

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

POSTAL RATE AND FEE CHANGES, 2005)

Docket No. R2005-1

INITIAL BRIEF

OF

VALPAK DIRECT MARKETING SYSTEMS, INC., AND
VALPAK DEALERS' ASSOCIATION, INC.

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STATEMENT OF THE CASE

The Postal Service's Request

On April 8, 2005, the United States Postal Service filed a request, pursuant to the Postal Reorganization Act (39 U.S.C. sections 3622 and 3623), for a recommended decision by the Postal Rate Commission on changes in all rates and fees, including proposals relating to (i) Standard Enhanced Carrier Route ("ECR"), (ii) Standard Regular, (iii) Standard Nonprofit ECR, and (iv) Standard Nonprofit Regular mail rates.

The Postal Service's request asserted that without those changes the Postal Service would incur a revenue deficiency of \$3.041 billion in the requested test year (FY 2006). The Postal Service chose not to seek a contingency in the revenue requirement. According to the Postal Service's initial filing, the requested rates would generate a revenue surplus of \$112.023 million in the test year (later revised to \$281.473 million). Notice of United States Postal Service of Filing of Errata to Testimony of Witness Tayman (USPS-T-6) (Errata), Exhibit USPS 6A-1, filed June 9, 2005.

Further, the Postal Service's filing revealed that, for the first time ever, rather than going into this rate case with accumulated prior years' losses, the Postal Service estimated that, even without any rate increase, it would have accumulated retained earnings ("cumulative net income") in the amount of \$2.58 billion at year-end FY 2005.

The Postal Service's case-in-chief was presented as an across-the-board rate increase of 5.4 percent, with Standard ECR rates receiving an average increase variously described as 5.5 percent¹ or 5.6 percent.² The Postal Service proposed a rate increase for Nonprofit ECR of 5.9 percent.

Commission Order

On April 12, 2005, the Commission issued a Notice of Filing of the Postal Service's submission (Order No. 1436). In accordance with Rule 20 of the Commission's Rules of Practice and Procedure (39 CFR 3001.20), Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. each filed a notice of intervention on April 11, 2005. These intervenors have proceeded jointly in this proceeding, and are referred to collectively as "Valpak" or "VP."

Discovery of the Postal Service's Case-in-Chief

Valpak conducted written cross-examination of 13 Postal Service witnesses with respect to their direct testimony.

Witness Robert L. Shaw, Jr.	USPS-T-2
Witness Bradley V. Pafford	USPS-T-4

¹ USPS-T-27, p. 35.

² USPS-T-28, p. 17.

Witness Thomas W. Harrahush	USPS-T-5
Witness William P. Tayman, Jr.	USPS-T-6
Witness Thomas E. Thress	USPS-T-7
Witness Karen Meehan	USPS-T-9
Witness A. Thomas Bozzo	USPS-T-12
Witness Michael D. Bradley	USPS-T-14
Witness John Kelley	USPS-T-16
Witness Samuel T. Cutting	USPS-T-26
Witness Maura Robinson	USPS-T-27
Witness Altaf H. Taufique	USPS-T-28
Witness Jeffery W. Lewis	USPS-T-30

Counsel for Valpak conducted oral cross-examination of the following 15 Postal Service witnesses, which appears in the record on the dates specified at the identified transcript pages:

Witness John E. Potter (USPS-T-1)	June, 27, 2005	Tr. 2/91-93
Witness Tayman	June, 27, 2005	Tr. 2/222-48
Witness Robinson	June, 28, 2005	Tr. 3/485-545
Witness Taufique	June, 28, 2005	Tr. 3/735-55
Witness Cutting	June, 29, 2005	Tr. 4/859-912
Witness Shaw	July, 6, 2005	Tr. 5/1234-68
Witness Eliane Van-Ty-Smith (USPS-T-11)	July, 6, 2005	Tr. 5/1356-75
Witness Bozzo	July, 6, 2005	Tr. 5/1543-58
Witness Harahush	July, 7, 2005	Tr. 6/1850-63
Witness Dennis P. Stevens (USPS-T15)	July, 7, 2005	Tr. 6/2027-32
Witness Bradley	July, 7, 2005	Tr. 6/2290-2315
Witness Lewis	July, 7, 2005	Tr. 6/2401-37
Witness Pafford	July, 8, 2005	Tr. 7/2548-70
Witness Smith	July, 8, 2005	Tr. 7/2711-17
Witness Kelley	July, 8, 2005	Tr. 7/2981-3026

Discovery by Other Intervenors to Valpak.

Advo, Inc. (“Advo”) submitted discovery to Valpak institutionally, responses to which appear in the record at Tr. 12/6378-83.

Valpak Discovery of Other Intervenors

Valpak submitted discovery to Advo institutionally, responses to which appear in the record at Tr. 12/6253-62.

Valpak Direct Testimony

Valpak sponsored direct testimony, filed on July 19, 2005, by:

- Witness Robert W. Mitchell (VP-T-1) (Tr. 9/5264-5354); and
- Witness John Haldi (VP-T-2) (Tr. 9/5474-5558).

During discovery, a total of 64 interrogatories and requests for production of documents were propounded to witnesses Mitchell and Haldi by the following parties:

- Advo (ADVO/VP-T1-1-14, and ADVO/VP-T2-1-26);
- Alliance of Nonprofit Mailers (ANM/VP-T1-1);
- Direct Marketing Association (DMA/VP-T1-1-9); and
- Postal Service (USPS/VP-T1-1-12, and USPS/VP-T2-1-6).

The responses to certain of these interrogatories were designated as written cross-examination in the transcript:

- Witness Mitchell (Tr. 9/5359-5411 and Tr. 12/6267-6300); and
- Witness Haldi (Tr. 9/5560-5629 and Tr. 12/6302-76).

On August 24, 2005, oral cross-examination was conducted of witnesses Mitchell and Haldi on their direct testimony:

- Witness Mitchell (Tr. 9/5412-57); and
- Witness Haldi (Tr. 9/5630-5713).

Institutional Discovery to the Postal Service

The Presiding Officer's scheduling order (Presiding Officer's Ruling No. R2005-1/11) provided that the deadline for discovery to the Postal Service on its case-in-chief regarding Group A witnesses was June 10, 2005, the deadline for discovery to the Postal Service on its case-in-chief regarding Group B witnesses was June 17, 2005, and the deadline for institutional discovery to the Postal Service was August 23, 2005. On August 18, 2005, Valpak filed interrogatories to the Postal Service (VP/USPS-14-17), and on August 23, 2005, Valpak filed another interrogatory (VP/USPS-18). On August 29, 2005, the Postal Service filed objections to these two sets of Valpak interrogatories on the interesting theory that the responses could not be used for rebuttal testimony, as Valpak was the only intervenor that had filed direct testimony. By contrast, between the dates of the two sets of Valpak interrogatories to the Postal Service, on August 19, 2005, Advo filed interrogatories to the Postal Service (ADVO/USPS-1-10), and these were responded to without objection and cited extensively by Advo in its rebuttal testimony. (*See, e.g.*, ADVO-RT-1, p. 33 (Tr. 10/5759), p. 34 (Tr. 10/5760), p. 36 (Tr. 10/5762), and p. 38 (Tr. 10/5764).)

Rebuttal Testimony

On September 8, 2005, filing testimony in rebuttal to witnesses Mitchell and Haldi were two Advo witnesses and three Postal Service witnesses. These witnesses were orally cross-examined on September 14 and 15, 2005.

September 14, 2005

Advo Witness	Antoinette Crowder	ADVO-RT-1	Tr. 10/5770-5880.
Advo Witness	Godfred Otuteye	ADVO-RT-2	Tr. 10/5907-5921.

September 15, 2005

USPS Witness	James M. Kiefer	USPS-RT-1	Tr. 11/6181-6228.
USPS Witness	Jeffery W. Lewis	USPS-RT-2	Tr. 11/5949-6015.
USPS Witness	Michael D. Bradley	USPS-RT-3	Tr. 11/6099-6130.

I. THE POSTAL SERVICE REVENUE REQUIREMENT SHOULD BE REDUCED TO ACCOUNT FOR UNPRECEDENTED AND UNAUTHORIZED RETAINED EARNINGS.

The Postal Service's requested across-the-board increases to postal rates and fees in this docket are designed to recover a revenue requirement of \$73,213.919 million. Table 1 shows the Postal Service's revenue requirement and "after rates" financial results, as originally filed in its Request on April 8, 2005, and as updated based on errata to the testimony of Postal Service witness William P. Tayman, Jr. (USPS-T-6) filed on June 9, 2005.

Table 1
Financial Results with Proposed Rate and Fee Changes
Test Year 2006 (\$000)

	Test Year (as filed 4/8/05) ¹	Test Year (based on errata filed 6/9/05) ²
<u>Present Rates</u>		
Total Revenue Requirement	\$ 73,237,070	\$ 73,213,919
Less: Total Revenues	<u>70,195,210</u>	<u>70,334,067</u>
Total Revenue Deficiency	\$ 3,041,860	\$ 2,879,852
<u>Proposed Rates</u>		
Total Increase in Revenue	\$ 2,527,964	\$ 2,583,653
Total Decrease in Costs (Revenue Requirement)	<u>625,919</u>	<u>577,672</u>
Decrease in Revenue Deficiency	<u>3,153,883</u>	<u>3,161,325</u>
Total Revenue Surplus	\$ <u>112,023</u>	\$ <u>281,473</u>

¹ Request of the United States Postal Service for a Recommended Decision on Changes in Rates of Postage and Fees for Postal Services, filed April 8, 2005, p. 2; *see also* USPS-T-6, p. 54, Table 62.

² Notice of United States Postal Service of Filing of Errata to Testimony of Witness Tayman (USPS-T-6) (Errata), Exhibit USPS 6A-1, filed June 9, 2005; Responses of Postal Service Witness Tayman to Interrogatories of the Office of the Consumer Advocate Based on Errata to Testimony Filed June 9, 2005, Exhibit USPS 6A Revised, filed June 23, 2005 (Tr. 2/164).

A. For the First Time since Postal Reorganization, the Postal Service Has Substantial Retained Earnings.

In developing the revenue requirement in this docket, the Postal Service did not take into account the fact that, for the first time, it enjoyed substantial cumulative net income, or retained earnings.³ In his testimony, witness Tayman stated that “the Postal Service has not incorporated a provision for prior years’ losses in the revenue requirement.” USPS-T-6, p. 17, ll. 17-18. Witness Tayman confirmed this fact in the response to an interrogatory of the Office of the Consumer Advocate (“OCA”), by stating “[t]here is no provision in the revenue requirement for accounting for cumulative net income,” and also in cross-examination on June 27, 2005. Response to OCA/USPS-T6-4(b), Tr. 2/111, and Tr. 2/228, ll. 5-10. Since the Postal Reorganization Act of 1970 currently does not authorize the Postal Service to have such retained earnings, and the disposition of the Postal Service’s retained earnings generated since FY 2003 is governed by Public Law 108-18, “Postal Civil Service Retirement System Funding Reform Act of 2003,” the Commission will need to resolve an issue of first impression as to how it should adjust the revenue requirement.

Table 2 shows the Postal Service’s estimated accumulated retained earnings as of the end of FY 2004 and FY 2005.

³ “Retained earnings” is used, rather than “cumulative net income,” for example, in the United States Postal Report FY 2004 Annual Report (p. 41), and in the United States Postal Service Financial & Operating Statements, August, FY 2005 (p. 11).

Table 2
Summary of Retained Earnings at End of FY 2004 and FY 2005
(\$ in millions)

<u>Fiscal Year</u>	<u>Retained Earnings (as filed 4/8/05)</u>	<u>Retained Earnings (based on errata filed 6/9/05)</u>
2004	897.259 ⁴	897.259 ⁴
2005 (estimated)	2,540.712 ⁵	2,577.158 ⁶

The Postal Service's Request filed on April 8, 2005 estimated FY 2005 net income of \$1,643.455 million. USPS-T-6, Exhibits USPS 6A and USPS 6I, filed April 8, 2005. As a result of better-than-expected results, witness Tayman filed errata to his testimony of June 9, 2005, which reflected an estimated **FY 2005 net income of \$1,679.889** million, or an increase of \$36.444 million. Notice of United States Postal Service of Filing of Errata to Testimony of Witness Tayman (USPS-T-6), Exhibit USPS 6A-1, filed June 9, 2005.

In witness Tayman's response to interrogatory OCA/USPS-T1-5(a), redirected from Postal Service witness John E. Potter (USPS-T-1), regarding whether the Postal Service intended to modify its pending Request in light of the \$169 million difference between the anticipated test year net income of \$112 million estimated on April 8, 2005, and the \$281 million estimated on June 9, 2005, witness Tayman states that the Postal Service did not intend to modify its Request because "[t]he **increase of \$169 million to the test year after rates net**

⁴ USPS-T-6, Exhibit USPS 6I, filed April 8, 2005; *see also* United States Postal Service 2004 Annual Report, p. 41.

⁵ USPS-T-6, Exhibit USPS 6I, filed April 8, 2005.

⁶ Cross-examination of witness Tayman (Tr. 2/203, 1. 7); *see also* Notice of United States Postal Service of Filing of Errata to Testimony of Witness Tayman (USPS-T-6) (Errata), Exhibit USPS 6A-1, filed June 9, 2005.

income based on the errata filed [on June 9, 2005] is **immaterial** relative to the \$800 [million] less net income expected in 2006 due to the proposed January 2006 implementation date for new rates.” Response of witness Tayman to OCA/USPS-T-1-5(a), Tr. 2/167 (emphasis added). Of course, witness Tayman was attempting to justify why the additional \$169 million increase in test year after rates net income was being ignored, based on a factor which already had been relied on to support a lower level of net income. The Postal Service’s Request, which was filed on April 8, 2005, had indicated already that the new rates would not be implemented before January 2006 and that actual FY 2006 income was expected to be \$800 million less than FY 2006, after rates projections. USPS-T-6, p. 54, ll. 9-11.

Table 3 shows the Postal Service’s estimated accumulated retained earnings as of the end of Test Year 2006 before rates and after rates.

Table 3
Summary of Retained Earnings at End of Test Year 2006
(\$ in millions)

Before Rates:

Retained Earnings (9/30/05)	\$ 2,577.158 ⁷
TY 2006 Net Income (Before Rates)	<u>201.148⁸</u>
Retained Earnings (9/30/06, before escrow)	\$ 2,778.306
Less: Sept. 30, 2006 Escrow Payment	<u>3,081.000</u>
Retained Earnings (9/30/06, after escrow)	<u>\$ (302.694)</u>

After Rates:

Retained Earnings (9/30/05)	\$ 2,577.158 ⁷
TY 2006 Net Income (After Rates)	<u>3,362.473⁸</u>
Retained Earnings (9/30/06, before escrow)	\$ 5,939.631
Less: Sept. 30, 2006 Escrow Payment	<u>3,081.000</u>
Retained Earnings (9/30/06, after escrow)	<u>\$ 2,858.631</u>

It is acknowledged that having retained earnings shown on its financial statements does not mean that the organization has an equivalent amount in its cash account. In fact, witness Tayman made this point during his cross-examination, stating that “cumulative net income does not necessarily mean you have a pot of cash sitting there to fund the escrow....” Tr. 2/226, ll. 17-19. Although it is true that “cumulative net income does not necessarily mean” the Postal Service has a pot of cash, in this case the Postal Service does actually have a

⁷ Cross-examination of witness Tayman (Tr. 2/203, l. 7).

⁸ Notice of United States Postal Service of Filing of Errata to Testimony of Witness Tayman (USPS-T-6) (Errata), Exhibit USPS 6A-1, filed June 9, 2005.

considerable “pot of cash sitting there to fund the escrow.” As of August 31, 2005, that pot of cash totaled nearly \$2 billion.⁹

Table 4 provides a comparison of the “Cash and cash equivalents” and the “Retained earnings” reported in the Postal Service’s monthly Financial & Operating Statements for the past five months since the Postal Service’s Request was filed on April 8, 2005 through August 31, 2005.

Table 4
Comparison of Cash and Cash Equivalents vs. Retained Earnings
for Selected Dates¹⁰
(\$ millions)

<u>Date</u>	<u>Cash and Cash Equivalents</u>	<u>Retained Earnings</u>	<u>Ratio of Retained Earnings to Cash and Cash Equivalents</u>
August 31, 2005	1,972	2,364	1.20
July 31, 2005	2,008	2,355	1.17
June 30, 2005	3,004	2,614	0.87
May 31, 2005	2,546	2,734	1.07
April 30, 2005	2,301	2,922	1.27

Recognizing there can be fluctuations due to payments for payroll and other items, Table 4 appears to show that the Postal Service’s cash position has not been totally unrelated to its retained earnings since the rate case was filed.

⁹ United States Postal Service Financial & Operating Statements, August, FY 2005 (p. 10).

¹⁰ United States Postal Service Financial & Operating Statements, April, FY 2005 through August, FY 2005 (*see* pp. 10-11 of each report).

Also, the Postal Service appears to have substantially improved its cash position as of August 31, 2005 (\$1.972 billion) compared with that as of August 31, 2004 (\$166 million¹¹). This may be even more noteworthy since, in October 2004, the Postal Service paid off its \$1,800 million debt to the Federal Financing Bank outstanding at the end of FY 2004. Responses of witness Tayman to OCA/USPS-T6-19, Tr. 2/133, and to OCA/USPS-T6-43(b), Tr. 2/159. The Postal Service currently has no outstanding debt to the Federal Financing Bank. Response of witness Tayman to OCA/USPS-T6-28, Tr. 2/142.

B. The Postal Reorganization Act Does Not Authorize the Postal Service to Have Substantial Retained Earnings.

The Postal Reorganization Act does not address explicitly “cumulative net income” or “retained earnings.” Regarding the Postal Service’s authority to fix rates and classes, section 3621 of the Postal Reorganization Act states:

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 of the Postal Service. [39 U.S.C. § 3621, emphasis added.]

The “will equal as nearly as practicable” wording in section 3621 has been taken to mean that a “break-even” concept should apply to the finances of the Postal Service, not authorization for the Postal Service to have substantial retained earnings.

Although section 3621 goes on to state that “[f]or purposes of this section, ‘total estimated costs’ shall include ... a reasonable provision for contingencies,” this would appear

¹¹ United States Postal Service Financial & Operating Statements, August, FY 2004, p. 10.

to be a slender reed on which to assert that, based on this section, Congress authorized the Postal Service to accumulate a substantial amount of retained earnings.

In its *Opinion and Recommended Decision* in Docket No. R94-1, the Commission stated: “[Congress] intended the Postal Service to operate on a **break-even** basis....” *Op. & Rec. Dec.*, Docket No. R94-1, p. II-30, ¶ 2083, emphasis added. Before that, in its *Opinion and Recommended Decision* in Docket No. R77-1, the Commission cited to the Postal Service’s “**statutory requirement of ‘break-even.’**” *Op. & Rec. Dec.*, Docket No. R77-1, p. 47, emphasis added. And, going back to Docket No. R76-1, the Commission stated in its *Opinion and Recommended Decision*:

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. This is the meaning of the “break-even”** equation of § 3621. [*Op. & Rec. Dec.*, Docket No. R76-1, p. 29, emphasis added.]

Witness Potter was asked, during his cross-examination on June 27, 2005 by the OCA, for his opinion regarding what it means “when Congress says 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 the total estimated costs of the Postal Service,” and whether “total estimated income include[s] the notion of cumulative net income....” Tr. 2/77, 1. 20 through 2/78, 1. 3. Witness Potter said:

If you read the Postal Service’s **transformation plan**, we dealt with this notion of **retained earnings** on cumulative net income, and what we said was that would provide an opportunity for us to use those funds to invest in capital to make us more productive.

It would also provide an opportunity for us, over the course of time, to smooth our rate increases. [Tr. 2/78, ll. 4-10, emphasis added.]

The United States Postal Service *Transformation Plan*, which was prepared by the Postal Service in April 2002 and submitted to Congress, addresses the issue of retained earnings in Section 3, “Preparing for the Future.” Section 3 states:

Ultimately, the future business model of the Postal Service is a policy decision. In recent years, discussion and debate over the proper role for the Postal Service in the 21st century has been vigorous, and appropriately so, for important public questions are [at] stake. After taking into account this public dialogue and stakeholder input ... the Board of Governors and senior leadership of the Postal Service have formed an opinion on the most appropriate model for the Postal Service for the next few decades. [United States Postal Service *Transformation Plan*, April 2002, p. 70.]

After briefly discussing two other models that were considered, the Government Agency model and the Privatized Corporation model, Section 3 goes on to discuss the Commercial Government Enterprise model:

Postal Service leadership has concluded that the model of a Commercial Government Enterprise offers the best hope for transforming the Postal Service into an enterprise equipped to maintain universal service at affordable prices in the economy of the 21st century. [United States Postal Service *Transformation Plan*, April 2002, p. 71.]

Section 3 of the *Transformation Plan* then states, under the subsection “Net Income and Retained Earnings,” that:

The Commercial Government Enterprise **should** have the goal of earning reasonable returns over the long term and **have the ability to accumulate retained earnings**. [United States Postal Service *Transformation Plan*, April 2002, p. 71, emphasis added.]

Based on the text of the report, it does not appear that the Postal Service believed that it was authorized to accumulate retained earnings, at least in 2002.

During cross-examination, witness Tayman was asked to explore the legal basis for the Postal Service having retained earnings. Witness Tayman stated that section 2009 of the Postal Reorganization Act “takes into consideration the existence of surpluses as well as deficits.” Tr. 2/219, ll. 14-15. Witness Tayman went on to state that, based on section 2009: “I’m suggesting that cumulative net income is appropriate for the Postal Service.” Tr. 2/219, ll. 15-16. However, section 2009, which addresses the requirement for the Postal Service to prepare an annual budget program and submit it to the Office of Management Budget (“OMB”), simply states that “[s]uch budget program shall include ... an analysis of surplus or deficit” 39 U.S.C. § 2009. Section 2009, which indicates only that a complete budget submission to OMB should include an analysis of surplus or deficit, certainly does not authorize the Postal Service to have substantial retained earnings.

Further, in response to interrogatory OCA/USPS-T6-17 regarding whether it would be appropriate for the Postal Service “to reduce the revenue requirement so as to reduce accumulated past year gains at a measured pace over a particular period of time,” witness Tayman indicated this would not be appropriate, stating “it is appropriate for the Postal Service to maintain cumulative net income.” Response to OCA/USPS-T6-17, Tr. 2/131. In response to interrogatory OCA/USPS-T6-41(b) regarding what should be the **basis** for determining the amount of cumulative net income that is maintained by the Postal Service, witness Tayman states that “[m]anagement should be responsible for determining an appropriate amount of cumulative net income.” Response to OCA/USPS-T6-41(b), Tr. 2/156.

As a justification for the Postal Service maintaining cumulative net income (*i.e.*, retained earnings), witness Tayman offers a novel rationalization, which is that “the cost of land has not been included in the revenue requirement even though all mailers have benefitted from the use of facilities located on the land, and, at the same time, gains from the sale of land have been recognized as reductions to the revenue requirement.” He goes on to state: “Since 1971 the Postal Service’s investment in land has increased from \$155 million to \$2,810 million,” and “Accordingly, it is appropriate for the Postal Service to maintain cumulative net income.” Response to OCA/USPS-T6-17, Tr. 2/131.

During witness Tayman’s cross-examination, in response to a question regarding whether he would place a dollar limit on the amount of cumulative net income the Postal Service should have, he stated: “I did suggest that one could make a case that cumulative net income equal to at least the value of land might be an appropriate consideration, not the only consideration.” Tr. 2/220, ll. 2-8. Witness Tayman then clarified this statement by saying: “I don’t think there is a set formula that would be appropriate to determine how much cumulative net income should be on hand at any one point in time, but I think it’s something [*i.e.*, the economy, the financial health of the Postal Service] that management should take into consideration on a year-to-year basis and would reflect that when they decide to increase prices.” Tr. 2/220, ll. 13-22.

In response to interrogatory OCA/USPS-T6-41(a), which requested an explanation of the relationship between “[t]he accumulated net income or loss of the Postal Service” and the Postal Service’s land investment, witness Tayman stated that “[t]here is no specific relationship,” although he adds that “the maintenance of a cumulative net income would be one

way of offsetting the cost to the Postal Service for the cash outlay required to purchase land.” Response to OCA/USPS-T6-41(a), Tr. 2/156. Also, in response to a question during his cross-examination by the OCA regarding whether the Postal Service has ever attempted to recover the cost of land in the revenue requirement, witness Tayman answered: “Up through this filing, we have not.” Tr. 2/218, ll. 21-24.

When witness Potter was asked during cross-examination by the OCA whether there should be any limit on the amount of cumulative net income that the Postal Service should be able to build over the years, he stated: “I would defer, I guess, to the board of governors when it comes to whether or not there should be a cap on retained earnings or cumulative net income.” Tr. 2/77, ll. 7-10. In any case, it is clear from its Request to raise postal rates and fees in this docket that the Postal Service did not take its retained earnings (*i.e.*, cumulative net income) into consideration in any way that is reflected in the proposed rates and fees.

C. Pending and Un-enacted Postal Legislation Could Give the Postal Service, for the First Time, the Right to Have Retained Earnings.

Both pending “postal reform” bills in the 109th Congress, S. 662 and H.R. 22, have provisions which, for the first time, would authorize the Postal Service to have retained earnings. The relevant sections of these two bills are summarized as follows:

- **S. 662.** Section 201 of S. 662, in amending 39 U.S.C. section 3622, provides that the new Postal Regulatory Commission shall establish a modern system for regulating rates and classes for market-dominant products, and that such system shall be designed to achieve a number of objectives, including:

(6) To assure adequate revenues, including **retained earnings**, to maintain financial stability

and meet the service standards established under section 3691. [S. 662, sec. 201(a), emphasis added.]

- **H.R. 22.** Section 201 of H.R. 22, in amending 39 U.S.C. section 3622, provides that the new Postal Regulatory Commission shall establish a modern system for regulating rates and classes for market-dominant products, and that such system shall be designed to achieve a number of objectives, including:

(6) To assure adequate revenues, including **retained earnings**, to maintain financial stability. [H.R. 22, sec. 201(a), emphasis added.]

However, these bills are still only pending and are not law, and provide no current authorization to the Postal Service to have retained earnings. If members of Congress believed that the Postal Service now has authority to maintain substantial retained earnings, they would not be considering proposals to give it that authority for the first time in amendments to the Postal Reorganization Act in the pending Senate and House bills.

D. As the Postal Service Is Not Allowed to Have Retained Earnings Under Current Law, Such Earnings Should Be Used to Reduce the Revenue Requirement.

Since the Postal Reorganization Act does not authorize the Postal Service to have any retained earnings, it would make sense that the revenue requirement should be reduced by the full amount of retained earnings.

Such an approach would be consistent with the Commission's interpretation of the "break-even" equation in section 3621 of the Postal Reorganization Act, discussed above, where the Commission stated in Docket No. R76-1:

we [*i.e.*, the Commission] are directed to insure, as nearly as practicable, that the enterprise [*i.e.*, the Postal Service] **neither makes a profit nor suffers a loss. This is the meaning of the “break-even” equation of § 3621.** [*Op. & Rec. Rec.*, Docket No. R76-1, p. 29, emphasis added.]

Certainly, as discussed above, witness Tayman’s claim during cross-examination that section 2009, “Annual budget,” of the Postal Reorganization Act provides a legal basis for the Postal Service to have retained earnings does not withstand scrutiny. Tr. 2/219, ll. 12-16. Section 2009 requires only that the Postal Service provide an annual budget program to OMB, and does not authorize it to have substantial retained earnings.

Moreover, it is not only the “break-even” requirements of the Postal Reorganization Act that mandates this result. The very law which created the Postal Service’s positive net income beginning in FY 2003 specifies how it must be expended. Section 3, “Disposition of Savings Accruing to the United States Postal Service,” of Public Law 108-18, which defines “savings” as the difference between the annual amounts that the Postal Service would have had to pay to the Civil Service Retirement and Disability Fund prior to Public Law 108-18 and the annual amounts required to be paid pursuant the Public Law 108-18, requires that such savings:

(1) shall, to the extent that such savings are attributable to fiscal year 2003 or 2004, be used to **reduce the postal debt** (in consultation with the Secretary of the Treasury) ...

(2) shall, to the extent that such savings are attributable to fiscal year 2005, be used to **continue holding postage rates unchanged** and to **reduce the postal debt**, to such extent and in such manner as the Postal Service shall specify (in consultation with the Secretary of the Treasury)... [Pub. L. 108-18, Sec. 3(a), emphasis added.]

The Postal Service paid off its debt to the Federal Financing Bank in October 2004. Responses of witness Tayman to OCA/USPS-T6-19, Tr. 2/133, and to OCA/USPS-T6-43(b), Tr. 2/159. Further, based on the filings in this docket, the Postal Service estimates it will have \$2,577.158 million in retained earnings at the end of FY 2005. Cross-examination of witness Tayman, Tr. 2/203, l. 7.

Now that the Postal Service's debt is paid, the balance of any "savings" must be used to continue holding down postal rates until the funds are exhausted. When the OCA asked witness Potter during oral cross-examination whether he agreed with witness Tayman's response to OCA/USPS-T6-1(c), which stated "[t]he 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," witness Potter said: "Particularly, the large part, yes." Tr. 2/71, l. 23 – Tr. 2/72, l. 2. As a follow-up question, the OCA asked witness Potter, "would you say that's generally true of Fiscal Year 2005 as well, the fact that there is a \$1.64 billion net income at the end of Fiscal Year 2005 is in large part due to the Civil Service retirement savings?", and witness Potter responded by saying "[w]ithout that, we would have a negative net income." Tr. 2/72, l. 14-19.

Accordingly, the full amount of the current retained earnings should be traced to savings from Public Law 108-18. And now, in this docket, the Postal Service is requesting a 5.4 percent across-the-board increase in postal rates and fees without applying any of its FY 2005 year-end retained earnings to reduce the revenue requirement, because it says that the escrow costs do not "serve a 'postal' function" and are "unrelated to postal operations...." USPS-T-27, p. 6, l. 13, and response of witness Tayman to OCA/USPS-T6-1(d), Tr. 2/106.

This rationale does not override the requirements of both the Postal Reorganization Act and Public Law 108-18, neither of which permits substantial retained earnings.

Although it is not known when the Postal Service intends to file the next rate case, when Chairman George A. Omas asked Postal Service witness James M. Kiefer (USPS-RT-1), during cross-examination on September 15, 2005, whether his office is “currently working on preparing the next Omnibus case,” witness Kiefer responded, “Yes.” Tr. 11/6230, ll. 1-11. “Rate Case Planning” is one of the agenda items for the closed session of the Postal Service Board of Governors meeting scheduled for September 26, 2005. 70 *Fed. Reg.* 55430, Sept. 21, 2005. Since it appears that the next rate case soon will be filed, the Postal Service cannot argue that it wants to accumulate retained earnings to put off the next case, even if that were a legal basis for having a substantial amount of retained earnings, which it is not.¹²

E. At a Bare Minimum, the “One-Ninth” Rule that Applies to the Issue of Prior Years’ Losses Should Apply to the Issue of Substantial Retained Earnings.

Witness Tayman indicated that, in calculating the revenue requirement of the Postal Service since Docket No. R77-1, the Postal Service and the Commission have included **one-ninth** of the prior years’ losses in order to recover the prior years’ losses.¹³ Response of

¹² We do not discount the possibility that the Postal Service may argue persuasively that retained earnings should be reduced to account for lost revenue due to delayed implementation in the rate increases beyond the beginning of the Test Year.

¹³ It is not clear whether witness Tayman is correct that the Postal Service and the Commission have included one-ninth of the prior years’ losses in order to recover the prior years’ losses in all past rate cases since Docket No. R77-1. It appears that one-ninth was used beginning in Docket No. R84-1, while one-seventh was used in Docket No. R77-1 and Docket No. R76-1. *See, e.g., Op. & Rec. Dec.*, Docket No. R84-1, p, 74, fn. 67.

witness Tayman to OCA/USPS-T6-3, Tr. 2/110. In its Request in this docket, the Postal Service has included a zero amount for “Recovery of Prior Year Losses” (“RPYL”), a line item which has been used in prior dockets, for the Test Year before rates and the Test Year after rates. USPS-T-6, Exhibit USPS 6A Revised, filed June 9, 2005, Tr. 2/164; response of witness Tayman to OCA/USPS-T6-2, Tr. 2/109.

In this docket, based on the financial information filed by the Postal Service, the Postal Service will have unprecedented retained earnings of \$2,577.158 million at the end of FY 2005 (earned from positive net income in FY 2003, FY 2004, and FY 2005). Cross-examination of witness Tayman, Tr. 2/203, ll. 4-7. And, as discussed above, at the end of Test Year 2006 **after rates**, the Postal Service anticipates that it will have net income of \$281.473 million, resulting in \$2,858.631 million in retained earnings at the end of the year, **after** the required \$3,081 million escrow payment is made. USPS-T-6, Exhibit USPS 6A Revised, filed June 9, 2005, Tr. 2/164.

In calculating the revenue requirement, the OCA asked (in interrogatory OCA/USPS-T6-17) whether, if the Commission wishes to reduce the accumulated retained earnings “smoothly and to conform the timing of the recovery of those gains more nearly in time with mailers who were responsible for the gains,” the Commission could use the methodology for handling past years’ losses (*i.e.*, the “one-ninth rule”) to reduce the revenue requirement so as to reduce accumulated retained earnings. In response, witness Tayman insisted that the Commission could not use this methodology, stating that “[t]he type of mechanism that was applied to recover prior years’ losses in the context of accumulated net deficits cannot simply be inverted and applied to gains and be assumed to be consistent with the policy of break-

even....” Response of witness Tayman to OCA/USPS-T6-17, Tr. 2/131. Witness Tayman later confirmed this position during cross-examination. Tr. 2/216, ll. 13-18.

Witness Potter, during cross-examination by the OCA, addressed the Postal Service’s cumulative net income, stating:

As you’ve stated, we’ve never been in a position where we’ve had cumulative net income. We’ve never established a policy of what do you do when you get into that position. [Tr. 2/76, ll. 1-4.]

Regarding the one-ninth rule, witness Potter appeared to be less dismissive of its possible application in using cumulative net income to reduce the revenue requirement. In discussing how cumulative net income might be handled, witness Potter stated:

Theoretically, **I guess if you look at what we do when we had a negative cumulative net income, you divide by nine**, you might want to play that scenario out. [Tr. 2/76, ll. 5-7 (emphasis added).]

Witness Potter qualified his comments regarding cumulative net income later by stating:

We will **when we file a true omnibus rate case**. In this case, we’re filing, very specifically. We made a policy decision to file very specifically for the escrow. So if you look at this case, it’s extremely narrow. I think if we have a cumulative net income, and we file the omnibus rate case, **you will see us proffer a policy** on how we deal with that situation. [Tr. 2/76, ll. 18-24 (emphasis added).]

However, it would appear that the Postal Service already has filed a “true omnibus rate case,” at least in the sense that rates for all products are proposed to increase. And it would appear that the Postal Service has in fact determined that it need not reduce the revenue requirement by even one dollar due to the fact that it had retained earnings of \$2.364 billion, with nearly \$2

billion of “cash in the bank,” as of August 31, 2005.¹⁴ The Commission cannot wait for the Board of Governors to devise a policy for the future. The Commission must determine in this docket whether the Postal Service is allowed to have unlimited retained earnings without any statutory authorization and in the face of the express requirements in Public Law 108-18, and if not, adjust the revenue requirement in this case before rates are set.

F. The Revenue Requirement as Proposed by the Postal Service Should Be Reduced.

The revenue requirement should be reduced by the **full amount** of retained earnings. If the Commission disagrees with this approach, for the reasons set out above, pending full consideration of the issue in the next docket, at a **bare minimum** the Commission should reduce the revenue requirement requested by the Postal Service, as follows:

- (1) Application of the One-ninth Rule to Cumulative Net Income. Positive retained earnings should be treated in the same way that the Board of Governors and the Commission have consistently treated negative retained earnings, and the revenue requirement requested by the Postal Service should be reduced by one-ninth of retained earnings in this docket. There does not appear to be any valid reason why the same rule cannot be applied to reduce prior years’ gains. Under this approach, the revenue requirement would be reduced by **\$286.351 million** (*i.e.*, year-end FY 2005 retained earnings of \$2,577.158 million ÷ 9).

¹⁴ United States Postal Service Financial & Operating Statements, August, FY 2005 (pp. 10-11).

- (2) Reduce Test Year Income to Match Test Year Costs. The Postal Service estimates there will be an after-rates revenue surplus in Test Year 2006. If this revenue surplus was eliminated by matching Test Year income and costs, the reduction in the revenue requirement would be **\$281.473 million**.

In aggregate, these two reductions to the revenue requirement total **\$567.824 million**, and a portion of this reduction could be used to offset the revenue loss from excess Standard ECR coverage, as discussed in Section V, *infra*.

It is true, as the Postal Service has said time and again, that the Postal Service will not be able to implement the new rates before January 2006, resulting in actual FY 2006 net income that is expected to be perhaps \$800 million less than FY 2006, After Rates projections. USPS-T-6, p. 54. If, in this docket, rate implementation were to occur three months **before** the beginning of a test year, it is highly unlikely that the Postal Service would argue that such earlier implementation date should be considered by the Commission, allowing it to reduce the revenue requirement by the amount of the extra revenues it would receive. If this argument should not be used regarding a rate implementation **prior** to the beginning of the test year, it should not be used regarding a rate implementation **after** the beginning of the test year. It has never been the responsibility of the Commission to determine when new rates should or should not be implemented. As in the past, we believe that the Commission should focus on, and be guided by, its analysis of the projected test year revenues and cost.

II. THE POSTAL SERVICE'S ACROSS-THE-BOARD PROPOSAL IN THIS CASE SHOULD BE REJECTED.

In this docket, the Postal Service has sought a contingency of zero. This unusual aspect of its request produced the apparently-satisfying coincidence that the FY 2006 test year deficit is roughly the same size as the Civil Service Retirement System ("CSRS") escrow payment due to be paid September 30, 2006. Working with this coincidence, the Postal Service has taken three positions:

- (1) the **deficit** is logically and causally linked to the **escrow payment**;
- (2) **funding the deficit** is essentially equivalent to **funding the escrow**; and
- (3) the **best way to fund the escrow** is through an **across-the-board** rate increase, consistent with each mailer being assigned a **postage-proportionate share of the escrow**, built on the rates and revenues of

Docket No. R2001-1.

None of these positions is justified. A causal link between the deficit and the escrow does not exist; funding the deficit is no more linked to the escrow than to any other pool of costs; and the deficit should be funded according to the ratesetting policies of the Postal Reorganization Act. The notion of each mailer somehow being burdened with some share of the escrow payment or any other operating expense is inconsistent with accepted ratemaking principles.

The Postal Service's proposed across-the-board approach should be rejected, and we believe that the Commission should develop rates consistent with the Postal Reorganization Act, by applying principles it has developed and honored in the past, including the appropriate recognition of estimates of current costs. In the case of Standard Mail rates, and ECR rates in

particular, due consideration should be given to the costs set forth by Valpak witness John Haldi (VP-T-2) and the rate design of Valpak witness Robert W. Mitchell (VP-T-1), as well as all of the five rebuttal witnesses.

A. Fixating on the Escrow Payment and Inserting It into an Across-the-Board Rate Increase Is Not Justified.

The method by which rates and fees are to be established is specified in 39 U.S.C. section 3621, which states:

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** of the Postal Service. For purposes of this section, “total estimated costs” shall include (without limitation) **operating expenses**, depreciation on capital facilities and equipment, debt service ..., and a reasonable provision for contingencies. [39 U.S.C. § 3621 (emphasis added).]

The Postal Service’s request to the Commission appears to follow the statute, by linking (i) the **requested rate and fee increases** to (ii) the **projected test year deficiency**. *See* USPS-T-6, p. 54. Indeed, the request states that “[w]ithout rate and fee changes, the Postal Service would incur a substantial revenue deficiency in the proposed test year, in contravention of 39 U.S.C. § 3621.” Request of the United States Postal Service for a Recommended Decision on Changes in Rates of Postage and Fees for Postal Services, Docket No. R2005-1, April 8, 2005, p. 1. Had the Postal Service followed through under the policies of the Postal Reorganization Act, it would have recognized current costs and selected markups, much as it has done in the past, and its proposal would not have an across-the-board character.

However, Postal Service witness John E. Potter’s testimony (USPS-T-1) envisions a link between (i) the **deficit** and (ii) the **requirement to meet the September 30, 2006 escrow**

payment — the escrow payment being that financial obligation, beginning in FY 2006, imposed on the Postal Service by the Postal Civil Service Retirement Funding Reform Act of 2003, Public Law 108-18, enacted on April 23, 2003. USPS-T-1, p. 2, ll. 3-11.¹ The Postal Service treats the September 30, 2006 escrow payment as an expense of a sort not anticipated by the Postal Reorganization Act, the payment of which “requires” what Postal Service witness James M. Kiefer (USPS-RT-1) calls an “innovative solution.” Postal Service rebuttal witness Kiefer, USPS-RT-1, p. 3, l. 22, Tr. 11/6151. The solution adopted is a proposed across-the-board rate increase. For the reasons set out below, no innovation is required.

Before looking at Public Law 108-18, it should be noted that Valpak witness Mitchell explains the dangers inherent in attempting to ascribe a deficit to a particular expense. *See* VP-T-1, pp. 10-11, Tr. 9/5276-77. He explains that deficits are residual in nature, being the difference between the sum of all revenues and the sum of all costs, and that they are no more linked to one expense than to another. Furthermore, no particular expense necessarily leads to a deficit.²

¹ Postal Service witness Maura Robinson’s testimony (USPS-T-27) takes some curious liberties with witness Potter’s testimony. According to witness Robinson, “as witness Potter explains, **absent the escrow requirement, the Postal Service would not currently be proposing a change in the rates and fees** and the associated ‘**institutional burden[s] borne by the subclass[es].**’ USPS-T-1 at 7.” USPS-T-27, p. 6, ll. 14-17 (emphasis added). Neither at the location specifically indicated, nor at any other place in witness Potter’s testimony, does he use the words ascribed to him by witness Robinson. Moreover, nowhere in witness Potter’s testimony does he make the statement “absent the escrow requirement, the Postal Service would not be proposing a change in rates and fees.”

² Witness Mitchell did agree that situations could be concocted in which most observers would tend to associate a deficit with a cause, such as a sudden and unexpected earthquake disrupting balanced-budget operation. But the escrow does not have these characteristics and, even if it did, the ratesetting guidance in the Postal Reorganization Act

Even beyond the logic flaws in the Postal Service's approach, the proper method to address a pending deficit is already governed by statute. Section 3 of Public Law 108-18 requires that, with regard to the Civil Service Retirement System, "amounts ... in any fiscal year [after FY 2005] ..., shall be computed by the Office of Personnel Management for each such fiscal year" Pub. L. 108-18, Sec. 3(b)(1). The same section then requires that such amounts:

(3) to the extent that ... [they] are attributable to any fiscal year after fiscal year 2005, **shall be considered** to be **operating expenses** of the Postal Service and, until otherwise provided by law, shall be held in escrow and may not be obligated or expended. [*Id.*, Sec. 3(a)(3) (emphasis added).]

In some respects, the Postal Service faithfully followed the statutory requirement that the escrow "be considered to be operating expenses of the Postal Service." The Postal Service did not set out the escrow payment as a separate line item, but rather included it in Segment 18, "HQ & Area Administrative & Corporatewide Personnel Costs," along with other Segment 18 operating expenses, such as "personnel costs for Headquarters and Headquarters related field service units, the money order function, Area Administration, and Law Enforcement, and other servicewide costs...." USPS-T-6, Exhibit USPS 6A Revised, filed June 23, 2005, Tr. 2/164, and USPS-T-6, p. 45, ll. 10-25.

Further, the Postal Service determined that the escrow costs, as required by Public Law 108-18, were not volume variable and not attributable to any particular class of mail. USPS-T-27, p. 6, ll. 9-11. The Postal Service likewise determined that, although the escrow costs

would be the appropriate way to raise any additional revenues needed. *See* response to DMA/VP-T1-3 and DMA/VP-T1-4, Tr. 9/5399-5402.

could be considered to be an “institutional” cost, the escrow costs did “not serve a ‘postal’ function.” USPS-T-27, p. 6, l. 13. The Postal Service states “the escrow requirement is unlike any other ‘expense’ that the Postal Service incurs, in that it is unrelated to the provision of postal services.” USPS-T-27, p. 6, ll. 22-23.

On cross-examination, however, Postal Service witness William P. Tayman, Jr. (USPS-T-6) was confronted with numerous other Congressionally-imposed obligations over the years imposing costs on the Postal Service in a manner not dissimilar in type or amount from the escrow payment (*e.g.*, OBRA 1990, Tr. 2/235, l. 12 – Tr. 2/239, l. 25). The best that he could do to differentiate these expenses was to say that the escrow expense is “unidentified and — and — and arbitrary.” Tr. 2/246, ll. 24-25. These descriptors do not apply. The origin and development of the escrow expense are well identified,³ and they are certainly not arbitrary.

The Postal Service analogized the escrow payment to a federal tax. Witness Tayman describes the escrow requirement to be a “legislated expense, over which management has no control, and provides no economic benefit to the Postal Service.” USPS-T-6, p. 12, ll. 3-4. He goes on to state that, although “Congress specifically dictated that the escrow obligation is an operating expense,” “[u]nder its current definition, the escrow represents a true **tax** or burden on the system.” USPS-T-6, p. 18, ll. 3-6 (emphasis added). Also, witness Robinson states: “As some commentators have observed, the \$3.1 billion escrow burden is not unlike a

³ Interestingly, in the only instance where witness Potter mentions the title of Public Law 108-18 in his written testimony, he refers to it as the “Civil Service Retirement Funding Reform Act of 2003,” omitting the word “Postal” from the beginning of its statutory title. USPS-T-1, p. 2, l. 9.

'tax' that has been placed on the Postal Service” USPS-T-27, p. 6, ll. 24-25 (italics original, emphasis added).

Despite the precedent for Congressional imposition of such “taxes,” and despite Congress’ clear inclusion of escrow costs with other “operating expenses” in seeking changes in postage rates and fees, the Postal Service has chosen to request an across-the-board increase in rates and fees, as if it had the authority to tax postal products and services in this docket. Witness Robinson states that “**Postmaster General Potter determined** that a very reasonable approach to fulling the escrow obligation was on a *pro rata* basis through an across-the-board rate increase resulting in substantially equal percentage rate changes for all customers.” USPS-T-27, p. 7, l. 14 – p. 8, l. 1 (emphasis added). In deferring to the determination of Postmaster General Potter, she does not address witness Potter’s candid admission that he is “not an expert in postal costing and pricing....” USPS-T-1, p. 6, l. 4. Moreover, witness Potter states that not he, but “the **Board of Governors** has directed the Postal Service to request that the Commission recommend uniform 5.4 percent increases over existing rates and fees.”⁴ USPS-T-1, p. 5, ll. 10-12 (emphasis added). Whether the policy decision in question was made by witness Potter, or by the Board of Governors, is somewhat beside the point, as Congress had already addressed the proper treatment of this cost.

⁴ In response to a question from Commissioner Covington regarding the decision to pursue an across-the-board increase while postal reform legislation was pending, witness Potter responded: “The board, again, gave us that direction. They are the only ones that can make decisions when it comes to filing a rate case. I don’t want you to think it was solely my decision.” [Tr. 2/94, l. 24 – Tr. 2/95, l. 2.]

Congress, in crafting what was to become Public Law 108-18, chose the same words to describe how it wanted the Postal Service to consider the escrow costs — “operating expenses” — as are used in 39 U.S.C. section 3921. The Postal Reorganization Act is abundantly clear on how “operating expenses” are to be recovered through the conventional ratemaking process. Presumably, if Congress wanted the Postal Service to handle the escrow costs in some different manner than all other “operating expenses,” it could have used another term, such as a “tax” or a “surcharge” and could have specified that it be recovered in a different method than all other “operating expenses” are recovered, such as being recovered across-the-board.

All considerations that went into the Postal Service’s decision to file an across-the-board increase in rates and fees, rather than a traditional omnibus rate case — which would have looked at all changes over the past four years since the last litigated rate case, Docket No. R2000-1 — are not known. However, witness Potter stated: “Should legislation be enacted that relieves the Postal Service of this \$3.1 billion obligation before a recommended decision is issued in this docket, we will withdraw this request.” USPS-T-1, p. 7, ll. 17-19. Certainly the Postal Service’s across-the-board increase was cited repeatedly in the House of Representatives to encourage support for postal reform legislation changing the escrow requirement. House members apparently believed that passage of a postal reform bill was necessary to eliminate the need for the rate case. The way in which the Board of Governors

presented the rate case has apparently had an effect on Congressional consideration of postal reform legislation.⁵

Irrespective of the purpose underlying the proposal, given the fact that the matter is governed by statute, the Commission should reject the simplistic across-the-board approach, and determine its recommended rates and fees based on the evidence presented in this docket.

B. Across-the-Board Rates Developed by Multiplication Are Not Cost-based Rates.

Although the fact that Congress has specified the proper treatment of the escrow payment should be considered sufficiently persuasive to reject an across-the board approach, the specific rationale argued by the Postal Service for its proposal gives even further reasons for rejecting this approach.

Witness Potter offers two justifications for the across-the-board approach. While these justifications offer some insight into why the Postal Service did not make the effort to submit a complete case-in-chief, they present at best a shallow logical or legal foundation to justify a Recommended Decision implementing the Postal Service's proposal.

- His first justification is: “[t]his approach is reasonable and fair under the circumstances because it generally seeks to require that mailers pay the same

⁵ See, e.g.:

“This past April, the Postal Service filed paperwork with the Postal Rate Commission to request a 5.4 percent rate increase for most categories of mail. These rate hikes, which are scheduled to take effect early next year **unless Congress acts to prevent them**, will impose a significant cost burden, let us call it what it is, a tax on the postal consumer.” Rep. Tom Davis (R-VA-11), p. H6513 (July 26, 2005) (emphasis added).

“Earlier this year, the Postal Service filed a request with the Rate Commission for yet another increase of 5.4 percent. It would be the fourth increase since 2001, and it is critical that we **release these monies in the escrow to delay this rate increase.**” Rep. Carolyn B. Maloney (D-NY-14), p. H6515 (July 26, 2005) (emphasis added).

percentage increase over and above the rates and fees they are paying now.” USPS-T-1, p. 5, ll. 12-14.

- His second justification is: “it will enhance the prospect for settlement of issues in this proceeding, permit a more expeditious conclusion, and allow the Postal Service to begin early in calendar year 2006 to generate the additional revenues necessary to meet the obligation.” *Id.*, ll. 15-18.

1. The Commission Has Determined Cost-Based Rates to be a Key Element of Fairness in Rate Design.

According to witness Robinson, “[t]he Postal Service’s proposals in this case have **fairness and equity** as their most fundamental objectives.” USPS-T-27, p. 11, ll. 14-16 (emphasis added). But as witness Mitchell notes in his testimony, witness Potter’s statement that an **across-the-board** increase is **more fair** because it is “**across-the-board**” is a mere tautology. VP-T-1, p. 12, ll. 1-3, Tr. 9/5278. The unspoken corollary to this reasoning is that across-the-board ratesetting is **more equitable** than cost-driven ratesetting. This is a curious view of “fairness and equity,” and not one which the Commission has embraced in the past.

In fact, the Commission has consistently expressed a far different understanding of what is required by 39 U.S.C. section 3622(b)(1) — fair and equitable rates — than the stance proffered by the Postmaster General in this docket. First and foremost, under the Commission’s determinations, the accurate reflection of current costs is a key element of fair rates. In Docket No. R2000-1, the Commission explained, in general:

The Commission begins the rate design process assuming equal implicit markups. This is a neutral starting position which seems to be implied by § 3622(b)(1), a fair and equitable schedule. It is consistent with the Commission’s general policies that the rates for each rate category be above cost; that **rates reflect the costs developed in the record**; and that rate design

results in identifiable relationships between rate categories. [*Op. & Rec. Dec.*, Docket No. R2000-1, ¶ 5533 (emphasis added).]

An unusual showing of the Commission’s preference for more current cost data over older cost data (as well as the updating of estimates) in the development of rates arose in Docket No. R2000-1. The Base Year in the case as filed was FY 1998. When FY 1999 costs became available somewhat late in the process of litigating the rate case, the Commission required the Postal Service to update the cost data undergirding its case-in-chief. The Commission then incorporated the newer costs in the development of its recommended rates, observing that:

“[t]he recommended rates reflect more recent actual operating results, and thus are **fairer** to both mailers and affected private businesses. Additionally, the update provided the Postal Service with the opportunity to correct earlier longer-range projections, identifying both underestimates and overestimates.” [*Id.*, p. iii (emphasis added).]

Similarly, in its consideration of the appropriate markup for third-class mail in Docket No. R90-1, the Commission discussed the critical importance of cost causality in rate design:

For the policy factors of the Act to have **real meaning**, they must be applied in an even-handed and consistent manner from one case to the next. When a subclass experiences only **moderate cost increases**, this should be reflected in **moderate rate increases**, and the rate history of third-class bulk reflects this policy, in the fairly small increases in carrier route rates over the last decade. **Attempting to keep rate increases for all subclasses equal would make the exacting determination of cost causality meaningless.**

In the same way, the noncost factors of the Act must be treated consistently.... [*Op. & Rec. Dec.*, Docket No. R90-1, ¶¶ 4109 and 4110 (emphasis added).]

When an across-the-board omnibus rate case was filed in the next case, Docket No. R94-1, the Commission analyzed the virtually same argument that the Postal Service is now making in this docket (albeit without the “CSRS escrow payment” twist):

The most vigorously contested issue in this case has been whether **rates for most major subclasses should increase by the same percentage amount**. The Service supports its uniform increase proposal by arguing that **uniform increases will be viewed by mailers as fair**, and that such increases will allow classification reform to go more smoothly. [*Op. & Rec. Dec.*, Docket No. R94-1, ¶ 1013 (emphasis added).]

The Commission did not find that argument persuasive, determining that:

there is no classification-related reason for freezing existing inter-class rate relationships, and **the across-the-board proposal does not override the need to insure a balanced application of the other factors in the Act, including questions of fairness and equity**.

The Postal Service’s across-the-board filing is **inconsistent with cost-based ratemaking**. The request **ignores changing differences in costs between the classes of mail**, includes no analysis of changing cost patterns within subclasses; and would result in substantial changes in the allocation of institutional costs among the subclasses of mail. The Service’s rate proposal **ignores changes in attributable costs**. [*Id.*, ¶¶ 1016-17 (emphasis added).]

2. The Postal Service’s Rates Proposed in this Docket Do Not Fulfill the Standard of Fairness, as Interpreted by the Commission.

Docket No. R2000-1 — filed (January 12, 2000) almost five years and three months before this docket (April 8, 2005) — was the last omnibus rate case that could be considered “normal.” The Postal Service developed a table of rate recommendations, the case was fully litigated by all parties, and the Commission formulated its recommended rates based on a comprehensive analysis of a wide range of factors, including current costs.

The rates recommended in Docket No. R2001-1 were not fully litigated, as the case was settled due to: (i) “the events of September 11,” and (ii) “the use of the mail system for spreading disease.” Docket No. 2001-1, Tr. 1/39, ll. 7-9. The rates recommended were essentially those proposed initially by the Postal Service, and were based therefore on rate positions and costs developed by the Postal Service. Those costs were not fully reviewed by the Commission.

In the instant docket, the proposed rates, on a cell-by-cell basis, were calculated directly from the settled rates of Docket No. R2001-1, which in turn were based on costs and cost studies no more recent than the FY 2000 base year, rolled forward to FY 2003. On their face, these all reflected Postal Service costing procedures, which might have been adjusted by the Commission. Thus, to some degree, the Postal Service’s proposed rates in this docket can be traced to Postal Service versions of costs for FY 2000, and to sometime before due to cost studies done earlier.

As witness Mitchell observed, examination of the Postal Service’s case-in-chief in this docket supports the view that the proposed rates reflect that “a perfunctory review of a range of other factors has been taken to show that the results fall within an acceptable range ... neglect[ing] all current costs and build[ing] on outdated cost and rate relationships, even relationships that were the result of a settlement.” VP-T-1, p. 12, l. 17 – p. 14, l. 1, Tr. 9/5278-80. We submit that rates developed under such a formulaic process do not merit recommendation by the Commission.

3. The Rates Recommended in this Docket Are Not Cost-Based, Yet Would Provide the Foundation for the Next Rate Case.

If the Postal Service's proposed rates (across-the-board as they are) were implemented, the next rate increase would be built upon those rates, and therefore on the settled rates of Docket No. R2001-1, after application of a 5.4 percent escalator. Even if one discounts the possibility of a gap between the settled rates and those the Commission might have recommended upon more thorough review, and the costs submitted by the Postal Service in that docket are taken to be the ones the Commission would have endorsed, the Docket No. R2001-1 rates reflect costs of the year 2000 rolled forward to TY 2003. Even if the next rate case were to be filed in 2006, the rates in place at that time would be derived from costs at least six years old. Appropriate recognition of costs in 2006 or 2007, because of this outdated foundation, could call for adjustments viewed by many as substantial.

As witness Mitchell points out, future efforts to develop efficient, cost-based rates in later rate cases will likely be hampered if the Postal Service's rates are recommended by the Commission in this docket. VP-T-1, pp. 22-30, Tr. 9/5288-96. The Postal Reorganization Act specifically requires that consideration be given to "the effect of rate increases upon the general public, business mail users, and enterprises in the private sector of the economy engaged in the delivery of mail matter other than letters." 39 U.S.C. § 3622(b)(4). If the Postal Service's proposed rates were recommended by the Commission, the increases required in the **next** case to achieve efficient, cost-based rates would be, for some categories, **larger** and for other categories **smaller** than otherwise would be the case. Thus, recommendation of the Postal Service's proposed rates would likely **exacerbate** future instances of **rate shock**.

4. Achievement of a Settlement Is Not More Important than the Establishment of Cost-Based Rates.

As discussed above, witness Potter stated that:

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

Like the Postal Service's curious — and we would submit, erroneous — assertion that non-cost-based rates would achieve greater fairness and equity (as discussed above), this “compelling justification” of enhancing the prospects for settlement appears chimerical at best.

As noted previously, the most recent fully-litigated omnibus rate case was Docket No. R2000-1. Thus, the proposed rates in the instant docket are based on the untested settlement-driven rates in Docket No. R2001-1, which were preceded by Docket No. R2000-1 rates, which originally were derived from FY 1998 costs, that later were updated to FY 1999 costs. Yet postal costs are always in a state of change, having varying effects on different subclasses and products. For example, the Postal Service is, and has been for some time, tightening its operations and increasing its productivity. New equipment, new methods of processing mail, and new technologies are being introduced. Also, mailers are changing the way their mail is prepared, a factor expressly identified in the Postal Reorganization Act as worthy of separate consideration. *See* 39 U.S.C. § 3622(b)(6).

Given such on-going processes, both the absolute and relative levels of mail processing, transportation, and delivery costs change regularly. The Postal Service's desire for an expedited — and presumably circumscribed — review (by means of settlement) of its proposal hardly constitutes a “compelling justification” for its decision to forego a proper and thorough

testing on the record of its case-in-chief. Rates that reflect current costs should have been prepared, and they could have been tested on the record. Although faced with that Postal Service failure, it is submitted that the Commission must nevertheless fulfill its statutory duty to recommend proper rates.

The Postal Service did provide a range of cost studies in this case, including a new study of carrier costs by Postal Service witness Michael D. Bradley (USPS-T-14), but did not use these studies in developing rates. In fact, it did not even look at the costs *ex post*, and it did not study trends in costs over time or assess the costing results in any other way. When witness Mitchell pointed to this neglect, Postal Service witness Kiefer responded on rebuttal by emphasizing that the Postal Service “has presented sound evidence of individual levels of costs in the test year, including detailed special cost studies, based on recent data collection and cost analyses.” USPS-RT-1, p. 19, l. 30 – p. 20, l. 1, Tr. 11/6167-68. He then justified the failure to use any of these costs by pointing to non-cost factor (b)(3) of the Postal Reorganization Act, which is generally applied only at the subclass level, and which goes only to whether a cost coverage is above 100 percent and not to whether the costs are referenced in any way when the cost coverages are selected. *Id.*, p. 20, ll. 5-8, Tr. 11/6168. During litigation of this docket, at times the Postal Service appeared almost defensive at efforts by even the Commission to probe the absence of attention to costs. For example, in Question 3(b) of Presiding Officer’s Information Request (“POIR”) No. 4, the Commission asked about the effects on mailers, competitors, and overall economic efficiency of building Parcel Select rates on rates from the past that are understood to be out of alignment with the cube-weight relationships. In response, witness Robinson argued that “the escrow requirement does not

vary depending on cube-weight relationships,” which suggests that if parcel costs have no relation to an exogenous fund, they should have no relation to parcel rates either. Tr. 3/471. Clearly, the Postal Service requests the Commission to recommend rates that were not developed from record costs.

Finally, if postal reform legislation is passed, there is no absolute guarantee that there will be another traditional rate case in which the issues raised herein can be considered before rates for market dominant products under a cap. In fact, the Board of Governors’ recent letter to Chairman Tom Davis, House Committee on Government Reform, regarding the pending postal reform bill, H.R. 22, expressly asks that such a case be allowed. The letter states:

As we consider proposed changes to the ratemaking process, it is also our belief that the Postal Service should initiate a **final, omnibus rate case** under the current rules of the Postal Rate Commission, with metrics similar to the case now pending. [Letter from Board of Governors to Chairman Tom Davis, House Committee on Government Reform, Sept. 13, 2005, p. 4 (emphasis added).]

For all of the reasons set out above, the Postal Service’s solution of an across-the-board rate increase to address the deficit projected for the test year should be rejected.

C. Conventional Commission Practice for Developing Costs, Coverages and Rate Design Should Be Followed.

If the Commission rejects the across-the-board proposal, and chooses to recognize current costs and cost relationships at least in Standard Mail and Standard ECR, as Valpak urges it should, several steps will be involved.

- First, costs will need to be developed consistent with the record (particularly involving the detached address label (“DAL”) issues, Section III, *infra*, and third bundle issues, Section IV, *infra*).
- Second, markups will need to be selected for the various subclasses and special services, consistent with breakeven. On this question, Valpak proposes that the markup on ECR be 10 percentage points below that proposed by the Postal Service, or, amounting to approximately the same thing, that its existing rate level not be changed (Section V, *infra*).
- Third, rates will need to be developed consistent with the record (particularly involving Standard Nonprofit rates, Section VI, *infra*, and rate design considerations, Section VII, *infra*).

III. DOCKET NO. R2001-1 POSTAL SERVICE COSTING MUST BE ADJUSTED TO PLACE THE COSTS OF HANDLING DETACHED ADDRESS LABELS ON ECR SATURATION FLATS WHERE THEY BELONG, LIFTING THIS UNFAIR BURDEN FROM ECR SATURATION LETTERS.

A. Postal Service Carrier Cost Systems Have Erroneously Charged the Cost of DALs Accompanying ECR Saturation Flats to ECR Saturation Letters.

1. ECR Saturation Products Distinguished.

ECR saturation mail includes:

- (i) letters;
- (ii) addressed flats; and
- (iii) unaddressed flats accompanied by detached address labels (“DALs”).

ECR saturation letters present no confusion in postal costing systems, in that they are easily recognized as letters.

Likewise, ECR saturation addressed flats present no confusion in postal costing systems, in that they are easily recognized as flats.

However, ECR saturation unaddressed flats with DALs are two-piece mailings, which create confusion for costing systems, especially carrier costing systems. Viewed from the perspective of the delivery function, the DAL is generally viewed as a letter. Cross-examination of witness Lewis, Tr. 11/5956, ll. 2-15. Therefore, each mailing of unaddressed flats accompanied by DALs requires the delivery of both (i) a flat, and (ii) a letter.

Ramifications of the problems for Postal Service costing systems posed by unaddressed flats and DALs have never been completely addressed in any prior docket. *See* Haldi testimony, VP-T-2, at 10.

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Flat-shaped pieces most commonly mailed with DALs are a collection of loose (unbound) pieces enclosed inside a folded host piece, referred to herein as a “cover.”¹ The only limit on the number of enclosures within the host piece is that the entire piece may not exceed the maximum thickness for an ECR flat.² In addition, all Standard ECR Saturation parcels are required to be merchandise samples and must be mailed with DALs. VP-T-2, p. 11, ll. 1-3, Tr. 9/5488.

2. Recording of DAL Revenues and Volumes Upon Entry.

When saturation non-letter mailings with DALs are entered with the Postal Service, the Revenue, Pieces and Weight (“RPW”) system credits non-letters with all revenue. Consistent with this treatment, the RPW system records the volume of all such mailings as the number of non-letter items only, *i.e.*, the DAL and accompanying piece are counted as only one item in the RPW database and RPW reports. Thus, **the RPW system neither counts nor records the volume of DALs.** Accordingly, if a mailing consists of 1 million DALs and 1 million accompanying covers, the RPW system records the volume of the mailing as 1 million non-letters.³ VP-T-2, p. 11, Tr. 9/5488.

¹ See Docket No. R2001-1, response to VP/USPS-T31-2 (Tr. 8/1684), which also states that “[c]onversationally, these pieces may be referred to by mailers as ‘wraps,’ ‘half covers,’ or other terms.” Overall size of the cover may not exceed the size limits for flats, as specified in DMM 602.4.0.

² See Docket No. R2001-1, response to VP/USPS-T31-3 (Tr. 8/1685).

³ See Docket No. R2001-1, response to VP/USPS-T4-6 (Tr. 3/337).

Another way of looking at this is that the RPW system does **not distinguish** between (i) mailings of unaddressed ECR flats accompanied by DALs, and (ii) mailings that consist of addressed ECR flats, such as catalogs. VP-T-2, p. 11, l. 14 - p. 12, l. 1, Tr. 9/5488-5499.

The fact that the volume of saturation flats accompanied by DALs is not recorded upon entry necessitates that this volume be estimated, as has been done in this docket.⁴

3. City and Rural Carrier Cost Treatment of DALs.

The Postal Service city carrier and rural carrier cost systems erroneously count DALs as letters. This results in the carrier costs associated with DALs, which should be attributed to ECR saturation flats, being attributed to ECR saturation letters. This error should be clear to all by now, but often it has been discussed in circuitous terms by Postal Service witnesses.

- Witness Kelley did not write one word of text in his testimony to explain this problem, or why he filed Library Reference USPS-LR-K-67 (revised 6/9/05). On oral cross-examination he said it never occurred to him to explain this costing error from Docket No. R2001-1 in his testimony. Tr. 7/2996, ll. 13-16. Witness Kelley did include two tables in his testimony (USPS-T-16, p. 6, Table 1, rev'd 6/17/05) — one with “with DAL City-Carrier Street-Time Costs and DAL Rural-Carrier Costs included in the numerator of ECR Saturation **Letters** Unit Cost” (emphasis added) and the other with DAL carrier costs included in the numerator of ECR saturation **flats** unit costs — but in the text of his

⁴ USPS rebuttal witness Kiefer, at the very end of the docket, revealed that starting on April 13, 2005, the Postal Service has modified its forms to begin to collect data on the volume of DALs. USPS-RT-1, pp. 31-32, Tr. 11/6179-80.

testimony he never indicated why two charts were presented, or which chart was correct and which chart was incorrect.⁵ (First in response to interrogatories, and then during cross examination, he explained the first chart as being based on the flawed methodology used in Docket No. R2001-1, with DAL costs being assigned to letters, and the second chart being based on the correct methodology of DAL costs being assigned to flats. Tr. 7/2994, l. 3 - 2995, l. 24.)⁶

- Witness Meehan’s list of improvements that had been made in Base Year costs did not identify the corrective work done by witness Kelley because, she explained, witness Kelley’s adjustments were made “downstream” of the Base Year. Response to VP/USPS-T9-1, Tr. 2/267.
- The Postal Service’s September 16, 2005 response to POIR No. 14 at one point states the correction not in terms of right and wrong, but mere preferences:

It seems reasonable to prefer that costs associated with DALs should be shifted from ECR Saturation letters to ECR Saturation flats. The reason for doing so is based on the definitions of the RPW ECR Saturation volumes in the denominators of the ECR unit delivery costs, which LR-K-67 and LR-K-101 are designed to measure. RPW ECR Saturation letter pieces exclude DAL, whereas ECR Saturation flat pieces do include counts of the DAL mailing host pieces. Therefore, the

⁵ Witness Kelley did not advise any other witness (such as witnesses Abdirahman and Moser who were identified by him as using the “outputs” of USPS-LR-K-67, USPS-T-16, p. 2) which set of carrier costs was accurate, but, of course, that would not have mattered, since USPS rates are based on across-the-board multiplication, not test year costs. Tr. 7/2996, l. 24 through p. 2997, l. 6.

⁶ However, Valpak would like the Commission to know that the Postal Service graciously made witness Kelley available for an informal technical conference to answer questions about the calculations contained in LR-K-67.

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correctly defined unit cost for ECR Saturation letters should likewise exclude DAL costs from its numerator, whereas the numerator of the ECR Saturation flats unit cost should include these same DAL costs, along with the costs of all host pieces and other Saturation flats.

Likewise, Advo witness Crowder did not spend one word in her testimony explaining how the cost of handling ECR saturation flat DALs, which are entered by mailers such as Advo, have been charged for years to ECR saturation letters, which are entered by mailers such as Valpak. She only referred to her “revised” estimate of the total volume of DALs (higher than witness Kelley’s estimate, lower than witness Haldi’s estimate), which was explained in her workpapers. *See* ADVO-RT-1, p. 11. ll. 23-24, p. 12. ll. 6-7, p. 20, ll. 13-14, Tr. 10/5737-38, 5746; ADVO-LR-1.

Actually, this error was brought to light by Valpak in interrogatories to the Postal Service during the litigation of Docket No. R2001-1. *See, e.g.*, Docket No. R2001-1, VP/USPS-2, Tr. 10-C/3692. At that time, the volume of DALs in the system was completely unknown. Therefore, the magnitude of the error that the Postal Service carrier costing systems had made was unknown. Now that the Commission has an estimate in the record of the volume of DALs accompanying Standard ECR flats, and the magnitude of the error is better known, an appropriate rate adjustment based on corrected carrier costs should be made. We turn now to the matter of estimating that volume of DALs in the system.

B. Standard ECR Flats Accompanied by DALs is Conservatively Estimated at 4.5 Billion Pieces, Substantially More Than the Postal Service Estimate of 3.375 Billion.

1. USPS Witness Kelley's Estimate of 3.375 Billion DALs is Clearly Understated and Should not be used by the Commission.

As discussed above, the Postal Service currently has no internal data on the volume of DALs which accompany Standard ECR flats. In this docket, the Postal Service has revealed that it has undertaken to collect such data on DALs for the very first time.⁷

Witness Kelley explains in USPS-LR-K-67 that he uses the Postal Service's Household Diary Study's estimate that "0.5 DAL pieces are delivered to each delivery point per week," and then uses the 0.5 average pieces to estimate the volume delivered by city and rural carriers. He developed an **estimate of 3.375 billion total DALs for TY 2004** in his library reference, but not in his testimony. USPS-LR-K-67 (revised 6/9/05). *See* Response of Witness Kelley to Valpak Interrogatories, VP/USPS-T16-10a, and Attachment to that response, Tr. 7/2866-68.

Witness Kelley's testimony did not contain any narrative statement or explanation concerning the estimate of DAL volume for 2004, including how it was estimated. Witness Kelley, also without explanation, deducted the costs of 2,912.5 million of these 3.375 billion DALs — he apparently assumed that only 2.9 billion were delivered by city and rural carriers — which he attributed to letters, and attributed those costs to flats. *See* Haldi Testimony, VP-T-2, at 51, Tr. 9/5528. Witness Kelley said that he could not recall any other source that may

⁷ Haldi Test., VP-T-2, p. 58, ll. 19-21, Tr. 9/5535. *See* Rebuttal Testimony of Postal Service Witness Kiefer, USPS -RT- 1, pp. 31-32, Tr. 11/6179-80.

have been used to cross-check the Postal Service's estimate, and that he was "satisfied" with that estimate. Tr. 7/3008-09.

As demonstrated by Dr. Haldi, the Household Diary Study data relied upon by the Postal Service with respect to an estimate of DAL volume are subject to a fairly wide range of uncertainty, and possible, if not obvious, unreliability. The Household Diary Study data are at odds with record evidence showing that major mailers that use DALs with their saturation mailings, including the largest, Advo, Inc., mail in a consistent pattern from year to year — casting doubt on the fairly significant fluctuations in the yearly averages of DALs set forth in the Household Diary Study. *See* Haldi Testimony, VP-T-2, at 65-66, Table A-2, Tr. 9/5542-43. The data reported in the Household Diary Study also are rounded to a single decimal point, which also increases uncertainty of the Postal Service's estimated annual volume of DALs. Applying the range revealed by the Household Diary Study data to the Postal Service's estimated annual volume of approximately 3.4 billion (3.375 billion), the actual volume of DALs — even using the Postal Service's approach — could have been anywhere from 3.06 billion to 3.74 billion. Haldi Testimony, VP-T-2, p. 66, Tr. 9/5543. Clearly, moreover, the data contained in the Household Diary Study, which represent survey findings from a few thousand homes, leave much to be desired with respect to a reliable, consistent, and representative sampling of mail volume sent to all households.⁸ In Dr. Haldi's words,

⁸ As Dr. Haldi also pointed out, the reliability of the Postal Service's estimate also is undermined by other data in the Household Diary Study, referred to as "Mail Not from One Organization," or "N-FOO mail." Dr. Haldi estimated that the N-FOO data show that Commercial ECR Flats for 2004 were 6.2 billion, an indication that the Postal Service's estimated volume of 3.4 billion DALs is substantially low. VP-T-2, p. 55, Tr. 9/5532. Even more important, perhaps, is his conclusion that the inexplicably wide variations in yearly N-

although some data are better than no data at all, the reliability of the Household Diary Study data to measure the Postal Service's annual DAL volume estimate is "highly questionable."

Id., at 59, Tr. 9/5536.

In any event, the reliability of the estimate of DALs using the Household Diary Study need not be discussed further, since it was essentially contradicted by more authoritative data by Advo, Inc. furnished in response to discovery. Those data confirmed that DAL mailings sent only by Advo and its network of related companies (without considering the volume of DALs mailed by other, non-Advo-affiliated organizations) is greater by at least 200 million pieces than the total annual volume of DAL mailings estimated by the Postal Service.⁹

2. Valpak Witness Haldi's Estimate of 4.5 Billion DALs Should be Used by the Commission.

Dr. Haldi's direct testimony as initially filed, in the absence of record data, developed an estimate of 5.4 Billion DALs based on SEC filings and other reliable public source data.

Then, in response to interrogatories from Valpak (Response to VP/ADVO-1), Advo identified its annual DAL volume in 2004 as follows:

- Advo's Shopwise — 3.145 billion
- Advo's A.N.N.E. Network — 383,785,000
- Advo's Mail Marketing Systems, Inc. ("MMSI") — 53,581,776

FOO volumes revealed by the Household Diary data — much greater than the yearly variations in total mail volume — are such that the Household Diary Study data are unreliable for the Postal Service's attempt to use them to estimate annual DAL volume.

⁹ See Haldi Test., VP-T-2, pp. 59-62, Table A-8, Tr. 9/5536-39, 5555. See also question of Commissioner Goldway and response of Dr. Haldi, Tr. 9/5709.

- Advo total — 3.583 billion

The Advo responses to interrogatories were received on Monday, August 22, 2005, two days prior to Dr. Haldi's appearance on the stand for oral cross-examination. The next day, Tuesday, August 23, 2005, Dr. Haldi filed errata to his testimony, and modified his DAL estimate downward to 4.5 billion.¹⁰ This estimate consisted of the 3.583 billion DALs entered by Advo, and other independent companies that mail DALs, including:

- Harte Hanks, Inc. — 572 million DALs (this volume was also used by Advo Witness Crowder in ADVO-LR-1.).
- All other companies — 345 million DALs. Advo witness Crowder denied that she had actually made an estimate of her own (Tr. 10/5782, ll. 6-11).

Nevertheless, in her cost calculations she reduced Dr. Haldi's estimate of 345 million downward by 185 million to 160 million, the precise number mailed by companies that he had expressly identified, as confirmed by Advo counsel in

¹⁰ On cross-examination, Dr. Haldi readily agreed that portions of his estimate, being based upon information obtained from statements of or on behalf of the mailing companies themselves, could be duplicative of DAL volume figures already included in other calculations, such as the annual DAL mailing volume attributed to the A.N.N.E. network. Haldi Test., Tr. 9/5635. And Dr. Haldi also testified, explaining how he derived the DAL figures with respect to "other regional mailers" for his Tables A-8 and A-9, that he had no personal knowledge concerning whether the estimated total DAL figures in those tables were actual DAL figures. *E.g.*, Tr. 9/5655-5657.

Nevertheless, even assuming that the various statements made by Advo counsel during cross-examination that Dr. Haldi agreed with or did not dispute were actual fact, this merely would have the effect of reducing the revised estimate of **345 million DALs** of "other regional mailers" in Tables A-9 and A-10 (*see* VP-T-2, at 78, Table A-8, Tr. 9/5555) to **160 million DALs**. *See* ADVO-XE-10, Tr. 9/5661; ADVO-XE-10, Tr. 9/5678. In other words, except possibly for **185 million DALs**, or 4 percent out of the entire estimated 4.5 billion DALs conservatively estimated by Dr. Haldi, there has been no showing of any party that his estimate is too high.

Advo cross-examination exhibit XE-1, on the unstated assumption that not a single other DAL was entered with ECR flat mailings anywhere in the USA.

This unstated assumption is not reasonable and should be rejected.

Dr. Haldi's estimate of an annual DAL volume of 4.5 billion, therefore, was based upon information furnished by the mailers themselves as opposed to the Postal Service's estimate, which was not based upon any Postal Service records related to mail acceptance or processing, but instead was based upon an indirect survey figure quite removed from the question of the annual volume of DAL mailings. This estimate of Dr. Haldi should be accepted by the Commission.

It is important to note that neither the Postal Service nor Advo, nor any other party, introduced rebuttal evidence that in any way impugns the conservative 4.5 billion estimate of annual DAL volume testified to by Dr. Haldi. It is true that one of Advo's rebuttal witnesses, Witness Crowder, assumed a lower volume than did Dr. Haldi, apparently based upon Dr. Haldi's agreement, during cross-examination, that certain of the DAL volume figures he had located reflected double counting and reasonably could be excluded from his calculations. Furthermore, the volume she did assume — 4.315 billion DALs annually — far exceeded the Postal Service estimate of 3.375 billion. As Commissioner Goldway correctly pointed out following the conclusion of Dr. Haldi's cross-examination,

But it's my understanding that even if we were to remove the questionable listings that you have presented, that Advo itself presented a number for DALs that's higher than what the Postal Service submitted. [Tr. 9/5709.]

Obviously, there is no serious issue in this proceeding about whether the Postal Service's annual DAL volume estimate is deficient; it is, by at least 1 billion DALs. The only possible dispute is whether the figure used should be 4.5 billion, as Dr. Haldi and Valpak submit, or the number used by (but not estimated by) Advo witness Crowder, 4.315 billion. For the reasons set out above, there should be no serious question that Dr. Haldi's conservative estimate of 4.5 billion should be adopted as a reasonable estimate of annual DAL volume.

3. The Postal Service understates the Proportion of DALs Delivered by City and Rural Carriers.

In addition to knowing the total volume of DALs accompanying Standard ECR flats, it is important to know the volume of those DALs delivered by City Carriers and Rural Carriers, on the one hand, as opposed to Post Office Boxes or Highway Contract Routes (or general delivery). Of course, only the volume of DALs delivered by City Carriers and Rural Carriers should be moved from letters to flats when developing the unit carrier costs of letters and flats.

USPS Witness Kelley. Witness Kelly assumed that only 86.3 percent of his total estimated 3,375.4 million DALs — or 2,912.5 million— are delivered by city and rural carriers, with the remaining **13.7 percent** — or 462.9 million — assumed to be delivered to P.O. Boxes (which are serviced by clerks) or by Highway Contract Carriers. *See* VP-T-2, at 61, Table A-1, Tr. 9/5538. Relying on this assumption, witness Kelley shifted the costs of 2,912.5 million DALs erroneously attributed to letters, to flats where they belong. VP-T-2, at 51, Tr. 9/5528. Witness Kelley's estimates were based on a series of assumptions about residential deliveries and business deliveries on city and rural routes. Although witness Kelley

did not have any evidence of the practices followed by mailers, and apparently did the best that he could when developing his estimate, the record now contains such information which disproves witness Kelley's estimates.

Witness Kelley attempts to shoehorn his estimated volume of DALs delivered by city and rural carriers into an estimate of the annual volumes of saturation letters delivered by city and rural carriers, which estimate was extrapolated from the data contained in the two-week carrier survey.¹¹ There is no evidence, however, that the two-week period selected for the carrier survey is representative of the entire year, hence no basis exists for relying on such an extrapolation.¹² Consequently, Dr. Haldi did not feel constrained to use these extrapolated annual volumes.¹³

Initial Testimony of Dr. Haldi. The testimony of Dr. Haldi explained that as a test of witness Kelly's assumption, Valpak — a major saturation mailer, whose mailing practices are thought to be representative of saturation mailers generally — calculated the volume of saturation letters it mailed to P.O. Boxes and determined (for the one month tested) that 0.77 percent of its mail was sent to P.O. Boxes. VP-T-2, at 63, Tr. 9/5540. Based on this observation, Dr. Haldi in his original testimony suggested that **1 percent** of DALs were not delivered by city and rural carriers.

¹¹ See Attachment 1 to ADVO/TP-T2-2, Tr. 6272.

¹² See the colloquy between Commissioner Tisdale and witness Kelley, who denies having selected the dates for the survey, and also does not know the rationale for the dates selected. Tr. 7/3026-28.

¹³ See Attachment 2 to ADVO/TP-T2-2, Tr. 6273.

Advo Responses to Discovery. Valpak propounded interrogatories to Advo about its use of DALs which were responded to on August 22, 2006. VP/ADVO-1-6, Tr. 12/6253-6262. These responses identified the volume of DALs addressed to P.O. Boxes at **6.13 percent**.

Errata to Dr. Haldi's Testimony. In errata to his testimony filed on August 23, 2006, Dr. Haldi relied on the responses to discovery by Advo. Accordingly, he recommended that the Commission should assume that only **6.13 percent** of all DALs are delivered to P.O. Boxes, and that the remaining 93.87 percent of all DALs are delivered by city or rural carriers.

Advo Witness Crowder. Advo witness Crowder adopted the Advo responses to Valpak interrogatories to develop unit cost estimates for letters and flats, and based her estimate on the fact that **6.13 percent** of Advo's shared mail/DALs during 2002-2004 were delivered to P.O. Boxes. *See* ADVO-LR-1.

Conclusion. The Commission should calculate unit costs based on the record evidence that **6.13 percent** are delivered to P.O. Boxes, and the remaining 93.87 percent of 4.5 billion DALs (4.224 billion) are delivered by city and rural carriers.

C. Properly Accounting for the City Carrier and Rural Carrier Cost of Handling Flats is Essential to Developing an Accurate ECR Saturation Letter-flat Differential.

In this docket, four alternative methods of developing carrier costs for ECR saturation letters and flats have emerged.

- The first approach is the admittedly erroneous method set out in the first table in USPS Witness Kelley's testimony. (USPS-T-16, Table 1, p. 6, rev'd 6/17/05.)

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This approach appears to reflect approximately the way in which costs for many years have been erroneously estimated. (Witness Crowder does not believe that the manner in which these costs are calculated accurately reflects Docket No. R2001-1 costs. *See* Tr. 10/5775, ll. 5-12.)

- The second approach is that of Witness Kelley, using the now discredited 3.375 billion estimate for DALs, and assuming an unrealistically high percentage of 13.7 percent of DALs being delivered to P.O. Boxes and Highway Contract Carriers.
- The third approach is that of Witness Crowder, using an estimate of 4.315 billion DALs and the estimate of 6.13 percent being delivered to P.O. Boxes. (ADVO-LR-1)
- The fourth approach is that of Witness Haldi, using an estimate of 4.5 billion DALs and the estimate of 6.13 percent being delivered to P.O. Boxes.

The table below is a modification of Valpak-XE-1 (Crowder), reflecting the four approaches set out above.

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	(1) R2001-1 <u>Erroneous</u>	(2) R2005-1 <u>Kelley</u>	(3) R2005-1 <u>Crowder</u>	(4) R2005-1 <u>Haldi</u>
Total DALs	—	3.375 billion	4.315 billion	4.5 billion
DALs delivered by city & rural carriers		2.912 billion (86.3 %)	4.050 billion (93.87 %)	4.224 billion (93.87%)
Flat Costs	3.191 cents	4.163 cents	4.358 cents	4.358+ cents
Letter Costs	<u>6.665 cents</u>	<u>4.137 cents</u>	<u>3.629 cents</u>	<u>3.629- cents</u>
L/F Cost Diff	-3.022 cents	0.026 cents	0.729 cents	0.729+ cents

Certain observations can be made regarding this table.

1. The magnitude of the USPS costing error embodied in current rates for ECR saturation letters and flats is enormous. Even using witness Crowder's volumes, the unit cost of flats is understated by **1.167 cents**, and the unit cost of letters is overstated by **3.036 cents**. The magnitude of this costing error can be demonstrated by applying the understatement of the cost of flats to **Advo's** combined volume of 3.583 billion DAL mailings generates an annual cost of **\$41,813,510**. Applying the overstatement of the cost of letters to **Valpak's** volume of 500 million pieces generates an annual cost of **\$15,180,000**.

2. The estimated volume of DALs is critical. Witness Crowder's estimate of the volume of DALs delivered by city and rural carriers exceeds witness Kelley's estimate by 1.138 billion, and increases the letter-flat differential from 0.026 cents to 0.729 cents, a 28-fold increase.

3. Use of the more accurate estimate of 4.5 billion DALs will result in slightly higher flat costs, slightly lower letter costs, and a letter-flat cost differential even greater than that of witness Crowder.

4. In addition to the estimated total volume of DALs, the second critical estimate is the number of those DALs delivered by city and rural carriers, as discussed in Section B.3, *supra*. Witness Kelley's testimony does not address this issue, but his library reference estimates that only 2.912 billion (86.3 percent) of his 3.375 billion DALs are handled by city and rural carriers. USPS-LR-K-67, file LR-K-67.2nd.revised.xls, worksheet '10.DALsVsECR%-EstOfRur1Covrs.' Likewise, witness Crowder does not address this issue in her testimony, but in her library reference she estimates that 93.86 percent of her 4.315 billion DALs (4.050 billion DALs) are handled by city and rural carriers. (ADVO-LR-1, file ADVO-LR-1.xls, worksheet 4.)

D. Additional Possible Problems Relating to the Costing of DALs May Exist and Should be Examined in the Future.

After Dr. Haldi describes his principal point regarding DAL costing — the enormous DAL problem of city and rural carrier mismatch of revenues and costs discussed in Section B, *supra* — he discusses four other possible problems that seem to exist, and which need further study.

Interestingly, witness Crowder nowhere takes time to discuss Dr. Haldi's main point — the enormous DAL problem of city and rural carrier mismatch — but launches into a frontal attack on the secondary points raised by Dr. Haldi as topics for further study as though they constituted the principal point in his testimony.

Despite the intensity of witness Crowder's attack on the merits of these secondary issues raised by Dr. Haldi, it is suggested that the long-standing mismatch between revenues and volumes, on the one hand, and city and rural carrier costs on the other, is so shocking as to require a thorough evaluation of the way that various data systems handle each situation where mismatches and inconsistencies might occur. Rather than dismiss out of hand virtually all of Dr. Haldi's concern about consistency in costing, as witness Crowder does, it is hoped that these points will become the basis for a thorough analysis by the Postal Service.

In addition to the main point regarding DALs and carrier costs, discussed *supra*, in Sections III A, B, and C, Dr. Haldi set out four additional concerns about how certain costs need to be accounted for.

1. Dr. Haldi criticized the Postal Service method of estimating how many DALs are cased (*see* USPS-T-14, p. 59, ll. 5-17; USPS-LR-K-67). VP-T-2, p. 17, l. 9 – p. 19, l. 16; Tr. 9/5494-96. This point is agreed with by witness Crowder. ADVO-RT-1, p. 20, Tr. 10/5746.

2. Dr. Haldi discussed Postal Service responses to Valpak discovery indicating that some DALs are sorted on automation equipment. VP-T-2, p. 19, l. 17 – p. 21, l. 16; Tr. 9/5496-98. Based on Postal Service responses, he described the number of DALs processed on automation equipment as “some unknown volume” (p. 20, ll. 1-2, Tr. 9/5497), “some unknown, but possibly large and growing volume...” (p. 21, ll. 14-16, Tr. 9/5498). Later, Postal Services responses to Advo interrogatories seemed to minimize the likelihood of this practice. *See* ADVO/USPS-2-3, Tr. 12/6237-38. Witness Crowder attacked Dr. Haldi on

various grounds. ADV0-RT-1, p. 23, l. 11 – p. 26, l. 2; Tr. 10/5749-52. For instance, she notes the testimony of witness Lewis, which is impressionistic and anecdotal in nature. Tr. 10/5750. Next, she notes that Advo, the single largest user of DALs, barcodes less than 1.0 percent; and its DALs have physical characteristics almost designed to preclude processing on an OCR and then on 2-pass DPS equipment. Tr. 10/5750. She also asserts that the IOCS would likely identify DALs if large quantities were to be DPS'd. At the same time, she acknowledges (in her fn. 16) that if question 24 of Handbook F-45 applies, DALs may be counted as “cards.” Tr. 10/5452. Despite the fact that witness Crowder would not like to see or admit that any DALs are ever processed on DPS equipment, the fact remains that if Postal Service initial responses to interrogatories were accurate, at least some DALs may be DPS'd — and the practice may be growing — while Postal Service data systems have no reliable way of assuring that the cost of any DALs that do get run on automated equipment is charged to flats.

3. Dr. Haldi discussed the possible mismatch which “can arise” (VP-T-2, p. 22, l. 4, Tr. 9/5499) between revenues and volumes on the one hand, and costs on the other “if costs of **letter-shaped pieces in excess of 3.5 ounces** were attributed to letters” (VP-T-2, p. 22, ll. 7-8, Tr. 9/5499 (emphasis original)). He said that it is “unclear whether these pieces are always counted as letters” (VP-T-2, p. 22, l. 11-12, Tr. 9/5499), since they clearly are recorded as non-letters in the Billing Determinants.¹⁴ Dr. Haldi also discussed problems that could occur

¹⁴ USPS-LR-K-77, The Billing Determinants, is an unsponsored library reference, and on oral cross-examination witness Pafford, the RPW expert, denied any knowledge about

with letter-shaped pieces that weigh between 3.3 and 3.5 ounces and which pay a pound rate plus the non-letter piece rate, less the differential between piece-rated letters and flats. He said it “is not known how such pieces are recorded when they are the subject of an IOCS tally, nor how such pieces are counted in the city and rural carrier cost systems.” VP-T-2, p. 23, l. 18 – p. 24, l. 1; Tr. 9/5500-01.

Witness Crowder attempts to minimize Dr. Haldi’s concerns about the quality and consistency of Postal Service data as regards saturation letters. ADVO-RT-1, p. 26, l. 3 – p. 29, l. 2; Tr. 10/5752-55. For instance, she states that Postal Service data “do not **appear to be** biased or seriously mismatched [and] ... [d]epending on one’s bias and choice of data source, it would be easy **to argue either** of the following: that unit Saturation **letter IOCS cost is too low** relative to Saturation flats **or the opposite.**” Tr. 10/5752 and 5754, emphasis added. She reasons that “cost for letter-shape pieces weighing more than 3.5 ounces **are likely** included in letter cost.” Tr. 10/5753, emphasis added. She acknowledges that RPW data on saturation letters do not align with Billing Determinant data, and states that “it **appears** that many **more** Billing Determinant **flats are recorded as RPW letter volume** than the reverse.” In view of the data quality problems suffered by the Postal Service,¹⁵ including the total absence of data on DALs, these equivocating statements by witness Crowder are hardly reassuring.

data contained in the Billing Determinants. Tr. 7/2557.

¹⁵ See GAO Report GAO-05-820, U.S. Postal Service: Improving Ratemaking Data Quality through Postal Service Actions and Postal Reform Legislation, dated July 28, 2005.

Indeed, the various situations discussed by Dr. Haldi may not encompass all the possible mismatches and inconsistencies that exist in postal costing. Certainly, more work to review postal costing systems and improve quality of the data used to develop costs for ratemaking purposes is required. Valpak requests that in this docket the Commission remedy the main problem of the mismatch in city and rural carrier costing, and with regard to other potential costing issues urge the Postal Service to conduct a separate analysis of these issues prior to the filing of the next omnibus rate case.

IV. POSTAL SERVICE COSTING SYSTEMS ARE NOT WELL SUITED TO THE THIRD-BUNDLE DELIVERY METHOD, ERRONEOUSLY INDICATING THAT THE ECR SATURATION FLATS ARE LESS COSTLY TO DELIVER THAN ECR SATURATION LETTERS.

Witness Haldi demonstrates in Section IV of his testimony (VP-T-2, pp. 26-57, Tr. 9/5503-34) that the Postal Service third-bundle delivery method creates a peculiar, previously overlooked problem for proper costing of ECR saturation letters and flats (including both addressed flats, and unaddressed flats accompanied by DALs).

Among these three types of saturation mail, ECR saturation letters are the easiest, and should be the cheapest, mail to handle, in that the Postal Service has the ability to process and deliver this mail in any one of three ways, as may be required by operational considerations.

All ECR saturation letters:

(i) can be taken **directly to the street as a third bundle** (sometimes referred to herein as “bypass”), as they are in walk sequence;

(ii) can be **DPS'd** in the plant, as they are barcoded and automation comparable; and

(iii) can be **cased** by the carriers, and at a faster rate than flats. (*See* cross-examination of Witness Lewis where he expressed his view that the value which mailers build into ECR saturation letters is not completely destroyed no matter how the letters are processed, since they are so versatile operationally. [Tr. 11, p. 5981, l. 6 – p. 5985, l. 6.]

The problem with postal costing arises from these operational facts:

(i) the **third-bundle** delivery method is the **most efficient** (cheapest) method, as it incurs significantly less in-office cost than casing mail (and less plant cost than DPSing letters);

(ii) the Postal Service has certain **capacity constraints** on its ability to take saturation mail to the street as extra bundles and, when there is a choice, will always prefer to take flats to the street as extra bundles (particularly unaddressed flats with DALs) rather than letters because it is more expensive to case flats than letters; and

(iii) **postal costing systems** faithfully record flats being handled using the cheapest method, and thereby giving the appearance of having the lowest cost, because they otherwise would be the most expensive to handle, while letters are often handled in a more expensive manner simply because they can be processed (DPS'd or cased) more efficiently than flats.

As a result, because saturation letter are not given equal access to the low-cost third-bundle delivery method, **the Postal Service fails to take advantage of the high value that ECR saturation letters offer** and, of course, this value is not recognized in the postal costing system. **In addition, the postal costing system forces saturation letters to bear most of the higher system costs imposed by the constraint on low-cost bypass capacity**, coupled with the fact that ECR saturation flats are given preferential access to the low-cost extra-bundle delivery method.

In response to Dr. Haldi's direct testimony, rebuttal witnesses Crowder (ADVO-RT-1) and Lewis (USPS-RT-2) question whether the Postal Service has a capacity constraint, or whether it simply chooses to DPS ECR saturation letters for other reasons. Witness Bradley (USPS-RT-3) testifies that the current costing systems accurately measure marginal costs, but on cross-examination explained that his testimony does not address rate making at all, not even the "suitability of the costs [he develops] for rate making." Tr. 11/6129, l. 16 - 6130, l. 5.

Although the issue raised by Dr. Haldi has generated considerable attention from rebuttal testimony, that attention has generated far more heat than light. This issue is challenging, and it has significant ramifications for the costing of saturation mail, which needs to be addressed both in this docket and in the future by the Postal Service and the Commission. The following sections address each of the third-bundle issues raised in this docket:

IV-3

- A. Taking Saturation Mail Directly to the Street is the Postal Service's **Lowest Cost Option**, but It is **not Always Available**
- B. There is no Dispute that on Some Routes and for Some Route Segments, the Postal Service has a **Contractual Constraint** on the Number of Bundles from which City Carriers can be Required to Work
- C. For All Routes and Route Segments on which City Carriers have **no Contractual Constraint** on the Number of Bundles from Which They can Work, Both **Ambiguity and Disagreement** Exist as to Whether City Carriers Have any **Practical Limit** on the Number of Extra Bundles They can Handle Efficiently
- D. Dr. Haldi **Assumes that the Postal Service Acts Rationally** and Attempts to Minimize Cost
- E. The **Rational Explanation for DPSing a Large Percentage of Saturation Letters** is That the Postal Service Frequently Faces a **Constraint on its Capacity** for Bypass Treatment of Saturation Mail
- F. All **Casing Costs Attributed to Saturation Flats** are Also an Indication of a **Capacity Constraint** on Extra Bundles
- G. **Witnesses Crowder and Lewis** Have a Dilemma Which They Attempt, but Fail, to Resolve in a Satisfactory Manner
- H. With Respect to Saturation Mail, the Postal Service is faced with **Increasing Marginal Cost**
- I. The Limit on Capacity for Bypass Treatment is An Important Constraint Because, In All Instances Where a Capacity Limit has been Reached, the Postal Service and Dr. Bradley Need to **Develop and Use a Different Model for Determining Marginal Cost**

These sections are followed by a recommendation as to what steps the Commission should take in this docket to address these issues.

A. Taking Saturation Mail Directly to the Street is the Postal Service's Lowest Cost Option, but It is not Always Available.

An important distinguishing feature of saturation mail is that the Postal Service has several options for handling it. *See* VP/USPS-T30-31, Tr. 6/2391-92; USPS-T-30, p. 3. Saturation mail can bypass all mail processing (for letters, bypassing DPS) and all in-office operations (for letters and flats, bypassing casing and collation), and be taken directly to the street. Saturation mail can be cased more rapidly than other mail. Saturation letters have the additional option that they can be DPS'd. Tr. 10/5882. Witness Bradley recognizes that saturation letters give the Postal Service two advantages: (i) flexibility, they help the supervisors figure out the least-cost way amongst the various alternatives, and (ii) they help the Postal Service meet their delivery standards. Tr. 11/6132.

An understanding of the relative unit costs of each of these various options is fundamental to evaluating arguments made in this docket about whether Postal Service costing systems develop costs properly for saturation mail. USPS Witness Lewis (Tr. 6/2426) and Advo witness Crowder (Tr. 10/5844, 5847) have each testified that the **lowest cost procedure** for handling any saturation mail — *i.e.*, letters, flats, or wraps with DALs — is to **bypass** all mail processing and in-office operations and take it directly to the street, whenever that is a

viable option.¹ Lewis, Tr. 6/2437, ll. 2-4.² According to witness Lewis, the Postal Service would prefer to case nothing. Tr. 6/2428, ll. 8-9.

Saturation Letters. With respect to the options for handling saturation letters, witness Lewis asserts that **DPSing**, when that is an option, **costs less than manual casing** by city carriers. Tr. 6/2434, ll. 18-19. No witness has challenged this assertion. DPSing also has the possible advantage, over casing, of integrating saturation letters with other letters, rather than with flats in vertical flats cases. With this understanding, it follows that in order for the Postal Service to minimize city carrier costs in handling saturation letters, such letters should be:

(i) **DPS'd only** when the option of taking them **directly to the street is not feasible**, and

(ii) **cased only** when **neither DPS nor bypass** is an option (*e.g.*, at carrier units not served by DPS).³

Saturation Flats. With respect to the options for handling saturation flats, it is generally understood that DALs, which accompany unaddressed flats (sometimes covers), are recorded as flats on IOCS tallies, are integral to the associated flat mailing, but are letter-

¹ See also Tr. 11/5981-2, "That's why where I'm not contractually constrained to only using three bundles, I send that mail directly to the street." (Lewis)

² "I think you're correct that it probably is cheaper to not send it [a mailing of saturation letters] back [to the plant] and process it and then go through the process of delivering it."

³ See Lewis, Tr. 11/5974-80, re casing saturation letter mailings only when (i) extra bundle treatment not possible, AND (ii) mailing must be delivered that day, AND (iii) DPS not a possibility.

shaped, and can be cased faster and easier than flats.⁴ Kelley, USPS-LR-K-67, relying on witness Shipe data from R90-1.⁵ Whenever city carriers have more flats (and DALs) than can be taken directly to the street effectively, witness Lewis has testified that **collating two bundles of flats** into a single bundle is more productive and less costly than casing them.⁶ Tr. 6/2431, 11/5976. Finally, it is understood that **unaddressed flats**, many of which contain loose inserts, would be **more expensive to case** than **addressed flats** that are stapled or bound or enveloped.

Choosing between Letters and Flats. For a comparison of the cost of handling letters versus flats, witness Lewis also has testified that:

If given a choice between handling a **letter-shaped** mailing in the office or handling a **flat-shaped** mailing in the office, most delivery managers **will prefer to case a sequenced letter-shaped mailing** into an empty case rather than case or even collate a flat mailing. [Tr. 11/5939 (emphasis added).]

Whenever delivery managers are faced with a choice such as that described by witness Lewis, it is clear that saturation flats will benefit from low-cost bypass treatment while saturation letters will be diverted and processed in a manner that is more costly than taking them directly to the street. *See also* Lewis, Tr. 6/2428. An understanding of the relative costs of these

⁴ “If I end up having to take both of them [letter-shaped pieces and flats] at the same time I would think that the productivity for casing the letters would be better than the productivity for casing the flats, so I would have them case the letters and take the flats to the street.” Tr. 6/2428. (Lewis)

⁵ *See* VP-T-2, pp. 32-33, Tr. 9/5509-10; *see also* Lewis, Tr. 11/5936.

⁶ For letter-shaped pieces, casing is more efficient than collating. Lewis, Tr. 11/5975-80.

different options for handling saturation mail confirms the handling priorities discussed by Dr. Haldi in his direct testimony. VP-T-2, pp. 32-33, Tr. 9/5509-10. *See also* Lewis, Tr. 6/2418, ll. 8-11. Succinctly, when handling saturation mail, the Postal Service always is presumed to use its lowest cost alternative first, so long as it is available, after which it is presumed to use the next lowest-cost alternative (see Section D, *infra*).

B. There is no Dispute that on Some Routes and for Some Route Segments, the Postal Service has a Contractual Constraint on the Number of Bundles from which City Carriers can be Required to Work.

According to witness Lewis, “[m]ost delivery units have delivery territories affected by the three-bundle restriction.” Tr. 11/5939. The three-bundle restriction is a constraint that delivery managers must work around. According to witness Lewis,

delivery managers seek to minimize the amount of mail that carriers must handle in the office prior to taking it to the street for delivery. In addition to implementing processes to DPS letters from saturation full-coverage mailings, managers will defer, within service commitment windows, delivery of mailings to avoid in-office handling of sequenced full-coverage mailings. [Tr. 11/5939.]

The existence of the three-bundle restriction is not at issue. The issues concerning the three-bundle restriction are:

- (i) How many routes, or route segments, are affected by the three-bundle restriction? and

(ii) On those route segments to which the three-bundle restriction applies, how often does a situation arise in which one or more saturation bundles must be diverted to some other, higher-cost option?⁷

As witness Lewis says:

Only where these two operational conditions overlap does the three-bundle workrule cause a City carrier to **case** a sequenced full coverage mailing. [Tr. 11/5941, ll. 17-18 (emphasis added).]

On all routes and route segments that do **not** fall under the three-bundle restriction, the issue of importance is whether city carriers face any **practical limit**, or constraint, on the number of extra bundles that they can take to the street.

On the basis of his survey, witness Lewis offers the following summary assessment:

Thus, systemwide, the Postal delivery network appears to experience a constraint in its ability to handle sequenced full-coverage mailings as additional bundles **only about 10 percent of the time** (44.3 percent of delivery points times 23 percent of days.) [Tr. 11/5945 (emphasis added).]

Of course, as discussed in more detail below, this rosy assessment does not help explain why approximately 80 percent of all saturation letters are not handled as additional bundles and given low-cost bypass treatment. Nor does it explain the significant percentage of saturation flats that are cased or collated. There appears to be an almost total disconnect between the results of his survey and the available data on the amount of saturation mail that either is not

⁷ Witness Lewis emphasizes that the restriction applies to route segments; *i.e.*, parts of some routes allow a fourth bundle, while other parts don't. In a colloquy with Commissioner Hammond, witness Lewis gives a somewhat detailed description of how supervisors and carriers handle saturation mail under those circumstances. Tr. 11/6024-26.

taken directly to the street at all or is first collated in order to take the mail out as an extra bundle.

C. For All Routes and Route Segments on which City Carriers have no Contractual Constraint on the Number of Bundles from Which They can Work, Both Ambiguity and Disagreement Exist as to Whether City Carriers Have any Practical Limit on the Number of Extra Bundles They can Handle Efficiently.

After being cross-examined on his direct testimony, witness Lewis apparently realized that the Postal Service has nothing but anecdotal data on the number of times city carriers, especially those not subject to the three-bundle restriction, must do something with saturation mail other than simply take it directly to the street. USPS-RT-2, p. 6, Tr. 11/5943. In order to gather some data that rose above the level of anecdotal, witness Lewis took the initiative and conducted an informal, “quick and dirty” survey.

In the survey that accompanies his rebuttal testimony, witness Lewis, USPS-RT-2, defines “conflicts” as situation in which a carrier cannot give bypass treatment to all saturation mail that needs to be delivered that day. According to witness Lewis, the purpose of his survey was to gather evidence to show that the Postal Service had fewer conflict situations than presented by Dr. Haldi.

At some points in his testimony, witness Lewis goes to considerable length to say that carriers not subject to the three-bundle restriction have great flexibility and almost no practical limit on the volume of saturation mailings that they can take directly to the street. For example, on cross-examination of his direct testimony, he says:

If I have a DAL mailing that comes in and I don't have routes that have restrictions on being able to take the bundles to the

street I would send both pieces out to the street and have them deliver them as additional bundles. [Tr. 6/2429.]

And when cross-examined on his rebuttal testimony about routes where the third-bundle restriction does not apply, as with curblines routes, witness Lewis says handling multiple extra bundles is the most efficient way to deliver the mail.

Q: Could a carrier in one of these curb line components that are not contractually limited to one extra bundle, could they take two unaddressed flat mailings with DALs directly out and work simultaneously from those four extra bundles as well as DPS letters and VFC –

A: That's what we tell them to do, yes. [Tr. 11/5994-95.]

Q: So if you have a curblines route, and you've got, you know, a bunch of unaddressed flats and a bunch of DALs, and then you've got another set of unaddressed flats and DALs, and then you've got your DPS mail, and you've got your VFC mail, is that carrier not working from six bundles at that point?

A: Yes. As you've described it or illustrated it there, it is a little more complicated to work from a bunch of different bundles rather than just from two bundles, but it's not so complicated that we can't do it. It takes much less time to work the mail that way than it would to put all of that mail into the case. That's why we send the mail to a street as extra bundles. [Tr. 11/5995.]

Q: So there is no practical limit on the capacity of a carrier to take third bundles to the street where it's not contractually prohibited?

A: I'm sure at some places you could find some limit in the number of mailings that you could take. It's not a limit that we face operationally. [Tr. 11/5996.]

Q: And if you have Option E, two addressed flats, it goes directly to the street?

A: Correct.

Q: You wouldn't collate it?

A: I wouldn't need to I would not likely need to. Put it that way. If I had 10 of them, 20 of them, something like that, you could get me to a number that I would say, yeah, I would probably do something to manage the bundle, but from just straight-up, normal operations, no, we would take them both as individual bundles.

Q: So you would think there is no capacity constraint until you get to 10 to 20 bundles?

A: I didn't say 10 or 20; I just said you could get me so some number. It's a housekeeping thing, that's all. [Tr. 11/5997.]

None of these answers explains, or even offers any insight into, the important question of why approximately 80 percent of all saturation letters are not taken directly to the street as extra bundles. At other points in his testimony, witness Lewis indicates that there are some considerations that weigh on and limit the number of extra bundles that can be handled efficiently by city carriers who are not subject to the three-bundle constraint. For example, when cross-examined on his direct testimony, he says

Sending [saturation letters] straight to the street has some **inconvenience and contingency things** associated with it as well that would lead me to say send it back to the plants and put it into DPS. Understand that?

Q: I think. Some of the **contingency factors** are that there could be, or example, **another saturation flat mailing** --

A: Correct.

Q: – that you’d want to take to the street more than you’d want to take and ECR saturation letter mailing to the street, correct?

A: Correct. Today I’m looking at mail for tomorrow, but tomorrow the plant might find something that’s committed for tomorrow that should have been here at the same time. **I always prefer to leave myself some contingency.** That’s why I would sent it back. [Tr. 6/2436, emphasis added.]

It thus appears that the operational procedure used for saturation letters depends **not only** on the volumes of saturation letters and flats **actually on hand** at a delivery unit, **but also** the possibility — or “**contingency**” — that more saturation flats may arrive the next day. If the Postal Service has almost unlimited bypass capacity for handling saturation mail, it is not clear why supervisors would need to leave themselves some contingency. And when cross-examined on his rebuttal testimony, witness Lewis indicated that a number of extra bundles may not be so good:

As we discussed before, working from more bundles is more complicated when carriers are delivering the mail in the street, and **one of the things that we want to do is minimize the number of bundles that a carrier has to handle when they are on the street.** [Tr. 11/5982, emphasis added.]

This statement is also somewhat at variance from the conclusion of his survey that the Postal Service is constrained only 10 percent of the time and has plenty of capacity for handling additional volumes of saturation mail. It would appear that witness Lewis would like to have it all ways:

Q: And based on your rebuttal testimony, the Postal service has almost unlimited capacity to take saturation mail to the street if it wanted to. Isn’t that correct?

A: I think I identified places where either because of the way the customers wanted the mail delivered or constraints within our

infrastructure where I would say it's not unlimited. I would say it's not as big of an issue as Dr. Haldi's testimony made it sound like. That was what my testimony was, that it's probably much less of an issue than Dr. Haldi's testimony would have someone believe. [Tr.11/6010, ll. 14-25.]

Mr. Lewis' problem is that he cannot have it both ways. He cannot claim that the Postal Service is unconstrained with respect to its bypass capacity for saturation mail while it is denying bypass treatment to approximately 80 percent of all saturation letters.

D. Dr. Haldi Assumes that the Postal Service Acts Rationally and Attempts to Minimize Cost.

All large organizations, including the Postal Service, have important major goals. They implement these goals by means of operational objectives. When an objective is consistent with and supports the organization's major goals, it is said to be **goal-congruent**. But when an objective does not support the major goals, and perhaps even works at cross-purposes with major goals, then the objective is not goal-congruent, and is said to be **dysfunctional**.

According to witness Crowder, when analysts submit testimony about the Postal Service, they generally assume that a major goal of the Postal Service is to minimize cost, subject to meeting service standards. Tr. 10/5848-9. Dr. Haldi's direct testimony, VP-T-2, likewise assumes that the Postal Service, subject to meeting service standards, endeavors to minimize cost and is not encumbered by pursuit of any dysfunctional objective that works at cross-purposes with, and impedes the goal of, cost minimization. And, according to witness Lewis, the Postal Service tries to minimize costs. Tr. 6/2424, ll. 9-10.⁸

⁸ It would seem that only the Postal Service can claim (or admit) that it is operating inefficiently, and in this docket it has not offered any such testimony.

When handling all Standard **Regular** letters, as well as **ECR Basic and High-Density** letters, the Postal Service has only **two options**. These letters must be either (i) cased or (ii) DPS'd. As discussed above, no witness disputes that DPSing costs less than casing by city carriers. In light of these limited options, the objective of maximizing the percentage of Standard Regular, ECR Basic and ECR High-Density letters cased would be congruent with the goal of minimizing cost.

In the case of **ECR saturation** letters, however, the Postal Service has **three options**. In order, from least costly to most costly, they are (i) take the letters directly to the street, (ii) DPS the letters, or (iii) case the letters. VP/USPS-T30-31, Lewis, Tr. 6/2391-92. Should the Postal Service DPS saturation letters in situations where it has no capacity constraint and they could have been taken directly to the street, subjecting such letters to DPS would destroy the value of the mailer's sequencing and increase cost needlessly over what it otherwise could be. *See* Crowder, Tr. 10/5848; Tr. 11/5983, ll. 9-12. Consequently, for saturation letters, **an objective of maximizing the percentage of letters DPS'd**, regardless of cost, regardless of the possibility of using the lowest-cost bypass option, and regardless of how much value is destroyed, clearly **would not be congruent** with the goal of minimizing cost. Instead, it would be **dysfunctional**. Therefore, one must seek a rational explanation, consistent with the goal of cost minimization, to explain why such a high percentage of saturation letters are DPS'd.

E. The Rational Explanation for DPSing a Large Percentage of Saturation Letters is That the Postal Service Frequently Faces a Constraint on its Capacity for Bypass Treatment of Saturation Mail.

Dr. Haldi recognizes that a high percentage of saturation letters are DPS'd or cased. In and of itself, sequencing letters that are already sequenced ignores all the presort value which

the mailer has added. Dr. Haldi assumes that when the Postal Service incurs the additional costs necessary to DPS or case saturation letters, it is acting rationally. That is, he reasons that there is a rational explanation, consistent with minimizing costs, for why the Postal Service fails to give low-cost bypass treatment to such a high proportion of saturation letters. Thus, although he cannot measure or document all the practical considerations that limit the volume of saturation letters given low-cost bypass treatment, he reasons that the Postal Service frequently must be constrained from taking saturation letters directly to the street, with the **only rational explanation** being that (i) the Postal Service is faced with such a large volume of saturation mail that the bypass option is not available for all of it, and (ii) when it comes to bypass treatment, **flats are given priority over letters.**⁹

Witness Crowder also claims to assume that the Postal Service acts rationally and in a manner so as to minimize costs. Tr. 10/5848-9. At the same time, she points out that the percentage of saturation letters that are DPS'd may be even greater than originally estimated by the Postal Service (Tr. 10/5763), all the while claiming that the Postal Service is rarely constrained from taking additional volumes of saturation mail directly to the street.

⁹ Dr. Haldi's "methodology" is similar to consumer studies found in the economic literature that use "revealed preference" to study consumption patterns. That is, although one cannot "see" or "measure" consumers' indifference curves discussed in economic theory, if it is assumed that people's consumption is based on rational behavior, one can ascertain a great deal about their preferences by observing what they actually consume. In this instance, he observes the large share of saturation letters that are not taken directly to the street (along with a significant volume of flats, including DALs, that are cased or collated) and, assuming that the Postal Service is behaving rationally, reasons that every such instance represents some kind of effective constraint which precluded the carriers from taking the mail directly to the street. His is the only rational explanation for behavior that would not be cost minimizing if the Postal Service has large amounts of unused bypass capacity for saturation mail.

Unfortunately for witness Crowder, she too simply cannot have it all ways. If the Postal Service's bypass capacity is rarely constrained, then the Postal Service is not acting rationally and minimizing costs when it repeatedly fails to take saturation letters directly to the street. Conversely, if the Postal Service is acting rationally and minimizing costs, then its ability to give bypass treatment to saturation mail is constrained far more frequently than she cares to admit.

F. All Casing Costs Attributed to Saturation Flats are Also an Indication of a Capacity Constraint on Extra Bundles.

Casing and Collating Flats and DALs. The Postal Service records certain in-office costs for the casing of flats.¹⁰ However, these costs include the costs of casing DALs, which are recorded as flats costs because of the host piece they accompany.¹¹ DALs are letter-shaped and are therefore cased at a faster rate than flats. In addition, according to witness Lewis, **flats often are collated instead of cased**, because this is more productive. In light of this, it is possible that no saturation flats are actually cased, as witness Crowder suggests in her rebuttal testimony. Tr. 10/5762, ll. 12-13. The Postal Service has an estimate of the casing rate for flats from witness Shipe in Docket No. R90-1, but it has no estimate of the rate at which DALs are cased or the rate at which flats are collated. Consequently, from the IOCS in-office cost estimate for flats, only a very rough estimate could be made of the number of pieces that actually were cased or collated by city carriers.

¹⁰ For Base Year 2004, these costs can be found in USPS-LR-K-67.

¹¹ See Library Reference USPS-LR-I-14, Handbook 45, In-Office Cost System, Field Operating Instructions, in Docket No. R2000-1.

The unit in-office cost of collating or casing any part of a saturation flats mailing, including DALs, exceeds by a substantial margin the cost of taking such sequenced pieces directly to the street. Therefore, anytime carriers case or collate DALs or flats, Dr. Haldi assumes that the costs of casing or collating are incurred for a rational reason that is consistent with minimizing overall costs. As stated in Dr. Haldi's testimony, the rational explanation, of course, is that carriers have some limit, either contractual or otherwise, on the number of extra bundles that they can handle efficiently while delivering mail on their routes. VP-T-2, pp. 35-36, Tr. 9/5512-13. Under the assumption that the Postal Service is minimizing cost in a rational manner, Dr. Haldi reasons that whenever casing costs are attributed to saturation flats, that should be interpreted as an instance where carriers have reached a capacity constraint of one kind or another, and it is more efficient to case or collate some extra bundles in the office. VP-T-2, p. 36, Tr. 9/5513. It is not necessary to have a precise definition or measure of the constraint.

Casing or Collating Flats. In the case of saturation flats, since all of them are in the same rate category, whenever some (*e.g.*, addressed flats) do not receive bypass treatment but instead are subjected to more expensive handling such as collating or casing (*e.g.*, due to the need to take unaddressed covers directly to the street), all additional processing costs of collating or casing are reflected in the costs attributed to all saturation flats. This is not the case with saturation letters, however, as Dr. Haldi points out. VP-T-2, p.34, ll. 1-13, Tr. 9/5511.

Casing or DPSing Letters. Whenever saturation letters are diverted from bypass treatment and subjected to more expensive handling due to a Postal Service's decision to give

bypass treatment to saturation flats instead, the higher costs of DPSing or casing are reflected in the costs attributed to letters, not flats.

G. Witnesses Crowder and Lewis Have a Dilemma Which They Attempt, but Fail, to Resolve in a Satisfactory Manner.

Witnesses Crowder (Tr. 10/5758-61) and Lewis (Tr. 11, pp. 5941-45, ll. 4-8), in their rebuttal testimony, would have the Commission believe that the Postal Service is far below any limit on its capacity to have additional saturation mailings bypass all mail preparation (*i.e.*, DPSing, casing, or collating) and be taken directly to the street. However, their assertion that the Postal Service has so much unused and available capacity for giving bypass treatment to saturation mail presents them with a fundamental dilemma. Namely, while (i) asserting that the Postal Service has so much unused bypass capacity for extra saturation mailings and (ii) simultaneously denying that the Postal Service is irrationally pursuing a dysfunctional subjective and needlessly incurring costs, they need to explain, first and foremost, why such a high percentage of saturation letters are DPS'd and cased, and in addition why so many DALs and addressed saturation flats are cased or collated.

Witness Lewis' survey is not without difficulties. He picked a period only three weeks long, which would not necessarily cover saturation mailings that are entered monthly. Tr. 11/5944. He agreed that his sample was not statistically valid. Tr. 11/6012, ll. 13-14. Moreover, his instructions to the field told them what response he was seeking (that few conflicts exist), and why he wanted to have that information (to oppose an intervenor, Valpak, which was taking a position against the Postal Service). Tr. 11/6014, l. 16 – 6015, l. 13. Particularly since he was already concerned that he might receive false information from those

being surveyed (Tr. 11/5998, l. 23.), explaining to them exactly what response he wanted does not inspire confidence in the results. Another possible problem is that the survey focused on his after-the-fact analysis of the mail that came into the delivery unit and not on how the mail was actually handled by the carrier. Tr. 11/5998, ll. 13-19. Because of what witness Lewis protecting against a “contingency” of the unknown as to what mail may need to be delivered the next day, the number of “conflict” situations is almost certainly understated. Tr. 11/6002-03.

In an effort to rationalize the dilemma of unnecessarily DPSing or casing letters, witness Lewis asserts that carriers sometimes encounter **ergonomic difficulties** when handling saturation letters as an extra bundle. Tr. 11/5940-3. Witness Lewis states that

In the years between DPS implementation in 1993 and 2000, both the NALC and delivery managers found that the composite bundle method, where carriers worked from two letter-shaped bundles of mail, was ergonomically difficult when carriers walked between delivery points. Working from two letter-shaped bundles requires carriers either to use a finger to separate the two bundles or to place the bundles back to back so that the addresses are visible on either side of the bundle. [Tr. 11/5940.]

The possibility of an ergonomic problem also is hinted at in the response to ADVO/USPS-9. Tr. 12/6245. The response to that interrogatory does not make explicit mention of ergonomic problems, but does state that “[h]andling more than one letter-shaped bundle is more difficult than handling more than one flat-shaped bundle.” In turn, witness Crowder relies on this “ergonomic” excuse as a partial explanation for why such a small proportion of saturation letters receive low-cost bypass treatment. Tr. 10/5883-4.

References to this asserted ergonomic problem are overblown for two reasons. First, carrying two bundles of letters in one hand while carriers walk their route is not even a

consideration with respect to a majority of route segments, where carriers work out of separate trays — *e.g.*, curblin routes, cluster box segments, and centralized segments. Witness Crowder herself recognizes this fact. Tr. 10/5756-7. In all of these situations, carriers would not be expected to hold two bundles of letters in one hand while making deliveries.

Second, even on those routes where carriers may find it necessary to hold two bundles of letters in one hand, the response to ADVO/USPS-9 states:

However, when taking a sequenced mailing directly to the street is an option, taking a sequenced letter mailing directly to the street is more efficient than casing that mailing. [Tr. 12/6245.]

It follows, therefore, that on every day and every route where the Postal Service is not faced with a capacity constraint, ergonomic problems provide no rational reason for failing to minimize costs by giving bypass treatment to saturation letters. Saturation letters may or may not be slightly more difficult to handle than flats on certain portions of routes, but the fact that bypass treatment of saturation letters is more efficient than either casing or DPSing is clear and unequivocal.

In addition to asserted ergonomic problems, witness Crowder cites¹² a Postal Service policy statement contained in the response to ADVO/USPS-2 (Tr. 12/6237). However, she does not acknowledge that such a policy can be totally dysfunctional and irrational if the Postal Service has all the unused bypass capacity which she and witness Lewis claim exists. She makes no effort to reconcile this policy with (i) her assumption that the Postal Service acts

¹² See Tr. 10/5875.

rationally in a manner designed to minimize costs, and (ii) the fact that so many saturation pieces are either cased, collated or DPS'd.

H. With Respect to Saturation Mail, the Postal Service is faced with Increasing Marginal Cost.

It is assumed that the Postal Service acts rationally, and in a manner designed to minimized costs. Therefore, it is reasonable to assume that since the Postal Service has various options for handling saturation mail, with some options costing more than others, the Postal Service uses the lowest cost option whenever and wherever it can — *i.e.*, up to the point where it no longer can do so. This accords fully with Dr. Bradley's testimony.

I would certainly agree as a general matter that if I found the least cost way of producing something and I then totally used up that least cost way of producing it so now I've got to use a second method, I would incur a higher marginal cost.

I think that's a well-founded economic principle. [Tr. 11/6095.]

The total RPW volume of saturation mail in FY 2004 — letters and flats combined — was approximately 13.8 billion pieces (including nonprofit, but not counting DALs). Response to VP/USPS-T16-2, alternative attachment B; also LR-K-87. Within limits, the Postal Service can defer saturation mail (typically for 1 day, but longer if the mailer has specified a wider delivery window). Using the deferral option if necessary, if the volume of saturation mail were to be comparatively low — *e.g.*, up to, say, 4.0 billion RPW pieces — even on those routes where the third-bundle constraint applies, the Postal Service could take virtually all of it directly to the street (without blinking an eye, figuratively speaking). The only exception would be DAL mailings on those routes or route segments that are subject to the three-bundle limitation. Since it is not possible to take the covers to the street and defer the DALs, or vice

versa, on those routes or route segments where carriers are contractually constrained to three bundles, the DALs always must be cased. These are some of the conflicts found by witness Lewis in his survey, but he claims that they occur infrequently. Tr. 11/5945. Thus, so long as the volume of saturation mail is comparatively low, the marginal cost of processing any of it (casing, collating, or DPSing) would likewise be quite low, almost non-existent. This would be true for almost any mix of saturation letters, addressed flats and unaddressed covers under an annual volume of 4.0 billion.

As volume increases — from 4.0 to 8.0 billion RPW pieces, say — there will be an increasing percentage of instances where, even using the deferral option to the maximum extent possible, the Postal Service may need to incur the additional cost of collating some flats, or DPSing or casing some letters. As the percentage of such conflicts increases, the marginal cost of additional saturation volume, on average, will be higher than in the low-volume scenario. It is not necessary for this to occur every day, or on every route.¹³ As Dr. Bradley observes, “a constraint only matters if its binding....” Tr. 11/6096. In order for marginal cost to increase, it only is necessary that, as volume increases from 4.0 to 8.0 billion RPW pieces, this situation occurs more frequently than would be the case if the volume were less than 4.0 billion RPW pieces.

¹³ The volume of mail is not evenly distributed across all routes. In fact, it is highly skewed. See Marshall Kolin and Edward J. Smith, “Mail Goes Where the Money Is: A Study of Rural Mail Delivery in the United States,” in “Emerging Competition in Postal and Delivery Services,” edited by Michael A. Crew and Paul R. Kleindorfer, 1999: Boston, MA: Kluwer Academic Publishers. Hence, substantial congestion and conflicts of the type described by witness Lewis will exist on some routes, while on many other routes there will be no extra-bundle constraint, ever.

Finally, we consider what happens to marginal cost as the volume of saturation mail increases from 8.0 to the FY 2004 volume, 13.8 billion RPW pieces. Within this range, the Postal Service will need to incur the cost of collating flats and DPSing or casing letters an even greater percentage of the time than when the volume was less than 8.0 billion pieces. At the current volume level of 13.8 billion RPW pieces, the Postal Service needs to DPS about 56.5 percentage of all letters and case approximately 21-22 percent, while also casing some unknown percent of all DALs and collating some unknown but significant number of addressed flats. When volume of saturation mail is in the range 8.0 to 13.5 billion RPW pieces, the marginal cost will be higher than the marginal cost in the range 4.0 to 8.0 billion RPW pieces. This is sufficient to demonstrate that the Postal Service faces an increasing marginal cost curve for saturation mail, as Dr. Haldi testified. VP-T-2, p. 43, ll. 2-6, Tr. 9/5520.

I. The Limit on Capacity for Bypass Treatment is An Important Constraint Because, In All Instances Where a Capacity Limit has been Reached, the Postal Service and Dr. Bradley Need to Develop and Use a Different Model for Determining Marginal Cost.

Dr. Haldi's testimony describes the Postal Service's hierarchy for handling saturation mail. VP-T-2, p. 32, l. 1 – p. 33, l. 11, Tr.9/5510. Nowhere does the testimony of witness Crowder or witness Lewis dispute that saturation flats always receive priority for bypass treatment. It also is undisputed that on those days when, and in those delivery units where, carriers have only one saturation mailing for delivery, and that saturation mailing consists of letters, those letters should receive bypass treatment. According to witness Crowder, this happens only about 21-22 percent of the time. Tr. 10/5763.

All saturation mail, both letters and flats, can be deferred for one day, and perhaps for two days if the mailer has requested a 3-day delivery window. Consequently, when carriers cannot take all their saturation mail directly to the street, some of the saturation mail, including letters, can be deferred. However, whenever saturation letters are not taken directly to the street, the rational interpretation, consistent with cost minimization, is that they have been diverted to another, more costly processing method, because of (i) first, the fact that the delivery unit also has saturation flats that must be delivered, and (ii) second, and most importantly, the fact that Postal Service gives flats priority for bypass treatment. As stated in Dr. Haldi's testimony, determination of which saturation mailings receive low-cost treatment, and which are given higher-cost treatment, is decidedly not random. VP-T-2, p. 34, ll. 10-13, Tr. 5511.

The handling hierarchy within saturation mail is fundamental to the cost-causing characteristics of saturation letters and flats. Succinctly, the handling hierarchy means that flats can "bump" — or pre-empt — letters from low-cost bypass treatment into some higher-cost processing procedure. Conversely, however, letters can never pre-empt flats from receiving low-cost bypass treatment. Discussion of marginal cost typically focuses on how costs change when volume changes. When bumping and cross-effects are possible, the cost model and methodology need to allow for the fact that the marginal cost of saturation letters

can and sometimes will change when the volume of saturation flats increases (or decreases).¹⁴

Dr. Bradley stated the issue as follows:

So you're saying the change in cost from the driver in the separate cost pool. Well, mathematically it would mean that you were assuming that there was some change in Cost Pool J [*e.g.*, DPS for letters] from a change in the driver in Cost Pool I [*e.g.*, bypass for flats]. [Tr. 11/6079.]

According to Dr. Bradley, the Postal Service's established cost methodology assumes that if a certain volume of some rate category such as saturation letters uses some of the available machine time and work hours in an automated cost pool, then that rate category should be charged its proportionate share of the variable cost of the machine time and labor hours. Tr. 11/6043-4. In other words, under the established methodology, mail "is where it is," and is not considered to be where it is because it has been displaced by the volume of some other rate category elsewhere in the postal network. Since the model and methodology obviously are not in accord with the handling hierarchy and facts as described by witness Lewis, we would agree with Dr. Bradley's observation that "this area is certainly worth exploring." Tr. 11/6066. In the meantime, the Commission should not accept the marginal cost that results from application of this flawed methodology and the cost model used to implement it.

Because of the handling hierarchy, the volume of flats failing to receive bypass treatment never depends upon the volume of saturation letters. That is, the only time when

¹⁴ Since no saturation letters would need to be DPS'd or cased if there were no saturation flats (or if, perchance, all saturation flats were routinely cased), it should be obvious that the cost of saturation letters, as determined by IOCS, already has been substantially affected by the volume of saturation flats.

carriers collate flats or case DALs is when the volume of saturation flats exceeds the number that they can handle, either contractually or efficiently, while on their routes. The reverse is not true, however. The volume of saturation letters that are DPS'd or cased depends critically on the volume of saturation flats which carriers must deliver within the same time frame. In other words, on those days and routes where saturation letters must incur the cost of DPSing or casing, a direct relationship exists between the volume of saturation flats to be delivered and the volume of saturation letters that are diverted to more costly processing.

The **interdependent relationship** between the volume of saturation letters that must be DPS'd or cased, and the volume of saturation flats is not captured in the Postal Service's cost model; in fact, it is totally ignored. That model presumes that utilization of a particular cost driver by one subset of mail depends solely on the volume of mail within the subset in question. Or, stated otherwise, the Postal Service cost model assumes that utilization of a particular cost driver by one subset of mail is **independent of** the volume in any other subset.

The Postal Service's cost model is explained by Dr. Bradley as follows:

In the second step, the volume variable costs are distributed to mail classes based upon a distribution key. The distribution key calculates the **proportion of the cost driver that is caused by each product**, and that proportion is used to distribute volume variable cost to each product. The distribution key may be proportions of the cost driver, proportions of time, or proportions of volume. [Tr. 11/5944-47 (emphasis added).]

From the preceding discussion, however, it should be clear that the volume (and proportion) of saturation letters that are DPS'd or cased does depend directly upon the volume of saturation flats taking priority in delivery units. Were it not for the presence of those flats and the low priority given to letters, minimizing costs would require that all saturation letters

be taken directly to the street. **The Postal Service's cost model does not capture this interdependency** between (i) the volume of saturation letters that is DPS'd or cased and (ii) the volume of saturation flats and, accordingly, it does not provide the appropriate measure of marginal cost for saturation letters.¹⁵ Instead, **it causes the marginal cost of saturation letters to be overstated relative to flats**. Using the marginal costs generated by the Postal Service's cost model has the **counter-intuitive result** of reducing rates for saturation mail that is the least flexible and most difficult to handle, while increasing rates for saturation mail that is the most flexible and least difficult to handle. *See, e.g.,* Bradley XE-5, Tr. 11/6139.

The Postal Service's order of priority makes the cost driver relationship asymmetrical. That is, the volume of saturation letters, no matter how large, can never cause an increase in the volume of saturation flats that is cased or collated. The reverse is not true, however. A causal link can and does exist between the volume of saturation flats and the volume of saturation letters processed for delivery by some method other than low-cost bypass — and, therefore, between the volume of saturation flats and the cost of handling saturation letters.

The cost model depicted graphically on page 7 of Dr. Bradley's rebuttal testimony (Tr. 11/6044) shows the rather simple "causal chain" that underlies the established methodology. That methodology assumes that utilization of a cost driver, such as pieces DPS'd or cased, depends solely on the volume of the rate category using the cost driver. It is well established,

¹⁵ Such interdependency can also be described as "**cross-effects**" or substitutability between the stages of production. An article co-authored by Dr. Bradley acknowledges that such cross-effects are not captured by the established methodology, and admits that "this area is certainly worth exploring." Tr. 11/6066.

however, that saturation letters can use any of three cost drivers. The driver with the lowest unit cost is bypass; the driver that results in the next highest unit cost is time on DPS equipment; and the driver that results in the highest unit cost is city carrier time spent casing. The problem with the established methodology and the cost model in current use is that it has no way to determine whether use of one of the drivers with a higher unit cost **is caused by** the volume in rate category A (*e.g.*, saturation letters), or instead actually is caused by the volume in rate category B (*e.g.* saturation flats), which of course is the reality of the handling hierarchy described by witness Lewis.

The issue involved here is outside the established CRA methodology and, admittedly, is complex. Another way to discuss it, albeit more abstractly, is to say that the Postal Service needs to stipulate a production function that encompasses the processing of all saturation mail: letters and flats, both addressed and unaddressed (with DALs). The need for this alternative approach, and the underlying problem with the existing methodology was discussed by Dr. Bradley as follows.

[e]ven a minimalist approach to economic theory would suggest that before one estimates an econometric function one investigates what the arguments should be in that function. Yes.

Q. So I guess what I'm trying to get at is when you discuss or mention a cost generating process is that something that can be estimated and, if so, **does one need to know the arguments of that function** to do the estimation?

A. Well, I would say that, **in the CRA** at least, **those are not always estimated**. Many times the cost generating process has **assumed characteristics** and can come by assumption or it could come from engineering analysis. So no, **I don't think that to apply this methodology one actually needs to estimate the cost generating process**. No.

Q. If we equate cost generating process with cost function, then in fact **isn't the whole methodology** that has developed here at the Commission **designed to avoid having to estimate the whole cost function?**

A. If I interpret your question I think - - well, let me try to answer and you tell me if I got it. I think the **cost function one's trying to avoid is the macro cost function, right?** That's what your referring to?

Not necessarily the cost function in any particular cost pool, but it's trying to avoid the requirement of having to estimate what I think - - we both know that we mean the macro cost function, right?

Q. Right.

A. Okay. I don't know if that's the sole reason it's developed in that way, but it's certainly a benefit of the approach.

Q. Within the cost pool we are trying to estimate that cost generating process, correct?

A. No. I think in many instances **it just comes from assumption.** I have often tried to find out what the cost generating process is with some success, some not, but **in the CRA model it's not a requisite condition that the cost generating process be explicitly identified to apply the costing methodology.** [Tr. 11/6084-86 (emphasis added).]

So, to summarize and conclude, the CRA model has not specified the cost function for saturation mail. Instead, it simply assumes that the model fits, because that assumption is convenient. Unfortunately, the model does not fit the facts as described in the testimony of witnesses Lewis and Crowder. What the Postal Service needs to do is specify a new cost

model, one that reflects the bumping of saturation letters and the increase in Postal Service cost that occurs when the volume of saturation flats increases.¹⁶

J. In this Docket, the Commission Should Use Either Modeled Costs or Revised Marginal Costs to Establish the Letter-Flat Cost Difference.

For the foregoing reasons, the issue of whether the postal costing systems deal properly with third bundles is a serious one, and one which needs additional attention in the future by the Postal Service and by the Commission. Until the issue receives that additional attention, however, the Commission should adopt one of the two recommendations offered by Dr. Haldi.

First, to establish the ECR saturation letter-flat cost differential the Commission could use **modeled costs** as it did in Docket No. MC95-1, as the Commission is not required to use costs based on IOCS samples to estimate the costs of the letter and flat rate categories within Standard ECR saturation mail. In Docket No. MC95-1, no eligible subset of mail was assumed to receive preferential access to extra bundle treatment, so when costs were adjusted to accord with CRA costs for saturation mail, both ECR saturation letters and flats were dealt with on a basis that was fair and equitable. Both saturation letters and flats participated ratably in the lower costs obtained by the extra-bundle method used to take mail directly to the street. Of course, this recommendation assumes that the Commission has adequate data to use for modeled costs. VP-T-2, p. 53, l. 21 – p. 55, l. 10, Tr. 9/5530-5532.

Second, to determine the ECR saturation letter-flat cost differential, the Commission could **combine (i) unit direct casing costs with (ii) unit city carrier street costs**. An estimate

¹⁶ Such a model would reflect, in the cost of saturation flats, what Dr. Haldi's testimony describes as the "opportunity cost." Tr. VP-T-2, p. 47, ll. 8-9, Tr. 9/5524.

of this differential was set out in Dr. Haldi's Table 4 (p. 56), but this was based on witness Kelley's underestimate of the total number of ECR saturation DALs, as well as his underestimate of the number of DALs delivered by city and rural carriers, and therefore would need to be adjusted upward substantially from the .81 cents estimated in that table. VP-T-2, p. 55, l. 11 – p. 56, l. 20, Tr. 11/5532-33.

V. THE POSTAL SERVICE'S PROPOSED COST COVERAGE FOR STANDARD ECR MAIL SHOULD BE REDUCED.

Although the Postal Service did not expressly select cost coverages in this docket, they were calculated and reviewed. According to witness Robinson, the after-rates cost coverages for Commercial ECR and Nonprofit ECR combined, at USPS costing, is **244.1 percent** (USPS-LR-K-114, revised 6/27/2005). This corresponds to a markup index of **1.610**. *Id.* Under PRC Costing, the coverage and markup index are **226.1 percent and 1.600**, respectively, *Id.*¹

Under both USPS and PRC costing, the cost coverage and the associated markup index that the proposed rates imply are **higher for ECR than for any other subclass**. As discussed in more detail below, an analysis of the non-cost factors of the Postal Reorganization Act shows that ECR has a low value of service, a high elasticity, a high degree of preparation, and multiple competitors. Properly applied, these factors support not the highest cost coverage, but a below-average cost coverage — as the Postal Service has acknowledged repeatedly in the past.

A. The Postal Service did not Actually Select Coverages for the Subclasses in this Docket.

Traditionally, ratesetting begins with costs, which are marked up by a coverage factor, selected according to policies in the Act. In this docket, however, current rates are increased by a designated factor, and the coverage is calculated as an implication of the resulting rates.

¹ Of course, whenever coverage for a subclass exceeds 200 percent, it creates the circumstance that more than half of the rate charged consists of contribution to the Postal Service's institutional costs, rather than payment of direct and indirect attributable costs of that subclass.

Witness Taufique (USPS-T-28) serves as the Postal Service’s rate design witness in this docket. Consistent with the policy of the Board of Governors, he applies the across-the-board proportion to all rate elements, dealing with several anomalies that arose from that formulaic approach. He addresses coverage for Standard Mail (including ECR) on pages 10-12 of his testimony, and in his workpapers (USPS-LR-K-115). Although the Postal Service’s across-the-board increase for all products is represented as **5.4 percent**, witness Taufique obtains an increase of **5.6 percent** for Commercial ECR, and of **5.9 percent** for Nonprofit ECR.²

Witness Robinson backs into a set of coverages for the subclasses. She (i) applies the proposed rates to the volumes to obtain revenues, (ii) divides the revenues by the costs, and (iii) proposes that the resulting coverages be the recommended coverages.

B. Having Rates Cover Costs Does Not Constitute Full Compliance with 39 U.S.C. 3622(b).

Coverage witness Robinson identifies section 3622(b)(3) of the Act as being “the most objective of the nine pricing criteria” and as “specifying that each class of mail must at least bear the direct and indirect postal costs attributed to that class.”³ The full context is:

Upon receiving a request, the Commission shall make a recommended decision on the request for changes in rates or fees in each class of mail or type of service in accordance with the policies of this title and the following factors...

² By contrast, witness Robinson (USPS-T-27) identifies the proposed increases as 5.5 percent for Commercial ECR and 6.0 percent for Nonprofit ECR (Exhibit USPS-27D). She explains that her calculations hold the “volume mix constant so movements in the volume forecast causing shifts between various rate categories don’t distort percentage change.” Tr. 3/524.

³ USPS-T-27, p. 16.

(3) the requirement that each class of mail or type of mail service bear the **direct and indirect postal costs attributable** to that class or type plus that portion of all other costs of the Postal Service **reasonably assignable** to such class or type....
[Emphasis added.]

Witness Taufique observes that the statutory provision requires “that the rates and fees for each subclass or special service generate sufficient revenues to cover its attributable costs or incremental costs **as portrayed by the Postal Service.**”⁴ His testimony concludes that “since all Standard Mail subclasses are adequately covering costs,”⁵ this requirement is met.

However, since a coverage of 105 percent satisfies this requirement with as much grace as a coverage of 500 percent, satisfying it cannot be viewed as a high hurdle. Similarly, focusing on it does not help in deciding whether a coverage of 175 percent is more or less suitable than a coverage of 135 percent. Clearly, a coverage certified as satisfying the constraint of criterion (b)(3), “objective” though it may be, cannot be viewed as necessarily having sufficient credentials.

Since criterion (b)(3) has been interpreted to apply with its greatest clarity at the subclass level, the conclusions reached by witnesses Robinson and Taufique are not inherently incorrect, at least not insofar as they observe that the (b)(3)-test is passed. However, the Commission has also used costs as a guide **below** the subclass level, in line with widely accepted ratesetting principles. This is done not only as a matter of fairness, but also to send

⁴ USPS-T-28, p. 2 (emphasis added). The phrase “as portrayed by the Postal Service” is inconsistent with the Act. A better interpretation would seem to be: as determined by the Rate Commission.

⁵ *Id.*, p. 12.

appropriate signals to mailers and support the efficient allocation of resources. Except to the extent the **rates from the last rate case** (Docket No. R2001-1) just happen to be aligned with **now-current costs**, a happening that the record shows not to have occurred, an across-the-board approach does not honor such additional rate setting guidelines.

At the subclass level, a simple observation that rates cover costs obscures the statutory path that leads to the establishment of coverages. The statute lists nine factors that should be considered, and covering costs is only one of them. It is the application of all of these factors, along with the other policies of the Act and any conventions found important by the Commission, that should guide the selection of the coverages. A perfunctory observation *ex post* on the adequacy of revenues, referring only to criterion (b)(3), is not sufficient, although it is precisely part of the approach that must accompany an across-the-board application.

C. The Proposed Coverage Is Contrary to Proper Application of the Non-cost Criteria.

Witness Robinson's testimony did not address how each of the non-cost criteria of the Act applies to Standard ECR or Standard Regular mail. On cross-examination, she explained that this omission was due to "the unique circumstances of this case." Tr. 3/533. However, Valpak witness Mitchell (VP-T-1) has filled this evidentiary void. Where witness Mitchell and Postal Service witnesses from prior omnibus rate cases applied the same non-cost criteria to ECR, the conclusions drawn were essentially identical.

1. Analysis of Each Non-Cost Criteria.

Factor No. 1

Starting with non-cost factor No. 1, the establishment and maintenance of a fair and equitable schedule, witness Mitchell explored the incongruity between the objective application of the non-cost factors and the excessive institutional cost burden which the Postal Service's proposed rates impose on ECR. Witness Mitchell observed that in Docket No. R90-1, before the MC95-1-establishment of ECR as a separate subclass, the Commission set a below-average cost coverage of 146.2 percent (a markup index of 0.927) on Bulk Rate Regular ("BRR"), in which subclass the ECR categories were housed. Since the characteristics recognized by the non-cost criteria have not changed since ECR was a constituent element of BRR, except that we now understand the elasticity to be even higher than was estimated at the time, it cannot be fair and equitable to impose a dramatically higher cost coverage on ECR in this docket, at least when viewed in terms of the markup index. In fact, since Nonprofit ECR is recognized as a preferred category and is now linked to Commercial ECR for cost coverage purposes, logically the markup index should be below 0.927.⁶

Witness Mitchell also observes that fairness can implicate national policy issues. For example, the Postal Service has been established to provide services to the American people at large, with a goal of establishing a low-cost, highly efficient operation by aggregating mail

⁶ The accommodation of Nonprofit ECR is not unimportant. Whatever coverage is selected for ECR carries through to Nonprofit mailers. Also, if a lower rate is accorded to Nonprofit mailers without reducing the overall ECR coverage, then the burden of the lower Nonprofit rates is carried by Commercial ECR mailers alone instead of by the overall postal system. *See* Section VI, *infra*.

from all sources into a universal delivery provider. Extensive preparation of mail by ECR mailers has achieved low costs to a considerable degree, minimizing the resources drawn from the nation to provide the service. However, this accomplishment is wasted if access to the low-cost mailstream is not made available to mailers at reasonable rates. Thus, the Postal Service's proposed imposition of an excessive cost coverage on ECR would subvert this process and prevent mailers and recipients of ECR mail from reaping the benefits of productive, efficient behavior.

Factor No. 2

For non-cost factor No. 2 — the value of the mail service actually provided each class or type of mail service to both the sender and the recipient, including but not limited to the collection, mode of transportation, and priority of delivery — witness Mitchell discusses the striking distinction between the own-price elasticities of ECR and Standard Regular, and he discusses how value can be erased by high markups.

Postal Service witness Thress (USPS-T-7) estimates the own-price elasticity of ECR to be -1.093 and of Standard Regular to be -0.267. USPS-T-7, p. 96, l. 23 – p. 97, l. 1. ECR's elasticity of -1.093 indicates that, *ceteris paribus*, a rate increase of 10 percent would result in a volume decline of 10.93 percent, which would lead in turn to a reduction in revenue. The indication is a **high sensitivity to rate increases** and substantial losses in value to mailers, even though the **net** revenue would not decrease. (In more detail, the volume reduction should lead to a cost reduction, which, when combined with the revenue decrease, would still allow an

increase in net revenue.⁷⁾ This high elasticity is testimony to the greater vulnerability of ECR to rate increases and should be reflected in its markup.

The Postal Service's across-the-board rate design in this docket takes no cognizance of the respective mail products' value of service. As witness Robinson observed:

it was not appropriate to allocate this unique cost on the basis of the relative value of service. Value of service was considered and is incorporated in the proposed rates through the cumulative judgments of the Postal Rate Commission regarding value of service of the specific mail classes. In this instance, it is not correct to say that value of service considerations were ignored, they were not. However, consideration of the unique nature of the escrow expense suggests that differential allocation of the escrow expense based on value of service was inappropriate.⁸

Prior Postal Service witnesses have consistently acknowledged ECR's low value of service. In the last rate case where a complete analysis of the non-cost factors of the Act was offered by the Postal Service, Docket No. R2001-1, witness Moeller presented the Service's explanation and justification for its proposed cost coverages. With regard to ECR's value of service, witness Moeller observed that:

⁷ Witness Mitchell explains that a rate increase, despite the revenue loss, will lead to an increase in net revenue as long as the own-price elasticity, in absolute value, is less than the price divided by the per-piece markup. For ECR, the net revenue would turn negative at a threshold elasticity of about -1.88, a figure not all that distant from -1.093. This threshold elasticity is lower than that for any other subclass. *See* VP-T-1, pp. 60-61, Tr. 9/5326-27.

⁸ Response to VP/USPS-T27-17, Tr. 3/439.

- the intrinsic value of service for ECR is relatively low (criterion 2), since it lacks access to the collection system, receives ground transportation, has no free forwarding and its delivery may be deferred.⁹
- The price-elasticity of ECR (-0.770 [in that docket]) is higher in absolute value than that of Standard Mail (A) Regular or First-Class letters, indicating a relatively low economic value of service (criterion 2).¹⁰

Witness Moeller's assessment of ECR's value of service differed little from that presented by the Postal Service's witnesses in Docket Nos. R97-1 or R2000-1.¹¹

Factor No. 4

For non-cost factor No. 4 — the effect of rate increases upon the general public, business mail users, and enterprises in the private sector of the economy engaged in the delivery of mail matter other than letters — witness Mitchell observed that “it is not only unfair to mailers but also poor national policy to elevate ECR rates, for both Commercial and Nonprofit mailers, whether the pieces can be delivered privately or not, in order to attempt to

⁹ Other factors noted by witness Moeller in his discussion of criterion 2 (*see* USPS-T-28, p. 4, Docket No. R2001-1) could also be cited in support for the low intrinsic value of service of ECR: the **level of privacy** afforded by the mail class, 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**. Witness Moeller also mentions ‘an additional consideration’ — “the availability of alternative services which have **features valued by customers**, but which are **not available** in the comparable **postal services**.” (Emphasis added, p. 6.)

¹⁰ USPS-T-28, p. 37, Docket No. R2001-1.

¹¹ USPS-T-32, p. 38, Docket No. R2000-1; USPS-T-30, pp. 34-35, Docket No. R97-1.

make it profitable for private enterprises to be successful in attracting a portion of the ECR mailstream.” VP-T-1, p. 65, ll. 8-11, Tr. 9/5331. Witness Mitchell concluded that application of an average markup (*i.e.*, a markup index of 1.000) on ECR would be sufficient to protect competition. He added that private competition could more appropriately be encouraged by changing the mailbox rule.

Factor No. 5

For non-cost factor No. 5 — the available alternative means of sending and receiving letters and other mail matter at reasonable costs — witness Mitchell discusses how some letters and other mail matter in ECR can be carried by private competitors if the addresses are removed or if the pieces have over 24 pages, but that most materials in ECR cannot be sent privately. He also noted that this factor is often considered to include alternatives to sending and receiving physically, such as when information equivalent to that contained in letters and other mail matter is transmitted electronically — by means of television, radio, or the Internet.

Witness Mitchell concluded that the Postal Service exists to serve mailer needs effectively and a high markup prevents that from occurring, thereby limiting the value and benefits that are achievable, and that therefore this non-cost factor does not support the exceedingly high markup on ECR that result from the Postal Service’s proposal.

Again, as in past Postal Service cases that did apply the non-cost criteria to ECR, it is agreed that “[u]sers of [ECR] mail have available a range of alternatives (criterion 5)” and that “due to its geographic concentration, both alternate delivery firms and newspaper inserts may

provide ways of delivering the same advertising message that would be carried in ECR.”¹² No discussion ensued as to whether this factor supported a higher or lower markup on ECR.

Factor No. 6

For non-cost factor No. 6 — the degree of preparation of mail for delivery into the postal system performed by the mailer and its effect upon reducing costs to the Postal Service — witness Mitchell stated that ECR mailers engage in preparation activities to a greater degree than any other subclass. ECR mail is variously presorted, prebarcoded, prepared in line-of-travel sequence, dropshipped, and presented in prescribed containers (usually trays and pallets). Acceptance processes and postage payment procedures also result in low Postal Service costs. The density of ECR mailings (the number of pieces per carrier route) and their bulk nature also reduce costs. As a result, the Postal Service’s costs for ECR mail are notably low — especially saturation mail.

Prior Postal Service witnesses have made the same points. In Docket No. R2001-1, Postal Service witness Moeller observed: “Relative to other mail, ECR has a very high degree of preparation by the mailer (criterion 6); even the basic rate category must be line-of-travel sequenced, and the high-density and saturation categories are walk-sequenced. In addition, for pieces to be eligible for the High-Density and Saturation letter rates, the pieces must bear a barcode and be machinable on letter processing equipment.”¹³

¹² USPS-T-28, p. 37, ll. 18-20, Docket No. R2001-1. *See also* USPS-T-32, p. 38, Docket No. R2000-1 and USPS-T-30, p. 35, Docket No. R97-1.

¹³ USPS-T-28, p. 37, l. 21 - p. 38, l. 4, Docket No. R2001-1. *See also* USPS-T-32, p. 38, Docket No. R2000-1; USPS-T-30, p. 35, Docket No. R97-1.

Factor Nos. 7 and 8

There is no analysis for non-cost criteria Nos. 7 and 8. ECSI value and simplicity of structure are not issues for ECR.

2. Conclusion From Analysis of Non-cost Criteria.

The extremely high cost coverage proposed by the Postal Service in this case for Commercial ECR and Nonprofit ECR combined is inconsistent with objective application of the non-cost criteria. As witness Mitchell observes, the time for proper application of the non-cost factors in the Act to ECR is long overdue. When this is done, as explained herein, it becomes clear that the appropriate coverage for ECR should be much lower than it is.

Postal Service witnesses in prior cases have acknowledged that application of the non-cost criteria points to a lower markup for ECR. For example, in Docket No. MC95-1, witness Moeller, the rate design witness for the proposed new subclasses of Automation Regular, Non-automation Regular, and ECR (only the latter of which the Commission recommended), when asked about the cost coverage that should apply to ECR, absent tempering to lessen the effects of the rate changes on mailers, testified:

if we were starting from a situation where the coverages for the three subclasses were equal, a somewhat lower coverage for Enhanced Carrier Route relative to the combined coverage for the three new subclasses could be supported. Even with the waiver of the constraint of avoiding major rate relationship changes, I have insufficient information to speculate as to how much lower of a coverage could be supported, but in the situation you describe it could be as little as 10 percent. [Docket No. MC95-1, response to OCA/USPS-T18-18, Tr. 11/4275-6, 25 emphasis added.]

In other words, ECR's cost coverage should have been **lower** than Non-automation Regular and Automation Regular (had these two been approved as separate subclasses instead of one). However, given the revenue-neutral approach to the changes of Docket No. MC95-1, proper application of the non-cost criteria to ECR was not undertaken — it had no choice but to wait. Thus the variance between the actual markup and the appropriate markup remained, looking for some correction in the next omnibus rate case, which turned out to be Docket No. R97-1.

However, since Docket No. MC95-1, the Postal Service has never proposed ECR rates reflecting a proper application of the non-cost criteria. Instead, as witness Robinson observed, "ECR's rate increases have been moderated since reclassification."¹⁴ In this bent, following his analysis of the application of the non-cost criteria to ECR in Docket No. R97-1, witness O'Hara said:

This [percentage rate increase for ECR] is somewhat below the system-wide average increase, **reflecting a desire to lower the very high cost coverage of this subclass.**¹⁵

Similarly, in Docket No. R2000-1, witness Mayes testified:

This [percentage rate increase for ECR] is somewhat below the system-wide average increase, **reflecting a desire to lower the very high cost coverage of this subclass.**¹⁶

And in Docket No. R2001-1, following his application of the non-cost criteria to ECR, witness Moeller explained:

¹⁴ Tr. 3/502.

¹⁵ USPS-T-30 at 34, Docket No. R97-1, emphasis added.

¹⁶ USPS-T-32, p. 38, Docket No. R2000-1, emphasis added.

The Postal Service is proposing a cost coverage of 217.8 percent over volume variable costs for the ECR/NECR subclass, which results in a 6.2 percent average rate increase for ECR, and a 6.5 percent increase for NECR. These are somewhat below the system average increase, **reflecting a desire to lower the very high cost coverage of this subclass.**¹⁷

Now, in Docket No. R2005-1, the Postal Service is proposing ECR rates which reflect the highest cost coverage/markup of any class of mail, as well as reflecting a **slightly above-average rate increase of 5.6 percent for the Commercial category and 5.9 percent for the Nonprofit category.** It is time for a meaningful reduction in the ECR cost coverage.

3. Impact of Past Excessive ECR Cost Coverages.

The combination of ECR's high own-price elasticity and the imposition of excessive markups has had a dramatic impact on ECR. According to witness Thress (USPS-T-7), there has been **"a 38.3 percent decline in Standard ECR mail volume over the past ten years."**¹⁸ This reflects "a decline in Standard ECR mail volume of approximately 4.1 percent per year."¹⁹ Since 1998, ECR volume has declined every year except 2000 (an increase of 0.02 percent) and 2004 (an increase of 3.48 percent).²⁰

As a result, ECR revenues have been largely stagnant.

- GFY 2000 ECR revenues were \$4.879 billion.²¹

¹⁷ USPS-T-28, p. 36, Docket No. R2001-1, emphasis added.

¹⁸ USPS-T-7, pp. 102-03, emphasis added.

¹⁹ *Id.*, p. 102.

²⁰ *Id.*, Table 18.

²¹ Revenue, Pieces, and Weight by Classes of Mail and Special Services for Government Fiscal Year 2001.

- GFY 2001 ECR revenues declined to \$4.731 billion.²²
- GFY 2002 ECR revenues declined to \$4.703 billion, even after a rate increase on June 30, 2002.²³
- GFY 2003 ECR revenues increased to \$4.922 billion.²⁴
- GFY 2004 ECR revenues increased to \$5.109 billion.²⁵

Thus, after two ECR rate increases (4.9 percent in Docket No. R2000-1²⁶ and 6.2 percent in Docket No. R2001-1²⁷), actual ECR revenues increased a total of only 4.71 percent from GFY 2000 to GFY 2004 — well below the rate of inflation over that 4-year period.²⁸

One facet of this dynamic is the existence of **dramatic, unexplained losses in ECR volume**, as reported in the Postal Service's case-in-chief by witness Bernstein (USPS-T-8). In an effort to explain empirically the overall 4.87 percent decrease in ECR volume from the first quarter of 2001 to the first quarter of 2005, witness Bernstein takes the current estimation of ECR's elasticity (-1.093), multiplies it by the amount the real price increased (3.1 percent),

²² *Id.*

²³ Revenue, Pieces, and Weight by Classes of Mail and Special Services for Government Fiscal Year 2002.

²⁴ Revenue, Pieces, and Weight by Classes of Mail and Special Services for Government Fiscal Year 2004.

²⁵ *Id.*

²⁶ *Opinion and Recommended Decision*, Docket No. R2000-1, para. 5364.

²⁷ *Opinion and Recommended Decision*, Docket No. R2001-1, Appendix G, Schedule 1.

²⁸ According to witness Tayman, CPI-W was 3.3 percent in FY 2000, 3.2 percent in FY 2001, 1.2 percent in FY 2002, 2.3 percent in FY 2003, and 2.2 percent in FY 2004. USPS-T-6, p. 15, Table 9.

and computes a drop in ECR volume (due to prices) of 3.32 percent.²⁹ Several other factors also are incorporated in the attempt to explain the changes in ECR volume over the four-year period studied, including changes in adult population, an econometric trend, retail sales, internet advertising, etc.

However, because this calculation fails to capture the actual loss of ECR volume over the period in question, witness Bernstein is forced to create a dummy variable — reflecting an additional volume drop of **8.59 percent** following Docket No. R2000-1 — to reflect “the unexpected decline in Standard ECR volume following the R2000-1 rate case.”³⁰ Thus, the ECR rate increases implemented on January 7, 2001 and July 1, 2001 following Docket No. R2000-1 had a dramatically negative effect on ECR volumes, which the Postal Service apparently finds to be both unexpected and inexplicable.

Moreover, a similar unexplained drop in ECR volume occurred after Docket No. R97-1. Witness Thress observed that “dummy variables are also included for the implementation of the R97-1 and R2000-1 rate cases that caused some mail to migrate from the ECR subclass to the Regular subclass.”³¹

4. There Is No Rational, Legal Justification for ECR to Have a Higher Markup or Contribution per Piece than Standard Regular.

As discussed above, before the Docket No. MC95-1-establishment of Regular and ECR from third-class bulk rate regular (“BRR”), the Commission had set a below-average cost

²⁹ USPS-T-8, p. 144, Table 33.

³⁰ *Id.*, p. 146.

³¹ USPS-T-7, p. 102.

coverage of 146.2 percent (a markup index of 0.927) on BRR in Docket No. R90-1. Since the establishment of Regular and ECR, very little has occurred to change how the non-cost criteria should be applied to the former constituent members of BRR.

Thus, applying the non-cost criteria to Regular and ECR, there is no significant difference between the two products except own-price elasticity (ECR has an own-price elasticity of -1.093; Regular of -0.267).³² Like ECR, Regular lacks access to the collection system, receives ground transportation, has no free forwarding, offers no privacy, suffers from equally poor reliability and image, and is subject to deferred delivery. ECR may have more alternatives than Regular, and ECR has a somewhat higher degree of preparation of mail for delivery into the postal system.

Why then should **ECR** have a markup index of **1.610**, while **Regular** has a markup index of **0.666**?³³ Why should ECR have gone from a below-average markup to the highest markup of any mail subclass,³⁴ particularly given witness Moeller's observation in Docket No. MC95-1, cited *supra*, that ECR should properly have been assigned a lower markup than that appropriate for a combination of the proposed Non-Automation Regular, Automation Regular, and ECR?

In Docket No. R2000-1, witness Mayes observed that if the degree of preparation of a subclass increases over time, and a certain contribution is to be maintained, the cost coverage

³² *Id.*, Table 1, p. 9.

³³ USPS-T-27, Table 3, revised June 27, 2005.

³⁴ *Id.*

must be increased. USPS-T-32, p. 10. Regardless of whether such a focus on contribution can be supported, it does not explain a high initial markup.

The cost coverage of ECR (including Nonprofit) is so excessively high, its **unit contribution** has consistently been substantially higher than that of Regular (including Nonprofit). For example from 1997-2000, the unit contribution of ECR was between 1.2 cents and 4.2 cents higher than that of Regular.³⁵ Under the Postal Service's proposal, the average test year after-rates unit contribution for ECR would be **2.28 cents higher** than for Regular.³⁶ This is an increase of 0.3 cents from the 1.96 cent unit differential in the Postal Service's proposed rates in Docket No. R2001-1.³⁷ The actual FY 2004 differential is 2.60 cents,³⁸ **32.7 percent higher** than the estimated TYAR differential in Docket No. R2001-1.

Although the unit **contribution** from ECR is substantially **higher** than the unit contribution from Regular, the unit **cost** of ECR is substantially **lower** than the unit cost of Regular.³⁹ Commercial Regular and Nonprofit Regular have TYAR volume variable costs of \$9,119,123,000 (Exhibit USPS-27B) and TYAR volume of 68,692,302,000 (Exhibit USPS-

³⁵ VP/CW-T-1, p. 43, Table 5, Docket No. R2000-1.

³⁶ VP-T-1, p. 47, Figure 2. Witness Robinson calculates the unit contribution from Regular/Nonprofit as 7.90 cents, and from ECR/NECR as 10.13 cents, resulting in a unit contribution difference of 2.23 cents. Response to VP/USPS-T7-4(c) and 5(c), redirected to Witness Robinson, Tr. 3/454, 457.

³⁷ Docket No. R2001-1 ECR/NECR revenue per piece 8.75 cents; Regular/Nonprofit revenue per piece 6.79 cents. Volumes from USPS-T-7, pp. 108, 115, 124, 129; Revenues from Exhibit USPS-28B.

³⁸ VP-T-1, p. 47, Figure 2.

³⁹ See VP/CW-T-1, pp. 48-50, Docket No, R2000-1.

28A), resulting in a unit cost of 13.28 cents. Commercial ECR and Nonprofit ECR have TYAR volume variable costs of \$2,481,440,000 (Exhibit USPS-27B) and TYAR volume of 35,135,957,000 (Exhibit USPS-28A), resulting in a unit cost of 7.06 cents. Yet, by the proposed rates in its case-in-chief, it is reasonable to conclude that the Postal Service remains committed to **spending more to obtain less net revenue**, using an above-average percentage rate increase to ECR to further shift volumes to Regular.

This divergence in unit contributions between ECR and Regular was wholly ignored by the Postal Service in its case-in-chief. The failure to raise Regular rates adequately to cover increases in Regular unit costs causes the burden of institutional contributions to be shifted to other subclasses, such as ECR, where costs have remained more controlled (perhaps due to the smaller degree of utilization of the postal network).

In addition to increasing the coverage and average unit contribution on the Standard Regular subclass, special attention needs to be given to those rate categories within Standard Regular where the unit contribution is substantially below the subclass average. Such rates do not appear to be properly aligned with costs, and this can create anomalous rate-cost comparisons with other products that are substitutes. Failure to keep unit contribution roughly equal on products within the Standard Class of mail that are, or can be, substitutes for each other will contribute to the creation of situations where there is “tremendous potential to improve the Postal Service’s ability to price its products.”⁴⁰

⁴⁰ Docket No. MC2005-3, Testimony of Michael Plunkett, USPS-T-1, p. 2, ll. 9-10.

5. ECR Rates Would Have Benefitted From ECR Not Becoming a Subclass.

As noted above, after ECR was established as a subclass, the markup imposed on it has jumped from below average (as part of BRR) to the highest of any mail subclass. It has been demonstrated at length that this excessive markup is not the result of an objective application of the non-cost criteria. Rather, it appears to be a consequence of a certain lethargy, or lack of effort, on the part of the Postal Service. With every omnibus rate case, the rate design witness acknowledges that the markup on ECR is too high, and proposes a tempered rate increase to mitigate the damage inflicted. Ten years after MC95-1, ECR and First-Class letters are the only subclasses with markup indexes above 1.000.⁴¹

Witness Mitchell examined the rate design dynamics at work for BRR before Docket No. MC95-1 and drew conclusions about what the rates for now-ECR categories would be if the proposed subclass had not been formed. For example, witness Mitchell explains that the passthroughs would in all likelihood have moved toward 100 percent of the relevant cost differences. As a natural outcome, the per-piece contributions from what are now Regular and ECR would have been roughly the same (instead of the ECR per-piece contribution being 28 percent higher than that of Regular).

Witness Mitchell then presents alternative rates for the now-ECR categories, based on seven reasonable assumptions: (i) revenue neutrality with the proposed revenue requirement for Standard Regular and ECR combined; (ii) retention of the Postal Service's proposed rates for non-machinable letter surcharges, the residual shape surcharges, the barcode discount for

⁴¹ USPS-T-27, Table 3, revised June 27, 2005.

qualifying residual-shape-surcharge pieces, and all four pound rates; (iii) setting the revenue-per-piece levels for the Nonprofits at 60 percent of the respective commercial revenue-per-piece levels; (iv) use of Commission costs to calculate dropship savings, with passthroughs set at R2001-1 levels; (v) 100 percent passthroughs on other cost differences and avoidances; (vi) treatment of negotiated service agreements as under the Postal Service's proposal; and (vii) use of Commission costs to calculate mail processing cost savings and the Postal Service's costs for delivery cost savings. The resulting rates document how the continuous imposition of excessive markups upon ECR since Docket No. MC95-1 has resulted in rates dramatically higher than the levels that would have resulted if no separate ECR subclass had been established.

D. Valpak Recommended Coverage.

The problems inherent in coverage for ECR mail cannot be put on hold again, hoping that the right time to apply the non-cost factors of the Act will arise sometime in the future. The time has come to expressly apply the non-cost factors of the Act to ratesetting for Standard mail, both Regular and ECR. The entire adjustment cannot easily be made in one step, but it is time to make a clear and deliberate step in the proper direction, decreasing the coverage for Standard ECR by 10 percentage points as proposed by witness Mitchell (USPS-RT-1, p, 80), and if necessary, increasing the coverage for Standard Regular.

VI. PROPOSED NONPROFIT ECR RATES WOULD VIOLATE THE POSTAL REORGANIZATION ACT.

The Commission cannot lawfully recommend the Nonprofit ECR rates proposed by the Postal Service, because those rates fail to comply with a plain reading of the statutory requirements in 39 U.S.C. section 3626(a)(6)(A).¹

A. The Postal Reorganization Act Prescribes a Specific Formula for Setting the Levels of the Nonprofit Rates.

The Postal Reorganization Act, as amended in 2000 by Public Law 106-384, requires that the estimated average revenue per piece to be received by the Postal Service from Nonprofit Regular and Nonprofit ECR, taken separately, be equal, “as nearly as practicable,” to 60 percent of the corresponding figure for their most closely corresponding Commercial categories:

¹ On the eve of the deadline to file this Initial Brief, the Alliance of Nonprofit Mailers (“ANM”) filed Comments in Support of Stipulation and Agreement on September 23, 2005. The thrust of these Comments is that ANM: (i) is in agreement with the position advanced herein by Valpak that the “as nearly as practicable” language of 39 U.S.C. section 3626(a)(6) sets out a “binding and nondiscretionary” standard, and the only deviations permitted are those required by rounding (p. 3); (ii) fears the “precedential effect” of any decision which permits a deviation from the statutory standard for any reason other than rounding; (iii) has obtained from the Postmaster General, as part of settlement, a formal commitment “to adhere precisely to the 60 percent ratio in future rate cases” although not in this one (p. 6); but (iv) believes that the “unique circumstances of this case,” which include the Postal Service’s desire to have an “across-the-board” rate increase (p. 7), “Hurricane Katrina” (p. 2), the coincidence of compensating errors as between the ECR subclass and the Regular subclass (p. 2), and the Postal Service’s commitment not to violate the law in the future, allow it to support settlement on the assumption that the deviation from the “statutory standard” is “nonprecedential” (p. 7).

While respecting ANM’s right to settle the case on any basis it desires, Valpak is not familiar with any legal doctrine to the effect that settlements, hurricanes, and promises not to violate the law in the future suspend the requirements of federal law on the Commission in this docket, and Valpak submits that nonprofit rates should be set on the basis of the mandatory statutory criteria.

The rates for mail matter under former sections 4452 (b) and (c) of this title shall be established as follows:

(A) The estimated average revenue per piece to be received by the Postal Service from each subclass of mail under former sections 4452(b) and (c) of this title shall be **equal, as nearly as practicable, to 60 percent** of the estimated average revenue per piece to be received from the most closely corresponding regular-rate subclass of mail.”

(B) For purposes of subparagraph (A), the estimated average revenue per piece of each regular-rate subclass shall be calculated on the basis of expected volumes and mix of mail for such subclass at **current rates in the test year** of the proceeding.... [Emphasis added.]

This requirement, codified as 39 U.S.C. section 3626(a)(6)(A), has been in effect in two prior omnibus rate cases — Docket Nos. R2000-1 and R2001-1.

**1. Prior Commission Interpretations of Section 3626(a)(6)(A)
Demonstrate how this Law is to be Applied in the Instant Docket.**

Docket No. R2000-1. Public Law 106-384 was enacted less than three weeks before the Commission issued its *Opinion and Recommended Decision* in Docket No. R2000-1. Therefore, the Commission (not the Postal Service) made the first application of the new statutory provision for the nonprofit categories. Upon receiving that Recommended Decision, the Governors and the Postal Service both criticized the Commission’s application; however, both the Nonprofit Regular and the Nonprofit ECR rates initially recommended by the Commission eventually were approved by the Governors.

In its *Opinion*, the Commission discussed the requirements imposed by Public Law 106-384, but did not specify the revenue-per-piece ratios for its rates.² However, the Governors did calculate those ratios, and found them inappropriately tied to the after-rates

² Docket No. R2000-1, *Op. & Rec. Dec.*, paras. 4038, 5556, 5927, 5932.

volumes and mixes instead of to the before-rates volumes and mixes, the latter being the ones to be used in applying the law's 60-percent requirement. The Commission conceded this error, but did not recommend new rates, noting the deleterious effects on nonprofit mailers, the limited impact on Postal Service revenues, and the Postal Service's interest in allowing the initially-recommended rates to remain in place. The Commission observed that under the rates initially recommended, the average per-piece revenue of Nonprofit ECR was **59.75 percent** of the corresponding commercial figure, which, it said, complied "as nearly as practicable" with the statutory requirement of 60 percent. The Commission did not specifically identify any variance from the 60-percent requirement for Nonprofit Regular rates.

Docket No. R2001-1. In Docket No. R2001-1, Postal Service witness Hope indicated that the 60-percent requirement was met for Nonprofit ECR, erroneously, based on **after-rates** volumes, and witness Moeller did not address the basis used for Nonprofit Regular. *See* USPS-T-31, p. 35, and USPS-T-32, p. 20, respectively. Issues relating to the requirement that before-rates volumes be used were not addressed during the case. In the end, the Commission observed:

The Service has developed rates to comply with Public Law 106-384, enacted in October 2000, that requires Nonprofit revenue-per-piece to be 60 percent of commercial revenue-per-piece, using test year before rates volumes. [Docket No. R2001-1, *Op. & Rec. Dec.*, p. 95, ¶ 3136.]

Docket No. R2005-1. In the instant docket, the Postal Service indicated initially that, relative to the corresponding commercial figures, its proposed rates reflect a revenue per piece for Nonprofit ECR of **56 percent** and for Nonprofit Regular of **61 percent**. USPS-T-28, p. 3.

Analysis then showed these Postal Service ratios to be improperly based on **after-rates** volumes and mixes, which the Postal Service had highlighted as erroneous just two dockets ago. When alerted to its error through Valpak's discovery, a proper calculation turned out to show negligible change from the figures of 56 percent and 61 percent, because very little change in volume mix results from the across-the-board proposal. Responses to VP/USPS-T28-52-55. Needless to say, both ratios differ notably from 60 percent, and the ratio for Nonprofit ECR differs widely.

2. The Postal Service's Proposed Commercial ECR and Nonprofit ECR Rates Prefer a Policy Choice Over a Statutory Requirement.

In this docket, witness Altaf H. Taufique (USPS-T-28) has described the Postal Service's application of the above-cited statutory requirement to the proposed Nonprofit rates, as follows:

Section 3626(a)(6)(A) requires a pricing relationship between the nonprofit and commercial subclasses of Standard Mail. It directs that the average revenue per piece for each nonprofit subclass be "equal, **as nearly as practicable, to 60 percent of the estimated average revenue per piece**" of the most closely corresponding regular-rate subclass of mail. With the proposed rates, the revenue per piece for Standard Mail **Nonprofit Regular** is **61 percent** of the Standard Mail Regular revenue per piece; the revenue per piece for Standard Mail **Nonprofit ECR** is **56 percent** of the Standard Mail ECR revenue per piece. The **Postal Service believes** that the above ratios of 61 percent and 56 percent for Standard Mail Nonprofit Regular and Standard Mail Nonprofit ECR respectively, are **as close to 60 percent** of the corresponding commercial subclass revenue per piece values **as is practicable under the unique circumstances of this uniform across-the-board rate increase request.** [USPS-T-28, p. 3, emphasis added.]

On discovery, Valpak explored the reasoning behind the Postal Service's development of Nonprofit ECR rates which are so highly variant from the statutory requirement. In VP/USPS-T28-2b, witness Taufique was asked to "identify and discuss the circumstances in this case that caused you to give (i) **little weight** to the requirement imposed by law (as witnessed by your 5.9 percent rate increase being considerably below the 13 percent **mandated by the statute**), and (ii) **substantial weight** to the **preference** of a 5.4 percent increase (as witnessed by 5.9 percent being just moderately above 5.4 percent)." Witness Taufique replied: "**The Postal Service interprets [the statutory] language to permit deviation from the 60 percent target** when the total circumstances of the case make it **not practicable** to achieve the 60 percent target more closely." VP/USPS-T28-2b, Tr. 3/625, emphasis added. He added that "**policy reasons** stated in witness Potter's testimony (USPS-T-1) were the basis for the Postal Service's judgment that a higher rate increase for [Nonprofit ECR] was not practicable in this case." (*Id.*, emphasis added.) When Postal Service witness Potter was asked if he provided specific policy direction to witness Taufique on how the Nonprofit rates were to be developed, he indicated that he had not. Tr. 2/92, l. 8. Indeed, witness Potter denied that he had any significant knowledge of how the 60-percent formula worked. Tr. 2/91, ll. 9-11. The decision to deviate from the 60-percent formula, it appears, was made by witness Taufique. On oral cross-examination, witness Potter speculated that it might be a case of the staff "working hard to stay within the direction that we were given" by the Board of Governors. Tr. 2/92, ll. 12-14.

Postal Service witness Maura Robinson (USPS-T-27), in her response to VP/USPS-T27-6(f)(iii), likewise attempted to justify the methodology underlying the Postal Service's rate design, which gives greater weight to "policy reasons" than to the statutory requirement:

It may be possible that some alternative rate design could reduce the overall cost coverage of the combined ECR and NECR subclasses, reduce ECR rates as compared to the current proposal, and result in the average revenue for NECR being exactly equal to 60 percent of the average revenue per piece for ECR. However, granting ECR preferential treatment — a lower rate increase — would effectively penalize non ECR subclasses through a higher percentage rate increase. Given the lack of association of the escrow requirement with the provision of postal services, I do not believe that it would be fair and equitable to exempt any subclass — either partially or totally — from an equal share in this Congressionally-mandated burden. [Tr. 3/413.]

On its face, this is a strange statement, since a reduction in the coverage of ECR would automatically and unequivocally reduce the ECR rates but would not carry any implications for the relation of the Nonprofit rates to the Commercial rates. In essence, however, witness Robinson's argument appears to be that compliance with the statutory 60-percent requirement would be unfair. If the 60-percent requirement had resulted in nonprofit rate increases that were less than those for the corresponding Commercial categories, it is unclear whether she would have viewed that too as unfair.

3. The Postal Service Justifies Its Nonprofit Rates with the Argument that Strict Compliance with the Law Is Not Required.

One justification given by Postal Service witnesses for divergence from the statutory requirement of section 3626(a)(6)(A) is that strict compliance it is not required. The Postal Service believes that other statutory rate design requirements differ fundamentally from the 60-percent rule for nonprofit ratemaking. For example, according to witness Taufique:

The statute does not specify an absolute tolerance around the 60 percent figure that must be achieved. Rather, it specifies that the target be achieved within “practicable” bounds. The Postal Service interprets this language to permit deviation from the 60 percent target when the total circumstances of the case make it not practicable to achieve the 60 percent target more closely. [Response to VP/USPS-T28-2(b), Tr. 3/625.]

The statutory requirement to cover costs is, in the view of the Postal Service, a **more specific standard** than the standard applied to Standard Mail Nonprofit and Standard Mail NECR rates. [Response to VP/USPS-T28-2(c), Tr. 3/625 (emphasis added).]

The statutory requirement for pricing Within-County Periodicals is, in the view of the Postal Service, a **more specific standard** than the standard applied to Standard Mail Nonprofit and Standard Mail NECR rates. [Response to VP/USPS-T28-2(d), Tr. 3/625 (emphasis added).]

Of course, the Postal Service is entitled to offer its interpretation of its governing statute.

However, it is also the Commission’s governing statute, and the Service fails to offer any objective basis for the Commission to distinguish the requirements set forth in section 3626(a)(6)(A) from the other statutory requirements cited by witness Taufique. Thus, in this docket, the Postal Service’s exaltation of its own policy preferences over implementation of plainly-expressed statutory requirements cannot be recommended by the Commission.

B. Postal Service-Requested Nonprofit ECR Rates Violate the Statute.

Late in this docket, witness Taufique filed a correction to VP/USPS-T28-52 (revised August 24, 2005) that provides “Corrected Nonprofit Ratios for Proposed Standard Mail Rates (based on TYBR billing determinants).” He shows the per-piece revenue for Commercial ECR as \$0.1777 without fees and \$0.1786 with fees. The corresponding figures for Nonprofit ECR are \$0.0993 and \$0.1007, respectively. Accordingly, he explains, under the Postal Service’s

proposed rates, the per-piece revenue ratio of Nonprofit to Commercial is **55.8 percent without fees** and **56.4 percent with fees**. *Id.* Thus, by the Postal Service's own calculations, these proposed rates are well below the statutory requirement that the estimated average revenue per piece for Nonprofit ECR be set **as nearly as practicable** to 60 percent of the estimated average revenue per piece of Commercial ECR.

Witness Taufique advised that, had the Postal Service actually complied with the 60-percent requirement, "Nonprofit ECR rates would have to increase on the order of 13 percent." USPS-T-28, p. 12, l. 10. Of course, the option presented by witness Taufique is not the only option. The Postal Service also could have met the statutory standard with an increase to Nonprofit ECR rates lower than 13 percent, had it requested that Commercial ECR rates be reduced less than 5.6 percent. If the Postal Service wanted to constrain the Nonprofit ECR rate increase at approximately 5.9 percent, it could have proposed that commercial ECR rates be left unchanged. (Leaving ECR rates at current levels is also justified by arguments relating to coverage, Section V, *infra*.)

1. A Variance from the Statutory Requirement Approximating Four Percentage Points Does Not Qualify as "As Nearly as Practicable," Particularly as Normally Applied to Postal Ratemaking.

In all applications of which we are aware, postal rates have been set to achieve their target within close tolerances, usually within limits associated with rounding. For example, First-Class rates are rounded to the nearest cent, Priority rates to the nearest nickle, and most bulk rates (including all Standard mail) to the nearest tenth of a cent. In context, meeting a legal requirement of 60 percent by coming in at 56 percent is a large gap, and is far greater than any effect due to a need to round precise rates that might come out of a computer. And

when the law says to meet the target “as nearly as practicable,” it becomes difficult to see how a spread of four percentage points could be justified.

Beyond the revenue requirement issue, a number of other similar requirements are contained in the Postal Reorganization Act, but none of these has been interpreted as witness Taufique asks the Commission to interpret the “as nearly as practicable” requirement in this case. Consider the following:

- a. With regard to its recommended rates for the preferred subclasses of second class — within-county, nonprofit, and classroom — the Commission found in Docket No. R76-1 that under those rates “the anticipated revenues will equal, **as nearly as practicable**, the attributable costs of each subclass.”³ The respective cost coverages under the recommended rates were all within a range of **0.2 percent** — 100.2 percent for within-county; 99.9 percent for nonprofit mail; and 100.0 percent for classroom.⁴
- b. In Docket No. R87-1, the Commission again referenced the requirement that classroom publications have a cost coverage of 100 percent, “as nearly as practicable.”⁵ The cost coverage employed by the Commission was not set forth in the text of its *Opinion*, but is shown in Appendix G, Schedule 3, p. 2, to be exactly 100 percent.
- c. Another provision of Public Law 106-384 requires the rates for certain Nonprofit Periodicals, Classroom Periodicals, and Library mail rate components to be set so that the postage is 5 percent lower than it would be if the corresponding commercial rates were applied, as nearly as practicable. Both the Commission and the Postal Service have applied this to the total postage bill, and

³ *Id.*, p. 210 (emphasis added).

⁴ *Id.*

⁵ *Id.*, Vol. I, p. 442.

rounded to the **nearest cent**. Docket No. R2000-1.⁶ This procedure provides an exacting implementation of the “as nearly as practicable” standard.

- d. Another statute, 39 U.S.C. section 3626(a), requires that the markup on In-county Periodicals be equal to one-half the markup on the corresponding commercial category. The Commission has followed the requirement to the maximum extent permitted while adhering to the convention of rounding to the **nearest tenth of a cent**.⁷ This statute does not use the phrase “as nearly as practicable,” but the requirement was understood.
- e. Where a statute required that certain rates for Science of Agriculture publications be set at 75 percent of the corresponding commercial rates, the Commission likewise has rounded the rates to the nearest tenth of a cent.⁸
- f. Public Law 99-509 directed that revenue foregone appropriations be set so as to replace the estimated revenue that would have been received had the preferred categories been assigned the same cost coverage that was imposed on the corresponding regular categories, rather than at 100 percent. In Docket No. R87-1, both the Postal Service and the Commission developed rates for the preferred categories that were rounded to the **nearest tenth of a cent**, in line with the statutory requirement. *See* testimony of Postal Service witness Lyons, Docket No. R87-1, USPS-T-17, pp. 14-16 and workpapers of Postal Service witness Mitchell, Docket No. R87-1, workpaper II-G, p. 3.
- g. In carrying out the phasing provisions of the original Act, which required that any new rate levels be achieved in either five or 10 years (revised in 1976 to eight and 16 years), with the “annual increases as nearly equal as practicable” (Pub. L. 91-375), the Commission and the

⁶ *See* Docket No. R2000-1, *Op. & Rec. Dec.*, App. 1, p. 18-19 of 64, Rate Schedule 421, footnote 1; DMM section 604.8.1.2e; and Form 3541, p. 2, line A43, available on www.usps.com.

⁷ *See* Docket No. R2000-1, PRC-LR-14, file PRC-2wc.xla.xls, cell D3 on ‘Input’ tab, cell B12 on ‘Pc Rts’ tab, and cell E9 on ‘# Rts’ tab.

⁸ *See* Docket No. R2000-1, PRC-LR-14, file PRC-LR-14-2Reg+.xls, cells D47-D50 on tab ‘E’.

Postal Service calculated rates for each phase in an exacting way that was constrained only by the convention of rounding to the **nearest tenth of a cent.**⁹

2. The Postal Service Could Have Met the Statutory Requirement, As Well as Its Revenue Requirement, and Avoided Nonprofit ECR Rate Shock Had It Proposed Lower Commercial ECR Rates.

Witness Taufique identified several options which would have resulted in proposed rates that complied with 39 U.S.C. section 3626(a)(6)(A). He explained that if the 5.5 percent increase for Commercial ECR were proposed, Nonprofit ECR rates would have to be increased by 13.9 percent. Had the Postal Service limited the Commercial ECR rates to an average increase of 5.4 percent — consistent with the across-the-board parameters — Nonprofit ECR rates would have met the requirement with an increase of 13.6 percent. Alternatively, had the Postal Service chosen to limit the increase to Nonprofit ECR's rates to 5.9 percent, and comply with the statutory 60 percent requirement, Commercial ECR rates would have decreased 1.8 percent. Response to VP/USPS-T28-56, Tr. 3/684. As a second alternative, if Commercial ECR rates were left at current levels, the 60-percent requirement could be met by an increase in Nonprofit ECR rates of somewhat more than 5.9 percent.

The Postal Service's artificial tempering of proposed Nonprofit ECR rates should be rejected. Making no change in Commercial ECR rates, as recommended by Valpak witness Mitchell, would result in an increase in Nonprofit ECR rates of just over the 5.9 percent requested by the Postal Service, well under the 13.9 percent required if Commercial ECR were to increase by 5.6 percent.

⁹ See, e.g., Docket No. R84-1, *Op. & Rec. Dec.*, Appendix 2, and Docket No. R84-1, *Governors' Decision*, December 11, 1984.

VII. THE COMMISSION SHOULD ADOPT WITNESS MITCHELL'S VARIOUS RATE DESIGN PROPOSALS, AS NO REBUTTAL WITNESS HAS OFFERED PERSUASIVE ARGUMENTS AGAINST THEM.

A. Witness Mitchell Proposes Several Important Rate Design Changes.

In addition to the proper cost coverage for ECR (discussed in Section V, *supra*), witness Mitchell makes five rate design proposals:

1. Set the letter-flat rate differential for ECR to at least 100 percent of the cost difference. VP-T-1, pp. 81-84, Tr. 9/5347-50. Using her revised DAL volume estimate, witness Crowder calculated the letter-flat cost differential to be **1.483 cents**, at Commission costing. Relative to this cost difference, the proposed rate difference of **0.9 cents** is a passthrough of **60.7 percent**. ADVO-RT-1, p. 12, ll. 14-16, Tr. 10/5738. For reasons discussed in Sections III and IV, *supra*, this letter-flat differential is actually larger than 1.483 cents, and witness Mitchell's testimony explains the good reasons for recognition of over 100 percent of this differential, up toward to the coverage of the subclass. It is submitted that this passthrough should be set at a **minimum of 100 percent**.
2. Decouple the rate relationship between the ECR Basic Letter rate and the 5-digit Automation Letter rate. VP-T-1, pp. 84-86, Tr. 9/5350-52.
3. Select passthroughs of 100 percent for presort discounts. *Id.*, p. 87, Tr. 9/5353.
4. Adjust the ECR residual shape surcharge, its barcode discount, and the pound rates proportionally to any change in subclass rates. *Id.*, p. 87, Tr. 9/5353.

5. Update the dropship cost avoidances and apply the passthroughs that were recommended in Docket No. R2001-1. *Id.*, p. 87, Tr. 9/5353.

The Postal Service did not file rebuttal testimony relating to these issues. For the reasons set out in the above-referenced portions of the record, all of these rate design changes should be adopted.

B. ADVO Witness Crowder Raises Questions Regarding Rate Design and the Cost of Flats, but Provides No Reason Not To Increase the Letter-Flat Rate Differential.

The first portion of ADVO witness Crowder's rebuttal testimony (ADVO-RT-1) focuses on ratesetting issues discussed by Valpak witness Mitchell. (The second portion focuses on costing issues discussed by Valpak witness Haldi, although, as discussed further below, these two areas of concern are not entirely separable.)

On the issue of ratesetting, witness Crowder argues that:

Mr. Mitchell's arguments reflect fundamental misunderstandings of (1) the nature of the letter-flat cost differential, and (2) the proper relationship of the letter-flat rate differential to the ECR pound rate.... [ADVO-RT-1, p. 1, ll. 9-12, Tr. 10/5727.]

She discusses these alleged misunderstandings within the context of two distinct approaches to ratesetting:

- The first context views "letters and flats as simply workshared variants of the same ECR product...." *Id.*, p. 2, ll. 1-2, Tr. 10/5728.
- The second views letters and flats "as completely different products" (*Id.*).

These two contexts are discussed below, starting with the latter.

ECR Saturation Letters and Flats are not Separate Subclasses. Although witness Mitchell said only that ECR **letters** and **flats** are **separate products** to a “considerable extent” (VP-T-1, p. 82, l. 16, Tr. 9/5348), witness Crowder went further and stated that ECR letters and flats “can be viewed as separate products....” ADVO-RT-1, p. 3, ll. 8-9, Tr. 10/5729.

Witness Crowder then subtly shifts the focus of her analysis to **saturation mail** — taking a view that considers **saturation letters** (including high-density letters (hereinafter “w/HD”)) and **saturation flats** (w/HD) to be **separate products that satisfy “the Commissions requirements for determining separate subclass treatment....”** *Id.* p. 15, l. 10, Tr. 10/5741 (emphasis added). This Crowder view, focused only on saturation mail, is considerably different from one that considers **all ECR letters** to be one subclass and **all ECR flats** to be another subclass.

Of course, the facts are that saturation letters (w/HD) and saturation flats (w/HD) are not separate subclasses. Furthermore, no proposals have been made in this docket, either by witness Mitchell or by anyone else, to make them separate subclasses. That is, from the viewpoint of the instant docket, questions relating to treating saturation letters and saturation flats as separate subclasses are a new idea introduced by witness Crowder only in rebuttal testimony, and do not address any issue on the table in this docket.

However, not wanting witness Crowder’s assertions about these extraneous matters to go unanswered, we note that, if saturation letters (w/HD) and saturation flats (w/HD) were to be considered separate subclasses, the cost coverage for each would be calculated by dividing the revenue for each by the cost for each, on a total or a per-unit basis. Using unit revenues developed from USPS witness Taufique’s workpapers and unit costs that witness Crowder

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develops (which have not been evaluated on the record and on which Valpak takes no position), she proceeds to calculate separate estimates of cost coverages for saturation letters (w/HD) and flats (w/HD), and displays them in a table that appears on page 3 and is reproduced on page 17 of her testimony. Tr. 10/5729 and 5743. Her estimated coverages are 292.9 percent for saturation letters (w/HD) and 325.4 percent for saturation flats (w/HD) at USPS costing.¹ She concludes that the higher coverage for saturation flats (w/HD) results from the fact that they (i) are more highly workshared, and (ii) pay the pound rate for a substantial portion of pieces. Of course, her difference in coverage would be reduced, and perhaps even reversed, if:

(i) her adjustment for DALs were to recognize the full number of DALs (4.5 billion) whose costs have been attributed erroneously to letters (*see* VP-T-2, p. 17, Tr. 9/5494); and

(ii) some adjustment were to be made for flats being accorded extra-bundle treatment much more often than letters, which diverts letters to a higher-cost processing mode and results in higher recorded costs for letters, while flats enjoy lower recorded costs (*see* VP-T-2, pp. 26-57, Tr. 9/5503-34).

Witness Crowder does not consider either of these as possible explanations for the difference in estimated coverages.

Interestingly, witness Crowder's revenue figures do not include Nonprofit letters or flats, although her unit costs may include such nonprofit mail. Further, even within the less

¹ Using PRC costing, her coverages are significantly closer, 282.9 percent and 290.4 percent for saturation letters and flats, respectively. Tr. 10/5743.

extreme context of a subclass for all **saturation (w/HD)** mail, it is a well-known effect that the more-highly-workshared category within the subclass (saturation flats, in her comparison) would have a higher implicit cost coverage, on a percentage basis, an effect that may be more pronounced here due to omitting the cost effects of DALs and privileged third-bundle priority. Therefore, witness Crowder's results are not surprising. Whether they are influenced in any substantial degree by the pound rate (paid by 35.5 percent of saturation non-letters, including Nonprofit, as shown in the billing determinants, USPS-LR-K-77) has barely been addressed in this docket, and is open to serious question. But since separate subclasses for these categories are not under consideration, the coverages she shows, and her accompanying discussion, have few or no implications concerning the appropriate rate design for the ECR subclass.

Letters and Flats are not "Workshare Variants." The bulk of witness Crowder's testimony on rate design concerns appropriate pricing within the ECR subclass as it actually exists, and within which some scheme is needed to recognize cost differences. Focusing on the extent to which relevant **cost differences** are reflected in **rate differences**, she says:

'Passthroughs' are used in conventional ratemaking where all rate categories within a subclass are considered to be **worksharing variants** of the same basic product. Differences between rate elements (e.g., the **letter** and **flat** piece rates) are based on their **worksharing cost differences**. When passthroughs are 100 percent, the unit contribution should be the same for each rate category. [ADVO-RT-1, p. 8, ll. 22-27, Tr. 10/5734 (emphasis added).]

Witness Crowder is correct to some degree that this approach has been taken (although the current passthrough at the ECR basic level is zero). What she fails to address, however, is the plain and simple fact that **the difference between letters and flats is not a matter of**

worksharing.² Accordingly, much of the support evaporates for an upper limit on the passthrough of 100 percent. When the difference is viewed properly as something other than worksharing, the appropriate relationship between rate differences and cost differences takes on new dimensions.

Mr. Mitchell's testimony supports increasing the rate difference to more than 100 percent of the cost difference, in the direction of the subclass coverage level. This would have the effect of moving ratesetting in the direction of recognizing letters and flats as separate products, although rate design for the two categories would still reflect the same break point, the same dropship discounts, the same relation to the Nonprofit category, and the same pound rates. It would also contribute to making the per-piece contribution of the Postal Service's more costly product, flats, somewhat higher than that of its less costly product, letters.

It should be noted that recognizing more than 100 percent of cost differences in rate design, within subclasses, is not unusual, supporting Mr. Mitchell's recognizing such solutions as "default" in nature. VP-T-1, p. 83, l. 11, Tr. 9/5349. For example:

- Relative to one-ounce letters, two-ounce letters in First Class pay an additional rate that is undoubtedly much larger than the additional cost associated with them.

² See Mr. Mitchell's discussion of this issue, VP-T-1, pp. 82-83 (Tr. 9/5348-49), and accompanying footnote 36, indicating that his view is consistent with that previously expressed by the Commission.

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- Except where it would yield anomalies, rate differences in Priority and Express Mail reflect markups on cost differences, going down to the level of individual rate cells for weight and zone.
- Prior to Docket No. R84-1, Periodicals rate design placed a cost coverage on the transportation costs before the zone rates were developed, a practice discontinued because of the importance of dropship decisions (*i.e.*, cross elasticities) and because of national policy relating to the rates for high-zone publications.
- In ECR itself, there has been discussion in past proceedings about the markup on pound-related costs, which supports the existing pound rates. *See, e.g., Op. & Rec. Dec.*, Docket No. R2000-1, p. 365, ¶ 5462.
- Cost differences in Parcel Post and Bound Printed Matter are marked up.³

If a rate difference above 100 percent of the cost difference, up to the subclass coverage, is the default solution, a case for which Mr. Mitchell suggests an argument can be made, the question becomes: What factors would contribute toward a decision to reduce the rate difference below the coverage level of the subclass, and move it down toward 100 percent of the cost difference? Mr. Mitchell addressed this question in his response to ADVO/VP-T1-8, Tr. 9/5381. Witness Crowder provides another reason why it might be in order to move the rate difference downward. She argues “that the letter-flat cost differential reflects not just shape-related cost differences but also weight-related cost differences due to the heavier

³ The Commission has addressed these issues before. *See, e.g., Docket No. R2000-1, Op. & Rec. Dec.*, p. 365, ¶ 5462.

average weight of flats versus letters.” ADVO-RT-1, p. 2, ll. 5-7 (*see also* p. 10, l. 7ff, and p. 18, l. 9-11), Tr. 10/5728, 5736, 5744.

On the effects of any weight-related costs in the letter-flat cost differential, witness Crowder refers to a Commission statement in Docket No. R2000-1 that:

‘As the pound rate is supposed to reflect the effect of weight on costs, passing through a substantial portion of the ECR letter/flat differential amounts to a double counting of the effect of weight.’
[ADVO-RT-1, p. 2, ll. 9-12, Tr. 10/5728.]

Witness Crowder takes the Commission’s recognition that there may be some “**double counting**” and uses it to support her expansive charge that there is “**double charging**.”

ADVO-RT-1, p. 2, l. 17, and p. 11, ll. 16 and 20-21, Tr. 19/5728, 5737. Clearly this charge cannot be supported.

For example, the issue cannot be that a 3-ounce letter converting to a flat is double-charged because of the pound rate, because it does not pay a pound rate. Also, within the framework of the way ECR rates are developed, a lower pound rate, *ceteris paribus*, would increase the minimum-per-piece rate for both letters and flats. Consequently, lowering the pound rate would not provide relief to a 3-ounce flat facing a higher letter-flat differential. In addition, neither the pound rates nor the piece rates cause the subclass to receive revenue beyond its cost coverage. Therefore, it does not appear to be an issue of “double charging,” as asserted by witness Crowder. Rather, it is simply an issue that some weight-related costs might be reflected in the letter-flat cost differential, as the Commission indicated based on the record then before it.

A certain amount is known about the weight of the letters and flats involved. For example, at the combined Commercial and Nonprofit basic tier of ECR, the average weight of a letter is 0.95 ounces and of a non-letter (predominantly flats) is 3.43 ounces. Billing Determinants, USPS-LR-K-77, also Tr. 10/5884. Thus, the cost used in the letter-flat differential reflects the cost for pieces with an average weight of 3.43 ounces (which could be greater than the specific cost for a 3.43-ounce piece), which is 2.48 (3.43 - 0.95) ounces higher than the weight of the corresponding letters.

Also, we know that the costs being used for letters and flats do not include transportation costs or vehicle service driver costs, both of which would reflect in some degree the effects of weight, and that these costs are shown on the 'Unit Costs' sheet of USPS-LR-K-119 to be only 0.32 and 0.23 cents per piece for flats and letters, respectively. If the letter-flat differential is based on this cost, it could be said that flats weighing less than 3.33 ounces are paying a rate better suited for a group of pieces that weigh, on average, 3.43 ounces, which might not be much higher than the cost for flats weighing from zero to 3.33 ounces. However, this comparison does not suggest that any weight-related costs in the minimum-per-piece rate are substantial.⁴

⁴ On oral cross examination, witness Crowder addressed whether the weight-related costs are large, and concluded essentially that they probably are not. She said: "My speculation is that the majority of the difference between unit letter cost and unit flat cost, at least at the high-density saturation level, is based on the piece and shape characteristics and not on weight, which means that it's not really the letter-flat differential that's the problem." Tr. 10/5824, ll. 5-11.

Should the Commission agree to accept witness Mitchell's recommendation concerning an appropriate letter-flat differential, as Valpak contends should be done, then witness Crowder feels that the pound rate also deserves to be adjusted. She states:

If the USPS-proposed High-Density/Saturation letter-flat rate differentials are increased, then a concomitant decrease in the pound rate is required in order to prevent High-Density/Saturation flats from being over-priced relative to letters.
[Tr. 10/5744, ll. 13-16.]

Valpak does not take the position that the weight effects described by witness Crowder are nonexistent, only that they may be quite small. Also, witness Crowder's opinion that an increase in the letter-flat rate differential has implications for the pound rate raises questions of its own. It is true that the letter-flat cost difference may need some correction for weight, but once this correction is made, an increase in the rate difference to the appropriate level would not have implications for the pound rate. The question of the appropriate pound rate, which affects pieces weighing over 3.3 ounces, is important in its own right. But a decrease in the pound rate would increase the minimum per-piece rates, so it does not appear that flats weighing less than 3.3 ounces would receive any benefit from a decrease in the pound rate.

Mr. Mitchell's suggestion that the passthrough of the letter-flat cost difference should be at least 100 percent in this case, and perhaps move up towards the level of the subclass coverage in subsequent cases, avoids making a major change in this case, while moving in the right direction. Witness Crowder has provided another reason for not having the rate difference reflect the full subclass coverage, but it is not clear that the effect she identifies is large. This is an issue that should receive attention in the future, but it should not deter

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progress in expanding the letter-flat differential in this case, as recommended by witness Mitchell.

VIII. WITNESS KIEFER PURPORTS TO REBUT WITNESS MITCHELL, BUT REALLY REBUTS NO ONE.

A. Witness Kiefer Begins His Testimony By Crafting Five Straw Men.

Postal Service rebuttal witness Kiefer (USPS-RT-1) has the stated purpose of rebutting “several contentions made” by Valpak witness Mitchell (VP-T-1). Five contentions are summarized on the first two pages of his testimony. Rather than joining issue on the points that **were made** by witness Mitchell, however, witness Kiefer prefers to argue within the context of an alternate reality, by challenging propositions that **were not made**, as follows.

1. Mr. Mitchell[] ... contends that a failure to establish a formal “logical” causal link between the ... escrow ... and the ... deficit establishes some kind of legal impediment that prevents the Commission from recommending it. [USPS-RT-1, p. 1, ll. 5-8, Tr. 11/6149.]

It is true that Mr. Mitchell sees no logical or causal link between the escrow and the deficit. His position, however, is that the presence or absence of such a link is irrelevant to the question of how the deficit should be covered. *See* VP-T-1, p. 9, ll. 10-16, Tr. 9/5725; VP-T-1, p. 11, ll. 8-11, Tr. 9/5277. And, although certainly stating why he believes the Commission **should** not recommend the Postal Service’s proposal,¹ witness Mitchell nowhere says there is any impediment, legal or otherwise, that prevents the Commission from giving it full consideration or from recommending it.

2. Mr. Mitchell also contends that the Postal Service’s policy choices that led to its rate and fee proposal are not a sufficient basis for the proposal and cannot form an appropriate factor for

¹ There was no antecedent to the word “it” in the above quotation, but during oral cross examination, witness Kiefer clarified that he meant for “it” to refer to the Postal Service’s proposal. Tr. 11/6215, ll. 12-13.

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the Commission to consider in recommending rates. [USPS-RT-1, p. 1, ll. 8-11, Tr. 11/6149.]

It is true that Mr. Mitchell testified that, in his opinion, the rates proposed are not sufficiently supported and that a different recommendation is most justified, but nowhere has he argued that the Postal Service's support for its proposal cannot or should not be considered by the Commission. *See generally* VP-T-1, *especially* p. 6-36, Tr. 9/5264 and 5272-5302, respectively.

3. My testimony also rebuts witness Mitchell's contention that the Postal Services' [sic] settlement efforts somehow conflict with the Act's ratemaking process by demonstrating that the Postal Service has, while seeking settlement, met all the legal requirements of the Act and followed all procedural rules established by the Commission for managing rate cases. [USPS-RT-1, p. 1, ll. 19-23, Tr. 11/6149.]

Mr. Mitchell argued that achievement of settlement is not an important factor that should guide the Postal Service in selecting the best set of rates to propose and that the deliberative process of the Commission is best served by the development of a thorough record. *See* VP-T-1, p. 15-17 and responses to USPS/VP-T1-6 and 7, Tr. 9/5281-83 and Tr. 12/6360-66. Nowhere did he say that the Postal Service has not met any legal requirements or has not followed any procedural rules.

4. Witness Mitchell's testimony contends that the Postal Service cannot legally propose and the Commission cannot legally consider an across-the-board (ATB) rate change proposal. My testimony rebuts this contention, showing that there is no provision in the Act or the Commission's rules that prohibit such a proposal. [USPS-RT-1, p. 2, ll. 3-7, Tr. 11/6150.]

Nowhere did Mr. Mitchell say that the Postal Service cannot legally propose an ATB case or that the Commission cannot legally consider an ATB case. *See especially* DMA/VP-

T1-8 and USPS/VP-T1-6, Tr. 12/6351 and 6360, respectively. In fact, Mr. Mitchell's testimony throughout supports the review process of the Commission, focusing on the policies in the Act and the record as developed.

5. My testimony finally rebuts witness Mitchell's specific proposal that the ECR subclass be not given any rate increase by pointing out that the proposed rate level for ECR is not out of line with recent Commission decisions and that to reduce ECR's rates in this case would unfairly shift ECR's share of funding the escrow burden to other subclasses. [USPS-RT-1, p. 2, ll. 8-12, Tr. 11/6150.]

In line with Commission recommendations covering more than three decades, Mr. Mitchell discusses a wide range of considerations that are rooted in the Act and backed by extensive economic and regulatory practice. If the Commission finds the ATB proposal to be supported by the record and relevant considerations, including those "point[ed] out" by witness Kiefer, it can recommend the proposal. The Commission performs such assessments in every case; some shifting of revenue burdens among mailers invariably occurs.

B. There is no Question that Witness Kiefer Faithfully Supports the Policies of the Postal Service Board of Governors.

A portion of witness Kiefer's testimony involves little more than additional direct testimony, and hardly qualifies as rebuttal. It primarily references and repeats the testimony of earlier Postal Service witnesses, and nothing new is added. He refers to the Board of Governors 35 times and uses the word "policy" 43 times. He is clearly supportive of the policies of the Board, and wants the Commission to be supportive as well. To the point of the full record being brought before the Commission, including all policy statements, Mr. Mitchell

agrees. But beyond that point, Valpak's position is that the policies should be evaluated on their merits, not on whether they emanated from the Board.

C. Witness Kiefer Raises Unfounded Questions About Witness Mitchell's Testimony.

Other portions of witness Kiefer's testimony are intended to be rebuttal. One section beginning on page 5 is entitled:

Formalistic Concepts of Causation Do Not Restrict The Postal Service Or The Commission In Postal Ratemaking.

This title is curious, as Mr. Mitchell has not contended that any concept of causation restricts the Postal Service or the Commission. Indeed, the emphasis of his testimony is that the appropriate way to deal with a deficit is not dependent in any way on questions relating to what might have caused it. However, in this section, witness Kiefer contends that:

witness Mitchell attempts to sever the relationship between the Board's policy and the Postal Service's proposal by erecting an imaginary restriction in the Postal Reorganization Act. [USPS-RT-1, p. 5, ll. 25-27, Tr. 11/6153.]

We believe that Mr. Mitchell makes no such attempt, and witness Kiefer points to none, but since it is not clear what this statement might mean, it is impossible to deny it categorically. Presumably, the Postal Service's proposal reflects all preferences of the Board, be they policy preferences or some other kind. And certainly no position is taken by Mr. Mitchell that the Postal Service "is not *entitled*" to adopt any policies or approaches it sees warranted, though witness Kiefer suggests on page 5, line 28 of his rebuttal testimony (emphasis in original) that this position has been taken. Furthermore, how witness Mitchell could sever the "relationship" between the "Board's policy" and the "Postal Service's proposal," even if he

wanted to, is completely unknown, since witness Kiefer did not explain what he relied on in this characterization. Finally, witness Mitchell has devised no imaginary restriction in the Postal Reorganization Act or anywhere else, and witness Kiefer points to none.

Another thread in this section and in others is a contention by witness Kiefer that Mr. Mitchell may believe that something in the Act:

restricts the Commission from considering a Postal Service policy choice. [USPS-RT-1, p. 8, ll. 4-5, Tr. 11/6156. *See also, id.*, p. 1, ll. 15-18, Tr. 11/6149; p. 2, ll. 3-5 Tr. 11/6150; p. 6, ll. 3-8, Tr. 11/6154; p. 7, ll. 2-3, and ll. 10-14, Tr. 11/6155.]

Mr. Mitchell has expressed no such belief, and witness Kiefer points to no indication that he has. In fact, the essence of Mr. Mitchell's testimony is that the Commission should consider the entire record, including all testimony and reasoning provided by the Postal Service to support its proposal, and that the Commission should find the proposal wanting.

D. Witness Kiefer Supports a Dangerous Notion that Could Be Described as Restricted Institutional Costing.

Beginning on page 8 of his rebuttal testimony, witness Kiefer addresses whether "There Is Clear Logical And Legal Support For The Postal Service's Request And Pricing Approach." USPS-RT-1, p. 8, ll. 16-17, Tr. 11/6156. In this section, witness Kiefer argues that Mr. Mitchell's "formalistic counter-examples and argumentation [relating to institutional costs being a residual] fail to address the implications of the fact that the escrow expenses are not volume variable." *Id.*, p. 10, ll. 9-11, Tr. 11/6158. That the escrow expenses are not volume variable is not in dispute, as witness Kiefer himself notes on lines 1-7 of the same page. He goes on to explain that "to the extent they are regarded as part of the pool of institutional costs to be assigned, rather than attributed, the escrow expenses would fall under the Commission's

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authority to allocate institutional costs as a judgmental exercise.” *Id.*, p. 10, ll. 15-18, Tr. 11/6158. He refers to Mr. Mitchell’s use of the term “distributed” on oral cross examination. *Id.*, p. 10, ll. 20-22, Tr. 11/6158.

Witness Kiefer is missing the point. It is true that institutional costs in total are covered by setting rates above costs for the various classes (and special services), and that the contribution of any particular subclass can be calculated as the difference between its revenue and its cost. In this sense, it might be said that each subclass has been assigned a portion of the institutional costs. But to begin thinking about allocating portions of institutional costs, and in particular about **assigning portions of a non-variable, non-attributable cost like the escrow**, directly to specific subclasses **as though they were variable costs**, to be carried forward directly into rates, is akin to an exercise in **restricted institutional costing**, if not to an exercise in fully distributed costing. Witness Kiefer confirms his intent on engaging in such exercises when he refers on page 11 (line 4) to “the cost allocations that the proposed rates and fees imply.” *Id.*, p. 11, l. 4, Tr. 11/6159.

The Commission does not engage in **restricted institutional costing**, for the same reason that it is regarded in economic theory and regulatory practice as not to be recommended. Witness Kiefer’s difficulties with Mr. Mitchell’s testimony are predicated on reasons which demonstrate why the ATB proposal has harmful characteristics and should be rejected.

E. Witness Kiefer Simply Objects to Witness Mitchell Objecting to the Across-the-Board Rate Increase.

In the third subsection of section III.A. of his rebuttal testimony, beginning on page 11, witness Kiefer says that “Mr. Mitchell challenges the appropriateness of considering the practical context giving rise to the Board’s decision to propose ATB rate and fee increases.” USPS-RT-1, p. 12, ll. 23-25, Tr. 11/6160. Virtually nothing contained in this subsection can be supported. At no point did Mr. Mitchell suggest that the practical context or any other reasoning behind the Board’s decisions, as laid out on the record, should not be considered in full and in detail by the Commission. In fact, it is that practical context that is evaluated by Mr. Mitchell in his testimony.

Witness Kiefer addresses the extent to which the Postal Service’s proposal is cost based in section II.C.1. of his testimony, beginning on page 19. He says “Mr. Mitchell reinforces the Commission’s statement in that case [Docket No. R94-1], and concludes that only pricing proposals that track changes in costs since the last rate proceeding can pass muster under the Act.” USPS-RT-1, p. 19, ll. 26-28, Tr. 11/6167. Then he indicates, in response, that the Postal Service:

has presented sound evidence of individual **levels of costs** in the test year, including **detailed special cost studies**, based on recent data collection and **cost analyses**. [USPS-RT-1, p. 19, ll. 30 – p. 20, l. 1 (emphasis added), Tr. 11/6167-68.]

This is a strange response, which actually supports Mr. Mitchell’s concerns. For while the Postal Service **has** presented detailed cost studies, they **are not linked** in any way to the Postal Service’s request, although certain anomalous results have been the focus of considerable

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attention. More to the point, each of the following observations about the Postal Service's case is true.

- There is no evidence that the Postal Service relied on these studies in any way.
- No rate design workpapers were submitted.
- No passthroughs of cost differences were selected or discussed, even *ex post*.
- No transportation costs were used to develop rates that vary with distance.
- No worksharing discounts were discussed.
- No discussion of trends in costs was provided and no comparisons were made with the costs behind the current rates.
- No analysis was performed to see if relative costs have changed.
- The costs which witness Kiefer highlights were neglected completely.

Indeed, the Postal Service's evidence on rebuttal actually highlights much of what is wrong with the Postal Service's case in this docket.

On page 21, witness Kiefer begins a section titled: "The Act Does Not Require Rate Change Proposals To Track Cost Changes." USPS-RT-1, p. 21, ll. 5-6, Tr. 11/6169. In it, he explains that "while it may be desirable to reflect cost changes" "in most circumstances," any importance of costs in this case is trumped by the "sound policy and circumstances" guiding the proposal, as explained on the record. *Id.*, p. 22, ll. 31-35, Tr. 11/6170.

Supporting trumping, he expresses his opinion that the ATB proposal should not be rejected. Along the way, witness Kiefer disagrees with what he calls witness Mitchell's position "that the Commission **cannot** recommend" the proposal, because it is not adequately cost based. *Id.*, p. 23, l. 2 (emphasis added), Tr. 11/6171. On cross-examination, he was asked where

Mr. Mitchell said that the Commission “cannot” recommend. He was unable to point to any specific source or statement. Tr. 11/6182-89. In fact, in this testimony, witness Mitchell argues that the circumstances of this case do not trump the importance of recognizing costs and that the Commission **should not** recommend it, not that the Commission **cannot** recommend it.

F. Witness Kiefer Completely Misconstrues Witness Mitchell’s Testimony as to the Future Effect of Across-the-Board Rates.

A central issue in this case is whether the recommendation of an ATB proposal at this time would be likely to “Unreasonably Affect The Development Of Rates Over Time,” quoting a portion of the title of witness Kiefer’s section on the same subject. USPS-RT-1, p. 23, ll. 7-8, Tr. 11/6171. Apart from the question of whether the most defensible set of rates would exist between now and the next case, Mr. Mitchell provided considerable discussion to the effect that the development of rates over time **would be** affected, and in a negative way. He even included a model to help make the nature of the likely effects clear. VP-T-1, pp. 22-30, Tr. 9/5288-96. Witness Kiefer views Mr. Mitchell’s discussion and model as “lack[ing] merit for three reasons.” USPS-RT-1, p. 24, l. 24, Tr. 11/6172.

First, he says Mr. Mitchell’s discussion lacks merit because of an assumption that there exists some “right” set of rates that “should” be recommended. *Id.*, p. 24, ll. 25-27, Tr. 11/6172. But this is 180 degrees from what Mr. Mitchell said. Mr. Mitchell defined the preferred (optionally optimal or right) set of rates in terms of whatever rates the Commission **would** recommend at the end of a deliberative process. USPS/VP-T1-9, Tr. 12/6369. When asked about this problem on cross-examination, witness Kiefer replied: “If Mr. Mitchell were

not implying that there is some right set of rates, then my criticism — my first criticism there wouldn't apply.” Tr. 11/6192, l. 24 – 6193, l. 1.

Second, he says Mr. Mitchell assumes that, if the Commission recommends the ATB rates, it would not have met its responsibilities under the Act to consider the future consequences of its recommendation. USPS-RT-1, p. 25, ll. 3-7, Tr. 11/6173. When asked about this purported assumption, he was not able to explain where or how Mr. Mitchell supposedly made it. Tr. 11/6193-97.

Third, he says that the conclusions of Mr. Mitchell's model “flow from ... speculative assumptions.” He agreed that the assumption that there will be a subsequent rate case is not speculative. Tr. 11/6198, line 10. He did not disagree with an assumption that rate shock will be considered in the next case. Tr. 11/6198, ll. 18-19. He generally agreed with the assumption that the rates going into the next case may be different if this case is ATB than if it is not. Tr. 11/6200, ll. 8-10. It is not clear what other assumptions were made, and what witness Kiefer was describing as speculative, as he did not explain his accusation.

The question of the dynamics of rates over time still stands as important. Witness Kiefer writes off all such concerns by saying: “With any rate request, there is some risk that conditions may turn out different than forecast when the case was litigated.” USPS-RT-1, p. 25, ll. 18-19, Tr. 11/6173. The only forecast that might justify an ATB proposal would be that neither market conditions nor relative costs change over time, not between the last case and now, and not between now and the next case. The evidence on costs available in the instant docket shows that relative costs have changed between the last case and now, and the chance of them not changing between now and the next case is between slim and none.

IX. ADVO REBUTTAL WITNESS OTUTEYE PROVIDES INFORMATION ABOUT HIS COMPANY AND ITS COMPETITIVE POSTURE, BUT PROVIDES NO GUIDANCE ON HOW APPROPRIATE RATES SHOULD BE DEVELOPED.

Advo witness Otuteye (ADVO-RT-2) is President and Chief Executive Officer of Money Mailer, LLC, a competitor of Valpak and other users of saturation ECR mail.¹ He explains that Money Mailer sees profit potential in a basic business model that involves a product with somewhat heavier weight characteristics than that selected by Valpak and with a less-well-specified relation to other saturation mailers.² Because of this, his company's revenue characteristics are somewhat different from those of Valpak, as are some of his company's costs.

More specifically, witness Otuteye explains that the coupons carried by Money Mailer are somewhat larger and heavier than those carried by Valpak, and it is thus easier for his product to exceed the 3.3 and 3.5-ounce weight limits on the letter product offered by the Postal Service. In effect, he is offering a product that, on average, weighs more than Valpak's, and he sometimes has to purchase the pound-rated non-letter product from the Postal Service: flats. As weight of the envelope grows, the possible need to begin purchasing the pound-rated non-letter product is an important consideration, because the non-letter rate is higher than the rate for letters.

¹ Witness Otuteye competes with "[s]aturation mailers of every ilk." ADVO-RT-2, p. 10, l. 9, Tr. 10/5904. *See also id.*, p. 3, l. 17, *et seq.*, Tr. 10/5897.

² Witness Otuteye says: "Our letter envelope measures 9.5" x 6", compared to Valpak's 9.5" x 4.5" format, and uses a better quality (thicker) paper. In addition, we print our individual coupons on a heavier paper stock than Valpak." ADVO-RT-2, p. 4, l. 6, Tr. 10/5898.

The behavior of rates relative to weight is an important characteristic of Standard mail. For both Money Mailer and Valpak, as well as any other competitors, coupons can be added until the envelope reaches 3.3 ounces without the total postage for the envelope increasing. This clearly provides a favorable environment for business expansion. Assuming automation-compatible pieces, postage increases with weight in the range of 3.3 to 3.5 ounces. When 3.5 ounces is exceeded, however, postage for the envelope increases in step fashion by (at rates proposed by the Postal Service) 0.9 cents, due to application of the letter/flat differential. Over 3.5 ounces, mailers are required to purchase the Postal Service's non-letter product, regardless of the size or thickness of the envelope.

Witness Otuteye's concern is his firm's ability to compete with Valpak and the 3.5-ounce threshold. He indicates that he crosses the threshold more often than Valpak (ADVO-RT-2, p. 4, ll. 13-15, Tr. 10/5898) and that he wants a smaller letter/flat differential. This stands out in importance at the point where the threshold is crossed, presumably more so than for an entire mailing. That is, it is possible for a single coupon to cause the threshold to be crossed and thus cause an increase in postage that places profitability of that additional coupon in jeopardy. Of course, any threshold has this effect. He says: "That surcharge ... can exceed the net revenue a franchisee may earn after costs." *Id.*, 5, l. 3-5, Tr. 10/5899. He explains that the letter/flat differential can be "an obstacle to ... growth." *Id.*, 5, l. 1, Tr. 10/5899. He also explains the general operating difficulties associated with having a threshold. *Id.*, 5-6, Tr. 10/5899-5900.

The support witness Otuteye provides for limiting the letter/flat differential to the level proposed by the Postal Service concerns his ability to compete. He says: "Money Mailer's

primary concern with Valpak's proposal is its adverse impact on our ability to compete effectively” *Id.*, 10, ll. 7-8, Tr. 10/5904. He also says: “Most importantly from our perspective, Valpak's proposal would hinder Money Mailer's ability to compete with Valpak.” *Id.*, 9, ll. 1-2, Tr. 10/5903. In addition, he says: “[Valpak's] proposal would further increase the spread between the effective postal rate we pay versus our main competitor. And in any case, its proposal would place us at a further competitive pricing disadvantage.” *Id.*, p. 9, l. 18, Tr. 10/5903. He does not explain that the “effective postal rate[s]” he pays are for a **different mix of postal products** than those purchased by Valpak.

Importantly, moreover, witness Otuteye **does not provide any rate design principles** that, if applied by the Commission, would lead to rates he would find more favorable. When asked if he had read any of the testimony presented by Valpak in this case, **he said he had not read it**, but he had been “briefed” on it. Tr. 10/5918, ll. 11-18.

- He agreed that whatever set of rates is recommended, it is available to all mailers. Tr. 10/5915, ll. 6-12.
- He agreed that Valpak had chosen to take advantage of the rates in one way and he another. Tr. 10/5915, ll. 13-17.
- He agreed that mailers other than Valpak and Money Mailer might look at those same rates and choose to compete in a way that is different yet. Tr. 10/5915, l. 18-5916, l. 13.
- He argued that “competition ... should be decided primarily in the marketplace” (ADVO-RT-2, p. 11, ll. 3-4 Tr. 10/5905), presumably in view of the rates that are set for all mailers.

- He agreed that there are other competitive “benefits to Money Mailer having the format” that it has chosen. Tr. 10/5916, ll. 22-24.

Witness Otuteye discusses the effects of a 3.5-ounce threshold that mailers might not want to cross. ADV0-RT-2, p.8, l. 12, *et seq.* He says: “That would not only hinder our growth, but would also deprive the Postal Service of the additional postage revenue we currently generate on these pieces.” *Id.*, p. 8, ll. 18-20, Tr. 10/5902. This points to an important issue in postal ratemaking. If the costs of letters and flats are not properly recognized in rates, there is an implication that the Postal Service might receive a higher per-piece contribution to fixed costs from letters than it would receive from flats. What this means is that “depriv[ing] the Postal Service of the additional postage revenue” from the flat (instead of a letter) would make the Postal Service more profitable instead of less profitable. If there is any irony at all, it cuts in a different direction from that suggested by witness Otuteye. Under normal circumstances of competition and ratesetting, one would expect a higher contribution from a heavier, more costly product, not a lower contribution.

Witness Otuteye was asked on several occasions if he objected to having costs recognized in rates. Various, he replied: “If the Post Office undertakes a study that approves that certain classes of mail cost certain amounts, then I don’t have an objection to paying a proper rate for the class of service that I am receiving.” Tr. 10/5922, l. 23 – 5923, l. 2. Similarly, *see also* Tr. 10/5910, ll. 11-14; 5911, ll. 21-25; 5912, ll. 4-7 and 16-20; and 5923, ll. 1-5.

An appropriate evaluation of witness Otuteye’s testimony should lead the Commission to recognize current costs properly, and then apply what it considers to be sound ratesetting

principles. Once rates are developed in this way, they should be presented on uniform terms to all mailers, and competition around them should occur, much as described by witness Otuteye. The Commission simply cannot design rates so that particular mailers are assisted in their competitive endeavors, as witness Otuteye seems to be requesting the Commission to do.

CONCLUSION

For the reasons set out above, Valpak urges that the Commission: (i) to reject the Postal Service's across-the-board proposal, as well as any settlement based on such a proposal (Section II, *infra*), (ii) to reduce the revenue requirement (Section I, *infra*), and (iii) based on proper costs (Sections III and IV, *infra*), to recommend rates (Sections V, VI, and VII, *infra*) which:

- (1) Adjust ECR rates so as to reduce the coverage by 10 percentage points below the proposed level, and
- (2) If the Commission determines that it has reliable costs at the level of rate categories, recommend ECR saturation letter rates that:
 - (a) reflect a proper cost adjustment to ensure that all city and rural carrier costs of handling ECR saturation Detached Address Labels (93.87 percent of 4.5 billion DALs) are borne by ECR saturation flats, not letters;
 - (b) base the letter-flat differential on either modeled costs or revised marginal costs due to the fact that current costing systems do not accurately reflect the relative cost of handling ECR saturation letters and flats handled by the third bundle delivery method; and
 - (c) reflect, at a minimum, a 100 percent passthrough of the letter-flat cost differential for ECR saturation mail, if not more than 100 percent.

Further, Valpak urges that the Commission recommend rates based on the following rate design features:

- (1) Decouple the rate relationship between the ECR Basic Letter rate and the 5-digit Automation Letter rate;
- (2) Employ passthroughs of 100 percent for presort discounts;
- (3) Adjust the ECR residual shape surcharge, its barcode discount, and the pound rates proportionally to any change in subclass rates;

- (4) Update the dropship cost avoidances and apply the passthroughs that were recommended in Docket No. R2001-1; and
- (5) Adhere to the statutory requirement that Nonprofit ECR rates be set “as nearly as practicable” to 60 percent of ECR commercial rates.

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