

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

Postal Rate and Fee Changes, 2006

Docket No. R2006-1

DIRECT TESTIMONY OF J. GREGORY SIDAK
ON BEHALF OF
THE NEWSPAPER ASSOCIATION OF AMERICA

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1 Since 2002, I have been a member of the U.S. Advisory Board for NTT
2 DoCoMo, Japan's largest wireless telecommunications company. In that capacity I
3 meet twice annually with DoCoMo's chairman to discuss global developments in
4 regulation relevant to DoCoMo's businesses.

5 I have written or edited numerous books. Two of my books specifically concern
6 postal regulation. With Daniel F. Spulber, I am co-author of *Protecting Competition*
7 *from the Postal Monopoly* (AEI Press 1996). I am the editor of *Governing the Postal*
8 *Service* (AEI Press 1994). My other books also concern regulation and competition in
9 network industries.¹ I have published approximately seventy scholarly articles in
10 journals including the *American Economic Association Papers and Proceedings*,
11 *Antitrust Law Journal*, *California Law Review*, *Columbia Law Review*, *Harvard*
12 *International Law Journal*, *Journal of Competition Law & Economics*, *Journal of*
13 *Network Industries*, *Journal of Political Economy*, *New York University Law Review*,
14 *Review of Industrial Organization*, *Stanford Law Review*, *Supreme Court Economic*
15 *Review*, *University of Chicago Law Review*, *Yale Law Journal*, and *Yale Journal on*
16 *Regulation*, as well as opinion essays in the *New York Times*, *Wall Street Journal*,

¹ DAN MALDOOM, RICHARD MARSDEN, J. GREGORY SIDAK & HAL J. SINGER, *BROADBAND IN EUROPE: HOW BRUSSELS CAN WIRE THE INFORMATION SOCIETY* (Springer 2005); J. GREGORY SIDAK, *FOREIGN INVESTMENT IN AMERICAN TELECOMMUNICATIONS* (University of Chicago Press 1997); J. GREGORY SIDAK & DANIEL F. SPULBER, *DEREGULATORY TAKINGS AND THE REGULATORY CONTRACT: THE COMPETITIVE TRANSFORMATION OF NETWORK INDUSTRIES IN THE UNITED STATES* (Cambridge University Press 1997); WILLIAM J. BAUMOL & J. GREGORY SIDAK, *TOWARD COMPETITION IN LOCAL TELEPHONY* (MIT Press 1994); J. BAUMOL & J. GREGORY SIDAK, *TRANSMISSION PRICING AND STRANDED COSTS IN THE ELECTRIC POWER INDUSTRY* (AEI Press 1995). I am the co-editor of *COMPETITION AND REGULATION IN TELECOMMUNICATIONS: EXAMINING GERMANY AND AMERICA* (Kluwer Academic Press 2000), and editor of *IS THE TELECOMMUNICATIONS ACT OF 1996 BROKEN? If SO, HOW CAN WE FIX IT?* (AEI Press 1999).

1 and other business periodicals. A number of my articles specifically address postal
2 regulation.²

3 I have testified before committees of the U.S. Senate and House of
4 Representatives. My writings on antitrust, regulation, and constitutional law have
5 been cited by the Supreme Court of the United States, the lower federal and state
6 supreme courts, state and federal regulatory commissions, the Supreme Court of
7 Canada, and the European Commission. In *United States v. Microsoft Corporation*
8 (2001), my article “Antitrust Divestiture in Network Industries” was quoted by the
9 U.S. Court of Appeals for the District of Columbia Circuit. In *Verizon*
10 *Communications Inc. v. FCC*, decided by the Supreme Court in May 2002, both the
11 majority and dissenting opinions quoted my writings on telecommunications
12 regulation. In *Case COMP/35.141—Deutsche Post AG*, decided in March 2001, the
13 European Commission quoted my writings with Professors Baumol and Spulber on
14 the relevance of common costs and universal service obligations to the proper
15 calculation of a predatory pricing floor for a regulated multiproduct firm, Deutsche
16 Post.

² John C. Panzar & J. Gregory Sidak, *When Does an Optional Tariff Not Lead to a Pareto Improvement? The Ambiguous Effects of Self-Selecting Nonlinear Pricing When Demand Is Interdependent or Firms Do Not Maximize Profit*, 2 J. COMPETITION L. & ECON. 285 (2006); Damien Geradin & J. Gregory Sidak, *The Future of the Postal Monopoly: American and European Perspectives After the Presidential Commission and Flamingo Industries*, 28 WORLD COMPETITION 163 (2005); David E. M. Sappington & J. Gregory Sidak, *Competition Law for State-Owned Enterprises*, 71 ANTITRUST L.J. 479 (2003); David E. M. Sappington & J. Gregory Sidak, *Are Public Enterprises the Only Credible Predators?*, 67 U. CHI. L. REV. 271 (2000); Daniel F. Spulber & J. Gregory Sidak, *Monopoly and the Mandate of Canada Post*, 14 YALE J. ON REG. 1 (1997); William J. Baumol & J. Gregory Sidak, *The Pricing of Inputs Sold to Competitors*, 11 YALE J. ON REG. 171 (1994).

1 I earned A.B. (1977) and A.M. (1981) degrees in economics and a J.D. (1981),
2 all from Stanford University. I was a member of the *Stanford Law Review*. Following
3 law school, I clerked for Judge Richard A. Posner during the judge's first term on the
4 U.S. Court of Appeals for the Seventh Circuit.

5 This is my first appearance as a witness before the Postal Rate Commission.
6 I have, however, submitted an expert report to the Presidential Commission on the
7 United States Postal Service, as well as an economic report to the Canada Post
8 Corporation Mandate Review Committee.

9 I have given live expert testimony before state public utilities commissions in
10 Indiana, Iowa, Kentucky, Minnesota, New Jersey, New Mexico, Ohio, Pennsylvania,
11 and Texas. I have given live expert testimony before the Federal Energy Regulatory
12 Commission, and I have submitted numerous declarations and affidavits to the
13 Federal Communications Commission. I have testified or submitted expert reports in
14 several U.S. district courts and in the U.S. Court of Federal Claims. I have submitted
15 expert reports in state trial courts in New York and California. I have testified before
16 committees of the U.S. Senate and House of Representatives on regulatory and
17 constitutional law matters.

18 In foreign proceedings, I have filed testimony or expert reports with the
19 Australian Competition and Consumer Commission, the Canadian Radio-television
20 and Telecommunications Commission, the Competition Bureau (Canada), the
21 Commission for Communications Regulation (Ireland), the Competition Directorate
22 of the European Commission, the Court of First Instance of the High Court of the

1 Hong Kong Special Administrative Region, the High Court of the Republic of Ireland,
2 the Office of the Director of Telecommunications Regulation (Ireland), and the Office
3 of Telecommunications Authority (Hong Kong). I have submitted an expert report
4 (under seal) to the London Court of International Arbitration and an expert report and
5 live cross-examination testimony (under seal) to the International Court of Arbitration
6 of the International Chamber of Commerce in The Hague. In addition to submitting
7 testimony to these courts, arbitral bodies, and regulatory agencies, I have submitted
8 an opinion of law to the Australian Parliament and an expert economic report to the
9 Australian Minister for Communications, the Information Economy, and the Arts.

10 I am testifying on behalf of the Newspaper Association of America. The views
11 that I present are my own and not those of Georgetown University Law Center,
12 which does not take institutional positions on specific legislative, regulatory,
13 adjudicatory, or executive matters.

14 My testimony concerns the application of efficient component pricing (ECP)
15 principles to postal discounts for worksharing and the applicability of ECP to the
16 determination of shape-based rates. Furthermore, I examine the proposed
17 surcharge on Detachable Address Labels (DALs) for saturation Enhanced Carrier
18 Route (ECR) mail and explain why, in the absence of a formal cost analysis, the
19 proposed surcharge could be considered a premium charge or, alternatively, an
20 optional rate element, for the DAL.

21 My testimony should be read in conjunction with the testimony of Dr. Allan T.
22 Ingraham (NAA-T-2), who proposes alternative rate designs for Standard Enhanced

1 Carrier Route mail consistent with the principles that I present. The Commission
2 should give his testimony serious consideration and adopt his approach.

3 **I. THE APPLICATION OF EFFICIENT COMPONENT PRICING TO POSTAL RATES**

4 In Notices of Inquiry (NOI) 2 and 3, the PRC invited comment on the proper
5 setting of worksharing discounts, efficient component pricing, and shape-based rate
6 distinctions. In this part of my testimony, I explain why it is appropriate to use ECP to
7 calculate postal worksharing discounts, as does Dr. Allan Ingraham in his
8 companion testimony (NAA-T-2). I then explain why ECP, in general, is not
9 applicable to the determination of shape-based postal rates (and Dr. Ingraham does
10 not use ECP for that purpose).

11 **A. It Is Appropriate to Use Efficient Component Pricing to Set Postal**
12 **Worksharing Discounts**

13 The USPS worksharing program allows for third parties and customers to
14 insert bulk mailings at postal facilities such as processing centers and delivery units.
15 This self-supply of certain postal processing and transportation functions by mail
16 customers reduces USPS mail costs and, when correctly priced, will increase overall
17 economic welfare. The USPS, however, holds a statutory monopoly on the delivery
18 of letter mail.³ Therefore, the worksharing program can be viewed as carving out
19 certain competitive activities from the mail monopoly.

³ 18 U.S.C. § 1725.

1 ECP is a general theory of access pricing for regulated markets that was first
2 developed by Professors Robert D. Willig and William J. Baumol. ECP provides a
3 framework for determining the efficient compensation for a competitor to pay to a
4 vertically integrated monopolist for access to the monopolist's bottleneck input(s).⁴
5 Consequently, ECP is a suitable methodology to calculate worksharing discounts.
6 Economists such as Professor John C. Panzar have explained how the pricing of
7 worksharing discounts corresponds to the ECP framework.⁵

8 When applied to postal ratemaking, the ECP inquiry poses the following
9 question: What rate should a mailer pay the Postal Service for entering workshared
10 mail into the postal system for ultimate delivery, given that the delivery function is the
11 Postal Service's monopoly input? As I shall explain, under ECP that access rate is
12 the full postal rate, minus the worksharing discount set at 100 percent of estimated
13 avoided costs.

⁴ See Robert D. Willig, *The Theory of Network Access Pricing*, in ISSUES IN PUBLIC UTILITY REGULATION (H. M. Trebing ed., Michigan State Press Utility Papers 1979); William J. Baumol, *Some Subtle Issues in Railroad Regulation*, 10 INT'L J. TRANSP. ECON. 341 (1983). For subsequent exposition of the efficient component-pricing rule (ECPR), see William J. Baumol & J. Gregory Sidak, *The Pricing of Inputs Sold to Competitors*, 11 YALE J. ON REG. 171, 187-89 (1994); WILLIAM J. BAUMOL & J. GREGORY SIDAK, TOWARD COMPETITION IN LOCAL TELEPHONY 105-107 (MIT Press & AEI Press 1994). See also SIDAK & SPULBER, *supra* note 1, at 283-87; JEAN-JACQUES LAFFONT & JEAN TIROLE, COMPETITION IN TELECOMMUNICATIONS at 23, 119-122 (MIT Press 2000).

⁵ See John C. Panzar, *The Economics of Mail Delivery*, in PROTECTING COMPETITION FROM THE POSTAL MONOPOLY 1, 6-10 (J. Gregory Sidak, ed., AEI Press 1996); John C. Panzar, *Clean Mail and Dirty Mail: Efficient Work-sharing Discounts in the Presence of Mail Heterogeneity* (2006), presented at the 14th CRRJ Conference on Postal and Delivery Economics, Bern, Switzerland (June 1, 2006).

1 The ECP rule specifies that “the price of an input should equal its average
2 incremental cost, including all pertinent incremental opportunity costs.”⁶ In other
3 words, under ECP the per-unit access price of an input supplied by a monopoly is
4 equal to the direct average incremental cost of supplying a unit of the monopoly
5 input plus the monopolist’s opportunity cost when it forgoes the sale of a single unit
6 of the final good in question.⁷ If the monopolist is a regulated firm subject to a break-
7 even (zero profit) constraint, the opportunity cost component of the ECP consists of
8 the forgone contribution that the sale of one unit of the final product would make to
9 the monopolist’s recovery of its common (institutional) costs.

10 The Private Express Statutes give the Postal Service a legal monopoly over
11 the delivery of the great majority of items in the postal system. In ECP terms, the
12 Postal Service is the sole supplier of the input of “delivery” of a piece of mail.
13 However, the Postal Service faces competition in the processing (presortation,
14 barcoding) and transportation (destination entry) parts of the process. So when the
15 Postal Service “allows” access to its delivery network for such workshared mail, the
16 price of that access (the postage paid) should recover the costs of the delivery
17 network *as well as* the opportunity cost of the Postal Service’s not providing the
18 workshared activity. In postal ratemaking, this opportunity cost is what the Postal

⁶ See SIDAK & SPULBER, *supra* note 1, at 286. Professor Armen Alchian is credited with having supplied the classic definition of opportunity cost: “the cost of an event is the highest-valued opportunity necessarily forsaken.” Armen A. Alchian, *Cost*, in David L. Sills, ed., 3 INTERNATIONAL ENCYCLOPEDIA OF THE SOCIAL SCIENCES 404 (Macmillan Co. & The Free Press 1968).

⁷ SIDAK & SPULBER, *supra* note 1, at 267.

1 Service would have earned towards the recovery of overhead had it provided the
2 workshared service (and thus the full retail service) instead of the mailer.

3 This result obtains because the “final product” in the ECP framework, is the
4 end-to-end handling of the mail piece—the entirety of collection, processing,
5 transportation, and delivery—which is what is reflected in the rate. I will call this final
6 product the “retail” service.

7 Setting the pass-through at 100 percent of avoided costs allows the Postal
8 Service to recover its opportunity costs. When a workshare discount equals the
9 avoided costs, but leaves the contribution to institutional costs from that piece
10 unaffected, the Postal Service should be indifferent as to whether it or the mailer
11 performs the function. In either case, the Postal Service will still recover its
12 opportunity cost. In effect, the Postal Service recovers its entire institutional cost
13 through the rates it charges for the delivery function.

14 My understanding of postal ratemaking practice as it has evolved over the
15 years is that the Commission has recognized that economic efficiency is served by
16 accurate pricing signals for each identified worksharing activity (for example,
17 presortation and dropshipping). This recognition enables the work to be done by the
18 lowest-cost provider, whether that is the Postal Service, the mailer, or a third-party
19 service vendor to the mailer. To promote such efficiency, the Commission has
20 applied ECP in setting discounts for worksharing such as presortation and
21 destination entry at, ideally, 100 percent of the estimated avoided cost of the activity
22 whose performance the Postal Service avoids. This correct application of ECP

1 advances economic efficiency by providing accurate pricing signals to mailers and
2 the Postal Service.⁸

3 Under ECP, accurately measured costs avoided would be passed through at
4 a rate of 100 percent to each particular category of mail responsible for those costs
5 avoided. In this manner, each category of mail would be charged only its incremental
6 costs, and the USPS would achieve break-even pricing.⁹ A deviation of pass-through
7 rates from 100 percent would result in postal rates that are inconsistent with the
8 general principles of ECP. In particular, a pass-through rate less than 100 percent
9 would result in a workshared mailer paying rates that exceed the incremental costs
10 of the particular category of mail used. It would violate ECP because the Postal
11 Service would receive more than the opportunity cost it would forgo in not providing
12 the workshared service, as that opportunity cost is already fully recovered in the
13 access charge—which is in effect the delivery charge plus a portion of overhead
14 costs.¹⁰

⁸ The cost avoided by worksharing is not the same as the incremental cost of a particular category of mail. Incremental cost is the difference in total costs that the Postal Service would incur with and without the production of a given category of mail. I understand that this cost concept is called, in postal ratemaking, product incremental cost. This cost difference will capture the effect of other cost drivers besides those associated with worksharing.

⁹ By statute, the USPS is directed to charge rates that enable it to break even. 39 U.S.C. § 3621. Furthermore, I understand that the Postal Service and the Postal Rate Commission have interpreted 39 U.S.C. § 3622(b)(3) to require that the revenue of any given subclass of mail be sufficient to cover its incremental costs.

¹⁰ From an economic perspective on ratemaking, a pass-through to a worksharing discount of other than 100 percent of avoided costs would discourage efficient use of worksharing by giving inaccurate pricing signals. However, this economic consideration is distinct from the principle of ECP, which strictly speaking applies to the pricing of access by competitors to a monopoly network.

1 Alternatively, pass-through rates exceeding 100 percent would be consistent
2 with workshared mailers paying rates that are less than the incremental costs of the
3 category of mail in question. That result would result in inefficient provision of
4 worksharing by mailers. In economic terms, a pass-through of more than 100
5 percent would underprice access to the Postal Service's delivery network because
6 the pass-through includes not only avoided costs but also some opportunity costs
7 (revenues) that the Postal Service would have received had it provided the
8 workshared service instead of the mailer.

9 **B. Efficient Component Pricing Is Generally Not Applicable to Shape-**
10 **Based Rates**

11 As stated above, ECP can be used to price access paid by competitors to a
12 monopolist that supplies a good needed in the production process of each
13 competitor. It is my understanding, however, that shape-based cost differences
14 generally do not stem from the type of competition that generates workshared mail
15 discounts. That is, shape-based cost differences occur because mail of different
16 shapes incur different costs when undergoing mail processing, transportation, and
17 delivery. Furthermore, when shape-based cost differences exist, the mail that cause
18 those cost differences are rarely transported together.

19 Because different mail shapes do not generate costs avoided for the USPS,
20 as does workshared mail, ECP is not an appropriate concept to use in calculating
21 shape-based rates in the same manner that would be used to determine
22 worksharing discounts. Although the choice of the shape of a mail piece might be

1 considered “optional” in some sense, it is not a choice between the mailer or the
2 Postal Service performing a particular function in the type of scenario to which ECP
3 is intended to apply.

4 **II. THE CORRECT INTERPRETATION OF THE PROPOSED SURCHARGE** 5 **ON DETACHED ADDRESS LABELS**

6 In this rate case, the USPS has proposed a surcharge for the use of
7 Detached Address Labels (DALs) in Standard Enhanced Carrier Route (ECR) mail.
8 Specifically, witness Kiefer has proposed a DAL surcharge of 1.5 cents per DAL.
9 Unlike the case of worksharing, however, the Postal Service has not supported this
10 proposed DAL surcharge with an analysis that specifically calculates the incremental
11 cost of DAL, although it has provided some data concerning DAL costs (as
12 discussed by Dr. Ingraham).

13 Consequently, there are several ways to consider the proposed DAL
14 surcharge. First, it can, at least in part, be considered a premium charge for an
15 optional service—a charge that has precedent within postal rates. Alternatively, it
16 may be considered simply an optional rate element available to ECR saturation
17 mailers that wish to use it where it is known that the use of that option imposes some
18 costs (although the amount of such costs may not be known with precision). In
19 neither case, however, would the surcharge have to be particularly cost-based in
20 order to achieve the Postal Service’s objective.

1 **A. The Economic Rationale for, and Value of, Detached Address Labels**

2 The testimony of USPS witness Coombs describes the historic rationale for
3 DAL and further explains why that rationale is no longer relevant to DAL:

4 [T]he historical rationale for the extension of the DAL option to ECR
5 saturation flats was based on the belief that, without a DAL, carriers
6 would constantly have to case the sequenced flat host pieces
7 manually. Having to case the host flat pieces would be logistically
8 more challenging than simply casing the letter-shaped DAL cards.
9 The critical assumption is that the presence of the DAL requires
10 different handling from what would apply without the DAL. This
11 assumption is not necessarily true in the current delivery operations
12 environment. Experience in today's delivery units suggests that the
13 sequenced flat-shaped pieces will be taken directly to the street in
14 most cases. This tends to validate the belief that the handling of
15 these flat-shaped pieces is unaffected by the presence or absence
16 of a DAL.¹¹

17 Witness Coombs' statement indicates that although DALs were, at one time,
18 considered a cost-saving method of casing ECR saturation flats, the current and
19 continued use of DALs frustrates the Postal Service's goal of eliminating manual
20 casing.¹² Her testimony goes on to say that DALs are no longer needed in today's
21 operational environment.

22 Witnesses Coombs¹³ and Kiefer¹⁴ both stated that the continued use of DALs
23 is inconsistent with the Postal Service's long-term efficiency goals. Although I am not
24 an expert in USPS delivery procedures, I will treat their testimony as a given that the

¹¹ Testimony of J. Coombs, USPS-T-44, on behalf of the U.S. Postal Serv., before the Postal Rate Commission, Postal Rate and Fee Changes, Dkt. No. R2006-1, at 12-13.

¹² *Id.* at 12.

¹³ *Id.*

¹⁴ Testimony of J. Kiefer, USPS-T-36, on behalf of the U.S. Postal Serv., before the Postal Rate Commission, Postal Rate and Fee Changes, Dkt. No. R2006-1, at 32.

1 Postal Service prefers to discourage the use of DALs in the future. I also understand
2 that USPS witness Kelley has estimated that DALs impose Base Year costs on the
3 Postal Service of approximately \$165 million,¹⁵ which indicates that this optional
4 form of address is not costless to the Postal Service.

5 Although witness Coombs' testimony states that the use of DALs is
6 inconsistent with the Postal Service's long-term goals, the continued use of DALs by
7 ECR saturation mailers indicates that it still has value to mailers. This value likely
8 stems from two sources. First, DALs are often imprinted with advertisements or
9 notices, which presumably offer some value to mailers at least as a means of
10 helping to offset the cost. Second, it is my understanding that the use of DALs allows
11 the mailer more flexibility in the preparation of saturation flats mailings. In particular,
12 the DAL allows the mailer to insert additional advertising into the host piece flats at a
13 later time than would be possible were the mailer to use on-piece labeling. In other
14 words, the DAL confers an option on the mailer, and options—whether they are
15 financial options or real options—obviously are recognized to have considerable
16 economic value.¹⁶

¹⁵ Testimony of J. Kelley, USPS-T-30, on behalf of the U.S. Postal Serv., before the Postal Rate Commission, Postal Rate and Fee Changes, Dkt. No. R2006-1, at 11.

¹⁶ On real options, see RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 518-21 (McGraw-Hill, 4th ed. 1991); AVINASH K. DIXIT & ROBERT S. PINDYCK, INVESTMENT UNDER UNCERTAINTY (Princeton University Press 1994).

1 **B. Pricing Considerations for a DAL Surcharge**

2 DALs are an optional means by which the mailer supplies the address. The
3 Postal Service has submitted evidence that DALs impose costs. However, to my
4 knowledge, no USPS witness offered testimony that clearly quantified the marginal
5 cost of DALs on a per-unit basis, or the net incremental cost effect of some large
6 portion of the approximately 4 billion DALs converting to on-piece addressing.
7 Furthermore, witness Kiefer did not cite any cost analysis of DALs when proposing
8 his DAL surcharge. Hence, it does not appear that the Postal Service is contending
9 that the particular level of the proposed DAL surcharge is based on evidence of the
10 incremental cost of DALs.

11 This absence of a cost justification for the proposal invites the following
12 question: On what grounds other than incremental cost should the DAL surcharge
13 be set? The answer to this question, in turn, may affect the optimal amount of the
14 surcharge.

15 Some precedent in postal ratemaking exists for rate setting when no
16 particular cost analysis is available. In Docket No. MC2004-5, the USPS proposed
17 rates for repositionable notes (RPN) that were based on the value created for the
18 mailer, rather than cost analysis. Specifically, USPS witness Kaneer testified that

19 [t]he value of an RPN attachment is over and above the value
20 implied in the price of the mail piece alone. This added value should
21 be separately recognized and will further contribute to the overall
22 cost recovery of the relevant class of mail. The RPN classifications
23 and rates, discussed below, for First-Class Mail, Standard Mail, and

1 Periodicals reflect the value of RPN and provide an effective way to
2 garner revenue reflective of that value.¹⁷

3 Furthermore, witness Kaneer stated that pricing based on the value of mail was a
4 reasonable practice under the statutory guidelines. In particular, witness Kaneer
5 cited¹⁸ to the statutory criterion in Title 39 that calls for rate setting that considers the
6 value of mail entered into the postal system.¹⁹ Consequently, precedent exists for
7 postal rates to be determined on the basis of value offered by the subclass of mail in
8 question, rather than on the basis of the incremental costs of that type of mail.

9 My understanding is that the Commission has not accepted value pricing in
10 the absence of costs except in the experimental case of RPNs.²⁰ DALs present a
11 different issue: Although costs are known to exist, the Postal Service does not
12 appear to have estimated the marginal costs imposed by DALs or, perhaps more
13 precisely, the marginal cost consequences of large numbers of DAL mailings
14 converting to on-piece addressing. For this reason, the DAL surcharge may not,
15 strictly speaking, be an instance of value pricing. However, insofar as the Postal
16 Service has not presented a marginal cost analysis on the record, and to the extent
17 that saturation mailers find value in DALs, the surcharge may constitute a form of
18 value pricing akin to RPNs.

¹⁷ Testimony of K. Kaneer, USPS-T-2, on behalf of the U.S. Postal Serv., before the Postal Rate Commission, Postal Rate and Fee Changes, Dkt. No. MC2004-5, at 2-3.

¹⁸ *Id.* at 5-6.

¹⁹ 39 U.S.C. § 3622(b), (2).

²⁰ Postal Rate Commission, *Opinion and Recommended Decision*, Docket No. MC2004-5 at 18-19.

1 Another way of viewing the proposed DAL surcharge might be as a premium
2 charge for an optional service (handling and delivering the DAL) that the Postal
3 Service would prefer not to provide. This interpretation could be appropriate,
4 because the item in question, DALs, creates economic value for the saturation
5 mailer in the sense that it provides added flexibility and perhaps some revenue. This
6 aspect of DALs is the value of the real option conferred on the mailer.

7 This characterization would appear consistent with rate elements for other
8 optional services (Certified Mail, for example) that are priced to reflect additional
9 costs that they cause (or avoid) relative to other mail. In the case of DAL, the
10 combined cost of the mandatory saturation rate plus the DAL surcharge conceivably
11 could exceed the rate for high-density flats. This result would not be anomalous:
12 DALs offer benefits to the mailer not available to high-density mailers that are
13 ineligible to use DALs.

14 Yet another way to view the proposed DAL surcharge is to characterize it as a
15 recapture of revenue displacement. As a matter of economic theory, there is a
16 possibility, although perhaps remote, that the sale of one unit of DAL displaces some
17 incremental revenue stream to the Postal Service. Perhaps the advertisement on the
18 DAL would have been mailed in some other way that would have generated
19 additional postage to the Postal Service, which in turn would have contributed to the
20 recovery of institutional costs. Hence, there would be not only a difference in
21 incremental cost, but also some amount of revenue forgone that goes to recovery of
22 institutional costs. The opportunity cost to the Postal Service from those forgone

1 units of advertising mail would be the contribution to the recovery of institutional
2 costs that those forgone revenues would have made.

3 In this proceeding, the Postal Service has not purported to set the surcharge
4 on the basis of a cost measurement. Instead, it has set the surcharge at a level that
5 it hopes will create sufficient incentive for mailers to shift to on-piece addressing.
6 Because the proposed DAL surcharge is a rate element for an optional feature, the
7 consideration for the Commission is to set the rate at a level that will encourage the
8 desired change in conduct by mailers while balancing any other ratemaking
9 considerations it may deem relevant. In so doing, the Commission may well find it
10 appropriate to set the combined rate for saturation flats plus DALs at a higher rate
11 than the rate for high-density flats.

12 **CONCLUSION**

13 Efficient component pricing is appropriate to use to compute presort
14 worksharing discounts in the manner that Dr. Ingraham has done in his companion
15 testimony (NAA-T-2). ECP enables a regulator to set efficient access prices for
16 inputs that the competitors or customers of a vertically integrated monopolists are
17 willing to supply themselves. The shape of a piece of mail, however, does not
18 inherently concern the self-supply of certain mail processing functions by the mailer
19 rather than the Postal Service. In this respect, ECP is a square peg in a round hole
20 insofar as the setting of shape-based rates is concerned.

21 With respect to Detached Address Labels in Standard Enhanced Carrier
22 Route mail, I understand that Dr. Ingraham (NAA-T-2) has estimated the cost of

1 DALs and proposed an alternative rate analyses that produces rates for DAL-
2 surcharged mail that exceed High Density mail rates. Rates for surcharged mail that
3 exceed High Density rates can be justified even in the absence of a formal cost
4 analysis. The two most plausible economic justifications are that the surcharge
5 constitutes a premium charge or, alternatively, an optional rate element, for the DAL.
6 For either reason, the Commission would have a sound economic basis for
7 accepting a proposed DAL surcharge such as proposed by Dr. Ingraham, even
8 without an empirical analysis, and either reason could support setting a surcharge
9 on the basis of factors other than cost alone.