

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

POSTAL RATE AND FEE CHANGES, 2005 )

Docket No. R2005-1

REPLY BRIEF  
  
OF  
  
VALPAK DIRECT MARKETING SYSTEMS, INC., AND  
VALPAK DEALERS' ASSOCIATION, INC.

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**TABLE OF CONTENTS**

	<b>Page</b>
SUPPLEMENTAL STATEMENT OF THE CASE . . . . .	1
I. THE POSTAL SERVICE’S EXCESSIVE REVENUE REQUIREMENT HAS GONE UNDEFENDED . . . . .	I-1
II. NO MYSTERY IS ASSOCIATED WITH THE ORIGIN, NATURE, OR MEANING OF THE ESCROW PAYMENT, WHICH IS NEITHER UNIQUE, EXTRAORDINARY, PHANTOM, NOR PSEUDO . . . . .	II-1
III. THE POSTAL SERVICE AND DMA MISCONSTRUE VALPAK TESTIMONY RELATING TO COST-BASED RATES, WHILE GCA MISCONSTRUES THE APPLICABILITY OF THE ACT . . . . .	III-1
A. Postal Service . . . . .	III-1
B. DMA . . . . .	III-3
C. GCA . . . . .	III-5
IV. ADVO’S RECOMMENDATIONS ON RATE DESIGN FOR STANDARD MAIL RAISE INTERESTING QUESTIONS BUT ARE MISGUIDED . . . . .	IV-1
A. The Basics of Standard Mail Rate Design . . . . .	IV-1
B. Advo Makes Observations on Brief That Have Been Explained by Valpak in its Brief . . . . .	IV-6
V. ADVO TRIES BUT FAILS TO REBUT THE PROBLEMS THIRD BUNDLES CREATE IN POSTAL SERVICE COSTING . . . . .	V-1
A. Processing of ECR Saturation Letters . . . . .	V-1
B. Valpak’s Cross-Examination Hypothetical . . . . .	V-11
VI. THE POSTAL SERVICE OVERSTATES THE ROLE OF NON-UNANIMOUS SETTLEMENTS IN OMNIBUS RATE CASES . . . . .	VI-1
A. The Postal Service Misreads the Commission’s Experience with Proposed Settlements . . . . .	VI-2
B. In Docket No. R94-1, the Only Previous Proposed Across-the-Board Rate Case, the Commission Rejected a Proposed Non-unanimous Settlement . . . . .	VI-8

C. In Docket No. R2001-1, the Commission Agreed to a Non-unanimous  
Settlement for Extraordinary Reasons which Do not Apply here . . . . . VI-12

D. Conclusion . . . . . VI-14

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**SUPPLEMENTAL STATEMENT OF THE CASE**

Initial Briefs were filed in this case on September 26, 2005, by the following parties:

- United States Postal Service;
- Office of the Consumer Advocate;
- Advo, Inc. and the Saturation Mailers Coalition, jointly (hereinafter "Advo");
- American Bankers Association and National Association of Presort Mailers, jointly;
- American Business Media, Dow Jones & Company, Inc., Magazine Publishers of America, Inc., the McGraw-Hill Companies, Inc., and Time Warner, Inc., jointly;
- American Postal Workers Union;
- Douglas F. Carlson;
- Direct Marketing Association, Inc.;
- Discover Financial Services LLC;
- Greeting Card Association;
- Major Mailers Association;
- Newspaper Association of America;
- Parcel Shippers Association;
- Pitney Bowes Inc.;
- David B. Popkin;
- Time Warner Inc.; and
- Valpak Direct Marketing Systems, Inc., and Valpak Dealers' Association, Inc.

On September 23, 2005, the Postal Service filed a proposed Stipulation and Agreement signed by 36 of the 46 parties in this docket.

It is notable that Advo has joined the proposed Stipulation and Agreement, and now urges the Commission to ignore and reject all of the revenue requirement, costing, coverage, and rate design issues raised by Valpak. *See* Advo Brief, p. 6 (“In sum, Valpak’s arguments and proposals should be rejected in their entirety.”). By urging total rejection of those important matters, Advo in its brief has backed away from costing improvements that Advo previously explained and supported through the testimony of its witness Crowder. *See* ADVO-RT-1, p. 12-13, Tr. 10/5738-39, transcribed onto VP-XE-1 (Crowder) page two, Tr. 10/5883.

However, not signing the settlement agreement were the following 10 parties:

- Office of the Consumer Advocate
- American Postal Workers Union, AFL-CIO
- Banta Corporation
- Douglas F. Carlson
- DigiStamp, Inc.
- Institute for Research on the Economics of Taxation
- Lexington Institute
- David B. Popkin
- Valpak Dealers Association
- Valpak Direct Marketing Systems, Inc.

**I. THE POSTAL SERVICE'S EXCESSIVE REVENUE REQUIREMENT HAS GONE UNDEFENDED.**

**Postal Service Revenue Requirement.** The Postal Service gives only passing attention to its own revenue requirement. USPS Brief, pp. III-3-8. It states that the revenue requirement of \$73.2 billion before rates will exceed the current rates' estimated income of \$70.3 billion by **\$22.9 billion**. Obviously, this is a typographical error. The correct number is **\$2.880 billion**. See Valpak Brief, p. I-1.

**Postal Service Requested Surplus.** The Postal Service estimates that its rate request would result in a **net surplus** in the Test Year of \$281.5 million. USPS Brief, p. III-4. Yet, not one word in the Postal Service Brief explains why (i) its revenue requirement exceeds its revenue needs, and (ii) it does not honor the concept of breakeven in the Test Year.

**History of Commission-Approved Surpluses.** Never, in any prior omnibus rate case, has the Commission approved a Test Year surplus of the magnitude requested by the Postal Service. Indeed, the Postal Service's requested Test Year surplus is nearly 10 times larger than any surplus ever previously approved by the Commission. Yet the Postal Service introduced not one word of testimony to support its request for this surplus. As shown below, the Commission has approved both test year deficits and surpluses, which have ranged from a **deficit** of \$20,646,000 in Docket No. R84-1 to a **surplus** of \$29,365,000 in Docket No. R2001-1, but nothing even close to what the Postal Service is requesting here. Also worthy of note is that the Commission's recommendation in Docket No. R2001-1 was issued November 13, 2000, after Test Year 2001 had begun, and the implementation date was January 7, 2001,

which is about the same point in the Fiscal Year as the January 2006 implementation date being talked about in this case.

<u>PRC Docket No.</u>	<u>PRC Approved TY Surplus (Deficit)</u>	<u>Source</u>
R71-1	(\$9,400,000)	<i>Op. &amp; Rec. Dec.</i> , Appendix F, p. 1
R74-1	\$1,979,000	<i>Op. &amp; Rec. Dec.</i> , Appendix C to Comm. Saponaro Dissent, p. 1
R76-1	\$1,230,000	<i>Op. &amp; Rec. Dec.</i> , Appendix A
R77-1	\$1,173,000	<i>Op. &amp; Rec. Dec.</i> , Appendix A
R80-1	\$9,746,000	<i>Op. &amp; Rec. Dec.</i> , Appendix A
R84-1	(\$20,646,000)	<i>Op. &amp; Rec. Dec.</i> , Appendix A
R87-1	(\$6,077,000)	<i>Op. &amp; Rec. Dec.</i> , Appendix A
R90-1	\$24,528,000	<i>Op. &amp; Rec. Dec.</i> , Appendix A
R94-1	\$1,974,000	<i>Op. &amp; Rec. Dec.</i> , Appendix A
R97-1	\$19,699,000	<i>Op. &amp; Rec. Dec.</i> , Appendix C
R2000-1	\$17,749,000	<i>Op. &amp; Rec. Dec.</i> , Appendix C
R2001-1	\$29,365,000	<i>Op. &amp; Rec. Dec.</i> , Appendix C

**Postal Service Brief Shattering Its Own Nexus.** The Postal Service Brief quotes witness Tayman’s statement as explaining how the Civil Service Retirement System (“CSRS”) escrow payment “forms the basis for the rate request....”:

By the end of FY 2005, the “savings” realized under Public Law 108-18 will have been fully absorbed by **the escalating costs of postal operations.** [USPS Brief, p. III-7 (emphasis added).]

Actually, even at current rates, by the end of FY 2005, the savings of Public Law 108-18 will by no means be exhausted. With current rates, Postal Service projects that it will have accumulated before rates retained earnings of **\$2,778.306 million** at the end of FY 2006 prior to making the escrow payment on September 30, 2006. Valpak Brief, p. I-5, Table 3.

(Valpak’s Brief discusses Postal Service testimony on the source of these retained earnings as

being Public Law 108-18. Valpak Brief, p. I-15.) This statement of witness Tayman's can be considered accurate only if he is considering the CSRS payment as just another part of what he calls the "escalating costs of postal operations." If this is actually the Postal Service's position, any nexus between (i) the filing of an across-the-board rate case and (ii) the CSRS payment is shattered, for witness Tayman is properly viewing the CSRS payment as part of the "costs of postal operations" and the only rationale for an across-the-board rate case has vanished. Under this position, the Postal Service should have filed a rate case seeking only the \$303 million Test Year deficit, as explained by the Office of the Consumer Advocate ("OCA"). *See* OCA Brief, Sec. II.

**Rebuttal of Possible Postal Service Defense of Retained Earnings.** Indeed, the fact that the Postal Service projects that it will have unprecedented retained earnings (or cumulative net income) in the amount of \$2.577 billion at the end of FY 2005 (nearly enough to cover the entire CSRS escrow payment) is never expressly mentioned in the Postal Service Brief. *See* Valpak Brief, II-2-4.<sup>1</sup> However, the Postal Service Brief contains one phrase which may be intended to provide support for retained earnings:

It is well-settled that the Board of Governors exercises the power to determine (1) what the Postal Service may do with any assets or **existing equity**...." [USPS Brief, p. V-1 (emphasis added).]

The authorities cited for this (and three other) propositions are Newsweek, Inc. v. United States Postal Service, 665 F.2d 1186, 1204-05 (2<sup>nd</sup> Cir. 1981) and Governors of the United

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<sup>1</sup> The OCA Brief provides a comprehensive review of the legislative history of the Postal Reorganization Act, demonstrating that "the power to retain earnings was not delegated to the Postal Service by Congress." OCA Brief, p. 17 (emphasis omitted).

States Postal Service v. United States Postal Rate Commission, 654 F.2d 108, 114 (D.C. Cir. 1981). However, neither authority cited supports the proposition possibly being asserted — that the Governors have the power to ignore accumulated retained earnings in an omnibus rate case. The Postal Service has never had retained earnings, and no prior litigated case, to the best of our knowledge, has addressed this issue.

**The Hurricane Exception.** The Postal Service mentions “recent national weather catastrophes” as “circumstances [that] contribute to understanding the Postal Service’s position.” USPS Brief, p. II-23. The Postal Service position for which “understanding” is being sought is unclear. The Postal Service admits that these matters have “not been established on the evidentiary record...”, so they probably should not have been mentioned by the Postal Service in its brief. Since they nonetheless have been argued on brief, it should be noted that scope of the Postal Service’s estimated losses from Hurricane Katrina were estimated by the Postal Service to be approaching \$100 million<sup>2</sup>, an amount which is less than 4 percent of retained earnings. Clearly, the Postal Service cannot invoke a “Hurricane Katrina” exception to justify retaining its projected \$2.778 billion in accumulated retained earnings at year-end FY 2006 in this docket.

**The Elephant in the Parlor.** Interestingly, briefs of the Postal Service and the OCA illustrate the two mutually exclusive ways to assess the revenue requirement needs of the Postal

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<sup>2</sup> Based on information obtained from USPS Senior Vice President for Government Relations Tom Day, CNN.com reported that “the price tag for Postal Service buildings, vehicles and mail handling equipment ruined by Katrina is expected to reach about \$100 million....” Paul Courson, “Post Office tries to Forward Mail,” CNN.com (September 8, 2005). <http://www.cnn.com/2005/US/09/07/katrina.mail/>

Service and the options before the Commission. Under the Postal Service's approach, the \$2.778 billion before rates retained earnings at year-end FY 2006 — the “elephant in the parlor” goes completely unrecognized. The Postal Service presents the Commission with a misleading choice between:

- (1) Forcing the Postal Service to finance the escrow with debt, or
- (2) Granting the requested across-the-board rate increase.

The possibility of using some or all of the Postal Service's retained earnings of \$2.778 billion at year-end FY2006 is never even considered. The USPS Brief explains it as follows:

Witness Tayman points out, as noted above, that **financing the escrow requirement through debt** would be inconsistent with the intent of the law, could result in reaching the Postal Service's borrowing limit of \$3 billion in FY 2007, and would unjustifiably **burden future ratepayers** at a time of stagnating or decreasing First-Class Mail volumes. [USPS Brief, p. III-7-8 (emphasis added).]

On the other hand, correctly recognizing that there indeed is a retained earnings “elephant in the parlor,” the OCA correctly presents the Commission with an accurate choice between:

- (1) Paying \$2.778 billion of the escrow payment with projected year-end FY 2006 retained earnings (and obtaining the \$303 million shortfall through rate increases, or even borrowing if it cannot be recouped through savings) (*see* OCA Brief, p. 9), or
- (2) Raising rates as requested by the Postal Service across-the-board to generate funds to give the Postal Service a surplus of \$2.859 billion at year-end, after making the escrow payment. *See* Valpak Brief, p. I-5.

The OCA Brief correctly describes the actual effect on mailers from the Postal Service's request as follows:

The effect of the Postal Service's request for an across-the-board 5.4% increase in rates producing \$2.577 billion in cumulative income is, effectively, to **ask mailers to pay in advance for potential deficits** that may arise in years following the test year. This is a radical proposal in conflict with the PRA. [OCA Brief, p. 9 (emphasis added).]

Only by ignoring the retained earnings elephant does the Postal Service's request for a 5.4 percent rate increase have any validity, and we urge the Commission not to ignore that record evidence. *See* Valpak Brief, pp. I-2-20.

**II. NO MYSTERY IS ASSOCIATED WITH THE ORIGIN, NATURE, OR MEANING OF THE ESCROW PAYMENT, WHICH IS NEITHER UNIQUE, EXTRAORDINARY, PHANTOM, NOR PSEUDO.**

**Argument by Adjective.** In an informal check among briefs filed in this case, Valpak found the word “**unique**” used 62 times, usually referencing the escrow and this case. The word “**extraordinary**” was used 9 times referring to this case. The word “**phantom**” was used twice by Mail Order Association of America (“MOAA”) (MOAA Brief, pp. 1 and 3). The word “**pseudo**” was even used, twice by the Greeting Card Association (“GCA”) (GCA Brief, pp. 5 and 10). With few exceptions, the adjectives describe the **escrow expense**.

The Postal Service tends to describe this expense more in terms of what it is not, instead of what it is:

The expense does not arise from the collection, processing or delivery of any mail, or provision of any service to any customer in the **past, present, or future**. [USPS Brief, p. V-3, emphasis added.]

But there is no mystery about the origin, the nature, or the meaning of the escrow cost. No information regarding it is secret or difficult to understand, particularly if one is willing to remove the blinders and look honestly at the facts.

**The CSRS Contribution is Not New.** In the year before FY 2003, the year Public Law 108-18 was passed, the Postal Service contributed to the **Civil Service Retirement System** according to the number of its employees and their anticipated retirement costs, pursuant to a formula specified by Congress. These retirement costs were attributed to the mail classes, at least in major part, according to the way other associated employee costs were attributed. The costs were not viewed as unusual. The formula was not considered to be

unfair, and it was certainly based on a thought process that appeared meaningful to Congress. **And these costs were built into rates, and, in fact, are built into the current rates, which are being multiplied forward in the Postal Service's request,** so that revenues were — and are and will be — flowing in to cover them. Furthermore, these costs were built into rates according to the ratemaking scheme pursuant to the Postal Reorganization Act.

**The Deficit Reflects Increased Operating Expenses Since FY 2001.** In passing Public Law 108-18, Congress acknowledged that the formula being applied might overfund actual retirement expenses, and it agreed to reduce the charges, resulting in a savings of billions per year. In essence, an off-balance sheet liability was being overfunded. For FY 2003 and FY 2004, Congress said the savings:

shall ... be used to **reduce the postal debt** (in consultation with the Secretary of the Treasury), and the Postal Service shall not incur additional debt to offset the use of the savings to reduce the postal debt ... ;<sup>1</sup> [Pub. L. 108-18, Sec. 3(a) (emphasis added).]

The first priority for these years, and indeed the only priority, was to use the CSRS money to reduce debt. For FY 2005, paying off debt continued to be a priority, along with an interest in avoiding rate increases. Congress said the savings:

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<sup>1</sup> For FY 2003 and FY 2004, the wording of this requirement might appear strange. What sense would it make to “incur additional debt to offset” the use of the CSRS money to pay off debt? The answer lies in another question: what if the Postal Service's financial situation was so tight in FY 2003 and FY 2004 that it could not pay off the requisite amount of debt? The answer would appear to be: if it were financially strapped and could not borrow more, it would have had to raise rates. Such a rate increase would have been occasioned by rising costs and a requirement to pay off debt for postal operations, even given the availability of the CSRS money. Congress must have understood that a constraint on the use of the CSRS funds could cause a rate increase.

shall ... 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); [*Id.* (emphasis added).]

According to witness Tayman's original testimony, the expectation is that FY 2005 will end with a net income of \$1.643 billion. USPS-T-6, p. 19. This means that a significant amount of the FY 2005 savings was diverted to cover ordinary operating expenses, resulting in rate relief.

Looking forward to FY 2006, the Postal Service projects that ordinary operating expenses will rise again, enough so that it would take about \$3.1 billion to break even. The fact that this is equal to the CSRS savings seems to be purely a coincidence. Even without addressing the issue of retained earnings, this means that if Congress would allow it to use the full CSRS savings, it could break even in FY 2006. Congress, however, had other plans. It did something that it thought important with the CSRS money in FY 2003 through FY 2005, and it did not want to lose the opportunity to do something further that it thought important. Congress said the savings:

to the extent that such savings 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 for by law, shall be **held in escrow** and may not be obligated or expended. [*Id.* (emphasis added).]

#### **Congress Has Legitimate Concerns about Unfunded, Off-Balance Sheet Liabilities.**

The fact that the funds may not "be obligated or expended" simply underscores how serious Congress was about the escrow and its desire to have the funds clear and unencumbered.

When the CSRS money is paid into escrow next year, the full deficit of approximately \$3.1

billion for FY 2006 must be treated as a routine operating expense, presumably creating a routine deficit situation.

The concerns of Congress are understood. While it saw an over-funded off-balance sheet liability in the form of the CSRS payment, it also saw an unfunded off-balance sheet liability in the form of obligations for retiree health benefits. This was made clear in the Sense of Congress recorded in Public Law 108-18. Congress prefers to fund that liability, instead of leaving it for future rate payers or, in default, for Congress. In fact, it asked the Postal Service to address this concern, which it did in two proposals on the Use of Savings, submitted to Congress on September 30, 2003. Therefore, at least for now, Congress is saying: take the CSRS money, which is already built into rates, and which has been used variously in the past (for CSRS expenses, for debt, to help maintain rates in FY 2005), put it into an escrow, and cover any contemporary increases in more ordinary operating expenses, including any expense increases of FY 2005 that ate into the CSRS money, with a rate increase, if you must. Eventually, Congress will address the disposition of the funds in the escrow account. Both of the Postal Service's proposals of September 30, 2003 suggest using substantial parts of the CSRS savings to pre-fund health benefits for retirees. Thus far, neither proposal has been acted on.

The way the statute is written — treating the CSRS-now-escrow dollars as “operating expenses of the Postal Service” — it really does not matter if the Postal Service suspects that Congress will direct that these funds be used for a non-postal purpose. However, no reason has been established on the record which would allow the Commission to determine that Congress will cavalierly disregard all needs and obligations of the Postal Service, such as the

unfunded health-care liabilities for retirees, and somehow confiscate these funds and use them for any purpose other than a postal purpose.

It may be the case, and apparently is, that neither the Postal Service nor some mailers are happy that these funds are to be put into an escrow and that they will in all likelihood be designated to cover an unfunded, off-balance sheet liability that otherwise would become a normal operating expense in a future period. Of course, the Postal Service would prefer to have control of the money and handle the health care obligation later. In other words: Let's use the money now; the future will take care of itself. Whatever might be said for having lower rates and higher volume now, on the thought that in the future things will be better, that is apparently not what Congress had in mind. The escrow is not difficult to understand. It is neither illogical, nor bad stewardship. Congress will specify how the escrow is to be treated. The Commission cannot presume Congressional malice. And absolutely nothing about the escrow requirement makes the instant case unique. In fact, it may not even make it unusual. *See* Tr. 2/234-239.

**The Postal Service Uses the Rate Request to Complain.** The Postal Service and other intervenors appear to be using this case to complain about decisions Congress has made.

- The Postal Service has labeled the escrow payment a “true tax ... on the system.” USPS Brief, p. III-7.
- In its five-page Brief, Discover Financial Services (“DFS”) refers to this “tax” five times. DFS Brief, pp. 3-5.

- The Direct Marketing Association (“DMA”) prefers instead to call it a “rate surcharge”, which is presumably different from a **temporary** rate surcharge. DMA Brief, p. 4.
- The Postal Service has indicated that it filed this case “solely as a consequence of the passage of Public Law (PL) 108-18”, even though it seems clear that a case could be filed with a deficit but without Public Law 108-18, but could not be filed with Public Law 108-18 were there no deficit. USPS Brief, p. iii

**The Argument “Wait until the next Case” Is a Thin Reed.** If normal rate relationships and trends are disrupted in this case, on the basis of a tax argument or any other,<sup>2</sup> it could be just a short while before new rates are in effect, but it also could be longer. DMA suggests that it will be “no longer than approximately one year.” DMA Brief, p. 11. DFS says twice on one page that it will be “soon.” DFS Brief, p. 5. But the Postal Service says it “cannot state categorically when the next rate case will be filed.”<sup>3</sup> USPS Brief, p. II-25.

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<sup>2</sup> Postal Service witness Robinson (USPS-T-27) says: “Faced with these circumstances [which include that the escrow “is not unlike a ‘tax’” (p. 6, l. 25)], Postmaster General Potter determined that a very reasonable approach to fulfilling the escrow obligation was on a *pro rata* basis through an across-the-board rate increase ....” USPS-T-27, p. 7, ll. 14-16, emphasis original. Then, apparently in pursuit of the possibility that there might be other “very reasonable approach[e]s,” (*id.*, p. 7, l. 15) she considers distributing the escrow on attributable costs or on absolute contribution levels. *Id.*, p. 8, ll. 1-11. It seems strange that she did not consider in this list the possibility of following the regulatory scheme in the customary way.

<sup>3</sup> Before the Commission accepted the complaint in Docket No. C2004-1, the Postal Service urged both the Commission and the complainants to wait for the next omnibus rate case, at which time all such issues could be considered. As the filing in this omnibus rate case shows, waiting for the “next omnibus case” can be akin to the situation faced by Lewis Carroll’s Alice — where, it was “jam tomorrow and jam yesterday — but never ever jam today.”

Even if the position were taken that rate relationships coming out of this case are unimportant — Valpak would emphatically disagree with any such position — and that they all will be fixed in the next case, whenever it occurs, it is far from clear that any such outcome will be easy, painless or even feasible. Valpak witness Mitchell testified at length concerning the dynamics of rates over time. VP-T-1, pp. 22-30, Tr. 9/5288-96. On brief, the Postal Service refers despairingly to “future rate case scenarios” and says that witness Kiefer has “remind[ed] the Commission” that there is no “basis in probability” for “witness Mitchell’s negative speculation.” USPS Brief, p. V-36. Nevertheless, it says on the next page, in effect, don’t worry, “the Commission will be poised to assess future rate case requests and assertions of ‘rate shock’ from offended intervenors.” Paraphrasing Postal Service witness Lewis: “we worry.” Tr. 11/5965.

In its Brief, DMA wonders why Valpak might be concerned about whether rates coming out of the next rate case might be affected by this one, and decides Valpak’s argument is flawed. It says:

Second, it **assumes that the Commission will be constrained** for some reason from recommending rates in the next rate case that it determines to be fair on the basis of the record in that case. To the contrary, experience has shown that the **Commission is perfectly capable** of making rate adjustments of substantial size if it determines that they are warranted.” [DMA Brief, p. 15 (emphasis added).]

Quite aside from the fact that non-cost factor (b)(4) **requires** the Commission to give consideration to the effects on mailers of any rate increases it recommends, Valpak’s reading of recent experience is a little different. Valpak believes the evidence shows a Postal Service tendency to temper substantially any rate increases that it might otherwise propose, to the point

of making progress difficult, or at least slow.<sup>4</sup> Importantly, any tempering proposed by the Postal Service **tends to be done before the intervenors have a chance to express themselves.** Also, we believe the Commission has honored factor (b)(4), and will continue to do so. But even if the Commission did not so honor this factor, the question is always open concerning how much tempering this factor requires, and Valpak believes **it is much better to take steps regularly, when the opportunity presents itself, rather than put off adjustment and look forward to big changes sometime in the indefinite future.**

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<sup>4</sup> The instant docket, in fact, may be taken as an example of an extreme form of tempering, to the end that all rates in all cells are proposed to have exactly the same percentage increase, except for rounding and a few special situations. This has all been done under the umbrella of fairness. The Postal Service says: “If **existing** rates and fees are **presumptively fair and equitable**, it follows then that modest, **across-the-board changes** and the resulting cost coverages, as witnesses Taufique and Robinson propose in this docket, generally **preserve those original rate relationships**. The resulting rates are **no less fair and equitable**.” USPS Brief, pp. V-13. Aside from the fact that the conclusion contained in the first sentence of this quotation “follows” whether or not the introductory “if” statement is met, it is difficult to see how perpetuating rate relationships found fair and equitable in the past assures that they are fair and equitable in the future. Also, more than a hint of difficulty is suggested by the observation that **this curious approach to ratesetting, if applied in all former cases, would have resulted in equal percentage rate increases for all rate cells since postal reorganization in 1970.**

**III. THE POSTAL SERVICE AND DMA MISCONSTRUE VALPAK TESTIMONY RELATING TO COST-BASED RATES, WHILE GCA MISCONSTRUES THE APPLICABILITY OF THE ACT.**

**A. Postal Service.**

Apparently taking its cue from witness Kiefer (*see* Valpak Brief, section VIII), the Postal Service would prefer to rebut a caricature of witness Mitchell than what he actually said. On the one hand, the Postal Service Brief attempts to minimize the role of costs in rate setting:

- “Valpak witness Mitchell **extrapolates** from § 3622(b)(3) a requirement that rates must be ‘cost based.’ However, as witness Robinson emphasizes, care should be taken not to assert that § 3622(b)(3) requires that **cost alone** be considered in designing rates.” USPS Brief, p. V-16 (*italics original, bolding added*).
- “Valpak witness Mitchell argues that the ‘ratemaking scheme as implemented by the Commission requires that ... current costs be **fully recognized**.’ Elsewhere, he claims that the Postal Service’s across-the-board proposal fails to track costs.... Yet, only one of the nine postal ratemaking pricing criteria can fairly be described as a cost-based requirement – § 3622(b)(3).” USPS Brief, p. V-34 (*emphasis added*).
- “Beyond this cost floor mandate, the Commission is authorized to reflect costs (**or not**) in rate design on the basis of § 3622(b)(6) or other factors under subsection (b)(9).” USPS Brief, p. V-35 (*emphasis added*).

On the other hand, the Postal Service concedes the important role of costs in rate setting, but says that in this case they are outweighed by “unique” circumstances:

- “Finally, the Postal Service is not unmindful of the relevance of considerations raised by Mr. Mitchell in this case, and the Commission in previous cases, regarding the **importance of costs and rate relationships** in adjusting rates and fees for all categories of mail and special services.” USPS Brief, p. II-24 (*emphasis added*).
- “Without question, **some changes in costs have occurred** since the implementation of the current rates in 2002; however, in the context of a case whose central goal is to meet a Congressionally-mandated escrow obligation, **none** of these changes seem **sufficiently large** to require an approach other than across-the-board.” USPS Brief, p. V-27 (*emphasis added*).

### III-2

- “[I]n the context of a case whose sole goal is to recover a Congressionally-mandated escrow obligation, **none** of these changes are **sufficiently large enough** to require an approach other than across-the-board.” USPS Brief, p. V-15 (emphasis added).

Although the Postal Service is on-again and off-again, finally landing on off-again, about the importance of cost-based rates, Mr. Mitchell has been on record consistently concerning the meaning of cost-based rates. For example, in Docket No. C2004-1, he said:

The term ‘cost-based’ has no generally accepted meaning and is used to mean different, sometimes mutually contradictory, things. Occasionally, the context is helpful. I use the term to mean that the costs of the mail in question are **known** and **acknowledged**, and that a decision on some defensible basis is made on what the markup over that cost should be. [Docket No. C2004-1, Tr. 3/935 (emphasis added).]

But, contrary to the Postal Service’s suggestion, nowhere in this case or in any other has Mr. Mitchell advocated that “cost[s] *alone* be considered in designing rates.” USPS Brief, p. V-16. Also, Valpak does not perceive any meaningful difference between acknowledging costs and recognizing costs. However, neither of these terms means that the costs, once acknowledged and recognized, must be applied in some mechanical way, to the exclusion of all else. In fact, Mr. Mitchell specifically says that a decision on some defensible basis must be made on the markup over costs. And, neither in the instant docket nor in any other has Mr. Mitchell said that the importance of recognizing costs in designing rates is an “extrapolat[ion]” of the constraint in section (b)(3) that rates cover costs, at least, as interpreted at the subclass level, as the Postal Service suggests.<sup>1</sup>

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<sup>1</sup> Section (b)(3) is normally viewed as specifying a lower limit on the cost coverages for subclasses, which may be viewed as a constraint. DMA views it as a “stricture.” DMA Brief, p. 3. The Periodicals Coalition views it as “an absolute requirement.” Brief of Periodicals Coalition, p. 9. Whatever it is called, meeting it is not a

### III-3

The importance of recognizing costs in rates is part of good economics and good regulatory practice by an expert Commission. The Act makes no clear statements about efficient resource allocation, efficient component pricing, appropriate signals to mailers, lowest combined cost, worksharing, or how to compete fairly with the private sector. These are issues that the Commission has recognized as important in previous rate cases, as has the Postal Service.

The Postal Service is long on enunciating principles but short on application. For example, the Postal Service nowhere addresses why its costing errors in Docket No. R2001-1 (and before) regarding the carrier costs associated with handling DALs, requiring an enormous change in the letter-flat differential that is even conceded by Advo witness Crowder (*see* Valpak Brief, pp. III-13-16), are too small and unimportant to be recognized in rates recommended by the Commission in this docket.<sup>2</sup>

#### **B. DMA.**

The Direct Marketing Association (“DMA”) identifies in its brief what it calls a “flaw[]” of Valpak. It says: “First, [Valpak] assumes that the Commission must base every rate decision on current, accurate, updated costs. To the contrary, many have been the times

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high hurdle. *See* Valpak Brief, p. V-3.

<sup>2</sup> In this docket, the Postal Service has submitted two new costs studies, one by witness Bozzo, USPS-T-12, and another by witness Bradley, USPS-T-14. Valpak takes no position with respect to either of these two studies. However, should the Commission determine that the cost information submitted by the Postal Service in this case is not adequate to enable it to develop cost-based rates, then in that event Valpak would urge the Commission not to adopt either of the two cost studies sponsored by witnesses Bozzo and Bradley, and instead subject to a full adversary hearing both of those studies (or any future updated versions thereof).

when the Commission has issued rate recommendations based on costs that it recognizes are less-than-optimal, but that it relies upon as being the best reasonably available at the time.” DMA Brief, p. 15. Actually, Valpak believes that the Commission **should** “base every rate decision on current, accurate, updated costs,” but it has not said that it **must set every rate based only on those costs**. What is more interesting, however, is that DMA proceeds to say that the Commission, even in those cases where it might recognize that the costs available are “less-than-optimal,” does not ignore them, but in fact proceeds to rely on them “as being the best reasonably available at the time.” *Id.*

Valpak understands that the costs available in this docket may be “less-than-optimal.” It also understands the Commission will have to decide (i) on the appropriate weight to give such “available” costs, and (ii) whether the weight should be attenuated or even annulled by the weight given to any “‘public interest considerations’” (USPS Brief, p. V-23) that are unique to this case and that may support an across-the-board approach. Such decisions are part of the duty of the Commission under the law.

DMA refers to “the Commission’s substantial flexibility concerning application of the statutory provisions in both the costing and pricing portions of the rate-making process” (DMA Brief, pp. 3-4) and argues that “the [Settlement] Agreement should be accepted by the Commission as a matter of policy” (*id.*, p. 2), presumably some unenunciated policy of the Commission. In other words, the importance of the presumed policy justifies straying far from the ratesetting process, as it is now understood. Apparently, all of this is to be done because of arguments that one element of the Postal Service’s costs, the escrow, has restrictions on it or otherwise appears to have a footing that differs somewhat from the footing of the other costs.

If the Commission finds merit in these arguments, and sees policy reasons why mailers should expect one ratemaking approach for one mix of costs and another ratemaking approach for another mix of costs, it should make that policy clear so that it can be applied in future cases. Valpak does not understand how two different approaches can coexist or how rates from two different approaches can be layered in a fair and equitable way.<sup>3</sup>

**C. GCA.**

The Postal Service and DMA raise questions about how much attention should be given to costs, and about whether that attention derives from section 3622(b). The Greeting Card Association (“GCA”), however, questions whether sections 3621 and 3622(b) are even **applicable** in this docket. In its brief, GCA provides its own rendition of “Valpak’s policy argument, as presented through witness Mitchell.” GCA Brief, p. 4 (footnote omitted).

Stripped to its essentials, GCA’s summary of witness Mitchell is as follows:

- Ordinary operating expenses are analyzed pursuant to section 3622(b).
- The escrow is an ordinary operating expense.
- Therefore, section 3622(b) should be used and an across-the-board approach is appropriate.

As authority, GCA points to a brief summary statement Mr. Mitchell made in the “Purpose of Testimony” section of his testimony, which says that he will “explain that this case is no

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<sup>3</sup> The American Postal Workers Union Brief (“APWU”) notes that in future years the annual escrow payments are scheduled to increase, and exceed \$4.0 billion by 2010. APWU Brief, p. 2 (citing witness Tayman). If the Commission accepts a “two-tier” approach to funding the escrow, in future years it may have to decide whether increments to the escrow requirement should be met by an across-the-board increase in rates, while rates to cover all other increases in operating costs are determined in the usual manner.

### III-6

different from any other omnibus postal ratemaking case and, accordingly, that it should be considered under conventional Commission rules pursuant to the **Postal Reorganization Act.**” VP-T-1, p. 4, Tr. 9/5270 (emphasis in original.) GCA implies, possibly because the word “accordingly” was used, that Mr. Mitchell may be saying that applicability of the 3622(b) factors hinges on whether a case can be made that the expenses are ordinary, and if the expenses are found to be anything other than ordinary, the factors would not apply and some other approach should be found, such as across-the-board. This reading of Mr. Mitchell’s words is badly flawed. Apparently, GCA misreads the word “accordingly” to be the equivalent of “because” or “therefore,” and then manufactures a new converse proposition concerning inapplicability in the case where the ordinary-expense argument cannot be made. Mr. Mitchell said no such thing.

More important than GCA’s rendering of Valpak testimony, however, is the position that GCA is taking — that an ordinary-expense determination is a prerequisite for using the 3622(b) factors. In a fit of creativity, GCA crafts a chain argument consisting exclusively of weak links, as follows:

- Public Law 108-18 “created a unique ‘**pseudo**’ operating expense.” GCA Brief, p. 5 (emphasis added).
- the escrow is **not** a “**run-of-mine**” (presumably meaning “run-of-the-mine” or “run-of-the-mill”) **operating expense**. *Id.*, p. 6 (emphasis added).
- “it is **highly probable** that in Public Law 108-18 Congress used ‘operating expenses’ as **shorthand** for ‘recoverable, currently, from postal customers’ – and as nothing more.” *Id.*, p. 10 (emphasis added).
- “the function of attribution under § 3622(b) is to channel the **costs of productive activities** ... to the classes and types of mail that can be shown to have caused them.” *Id.*, p. 7 (emphasis added).

- since the escrow is **not** in some direct way associated with a productive activity, “some of the **ordinary ratemaking procedures** the Commission uses to satisfy § 3621 [are] **inapplicable.**” *Id.*, p. 7 (emphasis added).

This curious progression, which seems more in line with divining hidden intents of Congress than with the straightforward application of a law that does not lack clarity, is enough to make the GCA Brief memorable, but GCA does not stop here. It then argues that Public Law 108-18 “not only does **not require ordinary rate-case treatment** of the resulting ‘expense,’ but actually **makes such treatment inappropriate** by negating in advance any conceptual connection between the escrow payment and the service-providing activities for which the Commission has developed attribution and assignment procedures.” *Id.*, pp. 7-8 (emphasis added). In short, according to GCA, section 3621 is inapplicable, and relying on section 3622(b) is *ipso facto* inappropriate.

GCA’s position stands in sharp contrast to that of the Postal Service. The Postal Service argues (i) that sections 3621 and 3622(b) were carefully and fully considered, (ii) the across-the-board approach can be reconciled with them, (iii) the across-the-board proposal satisfies the statutory criteria, and (iv) great weight in considering such criteria should be given to the Board’s policy judgment. *See* USPS Brief, pp. II-22, IV-10, V-11, V-12, and V-22. If GCA is correct, however, all of sections 3621 and 3622 should be thrown out as anathema to the most appropriate ratesetting procedure in this case, and much of the Postal Service’s testimony was unneeded.

Valpak believes the escrow is not a “pseudo” operating expense; in fact, it is understandable and not substantially different from other expenses. Sections 3621 and 3622(b)

govern how additional postal revenue should be raised, regardless of whether any one cost can be argued through cleverness to be somewhat different from the others. GCA's argument, it is submitted, is simply wrong.

#### **IV. ADVO'S RECOMMENDATIONS ON RATE DESIGN FOR STANDARD MAIL RAISE INTERESTING QUESTIONS BUT ARE MISGUIDED.**

##### **A. The Basics of Standard Mail Rate Design.**

**Overview.** Reduced to basics, Standard mail rates consist of a pound rate and a minimum-per-piece rate. There is an inverse relationship between these two elements, but no relation exists between the pound rate and any differential between the rates for letters and flats. In this docket, no proposals have been introduced that would change this basic rate structure or these relationships.

**History.** The pound-rate/minimum-per-piece structure has existed since before Postal Reorganization in 1970. In 1971, for example, third-class (now Standard) circulars paid 23 cents per pound, but the postage in no case was less than 4 cents per piece. USPS-LR-K-73. The lower limit of 4 cents, referred to as the minimum-per-piece rate, served as a stop-loss. The need for a stop-loss is easy to see. At 23 cents per pound, a one-ounce piece would pay postage of only 1.4375 cents ( $1/16 * 23$ ). Since this was not enough to cover the handling required, the minimum of 4 cents was applied. That rate structure is extremely simple.

**Breakpoint.** Rates structured in this way have what is widely referred to as a breakpoint, which is simply the weight at which the pound-rate postage equals the minimum-per-piece rate. On a graph, with rates on the vertical axis and weight on the horizontal axis, the breakpoint is the weight at which the upward-sloping pound-rate line intersects the horizontal minimum-per-piece line. For the 1971 rates, the breakpoint was 2.78 ounces, meaning that through application of the pound rate a 2.78-ounce piece paid postage of 4.0 cents ( $2.78/16 * 23$ , rounded), which equaled the minimum-per-piece rate. Pieces weighing

more than 2.78 ounces, up through 16 ounces, paid whatever application of the pound rate yielded, which always exceed 4 cents. Pieces weighing less than 2.78 ounces paid the uniform, minimum-per-piece rate of 4 cents. Today, the breakpoint is fixed at 3.3 ounces. No party has proposed any change to this breakpoint.

**Pound Rates with Per-Piece Add-ons.** As rates have evolved in Docket No. R90-1, *et seq.*, pieces above 3.3 ounces still pay the pound rate, but also pay a small piece rate, sometimes called a per-piece add-on. Pieces below 3.3 ounces still pay the minimum-per-piece rates. Under rates proposed for Commercial ECR in this docket (at the basic presort level), flats weighing more than 3.3 ounces pay 64.3 cents per pound plus an add-on of 7.2 cents. Flats weighing less than 3.3 ounces pay a minimum-per-piece rate of 20.4 cents. Rates for letters, discussed further below, are similar, but lower, and extend only to 3.5 ounces. (Letters weighing up to 3.3 ounces pay their minimum-per-piece rate, and automation letters weighing between 3.3 and 3.5 ounces pay the pound rate plus the per-piece add-on, minus the letter-flat rate differential.)

**Rate Relationship.** Under this rate structure, a specific and well-understood relationship exists between the pound rate and the minimum-per-piece rate. Specifically, under a revenue-neutral change (meaning that the total revenue for the entire subclass remains unaffected), **a decrease in the pound rate always brings about an increase in the minimum-per-piece rate.**<sup>1</sup> At the same time, the per-piece add-on for pound-rated pieces, 7.2 cents under the proposed rates (as referenced above), will increase to some degree, meaning that

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<sup>1</sup> The converse is also true. Under the same conditions, an **increase** in the pound rate always brings about a **decrease** in the minimum-per-piece rate.

pound-rated pieces realize the mixed effect of a lower pound rate and a higher per-piece add-on. The important effect, however, is the **inverse** relationship between the pound rate and the minimum-per-piece rate. So long as the breakpoint is held at 3.3 ounces, this relationship cannot be avoided or changed.

**Letters.** The advent of separate and lower rates for letters, available since Docket No. R90-1, does not change this inverse relationship. That is, one can select any desired rate difference between letters and flats, but once this difference is selected, the inverse relation between the pound rate and the minimum-per-piece rates applies. Furthermore, increasing the letter-flat rate differential does not automatically change the pound rate, although it does adjust the per-piece add-on. Changes in the pound rate must be made separately, according to what is desired for pound-rated pieces.

**Flats and Letters.** One further aspect of this inverse relationship deserves note. When the pound rate decreases, the minimum-per-piece rate for letters and the corresponding one for flats **both** increase. Since virtually all letters pay the minimum-per-piece rate, this means that a reduction in the pound rate, which on its face would seem to apply in a direct way only to those flats over 3.3 ounces, causes an increase in the minimum-per-piece rate for letters. This effect cannot be reconciled with a presumption that the rate for letters is based solely on the cost for letters and a suitable markup.

**Advo's Misunderstanding.** Herein lies the difficulty in Advo's analysis of the rate structure for Standard Mail (in particular ECR). Advo says: "If the letter-flat differential nevertheless were to be increased, then the pound rate would *have* to be reduced by a fully-offsetting amount." Advo Brief, p. 4 (emphasis original). This simply is not the case. The

pound rate does not “*have*” to be reduced. Furthermore, the notion of a “fully-offsetting” amount does not have meaning on the record. In fact, as far as the minimum-per-piece rates for flats are concerned, a decrease in the pound rate would exacerbate any effect of an increase in the letter-flat differential, not ameliorate it. And a decrease in the pound rate would move letter rates upward, which runs counter to the logical effect of the increase in the letter-flat differential that began the sequence of events. Nothing on the record explains why letters should be affected in this way.

**Advo’s Unsupported Views on the Pound Rate.** In the end, Advo concludes: “The real problem is not, as Valpak contends, that the letter-flat differential is too low, but that the ECR pound rate is too high.” Advo Brief, p. 4. In other words, even if the letter-flat differential is too low, that inadequate differential is not the **real** problem. The real problem, Advo now contends, is that the pound rate is too high. This issue, with which Advo appears to be struggling, has been discussed in rate cases before. However, Advo’s complaints about the pound rate have no support in the record of this docket. The current record contains no testimony concerning how big a problem this might be, or what might be done about it. Changes in the pound rate do not appear to be on the table in this docket, but the letter-flat differential is.

**Quantifying Rate Relationships.** It is relatively easy to quantify the effects of an increase in the letter-flat rate differential and of a decrease in the pound rate, implied by the structure of Standard rates, and thus to show the relationships involved. Using a spreadsheet it developed for ECR rates, Valpak provides the following comparison, based on the same costs used in VP-T1-workpapers.xls, provided in response to ADVO/VP-T1-1, Tr. 9/5359. For

IV-5

present purposes, the passthrough of the letter-flat differential was set at 150 percent and all other passthroughs were set at 100 percent. (Choosing different passthrough values has little or no effect on the relative levels in the comparison.) The following table shows the results. All rates are minimum-per-piece rates at the basic presort level for Commercial ECR, in cents per piece. The reference (Ref.) rates are to the base position before the changes are made. The inverse relationship between the pound rate and the minimum-per-piece rates for letters and flats, discussed above, is clear.

Commercial ECR Minimum-Per-Piece Rates	Ref. Letter Rate	New Letter Rate	Ref. Flat Rate	New Flat Rate	Ref. Ltr/Flt Diff.	New Ltr/Flt Diff.
Decrease Lb. Rt. by 10 cents	19.9	20.3	20.8	21.2	0.9	0.9
Increase Ltr/Flt by 1 cent	19.9	19.2	20.8	21.1	0.9	1.9
Both Changes	19.9	19.5	20.8	21.4	0.9	1.9

When the pound rate is **decreased** by 10 cents per pound, the piece rate for letters **increases** from 19.9 to 20.3 cents, and the corresponding rate for flats **increases** as well, and by the same amount (0.4 cents), from 20.8 to 21.2 cents. In other words, the reduction in revenue from decreasing the pound rate is spread over the piece rates for **all** pieces, letters and flats.

When the letter-flat rate differential is **increased** by 1 cent, the letter rate **decreases** 0.7 cents (from 19.9 to 19.2) and the flat rate **increases** 0.3 cents (from 20.8 to 21.1), but the pound rate does not change. Decisions on the pound rate are a separate matter.

When both changes are made, as shown in the last line of the table, the net effect is a **decrease** in the letter rate of 0.4 cents (from 19.9 to 19.5) and an **increase** in the flat rate of 0.6 cents (from 20.8 to 21.4). The fact that the increase in the flat rate is larger than the decrease in the letter rate is an outcome of the relative volumes involved.

**B. Advo Makes Observations on Brief That Have Been Explained by Valpak in its Brief.**

1. The Advo Brief states: “Technically, and as a matter of sound pricing, this [letter-flat] rate differential should be designed to recover only those *piece-related* cost differences between letters and nonletters that are due to *shape*.” Advo Brief, p. 6 (emphasis original). Valpak agrees in principle with that statement, but points out that (i) the costs behind the letter-flat rate differential do not include transportation costs or vehicle service driver costs, (ii) the differences in average weight underlying the costs are not large, and (iii) the effects of weight on the costs are in all likelihood small, as acknowledged by witness Crowder on cross-examination. Valpak Brief, p. VII-9, n. 4. Also, sound rate design does not limit passthrough of the letter-flat cost difference to 100 percent (it would be strange indeed if there were no markup whatever on a cost difference of this kind). Properly viewed, correcting for the effect of any weight-related costs should be viewed as a reason for moving the passthrough down toward 100 percent from some higher level such as the subclass coverage, not for keeping it below 100 percent. *See* Valpak Brief pp. VII-5-11.

2. The Advo Brief, in reference to the proposal that more than 100 percent of the letter-flat cost difference should be passed through into rates, states: “It would lead to a clearly improper **double-charging** for weight-related costs imbedded in the letter-flat cost

differential that are already over-recovered through the pound rate.” Advo Brief, p. 8

(emphasis added.) Valpak has already explained that no one is double-charged for weight.

Questions can be raised about the basis for the minimum-per-piece charges and for the pound charge, and these are acknowledged as reasonable questions, but it is in no way a matter of double-charging. *See* Valpak Brief, pp. V-8-9.

3. The Advo Brief suggests that product comparisons should consider shape and market differences, and says: “By that standard, the most apt product comparison is between (1) saturation and high-density flats, and (2) saturation and high-density letters.” Advo Brief, p. 11. Calculated cost coverages for these separate categories are then discussed. Valpak has already raised questions about the numbers used in these comparisons, including that they may omit Nonprofit revenues, and has pointed out that these categories are not subclasses. Moreover, the results obtained by ADVO are understandable and not surprising. *See* Valpak Brief, pp. VII-3-5.

**V. ADVO TRIES BUT FAILS TO REBUT THE PROBLEMS THIRD BUNDLES CREATE IN POSTAL SERVICE COSTING.**

Valpak's Initial Brief has already covered many of the points raised by Advo and the Postal Service in their respective Initial Briefs. Advo's Initial Brief, however, does raise a few points which warrant reply.

**A. Processing of ECR Saturation Letters.**

Advo's brief states:

The goal of the Postal Service's letter DPS program is to minimize carrier in-office work so that carriers can spend more time on the street, delivering mail to more addresses. This enables the USPS to increase route sizes and thereby minimize the total number of routes, carriers, and carrier cost in the system.

The Postal Service's policy to DPS as much saturation letter mail as possible (Tr. 12/6237) is entirely consistent with this goal, irrespective of the existence of saturation flats. [Advo Brief, p. 15.]

The first sentence above is partially correct. A legitimate postal objective is to **minimize carrier in-office work**. However, subject to meeting service standards, minimizing carrier cost is at best some sort of sub-objective, and is not necessarily congruent with the overriding goal of **minimizing total cost** — which includes mail processing cost as well as carrier cost. In other words, if the Postal Service incurs some cost elsewhere in the postal network for the express purpose of saving carrier in-office time, then a direct causal relationship and a trade-off obviously exist between the costs incurred and costs saved. Incurring costs in one part of the postal network to realize savings elsewhere makes sense only when the costs saved exceed the costs incurred. Efforts to maximize the volume of saturation letters that are DPS'd, regardless of the cost of so doing and the availability of lower-cost

options, and regardless of how much mailer presort value is destroyed or lost, do not make rational sense.<sup>1</sup> Indeed, the Postal Reorganization Act requires that:

Postal rates and fees shall be reasonable and equitable and sufficient to enable the Postal Service **under honest, efficient and economical management** to maintain and continue the development of Postal Services of the kind and quality adapted to the needs of the United States. [39 U.S.C. section 3621 (emphasis added).]

Valpak and all other saturation letter mailers are entitled to efficient and economical management decisions on a par with mailers of saturation flats.

- The **most expensive** way to prepare saturation letters for delivery is to **case them manually**.
- Further, as noted in Valpak's Initial Brief, no record evidence indicates that DPSing of saturation letters ever has a lower cost than bypass treatment and, significantly, the Advo brief pointedly omits any such references and makes no such claim. In fact, both witness Lewis (Tr. 11/5986 and 5989) and witness Crowder (Tr. 10/5844, 5847) have agreed that **bypass treatment has the lowest possible cost**.<sup>2</sup>

The Advo Brief asserts (at 22-25) that on all routes **other than those contractually constrained to three bundles**, the Postal Service has ample extra capacity for taking mail directly to the street. In support of this position it states that

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<sup>1</sup> The Postal Service obviously is aware that it in one sense pays mailers, in the form of discounts, for their presort effort.

<sup>2</sup> See Valpak Brief, p. IV-13-14.

- for curblines, centralized/cluster boxes, and dismount deliveries that account for over 60 percent of all city delivery points, city carriers can take out multiple extra bundles/trays. **This applies to both saturation letters and flats.** [Advo Brief, p. 22-23, emphasis added.]
- For all deliveries, city carriers, if they have too many saturation mailings to handle as an extra bundle on one day, may defer some of those mailings to the next day or two. [Advo Brief, p. 23.]

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Thus, **in the vast majority of cases**, the USPS has sufficient capacity to handle additional Saturation **mailings** as extra bundles either (1) on the many days that do not have a saturation mailing, or, if there is already another saturation mailing on that same day, by (2) deferring the mailing to a subsequent day, or (3) collating the mailings. And, on non-walking sections of a route that are **not subject to a third-bundle limitation**, multiple mailings can be carried out as extra trays (rather than bundles). [Advo Brief, p. 25, emphasis added.]

Despite all of the capacity that Advo asserts exists for taking **both letters and flats** directly to the street, the Advo Brief states (at 26) that

- **56.5 percent** of saturation letters are **DPSed**, and
- for the **43.5 percent** of non-DPS letters, roughly **half are cased** and the other **half sequenced**.<sup>3</sup>

That 21-22 percent of saturation letters are taken directly to the street, and another 21-22 percent are cased, is not questioned. The major issues presented in this docket are:

- (i) Why is such a high percentage of saturation letters cased?
- (ii) Why are so many letters DPS'd?

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<sup>3</sup> It is acknowledged that the Postal Service lacks reliable data on the volumes of saturation letters that are DPS'd, cased, or sequenced (*i.e.*, taken directly to the street).

- (iii) To what extent are casing and DPSing of saturation letters **caused by** giving priority in bypass treatment to flats?
- (iv) On those occasions when casing and DPSing **unquestionably are caused by** giving preference to flats, does the Postal Service cost methodology determine marginal cost in a manner that is appropriate for pricing decisions?

Advo would have the Commission believe that, within the saturation mail stream, flats never bump letters and cause the Postal Service to use a more costly processing mode to prepare letters for delivery by city carriers. Advo's principal arguments are:

- Letters are less physically suitable to be carried out as third bundles.
- DPS processing is an "all or nothing" proposition.
- Delivery offices receive no advance notification and cannot plan for most saturation letter mailings, unlike the situation with saturation flats.
- The great majority of saturation letters pass through DPS plants and are readily available for DPS processing.

Before addressing each of these points, we note that the following facts are undisputed on this record:

- All saturation letters are prepared by the mailers in line-of-travel sequence and **are eligible to be taken directly to the street as extra bundles**. Advo witness Crowder, Tr. 10/5882.
- All saturation letters are **automation compatible**, which makes them a far **more flexible** and versatile product for the Postal Service to handle than flats, especially unaddressed flats accompanied by DALs.<sup>4</sup> USPS witness Lewis, Tr.

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<sup>4</sup> Covers containing many loose, unbound pieces would be among the most difficult and expensive pieces to case, and they do not appear amenable to sorting on existing automated flat sorting machines. They thus qualify as the Postal Service's least versatile saturation product.

11/5984, “the letter-shaped [ECR] mail, includes features that will let it be of value both ways.”

**Physical suitability of letters for bypass treatment.** First, although Advo’s argument that letters are less physically suited to be carried as a third bundle **seems to be asserted as a general proposition, it relates solely to walking sections of city delivery routes.**<sup>5</sup> See Advo brief at 15.<sup>6</sup>

Second, it should be noted that Advo does not assert that saturation letters can never be carried as a third bundle on city carrier routes with walking sections. By Advo’s own admission, 21-22 percent of saturation letters are cased and, even on walking sections of city delivery routes, these letters should not be cased when there is no conflict. Advo knew this, as the Postal Service’s 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; see Valpak Brief, p. IV-20 (emphasis added).]

Witness Lewis likewise stated that “the **last resort** would be to case [the saturation letters] ... the last resort would be to case this stuff [referring again to saturation letters].” Tr.

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<sup>5</sup> In an attempt to obfuscate the fact that letters are frequently and systematically denied the Postal Service’s lowest-cost bypass treatment for saturation mail, Advo first focuses on **walking sections** of city delivery routes, and with respect to such sections, proceeds to discuss a variety of factors such as the ease of nestling “in the crook of the carrier’s arm,” “awkward to carry in the carrier’s hand,” delivery managers’ preferences (quoting Lewis as to when carrier has to **walk** between delivery points), carriers’ preferences, and ergonomic suitability. Advo Brief, pp. 15-17.

<sup>6</sup> Claiming “[s]aturation letters are **not as physically suitable** to be carried out as a third bundle **on walking sections** of city delivery routes **as are flats.**” Advo Brief, p. 15 (emphasis added).

11/5990 (emphasis added). However, the question that Advo dares not address is: **Why would saturation letters ever be cased on walking sections of city carrier routes?** The obvious answer is that on those routes with addresses that are under a **third-bundle restriction** they must be cased whenever unavoidable conflicts occur.<sup>7</sup>

To complete this inquiry: under what conditions, if any, would saturation letters ever be cased by city carriers on routes with **no walking sections** (*i.e.*, on curblines, centralized/cluster box and dismount routes)? According to Advo, these routes have **virtually unlimited capacity** for extra trays/bundles, so conflicts should not even be a conceivable consideration, and no reason should ever exist whereby city carriers on such routes would employ the most expensive form of preparing saturation letters (and DALs) for delivery.

The **only conceivable conclusion** is that when saturation letters are cased, it is because either the letters or some flats must be cased — that is, **the letters get “bumped”** (sometimes along with DALs) because **priority given to taking directly to the street flats that are more difficult, more expensive, and less versatile to handle**. Presumably, this occurs mostly, or even exclusively, on walking sectors of city carrier routes.

**The “all or nothing” argument for DPSing letters.** To explain why 56.5 percent of saturation letters are DPS’d, Advo leans heavily on what it refers to as the Postal Service “policy” to sort as many letters as possible on DPS equipment. The Advo Brief states (at 17), for example, that “[t]he decision of the DPS plant manager whether to DPS a saturation letter mailing is an “all or nothing” proposition.” This may be the case for single mailings, but it

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<sup>7</sup> See cross-examination of witness Lewis, stating that many of his conflicts involved Advo mailings. Tr. 11/6016-18.

does nothing to explain why so many mailings are DPS'd. Advo further states that “[t]his broader operational preference to DPS saturation letters applies even to those portions of a saturation letter mailing destined to motorized sections of a route that are *not* subject to a third-bundle limitation.” Advo Brief, p. 18 (emphasis original).

Advo implies that the Postal Service prefers to DPS saturation letters for some dysfunctional purpose such as to (i) increase the volume of letters DPS'd just for the sake of increasing the throughput on DPS equipment, or (ii) keep clerks at DPS machines busy, or (iii) increase the apparent return on investment (ROI) by increasing machine utilization and throughput. Such objectives are dysfunctional and do not constitute a rational explanation for DPSing such a high percentage of saturation letters, as explained in Valpak's Brief. *See* IV-13-14. Moreover, as the brief of Advo points out, 43.5 percent of saturation letters are not DPS'd, whereas the Postal Service reports that 95 percent of all letters are now being DPS'd. This statistic alone indicates that the Postal Service is not DPSing saturation willy-nilly, but rather is far more selective; *i.e.*, saturation letters, which the Postal Service pays mailers to presort (via the discount), are DPS'd at plants because of some constraint at DDU's (*e.g.*, too many saturation flats), which is best overcome by taking advantage of the fact that saturation letters are automation-compatible.

**Internal communication failures at the Postal Service.** In support of its assertion that “Haldi's capacity constraint theory is contrary to operational realities,” Advo states that:

3. Delivery Offices Receive No Advance Notification and Cannot Plan For Most Saturation Letter Mailings, Unlike The Situation With Saturation Flats.

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USPS regulations require that drop-ship mailers give advance notification to the specific postal facility where the mailing will be dropped, and further require that the mailer schedule a specific appointment for the drop shipment. DMM §346.2.8.3. For non-DDU drop-shipped mail, these required appointments must be made with the appropriate “district control center.”

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The DDU has no advance warning that a non-DDU saturation letter mailing might be coming. ... If, as Valpak apparently advocates, these non-DDU saturation letter mailings were to bypass DPS processing and be transshipped to the delivery office, the delivery supervisors and carriers would have no warning until the mailings showed up at the DDU. [Advo Brief, pp. 19-20.]

The allegation made here by Advo is a serious one, and it deserves careful analysis. It begins by explaining that (i) “district control centers” schedule appointments for all drop-shipped saturation mailings (both letters and flats) entered upstream of the DDU, and (ii) the district control centers thus have complete knowledge of when and where all such saturation mail will arrive (while the plants, typically the SCFs, have the mail itself). **Advo then alleges that within the Postal Service there exists a monumental lack of internal communication between the district control centers and plants, on the one hand, and DDUs on the other, such that all delivery supervisors at all DDUs are completely in the dark at all times and know nothing about saturation mail that is scheduled to be entered, or already has been entered, upstream of the DDU, and delivery supervisors had no hint of what might be coming “until the mailings showed up at the DDU.”**

If the above brand-new allegation by Advo were true, it would deserve to be considered carefully and subjected to scrutiny in the next omnibus rate case, at which time the Commission should request the Postal Service to provide it with an expert witness to testify

concerning such lack of communication within the Postal Service, and how it affects operational decisions which have enormous cost consequences (such as unnecessarily DPSing saturation letters).

On the other hand, if Advo's unsupported allegation were not found to be true in the next rate case, that would indicate how desperate Advo has become to obfuscate the facts and divert attention from what is going on with respect to the way saturation mail is handled and costs of processing and preparing saturation mail for delivery are estimated.

However, the fundamental problem with this whole section of Advo's Brief is that on brief Advo raises what is essentially a totally new argument after the record in this docket has been closed. Significantly, **the only citation to the record that Advo uses in this part of its brief is the virtually irrelevant statement that "saturation letter mailing, unlike saturation flats, have a less-than-monthly frequency."** Advo Brief, p. 20. Because Advo cited to no record evidence whatsoever to support even a shred of its allegations about internal communication failures within the Postal Service, in this docket the Commission should accord no weight whatsoever to such unfounded, speculative, last minute, and seemingly desperate arguments.

**Saturation letters are readily available for DPS processing.** Advo states (at 21) that "[t]he great majority of ECR saturation letters (74%) are entered upstream of the delivery office and pass through SCF plants that have DPS equipment.... These mailings are therefore readily available for DPS processing." Advo acknowledges that this statement is "unremarkable." It also goes hand-in-glove with the idea that saturation letters, which already

have been put in DPS sequence by the mailer, instead of being cross-docked should be taken in from the dock and run through DPS equipment simply because they “are where they are.”

Advo then proceeds to spin out other arguments. For example: “plant managers cannot know whether a particular saturation letter mailing will be physically suitable to be carried out as a third bundle.” Advo knows that every saturation letter mailing is both eligible and physically suitable to be carried as a third bundle. Or: “[d]elivery managers and carriers **prefer** not to carry letters as third bundles **even on days when there are no saturation flat mailings.**” Advo Brief, p. 22 (emphasis added). Advo does not even bother to qualify this statement as to the type of route (*e.g.*, foot routes) and it implies that the Postal Service essentially should, as a regular policy, throw away the discount which it gives mailers to have them presort saturation letters to DPS, and proceed to incur the expense of DPSing the letters just so carriers will not have to work from an extra tray of letters in their vehicles. Such an argument flies in the face of Advo’s own argument that most city carriers face no constraints and have plenty of capacity for taking extra trays/bundles to the street, and that working from extra trays/bundles is not so difficult and is the most efficient way to handle saturation mail.<sup>8</sup> Finally, Advo says (at p. 22) that a DPS plant manager worries about “the risk of creating in-office handling and delivery problems at the delivery office.” But if DDU’s have virtually

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<sup>8</sup> Advo’s brief (at 24) states “Thus, city carriers have substantially more capacity to handle extra bundles than recognized by Dr. Haldi.” *See also*, witness Lewis’ statement “That’s what we tell them [carriers] to do [take 4 extra bundles to the street], yes.” Tr. 11/5995. And “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 that mail to a street as extra bundles.” *Id.*

unconstrained extra capacity for taking saturation mail directly to the street, what is the risk that a plant manager is supposed to worry about? And if the plant manager is so worried about the risk of in-office handling and delivery problems at the delivery office, as Advo alleges, then why doesn't the manager arrange to give the DDUs some advance notification of how much mail is either in the plant, or scheduled to arrive at the plant, and what they can expect? The inconsistent arguments of Advo seem designed to obfuscate the issues more than to enlighten.

**B. Valpak's Cross-Examination Hypothetical.**

The Advo Brief criticizes at some length the hypothetical used by Valpak during its cross-examination of witness Bradley.<sup>9</sup> Tr. 11/6135-39. Advo complains on the one hand that the hypothetical is complex,<sup>10</sup> while on the other hand also complaining that it makes too many simplifying assumptions.<sup>11</sup> Advo Brief, p. 29. The inconsistency of such arguments is obvious. Most of the other comments by Advo are totally off-base because they either do not understand — or do not want to understand — the purpose of the hypothetical, what it was intended to demonstrate, and what it in fact did demonstrate. However, because they are so potentially misleading, some further explanation is warranted.

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<sup>9</sup> Advo describes the cross-examination exhibit as violating Commission rules, which it did not, but the point is that **no objection was made by either Advo or Postal Service counsel at the hearing, and was therefore waived.** Advo's attempt to impugn a legitimate cross-examination exhibit on brief is completely out of place. *See* Advo Brief, pp. 29-30.

<sup>10</sup> For example, "six cross-examination exhibits," and "five pages of calculations."

<sup>11</sup> *See* "the inconsistencies with actual postal operations" (Advo Brief, p. 33).

Dr. Bradley's rebuttal testimony, USPS-RT-3, contains the familiar explanation, including a mathematical "proof," complete with many equations and partial differentials, of why he thinks the Postal Service's "established methodology" always produces marginal costs for each rate category, under all circumstances in which mail is processed. The Postal Service Brief states that Dr. Bradley's rebuttal testimony "demonstrates mathematically and intuitively why the resulting cost estimates are truly measures of marginal (and not "average") costs. USPS Brief, p. IV-9. The Postal Service Brief on this issue not only is succinct, but also so complacent as to indicate a total unawareness of fundamental problems with its "established methodology," which are discussed below.

The methodology that Dr. Bradley recites is based on an underlying model of what economists call the "production function."<sup>12</sup> That model encompasses many underlying assumptions which, unfortunately, are scarcely discussed in Dr. Bradley's rebuttal testimony. From the Postal Service's perspective, it probably is well that they were not made explicit, because to do so would have revealed the proverbial "foundation of sand" supporting Dr. Bradley's mathematical model. After all, his proof is applicable only within the confines of the assumptions that underlie his model.

The production function that underlies the established methodology would aptly describe the mail processing environment that existed prior to the 1970's, when virtually all mail was sorted manually. It might even have been reasonably applicable to the era of letter sorting machines (LSMs), since the mechanized letter-sorting technology of those machines

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<sup>12</sup> See the cross-examination of Dr. Bradley by counsel for OCA, Tr. 11/6083-86.

constituted only a modest advance over manual processing. Over the last four decades, however, the mail processing environment has changed considerably, especially for letters, from the early letter sorting machines to today's widely-deployed DPS machines. Automated equipment for sorting flats also is evolving, with significant further advances promised for the near future. In addition to automation within the Postal Service, extensive presortation has been a growing practice among many mailers (especially all saturation mailers), and in response to such presortation the Postal Service has developed and implemented extra-bundle handling procedures as described by witness Lewis in his direct testimony, USPS-T-30.

Given Dr. Bradley's unstated assumptions, his mathematical *tour de force* and his "proof" are unassailable. The problem with Dr. Bradley's model is that the assumptions which underlie it no longer constitute a reasonable description for some, perhaps much, of today's mail processing environment.<sup>13</sup> Consequently, the estimates of marginal costs that result from the way the model is implemented can be incorrect, and provide an inappropriate basis for setting rates.<sup>14</sup> Nevertheless, rather than adapt his model and methodology to accord

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<sup>13</sup> See OCA Brief, pp. 36-40, which goes directly to the assumptions that underlie Dr. Bradley's model. See also *id.*, pp. 41-48, which discuss similar problems with the assumptions of witness Bozzo.

<sup>14</sup> Implementation of Dr. Bradley's model is via the IOCS, which records **what** is happening in mail processing operations, but never **why** mail is being processed via the particular option (cost pool) that is the subject of sampling. The Advo Brief (at 28) states that the "costs [of saturation letters] **are what they are.**" Indeed, with the IOCS, things always "are what they are," since the IOCS lacks any underlying causal nexus. The fallacy of this way of thinking was illustrated in Dr. Haldi's direct testimony. See Tr. 9/5518-5522.

with the many changes that have taken place in mail processing, Dr. Bradley sticks with his existing model, including the underlying production function.<sup>15</sup>

The problems with the established methodology propounded by Dr. Bradley can be demonstrated in either of two ways:

- (1) by showing how the methodology produces marginal costs that, if used for rate setting, give inappropriate price signals to mailers, or
- (2) by showing how the fundamental assumptions that underlie his theory do not apply.<sup>16</sup>

The purpose of the hypothetical used in the cross-examination of Dr. Bradley was the former.

Specifically, the hypothetical was designed to:

- (1) focus on how mail processing costs are estimated by the Postal Service when it has viable options with different unit costs;
- (2) demonstrate how mail processing costs vary, depending on the extent to which the use of the different available options by one eligible category of mail can be caused by volume of other eligible categories of mail; and
- (3) keep it as simple as possible — and much simpler than Dr. Bradley’s differential equations.

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<sup>15</sup> Paraphrasing the song “When I’m not with the girl that I love, I love the girl that I’m with,” for Dr. Bradley one could say, “When I don’t have a model that fits, I fit the model that I have.”

<sup>16</sup> Counsel for the OCA interrogated Dr. Bradley concerning some of the more esoteric theoretical points that underpin his model. Tr. 11/6078-94.

The hypothetical therefore assumed no extraneous costs such as those that arise when mail is entered upstream of the DDU (*e.g.*, the costs of cross-docking and transportation). All costs relating to different entry points are irrelevant to the core issue of the hypothetical — processing costs of saturation mail up to the point where carriers take it to the street — and the fact that most saturation letters are entered upstream of the DDU is equally irrelevant. Again, Advo’s discussion of such issues seems designed only to sow needless confusion. To reiterate, the purpose of the hypothetical was to show how the Postal Service costing system estimates the marginal costs for processing when mail can either bypass in-office handling, or be cased, or, for letters, be DPS’d — which it did.

Advo also alleges that “the hypothetical and exhibits delved into areas of mail characteristics and operations that went far beyond the scope of the [sic] witness Bradley’s testimony and areas of expertise.” Advo Brief, p. 30. To the contrary, Dr. Bradley acknowledged that the development of costs, including marginal costs, was his area of expertise and the subject of his rebuttal testimony. Consequently, this core part of the hypothetical fell squarely within the area of Dr. Bradley’s expertise. Advo is simply wrong. Dr. Bradley understood this, and agreed that the marginal costs estimated in the hypothetical are in accord with his understanding of how the IOCS implements the existing methodology. Tr. 11/6123-24.

To keep matters simple, and to keep the focus on how use of different processing options can affect mail processing cost, the hypothetical made another simplifying assumption: that the street costs of delivering letters, addressed flats, and unaddressed flats were all equal. Again, the purpose of the hypothetical was to focus on how the marginal cost of mail

processing is estimated under the existing methodology, and how those costs can feed into pricing decisions. Street costs were not at issue, hence the assertion of Advo that wraps and DALs are counted as two separate pieces in the city carrier costing system is equally beside the point of what the hypothetical was designed to illustrate.

Advo seems especially upset that Commissioner Goldway immediately grasped the essential point that the hypothetical illustrated — namely, how pieces of saturation mail which can be the least versatile, most cumbersome and difficult to handle, nevertheless consistently have such a low estimated marginal cost.<sup>17</sup> Advo Brief, p. 31.

Advo does make one other assertion that warrants reply. It states that:

letters are not particularly well-suited to be carried as third bundles due to **ergonomic difficulties** in carrying two bundles of letters. It is one of the reasons that the Postal Service **prefers to DPS letters**. ... Yet in its “DDU-only” construct, Valpak conveniently assumes that the only reason a saturation letter would be sent back upstream to be DPSed is due to “bumping” by a saturation flat mailing — and not due to the more likely cause, the Postal Service’s **preference to DPS letters** rather than carry them as third bundles. [Advo Brief, p. 32 (emphasis added).]

This assertion, although raised in the context of the hypothetical, has been rebutted previously here, as well as in Valpak’s Brief, pp. IV-13 to 16. Whenever the Postal Service is not somehow constrained from taking saturation letters directly to the street, then it would be incurring the cost of two-pass DPSing needlessly, which would be irrational and not cost-

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<sup>17</sup> The “two for the price of one” is not an issue between flats and letters. Rather, it is a matter only of concern to mailers of addressed flats. That is, the delivery of a saturation cover and DAL requires delivery of two pieces, each of which has a separate cost for delivery. Mailers of unaddressed covers with DALs benefit from rate-averaging within the rate category, which occurs at the expense of mailers of addressed flats.

minimizing, and Advo cannot just assume this is how the Postal Service operates. Indeed, such an assumption is not even reasonable.

**VI. THE POSTAL SERVICE OVERSTATES THE ROLE OF NON-UNANIMOUS SETTLEMENTS IN OMNIBUS RATE CASES.**

The Postal Service asks the Commission to give great weight to the fact that its request has now been incorporated into a proposed, non-unanimous Stipulation and Agreement, and to accept it without change.<sup>1</sup> USPS Brief, p. II-1.

Of course, the Stipulation and Agreement is, most decidedly, non-unanimous, with the OCA and nine intervenors declining to participate. Indeed, the rates in the proposed Stipulation and Agreement have been strongly contested as being:

- **contrary to the record** (Valpak Brief, sections III, IV, V, and VI);
- **contrary to law** (Valpak Brief, sections I and VI; OCA Brief, section II); and
- **contrary to good postal policy** (Valpak Brief, section II).

Valpak is not entirely alone in finding fault with the Postal Service's proposed rates:

- The **Postal Service** has even (discretely, reluctantly, but apparently) agreed that current Standard ECR letter and flat rates are based on **wildly erroneous costing** (carried forward under its across-the-board proposal), where the carrier costs of delivering **billions and billions of DALs** have been imposed on, and are currently are being paid by, ECR saturation letters, rather than ECR saturation flats (Valpak Brief, section III; Tr. 7/2994-95).

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<sup>1</sup> Although the Postal Service states that it “does not blindly reject the reasoning embodied in Valpak’s position or conduct in this case” and that “the types of issues Valpak raises are not frivolous,” the Postal Service has essentially treated them as “frivolous” as it “blindly rejected” or, more benignly but with the same effect, ignored them. As usual, the Postal Service brief has faithfully adhered to the script written at the outset of the case by the Board of Governors. Apparently, nothing that has transpired during the five-plus months of the litigation of this docket has caused the Postal Service to reassess any of its case, its costs, or its rates, or any of the positions laid down by the Board of Governors before any of the record in this docket was developed. In the Postal Service view of the world, nothing whatsoever has been learned.

- **Advo** through its witness Antoinette Crowder has quantified that ECR saturation letters are currently erroneously paying the cost of delivering, in her view, 4.315 billion DALs, and the delivery letter-flat carrier cost differential is at least 28 times that which the Postal Service believed when the case was filed. Advo-LR-1; Tr. 10, pp. 5787, l. 18 – 5788, l. 9; Advo Brief pp. 43-45. (However, disregarding the testimony of its own witness, Advo in its Brief states: “In sum, Valpak’s arguments and proposals should be rejected **in their entirety**.” Advo Brief, p. 6 (emphasis added).)
- The **Postmaster General** has signed a letter saying, in effect, that he will never violate the law again, after this case, in the context of Nonprofit rate setting. *See* Letter from Postmaster General John Potter to Neal Denton, Alliance of Nonprofit Mailers” (“ANM”) Executive Director, filed with Commission by ANM on August 23, 2005.
- The **OCA** makes a compelling case that the Postal Service’s revenue requirement was overstated by \$2.577 billion. OCA Brief, section II.

Yet the Postal Service has no problem ignoring the evidence, the law, and good postal policy in this case by insisting that the Commission rubber-stamp the Postal Service’s request as if nothing whatsoever has been learned over the past five months of litigation.

**A. The Postal Service Misreads the Commission’s Experience with Proposed Settlements.**

The Postal Service tries to draw on prior Commission rulings to find legal support for a settlement of this docket by stating that “[t]he Commission has recently summarized the role of settlement in its proceedings.” USPS Brief, p. II-4. The Postal Service then quotes from Commission Order No. 1443 (August 23, 2005), issued in Docket No. MC2004-3. This supposed authority for the Postal Service’s position raises several problems.

**Omission of pertinent language.** The Postal Service neglected to mention what type of cases the Commission was discussing in that Order – **uncontested, functionally-equivalent**

**Negotiated Service Agreements.** The following introductory language of the Commission in that case was omitted by the Postal Service:

The Governors request that the Commission provide **comments on the role of settlement in uncontested Negotiated Service Agreement cases.** The Governors seek clarification “whether, as a policy matter, (the Commission) disfavors **settlements in functionally equivalent NSAs.**” If so, the Governors ask the Commission to reconsider such a policy. Governors’ Decision at 9. [Docket No. MC2004-3, Order No. 1443, p. 14 (emphasis added).]

By failing to explain the issue being addressed, the Postal Service may have made it appear that the Commission’s discussion of settlement principles was generic, applicable to omnibus rate cases.

**Uncontested NSAs vs. Contested Omnibus Rate Cases.** Settlements in uncontested, functionally-equivalent NSA cases (like Docket No. MC2004-3) are much different than contested omnibus rate cases (like Docket No. R2005-1):

- Quite obviously, contested cases are not uncontested, and no “consensus” of the type the Commission referenced in Order No. 1443 exists in such cases.<sup>2</sup>
- Further, in functionally-equivalent NSA dockets, the Commission does not set generally-applicable rates.
- NSA dockets thus far are designed by the Postal Service to ensure that they enhance contribution to institutional costs, and it is anticipated that no mailer (possibly other than a direct competitor of the NSA recipient) would be worse off if the NSA were agreed to. *See, e.g., Op. & Rec. Dec.*, Docket No. MC2002-2, p. 146; Docket No. MC2004-4, pp. 9, 24, 25, 36, 52.

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<sup>2</sup> The Order stated “[i]f settlement resolves all factual issues, whole portions of the hearing process may be eliminated. Settlements may obviate the need for rebuttal and surrebuttal testimony and the related discovery process, providing a substantial cost benefit to the participants.” USPS Brief, p. II-4, quoting Commission Order No. 1443 (emphasis added). Obviously, this did not occur in the instant docket.

**Rate Cases are Not Bilateral Litigation.** The Postal Service quotes the following language from Order No. 1443: “[c]ase law is replete with examples of the courts favoring settlements in **many different contexts**,” citing two cases, one of which states that settlements are to be encouraged because “they are a means of amicably resolving doubts and uncertainties and preventing lawsuits” and the other of which states that settlements are to be encouraged because they “avoid[] ... wasteful litigation and expense incident thereto.” *See* USPS Brief, p. II-20 (emphasis added). These cases were cited by the Commission to provide context to the Commission’s discussions in its Order in Docket No. MC2004-3, but do not support the proposed settlement in the circumstances of the instant docket. To the contrary, judicial statements favoring settlements in **bilateral litigation** where both parties have agreed to resolve a specific dispute, saving the expense of a trial, affect the parties only. In no way would policies underlying such a settlement be considered relevant in a case involving a ratemaking procedure, where a statute specifies the role of the regulatory body, and the rates are not just the concern of the parties to the settlement agreement.

**APA does not require settlement.** The Postal Service quotation of the Commission’s comment on the Administrative Procedure Act (“APA”) settlement policy, set forth in 5 U.S.C. Section 554(c), is equally misplaced. To be sure, Section 554(c) does direct an agency to “give **all interested** parties opportunity for ... offers of settlement,” but it does not state that any such offer, if accepted by an interested party, must be imposed upon another “interested party” who was **not** interested in an agency’s settlement offer. To the contrary, Section 554(c) states that an agency must give such an interested party the “opportunity for ... submission of facts, arguments ... or proposals of adjustment when time, the nature of the proceeding, and

the public interest permit.” This adjudicatory rule, like its judicial counterpart, indicates that offers and acceptances of settlements are limited in their legal effect to signatory parties, and not binding on nonsignatory parties as the Postal Service as contended in this case.

**Commission Consideration of Proposed Settlements.** The Postal Service omitted any quotation from the Commission’s discussion of how it reviews proposed settlements. *See* USPS Brief, pp. II-4, 20-21. Yet the Commission’s statement in Docket No. MC2004-3 is most enlightening on that point:

The Commission seriously considers all settlement proposals when making its recommendation to the Governors. When a settlement proposal is presented to the Commission, it is **considered as a proposal on the merits**. The Commission strives to preserve the intent of the proposals and the suggestions of the participants, and only **make adjustments where necessary**. If a settlement proposal is deficient only in some limited way, the Commission’s preference is to accept the proposal **with adjustments to remedy the deficiencies**.

**Notwithstanding** Commission policy to favor the participants’ settlement of contested issues, **two absolute requirements** must be met before a settlement can be accepted. First, a settlement must be **consistent with applicable statutory requirements**, and second, a settlement must be **consistent with the evidentiary record**. [Docket No. MC2004-3, Order No. 1443, p. 17 (August 29, 2005) (emphasis added).]

In accord with this procedure, Valpak submits that the Commission should consider the Stipulation and Agreement filed in this docket as a “proposal on the merits,” determine whether it is both “consistent with applicable statutory requirements” and “consistent with the evidentiary record,” and, if not, as here, the Commission should “make adjustments where necessary.” *Id.* As demonstrated on the record, and by careful analysis of the applicable requirements, it is submitted that these “adjustments” include:

## VI-6

- adjusting the revenue requirement downward in accordance with the Postal Reorganization Act and Pub. L. 108-18 (Valpak Brief, Section I);
- adjusting the Postal Service's across-the-board proposal at least for Standard Mail rates where the Postal Service's proposed costs and rates have been contested on the record and found wanting (Valpak Brief, Section II);
- adjusting the Postal Service's erroneous costing of DALs (Valpak Brief, Section III);
- adjusting the Postal Service's erroneous costing of mail handled by the third bundle method (Valpak Brief, Section IV);
- adjusting downward the Postal Service's excessive coverage for ECR mail (Valpak Brief, Section V);
- adjusting the Postal Service's illegal rate relationship between ECR and Nonprofit ECR mail to make it equal 60 percent (Valpak Brief, Section VI); and
- adjusting ECR rate design, particularly increasing the Postal Service's understated letter-flat rate differential (Valpak Brief, Section VII).

**Non-Unanimous Proposed Settlements in Omnibus Rates Cases.** Non-unanimous proposed settlements are of limited value to the Commission in omnibus rate cases with respect to the matters determined in such cases.

- **Determining proper coverages.** Generally, mailers would prefer to have high coverages on subclasses that they do not use. Intervenors which do not use Standard ECR apparently are willing to settle where Standard ECR is given the **highest coverage of any postal product**. Where the revenue requirement is determined, postal ratemaking takes on the attributes of a “**zero sum game**” (*see* USPS Brief, p. V-38) and it is to the advantage of non-ECR mailers to settle a case which burdens ECR mailers with an outrageously high coverage.
- **Determining proper costing within a subclass.** Mailers that do not use Standard ECR mail are not concerned if the cost of handling DALs entered with unaddressed flats is imposed improperly on mailers of ECR letters. For example, no other intervenor filing a brief in this docket has mentioned the benefits resulting from uncovering the enormous costing error in the treatment of DALs in the city and rural carrier costing systems, and improving the estimate of the number of ECR DALs in the system. This matter is of concern

to Valpak (which has paid higher rates for years as the price of the error) and to Advo (which should have been paying higher rates for years), but of no concern whatsoever, for example, to the Parcel Shippers Association.

- **Determining proper rate design.** Mailers that do not use Standard ECR mail are not concerned if Advo's ECR flats are undercharged or Valpak's ECR letters are overcharged, or if any other ECR mailer pays too little or too much postage relative to the other. And, with respect to rate design within ECR, it should mean precisely nothing to the Commission that Advo has elected to agree to settle this rate case, since it would appear obvious that Advo would prefer to continue the status quo of an understated letter-flat differential, and would prefer that the Commission not address the rate design issues raised by Valpak throughout this docket.

The Postal Service's proposed use of settlement agreements to impose "consensus" resolutions of "contested issues" on all mailers affected by an omnibus rate change actually conflicts with the Commission's policy to limit such resolutions to the settlement agreement signatories as long as the settlement terms are "consistent with applicable statutory requirements" and are "consistent with the evidentiary record." Docket No. MC2004-3, Order No. 1443, p. 17. To go beyond that settled policy would be unprecedented and insupportable by practice or by reason or by law.

**Commission Consideration of Both the Proposed Settlement and the Opposition.**

To find authority for consideration of a "nonunanimous settlement," the Postal Service reaches back to the E-COM case, Docket No. MC84-2. The Postal Service quotes from the Commission's language which says that Commission rules permit parties "to submit for our consideration a nonunanimous settlement...." USPS Brief, p. II-6. But again, the Postal Service is highly selective in the information that it puts in its brief, as the following caveat of the Commission is omitted:

That we can, and indeed must, give consideration to a nonunanimous settlement **does not**, of course, **mean that we may adopt it** as a disposition **without considering the opposition....** [*Op. & Rec. Dec.*, Docket No. MC84-2, p. 5, para 0011 (emphasis added).]

Valpak certainly concurs. Valpak has no objection to the Commission considering the non-unanimous settlement as any other proposal, so long as it is not given any special deference or special standing by the Commission, particularly here, where Valpak has made a strong showing against the Postal Service's request on several different fronts, and that showing, it is submitted, is highly persuasive, if not compelling.<sup>3</sup>

**B. In Docket No. R94-1, the Only Previous Proposed Across-the-Board Rate Case, the Commission Rejected a Proposed Non-unanimous Settlement.**

The Commission's views on settlement agreements in omnibus rate cases involving proposed across-the-board rate increases such as the instant docket were extensively set out in its Opinion rejecting the settlement in Docket No. R94-1. Some relevant excerpts from that Opinion are as follows (emphasis added):

[1004] [The Postal Service] **has also combined two previously separate ratemaking elements, pricing and rate design, by a simple across-the-board increase....**

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<sup>3</sup> The Postal Service sets out a long quotation, which the Postal Service represents comes from this same Opinion and Recommended Decision at pages 12-13. USPS Brief, pp. II-6-7. Despite a thorough search of the pages specified by the Postal Service, followed by a search of the entire Opinion and Recommended Decision, and indeed a search of both the active dockets and archives of the Postal Rate Commission, counsel for Valpak has been unable to locate this quotation in this or any other Opinion and Recommended Decision. Interestingly, the only place where this quotation can be found is in the Postal Service Initial Brief filed in Docket No. R2001-1 (pp. I-8-9), where it carries the same erroneous reference. The quoted language, which involves unanimous proposed settlements, sounds like it might come from an Opinion and Recommended Decision, but is not particularly relevant to this case in any event.

[1006] **The Commission does not accept the proposed stipulation and agreement** offered in settlement of all issues in this case by the Postal Service and a majority of other participants. **Several aspects of that proposed settlement are contrary to facts developed on the evidentiary record, and it therefore could not be the basis for a Commission recommended decision.**

[1017] 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....**

[1021] In sum, the **arguments for an across-the-board approach** rather than the traditional development of rates are **more expedient and convenient than substantive.** An across-the-board request may be easier for the Postal Service to prepare: it need not compute cost-based rates; it avoids controversial issues; and it defers policy decisions. Thus it allows the Service to seek new revenues, and purportedly to focus its resources on reclassification. It seems evident that **these considerations** motivated the Postal Service's filing, but they **do not govern the Commission's obligations under the law.**

[1022] The Commission must issue a recommended decision on the basis of **record evidence and argument. There is a vast difference between simply filing an across-the-board request, and proving that such a request is consistent with statutory postal ratemaking policies. Participants have shown that the rates proposed by the Postal Service are inconsistent with the Act in several areas.**

[1026] Under existing circumstances, a **one-time deviation** from standard ratemaking practice is unavoidable. However, **the across-the-board "fix" offered by the Postal Service is inconsistent with important postal policies. Therefore, the Commission has designed rates which accommodate the statutory requirements, the evidence presented on the record, and the operating conditions facing the Postal Service....**

[1035] Need for Review of Existing System. The record of this case shows that the Postal Service's costing systems, **especially the IOCS**, require examination to **determine their continued usability in view of the major changes in mail-processing systems**. Concerns range from questions that address sampling errors associated with small-volume subclasses to more fundamental issues of **whether the IOCS, which was developed in an era of piece-by-piece mail processing, is still appropriate in a time of mass processing by automation....**

[1051] The Commission has rejected the non-unanimous settlement agreement as the basis for its recommended decision. It concludes that **the record demonstrates a need to make significant revisions to the cost and revenue estimates to which the participants had stipulated. It also concludes that some significant revisions to the rates proposed by the Postal Service are required by the rate setting criteria enumerated in section 3622(b).**

[1063] Departures of proposals from established costing methods and pricing principles. **The Postal Service's request for a general, across-the-board rate increase in this docket departs from the pricing principles established in Docket No. R90-1 on which current rates are based....**

The Postal Service argues that the lessons of Docket No. R94-1 do not apply to the instant docket for one reason only — the instant cases involves an alleged tie of the rate increase to the CSRS escrow payment mandated by Pub. L. 108-18:

In Docket No. R94-1, **the Commission found there to be no policy basis sufficiently compelling to warrant acceptance** of the Postal Service's proposal that it rely heavily on its section 3622(b)(9) discretion to recommend across-the-board rate and fee increases. However, there is no basis for reaching the same conclusions in Docket No. R2005-1. The **policy** underlying the Postal Service's current across-the-board approach is **indisputable and unassailable**. [USPS Brief, pp. V-25-26.]

Of course, the policy described as “indisputable” and “unassailable” was both persuasively disputed and assailed by Valpak witness Mitchell (VP-T-1, Section II, Tr. 9/5272, *et seq.*); Valpak Brief, Section II.

Perhaps one reason why the Postal Service does not understand that the escrow created by Public Law 108-18 has association with any postal purpose is widespread confusion at the Postal Service with the very **name of the bill**. The Postal Service brief calls it the “**Civil Service Retirement Funding Reform Act of 2003**.” USPS Brief, p. V-1 (emphasis added). Interestingly, this is exactly the same erroneous name given to the bill by witness Potter. USPS-T-1, p. 2, l. 9. *See* Valpak Brief, p. II-5, n.3. However, this is not the name of the bill. Public Law 108-18 begins with these words:

SECTION 1. SHORT TITLE. This Act may be cited as the “**Postal Civil Service Retirement System Funding Reform Act of 2003**.” [Emphasis added.]<sup>4</sup>

The Postal Service also misstates the terms of that statute. Congress declared in so many words that the escrow payment “shall be considered to be **operating expenses of the Postal Service**.” Pub. L. 108-18, sec. 3(a)(3) (emphasis added). *See* Valpak Brief, p. II-4. Yet the Postal Service brief continues to disagree.

Although PL 108-18 characterizes the escrow as an ‘**operational expense**,’ it is not an expense that arises from any operation of the Postal Service. [USPS Brief, p. 4; *see also* USPS-T-6 at 12 (emphasis added).]

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<sup>4</sup> By contrast, the OCA brief exhibits no such confusion, accurately quoting the name of the law beginning with the word “Postal,” (p. 22) and explaining how the savings from Public Law 108-18 must be applied “to maintain the lowest possible rates for mailers.” OCA Brief, p. 22-26.

Note the Postal Service Brief changes the statutory plural term “**operating expenses of the Postal Service**” to a shorter singular term “**operational expense**” significantly by omitting the words “**of the Postal Service.**” The sheer stubbornness of the Postal Service’s argument that the escrow payment must be treated in an entirely new matter, and not as operating expenses recovered through the normal ratesetting process, is revealed by restating the Postal Service’s own argument, recast, but this time using the correct and complete words of the statute —

Although PL 108-18 characterizes the escrow as “**operating expenses of the Postal Service**” it is not an expense that arises from an **operation** of the **Postal Service**.

We submit that Congress has spoken on this matter, and **the Postal Service’s disagreement with the Congressional characterization of how the escrow is to be treated is nothing more than a transparent attempt to manufacture some “policy reason” for an across-the-board rate increase that can make an end run on the Commission’s clear decision in Docket No. R94-1.** The Postal Service clearly continues to resist the Congressional classification of these costs. However, the Board of Governors should not be allowed to defy this Congressional determination by fashioning a policy reason which seeks to circumvent the ratesetting role of the Commission.

**C. In Docket No. R2001-1, the Commission Agreed to a Non-unanimous Settlement for Extraordinary Reasons which Do not Apply here.**

The Postal Service relies on the fact that the Commission accepted a proposed settlement in Docket No. R2001-1. It must be remembered, however, that Docket No. R2001-1 was not a proposed across-the-board case. It was never fashioned with the thought or intent that the case would be settled. The Postal Service’s proposed rates were tied to its costs in that

docket. However, the events of “9-11” caused most intervenors to support settlement. The Postal Service’s current effort to take the Commission’s language in Docket No. R2001-1 based on the events of “9-11” — such as reliance on criteria 9 — out of that context, to leverage it to find a way to approve the proposed settlement in Docket No. R2005-1, is neither appropriate nor persuasive. In agreeing to settlement in Docket No. R2001-1, the Commission did not decide to go out of business and hand over the keys to postal ratemaking to the Governors, as the Postal Service apparently believes.<sup>5</sup>

Indeed, in the Postal Service’s Initial Brief in Docket No. R2001-1, reliance was not on “uniqueness” but on the “**extraordinary** circumstances created by the national events shortly before and following the filing of the Postal Service’s Request.” (p. I-1). Use of the term “extraordinary” was apparently drawn from Chairman Omas when he said “I urge all participants to recognize that **extraordinary** times warrant **extraordinary** acts.” Docket No. R2001-1, Prehearing Conference, October 25, 2001, Tr. 1/41, ll. 14-16 (emphasis added). Moreover, the Opinion and Recommended Decision described the time as “**The National Crisis.**” Op. & Rec. Dec., p. 1, para. 1003 (emphasis added).<sup>6</sup> The Postal Service has

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<sup>5</sup> The Postal Service apparently relies on 39 U.S.C. section 205(a) for the proposition that the Board of Governors have “the authority to make fiscal policy determinations for the nation’s postal system.” USPS Brief, p. V-1. However, this provision of the law on all matters involving “fiscal policy” does not allow the Governors to dictate ratesetting decisions, which are committed in the first instance to the Commission. 39 U.S.C. sections 3622, 3623.

<sup>6</sup> The Commission described the circumstances surrounding Docket No. R2001-1 as follows. “This omnibus rate proceeding is unlike any other heard by the Commission. Not for its substance, but for unprecedented recent events.... On September 11, 2001, terrorists attacked the United States in New York and Washington, D.C. The effects on the Postal Service were immediate.... Nationally, airports were closed and commercial air traffic

attempted to morph Chairman Omas' standard of "extraordinary circumstances" into "uniqueness." In some sense, each case is unique, but certainly this case is not "extraordinary" and no national crisis exists over the CSRS escrow. If the term "**unique**" is to be applied to rate cases, it should be reserved for events such as "9-11," and not invoked casually and erroneously to describe the passage of one of many laws imposing cost burdens on the Postal Service — the Postal Civil Service Retirement Funding Reform Act of 2003 (Public Law 108-18). *See, e.g.*, Valpak oral cross-examination of witness Tayman relating to several earlier Congressional burdens imposed on the Postal Service by OBRA's and other laws. Tr. 2/234-39.

**D. Conclusion.**

Parties urging settlement cannot deny that the Commission has a duty under the Postal Reorganization Act to apply the law to the record evidence, and to issue its own Opinion and Recommended Decision. Failure to do so would have a chilling effect in the future on any intervenor who contemplates challenging a proposed settlement on its merits. A non-unanimous settlement cannot be argued to relieve the Commission of this obligation. And it is simply irrelevant that the rates recommended might only be in effect for a short time. (*See* USPS Brief, p. II-25.) Indeed, no one ever could have anticipated that the rates adopted in

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halted.... [T]he Postal Service experienced a sharp drop in revenues.... [T]he Postal Service estimated that for the three weeks following the September 11 attacks, revenues fell by \$300-400 million. [The Postal Service] bore the full brunt of the subsequent biological terrorism.... The Service has had to bear the unexpected short-run costs of disruption, decontamination and protection, and the long-run costs of reconstructing facilities, securing its personnel and customers from further attack, and restoring the shaken confidence of the public in the safety of the mail. In sum, Postal Service operations were thoroughly disrupted, causing expenses to rise sharply....' *Op. & Rec. Dec.*, p. 1-3, para. 1003-08.

Docket No. R2001-1 would still be in effect until January 2006, or that the Postal Service would not file another case for 43 months after initiating Docket No. R2001-1, but both unexpected events occurred. The future simply cannot be known. The Postal Service admits that it “cannot state categorically when the next rate case will be filed...” USPS Brief, p. II-25. Based on this experience, the Commission simply cannot assume that the rates it recommends in this docket will stay in effect only a short time and that therefore an across-the-board approach would not make much difference to nonsettling mailers.

Respectfully submitted,

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