

**BEFORE THE
POSTAL RATE COMMISSION**

POSTAL RATE AND FEE CHANGES, 2006

:
:
:

DOCKET NO. R2006-1

**DIRECT TESTIMONY OF
R. RICHARD GEDDES
ON BEHALF OF
UNITED PARCEL SERVICE**

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1 **AUTOBIOGRAPHICAL SKETCH**

2 My name is R. Richard Geddes. I am Associate Professor and Director of
3 Undergraduate Studies in the Department of Policy Analysis and Management at
4 Cornell University. I have conducted research and published papers on the regulation
5 of public utilities. I have also conducted research and published numerous papers and
6 a book on policy issues relating to the United States Postal Service.

7 I earned MA and PhD degrees in Economics from the University of Chicago. My
8 undergraduate degree in Economics and Finance was awarded by Towson State
9 University. I served as a Senior Economist on the President's Council of Economic
10 Advisers during the 2004-2005 academic year, and I am currently a Commissioner on
11 the National Surface Transportation Policy and Revenue Study Commission. In Docket
12 No. R94-1 I testified before this Commission on behalf of United Parcel Service on the
13 recovery of the Postal Service's losses incurred in prior years. A copy of my curriculum
14 vita is attached to this testimony.

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I. PURPOSE OF TESTIMONY

The purpose of my testimony is to recommend cost coverages (defined as the ratio of revenue to attributed cost for a particular subclass) for Priority Mail and Parcel Post, and to explain why my recommendations best reflect the ratemaking criteria of the Postal Reorganization Act, 39 U.S.C. § 101, et seq.

1 **II. GUIDE TO TESTIMONY**

2 In section III, I discuss principles of ratemaking in light of the nine ratemaking
3 criteria laid out in section 3622(b) of the Postal Reorganization Act. I also discuss
4 several other relevant issues, including the special circumstances created by the last
5 two rate cases and the negative effects of markups designed to protect the Postal
6 Service's market share. In Section IV, I recommend a Priority Mail cost coverage. I also
7 review changes in markup indices for Express Mail and discuss their implications. In
8 Section V, I recommend a cost coverage for Parcel Post.

1 **III. RATEMAKING PRINCIPLES**

2 Under section 3622(b) of the Postal Reorganization Act (the “Act”), the Postal
3 Rate Commission is to consider nine factors when making its recommended decision on
4 rates and fees. I discuss each of those factors below.

5 **A. The Nine Ratemaking Factors**

6 Factor 1. Fairness and Equity (§ 3622(b)(1))

7 The first factor is “the establishment and maintenance of a fair and equitable
8 schedule” of rates. This factor suggests that the Commission engage in a careful
9 balancing of the multiple social and economic objectives of the Act, and weigh carefully
10 the concerns of all interested parties when recommending rates and fees.

11 Factor 2. Value of Service (§ 3622(b)(2))

12 The second factor is “the value of mail service actually provided each class or
13 type of mail service to both the sender and the recipient.” This factor mentions several
14 specific dimensions of service quality that may affect the value of a mail class -- the
15 collection, transportation mode, and delivery priority of the mail. Other dimensions of
16 service quality that may affect the value of a particular type of mail service include
17 options available to consumers for service upgrades (such as Delivery Confirmation),
18 speed of delivery, reliability of delivery, and the priority the service is given in mail
19 processing.

20 Factor 3. Cost Recovery (§ 3622(b)(3))

21 The third factor is “the requirement that each class or type of mail service bear
22 the direct and indirect postal costs attributable to that class or type plus that portion of
23 all other costs of the Postal Service reasonably assignable to such class or type.” This

1 is the only factor that Congress identified as a requirement, and the Commission has
2 determined that this is the most important of the nine criteria.¹ It gives rise to the
3 Commission’s two-step process for developing recommended rates. The Commission
4 first determines the direct and indirect costs attributable to each subclass of mail; those
5 costs that cannot be attributed to a particular mail subclass are by definition institutional
6 costs. The second step is to allocate those institutional costs across the various mail
7 subclasses looking to the other eight ratemaking factors for guidance.

8 Factor 4. The Effect of Rate Increases (§ 3622(b)(4))

9 The fourth factor is “the effect of rate increases upon the general public, business
10 mail users, and enterprises in the private sector of the economy engaged in the delivery
11 of mail matter other than letters.” Rates that are higher than necessary should be
12 avoided. However, while low rates or rate reductions may benefit some mailers, they
13 can disadvantage other mailers who must pay higher rates to make up for the lost
14 revenue. In addition, rates that are too low can harm competing suppliers, who may be
15 unfairly disadvantaged in competing against a lower-priced government alternative even
16 though the private supplier is a more efficient supplier of the service. Careful balancing
17 of all the criteria specified in the Act, with particular attention to the requirement that all
18 mail subclasses cover their attributable costs plus a reasonable portion of institutional
19 costs, will help avoid rates that harm either mailers or competitors.

20 Factor 5. Available Alternatives (§ 3622(b)(5))

21 The fifth factor for consideration is “the available alternative means of sending
22 and receiving letters and other mail matter at reasonable costs.” The application of this

¹ Docket No. R87-1, Opinion and Recommended Decision, ¶ 4031.

1 factor should be straightforward: if consumers have a wide range of available
2 alternatives at reasonable costs, then, all else being equal, higher rates are less
3 burdensome to them. Faced with higher rates, consumers are free to choose one of the
4 alternatives. Conversely, if consumers are captive to the delivery monopoly or are
5 otherwise constrained in the choices they face, then the Commission should be
6 particularly diligent in protecting them from high rates.

7 Factor 6. Degree of Preparation (§ 3622(b)(6))

8 The sixth factor is “the degree of preparation of mail for delivery into the postal
9 system performed by the mailer and its effect upon reducing costs to the Postal
10 Service.” This factor suggests that it is appropriate, through rate discounts, to pass on to
11 mailers some or all of the cost savings they generate when they engage in mail
12 preparation. This provides mailers with an incentive to prepare mail when they can do
13 so at lower cost than the Postal Service.

14 Factor 7. Simplicity of Structure (§ 3622(b)(7))

15 The seventh factor is “simplicity of structure for the entire schedule and simple,
16 identifiable relationships between the rates or fees charged the various classes of mail
17 for postal services.” A simple rate structure with understandable relationships between
18 rates helps to promote confidence in the fairness and equity of the rate structure,
19 particularly for individual mailers.

20 Factor 8. ECSI Value (§ 3622(b)(8))

21 The eighth factor is “the educational, cultural, scientific, and informational value
22 to the recipient of mail matter.” It is appropriate to consider this type of mail content

1 because lower rates can facilitate its wider dissemination, which may have social
2 benefits. This is consistent with the Postal Service's basic function.²

3 Factor 9. Other Factors (§ 3622(b)(9))

4 The ninth factor is "such other factors as the Commission deems appropriate."
5 This factor authorizes the Commission to use its experience and expertise in
6 considering other important factors that may be relevant for ratemaking.

7 **B. The Rate Relationships Adopted in the Last Fully**
8 **Litigated Rate Case Are Presumptively Reasonable.**

9 In a crucial respect, this case is atypical. The time period between Docket No.
10 R2000-1 and this case is, by a substantial margin, the longest period yet experienced
11 between fully litigated postal rate cases. For good reasons, the two intervening rate
12 cases did not provide an opportunity for the Commission to receive testimony and hear
13 debate from all of the large number of interested parties who normally participate in an
14 omnibus rate case.

15 The R2001-1 rate case was unusual because the Postal Service filed its request
16 shortly after September 11, 2001, around the same time the mails were used to
17 distribute lethal anthrax. Combined with a slowing economy, the events of September
18 11 and the subsequent anthrax attacks distorted the Postal Service's revenue needs
19 and cost projections. Because of these unusual circumstances, almost all interested
20 parties reached an historic negotiated settlement that the Commission agreed would
21 have no precedential effect in future cases.

² Section 101(a) of the Postal Reorganization Act states that "The Postal Service shall have as its basic function the obligation to provide postal services to bind the Nation together through the personal, educational, literary, and business correspondence of the people."

1 Docket No. R2005-1 was also unusual in that the Postal Service requested a 5.4
2 percent across-the-board rate increase designed specifically to fund a \$3.1 billion
3 escrow payment required by Congress. Most intervenors agreed to allow the Postal
4 Service to meet this unique financial obligation through a simple across-the-board rate
5 increase and, similar to Docket No. R2001-1, without a wide-ranging or precedential
6 omnibus rate case. The Commission again concurred. However, the Commission noted
7 that, because of the passage of time and changes in technology, the next rate case
8 would require a detailed examination of cost and rate relationships that could require
9 disproportionate or large rate changes:

10 After careful consideration, the Commission agrees that under these
11 unique circumstances, small equal increases now, to be followed by a
12 proceeding to “true-up” rates after a thorough examination of postal costs,
13 is consistent with sound public policy. . . . It is concerned that the delay in
14 recognizing the impact of recent innovations and improvements in postal
15 operations, coupled with the passage of time, will probably result in
16 unusually disproportionate increases and decreases in different rates in
17 the next case.³

18 The Commission has noted that the rate relationships resulting from full hearings
19 are presumptively reasonable.⁴ This presumption of reasonableness emanates from
20 the fact that the Commission has conducted a thorough review of all issues and has
21 considered carefully the ratemaking criteria in section 3622(b). The two most recent
22 cases did not allow such a thorough review. Thus, the most recent case from which
23 such presumptively reasonable rate relationships arise is Docket No. R2000-1, the last
24 fully litigated case. The Commission has also noted that it evaluates rate requests with

³ Docket No. R2005-1, Opinion and Recommended Decision, p. ii.

⁴ Docket No. R87-1, Opinion and Recommended Decision, ¶ 4026

1 an “eye on historic relationships” across mail classes.⁵ Such a review of historic rate
2 relationships is particularly important in this case.

3 **C. Acceptance of the Commission’s**
4 **Attributable Cost Estimates**

5 As the United States Supreme Court has held, the Commission is the body
6 primarily charged with the responsibility to determine attributable costs for subclasses of
7 mail.⁶ I have therefore used the results of the attributable cost methods used by the
8 Commission in Docket No. R2000-1 as my reference point in arriving at my cost
9 coverage recommendations.

10 **D. Cost Coverage Should Not Be Lowered in Order**
11 **to Protect the Postal Service’s Market Share.**

12 The Commission has indicated in several decisions that a reduction in the cost
13 coverage for a mail subclass may be justified because of the Postal Service’s status as
14 a competitor under section 3622(b)(5).⁷ The logic of this approach is that as the
15 number of alternatives to the Postal Service rises (perhaps due to a larger number of
16 competitors), the markup on a particular mail subclass may be reduced to help the
17 Postal Service capture or maintain market share. It could have several undesirable
18 consequences.

19 First, a policy of recommending rates intended to protect the Postal Service’s
20 market share would effectively grant the Postal Service lower markups when it

⁵ Docket No. R2000-1, Opinion and Recommended Decision, ¶ 4013.

⁶ National Association of Greeting Card Publishers v. United States Postal Service, 462 U.S. 810, 821, 103 S.Ct. 2717, 2725 (1983).

⁷ For example, in Docket No. R94-1 the Commission stated that “. . . witness Foster notes that there are signs the Postal Service has had difficulty maintaining its share of volume and revenue,” and that “[t]his decline is a sign of potential market deterioration and supports a below systemwide average rate increase.” See also, Docket No. R2000-1, Opinion and Recommended Decision, ¶ 5361 (“ . . . the Postal Service’s status as a competitor under 3622(b)(5) suggest[s] moderating Priority Mail’s contribution to institutional costs.”).

1 generates higher attributable costs in those subclasses where it faces competition. The
2 Postal Service will have less incentive to keep attributable costs under control if it
3 believes that those costs will not be fully passed on through higher rates, which may
4 reduce volume, but instead will be mitigated or eliminated through a reduced markup.
5 Such an approach is therefore likely to make the Postal Service less efficient.

6 Second, in any rate case there are a certain amount of institutional costs that
7 must be recovered through rates. Therefore, lower markups on competitive mail
8 subclasses necessarily require higher markups on monopoly subclasses. If competitive
9 markups are lowered to protect market share, then captive mailers will effectively be
10 penalized through higher markups as a result of the Postal Service's failure to operate
11 efficiently in competitive markets. This appears on its face to be unfair to mailers
12 constrained in their choices by the delivery monopoly, which conflicts with the first
13 ratemaking factor of a "fair and equitable" rate schedule. It also appears to conflict with
14 the fifth factor, which implies that the Commission should be diligent in protecting
15 mailers who have few alternatives, that is, those who are largely captive to the delivery
16 monopoly. Finally, it conflicts with the intent of Congress in creating an independent
17 Postal Rate Commission. The Senate Report on the Act suggests that Congress was
18 particularly concerned with avoiding unduly high rates for First Class mailers: "The
19 temptation to resolve the financial problems of the Post Office by charging the lion's
20 share of all operational costs to first class is strong; that's where the big money is. The
21 necessity for preventing that imposition upon the only class of mail which the general

1 public uses is one of the reasons why the Postal Rate Commission should be
2 independent of operating management.”⁸

3 Third, such an approach effectively penalizes competitors. It allows the Postal
4 Service to avoid markups for competitive services that would otherwise be reasonable
5 and thereby charge lower rates as a result of its unsuccessful attempts to compete. This
6 requires competitors to face a less efficient yet lower-priced government-owned firm.⁹
7 Notably, this effect is contrary to normal market processes: a firm must typically bear
8 the consequences of its own higher costs via higher prices and thus lost market share.
9 Competitors typically gain from another firm’s inefficiency through greater market share.
10 Here, competitors could still lose market share even if the Postal Service were to
11 become *less* efficient.

⁸ S. Rep. No. 91-912, 91st Cong., 2d Sess. (1970), at 13.

⁹ Competing against the Postal Service is also more difficult because of the special cost-reducing benefits it receives as a result of its status as a government-owned enterprise. In addition to its delivery and mailbox monopolies, it is not required to pay the same taxes and fees its competitors are required to pay, it receives privileged access to the U.S. Treasury through the Federal Financing Bank, and it is immune from antitrust scrutiny, among other benefits.

1 **IV. PRIORITY MAIL RATE RECOMMENDATION**

2 After careful consideration of the ratemaking factors in section 3622(b) of the Act,
3 the special circumstances surrounding the last two rate cases, and the undesirable
4 effects of excessively low cost coverages, I recommend a cost coverage for Priority Mail
5 of 163 percent, or a markup of 63 percent. This is the same markup that the Postal
6 Service recommends.¹⁰ It is also close to the markup of 62 percent recommended by
7 the Commission in Docket No. R2000-1, the last fully litigated rate case.¹¹ Using the
8 Commission's cost attribution methods, this results in an average rate increase for
9 Priority Mail of 23.6 percent. It translates into a markup index of 0.807.

10 **A. The Markup Index for Priority Mail Has**
11 **Declined Significantly Over Time.**

12 Cost coverages are a straightforward, useful tool for comparing relative
13 institutional cost burdens borne by mail classes or subclasses. The use of cost
14 coverage over time can be problematic, however, because changed circumstances
15 (such as changes in costs or attribution methodologies) may cause overall attribution
16 levels to change.¹² The Commission has therefore used a markup index to compare the
17 markup for each mail subclass to the systemwide average markup. A markup index of
18 one indicates that the markup for that mail subclass is the same as the systemwide
19 average markup. A markup index greater than one indicates that the class of mail has a
20 larger markup than the systemwide average; an index less than one shows that the
21 markup for the class is less than the systemwide average. The Commission has stated

¹⁰ USPS-T-31, p. 21.

¹¹ Docket No. R2000-1, Opinion and Recommended Decision, ¶ 5316.

¹² Docket No. R2001-1, Opinion and Recommended Decision Approving Stipulation and Agreement, ¶ 2058.

1 that the markup index “remains the most useful tool available for measuring relative
2 burdens over time.”¹³

3 I thus compare the markup index on Priority Mail with that of First Class Mail over
4 time. First Class Mail accounts for the largest share of revenue from mail for the Postal
5 Service.¹⁴ Additionally, the postal monopoly is likely to be the most binding for First
6 Class Mail users, so it is appropriate to be particularly concerned about the markup on
7 that mail class. Indeed, the Commission has articulated a goal of reducing the relative
8 burden on monopoly mail users.¹⁵ On the other hand, Priority Mail is largely a
9 competitive service.

10 Figure 1 displays the markup indices for First Class Mail and for Priority Mail
11 since Docket No, R84-1.¹⁶

12

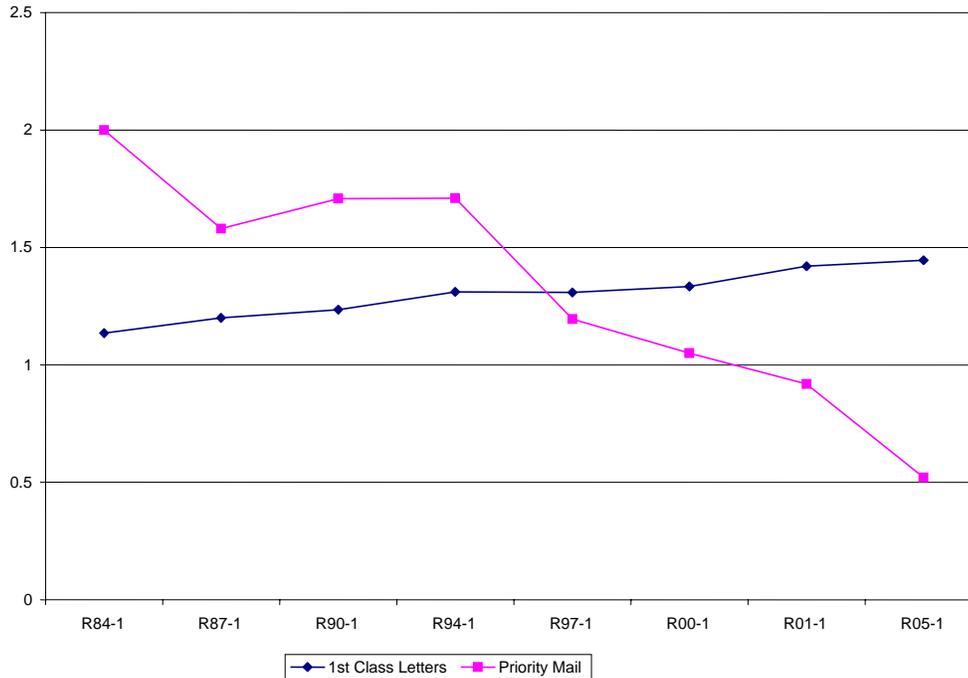
¹³ Ibid.

¹⁴ See 2005 United States Postal Service Annual Report, pp. 54-55 (First Class Mail accounted for about 54 percent of the Postal Service’s revenue from mail in 2005).

¹⁵ Docket No. R2000-1, Opinion and Recommended Decision, ¶ 4022.

¹⁶ See Docket No. R2005-1, Opinion and Recommended Decision, Appendix G, Schedule 3, p. 37 of 37.

Figure 1:
Markup Indices for First Class Letters and Priority Mail



1
2 As Figure 1 shows, the Priority Mail markup index has consistently and substantially
3 declined beginning with Docket No. R97-1. Prior to that case, the Commission always
4 assigned a markup on Priority Mail that resulted in an index exceeding 1.5, and above
5 the markup assigned to First Class Mail. The markup on Priority Mail fell below the First
6 Class Mail markup for the first time in Docket No. R97-1, and it fell below the
7 systemwide average for the first time in Docket No. R2001-1, a settled case. The
8 percent change in the markup index for Priority Mail between Docket No. R2005-1 and
9 Docket No. R2001-1 alone is *minus* 43.31 percent, the largest percentage decline in
10 history. The Priority Mail markup index resulting from the settlement in Docket No.
11 R2005-1 was 0.521. In other words, the markup on Priority Mail has now declined to
12 almost half the system-wide average markup.

1 One concern that such low Priority Mail markups raise relates to the impact of
2 Priority Mail rates on competition (section 3622(b)(4)). Given that the current Priority
3 Mail markup index is at only half of the systemwide average, the danger appears to be
4 rates that are excessively low, thus harming competitors. If rates do not cover their
5 attributable costs plus a reasonable portion of institutional costs, as required by section
6 3622(b)(3), then those rates run the risk of forcing a supplier that may be more efficient
7 in producing the service to inefficiently reduce its output, or may even drive it out of the
8 market.¹⁷

9 Since this low markup index is the result of two settled cases, the recent
10 substantial decline in the Priority Mail markup suggests that the Commission may wish
11 to consider a “truing-up” over time of the rate relationships resulting from those
12 settlements. My recommended markup would help achieve that.

13 **B. The Alternatives Available for Priority Mail**

14 The fifth ratemaking criterion to consider is “the available alternative means of
15 sending and receiving letters and other mail matter at reasonable costs.” As discussed
16 above, if there are a number of alternatives available for a particular mail class, then
17 higher rates are unlikely to impose as great a hardship on users of that mail class.
18 Users can more readily choose an alternative service if they find postal rates to be
19 onerous. Higher markups are thus more appropriate when users enjoy a variety of
20 alternatives.

¹⁷ The Commission has recognized, in the context of new products, that preventing entry of more-efficient producers is a source of concern. See Docket No. R97-1, Opinion and Recommended Decision, ¶ 4048.

1 Priority Mail operates in a highly competitive market.¹⁸ It faces competition from
2 UPS, Federal Express, DHL, and others, so Priority Mail users have a number of
3 alternatives from which to choose. Those alternatives have also become more
4 accessible to the general public in recent years.¹⁹ There is no need to fear undue
5 hardship on users if markups on Priority Mail are increased. Conversely, a Priority Mail
6 markup index substantially lower than the systemwide average runs counter to the fifth
7 ratemaking factor. It shifts a greater share of institutional costs to services where
8 consumers have fewer choices available to them.

9 **C. Priority Mail Provides a High-Value Service.**

10 The second factor for ratemaking is “the value of the mail service actually
11 provided each class or type of mail service to both the sender and the recipient,
12 including but not limited to the collection, mode of transportation, and priority of
13 delivery.” As Dr. O’Hara notes in his testimony, “Priority Mail clearly has a high intrinsic
14 value of service.”²⁰ It receives higher priority in processing and dispatch than First Class
15 Mail, and it utilizes air transport more intensively.²¹ It also offers Delivery Confirmation.²²

16 Moreover, recent Priority Mail volume history indicates that it provides sufficiently
17 high value to permit it to recover from a series of adverse events. Table 1 displays
18 Priority Mail volume from 1990 to the present. As shown in that table, Priority Mail
19 volume grew throughout the 1990s, suffered a decline starting in 2001, and, in 2005 and
20 2006, has returned to positive growth. Postal Service witness Scherer identifies several

¹⁸ USPS-T-33, p. 7.

¹⁹ USPS-T-33, p. 10.

²⁰ USPS-T-31, p. 21.

²¹ USPS-T-31, p. 21.

²² Domestic Mail Manual, § 503.9.2.2.

1 reasons for the decline, including the rate increases of 2001 and 2002, increased
 2 competition, and a slowing economy, among others; the anthrax attacks associated with
 3 September 11 can undoubtedly be added to the list.²³

4 **Table 1**
 5 **Priority Mail Volume History Since 1990**
 6 **(Millions of Pieces)²⁴**

| Fiscal Year | Volume | % Change from Year Before ²⁵ |
|-------------|--------|---|
| 1990 | 518 | 10% |
| 1991 | 530 | 2% |
| 1992 | 584 | 10% |
| 1993 | 664 | 14% |
| 1994 | 770 | 16% |
| 1995 | 869 | 13% |
| 1996 | 937 | 8% |
| 1997 | 1,068 | 14% |
| 1998 | 1,174 | 10% |
| 1999 | 1,189 | 1% |
| 2000 | 1,222 | 3% |
| 2001 | 1,117 | -9% |
| 2002 | 998 | -11% |
| 2003 | 860 | -14% |
| 2004 | 849 | -1% |
| 2005 | 887 | 5% |
| 2006Q1 | 249 | 4% |
| 2006Q2 | 241 | 10% |
| 2006Q3 | 221 | 1% |

7
 8 These recent volume improvements indicate that whatever Priority Mail's
 9 perceived service performance may be, it has a sufficiently high value that its volume
 10 can recover from a series of unfavorable events and rate increases. The rate increases

²³ USPS-T-33, p. 10. Postal Service witness Thress also notes that overnight delivery services were severely adversely affected by the September 11 terrorist attacks, since air traffic was banned for several days. USPS-T-7, p. 142. To the extent that Priority Mail relies on air transport, it was likely affected directly by the attacks.

²⁴ USPS-T-33, p. 9, Table 1; Preliminary Revenue, Pieces, and Weight by Classes of Mail and Special Services for Quarters 1, 2 and 3 Fiscal Year 2006 Compared with the Corresponding Periods of Fiscal Year 2005.

²⁵ Quarterly data represent the percentage change relative to the same quarter in the previous year.

1 in Docket Nos. R2000-1 and R2001-1 together increased Priority Mail rates by over 30
2 percent, and Docket No. R2005-1 increased rates a further 5.4 percent. Yet volume
3 rose 5 percent in 2005, and it continues to grow in 2006.²⁶

4 All of these considerations suggest that Priority Mail actually provides high value
5 to users. Based on section 3622(b)(2) of the Act, it is appropriate to assign a markup to
6 Priority Mail that results in a markup index above the systemwide average. Although my
7 recommended markup for Priority Mail would not achieve that level at this time, it would
8 move markups and cost coverages in the right direction.

9 **D. The Implications for Priority Mail of Recent**
10 **Markup Improvements for Express Mail**

11 While I do not provide a recommendation for Express Mail, an examination of
12 Express Mail's markups and markup indices over time provides insight into the
13 appropriate markup for Priority Mail.

14 Express Mail is the Postal Service's premium service. Postal Service Witness
15 Berkeley describes some of the features associated with Express Mail which give the
16 product its high value.²⁷ Express mail offers, among other features:

- 17 • Expedited overnight delivery
- 18 • Second-day guaranteed delivery
- 19 • Specially marked envelopes and boxes, including the "flat-rate" envelope
- 20 • Proof of delivery information
- 21 • Document reconstruction insurance against loss, damage or rifling

²⁶ Mr. Thress also notes the recent recovery in Priority Mail volumes, referring to a new period in the product's volume history, stating that "[t]he final period of Priority Mail volume history is the current period, which saw Priority Mail volume grow 3.4 percent per adult from 2004 to 2005." USPS-T-7, p. 156.

²⁷ USPS-T-34, pp. 3-5.

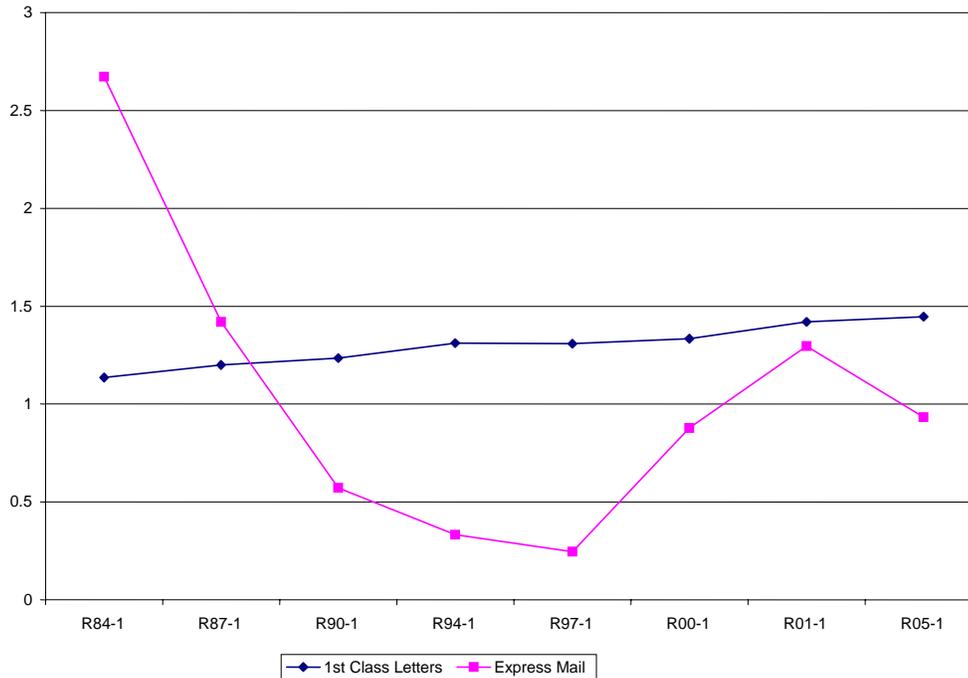
- 1 • Merchandise insurance against loss, damage or rifling
- 2 • The option of establishing a corporate account

3 These valuable features suggest that a high cost coverage and markup index are
4 appropriate. Additionally, there are a variety of alternatives available for Express Mail,
5 including those offered by UPS, Federal Express, DHL, and others. Thus, consumers
6 have other choices if they believe Express Mail rates are higher than they want to pay.

7 I display markup indices for First Class Mail and Express Mail in Figure 2.²⁸ The
8 Express Mail markup index fell continuously from Docket No. R84-1 (when it was 2.673)
9 to a low in Docket No. R97-1 of 0.245. This is similar to the extended decline in the
10 Priority Mail index. Unlike the Priority Mail index, however, the Express Mail index
11 shows a general increase since Docket No. R97-1. The increase in the Express Mail
12 index between Docket Nos. R2001-1 and R97-1 was over 400 percent. Indeed, the
13 index exceeded the systemwide average in Docket No. R2001-1 and was close to that
14 of First Class Mail at that time. Unfortunately, the index again fell below the systemwide
15 average as a result of the across-the-board rate increase in Docket No. R2005-1.

²⁸ Docket No. R2005-1, Opinion and Recommended Decision, Appendix G, Schedule 3, p. 37 of 37.

**Figure 2:
Markup Indices For First Class Letters and Express Mail**



1

2 The general increase in Express Mail's markup since Docket No. R97-1 is
3 laudable and instructive. It indicates that an improvement in markups for a competitive
4 mail class is feasible and appropriate. However, the correct markup index for Express
5 Mail should be significantly above the systemwide average. The general positive trend
6 illustrated above should be continued until that goal is achieved. It is also instructive for
7 considering markups in other competitive mail classes.

8 **E. The Markup Index on Priority Mail Should**
9 **Exceed the Systemwide Average.**

10 The high value provided by Priority Mail combined with the ability of users to
11 move to alternative suppliers imply that the final step in the realignment of rates over
12 time would be to apply a markup on Priority Mail that results in a markup index above
13 the systemwide average. However, given the severe deterioration in the markup since

1 the last fully litigated case, it may not be feasible to restore that relationship in one rate
2 case.

3 The realignment of these rate relationships is best viewed as a process.

4 Therefore, I recommend adopting the Postal Service's proposed markup of 63 percent
5 as a first step only. An intermediate step would be to raise Priority Mail's markup to
6 produce an index at the systemwide average, just below that of the last fully-litigated
7 rate case. Doing so in this case would require a markup of approximately 78 percent. In
8 the longer term, the robust volumes, the array of alternatives, the improving accessibility
9 of those alternatives, and the substantial value provided by Priority Mail imply that its
10 markup index should exceed the systemwide average.

1 **V. PARCEL POST RATE RECOMMENDATION**

2 After careful consideration of the ratemaking factors in section 3622(b) of the Act,
3 I recommend a cost coverage of 115 percent for Parcel Post. This is essentially the
4 same coverage that the Commission recommended for Parcel Post in Docket No.
5 R2000-1, a coverage that is presumptively reasonable.²⁹ It is also identical to the Postal
6 Service's recommended cost coverage in this case.³⁰ It results in an average rate
7 increase for Parcel Post of 15.1 percent, and a markup index of 0.192.

8 **A. The Alternatives Available for Parcel Post**

9 Like Priority Mail and Express Mail, Parcel Post is a highly competitive service. It
10 faces competition from a variety of private firms, including UPS, Federal Express, and
11 DHL. The fifth ratemaking factor therefore supports a reasonable markup on Parcel
12 Post. Given the large number of alternatives available for Parcel Post and the recent
13 increased accessibility of the public to those services,³¹ my recommended markup of 15
14 percent is unlikely to burden customers. Additionally, Parcel Post is mainly used by
15 businesses, so individual mailers are less likely to be significantly impacted by a rate
16 increase.³²

17 **B. The Changing Intrinsic Value of Parcel Post**

18 Parcel Post has traditionally been viewed as a lower value service. However,
19 there have been a number of relatively recent changes to Parcel Post service that
20 increase its value. These value-increasing changes indicate that an improvement in cost
21 coverage is justified.

²⁹ Docket No. R2005-1, Opinion and Recommended Decision, Appendix G, Schedule 3, p. 36 of 37.

³⁰ USPS-T-37, p. 3.

³¹ See USPS-T-33, p. 10.

1 Parcel Post contains multiple rate categories. There are two retail categories
2 (Intra- BMC and Inter-BMC) and three drop-ship categories (DBMC, DSCF, and DDU).
3 These drop-ship categories are known collectively as Parcel Select. Although Parcel
4 Post volume displayed a decline soon after postal reorganization in 1970 that extended
5 into the 1980s, there was a resurgence in the 1990s that has continued into this
6 decade.³³ Parcel Post volume in 2005 was about 388 million pieces, which is the
7 highest volume in thirty years.³⁴ This volume growth has been attributed to the
8 introduction of Parcel Select.³⁵ Parcel Select now accounts for over 70 percent of total
9 Parcel Post volume.³⁶ Over 50 percent of Parcel Post volume is entered at the
10 Destination Delivery Unit.³⁷ Additionally, the Postal Service's website indicates that, for
11 the most recent quarter, 96 percent of Parcel Select shipments arrive on time.³⁸

12 Parcel Select is not the only value-increasing feature that has recently been
13 added to Parcel Post. Since Docket No. R2000-1, the Postal Service has added a new
14 feature called Carrier Pickup.³⁹ Carrier Pickup allows customers, for no extra charge, to
15 contact the Postal Service via telephone or the Internet and request that a package be
16 picked up at the time of the next day's delivery. There is no limit to the number of

³² USPS-T-37, p. 1, fn. 1; Tr. 8/2162-63.

³³ USPS-LR-L-74.

³⁴ USPS-LR-L-74.

³⁵ USPS-T-37, p. 4.

³⁶ Ibid.

³⁷ Tr. 8/2182.

³⁸ <http://www.usps.com/serviceperformance/welcome.htm>; see Docket No. R2006-1, Tr. 8/2172-73.

³⁹ See http://www.usps.com/news/link/2204jan30_1.htm.

1 packages that can be sent via Carrier Pickup.⁴⁰ (As in the case of other services,
2 customers may receive same-day pickup for a charge of \$12.50.)

3 The Postal Service has also added a new rate category within Parcel Post called
4 "Parcel Return Service."⁴¹ This service allows Parcel Post customers to use a pre-paid
5 return label to return unwanted items to the retailer.⁴² It allows the retailer to pay the
6 postage and facilitates the return of merchandise, which should improve customer
7 satisfaction. This service is likely to increase in value as more purchases are made from
8 online companies.

9 Rising volume combined with these popular new features suggests that Parcel
10 Post's value is rising. Therefore, the markup for Parcel Post should rise over time from
11 its recent low levels to reflect its improving value. However, in the interim, it should at
12 least return to the level adopted in the last fully litigated rate case. The proposed
13 markup would help to restore Parcel Post's markup to the appropriate level, given its
14 numerous alternatives, valuable new features, and volume history.

⁴⁰ "Don't Fight Mother Nature this Holiday Season," U.S. Postal Service media release No. 05-102, November 28, 2005.

⁴¹ See Docket No. MC2006-1, Opinion and Recommended Decision Approving Stipulation and Agreement.

⁴² Docket No. MC2006-1, Opinion and Recommended Decision Approving Stipulation and Agreement, p. 3.

1 **VI. SUMMARY AND CONCLUSION**

2 This case is atypical in important ways. It is the first fully litigated rate case since
3 Docket No. R2000-1. The passage of time and the two rate case settlements have
4 allowed cost coverages across mail classes to become misaligned. This case presents
5 the Commission with an opportunity to adjust cost coverages in an appropriate
6 direction. I recommend cost coverages that would help achieve that adjustment.

7 The 163 percent cost coverage that I recommend for Priority Mail stems from a
8 straightforward application of the ratemaking factors in section 3622(b). The markup
9 index for Priority Mail has declined precipitously over time, and this mail subclass is now
10 contributing far less than the systemwide average. That is unfortunate because Priority
11 Mail is a high-value service, has many alternatives, and has recently displayed robust
12 volume growth. My recommendation would move Priority Mail markups in the right
13 direction. My discussion of Express Mail markups suggests that a markup increase for a
14 competitive mail class like Priority Mail can be achieved.

15 I recommend a cost coverage of 115 percent for Parcel Post. There are many
16 alternatives for Parcel Post, and a number of new service features have increased its
17 value. The historically low cost coverage provided by this subclass is no longer
18 appropriate. My recommended cost coverage is presumptively reasonable, and would
19 move Parcel Post's cost coverage in the appropriate direction.

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PEER REVIEWED PUBLICATIONS

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Consultant to the Defense Business Board, Task Group on the Military Postal System, 2006.
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Consultant to the Australian Price Surveillance Authority, regarding the application of the Price Surveillance Act to BHP Steel, Inc., 1995.
Consultant to Schnader, Harrison, Segal & Lewis, Philadelphia, Pennsylvania, on Postal Rate Case R-94. Submitted written testimony to and testified before the Postal Rate Commission, on behalf of United Parcel Service, 1995.

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- Self-Ownership and the Rights of Women.* Meetings of the Economic History Association, New Brunswick, New Jersey.
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- Electricity Regulation: Consumers and Competition.* Center for Market Processes' Congressional Administrative Assistant Winter Retreat, Baltimore Maryland.
- Electricity Restructuring.* Center for Market Processes' Seminar for Congressional Staff Canon House Office Building, Washington, DC.

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