

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

Postal Rate and Fee Changes, 2006

Docket No. R2006-1

DIRECT TESTIMONY OF ALLAN T. INGRAHAM
ON BEHALF OF
THE NEWSPAPER ASSOCIATION OF AMERICA

September 6, 2006

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1 **QUALIFICATIONS**

2 I am Senior Vice President of Criterion Auctions LLC. I am an expert on
3 auctions, industrial organization, econometrics, and statistical analysis. My research
4 has applied this expertise to the detection of bid-rigging and corruption, analysis of
5 network industries, corporate finance and investment, and public finance.

6 I earned my B.S. in Economics from Colby College, and my M.A. and Ph.D. in
7 Economics from University of Maryland, College Park. My dissertation, a chapter of
8 which has since been published in a peer-reviewed economics journal, derived a
9 statistical test to detect collusion between a bidder and an auctioneer. I then applied
10 that test to a \$1 billion per year construction market in New York City.

11 I have provided statistical and econometric analysis for several corporate and
12 government clients. Between July 2003 and February 2005, I served as a data and
13 statistical expert to the U.S. Attorney's Office in its discrimination case against the
14 New York City Department of Parks and Recreation. Since 2003, I have provided
15 expertise on economic and statistical issues to the National Basketball Association
16 (NBA). Between 2002 and 2004, I was part of an expert team that examined the
17 market for timber in British Columbia. Using state-of-the-art statistical techniques, I
18 developed a system through which the British Columbian Ministry of Forests could
19 use auction results to price timber held under long-term tenure. I have also
20 performed economic and statistical analysis on behalf of General Motors, Verizon
21 Communications, Verizon Wireless, SBC, Brown & Williamson Tobacco Company,
22 and RJ Reynolds Tobacco Company.

1 an increase of more than 144 percent—would, on its face, give Saturation mailers a
2 potentially significant competitive rate advantage over newspaper Total Market
3 Coverage (TMC) programs that rely on High-Density mail.

4 I conclude that the Postal Service's proposed rates for Standard ECR mail
5 are flawed because they fail properly to reflect cost differences between rate
6 categories in flats and letters. Also, the proposed DAL surcharge, while well-
7 intentioned, has distorted the rate design in a manner that is inappropriate for an
8 optional mail feature.

9 To correct these errors while not changing the assumptions underlying the
10 Postal Service's rate proposal, I recommend, in Section VI(A), new rates for ECR
11 flats and letters as follows:

1

TABLE 1A: PIECE-RATED RATES FOR ECR FLATS(\$)

	Origin	DBMC	DSCF	DDU
Basic	0.234	0.206	0.199	0.191
High Density	0.190	0.162	0.155	0.147
Saturation	0.189	0.161	0.154	0.146

TABLE 1B: POUND-RATED PIECE CHARGES (\$) FOR ECR FLATS

	Origin	DBMC	DSCF	DDU
Basic	0.101	0.101	0.101	0.101
High Density	0.057	0.057	0.057	0.057
Saturation	0.056	0.056	0.056	0.056

TABLE 1C: POUND-RATED POUND CHARGES (\$) FOR ECR FLATS

	Origin	DBMC	DSCF	DDU
Basic	0.643	0.507	0.475	0.438
High Density	0.643	0.507	0.475	0.438
Saturation	0.643	0.507	0.475	0.438

2

TABLE 1D: PIECE-RATED RATES (\$) FOR ECR LETTERS

	Origin	DBMC	DSCF
Basic	0.234	0.206	0.199
High Density	0.179	0.151	0.145
Saturation	0.170	0.142	0.136

3 This rate design includes the Postal Service’s proposed DAL surcharge of 1.5 cents.
 4 These proposed rates are based on the Postal Service’s assumption that no DALs
 5 will convert to on-piece addressing in the Test Year.

6 One problem with the Postal Service’s rate proposal is that its assumption
 7 that no DAL mailings will convert to on-piece addressing when faced with a 1.5 cent
 8 surcharge is unrealistic. Due to the likelihood that a substantial number of DAL
 9 mailings will convert to on-piece addressing, I also offer in Section VI(B) an

1 alternative rate design that could apply if the Commission were to set rates on the
 2 basis of an assumption that 75 percent of DAL mailings were to convert to on-piece
 3 addressing. This alternative is set forth below:

4 TABLE 1E: PIECE-RATED FLATS RATES (\$)

	Origin	DBMC	DSCF	DDU
Basic	0.236	0.208	0.201	0.193
High Density	0.192	0.164	0.157	0.149
Saturation	0.184	0.156	0.149	0.141

5

6 TABLE 1F: POUND-RATED PIECE CHARGE FOR FLATS (\$)

	Origin	DBMC	DSCF	DDU
Basic	0.103	0.103	0.103	0.103
High Density	0.059	0.059	0.059	0.059
Saturation	0.051	0.051	0.051	0.051

7

8 TABLE 1G: POUND-RATED POUND CHARGE FOR FLATS (\$)

	Origin	DBMC	DSCF	DDU
Basic	0.643	0.507	0.475	0.438
High Density	0.643	0.507	0.475	0.438
Saturation	0.643	0.507	0.475	0.438

9

10 The DAL surcharge in this alternative is 1.4 cents, slightly less than in the
 11 Postal Service’s proposal. ECR letter rates in this alternative are as follows:

12 TABLE 1H: PIECE-RATED RATES FOR ECR LETTERS (\$)

	Origin	DBMC	DSCF
Basic	0.236	0.208	0.201
High Density	0.180	0.152	0.146
Saturation	0.171	0.143	0.137

13

1 Three workpapers accompany my testimony. They are NAA-LR-T2-1, NAA-
 2 LR-T2-2, and NAA-LR-T2-3.

3 **II. SUMMARY OF USPS PROPOSAL**

4 Witness Kiefer (USPS-T-36) proposes the following rates for ECR flats:

5 TABLE 2A: ECR FLATS RATE PER PIECE FOR PIECE RATED PIECES

	Origin	DBMC	DSCF	DDU
Basic	0.233	0.205	0.199	0.191
High Density	0.204	0.176	0.170	0.162
Saturation	0.182	0.154	0.148	0.140

6 TABLE 2B: ECR FLATS CHARGE PER PIECE FOR POUND RATED PIECES

	Origin	DBMC	DSCF	DDU
Basic	0.101	0.101	0.101	0.101
High Density	0.072	0.072	0.072	0.072
Saturation	0.050	0.050	0.050	0.050

7
 8 TABLE 2C: ECR FLATS CHARGE PER POUND FOR POUND RATED PIECES

	Origin	DBMC	DSCF	DDU
Basic	0.641	0.505	0.473	0.436
High Density	0.641	0.505	0.473	0.436
Saturation	0.641	0.505	0.473	0.436

9
 10 There are two significant aspects of the Postal Service’s proposed rates. One
 11 is the 2.2 cent difference between High-Density and Saturation flats mail. Another is
 12 witness Kiefer’s proposed surcharge of 1.5 cents for Saturation flats mail that uses
 13 the optional DAL to supply the address.

14 Witness Kiefer’s rate proposal in the 2006 rate case is a departure from
 15 previous rate designs for Standard ECR mail. I will focus my testimony on three
 16 aspects of that design.

1 First, the difference between the rate for High Density flats and Saturation
2 flats would more than double from the current 0.9 cents to 2.2 cents. This increased
3 rate differential is not, however, based on a change in the relative costs of those mail
4 categories. Instead, the Postal Service has proposed to increase the price of ECR
5 High Density mail relative to the price of ECR Saturation mail at a time when Postal
6 Service data show that the cost difference between those two flats categories has
7 significantly *diminished* to less than 0.1 cents. This means that the Postal Service is
8 proposing to passthrough an astounding 2200 percent of the estimated cost
9 difference between High-Density and Saturation flats.¹

10 Second, I analyze the proposed surcharge on Detached Address Labels
11 (DALs). As I explain below, the inclusion of the DAL surcharge appears to have
12 significantly complicated the rate design process for ECR flats.

13 Finally, the Postal Service has proposed to pass through an excessive 120
14 percent of inaccurately estimated cost differences between Basic and High Density
15 ECR flats and between High Density and Saturation ECR flats respectively. These
16 three factors have contributed to a flawed rate design for commercial Standard ECR
17 mail.

¹ Such a passthrough percentage would grossly violate the principle of Efficient Component Pricing, which is discussed in the testimony of J. Gregory Sidak (NAA-T-1).

1 **III. THE USPS PROPOSAL FOR HIGH DENSITY FLATS IS FLAWED BECAUSE IT IS NOT**
2 **BASED ON READILY AVAILABLE UNIT DELIVERY COSTS OF HIGH DENSITY FLATS**

3 The increased rate differential between Saturation ECR flats and High
4 Density ECR flats in the Postal Service's rate proposal is caused, in major part,
5 because the rate design witness (Kiefer) relied upon unit delivery cost data for Basic
6 and High Density ECR flats that were averaged together. Specifically, witness
7 Kiefer obtained unit delivery cost data from witness Kelley (USPS-T-30). However,
8 the delivery cost data supplied by witness Kelley presented ECR flats costs in only
9 two groupings: Saturation and Non-saturation. The latter grouping combined the unit
10 delivery costs of both Basic and High Density flats. This means, as witness Kiefer
11 conceded,² that the Postal Service's rate proposal is not based on delivery cost
12 differences between Basic and High Density rates. This failure to base High-Density
13 (and Basic) flats rates on the unit delivery costs of those two tiers results in
14 proposed rates that underprice Basic flats and overprice High-Density flats.

15 By averaging Basic and High Density delivery costs, which are a component
16 in the cost differentials that determines relative rates, witness Kelley departed from
17 the approach that the Postal Service has used in past cases. Since at least 2000,
18 the Postal Service has relied on disaggregated Basic, High Density, and Saturation
19 unit delivery costs. Indeed, witness Kelley himself had done so only last year in
20 Docket No. R2005-1. Table 3 below provides a historical context for Kelley's cost

² Response of U.S. Postal Serv. Witness Kiefer, NAA/USPS-T36-17(a)-(e).

1 information, along with de-averaged cost estimates he supplied in response to an
 2 interrogatory.³

3 TABLE 3: FLATS DELIVERY COST ESTIMATES FOR DOCKET YEARS 2000, 2001, 2005, AND
 4 2006 (ALL IN CENTS)

	Kelley, as filed LR-L-67 2006		Kelley Response to NAA/USPS- T30-7, 2006	Kelley, 2005	Hope, 2001	Daniel, 2000**
ECR Non-Saturation	7.083	ECR Basic (cents)	7.325	6.143	6.07	4.615
		ECR High Density (cents)	5.303	4.609	4.862	3.55
ECR Saturation	5.213	ECR Saturation (cents)	5.226	4.163	4.031	3.049
<i>Difference HD - Saturation</i>	1.87	<i>HD - Saturation</i>	0.077	0.446	0.831	0.501
** (found in Taufique, 2000, USPS-LR-I-167, WC1)						

5 Sources: Kelley (2006),⁴ Kelley (2006),⁵ Kelley (2005),⁶ Hope (2001),⁷ Taufique (2000).⁸

6 As Table 3 indicates, Kelley reported that ECR Non-Saturation cost—that is,
 7 the cost of ECR Basic and ECR High Density averaged into one single grouping —
 8 equaled 7.083 cents. By doing so, ECR High Density costs were overestimated and
 9 ECR Basic costs were underestimated.

³ Response of U.S. Postal Serv. Witness Kelley, NAA/USPS-T30-8.

⁴ Testimony of J. Kelley, USPS-T-30, at 4.

⁵ Response of U.S. Postal Serv. Witness Kelley, *supra* note 3.

⁶ Testimony of J. Kelley, USPS-T-16, at 6.

⁷ Testimony of L. Hope on behalf of the U.S. Postal Serv., Dkt. No. R2001-1, USPS-LR-J-131, Workbook WP1.

⁸ Testimony of A. Taufique on behalf of the U.S. Postal Serv., Dkt. No. R2000-1, USPS-LR-I-167, Workbook WC-1.

1 In response to interrogatories, witness Kelley provided disaggregated unit
2 delivery costs for Basic and High Density ECR flats and also for ECR letters. These
3 data are shown in the column labeled “Kelley Response to NAA/USPS-T30-7, 2006.”
4 Kelley’s restated cost estimates have High Density ECR delivery costs exceeding
5 Saturation ECR delivery costs by only *0.077* cents in the Test Year. This means that
6 the cost difference between High-Density and Saturation flats has shrunk to less
7 than one-tenth of a cent, from more than 0.45 cents in the 2005 rate case. Indeed,
8 witness Kelley’s data show that High Density flats incur *lower* unit delivery costs
9 (1.743 cents) on rural routes than Saturation flats (2.154 cents).⁹ Accordingly, an
10 appropriate rate design for ECR mail should use the data estimating the cost
11 differences between the High-Density and Saturation flats worksharing tiers to
12 reduce the rate difference between the tiers. Instead, the Postal Service is
13 proposing to increase the rate difference from 0.9 cents to 2.2 cents, an increase
14 that exceeds 144 percent and would passthrough 2200 percent of the estimated cost
15 difference. For this reason, the Postal Service’s proposed rate design for ECR mail
16 is flawed.

⁹ Tr. 12/3404 (Kelley).

1 IV. THE SURCHARGE ON DETACHED ADDRESS LABELS

2 In this rate case, witness Kiefer also is proposing a 1.5 cent surcharge for the
3 use of Detached Address Labels (DALs), which are most commonly used by ECR
4 Saturation flats mailers.¹⁰ He explains:

5 [t]he Postal Service has determined that it wants to encourage on-
6 piece addressing for all mail in furtherance of its goals of improving
7 efficiency . . . To further that policy decision, I am proposing that all
8 mail that uses detached address labels (DALs) pay a surcharge.¹¹

9 I do not quarrel with the Postal Service's stated purpose for the DAL
10 surcharge, as it makes sense to impose a distinct charge for a distinct optional
11 aspect of DAL mailings that the Postal Service has identified as causing distinct
12 costs. The Postal Service now presumably believes that handling and delivering
13 DAL flats entails higher costs than would pieces bearing on-piece addresses.
14 Furthermore, it is unlikely that the Postal Service would want to discourage the use
15 of DALs unless it believes that Saturation mail with DALs are more costly than
16 Saturation flats with on-piece addresses.

17 However, the proposed overall rate design for commercial ECR flats mail—of
18 which the DAL surcharge as proposed is an optional component—makes little
19 sense. In particular, Kiefer's proposed rate structure dilutes the negative incentive of
20 the DAL surcharge while distorting significantly the relative price of High Density
21 ECR flats to Saturation ECR flats.

¹⁰ Testimony of J. Kiefer, USPS-T-36 at 32.

¹¹ *Id.* at 32, ll. 7-12.

1 **A. The Postal Service’s Rationale for the Surcharge on Detached Address**
2 **Labels**

3 Postal Service witness Kiefer does not contend that the 1.5 cent surcharge is
4 cost-based. Instead, he says that he set the rate at that amount because it would
5 “strongly encourage mailers to put addresses directly on their mail pieces.”¹²

6 The reason why the Postal Service would prefer on-piece addresses for
7 Saturation flats was presented by witness Coombs. She testified that from the
8 perspective of the Postal Service, DALs no longer serve their original purpose of
9 easing (or avoiding) the casing of Saturation flats: “the original justification for the
10 DAL is no longer applicable in today’s operating environment.”¹³ In essence,
11 witness Coombs’ testimony is that the continued use of DALs are inconsistent with
12 the long-term efficiency goals of the postal system.

13 The Postal Service’s rationale for a DAL surcharge makes sense from a rate
14 design perspective. DALs are handled separately and therefore impose distinct
15 costs on the postal system. As an optional means of address, it is appropriate that
16 the rate structure contain a signal for that particular addressing option, which is a
17 privileged form of addressing not available to most other ECR mail.

¹² Testimony of J. Kiefer, *supra* note 10, at 32.

¹³ Testimony of J. Coombs, USPS-T-44, at 13.

1 **B. The Proposed DAL Surcharge Is Not An Appropriate “Offset” Of The**
2 **Proposed Expansion Of The Rate Differential Between High Density and**
3 **Saturation ECR Flats To 2.2 Cents**

4 In defending the proposed increase in the difference in rates between High-
5 Density and Saturation flats from 0.9 cents to 2.2 cent, witness Kiefer in effect
6 claimed that the DAL surcharge should dictate the size of this rate difference.
7 Specifically, he asserted that the comparison between the current 0.9 cent rate
8 difference and the proposed 2.2 cent rate difference is illusory because the
9 proposed DAL surcharge would mitigate the effect of this reduction in the rate of
10 Saturation flats to High-Density flats.¹⁴ For several reasons, witness Kiefer’s
11 assertion that a 1.5 cent DAL surcharge alleviates the 2.2 cent rate differential he
12 proposed is incorrect.

13 First, witness Kiefer errs by attempting to use the optional DAL surcharge,
14 which would be paid by only a minority of Saturation mailers, in comparing the rate
15 increases for High-Density and Saturation flats. Even today, the majority—56.3
16 percent of Saturation ECR flats mail—do not use DALs.¹⁵ Witness Kiefer assumes
17 that approximately 40 percent of ECR Saturation flats will use DALs in the Test Year
18 (his testimony now formally assumes that no DAL mailers will convert to on-piece

¹⁴ Response of U.S. Postal Serv. Witness Kiefer, USPS-T-36, NAA/USPS-T36-14. Kiefer contends that, if the DAL surcharge is included, the rate differential would be only 0.7 cents.

¹⁵ Testimony of J. Kelley, USPS-T-30 at 13, and Kiefer, USPS-LR-L-36, WP-STDECR, “Comm Piece-Pound Dist –BY”, cell M15. Based on estimates of DAL volume in Kelley (4,607,996,000) and Saturation ECR flats volume for 2005 found in Kiefer (10,540,489,658), one can calculate a Saturation non-DAL percentage of $((10,540,489,658 - 4,607,996,000)/10,540,489,658)*100 = 56.3$ percent.

1 addressing).¹⁶ Therefore, Kiefer's DAL surcharge would have no offset for the
2 majority of Saturation flats mailers because that majority will not, today or in the
3 future, use DALs. As a consequence, the rate advantage enjoyed by the majority of
4 Saturation mailers over their High-Density mailer competitors would rise from 0.9
5 cents to 2.2 cents without their making any changes in their addressing practices.

6 A second flaw in Kiefer's proposal is the assumption that no DAL mailings
7 would shift to on-piece addressing. In effect, Kiefer's assumption implies that the
8 demand for DALs (which are optional) is perfectly price-inelastic. This is highly
9 unlikely. Furthermore, a major DAL user (Advo) has already declared its intention to
10 switch to on-piece addressing by the summer of 2007.¹⁷ Therefore, witness Kiefer's
11 assumption that no DAL mail will convert to on-piece addressing is unlikely to prove
12 correct. Instead, the proportion of ECR Saturation mail that, in reality, will continue to
13 use DALs will almost certainly be far smaller than the USPS assumes. Hence,
14 significantly more than 56 percent (Kelley) to 60 percent (Kiefer) of ECR Saturation
15 mailers will enjoy rates that are fully 2.2 cents less than the High Density ECR piece
16 rate.

17 To illustrate these flaws in Kiefer's analysis, I have calculated the proportion
18 of Saturation flats mailers that would have to use DALs for the total price for
19 Saturation mailings to maintain, on average, the current 0.9 cent difference between

¹⁶ Witness Kiefer's testimony as originally filed had assumed that 50 percent of DALs would convert to on-piece addressing. He subsequently amended his testimony to assume no DAL conversion due to the absence of any calculations in the Postal Service's direct case of cost savings resulting from DAL mailings converting to on-piece addresses.

¹⁷ ADVO, *ADVO Discusses Postal Rate Case*, June 14, 2006, available at: http://www.advo.com/document/Postal%20Rate%20Case_6_14_06_Final.pdf.

1 High-Density and Saturation flats rates.¹⁸ In particular, Table 4 gives the average
 2 rate differential between High Density and Saturation flats for various percentages of
 3 ECR mail that would continue to use DALs in the test year.

4 TABLE 4: KIEFER’S PROPOSED DIFFERENTIAL BETWEEN HIGH DENSITY AND SATURATION
 5 FLATS FOR VARIOUS INTENSITIES OF DAL USAGE

Differential for non-DAL Mailing	Differential for DAL Mailing (2.2 – 1.5)	Saturation Mail Using DAL (%)	Average Differential (cents)
2.2	0.7	40	1.600
2.2	0.7	45	1.525
2.2	0.7	50	1.450
2.2	0.7	55	1.375
2.2	0.7	60	1.300
2.2	0.7	65	1.225
2.2	0.7	70	1.150
2.2	0.7	75	1.075
2.2	0.7	80	1.000
2.2	0.7	85	0.925

6 As the data in Table 4 show, given Kiefer’s proposed 2.2 cent rate differential
 7 between Standard and High Density ECR and a DAL surcharge of 1.5 cents, more
 8 than 85 percent of all ECR Saturation mail would need to use DALs before the
 9 differential paid by High Density and Saturation flats mail, on average, would equal
 10 its current level of 0.9 cents. Considering Advo’s statement that it will switch to on-
 11 piece addressing to avoid the DAL surcharge, it is highly likely that considerably
 12 fewer than 40 percent of ECR Saturation flats will use DAL, rather than that DAL
 13 usage will rise to more than 85 percent. Consequently, the average differential
 14 between High Density and *all* Saturation flats will likely exceed 1.6 cents per piece.

¹⁸ Before proceeding, I note that I do not, as a principle, endorse this methodology in rate setting. Rather, I am merely using the following example to illustrate the flaws in Kiefer’s rate design.

1 In short, given the current and future percentage of Saturation flats that use (or are
2 likely to use) DALs, the proposed optional DAL surcharge cannot be considered a
3 reasonable “offset” for the proposed 2.2 cent differential in the mandatory rates for
4 High-Density and Saturation mailings.

5 **V. THE POSTAL SERVICE ERRONEOUSLY PROPOSES TO PASS THROUGH MORE THAN 100**
6 **PERCENT OF THE ESTIMATED COST DIFFERENCES BETWEEN HIGH DENSITY AND**
7 **SATURATION FLATS**

8 Finally, the Postal Service has proposed to pass through 120 percent of cost
9 differences between Basic and High Density flats, and between High Density and
10 Saturation flats, respectively. This passthrough rate violates the principle of Efficient
11 Component Pricing, as further explained in the testimony of J. Gregory Sidak (NAA-
12 T-1).

13 Witness Kiefer testified that he used 100 percent passthroughs as the starting
14 point of his rate design.¹⁹ However, his reliance on aggregated Basic/High Density
15 unit delivery costs—instead of the more accurate disaggregated costs—may have
16 led him to use excessive passthroughs to obtain what he viewed as a reasonable
17 rate design for ECR flats. A better approach, which I use in my alternative rate
18 design, is to use the disaggregated delivery costs for Basic and High Density flats
19 (along with the Saturation costs which have been disaggregated all along) and
20 passthrough 100 percent of those cost differences between density tiers.

¹⁹ Response of U.S. Postal Serv. Witness Kiefer, USPS-T-36, NAA/USPS-T36-8(b)-8(c).

1 **VI. ALTERNATIVE RATE DESIGN**

2 In this section I provide two alternative rate designs. The first rate design
3 (subsection A) corrects certain errors in witness Kiefer's proposed rate design, but
4 otherwise is based on the same assumptions as the USPS. In short, my first rate
5 design uses the same assumptions – including no DAL conversion -- as in witness
6 Kiefer's rate proposal, but corrects it by using the de-averaged delivery cost
7 calculations for ECR flats (and letters) that Kelley provided; 100 percent
8 passthroughs, rather than the 120 percent proposed by the Postal Service; and
9 treats the DAL surcharge as an optional rate element.

10 The second rate design (subsection B) offers an alternative in the event the
11 Commission chooses to reject the Postal Service's unrealistic assumption that no
12 DALs will convert to on-piece addressing in the Test Year. In this second rate
13 design, I apply a simple model of DAL cost reduction and apply it to witness Kelley's
14 workbooks to determine an appropriate cost for ECR Saturation were a certain
15 percentage of DAL users to convert to on-piece addressing. I then apply those
16 adjusted costs to design an alternative in Tables 7A, 7B, and 7C. My assumptions
17 are described further in subsection (B).

18 **A. Rate Design Based on De-Averaged Delivery Costs**

19 Using Kiefer's formulas as reported in WP-STDECR-16, the following rates
20 for ECR flats were derived:²⁰

²⁰ Full calculations can be found in my workbook NAA-LR-T2-1.

1

TABLE 5A: PIECE-RATED RATES (\$)

	Origin	DBMC	DSCF	DDU
Basic	0.234	0.206	0.199	0.191
High Density	0.190	0.162	0.155	0.147
Saturation	0.189	0.161	0.154	0.146

2

3

TABLE 5B: POUND-RATED PIECE CHARGE (\$)

	Origin	DBMC	DSCF	DDU
Basic	0.101	0.101	0.101	0.101
High Density	0.057	0.057	0.057	0.057
Saturation	0.056	0.056	0.056	0.056

4

5

TABLE 5C: POUND-RATED POUND CHARGE (\$)

	Origin	DBMC	DSCF	DDU
Basic	0.643	0.507	0.475	0.438
High Density	0.643	0.507	0.475	0.438
Saturation	0.643	0.507	0.475	0.438

6

7

In this alternative rate design, I have used the de-averaged Basic and High Density delivery cost estimates provided by USPS witness Kelley.²¹ Also, I used the current pound charge of 64.3 cents instead of the Postal Service’s proposed 64.1 cents, because to my knowledge witness Kiefer nowhere specifically explained why he proposed to change this rate.

12

Because witness Kelley also provided de-averaged delivery cost calculations for ECR letters, I provide proposed rates for that category in Tables 6A below.

13

²¹ Response of U.S. Postal Serv. Witness Kelley, *supra* note 3. Furthermore, I use the same mail processing cost estimates for ECR letters and flats as those used by USPS witness Kiefer. I recognize that the processing cost estimates for ECR Saturation and High Density flats were not de-averaged by USPS witness Talmo (USPS-LR-L-84) because insufficient data was available to perform that de-averaging in a precise manner.

1

TABLE 6A: PIECE-RATED RATES (\$)

	Origin	DBMC	DSCF
Basic	0.234	0.206	0.199
High Density	0.179	0.151	0.145
Saturation	0.170	0.142	0.136

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6

Using the proposed rates in the tables presented above, and Kiefer's proposed DAL surcharge of 1.5 cents, I find that forecasted revenues from commercial ECR mail would be \$5.695 billion. This revenue figure exceeds the revenues forecasted under witness Kiefer's proposal (including the revenues from Kiefer's DAL surcharge) by \$3.2 million.

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B. Rate Design That Assumes Conversion Of DALs To On-Piece Addresses

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The Postal Service's direct case now assumes that no DALs will convert to on-piece addresses even when faced with a 1.5 cent DAL surcharge. However, as explained above, that assumption appears unrealistic, and it is likely that a significant number of DAL mailings will convert to on-piece addresses. In this section, I present an alternative rate design based on my calculation of cost savings from the conversion of DALs to on-piece addresses, based on data from Postal Service witness Kelley.

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Witness Kelley provided in his workbooks an estimate of Base Year DAL costs, which I will use below to calculate the incremental DAL cost and the unit delivery cost of ECR Saturation after a reduction in DAL usage. However, witness Kelley testified that a substantial reduction in DAL usage by ECR Saturation mailers would not necessarily result in a one-to-one reduction in ECR Saturation costs. Therefore, I will develop a simple model of DAL conversion that will incorporate a

1 percentage of the DAL costs that Kelley included in his calculation of total unit
2 delivery costs for ECR Saturation mail.

3 To present an alternative rate design that would reflect DAL conversion, I
4 have made several assumptions. In particular, I assume a 75 percent reduction in
5 DAL usage, which would leave approximately 1 billion DALs in the system.
6 Furthermore, I assume that the Postal Service would capture 80 percent of the cost
7 savings that would accrue from a 75 percent reduction in DAL usage, or a total
8 reduction in DAL costs of 60 percent. That is, I assume that the cost elasticity of DAL
9 is 1.25.²² As in my other rate design, I use the disaggregated costs for Basic and
10 High-Density flats and letters and passthrough 100 percent of the High-Density and
11 Saturation cost savings.

12 Tables 7A, 7B, and 7C present the proposed rates for ECR flats. To generate
13 sufficient revenue to approximate the target revenue and contribution for ECR
14 required by Postal Service witness O'Hara,²³ I increased the per piece rate by two-
15 tenths of a cent over Kiefer's rate design—that is, I increased the per piece rate from
16 \$0.101 to \$0.103. Again, I used a pound rate of \$0.643 and 100 percent
17 passthroughs. I have reduced the DAL surcharge to 1.4 cents. This results in
18 piece-rated Saturation DAL mailers paying no more than one-tenth of a cent more
19 under this design for piece-rated flats than under witness Kiefer's proposal.

²² 100 percent / 80 percent = 1.25.

²³ The cost coverage percentage in the alternative rate design I propose below is 213. Furthermore, the contribution to institutional costs is \$3.141 billion, within \$2 million of the Postal Service's original proposal. It is \$34 million less than the institutional cost contribution cited in O'Hara's errata testimony, but that figure depends on the unrealistic DAL assumption (in USPS-LR-L-174, _AR Rate Level Workpapers.xls, cell J45 of worksheet "AR 2008 Rev & Cost").

1 Furthermore, under this proposal, the most common Saturation flat (entered at the
 2 DDU) would pay no more than under Kiefer’s design, I would also note that I have
 3 calculated the incremental cost of a DAL to be 0.751 cents per DAL. Therefore, my
 4 proposed DAL surcharge recovers that incremental cost and also would include an
 5 optional or value component consistent with the testimony of NAA witness J.
 6 Gregory Sidak (NAA-T-1).

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TABLE 7A: PIECE-RATED FLATS RATES (\$)

	Origin	DBMC	DSCF	DDU
Basic	0.236	0.208	0.201	0.193
High Density	0.192	0.164	0.157	0.149
Saturation	0.184	0.156	0.149	0.141

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TABLE 7B: POUND-RATED PIECE CHARGE FOR FLATS (\$)

	Origin	DBMC	DSCF	DDU
Basic	0.103	0.103	0.103	0.103
High Density	0.059	0.059	0.059	0.059
Saturation	0.051	0.051	0.051	0.051

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TABLE 7C: POUND-RATED POUND CHARGE FOR FLATS (\$)

	Origin	DBMC	DSCF	DDU
Basic	0.643	0.507	0.475	0.438
High Density	0.643	0.507	0.475	0.438
Saturation	0.643	0.507	0.475	0.438

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Table 8A presents the proposed rates for ECR letters. To generate these rates I increased the per piece letter rate by one-tenth of a cent over Kiefer’s rate design—from \$0.098 to \$0.099.

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TABLE 8A: LETTER RATES (\$)

	Origin	DBMC	DSCF
Basic	0.236	0.208	0.201
High Density	0.180	0.152	0.146
Saturation	0.171	0.143	0.137

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3 With a DAL surcharge of 1.4 cents and 75 percent conversion from DAL to
4 on-piece addressing, the above rates would result in commercial ECR revenues of
5 5,627,152,983. This total is within \$2.6 million of the commercial revenues from
6 witness Kiefer's original workbook.

7

VII. CONCLUSION

8 In conclusion, I find that the Postal Service's proposed rate design for
9 Standard ECR High-Density and Saturation flats is flawed because it erroneously
10 fails to use disaggregated cost data and contains excessive passthroughs. It also
11 erroneously assumes that the proposed DAL surcharge would offset a seriously
12 flawed 2.2 cent proposed differential between High-Density and Saturation flats
13 rates.

14 I offer two alternative rate designs. Both use disaggregated costs and 100
15 percent passthroughs of estimated cost differences between High Density and
16 Saturation flats. The principle difference between the two rate designs is that the
17 first continues to use the Postal Service's unrealistic assumption that no DALs will
18 convert to on-piece addresses. The second and more realistic rate design assumes
19 that 75 percent of DALs will convert to on-piece addressing in the Test Year, and
20 incorporates my estimate of the net cost savings to the Postal Service.