only intended to provide detailed information on new cost studies during formal proceedings under 39 U.S.C. §3622. Without access to much of the foundational material, OCA entered the current rate case with only a superficial acquaintance with the new CCSTS. It is significant that Mr. Foucheaux represented that:

> The Postal Service is confident that the documentation it will provide in support of upcoming rate cases will be sufficiently detailed and accessible to enable the OCA and all other interested parties to quickly come to speed and participate fully and meaningfully in future proceedings. We look forward to working cooperatively with the OCA in such proceedings.

That promise proved to be an empty one after the Postal Service went into litigation high gear. In response to an OCA motion to compel the production of Delivery Operations Information System (DOIS) data for OCA's alternative econometric analysis

of the volume variability of City Carrier delivery costs, the Postal Service complained that providing data of this type to another party would inhibit its ability to defend its own model:[77]

> [A]t the same time the Postal Service's technical staff is diligently working to litigate the case in defense of its own analysis, responding to legitimate inquiries from other parties and the Commission, its limited resources would be drained trying to assist the OCA in its struggles to come up with a different approach. The Postal Service, like all parties, has a due process right to be able to litigate its case fully and fairly. Burdens placed on the Postal Service which interfere with its ability to so litigate can amount to a violation of its due process rights.

In fact, the Postal Service's general philosophy appears to be to deny due process to any entity but itself. In Comments filed during the proposed rulemaking to amend Periodic Reporting Rule 102,[78] the Postal Service argued:

> [T]he thrust of the proposed rules, as well as the comments by the Commission's staff during the technical conference, demonstrate that one of the primary motives of the proposed amendments is to take the pressure off the ten-month limit on rate proceedings by permitting premature exposure of the basis for proposed changes to create a "head start" on analyzing and formulating responses to the Postal Service's proposals. That determination directly conflicts with the Postal Service's determination that premature disclosure could compromise its position as a litigant.

The combined effect of the Postal Service's pre- and post-R2005-1 actions was to deny access to the City Carrier data prior to the filing of the rate case, and to continue to deny access during the rate case on the ground that release of the details and operation of new models would undermine the Postal Service's distinct litigation

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[77] "Response of the United States Postal Service in Opposition to the OCA's Motion to Compel Regarding OCA/USPS-74, 76 – [77]. 100(a) and 101," June 22, 2005, at 6 – 7.

[78] "Substantive Comments of the United States Postal Service," Docket No. RM2003-3, July 2, 2003, at 35 – 36.

advantage in a rate case. This philosophy leaves no opportunity for other litigants ever to develop alternative models that they believe satisfy the goals of the PRA better than the Postal Service's model. Fortunately, the Presiding Officer recognized the dilemma that the Postal Service wished to create for other litigants:[79]

> The moral that the Postal Service seems to draw from . . . unpleasant realities is that where hearing time and staffing resources are scarce—as they always are in an omnibus rate case—they should be devoted to its cost studies, based on its preferred datasets, because only it has had ample time to develop them carefully and thoroughly in the interim years between rate cases. The Postal Service argues as though a participant attempting to duplicate this feat within the confines of an omnibus rate case should be regarded as either naïve or obstructionist. It suggests that the OCA's day in court should come at some point down the road, presumably in a subsequent omnibus rate case. What the Postal Service leaves unanswered, is how the OCA or any other participant who wants to develop an alternative study based on an alternative dataset could ever get its day in court, under the restrictions that the Postal Service would have me impose.
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> The Postal Service is the source of virtually all data that are relevant to postal ratemaking. It has recently made it clear that it does not believe that it has a duty, outside of omnibus rate cases, to give the outside world access to any cost database—including those that it routinely assembles and relies on to produce its own costing analyses. . . . [P]articipants would be effectively barred from ever basing a study on a database that the Postal Service had not already compiled to serve its own ratemaking objectives and provided in a prior rate case.
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> If the Postal Service will not provide access to cost databases between rate cases, and cannot assemble alternative databases of "rate case quality" in time for participants to use while a rate case is pending, it effectively prevents the use of any alternative database in postal

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[79] P.O. Ruling No. 46, "Presiding Officer's Ruling Granting, in Part, Office of the Consumer Advocate Motion to Compel Responses to Interrogatories OCA/USPS-74, 76-77, 100(A), and 101," issued July 8, 2005, at 12 – 14, *inter alia*.

> ratemaking. Under the conditions that the Postal Service would have me impose, participants, including the OCA, could never exercise their due process right to present alternative cost analyses that employ alternative datasets. In my view, this conflicts with section 3624 of the Act. Section 3624 specifically requires the Commission to afford users of the mails and the OCA the right to a hearing on the record that satisfies sections 556 and 557 of the Administrative Procedures Act. Inherent in that right is a right to submit alternative cost analyses based on databases other than those that the Postal Service has itself endorsed. This requires that a path be made available by which a participant has a realistic chance to present an alternative cost analysis based on data other than those that the Postal Service has specifically endorsed.

In Ruling No. 46, the Presiding Officer directed the Postal Service to furnish "data covering two-week periods from 14 quarters, going back several years," from the Postal Service's mainframe DOIS database. These data were filed as LR K-152, on September 22, 2005. OCA is charged with editing and auditing the data, but "the Postal Service should provide reasonable assistance, including participation in technical conferences, if the OCA identifies a need for guidance."[80]

D. The Failings of the CCSTS Make It Unusable for Ratemaking

1. General description of the CCSTS

The Postal Service implemented a new data collection effort that spanned 12 days at the end of May 2002, i.e., from Saturday, May 18, 2002, through Friday, May 31, 2002 (although a holiday falling within that period meant that data could, at most, be gathered for 11 days). Some of the ZIP codes participating in the study were unable to

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[80] Id. at 11 – 12.

collect data during the planned interval and collected it in June 2002 instead.[81] The original plan was to collect data for 12 days, but the Memorial Day holiday (which was not a delivery day) prevented this.[82] The holiday interruption apparently caused confusion and inconsistent reporting for some of the ZIP codes.[83] Several of the routes selected for the study provided data for fewer than 11 days.[84]

CCSTS utilizes a probability sample of 167 ZIP codes that include city carrier routes. USPS-T-16 at 8. The ZIP codes were divided into 3 strata, according to number of city letter routes within the ZIP code (Id. at 9 – 10):

- ZIP codes with 1 - 10 city letter routes
- ZIP codes with 11 – 60 city letter routes
- ZIP codes with 61 or more city letter routes

The initial sample design called for 221 ZIP codes, but was reduced to 167 ZIP codes to save money. (Id. at 11). The coefficient of variation increased “slightly” as a result of the decision to reduce the size of the sample. (Id.) The 60+ ZIP code stratum (incongruously called a “certainty” stratum) was reduced from 48 ZIP codes to 12 ZIP codes, and then reduced again to 10 ZIP codes, in order to save money and not inconvenience offices with a common finance number. (Id. at 12 – 13). The remainder

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81 Tr. 6/2093 (response to interrogatory NAA/USPS-T14-1).

82 Id.

83 Id. at 2166 (response to interrogatory OCA/USPS-T14-30).

84 Id.

of the sample was 128 ZIP codes with 11 – 60 city letter routes and 29 ZIP codes with 1 – 10 city letter routes. According to witness Stevens, the final dataset included data from 3,668 routes for 161 ZIP codes. USPS-T-15 at 3. OCA estimates that the number of routes contributing to the database is 3,361. The real number is uncertain since it depends on whether one is speaking of intended data collection, actual data collection, or collected data that could actually be used.

The method of recording time spent on delivery activities on the street was to have carriers self-report these activities by means of scanners (Mobile Data Collection Devices or MDCDs). USPS-T-30 at 5 and USPS-16 at 14. Volume data for 137 ZIP codes came from DOIS and DSIS (called, variously, Delivery "Service" Information System, USPS-T-30 at 6; or Delivery "Support" Information System, USPS-T-15 at 21) reports, while 24 ZIP codes used other "forms." USPS-15 at 3.

The Postal Service, untroubled by the very brief time period for collecting data, turned over the data to witness Bradley to use in his econometric analysis.[85] In fact, based on a surreal view that the 2-week sample is representative of seasonal effects and yearly variations, witness Bradley states that: "The end of May/beginning June of time period was selected because it is characterized by neither seasonal volume peaks nor seasonal volume troughs. In that sense it is thought to be representative." Of course, this defies all logic because that period is only representative of a non-peak, non-trough time of year. The Postal Service has not offered even a shred of proof that

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[85] Tr. 6/2156 (response to interrogatory OCA/USPS-T14-16).

any volume variability that is produced by peak or trough volume patterns can be captured by such a limited data collection time frame.

In witness Bradley's equations, cost is measured in terms of delivery time, i.e., the amount of time required (1) to deliver 6 types of mail (letters, flats, sequenced mail, small parcels, large parcels, and accountables) and (2) to collect mail. These 7 possibilities are divided between 2 equations. His definition of the volume variability of delivery costs is "the response in delivery time to a sustained change in volume." USPS-T-14 at 26.

Witness Bradley specifies 2 equations: (1) a "regular delivery equation" that models the volume variability of letters, flats, sequenced mail, collection mail, and "small parcels," and (2) a "large" parcel/accountable equation that estimates the volume variability of items too large to fit into a recipient's mail receptacle and accountable items that require interaction with the customer (i.e., they cannot be left in the mail receptacle, either). USPS-T-14 at 29 – 30.

Commissioner Goldway questioned witness Stevens about the definition of a "small" parcel.[86] She pointed out that the CCSTS definition of "large" parcels likely captured flats that could not fit into a small mail receptacle (such as in an apartment building). Witness Stevens defended the Postal Service's actions, stating that the distribution keys would take care of the problem. They most assuredly do not, as this is an estimation issue. The carrier time for delivering flats (too big to fit into small apartment mail receptacles) to the customer's door would only be associated with the

"large" parcel cost pool, not the flats pool. Similarly, the regular delivery equation would fail to capture this flat-caused cost that arises in the small-receptacle situations. The time to deliver flats would be underestimated because the assumption would be made that the variable time of flats only occurred when flats were delivered directly into a mail receptacle (thereby avoiding a time-consuming trip to the recipient's door). The causation for the time-consuming trip would be assumed to have been associated only with large parcel delivery.

Professor Bradley estimates an unrestricted (with cross products), quadratic equation, as well as a restricted (without cross products) quadratic equation. Volume variability is computed from the data and the regressors in the equations.

He reports the following variabilities for the regular delivery equation (restricted quadratic, which he prefers) (USPS-T-14 at 38 – 39) –

Letters:	22.28 percent
Flats:	7.12 percent
Sequenced Mail:	1.29 percent
Collection Mail:	8.82 percent
Small Parcels:	1.58 percent

He reports the following variabilities for the large parcel/accountable delivery equation (USPS-T-14 at 43) –

Large Parcels:	28.5 percent
Accountables:	25 percent

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[86] Tr. 6/2034 – 2038.

He also provides marginal delivery times for the 2 equations[87] –

Regular delivery, restricted quadratic

Letters:	1.393
Flats:	1.359
Sequenced Mail:	0.824
Collection Mail:	3.995
Small Parcels:	9.557

Parcel/Accountable Delivery

Large Parcels:	37.796
Accountables:	80.564

2. The chief failing of the CCSTS is the inadequacy of the database.

First, the database is missing some potentially important explanatory variables, such as length of route, number of bundles of sequenced mail, a failure to distinguish sequenced flats from sequenced letters,[88] and characteristics of individual ZIP codes.

Second, the database contains only 11 days of data, instead of panel data covering approximately the period of time over which rates will be in effect. Lack of these data prevents the analysis of route and network optimization under recurring

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87 Tr. 6/2106 (response to interrogatory OCA/USPS-T14-5).

88 Tr. 6/2007.

cyclical and seasonal conditions. P.O. Ruling No. R2005-1/46[89] suggests that the limited time period triggers a question whether route realignment, an essential feature of street time variability, can be captured by the CCSTS database:

> Route realignment is the essential feature of carrier street time variability, according to Postal Service witness Bradley. USPS-T-14 at 26. The two-week period to which the Bradley study is confined, however, does not capture it. . . . An argument can be made that the data that the OCA seeks, because it has a much longer time dimension, is more likely to capture route realignment effects. For this reason, the OCA's proposal may add significantly to the analysis of carrier street time variability.

Third, the regression equations are seriously flawed. In particular, several of the regressors are insignificant, but are used anyway to compute volume variabilities and other regressors. Some of these variabilities and regressors exhibit incorrect signs – a strong indication of a failed analytical effort. There is a distinct possibility that the multicollinearity of the data – one of the primary problems of the analysis – could be minimized by the collection and incorporation of panel data.

Unfortunately, the CCSTS study also has significant methodological and data problems, leaving the Commission in the unfortunate position that it cannot use the study, as presently designed, for rate making purposes. By default, the Commission must continue to rely on the City Carrier variability analysis, whose analytical roots date back to Docket No. R87-1.

The number of routes for which data were gathered in a ZIP Code varied from day to day. Route level data eventually were aggregated to ZIP Code level, and the

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[89] At 9.

subsequent analysis was performed at the ZIP Code, rather than the route, level. Accordingly, the regressions developed by witness Bradley reflect fluctuations in data due to the inclusion/exclusion of routes on various days.

Witness Bradley had to rule out the use of Fixed Effects estimators since they depend on information concerning day-to-day fluctuations. An 11-day set of data is far too limited in duration for meaningful Fixed Effects analysis. Also, as noted above, the composition of routes in a ZIP Code (in the CCSTS reporting) varied from day to day and would suggest volume variability that has nothing to do with marginal costs, but would merely reflect *variability in the data collection effort*. It comes as no surprise that the Fixed Effects approach, presented as one of the possible alternatives in witness Bradley's testimony, could yield no useful results.

The too-brief time frame limits the analysis, essentially, only to cross sectional examination.[90] The limited duration of data collection would capture *daily* variations in mail count but not *monthly, quarterly, seasonal, or annual* changes in mail volumes. This demonstrates that the Postal Service has not satisfied its objective – to measure volume variability in terms of the change in costs with respect to a small sustained change in the volume of mail. Over a two-week time frame there would be virtually no sustained change in mail volume at a specific location. Sustained changes occur over a period of months or years.

During oral cross-examination, witness Stevens conceded that there are many types of seasonal variations that are missed altogether by the extremely limited time

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[90] For some ZIP codes, the collection time period lagged beyond two weeks.

span of CCSTS.[91] When asked whether "there is seasonality in the shapes of mail the Postal Service has to deliver and the total volumes that the Postal Service has to deliver over the course of a year" and whether it would be reflected in the study, he answered, "No. That was not my goal." He speculated that seasonality would "come[ ] out of the CCS in terms of distribution fees," but he does not explain how CCS could fix the problem. In fact, the distribution keys will not fix the problem. Data collected in May and June cannot possibly substitute for data collected during other seasons if the other seasons exhibit important differences in volumes by shape or other class-related characteristics. City carrier time may well be expended differently under those differing conditions.

Other Postal Service witnesses in the instant proceeding have identified such seasonal trends.[92] For example, the unusually large number of parcels (and their comprising an uncharacteristically large proportion of mail) during the winter holiday season is not reflected in the CCSTS database. This may well have an important impact on time spent by city carriers delivering them. Seasonal differences span the full range of postal classes and mail shapes, e.g., First-Class letters, Priority Mail, Express Mail, Periodicals, Standard Mail, Non-profit Mail, and several special services. In addition, there are annual trends, such as that found in an election year, that are of concern to postal witness Bernstein. This annual trend is also missed in the too-short CCSTS data collection.

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91 Tr. 6/2009 – 2019.

92 Relevant citations to witness Bernstein's testimony are given at Tr. 6/2013 – 14.

Seasonal variations in mail have an impact on the need for overtime by city carriers and on the use of casual and temporary employees. Fluctuation in the use of flexible, casual, and temporary labor may have an impact on productivity, which in turn may affect volume-driven variability. Postal revenues exhibit seasonal variation, too. These variations may suggest, not only a difference in the number of pieces of mail delivered by class, but also differing characteristics of the pieces (for example, the distance between point of origin and point of destination, or weight) that may affect city carrier delivery time. Such variations would be missed in the CCSTS.

In the CCSTS, mail volume does vary substantially among locations (the study having encompassed small, medium, and large ZIP codes). The method of analysis chosen by Professor Bradley computes volume variability based on data variations across ZIP codes. Because witness Bradley fails to account for different demographic and service characteristics among the ZIP codes studied, the resulting variabilities are a function, not only of differences in mail volumes among ZIP codes, but also the non-volume-related ZIP code characteristics. The variabilities he reports are a muddle of factors that affect marginal costs and those that do not. They are distinctly unsuited to satisfying the goal established by Congress to attribute to the classes and services the costs that *they* cause, as contrasted with cost-influencing factors having nothing to do with mail.

It is well established that there are important demographic variations among ZIP codes. These could mask the volume/cost interaction. ZIP codes vary substantially due to differences in demographics, economics, psychographics, and physical characteristics. Such information is available for most ZIP codes, from sources such as

government censuses and data collected by a variety of commercial vendors. Market researchers frequently use this type of information in analyzing economic activity in a ZIP code or other geographic area. These ZIP Code characteristics may contribute to the delivery costs of mail. Witness Bradley accounted for one of the characteristics of the delivery area by his use of data on square miles in a ZIP Code; but inclusion of only this variable was insufficient. Further analysis of ZIP Code characteristics is needed.[93]

The database is inadequate in its treatment of Sequenced Mail. Sequenced Mail can be letter-shaped or flat-shaped, but the data collected on Sequenced Mail made no distinction by shape. If shape is a relevant variable for loading and delivering Sequenced Mail, then an important variable has been omitted from the database. In addition, under the three bundle rule,[94] in certain circumstances Sequenced Mail was cased,[95] put into the DPS mail stream,[96] or collated[97], thereby altering the sample size of Sequenced Mail from the way it started out. Another fact that must be considered is that the three bundle rule does not apply to motorized routes; such routes can have

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[93] In response to interrogatory OCA/USPS-T15-10 (Tr. 6/1927), the Postal Service provided under seal a cross reference between actual and coded ZIP Codes; assuming Postal Service cooperation, the decryption can be used in future analyses of the marginal costs of city carriers.

[94] In the case of non-motorized routes, carriers do not work from more than three bundles, thereby requiring that additional bundles be combined with other mail in one way or another.

[95] Witness Lewis, Tr. 11/ 5950.

[96] Id. at 5973.

[97] Id. at 5976.

multiple bundles.[98] The Postal Service should turn its attention to collecting data on the various ways that Sequenced Mail may be handled.

In the case of a Detached Address Label (DAL) accompanying an unaddressed flat, it appears that the DAL may have been counted as a letter, even though it was part of the Sequenced Mail delivery. In addressing Sequenced Mail bundles, witness Lewis indicated, in response to a question from Commissioner Hammond, that for some routes, a carrier might handle part of a mailing using in-office handling, while other parts of the mailing might be delivered as a fourth bundle.[99] Accordingly, data on Sequenced Mail may not be random, comprehensive, complete, or representative.

It is probable that the time required for the delivery of Sequenced Mail varies with the number of sets of that must be delivered. As indicated in interrogatory VP/USPS-T14-10,[100]

> [T]he cost of handling sequenced mail on the street may be different from the cost of handling other types of mail on the street. This may (be) because the nature of fingering and loading sequenced mail is different or because sequence mail has a different propensity to cause accesses.

One would expect the time involved for multiple fingerings of multiple sets of Sequenced Mail to be different from the time for the fingering of the same amount of mail in a single set. Thus, the addition of an extra set could increase the complexity of

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98 Id. at 5995-97.

99 Id. at 6024-6026.

100 Tr. 6/2247.

work and raise the marginal time for all sets. In conclusion, there remain several characteristics of Sequenced Mail that still need to be addressed.

3. The CCSTS database lacks panel data, which the Commission and the Postal Service have agreed are essential to a meaningful analysis of cost variability.

The Postal Service has repeatedly indicated that changes in the delivery network through the growth of routes are a major cost driver.[101] Witness Bradley's SAS generated equations show that the number of delivery points is a cost driver. The Postal Service has indicated that the approach for the minimization of delivery costs is through the management of route size and the adjustment of routes to provide work in eight hour segments. Neither of these accommodations can be modeled with two weeks of data. The analysis of route size and adjustments on a cross sectional basis is not the same as the analysis of size and adjustments over time.

The Commission has expressed a preference for analyses based on both time series and cross sectional data. In PRC Op. R90-1, para. 3019, the Commission stated: "We repeat our long-standing exhortation that the Postal Service take the initiative in gathering panel data on [carrier street time] costs;" and that the panel data should "combine cross-sectional volume data with time series data from sampled stops." The data sample that has been used in this proceeding fails to conform to the Commission's benchmark it contains almost no time series data.

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[101] *See, for example*, "Network Growth" on page 33 of the USPS *2004 Annual Report*.

Witness Bradley himself, in previous testimony on mail processing costs, emphasized the advantages of using panel data:[102]

> [A] panel data set provides many more observations than either a cross-sectional data set or at (sic) time series data set. For example, in the instant analysis, a cross-sectional data set for a MODS operation could have as many as 300 observations, one for each site. Alternatively, a time series data set could have as many as 117 observations, one for each of the accounting periods in the fiscal years for which data are available. In contrast, a panel data set, by making use of both of these dimensions could have as many as 35,000 observations. The availability of substantially more data both increases the precision of the estimated parameters and permits the construction of more sophisticated econometric models.

He also explained,

> A second advantage of panel data is that it alleviates the problem of multicollinearity. Because the explanatory variables vary over two dimensions in a panel, they are less likely to be highly correlated with one another.
>
> Perhaps the most important advantage of panel data, however, is its ability to mitigate or eliminate estimation bias. Besides the advantage that panel data allows us to construct and test more complicated behavioral models than purely cross-sectional or time-series data, the use of panel data also provides a means of resolving or reducing the magnitude of a key econometric problem that often arises in empirical studies, namely, the often-heard assertion that the real reason one finds (or does not find) certain effects is because of omitted (mismeasured, not observed) variables that are correlated with explanatory variables. By utilizing information on both the intertemporal dynamics and the individuality of the entities being investigated, one is better able to control in a more natural way for the effects of missing or unobserved variables.

For a City Carrier Cost study to be meaningful, the underlying database needs to span a time frame adequate for the analysis of changes in the level of cost drivers.

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[102] Direct Testimony of Michael D. Bradley, Docket No. R97-1, USPS-T-14, at 23-24.

These include mail volume, seasonal fluctuations, and delivery points, among others. In noting the importance of delivery points, the Postal Service has indicated,[103]

> Over the last several years . . . the volume of First-Class Mail has declined while the number of delivery points in our network has continued to increase. . . .
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> * * * * *
>
> Each year, we add between 1.6 million and 1.9 million delivery points to our network. From 2000 through 2004, the number of delivery points we serve has grown by 6.4 million. . . .
>
> * * * * *
>
> We expect delivery point growth to continue for the indefinite future as a result of population growth. . . . The Postal Service has also noted the importance of changes in the number of delivery points in driving postal costs.

Accordingly, in order to capture the effects of changes in relevant cost drivers, it is necessary to obtain data over a multiyear time period. Considering, for example, the length of time periods used in the gathering of data for mail processing, it appears that a four year time frame, covering 2002 to the present, would be appropriate. Such a time frame would allow for the analysis of three annual changes in the number of delivery points, as well as changes in the quantity and mix of mail. It would provide a number of cyclical time periods for analysis, and would provide data over a major part of an economic business cycle.

In a baffling break with his Docket No. R97-1 testimony, witness Bradley defends the use of a two-week database, noting that the Commission has previously accepted

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[103] United States Postal Service, *2004 Annual Report*, at 33.

variability studies that are cross sectional—purchased highway transportation, load time variability, the CAT/FAT study, and a study on Vehicle Service Drivers. He states that[104]

> because of its inherently cross-sectional nature, the CCSTS contains a very wide range of variations in volumes and carrier street times, and these variations include all of the responses of the Postal Service to sustained volume changes, including factors like route adjustments. This is one of the well-known strengths of cross sectional data.

Witness Bradley is wrong. There is no substantiation that each route or ZIP code in the CCSTS had adjusted to volume changes or was in the process of adjusting to volume changes. Furthermore, there was no measurement indicating the degree of adjustment within a route to volume changes, nor whether additional changes and adjustments were likely. More importantly, cross sectional data reflect the differences between large and small ZIP codes, including differences in non-volume-related characteristics.

Witness Bradley uses 1545 ZIP code/date observations in his analysis. Assuming that one had available a year's worth of data based on biweekly observations for the ZIP Code sites used in the study, one would have 40,170 observations (26*1545), which would become 160,680 observations over a four-year time period (4*40,170).

Witnesses Kelley and Stevens describe the production of the study databases. A substantial amount of effort was expended, including specification of the required sample size, management and training efforts, and database creation. Clearly, if one

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[104] Response of Postal Service Witness Bradley to Oral Question From the Bench, July 15, 2005, Docket No. R2005-1.

were to advocate the gathering of data through a field survey to obtain observations over the proposed four-year time frame, the Postal Service would face a much more expensive task. However, obtaining additional data can be achieved at a relatively small additional expense. The Delivery Operations Information System (DOIS) apparently collects (and has archived) much of the data. Hence the data is available on an historical basis.

DOIS was being activated at the same time that the study data were being gathered by the Postal Service in the CCSTS data collection effort. Deployment of DOIS began in May of 2001. According to witness Lewis,[105] there are now 7,939 delivery units that use DOIS. Headquarters can generate unit level reports, data on hours worked, volume workload, and route and carrier performance statistics. The Managed Service Point application in DOIS, in conjunction with other information gathered, provides much of the type of scanned data that was gathered in the database and used by the Postal Service in this case.[106]

Accordingly, the OCA recommends that, if the Postal Service intends to continue with the revision of its City Carrier analysis, the City Carrier study should utilize all relevant DOIS data. The database is apparently based on contemporaneous data collection and gathers substantially identical data to that used by witness Bradley. DOIS may also contain other data that are relevant but were not gathered in the data collection effort. It should be added that the use of DOIS for the purpose of generating

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105 His response to interrogatory OCA/USPS-T30-1 (Tr. 6/2338).

106 *See* witness Lewis' response to interrogatory OCA/USPS-T30-4 (Tr. 6/2346).

a database suitable for a City Carrier study should not present too formidable a programming problem. The Postal Service has just complied with P.O. Ruling No. 46 and has provided DOIS data in LR-K-152. This tends to show the feasibility of using DOIS data stored and maintained over a period of several years.

4. Witness Bradley's analysis suffers from multicollinearity and other data problems.

Witness Bradley develops both unrestricted and restricted quadratic equations[107] for delivery time as a function of numbers of pieces of mail and other independent variables and the independent variables squared. An unrestricted quadratic equation includes the cross products between the independent variables; a restricted equation eliminates cross products in the estimating procedure. The following independent variables are considered:

let: number of letter shaped pieces;
cf: number of flats;
seq: number of pieces of sequenced mail;
cv: collection volume of mail collected by the carrier during deliveries;
spr: number of small packages;
dp: number of delivery points;
dens: number of delivery points per square mile.

In addition to the standard criteria for the evaluation of econometric equations, the following criteria are relevant to the current study:

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[107] He doe not use the translog form because of the number of variables with zero values. Witness Bradley chose to use a pooled rather than Fixed Effects estimation procedure. However, he subsequently furnished Fixed Effects estimators. In USPS-T-14, at 45, he indicates that he prefers the pooled model results to the Fixed Effects results. As discussed above, the daily rearrangement of loads between routes and short time frame prevents meaningful Fixed Effects estimators. However, the

- On an *a priori* basis the signs of the mail variables should be positive: a negative sign would indicate that additional mail required less delivery time, a meaningless conclusion.

- If a t value is insignificant for a regressor, then the subsequent use of the regressor in computing volume variability involves the use of a statistically meaningless variable to reach a conclusion.

- Signs for regressors that do not make sense on an *a priori* basis will indicate that an equation is not useful in estimating volume variability.

- VIF measures over 10 indicate a multicollinearity problem.

- For an unrestricted quadratic, insignificant t values for the cross products may indicate a problem. Possibly the wrong form of equation is being used, or there may be a multicollinearity problem, or the variable may be insignificant.

- The equations of delivery time as a function of independent variables can be used to generate estimates of marginal cost (change in amount of time to deliver mail with respect to change in amounts of various types of mail). Marginal cost estimates which appear to be meaningless will cast doubt on the reliability of the equations.

A review of the witness Bradley's proposed equations uncovers several problems:

The Unrestricted Quadratic: The results for the unrestricted quadratic have a sign problem for small packages, rendering the equation unacceptable, and the regressors for some of the independent variables—such as sequential mail and small parcels--are statistically insignificant. In addition, the majority of the cross product regressors are statistically insignificant. Witness Bradley subsequently discarded the use of the Unrestricted Quadratic.

The Restricted Quadratic: This equation also had a number of statistically insignificant terms, e.g. regressors for flats, Sequenced Mail, and small parcels.

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provision of panel data, as discussed elsewhere in this testimony, would permit such an analysis, and

Neither equation yielded results that have statistically significant regressors for all of the mail shapes. Accordingly, the computation of volume variabilities is based on statistically insignificant inputs. The presence of meaningless signs for variables and statistically insignificant results may be caused by multicollinearity problems with the data.[108] This is a property of the dataset. The Variance Inflation Factor (VIF) measures the impact of multicollinearity on specific independent variables; VIF values below 10 are indicative of minimal multicollinearity problems. The formulation of alternative models may avoid some of the multicollinearity problems if different variables or panel data are used. This is why OCA is interested in obtaining multiple years of data.

The equations show that the number of delivery points and the density of delivery points in a ZIP code affect carrier delivery times. In witness Bradley's model there is no distinction between types of delivery points. In actuality, there are substantial differences in the way mail is delivered on residential and commercial routes. Data were available for the number of deliveries in terms of types of delivery points:

- BUD: Business curbline deliveries--A method of city delivery where the letter carrier, walking or in a vehicle, delivers to customer mailboxes located at the curb.
- BED: Business central deliveries—Delivery to several addresses at one delivery point, such as a collection box unit.
- BND: Business NDCBU deliveries--NDCBU denotes a centralized unit of more than eight individually locked compartments sized to accommodate the delivery of magazines, merchandise samples, and several days' accumulation of mail.

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should be performed.

[108] Measures of mail volume are likely to vary together, creating multicollinearity. The use of panel data is advocated as a potential solution to the problem.

- BOD: Business other deliveries.
- RUD: Residential curbline deliveries.
- RED: Residential central deliveries.
- RND: Residential NDCBU deliveries.
- ROD: Residential other deliveries.

The above classification of delivery points is one of a number of ways in which the Postal Service classifies delivery points; unfortunately, none of the classifications map into each other. For example, information is available for delivery points in terms of Central Point Delivery (a residential service that provides delivery to several addresses at one delivery point, such as a neighborhood delivery and collection box unit); Mounted routes (a city route on which the letter carrier drives a vehicle to deliver the mail, but does not walk); VIM, a mail service within high-rise office buildings (the letter carrier provides delivery and collection of mail for the entire building by operating a small elevator from a mailroom or by using a call window or centralized mail delivery system); or Loop/foot (a delivery method in which the letter carrier parks the vehicle and walks out and back over one or more streets, delivering mail away from and looping back to the vehicle). However, in the database these classifications do not map into the other delivery point classifications.

Data were also available by MODE for a route. The mode of delivery variable for each route is defined in terms of one of six technologies: Curbline routes (mode = C), Dismount routes (mode = D), Foot routes (mode = F), Other routes (mode = O), Park/Loop routes (mode = P), Unknown routes (mode = X). The Postal Service apparently assigns the variable Mode on the basis of the technology describing the

route being the technology believed to be most representative of the delivery mode on the route. However, the Mode designation refers only to the predominant technology on a route; some analysis of other technologies is needed.

Accordingly, the equations need to be rerun, with consideration of various alternatives for delivery points as well as other relevant data, i.e. data related to length of the route, ZIP code characteristics, and possibly other information available in DOIS. One would expect that the values of the regressors, HC t-statistics, and VIFs would change, resulting in changes in the previously computed volume variabilities.

An examination of the regressors as related to the quantification of marginal costs is also useful in evaluating the equations. Witness Bradley provided marginal cost estimates for both the Unrestricted Quadratic and the Restricted Quadratic. The results in both cases appear to be unreliable, showing that flats require slightly less effort at the margin to deliver than is the case for letters.[109] This is a result that is at variance with common sense. Flats would generally be characterized by greater thickness and weight than those of a letter. Given the small size of many mail receptacles it would be difficult to visualize a flat being cheaper to deliver than a letter. The result does not comport with reality.

Witness Bradley's econometric analysis also produces implausible results for the time expended by city carriers to collect mail. Witness Kelley testifies that the Postal Service proposes to attribute an additional $406 million to single-piece First-Class

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[109] Detailed information is available in "Response of Postal Service Witness Bradley to POIR No. 6, Question 6" as well as OCA/USPS-T14-5.

letters (as compared to the attribution under the Commission's methodology).[110] Applying the piggy back factors and rolling this cost forward to the test year produces $839 million of collection costs that are imposed on single-piece First-Class letters.[111] A change of this magnitude warrants careful examination and checks for reasonableness. One important check is to see how the city carrier unit collection costs for single-piece First-Class letters compares to the equivalent rural carrier cost. This comparison demonstrates that witness Bradley estimates a city carrier collection cost that is 8 times that of a rural carrier.[112] This result defies common sense, because the collection activity is so similar for city and rural carriers. Without question, the array of defects OCA identifies throughout this section are responsible for such improbable results.

An examination of Sequenced Mail in witness Bradley's analysis also raises questions. One might expect that Sequenced Mail ought to cost the same as letters and flats to deliver, since the motions of accessing and delivery are approximately equal. The difference between Sequenced Mail and letters and flats is that the carrier receives Sequenced Mail in a special container, sequenced for all stops along the route. Physically, there is no reason to expect sequenced mail to be different from other mail. The major difference appears to be that sequenced mail is in a separate container; it is difficult to imagine that this difference would account for the substantial differences in

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110 Tr. 6/2748 (response to interrogatory GCA/USPS-T16-1).

111 Tr. 6/2802 (response to interrogatory MMA/USPS-T16-21).

112 The test year rural collection costs are only $65.4 million for single-piece First-Class letters. Tr. 6/2803. To make a crude comparison of the city/rural cost relation ship, OCA divides total city carrier collection costs by single-piece First-Class delivery volumes (city) of 17.6 billion and total rural carrier collection costs by single-piece First-Class delivery volumes (rural) of 10.3 billion. Tr. 6/2804 (response

delivery times in witness Bradley's analysis. OCA has previously noted potential problems with the collection of data for Sequenced Mail; these problems may have contributed to the unexpected results.

Witness Bradley also presents equations for Parcels and Accountables. The equations estimate volume variability in terms of the additional time for delivery given the delivery efforts for the other types of mail already discussed. The HC t-statistics are generally acceptable; the VIF is in excess of 10 but less than 20 in a number of cases: multicollinearity is a relatively minor problem, although it still continues to be a problem. Given the lack of panel data (a problem which will probably be resolved using DOIS data) and recognizing that the amount of accountables and deliverables data is less than used for the rest of the volume variability analysis, OCA believes that the Parcels/Accountables analysis would benefit from additional consideration when the rest of the study is revised and extended.

5. Major Conclusions

1. The revision of the study using panel data is clearly important. First, panel data would help to address the multicollinearity problems. Second, delivery points have been shown to be important drivers of costs, and panel data will permit the analysis of changes in delivery points on costs. Changes in delivery points and the adjustment of routes to delivery points is the way the Postal Service says it minimizes carrier costs. This is a phenomenon that has not yet been considered. In addition, the use of panel

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to interrogatory MMA/USPS-T16-22). $839 million/17.6 billion = 4.8 cents; $65.4 million/10.3 billion = 0.6 cents; 4.8/0.6 = 8.

data would assure that delivery costs are modeled across the various months of the year rather than for a two week time frame.

2. The volume variability of Sequenced Mail appears to be implausibly low. Cost drivers suited to future examination are the number of sequenced bundles handled and an examination of whether the nature of fingering and loading sequenced mail is different. Also, does sequenced mail have a different propensity to cause accesses?

3. The consideration of types of delivery points should be a factor in future analysis. In addition, other data collected by the Postal Service—such as the length of route—may be available for analysis from the DOIS.

4. Witness Lewis has stated that there has been an increase in curb line, cluster box, and centralized deliveries, and virtually no growth of door delivery. He states that over time, as these modes of delivery have grown as a percentage of total deliveries, the change has fueled an increase in carrier street productivity. It seems likely that delivery Mode may have an effect on delivery time, particularly if Mode data could be made available on a section-by-section basis. As indicated in OCA/USPS-140 (Tr. 8B/4907), in response to a request for the number of delivery points by route section, by mode (Foot, NDCBU, etc.), complete information is not available on this important cost driver. VP/USPS-T14-1 (Tr. 6/2233-34) shows how individual routes can have route sections with multiple mode types. However, data are available to some degree on the types of delivery points; this may be an area worth further examination. Accordingly, additional consideration of delivery points and Mode would be appropriate.

5. One would wish to consider whether and how route optimization (i.e., route readjustments, by route) has an impact on volume variability. It is OCA's understanding that the Postal Service regularly adjusts the workload on routes within a ZIP Code through a process known as pivoting—the off loading of volume by one carrier (who has too much volume on a given day) to other carriers with under time (i.e., a work load of fewer than eight hours for the day). Witness Stevens discusses this in his response to in POIR No. 6, question 4(c.)-(d) (Tr. 6/1971):

> Route pivots are a normal daily occurrence in city carrier delivery.
>
> * * * * *
>
> Route pivots were not tracked separately in the City Carrier Street Time Study.

Further analysis is needed.

6. Information is available from Census and other sources for some of the characteristics of a ZIP Code as related to Postal Service operations. A previous section of the brief indicated that detailed information on the demographics, psychographics, and economic characteristics of a ZIP Code are important factors. Further, it is well known that changes in the national economy can affect the Postal Service's financial situation of the Postal Service. Whether this is true at the ZIP Code level is worth exploring.

7. OCA/USPS-140 (Tr. 8B/4907) indicates that the number of sequenced mailings, the number of sequenced mailings with detached address labels, overtime street hours, routes without an assigned carrier, volume in bulk deliveries by shape, and carrier type

for each carrier who delivered mail on a route are not conveniently available. Some of these characteristics are likely to affect cost, and the availability of data needs to be pursued.

8. The current study has integrated concepts of load and access time and permits a clearer analysis of the addition of coverage points. However, the study does not permit the integrated analysis of in-office activities, street activities, travel times from the office to the first route section or between route sections, relay time (time spent by the carrier collecting or depositing mail in a relay box), and general mailbox collection time. In-office and travel times have an impact on the amount of time required for street activities. Other activities may influence the amount of time spent on the street to deliver mail. These issues should be analyzed. Much of the data for an analysis should be available from DOIS.

9. The current study yields results that do not explain reality – incorrect signs for regressors, marginal costs that seem to be unreasonable, and regressors that are not statistically significant. The study needs to be enhanced with additional data and consideration of the underlying economics.

Given the various deficiencies mentioned in connection with the existing study, the OCA is unable to advocate its adoption by the Commission and urges its rejection.

E. The Postal Service Has Condemned the City Carrier Studies Upon Which Its Own Methodology is Founded

Witnesses Stevens (USPS-T-15, at 4-5) and Bradley (USPS-T14, at 3-13) have made convincing arguments that the prior approach used by the Postal Service to measure City Carrier street time volume variability was based on outdated information, was riddled with many measurement problems, and does not reflect current operational reality:

- The underlying databases were from the mid 1980's and were based on small data samples.
- The methodology made an artificial distinction between access and load time. The earlier study broke delivery time into three sub-portions: route time, access time, and load time. Operational personnel found these distinctions to be unobservable, and the use of the distinctions was considered to be unreliable.
- The methodology did not account for adjustments to route structures to equalize work loads, the primary method by which the Postal Service manages carrier costs.
- The underlying studies were fragmented, there being separate studies and procedures for the various aspects of the carrier workload, with a lack of methodological and data consistency between studies.
- The estimated parameters had large variances.

If the old City Carrier methodology is as unsound as the Postal Service contends, the only solution may be to assume that these costs are 100 percent volume variable, just as the Commission does for mail processing costs.

VII. THE COMMISSION SHOULD REQUIRE THE POSTAL SERVICE TO PRODUCE THE DATA AND MODELS NEEDED FOR PROPER ECONOMETRIC ANALYSIS OF VOLUME VARIABILITY

The OCA fully supports attempts to use econometric techniques to estimate volume-variable costs. However, the word "econometrics" implies something more than the application of statistical techniques to large amounts of data. The Commission should require that Postal Service witnesses (1) present explicit models of production, (2) provide precise definitions of the inputs and outputs included in the models, and (3) *demonstrate empirically that the assumptions needed to generate marginal costs are true*.

The OCA recognizes that the Postal Service has invested a great deal in its current system for collecting data, estimating attributable costs, and presenting financial reports. And this seems to be the root of the problem. The Postal Service prefers to sacrifice accuracy for the convenience of using an antiquated cost-allocation system. Rather than devote resources to eliminating unverifiable assumptions about cost incurrence, the Postal Service presents testimony attempting to show that its cost allocations are "close enough for government work."

The Postal Service's testimony on mail processing has relied on micro data on inputs and output collected on a consistent basis for a large number of processing plants. While not perfect, the data provides a reasonable base for estimating models of production and quantifying marginal cost of processing. On the other hand, micro data presented in this case on carrier street time is inadequate. And changes need to be

made in the overall framework for estimating attributable costs if its use in rate-setting procedures is to continue.

1. The theoretical model needs to be generalized and the assumptions that are made need to fully explored, their implications examined, and empirical support for them needs to be presented. The theoretical model unnecessarily relies on the assumption that processing steps are separable and that volume and the output of each processing step are proportional. This places restrictive conditions on the patterns of substitution among processing stages.

2. In presenting results of the model, much more information needs to be provided to convince the Commission that the estimates accord with what is known about mail processing and make sense. Simply presenting a set of elasticity estimates with standard errors is insufficient for judging the ability of the model to estimate the technology accurately.

3. The data on FHP needs to be improved. FHP counts need to be disaggregated into categories that correspond to the amount of mailer preparation (presorting and barcoding) on the arrival side and the depth of final sorting (5 digit, carrier route, or DPS) on the destination side. This will allow measurement of marginal cost for a letter that enters with different characteristics. The measurement of FHP for parcels and priority mail needs to be better developed so that the production model can be used to estimate marginal cost for those shapes.

4. The capital data needs to be improved and integrated with the MODS data in a more timely way. When a new technology is introduced into a plant it is frequently the case that the MODS data will show TPF, FHP, and/or labor hours in the new technology

category many quarters before the capital data indicates any capital stock in that category. This was particularly evident in the AFSM processing operation in the current case. This technology was introduced during the time period 2000-2004 being studied and many plants had hours of labor in AFSM operations but no capital data. It appears that the capital data, which is not collected as part of the MODS system, is either collected with a lag or was improperly merged with the MODS data for hours and output.

5. The empirical model to estimate marginal cost needs to recognize that there are more inputs in mail processing than just the labor hours in the major sorting operations. Other categories of labor, including maintenance and repair and allied operations, should be recognized. The amount of capital and the cost of capital equipment also needs to be better integrated into the production model, so that the substantial costs of capital equipment are recognized as contributing to processing costs.

6. Much more data on carrier street time needs to be analyzed. More delivery units, more time periods, and more variables are needed.

VIII. THE POSTAL SERVICE'S COMMITMENT TO MAKE EXISTING SERVICE QUALITY INFORMATION FOR SEVERAL MAIL SERVICES WIDELY AVAILABLE WILL BENEFIT RETAIL POSTAL CUSTOMERS; HOWEVER, ADDITIONAL MEASURES OF SERVICE QUALITY ARE NEEDED FOR RATEMAKING PURPOSES

An important outcome of this proceeding of benefit to retail postal customers is the Postal Service's commitment to increase access to a considerable amount of service quality information for Express Mail, Priority Mail, First-Class Mail, and Package Services.[113] The Postal Service's commitment, detailed in a letter from the Postmaster General (herein "OCA-Postal Service agreement" or "agreement") dated July 22, 2005, will result in currently collected service performance data being regularly posted on the Postal Service's website for retail postal customers in exchange for the OCA's agreement not to file a direct case.[114]

The Postal Service is to be commended for expanding access to existing service performance information that can be used by retail postal customers in their purchasing decision for these mail services.[115] Postal customers can only benefit from greater

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[113] Office of the Consumer Advocate Notice to the Commission of An Agreement Reached With the Postal Service that OCA Will Not File A Direct Case, In Exchange for Postal Service Commitments Beneficial to Consumers (herein "Notice of Agreement"), July, 19, 2005, at 1.

[114] Office of the Consumer Advocate Notice of Receipt of Letter From Postmaster General Potter Detailing the Agreement Reached Between the Postal Service and OCA, July 25, 2005. This notice attaches a letter from Postmaster General Potter (herein "PMG Letter"), dated July 22, 2005.

[115] Pursuant to the agreement, the Postal Service also commits to "establish a working group, to include OCA, to investigate the possibility of a non-denominated stamp that, once purchased, would be valid in the future for first-ounce, single-piece, First-Class Mail postage, regardless of the then-current rate." Notice of Agreement, at 1.

access to service performance information for the postal products and services they use most often.

While the OCA-Postal Service agreement will provide retail postal customers with greater access to information on service quality, existing service performance data to a large extent is insufficient for ratemaking purposes. The agreement provides delivery performance data for four postal services of primary interest to retail customers. However, the Postal Reorganization Act (herein “the Act) places an affirmative duty on the Postal Service and Commission to evaluate proposed rates based upon “value of service.” Current concepts used to evaluate value of service do not directly address the Act’s requirement to consider the “service actually provided” mail classes and services. Of necessity, then, that evaluation has been limited because performance measurement systems are not established, or limitations of existing performance measurement systems produce data that is not statistically representative of delivery service for mail classes and services as a whole. Moreover, delivery service performance is but one aspect of service quality—arguably the most important. Nevertheless, service quality is multi-dimensional, and other measures of service quality are lacking. The Postal Service must develop measures of delivery performance as well as additional measures of service quality in order to create a more robust service quality measurement system for use in evaluating value of service in the context of rate proceedings.

A. The OCA-Postal Service Agreement Will Ensure Greater Access to Certain Existing Service Performance Data and Better Inform Retail Postal Customers About Service Quality for Several Classes of Mail

Retail postal customers are extensive users of Express Mail, Priority Mail, First-Class Mail, and Package Services. Under the agreement, the Postal Service commits to post on its website national service performance data for these classes of mail.[116] The agreement, however, does address service quality information for other postal services used by retail customers, such as special services.

The service performance data will consist of statistical estimates of on-time delivery as measured against stated service standards, or delivery data derived from scans of Delivery Confirmation barcodes. Such statistical estimates and barcode scan data are generally not accessible to retail postal customers. The Postal Service's commitment to expanded access to delivery performance data via its website will benefit postal customers in evaluating service quality and price when making purchase decisions for delivery services.

1. The agreement increases access by retail postal customers to delivery performance data for Express Mail, Priority Mail, First-Class Mail, and Package Services

Delivery performance data for Express Mail, First-Class Mail, Priority Mail, and Package Services will be provided from several statistical data systems. Express Mail delivery performance data will be derived from the Postal Service's Product Tracking

System (PTS). The External First-Class Mail measurement system (EXFC) and the Priority Mail End-to-End (PETE) measurement system will be the source of data for First-Class Mail and Priority Mail, respectively.[117] The delivery performance data for Package Services will be obtained from the Delivery Confirmation system.[118]

For Express Mail, the Postal Service will provide statistical estimates representing the percentage of mailpieces scheduled to receive overnight, second day and second delivery day service that are actually delivered overnight, by the second day, and by the second delivery day, respectively.[119] Similar statistical estimates are to be provided for First-Class Mail overnight-, two-, and three-day service, and for Priority

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[116] The Postal Service agrees to post the most recent quarterly service performance data on its website beginning the first full quarter following implementation of the rates established in this docket. PMG Letter, at 2.

[117] Id.

[118] The Delivery Confirmation system is the name given to the source of Delivery Confirmation service performance information on the Postal Service's website, https://mailtracking.usps.com/mtr/resources/ppr/pprLaunch.pge. However, the Postmaster General's letter does not refer to the Delivery Confirmation "system." PMG Letter, at 2.

[119] Id. Also, with respect to Express Mail, the Postal Service agrees to provide a chart that explains to postal customers the scheduled day of delivery for Next Day and Second Day service, and delivery on the "second delivery day." The "second delivery day" can be a source of confusion to postal customers since Express Mail is offered as a one-day or two-day delivery service. However, the "second delivery day," defined as delivery on the next regular delivery day, may be three or more days after the day of entry of the mailpiece. Tr. 8D/4675 (OCA/USPS-13(b)). The chart, to be modeled after a chart included in interrogatory OCA/USPS-194, is an attempt to eliminate uncertainty by providing an immediate visual guide for customers as to the day of delivery when the Postal Service does not provide Express Mail service on Sunday or Federal holidays in certain ZIP Codes.

Mail overnight and two-day service.[120] The Postal Service agrees to use Delivery Confirmation data to develop performance statistics for Package Services.[121]

The data from these statistical data systems is often not available to the general public, or it is not readily accessible for use by retail postal customers. For example, the Comprehensive Statement on Postal Operations, published annually and posted on the Postal Service's website, states that the actual delivery performance of Express Mail and Priority Mail is "Proprietary Information."[122] Nor is Express Mail and Priority Mail delivery performance data to be found elsewhere on the Postal Service's website. While the Postal Service provides such data pursuant to discovery requests in Commission proceedings, or in response to Freedom of Information Act (FOIA) requests,[123] such proceedings and requests are not designed to facilitate easy access to delivery performance data by the general public or use by postal customers.

Unlike Express Mail and Priority Mail, delivery performance data for First-Class Mail is given wider release than Commission proceedings and FOIA requests. Such data is available publicly in the aforementioned annual Comprehensive Statements, and quarterly through Postal Service news releases issued in conjunction with regularly

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[120] PMG Letter, at 2. Priority Mail is offered to postal customers with "a service standard that can be overnight, 2nd day, or 3rd day." Tr. 8D/4676 (OCA/USPS-14(a)). However, PETE is a performance measurement system for Priority Mail with one- and two-day service standards. Tr. 8C/4505 (DFC/USPS-53(b)).

[121] PMG Letter, at 2.

[122] *See* "2003 Comprehensive Statement on Postal Operations," U.S. Postal Service, at 107.

[123] 5 USC § 552.

scheduled meetings of the Board of Governors.[124] However, First-Class Mail delivery performance data is not readily accessible on the Postal Service's website or otherwise presented in a user-friendly format for postal customers as they make their purchasing decisions.[125]

Package Services delivery performance data collected from the Delivery Confirmation system is presented in Product Performance Reports. However, such reports are not available to retail postal customers; they are only "available to internal Postal users and participating customers."[126] Package Service performance data from Delivery Confirmation barcode scans is provided in response to discovery requests.[127]

2. Greater access to delivery performance data will permit retail postal customers to choose mail services based both on price and actual service quality

The Postal Service's commitment will produce a vast improvement in availability and access to service performance data that will have lasting benefit for retail postal customers. For the first time, service performance data on mail classes and services

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124 *See* www.usps.com/communications/news/press/2005/pr05_064.htm.

125 For example, the "2004 Comprehensive Statement on Postal Operations" displays the five-year trend in national First-Class Mail service performance for overnight, two-day and three-day scheduled mail for the period FY2000 – 2004. This information is presented in the body of the report, a PDF document located on the Postal Service's website. However, the relevant pages are not referenced using the search function on the website with such obvious terms as "First-Class Mail service performance," "First-Class Mail delivery service," "First-Class Mail on-time delivery," "First-Class Mail overnight delivery", "First-Class Mail delivery performance," "EXFC," etc. Using such terms as "First-Class Mail delivery performance" and "EXFC," however, did produce references to several press releases containing quarterly EXFC results by performance cluster (i.e., 3-digit ZIP Codes), although the releases were from previous fiscal years.

126 https://mailtracking.usps.com/mtr/resources/ppr/pprLaunch.pge.

used extensively by retail postal customers will be provided in a single, easily accessible location—the Postal Service's website, usps.com—and such data will be updated quarterly. To alert as many retail customers as possible to the availability of this information, notices will also be placed in post offices, stations and branches informing customers that performance data for Express Mail, Priority Mail, First-Class Mail and Package Services is available at the Postal Service website.[128]

Moreover, the service performance data will be placed so that retail postal customers may access the data in conjunction with pricing information. Express Mail, Priority Mail, First-Class Mail and Package Services delivery performance data will be linked to the Click-N-Ship webpage and the domestic Postage Rate Calculator. As a result, retail customers will not only have pricing information and the service standard for the services they are considering purchasing, they can obtain the actual delivery performance for those services through links from the Postage Rate Calculator and Click-and-Ship webpage. These features should benefit retail postal customers in choosing delivery services.

B. The Existing Service Performance Data Is Insufficient For Purposes of Evaluating the Ratemaking Criterion: Value of Service

1. Evaluation of value of service requires measurement of "service actually provided"

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[127] *See* for example DFC/USPS-11. Tr. 8C/4443.

[128] PMG Letter, at 2.

With respect to setting new rates, §3622(b)(2) of the Act requires that consideration be given to "the value of the mail service actually provided each class or type of mail service to both the sender and the recipient . . . ."[129] A condition predicate to making a judgment about "value" requires a determination of the "service actually provided," as directed by the Act. In theory, at least, this requires measurement of the service provided, ideally against stated standards of performance.

Current concepts applied to evaluate value of service have been acceptable for many years, and they are useful. That said, however, the concepts do not squarely address the Act's requirement to consider the "service actually provided" for purposes of evaluating value of service. A much more rigorous analysis of the service actually provided must be demanded from the Postal Service and applied by the Commission in the future. Service quality is of increasing importance to postal customers. The Commission must take steps to secure service performance data and improved measurement systems.

Traditionally, the Postal Service has relied on two concepts of value of service—intrinsic value and economic value.[130] Intrinsic value considers specific "operational aspects" or features of the mail service.[131] Section 3622(b)(2) specifically mentions "collection, mode of transportation, and priority of delivery." Other aspects of service discussed by the Postal Service include "the level of privacy afforded by the mail class,

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[129] 39 USC § 3622(b)(2).

[130] USPS-T-27 (Robinson), at 13-15.

[131] Id., at 13.

the reliability and image associated with the mail class, the presence of features such as free forwarding, and the availability of such ancillary services as insurance or delivery confirmation."[132]

At base, the concept of "intrinsic value" is a listing of specific service features or characteristics of a mail service. The mere listing of such service features or attributes does not constitute measurement of "service actually provided," as required by the Act. More directly, judgment about the value of service should be based on facts as to how well the service is actually provided, which requires measurement.

The second concept—economic value—considers customer perception of the value of the service in question, and the availability of alternative services. Customer perception can be determined from market survey responses and observed responses of customers to changes in price over time.[133] From such responses, an own-price elasticity of demand can be calculated, defined as "the percentage decline in usage that results from a one-percent increase in price."[134] The Postal Service uses such estimates of price elasticity to infer the relative value of the service from the customer's perspective.[135] Unfortunately, the concept of "economic value" does not address the value of service actually provided because it does not involve measurement of the

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[132] Id., at 14.

[133] Witness Robinson observes that operational aspects and features also "affect postal customers' perceptions of value they receive." Id.

[134] Id.

[135] Id.

service itself. Rather, it relies on estimates of customer perception of value, which is not a direct or objective measure of the service actually provided.

Using the concepts of intrinsic value and economic value in evaluating value of service as a starting point, the Postal Service should also undertake the direct measurement of service actually provided as measured against stated service standards. Such direct measurement can become an objective means of determining the service performance actually provided as a basis for evaluating value of service.

In the first instance, the standard to be measured should be delivery performance—an important component of service quality and consequently of value. Logically, the extent to which actual delivery achieves the stated delivery standard, the higher the quality of service and by extension the more valuable the service. In the absence of delivery performance data, the Postal Service cannot objectively evaluate value of service in a meaningful way.

2. Service performance measurement data provided in response to commission rule 54(n) is inadequate for measuring service actually provided

As part of a request for changes in rates, the Postal Service must provide service performance information responsive to Commission Rule 54(n). Rule 54(n) requires the Postal Service to:

> identify any performance goals which have been established for the classes and subclasses of mail . . . . [t]he Request must identify the achieved levels of service for those classes and subclasses of mail and mail service for which performance goals have been set.[136]

a. Service Standards

In response to Rule 54(n), the Postal Service provided the "currently effective service standards for mail" in only a one-page chart entitled "United States Postal Service Service Standards."[137] The chart covers the following classes of mail: Express Mail, Priority Mail, First-Class Mail, Periodicals, Standard Mail (referred to in the chart as "Standard A"), and Package Services (referred to as "Standard B").

The Postal Service's response to Rule 54(n) is woefully lacking as a basis for determining achieved levels of service performance. A prerequisite to the development of meaningful service performance data is the establishment of standards of service for mail classes and services. The chart submitted pursuant to Rule 54(n) does not indicate mail services for which service standards have been established.[138]

The Postal Service identifies several special services for which service standards have been established. Those special services are 1) processing times for properly

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[136] 39 CFR §3001.54(n).

[137] Attachment F to Request, Docket No. R2005-1, at 35.

[138] Service standards have not been established for all mail services. According to the Postal Service, "There are no service or performance goals, objectives, or directives for the special services listed in Tables 11 and 12 of USPS-T-28," with three exceptions. Tr. 8D/4698 (OCA/USPS-32). The special services listed in Tables 11 and 12 without service standards are Registry, Insurance, COD, Money Orders, Return Receipts, Stamped Cards, Stamped Envelopes, PO Box/Caller Service, Bulk Parcel Return Service, Meter Service, Permit Imprint Permits, Restricted Delivery, and Shipper Paid Forwarding. As a preface, however, the Postal Service states that "Special services generally are ancillary to the mail classes, which have their own service standards." Id. To the extent the Postal Service is suggesting that service standards of the underlying mail classes are relevant to the special services, it should be noted that such underlying service standards are insufficient. For example, a separate service standard is necessary for Return Receipt as to the number of days between the day of mailing and the day a return receipt is received by mail, or received electronically. Similarly, separate

completed and supported claims seeking payment of Postal Insurance; 2) delivery scan rates for Delivery Confirmation and Signature Confirmation services used in conjunction with Priority Mail, First-Class Mail parcels, and Package Services; and, 3) response times for the correction and return of mailing lists with respect to Address Changes for Election Boards, Correction of Mailing Lists, and ZIP Coding of Mailing Lists services.[139] Other special service service standards include post office "Box Up Times," and scan rates for Certified Mail.[140] These mail services and their accompanying service standards are not referenced in the chart.

The Postal Service's chart is insufficient to identify the service standards for the mail classes and services, as required by Rule 54(n); rather, identification of the service standards occurred through discovery, and are scattered in various sources. The Postal Service concedes that the chart presents the performance goals required to be identified by the Rule only "[i]n a general sense."[141]

Discovery was necessary to gather the information that should have been provided pursuant to Rule 54(n). Through discovery, the Postal Service cites the Domestic Mail Manual (DMM) for the service standards for Express Mail, and the aforementioned correction and return of mailing lists.[142] Discovery was also necessary

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service standards are warranted where certain service features are bundled in the mail class, such as forwarding service in First-Class Mail.

[139] Tr. 8D/4698 (OCA/USPS-32)

[140] Tr. 8D/4948 and Tr. 8D/4945 (OCA/USPS-166 and 164), respectively.

[141] Tr. 8D/4670 (OCA/USPS-9).

[142] DMM §113.4.2 and 4.3. (Express Mail); and, DMM §507.6.3.6 (Address Changes, and Correction and ZIP Coding of mailing lists).

to obtain a Postal Service cite to Publication 122 as the source for the written service standard for the payment of properly completed and supported claims for postal insurance.[143] The Postal Service's service standards for Delivery Confirmation and Signature Confirmation, also provided in response to an interrogatory, are in the Web-Enabled Enterprise Information System (WEBeis).[144] For the mail classes listed in the chart, the Postal Service references the USPS Service Standards CD-ROM, published quarterly. The service standards identified for these mail classes in the CD-ROM is equivalent in detail to the information presented in the chart.[145]

In general, the chart and its notes fail to identify details of service standards, which the Postal Service provided only in response to discovery requests.[146] In some cases, responses to interrogatories first reveal the existence of service standards. As noted above, the Postal Service's response to interrogatories is the only indication in this record that it has established a service standard for Certified Mail[147]—a scan performance goal of 98 percent—and Delivery Confirmation and Signature Confirmation, i.e., scan rates of 98 percent, 97 percent and 97.5 percent for Priority

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[143] Tr. 8D/4698 (OCA/USPS-32). Publication 122 is entitled "Customer Guide to Filing Domestic Insurance Claims or Registered Mail Inquiries," dated April 2005.

[144] Id. WEBeis is a web-based reporting system that gathers information from various Postal Service systems, including finance records, performance measurements, and mail products and mailing facility details.

[145] *See* "Service Standards [1.0]," Service Standards CD-ROM. It should be noted that the Service Standards CD-ROM is interactive, which permits users to determine the service standard in days between specific 3-digit origin and destination ZIP Code areas by class of mail.

[146] *See* for example responses of the U.S. Postal Service to OCA interrogatories OCA/USPS-14, 20, 23, 26, and 29. Tr. 8D/4676, 4684, 4688, 4692, and 4695, respectively.

[147] Tr. 8D/4948 (OCA/USPS-166).

Mail, First-Class Mail parcels, and Package Services, respectively.[148] Similarly, a service standard exists for post office box service, known as the "Box Up Times," which varies by office but is generally between 9:00 a.m. and 12:00 p.m.[149] This too was identified only in response to an interrogatory and not in response to Rule 54(n).

b. Achieved levels of performance

More problematic is the Postal Service's failure to "identify the achieved levels of service" in response to Rule 54(n). The Origin-Destination Information System (ODIS) Quarterly Statistics Reports,[150] filed at the Commission quarterly as part of the periodic reporting requirements, is the only source cited by the Postal Service for the achieved levels of performance for the mail classes listed in the chart.[151] Further reference is given to USPS Library Reference LR-K-82, which contains copies of the quarterly ODIS reports for FY 2004.[152] However, use of ODIS for measuring achieved levels of performance is unsatisfactory.[153] ODIS measures time-in-transit between 3-digit origin and destination ZIP Codes.[154] ODIS does not measure entry to exit (delivery

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148 Tr. 8D/4698 (OCA/USPS-32).

149 Tr. 8D/4945 (OCA/USPS-164).

150 The ODIS and RPW systems were merged effective October 1, 2003, or Postal Service Quarter 1, FY2004. Tr. 8D/4866 (OCA/USPS-7(d)). Herein, the acronym "ODIS" is used.

151 Attachment F to Request, Docket No. R2005-1, at 35-36.

152 Attachment F to Request, Docket No. R2005-1, at 36.

153 Nevertheless, ODIS does produce data that is not duplicated elsewhere, such as comparison of the percentage of First-Class Mail and Priority Mail delivered for Day 1 through Day 10. Tr. 8D/4681 (OCA/USPS-18(c),(e)).

154 Tr. 8D/4677-78 (OCA/USPS-15).

receptacle), an end-to-end measurement[155]—the only true measurement for assessing achieved service performance. For these reasons, the Postal Service concludes that "ODIS-RPW is not the best tool for measurement of service standard performance" and, its insight to service performance is only "indirect."[156]

Consequently, ODIS does not address levels of achieved performance for overnight and second day Express Mail[157] Nor does ODIS provide levels of achieved performance for overnight, 2nd day, and 3rd day service standards for Priority Mail.[158] ODIS does not provide data on the achieved levels of performance for Periodicals Mail,[159] or Standard Mail.[160] Similarly, ODIS cannot provide data on achieved levels of performance for First-Class Mail or Package Services.

Finally, it should be noted that even where end-to-end service performance data is available, the Postal Service did not provide it in response to Rule 54(n). EXFC and PETE are measurement systems that provide end-to-end data directly responsive to the requirement to provide achieved levels of service performance. The Product Tracking System provides similar service performance data for Express Mail. However, data for

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155 Id.

156 Id.

157 Tr. 8D/4672 (OCA/USPS-11).

158 Tr. 8D/4677-78 (OCA/USPS-15).

159 Tr. 8D/4690 (OCA/USPS-24(d)).

160 Tr. 8D/4696 (OCA/USPS-30).

these mail classes was not provided in response to Rule 54(n). Service performance data for these services was provided only in response to discovery requests.[161]

3. Limitations of existing service measurement systems do not measure the service actually provided for all mail classes or services

With few exceptions, the Postal Service does not have in place performance measurement systems that can measure service actually provided. The exceptions are EXFC and PETE, and the Product Tracking System for Express Mail. In addition, the Postal Service is able to provide delivery scan rates for only a few special services: Certified Mail, Delivery Confirmation and Signature Confirmation from the Product Tracking System,[162] and processing times for claims requesting payment of postal insurance.[163]

Nevertheless, performance measurement systems have not been established for important classes of mail. The Postal Service states that "no systematic measures are known to exist" on achieved levels of performance with respect to Periodicals.[164] The Postal Service also states, "No such statistical or other measurement system is known to exist" that provides data on the achieved level of performance with respect to

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[161] *See* for example responses of the Postal Service to OCA interrogatories providing EXFC national overnight, two-day and three-day scores by quarter for Fiscal Years 2002-04, Tr. 8D/4876-78 (OCA/USPS-120(a)), and PETE national overnight and two-day scores by quarter for the same fiscal years. Tr. 8D/4882 (OCA/USPS-122(c))

[162] Tr. 8D/4948 (OCA/USPS-166).

[163] Tr. 8D/4836 (OCA/USPS-110).

[164] Tr. 8D/4690 OCA/USPS-24(d)).

Standard Mail.[165] For special services, there are no statistical or other measurement systems that provide data on the level of service for the special service, with the exception of the Product Tracking System used to measure delivery scan rates for Certified Mail, Delivery Confirmation, and Signature Confirmation.[166]

While there are measurement systems other than ODIS, the performance data produced is not statistically representative for the mail classes and services as a whole. With respect to Standard Mail, CONFIRM is used to track service performance. However, the Postal Service acknowledges that CONFIRM is not statistically representative for Standard Mail pieces.[167] With respect to Package Services, data on performance is derived from scans of Delivery Confirmation and Signature Confirmation. However, such data is not statistically representative for Package Services since scans can only occur on pieces that have Delivery Confirmation and Signature Confirmation barcodes, and where "the pieces receive both an acceptance scan and a delivery scan."[168]

C. Service Performance Measurement Systems Should Be Developed for All Mail Classes and Services, As Well As New Measures of Service Quality, To Evaluate Value of Service

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165 Tr. 8D/4696 (OCA/USPS-30).

166 Tr. 8D/4699 (OCA/USPS-33).

167 Tr. 8D/4846 (OCA/USPS-115(c)).

168 Tr. 8C/4442 (DFC/USPS-11).

Direct measurement of the service actually provided as measured against stated service standards should be the cornerstone for any meaningful evaluation of value of service. Some Postal Service measurement systems, such as EXFC and PETE, produce data that directly measure the service actually provided. Still others have inherent limitations, such as ODIS, that make direct measurement of the service actually provided problematic. However, for some mail classes, there are no service performance measurement systems in place.

As delivery is the most important service of the Postal Service, it is only appropriate that delivery performance measurement systems be established for all mail classes and services. Toward that end, the Postal Service should establish delivery performance measurement systems for Periodicals, Standard Mail, and Package Services, and establish service standards and service performance measurement systems for special services where such standards and systems do not already exist.

However, even where the actual service provided is known through measurement of delivery performance, it should not be the only measure of service quality. The reason: the service actually provided may be degraded in ways that are not captured by measurement of delivery service performance alone. That is, unchanged service standards and delivery performance results could mask a degradation of service quality.

For example, EXFC measures First-Class Mail delivery performance between overnight, two-day, and three-day ZIP Code pairs. However, the Postal Service generally changes service standards quarterly for numerous ZIP Code pairs, upgrading certain ZIP Code pairs from three-day to two-day or overnight, or two-day to overnight,

and downgrading others from overnight to two-day or three day, or two-day to three-day.[169] Such changes may not alter reported overnight, two-day and three-day EXFC scores. However, the net change in ZIP Codes may result in a larger percentage of First-Class Mail volume receiving a lower standard of service between the affected ZIP Code pairs.

This suggests the need for measurement of service actually provided in several different ways in addition to delivery service performance. In the case of First-Class Mail, upgrades or downgrades in service standards for ZIP Code pairs could be accompanied by the percentage increase or decrease in mail volume receiving higher or lower service standards.

In another example, measurement of service actually provided other than delivery performance should involve damaged mail. The delivery performance for damaged mail may very well track the delivery performance for all mail within a subclass. However, damage to the mail represents degradation in service actually provided.

Similarly, postal customers who move often experience delays in mail being forwarded from their previous address. The forwarding of mail is a distinct service feature of some classes of mail, such as First-Class Mail and Periodicals. The delivery performance in days of forwarded mail should be measured separately. Of course, service standards should be established first, and the service actually provided with respect to forwarded mail should then be measured and reported.

IX. SHOULD THE COMMISSION RECOMMEND THE GENERAL RATE INCREASE OF 0.8 PERCENT ADVOCATED BY OCA, A COMPARABLE INCREASE SHOULD BE RECOMMENDED FOR REGISTERED MAIL

In its filing, the Postal Service requests a fee increase for Registered Mail of 70.16 percent.[170] This fee increase far exceeds the 0.8 percent increase advocated by OCA, as well as 5.4 percent across-the-board increase proposed by the Postal Service, in response to the costs of Registered Mail that have "increased substantially" since the last rate proceeding.[171] The Postal Service considers "increases of this magnitude [ ] undesirable," but concludes that Registered Mail fees must cover costs.[172]

As a result, the Postal Service proposes to recommend that the Board delay implementation "if a 70 percent increase in Registered Mail fees were recommended by the Commission and approved by the Governors."[173] Delayed implementation is intended to "provide a measure of protection against a large rate increase for Registered Mail customers."[174] Delayed implementation is also intended to facilitate a thorough review of Registered Mail to "provide postal management with a basis for

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169 Tr. 8D/4839-40, 4843-44 (OCA/USPS-112, 114).

170 Exhibit USPS-27F, at 6.

171 USPS-T-27 (Robinson), at 16.

172 Id., at 17.

173 Id.

174 Id.

determining whether to pursue classification or fee changes in a future Commission proceeding."[175]

In this proceeding, the Commission has an alternative to the 70 percent fee increase proposed by the Postal Service that would treat Registered Mail customers in the same manner as virtually all other mailers. Toward these ends, should the Commission decide to recommend the OCA-proposed 0.8 percent across-the-board increase for rates and fees generally, OCA submits that the Commission should also recommend an average fee increase of 0.8 percent for Registered Mail.[176]

A. A 0.8 Percent Fee Increase Would Cover the Cost of Registered Mail Based Upon the Commission's Total Cost of Registered Mail

OCA's proposal of a 0.8 percent across-the-board increase can be applied to Registered Mail. A 0.8 percent increase would cover the cost of Registered Mail, using the Commission's cost methodology, which produces a total cost for Registered Mail substantially less than the Postal Service's total cost. In the test year after rates, the Postal Service estimates a total cost for Registered Mail of $62,686,000, while the Postal Service estimates the Commission's total cost at $39,740,000.[177]

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175 USPS-T-1 (Potter), at 7.

176 Or a 5.4 percent across-the-board fee increase if rates for other mail classes and services are raised to that level.

177 Tr. 8D/5013 (OCA/USPS-T10-7(b)).

Based upon forecasted Registered Mail transactions of 3,738,000 in the test year,[178] an average fee increase of 0.8 percent would generate total revenue of $39,762,403.[179]

The resulting cost coverage for Registered Mail, based upon revenues of $39,762,403 and the Commission's total cost of $39,740,000, would be 100.1 percent in the test year.

B. The Cost Coverage for Registered Mail Resulting From a 0.8 Percent Fee Increase and the Commission's Total Cost Is Adequate

A Registered Mail cost coverage of 100.1 percent results from an 0.8 percent across-the-board increase to the current fees for Registered Mail. OCA believes the cost coverage of 100.1 percent is adequate, especially in light of the Postal Service's intention to investigate the source of the dramatic cost increases.[180] In a sense, the 100.1 percent cost coverage is a placeholder until the next rate case.

At the time of its filing, the Postal Service's proposed fee increase of 70.16 percent resulted in a cost coverage of 102.8 percent in the test year.[181] In response to discovery requests by the OCA, the Postal Service revised its total cost for Registered

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178 USPS-LR-K-115, File "USPST28Cspreadsheet.xls," worksheet "SS-28 Registered Mail."

179 See Excel Spreadsheet "RM_Worksheet_0.8%" for the development of Registered Mail revenues. Because a 0.8 percent increase represents substantially lower fees compared to the fees proposed by the Postal Service, the number of Registered Mail transactions and revenues would necessarily differ from the test year forecasted estimate of transactions and revenues. For purposes of analysis, however, the number of Registered Mail transactions in the test year is assumed to be the same as is estimated by the Postal Service, or 3,738,000.

180 USPS-T-1 (Potter), at 7.

Mail. This revision—caused by the inclusion of the costs of international Registry—reduced the test year after rates total cost from $65,313,000 to $62,686,000, and the unit cost from $17.47 to $16.77.[182] Based upon the Postal Service's revised total cost for Registered Mail and the same percentage fee increase, the resulting cost coverage is 107.1 percent. Table 1 compares the cost coverage resulting from a 0.8 percent fee increase at the Commission's total cost and at the Postal Service's proposed and revised total cost.

TABLE 1
REGISTERED MAIL
Comparison of OCA and USPS Cost Coverage

	TOTAL COST (000)	TOTAL REVENUE (000)	VOLUME (000)	UNIT COST	UNIT REVENUE	COST COVERAGE %
OCA	$39,740	$39,762	3,738	$10.63	$10.64	100.1%
USPS Revised	$62,686	$67,126	3,738	$16.77	$17.96	107.1%
USPS Proposed	$65,313	$67,126	3,738	$17.47	$17.96	102.8%

C. A 0.8 Percent Fee Increase Would Treat Registered Mail the Same As All Other Classes of Mail, and Permit Postal Service Review of Registered Mail as Planned

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181 Exhibit USPS-27F, at 6.

182 Tr. 8D/5013 (OCA/USPS-T10-7(b)). The circumstances prompting revision of the Postal Service's total cost for Registered Mail also required revisions to Postal Service's estimate of the Commission's costs, reducing total costs from $42,380,000 to $39,740,000, and unit costs from $11.34 to $10.63. Id.

With the exception of Registered Mail and Within County Periodicals, the Postal Service proposes a uniform increase in rates and fees for all mail classes and services.[183] For Registered Mail, the Postmaster General plans to recommend that the Board delay implementation should the Commission recommend and the Governors approve "Registered Mail fee increases of a magnitude suggested" by the Postal Service.[184] The contingent nature of the Postmaster General's statement recognizes the possibility that the Commission might recommend "a significantly smaller fee increase for Registered Mail," whereby "the Board might implement such [a] change at the same time as the other recommended rate and fee changes."[185]

Should the Commission recommend a 0.8 percent increase for rates and fees generally, it should recommend a 0.8 percent fee increase for Registered Mail. A 0.8 percent fee increase would be the same as the increase in rates and fees for nearly all mail classes and services. Moreover, as such a fee increase would be "significantly smaller" than proposed by the Postal Service, the Board could implement the fee increase for Registered Mail at the same time as the rate and fee changes are implemented for all other mail classes and services.

The Postal Service's intention to delay implementation of its 70.16 percent fee increase is based, in part, on concern as to the effect of such an increase on Registered Mail customers. The Postal Service recognizes that Registered Mail customers need

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183 USPS-T-27 (Robinson), at 2.

184 USPS-T-1 (Potter), at 7.

some "protection against [such] a large rate increase."[186] A 0.8 percent fee increase, being far smaller than the increase proposed by the Postal Service, would have a similarly smaller effect on Registered Mail customers, if recommended, than the Postal Service's proposed fees.

Moreover, the Postal Service's plan to delay implementation of its Registered Mail fee increase is intended to facilitate a review of the "operations, costs, customer needs and fee structure" of Registered Mail.[187] The Postal Service states that it is "not aware of any operational changes" that would significantly increase the cost of Registered Mail.[188] Nevertheless, the Postal Service observes that Registered Mail volume has been declining for many years.[189] This long-term decline appears little affected by changes in fees. According to the Postal Service, the "difference between the FY 2006 Before Rates and After Rates volumes shows the limited impact of the proposed Registered Mail fees on volume."[190]

Delayed implementation is also intended to "facilitate operational adjustments or redesign of the service if they were found to be needed."[191] In this manner, delayed

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185 "Response of United States Postal Service to Notice of Inquiry No. 1 Concerning Registered Mail, May 10, 2005," at 2.

186 USPS-T-27 (Robinson), at 17.

187 USPS-T-1 (Potter), at 7.

188 Tr. 8D/5002-06 (OCA/USPS-T10-2-3).

189 USPS-T-8 (Bernstein), at 208.

190 Tr. 8C/4055 (DBP/USPS-52).

191 USPS-T-27 (Robinson), at 17.

implementation "will guard against the potential of substantial changes in Registered Mail fees that may later be found to be inappropriate."[192]

Implementation of a 0.8 percent fee increase for Registered Mail need not be delayed in order for the Postal Service to conduct its review of Registered Mail as planned. In fact, implementation of the 0.8 percent increase, rather than delay, at the same time as the changes for all other mail classes and services would generate revenue while the Postal Service completes its review of Registered Mail.

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192 Tr. 3/374 (OCA/USPS-T1-3).