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

POSTAL RATE AND FEE CHANGES, 2006) Docket No. R2006-1

Direct Testimony of

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Concerning

STANDARD MAIL

On Behalf of

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

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Direct Testimony

of

Robert W. Mitchell

AUTOBIOGRAPHICAL SKETCH

My name is Robert W. Mitchell. I am a consultant on issues relating to postal rates. From 1992 until my retirement in 2002, I worked as Special Assistant to the Postal Rate Commission and, before that, as Special Assistant to the Chairman. From 1975 to 1992, I was a Cost Systems Analyst, a Planning Officer, an Assistant to the Assistant Postmaster General of Rates and Classifications, Manager of the Primary Rates Branch in the Office of Rates, and a Principal Economist at the United States Postal Service. I have worked on a wide range of rate issues, from costing to rate administration to rate design to regulatory policy. I have represented the Commission and the Postal Service to mailers and various postal groups. I was the Postal Service's witness on Periodicals and Standard Mail rates (then second class and third class) in Docket Nos. R87-1 and R90-1, and testified on behalf of the Postal Service in four other dockets. I testified on behalf of Time Warner Inc. in Docket No. C2004-1 and on behalf of Valpak Direct Marketing Systems, Inc., and Valpak

Dealers' Association, Inc. in Docket No. R2005-1. I have also been a consultant on rates to the nations of Dominica and The Gambia.

Prior to joining the Postal Service, I was an Assistant Professor of Business at the University of Wisconsin-Milwaukee, teaching Economic Theory and Managerial Economics. I have a Bachelor of Science in Mechanical Engineering from the University of Cincinnati and an M. A. in Economics from Case Western Reserve University. While at Case, I passed my written and oral comprehensive examinations for the Ph.D. in Economics, with major areas in Economic Theory, Econometrics, and Industrial Economics.

I have written a number of articles and published papers, primarily on economic issues relating to postal rates, including: "Postal Worksharing: Welfare, Technical Efficiency, and Pareto Optimality," in *Emerging Competition In Postal and Delivery Services* (1999), and "Preparing the Postal Service's Rate Structures for Competition: A Study of How the United States Postal Service Might Adjust to Increased Competitive Pressure," in *Future Directions in Postal Reform* (2001).

I. PURPOSE OF TESTIMONY

The purpose of this testimony is: (1) to demonstrate that the cost coverage proposed by the Postal Service for Enhanced Carrier Route ("ECR") Standard is excessively high and, similarly, that the cost coverage proposed for Regular Standard is lower than it should be, both in relative and absolute senses; (2) to support with limitations certain changes the Postal Service has proposed for the various categories of Standard Mail; and (3) to propose an alternative set of rates for Regular and ECR, both Commercial and Nonprofit, that is more in line with accepted ratesetting principles and the policies of the Postal Reorganization Act of 1970 (the "Act"). Regular and ECR were created at the same time by a decision to deaverage the former third class. That decision had intended results that have not been fully implemented. My workpapers take the form of an Excel workbook, contained in VP-LR-1.

II. SUMMARY

My testimony may be summarized as follows:

1. Heavy demands are made on this case by a need to bring markups and rates into appropriate alignment with ratesetting principles. Not only has it been some years since these issues received attention, there is also the possibility in the near future that a regime of price caps will be imposed by legislation. Adjustments of some magnitude are in order.

2. In Docket No. MC95-1, consistent with Commission guidelines, the Postal Service proposed to deaverage then third class, to the point of creating separate subclasses for Regular Standard and ECR Standard mail. With no dissent from mailers, the Commission recommended the change.

3 In accordance with the deaveraging recommendation, the markup on Regular should increase and the markup on ECR should decrease. Such an outcome was explained by the Postal Service at the time and has been endorsed since. It was understood by mailers at the time. It was recognized by the Commission.

4. To date, for a variety of reasons, the contemplated and appropriate adjustments to the markups on Regular and ECR have not occurred.

5. Accepted principles of ratesetting, including notions of economic efficiency and the recognition of the value of the mail service to mailers, support the position that adjustments in markups should be made. It is not fair to mailers to undercharge one group and overcharge another, especially when both groups consist of bulk mailers, mailing to support the needs of their businesses and organizations.

6. Rates for Nonprofit Regular and Nonprofit ECR depend on the rates for their commercial counterparts. If the rates for the commercial counterparts are out of alignment with accepted ratesetting principles, then the Nonprofit rates will be out of alignment as well. This increases the importance of setting the commercial rates properly.

7. A review of the ratemaking guidance in the Act, as well as Commission precedent, suggests that the markup on Regular is too low and on ECR is too high.

8. The design of rates *within* subclasses should also be guided by principles, including notions of worksharing, efficient component pricing, cost-based rates, the efficiency of signals sent to mailers, and fairness. The proposals made by the Postal Service are not well founded or explained, and are out of alignment with what should be expected.

9. Based on accepted principles of ratesetting and appropriate regulatory practice, as well as on precedent established over some years by the Commission, an alternative set of rates for Regular and ECR is proposed, including the Nonprofit subclasses. Within Standard Mail, continued protection of mailers now making low contributions, to the detriment of mailers making high contributions, is not warranted. The rates I recommend are fair to mailers of all four subclasses.

10. In view of the demands on and context of this case, and in line with my review of relevant history and accepted ratesetting principles, grounded in the Act and developed by the Commission, as explained herein, I recommend a cost coverage for Regular of 180.2 percent and for ECR of 177.0 percent. The resulting rate change for Regular is 17.56 percent and for ECR is -8.47 percent. The total contribution from Standard Mail at my rates is approximately the same as that proposed by the Postal Service.

11. For all rate elements in Regular and ECR, including the Nonprofit categories, specific rates are proposed that honor accepted rate design standards, including appropriate recognition of the automation categories. Unlike the Postal Service proposal, these rates do not discriminate in favor of flats and do not withhold the discounts and price signals made available to commercial mailers from Nonprofit mailers.

III. INTRODUCTION

History and current circumstances combine to make Docket No. R2006-1 unusually important. Several factors should be recognized at the outset. These are outlined briefly in the following paragraphs and frame much of the discussion in my testimony.

First, this case follows two unusual predecessors: Docket No. R2005-1, a case that resulted predominantly in across-the-board rate increases; and Docket No. R2001-1, a settled case that contained few rate adjustments. This means that the last case receiving full and detailed testing through adversarial litigation by interested parties was Docket No. R2000-1,[1] which was filed on January 12, 2000, based on FY 1998 costs, that were updated in an *ad hoc* manner to FY 1999 costs. As a result, the costs receiving the attention of interested parties were different from those undergirding the Commission's *Opinion and Recommended Decision*. Therefore, the cost bases for the rates now in place go back as far as eight years. During this period, postal operations have

[1] The Commission noted in its *Opinion and Recommended Decision* in Docket No. R2005-1: "For the most part, the most recent recommendations were made in Docket No. R2000-1." *Id.*, ¶ 2019. Similarly, it said: "there have been no authoritative decisions on appropriate ratemaking methodologies or standards since Docket No. R2000-1...." *Id.*, ¶ 2023. It also referred to Docket No. R2000-1 as "the most recent omnibus rate proceeding in which attribution principles were fully litigated...." *Id.*, ¶ 4003.

changed, mail preparation has changed, and the capabilities of the Postal Service and mailers have changed, not to mention changes in markets and the competitive environment. One would expect recognition of these changes, particularly in costs, to require numerous and significant rate adjustments.

The possibility that disproportionate changes might arise in this case was recognized by the Commission in its *Opinion and Recommended Decision* in Docket No. R2005-1. Specifically, the Commission said:

> Cost-based rates have been the touchstone of postal ratemaking for 35 years, and the Commission has significant concerns about deviating from that policy, even for a limited time. [*Id.*, p. i.]
>
> Facing an additional, imminent rate case most participants are willing to accede to the Postal Service's preference, and defer the complex cost analyses necessary to apply efficient component pricing principles until that case. [*Id*., p. ii.]
>
> ... small equal increases now, to be followed by a proceeding to "true-up" rates after a thorough examination of postal costs, is consistent with sound public policy. The Commission's preference is to develop rates that accurately reward mailers' worksharing. It is concerned that the **delay** in recognizing the impact of recent innovations and improvements in postal operations, coupled with the passage of time, **will probably result in unusually disproportionate increases and decreases in different rates in the next case**. The Postal Service and mailers seem prepared for that possibility as they too recognize that proper cost-based rates foster efficiency and promote a healthy postal system. [*Id*., p. ii, emphasis added.]

> Rate shock arguments are often raised in rate proceedings. They are likely to be raised in the next proceeding as well, in which case the Commission will assess their merits based on the record developed in that proceeding. **Parties should be aware that the Commission will seek to obtain economically efficient cost-based rates and appropriate allocations of institutional burdens**. [*Id.*, ¶ 5032, emphasis added.]

On the issue of "disproportionate increases and decreases in different rates in the [then] next case," the Commission noted: "Participants were made fully aware of the scope of problems in this area by Presiding Officer's Information Request No. 1, issued April 22, 2005, that identified the extent to which proposed rates varied from economically efficient component prices." *Id.*, p. 90, fn. 43. The stage has clearly been set for dealing with these matters fully in this case.

Second, this case should recognize the implications of an important deaveraging recommendation, made by the Commission and supported by the Postal Service and all mailing parties in Docket No. MC95-1. Except for certain parties that sought higher postal rates for their own competitive benefit, there were no dissenters — the recommendation was supported even by mailers whose rates would be expected to increase because of the change. Recognizing these implications is necessary not only because this may be the last opportunity to do so efficiently, but also because such recognition implements the very ratemaking principles that were the basis for the Docket No. MC95-1 recommendation. More specifically, a recommendation was made in

that docket to deaverage then third class, to the extent of creating separate subclasses. This decision has consequences that were understood at the time but have not been appropriately implemented. Without implementation, the benefits that formed the basis for that recommendation will continue to be unrealized.

Third, if postal legislation now being considered in Congress is enacted, it is possible, depending in part on implementation decisions, that the rate levels decided in this case, particularly those for subclasses of mail, will establish a platform that will be perpetuated into the future by means of price caps.[2] Therefore, the rates recommended in this case should reflect the best possible application of principles of regulatory ratesetting, as developed and applied by the Commission, consistent with all of the policies of the Act. At least as of the time this testimony was submitted, it cannot be presumed that a second (or third) step, moving gradually toward preferred rate positions, will be possible in the next omnibus case or in the one after that.[3] The most appropriate rates must be reached in one step, even if it is a large one, in order to prevent present

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[2] A characteristic of price caps is that changes in a product's costs have no effect on the price of that product. For example, the costs of a certain subclass could be reduced by mailer cooperation or by improved mechanization, but the rates for the cost-reduced subclass would continue upward unabated. The optimal platform for a regime of price caps is to set the rates in full recognition of current costs and circumstances. Failure to do so will make matters worse.

[3] I understand that improved perspective on legislative matters should be available by the time the Commission issues its *Opinion and Recommended Decision* in this docket.

inefficiencies and inequities from being etched into relationships that will be difficult, if not impossible, to correct. The Postal Service's success in facing the future effectively will be determined in part by its rate schedule.

A. Applied to Postal Ratemaking, There Are Several Gradations of Deaveraging, and the Role of Each Is Clear.

Whether applied to a subclass or some other rate category, the step of deaveraging is not one dimensional. It occurs in various forms and degrees, each with implications. Four specific kinds of deaveraging may be identified.

1) Deaveraging can be done to recognize a *worksharing activity*, such as presorting. In these cases, the cost basis is usually the cost avoidance associated with the worksharing activity and the passthrough of the avoidances into rate differences is generally limited to one hundred percent.[4] The justification for this kind of deaveraging usually centers on matters of technical efficiency, such as getting the lowest-cost entity to do the work.

2) Deaveraging can be done to recognize *specific product characteristics*, such as being non-standard or non-machinable. Here, the cost basis is usually the cost of the feature being recognized. If there is no interest in having the surcharged pieces pay higher per-piece contributions, the passthrough would be limited to 100 percent.[5]

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[4] The term "passthrough," sometimes "percentage passthrough," refers to the proportion of a cost difference, however defined, that is passed through into a rate difference. If x is the passthrough (possibly, $x = 0.95$), c is the cost difference, R_i and V_i are the rate and volume for product i (i = 1 for the higher-cost category and 2 for the lower-cost category), the rate equation becomes $R_1V_1+R_2V_2$ = the revenue requirement, where $R_1 - R_2 = x^*c$. Substituting, obtain: $R_1V_1 + (R_1 - x^*c)\ V_2$ = the revenue requirement. It is clear that as x increases, R_1 increases and R_2 decreases.

[5] The per-piece contribution is the per-piece revenue minus the per-piece cost, usually expressed in cents per piece. It is a contribution made by the piece toward

(continued...)

3) Deaveraging can be done to recognize *general product characteristics*, such as weight or distance carried or shape, which might be viewed as tending to identify separate products. The default prescription is to apply a subclass markup[6] to the bottom-up costs of pieces having the characteristics in question, which yields the rates. Alternatively, the rate difference is set equal to (i) the cost associated with the characteristic times (ii) the subclass cost coverage. The end result is the same. This is commonly done to recognize weight and zone in subclasses like Parcel Post and Priority Mail.

4) Finally, deaveraging can involve separation into distinct *subclasses*, with the rates for each based on separate markups applied to the costs of each. This is appropriate where a separate and independent application of all ratemaking factors is warranted for each new subclass. The implication is that the before-new-subclasses rates for the two categories are inappropriate and need to be changed. Markups different from both that of the former joint subclass and the implicit ones of the former rate categories would be expected.[7]

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[5] (...continued)
covering the non-attributable costs of the Postal Service, called variously institutional costs, fixed costs, and overhead costs.

[6] Markups are generally applied by multiplying a relevant cost by one plus the markup, both often expressed in percentage terms. Thus, if the markup is 60 percent, the cost would be multiplied by 160 percent. Viewed alternatively, the revenue divided by the cost would be 1.6, which is usually referred to as a "cost coverage" of 160 percent. Since the concept of a markup seems more basic than the concept of a cost coverage, I will refer to markups unless the context suggests otherwise. Always, the cost coverage (in percentage terms) equals the markup (in percentage terms) plus 100 percentage points. Applying Revenue Foregone Reform Act of 1993 (Pub. L. 103-123, commonly "RFRA") and calculating markup indexes requires working with markups, not coverages.

[7] In postal rate case parlance, markups on components of subclasses are often called implicit markups, even when they are not implied by anything more (or less) than estimates of the revenues and the costs of the mail involved. The fact that they may be called "implicit" instead of something like "intra-subclass" does not make their measure of the relation between rates and costs any less meaningful. In the end, it is the relation between rates and costs that is important. On this point, the Commission
(continued...)

Unless the volume in one of the new categories is zero at the time the deaveraging is done (which would be unusual), all forms of deaveraging cause the rates of one group to increase and of the other group to decrease, assuming the change is a breakeven adjustment. The expectation would be for the most pronounced rate adjustments in the case of the fourth kind of deaveraging, subdividing an existing subclass into two new subclasses, as done in Docket No. MC95-1, when Regular and ECR were created from third-class mail. It was expected that new markups for each of the two new subclasses would be selected, in order to improve the alignment of rates and costs, consistent with accepted ratesetting principles and the guidance in the Act, and that some rates would increase and others would decrease. As I explain in detail in my testimony, this process has been forestalled. It is time to take the steps understood at the time the two subclasses were created and adjust the markups and the rates accordingly.

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[7] (...continued)
said in its *Opinion and Recommended Decision* in Docket No. R90-1, ¶ 4006: "The central theme of postal ratemaking following the Postal Reorganization Act has been to assure that every piece of mail pays rates sufficient to compensate the Postal Service for whatever costs the Service incurs in order to provide that service." Similarly, in its *Opinion and Recommended Decision* in Docket No. MC95-1, ¶ 3017, it said: "and the function of mail classification is to create mail groupings which allow, and even help, the Postal Service to charge fair and equitable rates."

B. Deaveraging in the Past Has Caused Marked Adjustments in Rates.

Many examples of deaveraging exist, and the associated rate adjustments have sometimes been large. Several examples are summarized below.

1. In Docket No. R84-1, a decision was made to base the rates of then regular second class on an improved estimate of the proportion of costs caused by pieces (as opposed to pounds). As a result, the piece rates increased 75.7 percent for basic presort, 77.8 percent for 3/5-digit presort, and 77.3 percent for carrier route presort. These adjustments had large effects on mailers, even though they were tempered by varying reductions in the pound rates. *See* Rate History, USPS-LR-L-73.

2. In Docket No. R90-1, a decision was made to deaverage[8] then third-class mail in order to recognize separately the costs of letters and flats, as well as to provide dropship discounts. Many of the rate changes were large, even in the first step. For example, the rate for carrier route presorted flats, not dropshipped, increased 40.6 percent, and the corresponding rate for Nonprofit increased 50.9 percent. These rates applied in many cases to the total mailing, not just to certain portions. *See* Rate History, USPS-LR-L-73.

3. Even in Docket No. MC95-1, a case that was heralded as "contribution neutral" (as though it were making changes without *immediate* effects on mailers), the rate for basic flats, not dropshipped, increased 15.0 percent and the corresponding rate for letters increased 14.1 percent. Other rates decreased. These changes occurred not because of the new subclasses, but rather because of greater recognition of the costs of the constituent rate categories. One would presume that the presence of such effects was one reason for holding off on immediate application of the appropriate criteria to the new subclasses.

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[8] In introducing its third-class rate development section, the Commission said: "The main theme that emerges is restructuring third class to recognize past concerns about the alignment of rates with costs. This evidences itself in two Service-proposed rate design changes which 'de-average' third-class rates by shape and distance." Docket No. R90-1, *Op. & Rec. Dec.*, ¶ 5801. In reference to the changes made in third class in that docket, the Commission referred to deaveraging 11 times.

4. In Docket No. R97-1, a decision was made to deaverage certain Standard Mail rates by applying a surcharge to residual-shape pieces. In the Regular subclass, piece-rated residual-shape pieces in the basic category, not dropshipped (accounting for about one-third of piece-rated residual-shape pieces), received a rate increase of 32.0 percent. Five-digit presorted pieces dropshipped to the destination SCF, accounting for just under one-half of the same category, received a rate increase of 54.1 percent. *See* Rate History, USPS-LR-L-73.

Other examples could be given, even from the instant docket. It is clear that efforts to improve rates can have large effects on mailers, both positive and negative. The existence of such effects has not prevented progress in the past, and it should not prevent progress now.

C. Fairness Considerations Have Not Been and Should Not Be a Hindrance to Deaveraging.

When deaveraging, the Commission always considers the fairness of the changes and the effects on mailers. In Docket No. R90-1, which led to the increases of 40.6 percent and 50.9 percent for important categories of regular third class, described in item B-2 above, as well as to some increases that were far smaller than the approximately 20-percent average increase for the subclass as a whole, the Commission pointed to the need to recognize costs when demonstrated on the record consistent with issues of fairness:

> Subsection (b)(1) directs that the overall schedule be, and remain, fair and equitable. We believe this supports our reluctance to precipitously enact major readjustments in rate relationships between classes, and between groups within classes, **absent evidence and analysis justifying such a change**. To the

> contrary, we assume that mailers are entitled to expect that what was found fair and equitable in the recent past will be considered fair and equitable in the near future **unless evidence is presented which suggests a different outcome**. [Docket No. R90-1*, Op. & Rec. Dec.,* ¶ 4122, emphasis added.]

Further:

> The fair and equitable guideline involves far more than merely searching the evidentiary record to identify places where existing relationships have been shown to be unfair. The Commission is a collegial body with five members, each of whom has a separate, distinct view of what is fair and what is equitable. These five views become balanced as rate recommendations are being developed.
>
> We recognize that more than one schedule of rates could be constructed which would meet some particular individual commissioner's standard of fair and equitable. Several issues before us in this case, such as the extent to which de-averaged costs should immediately be reflected in rates, and the maximum amount specific rates should be allowed to increase or decrease in the context of an overall rate increase of almost 20 percent, are issues which can best be understood in terms of fairness and equity. And it is the benefit of balanced determinations of fairness and equity that has led Congress to establish multimember commissions such as the Postal Rate Commission.
>
> Our recommendations in this case should not be read as representing our view of the only possible schedule of postal rates and fees. But we have assured ourselves that the rates we recommend, both the individual rates and the complete schedule as a whole, satisfy each of us as a fair and equitable ... system ... among the various users of that system. [*Id.*, ¶¶ 4124-26.]

It is a common feature that rate issues have two sides. Specifically, when one rate is too low, and concern exists over whether it is fair to increase it, another rate is too high. The same or greater level of concern should exist over the fairness of charging such a high rate and of maintaining it. One would not expect a mailer benefitting from a too-low rate to complain; on the contrary, he would probably do all he could to perpetuate the situation he finds favorable. On the other hand, it should not be surprising if a mailer paying the higher rate expresses considerable concern.

These kinds of fairness considerations suggest further important changes are needed in the rate relationships among categories of the former third class. Indeed, considerations of fairness should stimulate the Postal Service and the Commission to make the changes needed, not prevent those changes. Rates are an important determinant of both the effectiveness of the Postal Service and the efficiency of the nation. Improvements can and should be made.

IV. ANALYSIS OF IMPORTANT ISSUES

The Regular and ECR subclasses[9] were created pursuant to a recommendation of the Commission in Docket No. MC95-1, the reclassification

[9] According to the Domestic Mail Classification Schedule ("DMCS"), Standard Mail is composed of four subclasses: Regular (section 321), Nonprofit (section 323), ECR (section 322), and Nonprofit ECR (section 324). For rate development purposes, however, only two subclass-type costs are estimated and only two markups are selected. Within each of these two, as required by P.L. 106-384 (October 2000), the rates for the Nonprofit categories are developed to yield a per-piece revenue that is 60 percent of the per-piece revenue of the host commercial category. Accordingly, and to be clear, I will discuss Standard Mail as though it had two subclasses, each with two categories, these being Regular (composed of the categories of Commercial Regular and Nonprofit Regular) and ECR (composed of the categories of Commercial ECR and Nonprofit ECR). For reasons of symmetry, I will sometimes capitalize "Commercial."

Ambiguity in referencing these categories is not uncommon. For example, the Postal Service RATEFOLD, Notice 123 (January 8, 2006), shows three categories of "Standard Mail Regular–Flats," those being Presorted, ECR, and Automation, in that order, even though ECR is a separate subclass and even though the term "Regular" is not associated with any category of ECR mail. The Domestic Mail Manual ("DMM") is similarly misleading; for example, section 243.1.3 is headed: "Regular Standard Mail–Presorted, ECR, and Automation Rates."

In apparent response to some of this confusion, witness Kiefer proposes "that the Standard Mail Nonprofit subclass be renamed Standard Mail Nonprofit Regular." USPS-T-36, p. 4, ll. 5-6. This seems a rather cumbersome designation. The DMCS language proposed by the Postal Service in Attachment B of the Request shows a "Regular Subclass" (section 321), a "Nonprofit Regular Subclass" (section 323, an "Enhanced Carrier Route Subclass" (section 322), and a "Nonprofit Enhanced Carrier Route Subclass" (section 324). This improves parallelism, as witness Kiefer notes. *Id*. However, it does not make clear whether Nonprofit Regular is part of Regular, and a similar question exists for ECR. In other words, does the twosome of Regular and Nonprofit Regular (for which rates are designed jointly and for which costs are developed jointly) have a name, and is it "Regular"? My inclination is to think of the twosome when Regular is discussed, and similarly for ECR.

case. More specifically, the reclassification decision was to split regular third-class mail into two new subclasses, Commercial Regular and Commercial ECR. A cost and a markup existed for each new subclass. At the time, Nonprofit Regular and Nonprofit ECR, created in Docket No. MC96-2 (the follow-on reclassification case for Nonprofit), had rates developed by applying to their costs a markup equal to one-half the markup of their most closely corresponding commercial category, as required by the Revenue Forgone Reform Act of 1993. Therefore, the burden associated with setting Nonprofit rates at less than the full commercial markup was carried by the overall postal system, and not by the corresponding commercial category.

Beginning with Docket No. R2000-1, however, as required by P.L. 106-384 (October, 2000), the rates for Nonprofit Regular and Nonprofit ECR have been developed to obtain for each an average per-piece revenue equal, as nearly as practicable, to 60 percent of the average per-piece revenue of their most closely corresponding commercial category, meaning that they are linked to Commercial Regular and Commercial ECR, respectively. Also, the law required that markups be selected to apply to "the costs attributable to the regular rate mail in each class or subclass combined with the mail in the corresponding special rate categories," making it clear that the Commercial and Nonprofit costs are to be "combined" and that the Nonprofit subclasses are now, for ratesetting purposes, "categories."

The rates resulting from Docket Nos. MC95-1 and MC96-2 were constrained to be contribution-neutral, and thus their initial markups did not result from an independent application of the non-cost factor. However, despite this constraint, numerous rate adjustments did occur as a first step, as discussed above. In Docket No. R97-1, separate markups were selected for Commercial Regular and Commercial ECR, and the Nonprofit coverages followed the RFRA rule. In Docket No. R2000-1, as required by P.L. 106-384, markups were selected for the aggregate categories of Regular and ECR, and rates for the Nonprofit categories were set according to the then new 60-percent rule. In Docket Nos. R2001-1 and R2005-1, due to settlement agreements, very little record was developed, so that the consideration given to the coverages was accordingly limited.[10]

This history frames the role of the instant docket and must be understood in order to address questions of markup with perspective. Therefore, this section reviews these matters in some detail and ends with a proposal on what the markups should be.

[10] Paragraph 16 of the Stipulation and Agreement stated: "The undersigned parties also agree that, as the matter presented in the Postal Service's Request, in any Commission Recommended Decision, or in any decision of the Governors of the Postal Service in this proceeding have not actually been fully litigated, they are not entitled to precedential effect in any other proceeding." Docket No. R2005-1, *Op. & Rec. Dec.*, ¶ 4002.

A. The Commission's Guidelines for Deaveraging Existing Subclasses into Two or More Separate Subclasses Require that the Categories Being Considered for Subclass Status Have Different Costs and Different Demand Characteristics.

Any time a category of mail is defined so as to receive separate rate treatment, it necessarily excludes other categories.[11] The question of when to create exclusionary categories, and then to decide what form any new classification should take, has been the subject of considerable Commission deliberation since just after postal reorganization in 1970. Indeed the Act provides separate criteria for classifying mail, in 39 U.S.C. section 3623(a), and anticipated that reclassification would occur.

In its *Opinion and Recommended Decision* in Docket No. MC95-1, the Commission reviewed some of the earlier deliberation on classification. (*See* section beginning on p. II-17.) The question of what should be put in the DMCS, as distinct from the DMM, which is within the control of the Postal Service, was

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[11] Discussing this issue of exclusion in the Bulk Small Parcel Service case, Docket No. MC93-1, the Commission said:

> As configured by the Postal Service, BSPS is a somewhat exclusive mail classification. While there are no content-related restrictions (unlike some other fourth-class categories), the proposed eligibility requirements regarding bulk entry, weight limitation, required presortation, etc. have an exclusionary effect. Contrary to the arguments of some parties, we do not find this exclusivity to be inherently objectionable; after all, with the exception of First Class and Priority Mail, every grouping of mail has exclusionary features. As we observe elsewhere in this opinion, the proper inquiry is whether exclusionary, arguably discriminatory, eligibility requirements have rational bases. [*Id., Op. & Rec. Dec.*, ¶ 409.]

raised in Docket No. MC73-1, and then put off, partly in response to a settlement reached by the parties.

In Docket Nos. MC76-5 and MC78-3, the Commission went further, determining that the DMCS should contain classifications that bear significantly on the intrinsic costs or value of the services in question or that "have a significant effect on competition." Docket No MC95-1, *Op. & Rec. Dec.,* including fn. 5, ¶ 2057. The Commission observed:

> Mail classification was recognized in these early cases as a process for identifying groupings of mail **for the purpose of setting rates, based on differences in costs and values of service**, with the Commission recommending the scope and extent of the DMCS and the Postal Service retaining ability to issue implementing regulations. [*Id*., ¶ 2059, emphasis added.]

It was clear at this point that costs and value of service would be important. However, the question of subclass status was not decided:

> That proceeding [MC76-5] ... did not attempt to decide whether a Postal Service proposal should be incorporated as a separate class or subclass (to which all of the Act's policy factors would be applied in setting rates), or merely as a category within a subclass (rates for which would normally be set on the basis of costs avoided owing to worksharing). [*Id*, ¶ 2069.]

The question of subclass status was raised in Docket No. R77-1 in connection with the presort discount in First-Class. The Commission stated in its *Opinion and Recommended Decision* that the purpose of presort was

> primarily ... to bring about a structural reform within

> first-class mail in order to align rates with costs rather than to give recognition to unique characteristics of presorted first-class mail which would warrant an independent application of all of the § 3622(b) ratemaking criteria to this category. [*Id.*, p. 247.]

It went on to say:

> Factors such as unique content, value of service, elasticity of demand or required levels of service, which would make a separately determined cost coverage relevant and appropriate, were absent from our discussion of the presort discount. [*Id.*, p. 248.]

In its Opinion in Docket No. MC95-1, the Commission referenced this section of Docket No. R77-1, saying: "In the past, the Commission has accorded subclass status to a grouping of mail when that status will facilitate the application of the ratemaking factors of the Act." *Id.,* p. I-2. It then said:

> In the past, a showing of cost and demand differences has been important for concluding that independent application of all of the § 3622(b) ratemaking criteria is warranted. The Postal Service policy witness recognizes that "[d]efining homogenous mail subclasses with respect to cost and market factors *allows the various pricing factors of the Act to be applied in an effective manner*." USPS-T-1 at 25 (emphasis added). The cost characteristics test reflects the need to classify mail for purposes of attributing costs. The market-demand characteristics test reflects the need to classify mail for purposes of assigning institutional costs, particularly to take into account "the value of mail service actually provided each class or type of mail service to both the sender and the recipient...." 39 U.S.C. § 3622(b)(2). [*Id.*, ¶ 1007, emphasis in original, footnote omitted.]

The question of subclass status for presorted First-Class was addressed again in Docket No. R80-1. The Commission said:

> the critical factors to be considered are whether the cost characteristics and market demand characteristics of presorted first class are sufficiently different to warrant independent evaluation under the § 3622(b) factors. [*Id., Op. & Rec. Dec.*, ¶ 0686.]

The same emphasis on costs and demand was key in Docket No. MC83-2. *See especially id., Op. & Rec. Dec.*, ¶¶ 2064-67. In Docket No. MC95-1, referring to consistency with past analysis, the Commission said: "To identify groupings of mail, which should be accorded subclass rather than rate category treatment, the Commission traditionally has sought to identify differences in both cost and market, or demand." *Id., Op. & Rec. Dec.*, ¶ 3022. The next paragraph says: "The Commission has consistently expected proponents of separate subclass treatment to show differences in both costs and demand." *Id*., ¶ 3023. A footnote at this point says:

> It is possible to hypothesize a group which might warrant separate subclass treatment, even if its costs and demand were similar to those of an existing subclass because of other characteristics (such as high ECSI value), which justify separate application of the § 3622(b) factors of the Act. However, such a case has never been made to the Commission. Since proposals for separate subclass status have been justified by cost and demand arguments, those factors have been discussed the most in past opinions. [*Id*., fn. 5.]

The issue is whether a candidate subclass is sufficiently different to warrant an independent application of the factors in the Act, which generally boils down to a focus on costs and demand. More recently, in its *Opinion and Recommended Decision* in Docket No. MC2004-5, the Commission said: "When

the Commission evaluates a proposal to create a subclass of mail, its first concern is to determine whether the candidate mail exhibits common cost and demand characteristics that are distinct from other subclasses." *Id.*, p. 14.

B. The Postal Service Proposal for Separate Regular and ECR Subclasses in Docket No. MC95-1 Focused on Unique Cost and Demand Characteristics.

The notion of separate subclasses for what were proposed to be called Regular mail and Enhanced Carrier Route mail was introduced in the testimony of Charles McBride.[12] Although he discussed a wide range of considerations, his bottom line, as far as subclass justification is concerned, was that "[a] carrier route subclass is justifiable both on the basis of unique cost and market characteristics and because it meets a significant and substantial need." *See generally* USPS-T-1, and *specifically* p. 50, ll. 17-18, Docket No. MC95-1. The proposal, then, was very much in line with Commission guidelines, as outlined above.

Additional discussion of the subclass question was provided by witness Moeller. *See* Docket No. MC95-1, USPS-T-18. On page 4 (ll. 5-6 and 19-25,

[12] A carrier route category had existed within third class for some time. Aside from the fact that the original proposal was to price letter-size and flat-size pieces the same in the new subclass, ECR was simply a new name for the carrier route category. The only enhancement was a line-of-travel requirement, which would tend to reduce costs. This requirement would have seemed a normal progression for the category, even if a separate subclass had not been created. The saturation and high-density portion of the carrier route category already had a walk sequence requirement.

respectively), he said: "The characteristics of mail in Enhanced Carrier Route cause its costs to be intrinsically different from those of other mail in the Standard class." And, "[b]y virtue of its higher density requirement, Enhanced Carrier Route is more likely [than Regular] to be used for ... distribution of more generalized advertising pieces that appeal to a broader range of consumers.... The most telling indication that carrier route serves a distinct market is its substantially different elasticity coefficient."

In connection with an interrogatory dealing with intrinsic cost differences, witness Moeller was asked on oral cross examination: "So you are hoping that reclassification will move you toward a position where the rates for carrier route will better reflect intrinsic costs rather than the model discounts, correct?" His answer was: "I believe that is the point of this response." Docket No. MC95-1, Tr. 11/4083, ll. 14-18; *see also* Tr. 11/4208.

The Commission recognized the Postal Service proposal for an ECR subclass as based on differences in costs and demand. In its *Opinion and Recommended Decision*, it said: "To justify the proposed subclasses [in the former third class], the Postal Service argues that there are cost and market differences among the proposed subclasses, and that other benefits also accrue from this proposal." *Id.*, p. V-147, ¶ 5340; *see also* p. V-156. In paragraph 5373, the Commission said: "Moeller argues that the costs of Enhanced Carrier Route Mail are intrinsically different from the other subclasses because of its characteristics." And on page I-3, the Commission says: "The Postal Service

policy witness recognizes that '[d]efining homogenous mail subclasses with respect to cost and market factors *allows the various pricing factors of the Act to be applied in an effective manner*.'" (Emphasis in original.)

C. The Postal Service's Proposal in Docket No. MC95-1.

In order to facilitate the initial implementation of its subclass proposals, the Postal Service proposed a "contribution-neutral" approach in Docket No. MC95-1. That it expected contribution levels to change in the future became clear early in witness McBride's testimony (USPS-T-1). Witness McBride's testimony included: (i) a section entitled "Efficient Mail Pays Disproportionate Contribution," (ii) a section entitled "Efficient Mail Is Most Susceptible to Non-USPS Delivery," and (iii) a section entitled "Efficient Mail Must Be Retained to Maintain Reasonable Rates for All."[13] USPS-T-1, pp. 16, 17, and 18, respectively. In its Reply Brief, the Postal Service said: "NAA would simply have the Commission ignore the fact that the current institutional cost burden borne by the mail which would be entered in those [proposed-to-be Standard] subclasses is **excessive by any measure**." Postal Service Reply Brief, p. 140 (emphasis added).

[13] In the context of Docket No. MC95-1, "Efficient Mail" was a reference to mail with a low cost to process and deliver, and had nothing to do with whether the Postal Service was efficient in performing any processing and delivery operations that any particular category of mail required.

Postal Service witness Moeller addressed this issue for ECR specifically. He said: "In order to move toward a more market-based structure and to limit the effect of rate changes, I propose a 212 percent coverage for the Enhanced Carrier Route subclass.... This filing is a *first step* in moving toward a more market-based structure. USPS-T-1. If not for the desire to avoid major rate relationship changes, I would propose a lower cost coverage for Enhanced Carrier Route." USPS-T-18 at 6, l. 18-20 and 7, line 4-7 (emphasis added). The subject sentence of the next paragraph is: "Other criteria also support a lower cost coverage for Enhanced Carrier Route." *Id.*, p. 7, l. 8.

Witness Moeller proceeds to discuss the appropriate cost coverage for the proposed Regular subclass. After discussing several relevant criteria of the Act, he concludes: "these suggest a higher cost coverage than Enhanced Carrier Route." *Id.*, p. 9, ll. 11-12.

The emphasis on contribution neutrality distracted attention from sizable effects in the rates actually proposed. These resulted from changes in the costs proposed to be used within the subclasses to develop the various rate elements. For example, the then current rate for basic letters weighing less than the breakpoint was 22.6 cents (per piece), and the corresponding rate in the new Regular subclass was proposed to be 26.1 cents, an increase of 15.5 percent. At the same time, the then current rate for prebarcoded letters was 20.4 cents, and in the same new Regular subclass was proposed to be 17.5 cents, a decrease of 14.2 percent. This means that, despite contribution neutrality as

proposed, there was a swing of 29.7 percentage points between basic letters and automation letters. Also, changes were proposed in the dropship discounts, with the DSCF per-piece discount for pieces under the break-point declining 15 percent. My review of the record revealed that no mailers experiencing any of the increases contested the changes on the grounds of fairness, effects, or any other basis.

Witness Moeller was asked about his assessment that a reduction in cost coverage would be appropriate. *See* Docket No. MC95-1, Tr. 11/4258, 4260, 4261, 4269, and 4275-76. For example, OCA/USPS-T-18-4(a) asked with specific regard to ECR:

> Q. If you were not constrained by your desire to avoid major rate relationship changes (page 8), what cost coverage and markup index would you recommend for Enhanced Carrier Route? In providing this recommendation, please assume the Docket No. R94-1 systemwide cost coverage of 156.8 percent. [Tr. 11/4258.]

Witness Moeller's response was:

> A. I have not specifically quantified cost coverages that I would recommend in the absence of the desire to avoid major rate relationship changes. However, if we were starting from a situation where the coverages for the three subclasses [the three being proposed in Standard] were equal, a somewhat lower coverage for Enhanced Carrier Route relative to the combined coverage for the three

> new subclasses could be supported.
> [*Id.*]

This identical answer was repeated in response to OCA/USPS-T18-5, OCA/USPS-T18-6, and OCA/USPS-T18-18, and was referenced in response to OCA/USPS-T18-12.

In its *Opinion and Recommended Decision*, the Commission acknowledged the assessment of the Postal Service witnesses that relative cost coverages are out of alignment and would be expected to change, saying: "The Service's three pricing witnesses all aver that, except for constraints such as contribution neutrality, they would have reduced coverages of the new, 'efficient' subclasses while shifting additional institutional cost coverage to the 'regular' mail." Docket No. MC95-1, *Id.*, ¶ 2129.

The Postal Service posture in Docket No MC95-1, then, is hardly captured by references to contribution neutrality. It proposed relative rate swings of 29.7 percentage points and argued that appropriate recognition of the ratesetting guidance in the Act would suggest further changes in the future, assuming defensible rates under the Act were to be achieved, and it did all of this under the banner of being unwilling to affect mailers in a negative way. (I will return to this issue, after discussing the Postal Service's unwillingness in subsequent cases to propose effects on mailers of anywhere near this size.)

D. The Commission's Recommendation in Docket No. MC95-1.

The Commission evaluates candidate subclasses by looking for evidence of distinct cost and demand differences, and the Postal Service request to split third class sought to make such a showing. The Commission concluded the Postal Service succeeded with respect to ECR:

> Of the new subclasses proposed by the Postal Service, only Enhanced Carrier Route has been shown on this record to exhibit sufficiently distinct market characteristics from the remainder of the subclass within which it currently is found to warrant treatment as a separate subclass for rate design purposes. [Docket No. MC95-1, *Op. & Rec. Dec.,* ¶ 4208.]

Explaining its decision further, it said:

> Based on the record in this docket, the Commission recommends that the Standard Mail currently classified as Bulk Regular Rate third-class mail be divided into two subclasses designated as Enhanced Carrier Route and Regular. The Enhanced Carrier Route Standard Mail being recommended is the Service's proposed Enhanced Carrier Route Standard Mail, plus those automation carrier route letters that are included in the Service's proposed Automation Subclass. The Regular Standard Mail, is composed of the Service's proposed Automation and Regular Standard Mail, minus the carrier route mail which would be placed in the Enhanced Carrier Route subclass.
>
> The Commission does not find the arguments on cost differences among the three proposed subclasses sufficient to warrant recommendation of the three separate subclasses. The cost differences, however, combined with market and demand arguments and broad agreement among the users of Standard Mail,

> are sufficient to recommend an Enhanced Carrier Route subclass. [*Id*., ¶ 5343-44.]

The Commission also said: "The driving factor for the definition of the subclass, however, is the perceived differences in demand as well as costs, and the corroborating evidence of Postal Service and mailer support." *Id*., ¶ 5481. In reference to demand differences, the Commission said: "The Commission is satisfied that the proposed Enhanced Carrier Route subclass has distinct demand characteristics which indicate differences in value to senders." *Id*., ¶ 3121. It said "carrier route and noncarrier route mail have different own-price elasticities" and that "the two subclasses would tend to group mailers with similar price sensitivities, thereby creating more homogeneous subclasses than the current single subclass." *Id.,* ¶ 5344. It also referred to ECR as a "distinct group[ing]." *Id*., ¶ 5345. *See also generally id*., ¶ 1009.

The Commission's wording make it clear that third class was "divided into two subclasses," which is a process of deaveraging.[14] In a section rejecting a separate subclass for an automation category, the Commission said "that the **only benefit** of disaggregating subclasses further would be the ability to reflect differences in demand or other non-cost factors in the Act in **separate**

[14] The notion of "deaveraging" is often associated with costs, as in deaveraging rates to reflect cost differences. But it can just as well be associated with demand, or, as in the present case, with both.

markups." *Id*., ¶ 4253 (emphasis added).[15] In other words, separate markups recognizing the demand differences and any other non-cost factors would be expected.

In a section on the economics that underlie the role of subclasses, which reminds the reader that "equity and efficiency considerations are foundations of Commission rate recommendations," the Commission states:

> establishment of subclasses whenever market studies reveal a possibility for price discrimination is not useful, unless it can also be demonstrated that corresponding opportunities exist to make postal pricing more efficient or more equitable to mailers. [*Id*., ¶ 5447.]

and

> the own-price elasticities and other demand characteristics of carrier route and noncarrier route mailers are sufficiently different so that separate rates and discounts for carrier route and noncarrier route mail should improve the equity and economic efficiency of the postal rate structure. [*Id*., ¶ 5460.]

The Commission further explains that:

> **Equity** and **economic efficiency** considerations can have the same force and effect among the mailers within a subclass only when these mailers' own-price elasticities are **similar**. The most appropriate demonstration that opportunities exist to make postal pricing more efficient and/or more equitable to mailers is the presentation of reliable estimates showing that a proposal separates mailers with **distinctly different** own-price elasticities of demand into more

[15] In context, I do not see the notions of disaggregating and deaveraging to be different in any meaningful way.

> homogeneous subclasses. [*Id.*, ¶ 5448 (emphasis added).]

The improvements in postal pricing held out by the Commission as the purpose of making the classification changes, which would bring about increases in economic efficiency, cannot occur unless the rates are changed and mailers respond. This requires that the markups be changed. That is, elasticity differences may exist and they may even be the basis for splitting a subclass into separate subclasses, but, unless the demand differences are recognized in changed markups for the two subclasses, no efficiency improvements will be realized and the time and effort required to create the subclasses will have been wasted. Changes in the markups were implied by the Commission's analysis, as should have been clear to all parties at the time.

The Commission included in its evaluation the long-term consequences of creating new subclasses, pointing out that "§ 3623's standards require a longer term view, at least in major proceedings," and that it "must attempt to evaluate the probable ramifications of its recommendations." *Id.,* ¶ 2084 and ¶ 2133, respectively. One consequence of splitting regular third class into Regular and ECR is that the rates and coverage for Regular would increase, while the rates and coverage for ECR would decrease. The finding of distinct cost differences applied to both Regular and ECR. Similarly, the finding of distinct demand differences applied to both. It makes no sense to split a subclass based on cost

and demand differences, and then not recognize those differences when rates are set. The basis for these consequences was spelled out in the Commission's *Opinion and Recommended Decision*.

E. The Postal Service's View of ECR Coverage Since Docket No. MC95-1.

During the pendency of Docket No. MC95-1, the Postal Service indicated at several points that the case should be viewed as a first step. As noted above, witness Moeller said: "This filing is a first step in moving toward a more market-based structure. USPS-T-1. If not for the desire to avoid major rate relationship changes, I would propose a lower cost coverage for Enhanced Carrier Route." USPS-T-18, p. 7, ll. 4-7.

The next omnibus rate case was Docket No. R97-1. Witness O'Hara, the rate level witness, addressed the coverage for ECR on page 34 of his testimony, saying: "The Postal Service is proposing a cost coverage of 228 percent for the Enhanced Carrier Route (ECR) subclass, which results in a 3.2 percent average rate increase. This is somewhat below the system-wide average increase, reflecting a desire to lower the very high cost coverage of this subclass." *Id.*, USPS-T-30.

Witness O'Hara was asked in DMA/USPS-T30-2 whether, "given the facts of this case, the coverages for First-Class Mail and Standard (A) Regular mail should be 'close together, near the systemwide average.'" He responded:

> Yes, at least to the degree indicated in my testimony at page 36, lines 1-9, where I note that, were it not for the effects of rate increases on mailers and the other factors discussed in that paragraph, a lower cost coverage for Standard A ECR would have been appropriate, which would have meant higher rate increases (and coverages) for other subclasses (such as Standard A Regular). Since the ECR coverage is above both that of First-Class Mail letters and the system average while the Regular coverage is below, this would move in the direction indicated in the question, bringing the coverages 'closer' together (as in the quote from [the Commission in] R90-1), if not necessarily 'close' (as in parts a-b of the question). [*Id.*, Tr. 2/131.]

Further explanation was provided in oral cross examination, where witness O'Hara said:

> I have a rate increase for Standard A regular, which, again, starting from the existing situation, winds up being low, as it was in the before rate situation, and I have a slightly higher rate increase for Standard A regular, bringing those two categories, as this interrogatory raises the possibility of, slightly closer together. We're not moving very fast in that direction, but we are moving them slightly closer together. [*Id.*, Tr. 2/350.]

I interpret this to mean that the Postal Service's fundamental position was that, in line with the Act and accepted principles of regulatory ratesetting, the coverage on Regular should be higher and the coverage on ECR should be lower, that it was moving in that direction, but that it was restraining itself due to the effects on mailers who are paying, and will continue to pay, rates that, based on the same principles, are lower than they should be.

The question of the appropriate speed of movement toward defensible, preferred rate positions is an important one. Proposed rate swings as wide as 29.7 percentage points in Docket No. MC95-1 already have been noted. In Docket No. R97-1, the pound rate for ECR mail was proposed to decrease 19.7 percent (along with an increase in the associated piece rate for the basic category of 205.6 percent), clearly because the Postal Service felt that it should be lower and wanted to take steps to move in that direction. Yet when it came to the coverage for ECR, which the Postal Service also felt should be lowered, it proposed a rate increase of 3.0 percent, just 1.5 percentage points below the systemwide average of 4.5 percent.

Clearly, the statute requires that effects on mailers be considered. I contend, however, that bigger steps should have been taken. If only baby steps are taken toward preferred rate positions, the process can take decades, which I believe is actually unfair to the mailers involved. That is, if it is fair to reflect costs and associated factors in rates, then it is unfair not to reflect costs and associated factors in rates, including those mentioned in the Act.

In Docket No. R2000-1, the Postal Service's rate level testimony was presented by Virginia Mayes:

> The Postal Service is proposing a cost coverage of 208.8 percent over volume variable costs for the Enhanced Carrier Route (ECR) subclass, which results in a 4.9 percent average rate increase. This is somewhat below the system average increase [of 6.4 percent], reflecting a desire to lower the very high

> cost coverage of this subclass. [*Id.*, USPS-T-32, p. 38, ll. 4-8.]

She elaborated on this proposal in response to two interrogatories. In NAA/USPS-T32-21, she was asked about her position that a reduction in the coverage of ECR is "desired." She responded:

> It is my understanding that ECR was established as a subclass with the intent of more directly reflecting the unique cost and market characteristics of this mail. As a rate category of Standard Mail, the ratio of revenue to cost for this category had been very high. Establishing ECR as its own subclass permits the direct application of the pricing criteria which, when considered all together, may justify a lower ratio of revenue to cost than had been the case when ECR was only a rate category. However, as a look at Library Reference LR-I-149 would demonstrate, the cost coverage for ECR as proposed by the Postal Service does not represent a reduction in the cost coverage relative to what the Commission recommended in Docket No. R97-1. There is a disconnect between the desire to reduce the cost coverage and the conclusion, after considering all of the pricing criteria, that a reduction would not be feasible at this time without shifting the burden for institutional cost recovery to other subclasses and possibly exacerbating the relatively high rate increases or cost coverages already being borne by those subclasses. Please see my response to your interrogatory NAA/USPS-T32-23. [*Id*., Tr. 11/4324-25.]

In response to NAA/USPS-T32-23, she said:

> ECR is a large enough subclass that it represents a substantial contribution to institutional cost recovery (see my Exhibit USPS-32B). As I already had several subclasses for which criterion 4, impact of rate increase on mailers, would necessitate that their share of institutional burden be somewhat mitigated

> due to large increases in their costs, I was aware that there were not very many sources for this additional contribution. [*Id*., Tr. 11/4327.]

Though it is apparent that witness Mayes supported a "direct application of the pricing criteria" and that she believed this application suggests a lower coverage for ECR, it is also apparent that she viewed the admonition in the Act to consider the effects of rate increases on mailers to place an overwhelming constraint on movements toward preferred and indicated rate positions. She says that she "somewhat" mitigated the extent to which "several subclasses" were being asked to face the "increases in their costs," meaning in the Postal Service costs of handling the mail involved, though it is apparent that she substantially mitigated the extent of these increases.

Witness Mayes acknowledges that ECR "was established as a subclass with the intent of more directly reflecting the unique cost and market characteristics of this mail," but does not appear to recognize that Regular was established with the same intent. In this regard, she refers specifically to mitigating the exposure of mailers to "increases in their costs," but she does not refer to the need to take steps in the direction of recognizing each subclass' "unique cost and market characteristics." Both the costs of the mail involved, and the need to take steps toward improved rate positions, should be recognized.

Yet another Postal Service constraint on the coverage for ECR was identified. In NAA/USPS-T32-27, witness Mayes was asked if she agreed with a

statement made by Postal Service witness O'Hara in the previous omnibus docket that "a lower coverage for ECR would have made it more difficult to design rates so that the Automation 5-digit rate in Standard Regular was below the ECR basic rate." She responded "yes," and cited a management concern. Tr. 11/4332. But allowing a constraint like this to play a role in setting coverages is directly at odds with her position in NAA/USPS-T32-21, referenced above, that one of the beauties of a subclass is that it is possible to reflect more directly its "unique cost and market characteristics." The Commission has been clear that an independent application of the factors in the Act is warranted for a subclass, an issue I discuss further below. Also, the Commission has made it clear that the coverage for ECR should not be biased or constrained by such a concern.[16]

The issue of constraining rate increases came up again in NAA/USPS-T32-29, in which witness Mayes was asked how the coverages of Regular and ECR "satisfy the 'need to maintain rate relationships across subclasses.'" She responded: "Cost coverages, while useful in understanding the allocation of institutional cost burden, ultimately tie to rate changes. The rates which result from the application of cost coverages and rate design concerns would be of more primary concern in maintaining rate relationships than would be the cost coverages." Tr. 11/4334. Witness Mayes appears to be focusing narrowly on

[16] "The Commission finds persuasive witness Mitchell's arguments for decoupling the ECR basic and Standard Regular 5-digit automation rates, and expanding the letter/flat differential at the basic level to better reflect cost differences." Docket No. R2005-1, *Op. & Rec. Dec.*, ¶ 6075.

criterion 4 (“the effect of rate increases”), or rate shock. As I explain elsewhere in my testimony, cost coverages developed based on all rate criteria are much more important than this sentence suggests – they are the principal tie to notions of fairness in rates and to the guidance to ratesetting provided by economic theory and general regulatory practice. Also, as a practical matter, focusing on “rate changes” as the “more primary concern” puts off and may forestall completely rate improvements, such as recognizing “cost and market characteristics” in an improved way, which was the principal issue in the reclassification decision in Docket No. MC95-1.

Docket No. R2000-1 was the last docket in which an extensive record based on a genuine adversarial process was developed. Docket Nos. R2001-1 and R2005-1 were largely settled dockets. However, the Postal Service’s initial proposal in Docket No. R2001-1 was conventional, in that a settlement was not anticipated at the time the case was prepared and filed. There, witness Moeller said:

> The Postal Service is proposing a cost coverage of 217.8 percent over volume variable costs for the ECR/NECR subclass, which results in a 6.2 percent average rate increase for ECR, and a 6.5 percent increase for NECR. These are somewhat below the system average increase, reflecting a desire to lower the very high cost coverage of this subclass. [USPS-T-28, p. 36, ll. 15-19.]

This compares with a proposed cost coverage for Regular of 146.2 percent, yielding a rate increase for Regular Commercial of 8.0 percent and for Regular Nonprofit of 6.7 percent. *Id*., p. 33, ll. 5-7. Witness Moeller explained further:

> Although the percentage rate increase proposed for this subclass is below the system average in this case, many of the factors considered above indicate a cost coverage lower than that actually proposed. However, a lower markup would mean shifting more of the burden of covering institutional costs to other subclasses. [USPS-T-28, p. 38, ll. 11-14.]

In response to NAA/USPS-T28-10, witness Moeller said: "The 'desire' to lower the cost coverage for ECR is based on examination of the pricing criteria, and comparison of the ECR coverage to the coverages for other subclasses." Tr. 9/2544.

In response to AAPS/USPS-T28-4, witness Moeller was asked if he agreed "that the extent of competition is not the same for all types of Standard mail." His answer was:

> Yes; in Classification Reform, Standard Mail was split into two subclasses, Regular and ECR, in part to recognize the market (and presumably competition) differences within what had been the Bulk Rate Regular subclass. [Tr. 9/2511.]

In my view, this recognition that bulk third class was "split into two subclasses" with the intent to recognize more effectively cost and market differences should have led to a larger adjustment, in line with witness Moeller's assessment that "many of the factors considered ... indicate a cost coverage lower than that actually proposed." It is apparent that concern over the effects of shifting

institutional costs overwhelmed other factors and dominated the final proposal, even though such shifting should be expected when subclasses are split.

One other contributing factor may be indicated, as witness Moeller noted specifically that "[i]n Docket No. R97-1, the rate level for ECR was cited as facilitating the rate relationship between ECR Basic and 5-digit automation letters." USPS-T-28, p. 12, fn. 5. The suggestion is that the coverage on ECR has been held high in order to keep the rate for basic letters above the rate for 5-digit automation letters, despite the fact that the 5-digit automation letters are in a separate subclass. In Docket No. R2005-1, the Commission recognized the arguments against such a constraint as "persuasive."[17]

F. Economic Efficiency and the Recognition of Value in Ratemaking.

Over the years, issues relating to the efficient allocation of the nation's resources have been emphasized by the Commission, as well as by intervenor witnesses:

> It is widely accepted in the field of economics that marginal cost prices lead to the most efficient allocation of the society's resources (*i.e.*, economic efficiency). [Docket No. R94-1, *Op. & Rec. Dec.*, App. F, ¶ 105.]

> Prices for postal services also send signals to customers. They indicate the costs that consumption of postal services impose on society. Prices set below marginal cost understate the costs that society

[17] Docket No. R2005-1, *Op. & Rec. Dec.*, ¶ 6075.

incurs, causing excessive consumption of postal services and waste of society's resources, while prices set above marginal cost overstate social costs and cause consumers to turn to substitutes that impose greater costs on society. [Docket No. MC95-1, *Op. & Rec. Dec.*, ¶ 4257.][18]

In order to maximize the contribution of any regulated firm to the national economy, regulators must set rates to be as consistent with economic efficiency as is allowed by the other policy goals they are charged with pursuing. Basing rate levels and structures on marginal costs is central to assuming that services will be efficiently (and fairly) priced and to assuring that those services will be efficiently produced. [Rebuttal Testimony of Richard Schmalensee, Docket No. MC95-1, USPS-RT-1, p. 2, l. 24 to p. 3, l. 1 (footnote omitted), Tr. 33/15002-3.]

In other words, disregarding economic pricing principles and failing to align postal rates with marginal costs will "impair the overall value of postal service to the Nation." [*Id*., p. 19, l. 34 to p. 20, l. 2, Tr. 33/15019-20.]

[Referring to the cost differences between the proposed subclasses in Docket No. MC95-1:] Such large deviations from the class average attributable costs are clear signals that deaveraging is likely to produce substantial gains in economic efficiency. [*Id*., p. 17, ll. 17-18, Tr. 33/15017.]

Where full reliance on competition is not feasible for economic or other policy reasons, economists have long realized the social value of regulation aimed in large measure at bringing about the sort of cost-

[18] Note that setting rates below marginal cost is not necessarily worse than setting rates above marginal cost. It is a continuum. Rates below marginal cost will move consumption patterns and associated resource usage away from optimal, with associated losses, as will rates above marginal cost. The losses are equally real in each direction and can be of equal magnitude.

> based rates that competition tends to produce. Professor Kahn, the well-known scholar and practitioner of regulation, emphasized that regulation should seek to emulate the results of effective competition: [*Id*., p. 7, ll. 10-15 (quotation from Kahn omitted), Tr. 33/15007.]
>
> it is again useful to come back to our competitive benchmark. Competitive markets produce deaveraged rates to the extent that deaveraging is on balance efficient, given the associated transactions costs described above. [*Id*., p. 23, ll. 5-7, Tr. 33/10523.]

The concept of value, as developed to a high level of agreement through economic writings beginning as early as 1850, is central to explaining and understanding the decisions made by consumers, whether individuals or firms. When potential buyers do not see value in buying a product, they will not buy it. But much more than this can be said. Consumers compare various potential purchases. If the value expected from product A is greater than the value expected from product B, per dollar spent, the consumer will buy product A, even if the value associated with A is greater by only a small margin, and even if the cost to the nation of product A, in terms of resources absorbed in its production, is greater by far than the cost of the resources absorbed by product B. Consumers act in their own self interest and cannot be expected to watch out for the nation. Consumers are free to make decisions that make themselves marginally better off while making the rest of the nation substantially worse off. One way to prevent this from happening is to keep prices as close to costs as possible. Disagreement with this prescription is virtually nonexistent. Also, since

the sole purpose of producing output, including providing mail services, is to allow customers to receive value, it is clear that issues relating to value are important. More value is obviously better than less value.

In even more practical context, the concept of value explains decisions made at the margin, *i.e.*, decisions on whether to buy a little more or a little less of a product. Buyers receive less *additional* value as they buy more. For example, a person might receive value of $40,000 from having a car. He might buy a car for $30,000, but this has nothing to do with whether the value received is $40,000. The same buyer might receive value of only $60,000 from having two cars, $20,000 more than having one car. Under these circumstances, he would be willing to pay as much as $20,000 for a second car. Then, if he would receive value of only $63,000 from having three cars (just $3,000 more than from having two cars), he is not likely to buy a third car.

Given that the *additional* value received from purchasing an *additional* unit of a product declines as more items are purchased, it becomes clear that the quantity purchased depends on the price and that the quantity changes as the price changes. In a beginning position with a price of 20 cents, the consumer will purchase as many items as are worth at least 20 cents. If the price declines to 18 cents, he will purchase as many items as are worth at least 18 cents, which will be more. Similarly, if the price increases to 22 cents, the number that he purchases will decline. Importantly, the total value received from the consumption of more items is greater than the total value received from the

consumption of fewer items. Therefore, if we want the customer to receive a lot of value, we must keep the price down and the quantity up.

The relationship between price and quantity, which is fully explained by the theory of value, is generally expressed as a demand function, which is often displayed as a demand curve. And the amount by which the quantity changes as the price changes is often quantified using an ordinary elasticity measure. If the elasticity is -0.8, for example, it means that a 1 percent increase in price leads to a 0.8 percent decline in quantity, *ceteris paribus.*[19]

To firms that have degrees of pricing freedom, the concepts of value and elasticity are critically important. To make this clear, suppose that the cost of a certain Standard Mail product is 20¢, and that at a price of 20¢, 10B (B=billion) units are purchased. This makes the revenue equal to $2B. Now suppose the firm, in order to break even, needs an additional $300M (M=million), and decides to get it from its 20¢ product. In the special case where the demand is not sensitive to price (*i.e.*, the elasticity is zero), the firm can simply increase the price to 23¢, which is equivalent to a cost coverage of 115 percent (23 ÷ 20). The new revenue will be $2.3B, and the firm will break even. The customers will be receiving just as much value as before, because they are purchasing and consuming the same volume as before, but their surplus, defined as value net of

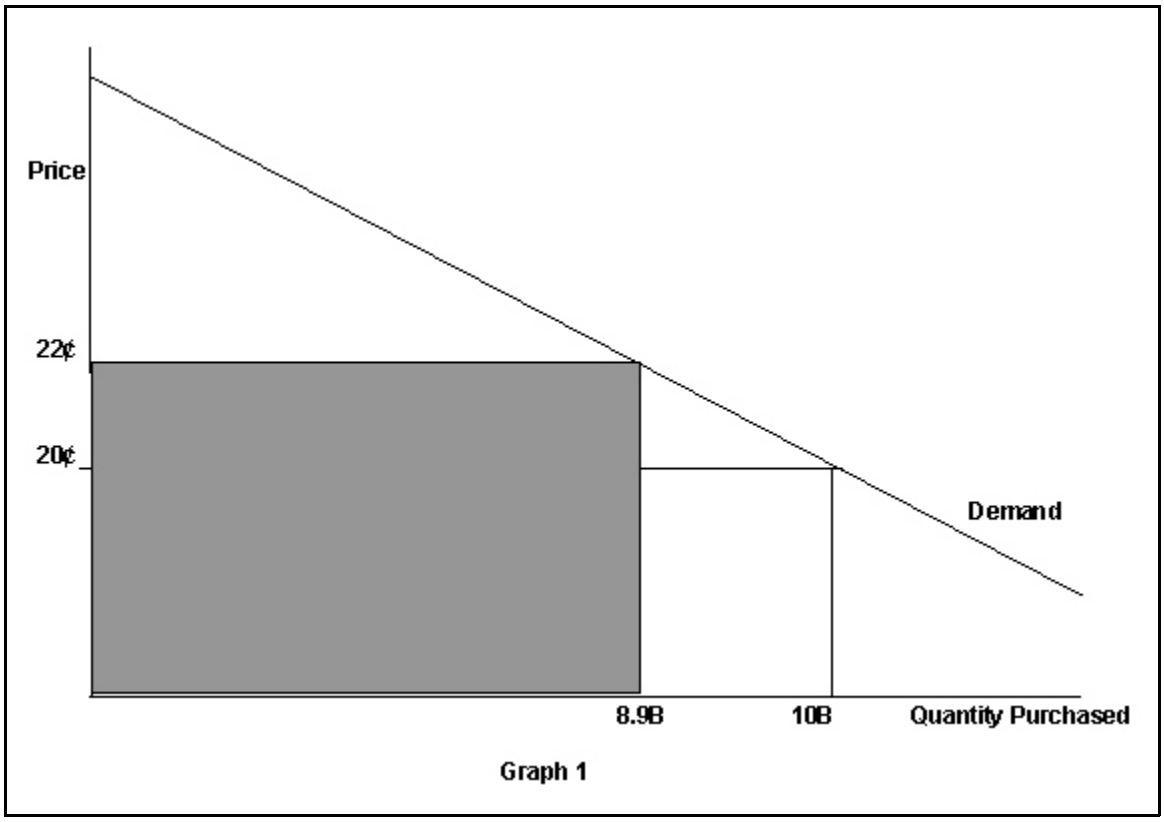
[19] *Ceteris paribus* in this case means that all non-price factors that affect quantity remain unchanged, and therefore remain at their current level while the price changes.

what they are paying, is reduced by $300M. Simply put, the price increase transfers $300M of surplus from customers to the firm.

Now take the same example, but assume the quantity purchased is sensitive to price, as is the case for Standard Mail. In fact, assume the elasticity is -1.1, which is approximately the elasticity of ECR. And, as a first step, suppose the firm increases the price to 22¢. According to the elasticity, the volume will decline by 11 percent,[20] to a level of 8.9B pieces. The new revenue is $1.958B (22¢ * 8.9B pieces). The attempt was to obtain additional revenue, but the result is a reduction in revenue of $42M (going from $2B down to $1.958B), an outcome that would obviously attract considerable attention at the firm. This result, however, should not be a surprise – a reduction in revenue is a direct implication of an elasticity greater in absolute value than 1.0.

The firm notices immediately that its costs have declined, due to the volume decline. Volume has declined by 1.1B pieces, a not inconsequential amount. At a cost of 20¢ per piece, costs in total are $220M lower than they were before. With a revenue decline of $42M and a cost decline of $220M, the firm is $178M better off. This may be viewed as a favorable outcome, but it is short of the $300M it needed. Thus, it must increase the price further.

[20] A price increase of 10 percent (from 20¢ to 22¢) multiplied by an elasticity of 1.1 yields a quantity decrease of 11 percent.

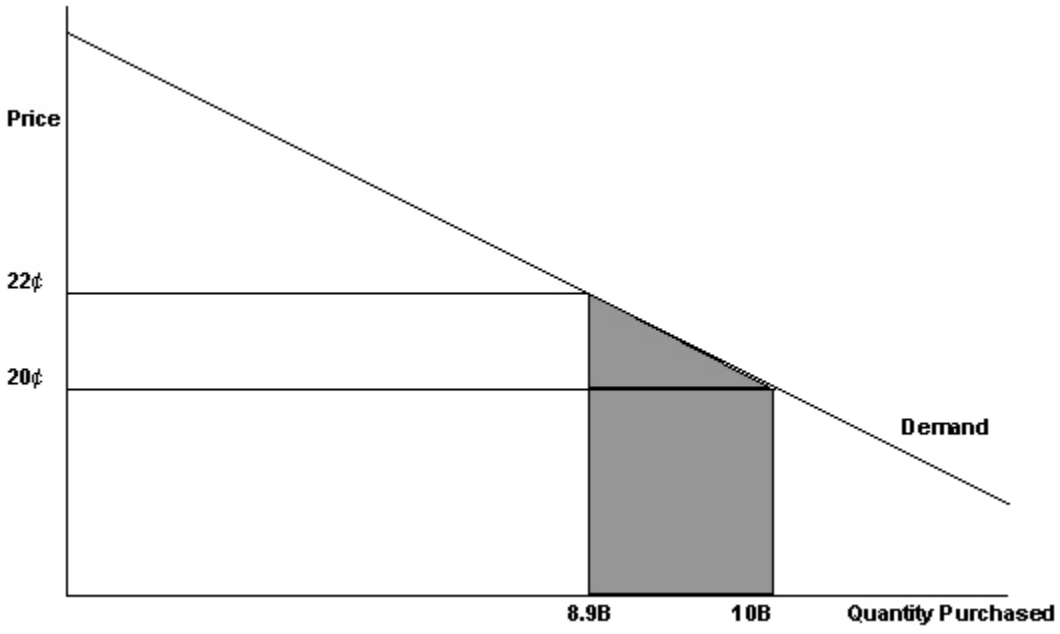


Graph 1

This example is easy to show graphically. Graph 1 shows the Demand curve as a sloping line. At a price of 20¢, the quantity is 10B units, and at a price of 22¢, it is 8.9B units. The area of the shaded rectangle, 8.9B units wide by 22¢ high, represents the new revenue of $1.958. The original revenue of $2B is a similar rectangle, 10B units wide and 20¢ high. The reduction in cost of $220M is the non-shaded rectangle, 20¢ high and extending from 8.9B to 10B units.

Now consider the value being received by the customers, the provision of which is the reason for the existence of the firm. At the price of 20¢, the volume

was 10B units, and the customers were receiving value on the consumption of 10B pieces. For example, some pieces were bringing value of 60¢ to 75¢, some 25¢ to 50¢, some 22¢ to 25¢, and some as low as 20¢. At the price of 22¢, the volume has declined to 8.9B pieces, and the customers are receiving value from the consumption of those 8.9B pieces only. As before, some pieces might be bringing value of 60¢ to 75¢ and some 22¢ to 25¢, but all of the pieces that were bringing values of from 20¢ to 22¢ are gone. Value from consuming 1.1B pieces, ranging from 20¢ to 22¢, is no longer being realized.



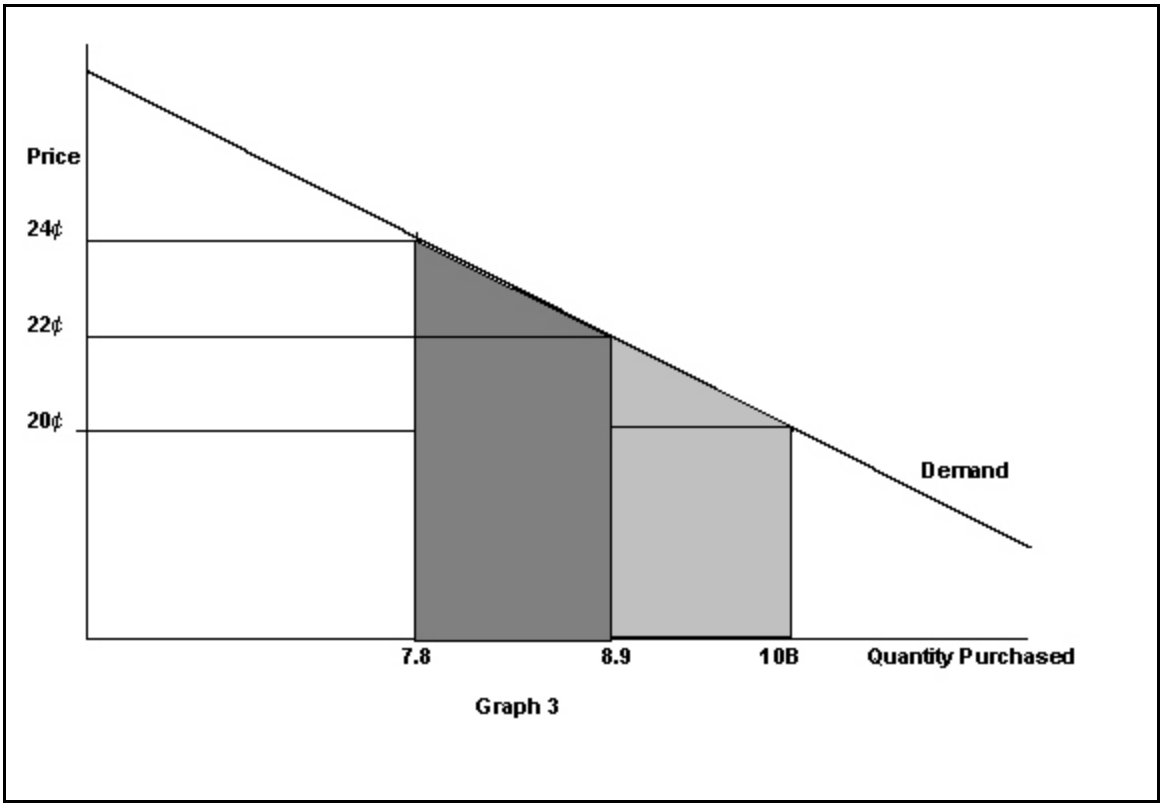
Graph 2

Graph 2 is the same as Graph 1, except that the loss in value to the market is shaded. Specifically, the loss in value is a rectangle capped by a

triangle (which qualifies geometrically as a trapezoid). It is 1.1B units wide, 22¢ high on the left, and 20¢ high on the right. The area of this trapezoid is $231M. The firm is attempting to solve a $300M shortfall. It realized a decrease in revenue of $42M; its costs declined $220M; its net revenue increased $178; and the value being received by its customers declined $231M. The firm is still in the red, to the tune of $122M.

Now, to solve the breakeven problem, suppose the rate is increased to 24¢, which is a cost coverage of 120 percent. Based on the elasticity, the volume declines to 7.8B units. The revenue will be $1.872B, $128M below the initial position. The cost will be $440M below the initial position. With a revenue reduction of $128M and a cost decrease of $440M, the firm is $312M better off. It has solved its deficit problem of $300M, with a small amount to spare. The break-even price is clearly somewhere slightly below 24¢.

Look again at the value being received from consuming the product, as shown in Graph 3.



Graph 3

When the rate went from 22¢ to 24¢, all of the pieces bringing value below 24¢ left the system. No one would buy a piece valued marginally at 22¢ when the price is 24¢. The additional amount of value lost this time is the heavily shaded area, 1.1B units wide, height on the left 24¢, and height on the right 22¢. This area is a value loss of $253M. It is larger than the value lost when the price was increased from 20¢ to 22¢, shown in Graph 3 as the lightly shaded area, due to the fact that the value associated with each piece lost is higher. Compared to the at-cost price of 20¢, the 24¢ position is a decrease in revenue of $128M, a reduction in cost of $440M, and a loss in value to the market of $484M (the total shaded area in Graph 3). The message is clear:

- Mailers lost a substantial amount of value when the cost coverage went from 100 percent to 110 percent (price going from 20¢ to 22¢), but lost even more (on an incremental basis) when the coverage went from 110 percent to 120 percent (price going from 22¢ to 24¢). And, if consideration were given to increasing the cost coverage to 140 percent, which would be a price of 28¢, and which would still be far short of the current cost coverage of ECR, the additional loss in value would be even larger than the loss caused by going from 100 percent to 120 percent. *The relationship is non-linear, with the losses in value growing exponentially as the cost coverage is increased.*

- When the price went from 20¢ to 24¢, and the volume declined from 10B to 7.8B, the revenue from the sale of the product decreased from $2B to $1.872B. The net gain to the firm was $312M (it started $300M in the red and ended $12M in the black). The loss in value to the market, however, was $484M.

- It is unsettling, to say the least, that none of the net gain came from the market providing more revenue; in fact, the market provided less revenue each time the price was increased. *Instead, all of the net gain, plus another $128M, came from the reduction in cost from not having to produce the product.* Just on its face, using a means like this to improve a financial condition should give pause. It threatens to degenerate into a process of not providing the service at all.

In the Postal Reorganization Act of 1970, Congress noted specifically that the Commission should give consideration to the "the value of the mail service actually provided each class or type of mail service to both the sender and the recipient, including but not limited to the collection, mode of transportation, and priority of delivery." 39 U.S.C. section 3622(b)(2). In the areas of economics and regulatory practice, the concept of value of service was well developed at that time and was commonly accorded attention in the regulatory literature. Significantly, such was the position of Foster Associates in its study for the

Kappel Commission. *See generally*, *Rates and Rate-making: A Report to the President's Commission on Postal Organization*, Annex II to the Kappel Commission Report (1968), *especially* pp. 1-3. It is my opinion that the discussion of value presented above is consistent with the intent of Congress and is the appropriate framework for discussing value.

As cost coverages increase, and rates get further from marginal cost, and losses in value grow exponentially, it appears to me that the value of the mail service to mailers is being impaired. Congress specifically warned in section 101(a) of the Act that this should not be allowed to occur;[21] yet it is occurring. The distance of the rate from marginal cost is important for purposes of resource allocation and economic efficiency, and also for purposes of preserving the value of the mail service to mailers. As should be obvious in the above example, the extent to which these exponential losses occur is dependent on the level of the elasticity of demand. Specifically, the rate at which the losses occur increases as the absolute value of the elasticity increases. The problem is particularly acute for ECR, because its elasticity is so high.

1. The Creation of an Expert Commission. My general view is that Congress created an expert commission with the expectation that the

[21] Section 101(a) of the Act is composed of one paragraph with four sentences. After three sentences saying what the Postal Service is to do, it has one sentence saying what it is *not* to do, specifically: "The costs of establishing and maintaining the Postal Service shall not be apportioned to impair the overall value of such service to the people."

commission would bring to bear on ratemaking all that economics and regulatory practice have to offer. By this I do not mean that a broad range of considerations is not relevant, just that there is a science of ratesetting, supported by an extensive literature, and that attention to this literature is in order.

Support for my position can be found in a Senate Report accompanying S. 3842 at the time, which said:

> if postal rates and postal classification are going to be established on the basis of ... "social acceptability," then Congress is clearly better qualified to make such judgments than the Postal Service or any expert commission. Such purely political judgments are the province of Congress. But if rates and classifications are to be established on the basis of expert consideration of the overall value of service provided and the allocation of costs on a scientific or quasi-scientific basis, the Congress should be removed entirely from the ratemaking and classification business. [S. Rept. No. 91-912 (to accompany S. 3842), at 11 (June 3, 1970).]

Similar support is found in President Nixon's transmittal message to Congress on postal reform, which states:

> The nation simply cannot afford the cost of maintaining an inefficient postal system.... The Post Office is a business that provides a vital service which its customers, like the customers of a private business, purchase directly.... The work of the Post Office is that of a business enterprise." [President's Message to Congress Relating to Reform of the Nation's Postal System, H.R. Doc. No. 121, 91st Cong., 1st Sess. 3 (1969).]

Some of these issues were addressed by DMA in its Reply Brief in Docket No. MC95-1, where it said:

> Congress was perfectly capable of making policy decisions and of taking political considerations into account. What it did not think that it was good at was setting rates that would be economically rational, rates that would permit the Postal Service to act more like a business, rates that would permit the Postal Service to fulfill its functions of providing services to the all (sic) people of this country at the lowest possible cost ... in other words to permit the Postal Service to act in an economically rational, business-like way. [*Id.*, p. 13.]

In considering the weight to be accorded these kinds of considerations, which are both businesslike and in line with regulatory practice, it should be noted that both Regular and ECR are bulk, commercial subclasses, used extensively by businesses and professional mailers, almost exclusively for advertising purposes. Both subclasses are used extensively by the very smallest to the very largest of firms. Also, both subclasses are used by nonprofits. I see no public policy basis for favoring one over the other. Rates for each should be set according to accepted ratemaking principles, with due weight given to all considerations thought important.

To allow emphasis on considerations that might come natural to an expert commission but that might place a heavy analytical burden on Congress, the Act states that the Commission should consider "such other factors as the Commission deems appropriate." 39 U.S.C., section 3622(b)(9). I believe that the section (b)(9) provision is important and is consistent with the notion of an

expert commission. Also, a meaningful role for (b)(9) is consistent with the view of the court in AAP v. Governors that "[t]he factors are reminders of relevant considerations, not counters to be placed on scales or weight-watching machines." Association of American Publishers, Inc. v. Governors of the United States Postal Service, *et al.*, 485 F.2d, 768, 774 (D.C. Cir. 1973).

In discussing these matters, I do not mean to suggest that the Commission has not considered and given weight to economic theory, principles of regulatory ratemaking, and business concerns. The Commission has clearly given weight to ECP, notions of lowest combined cost, worksharing, the signals sent to mailers, how competition should be recognized, how products should be defined, the capabilities of mailers, elasticity, issues of resource allocation, costing theory, long run vs. short run, cost homogeneity, notions of cross subsidy, questions of when mailers are similarly situated, ease of administration, and others, none of which is addressed specifically in the Act. In fact, the Act does not point to well-defined roles for subclasses instead of rate categories, though these have come to be an important part of Commission practice. As the Commission has said: "The significant role of 'subclasses' has evolved through Commission decisions — they have become integral to ratemaking in accordance with the Act." Docket No. MC95-1, *Op. & Rec. Dec.*, ¶ 3017. The practice of giving weight to such concerns should continue.

G. Saturation Rates May Be Above Stand-Alone Costs, Yet Are Protected by the Mailbox Rule.

At the microeconomic level, economists normally focus on issues relating to the efficiency of resource allocation and how consumers make associated decisions. In this regard, concepts of profitability, marginal cost, value, supply, and demand have been important. Notions of fairness, however, are not necessarily in their province. It is well recognized that opinions on fairness differ and that such notions are often in the mind of the beholder. No matter how reasonable a thing might seem, some people say: "that is not fair!" Two notions of fairness, however, are commonly accepted by economists and others. First, rates should not be set below unit *incremental* costs. Second, rates should not be above *stand-alone* costs.

As applied to the Postal Service, the *incremental* cost of a product is the total number of dollars that the Postal Service could save if 100 percent of the volume of the product in question were withdrawn from the Postal Service, and the Postal Service adjusted in an efficient and complete way to this withdrawal. The usual prescription is that if rates are not above unit incremental costs, a cross subsidy exists, and that cross subsidies are unfair. The explanation that a cross subsidy exists is that if the product in question were withdrawn, the costs would decline more than the revenue; and, if this were to occur, bringing the organization back to breakeven could allow the rates for the remaining products

to be reduced. Viewed another way, the rates for the remaining products are being elevated to make up for the fact that the product in question exists.

The other notion, that rates should not be above *stand-alone* costs, also is rooted in a fairness notion. The usual situation is that the regulated firm produces many products jointly, possibly with monopoly protection, and that the consumers are better off that way, possibly because of the realization of economies of scale and scope, than they would be under some variant of a competitive system. Further, the opportunity of joint production usually is taken to mean that the cost of producing the products jointly is less than if they were produced separately. Within this framework, it is presumed to be unfair for a product to end up with a rate that is higher than the rate that would be possible if a stand-alone organization were set up to produce only the product in question.

Technically, these two rules are connected, and meeting one of them in full implies meeting the other. To see this, consider that the requirement that each product cover its incremental costs should be applied not only to each product one at a time, but also to groups of products, in twos, threes, fours, and so forth. If there are n products in the firm, then the revenue for products 1 through n-1 must cover the incremental cost of products 1 through n-1. If products 1 through n-1 were withdrawn from the firm, only product n would be left, and its rate would be set to cover its costs in the productive system that remained. This would be a productive system set up to produce only one product, product n. So, if products 1 through n-1 pass their incremental cost

test, then the rate for product n would have to be below its stand-alone cost. To the contrary, if products 1 through n-1 do not pass their incremental cost test, then the rate for product n is above its stand-alone cost and it is subsidizing the other products, which is unfair.

Obviously, as the cost coverage for a product increases, so that its rate becomes far above the cost, the likelihood increases that a stand-alone operation could carry that product at a lower rate and make a profit. I contend that for saturation mail, we are at or above that point now.

My contention is based on several observations.

1. A large number of free community newspapers, all saturation, are delivered privately now. These are often delivered by carriers that deliver only that paper, one day per week. It is obvious that the viability of these operations would improve if their volume per delivery point increased.

2. Over a period of years, I have spoken with a number of private carriers. To the last one, they have all said the equivalent of: "If I could just use the mailbox, I could turn into a viable operation." The general sentiment seems to be that they are close to calling it quits.

3. A substantial volume is not protected by the Private Express Statutes, and can be carried privately now. This includes all saturation mail (from which the addresses can be removed easily) and all pieces with over 24 pages. Therefore, the constraining issue is not the Private Express Statutes.

4. In the case of Periodicals, which are not covered by the Private Express Statutes and which would have higher costs because they are not saturation and must be prepared for delivery, I have talked extensively with the CEO of Publishers Express, a private delivery operation that began in Atlanta, Georgia. Despite the fact that Publishers Express had not yet begun to automate, but would have with cooperating publishers, Publishers Express was profitable at

> the time it ceased operations. The one thing that stopped it was people's preferences for receiving their magazines in their mailboxes. If it could have used the boxes, it would still be growing today. And in the case of Periodicals, which Publishers Express carried, the cost coverage is not high.[22]

My conclusion is that it is the mailbox rule, not the letter prohibition of the Private Express Statutes, that today keeps private delivery operations from being profitable and growing, particularly in the case of saturation mail. For all intents and purposes, ECR rates, particularly saturation rates, are so far above postal costs that even stand-alone private operations can carry the volume for a lower rate. I am not talking about cream skimming, cherry picking, or pockets of competition. I am talking about competition on a broad basis. Generally, I contend that it is poor public policy to handicap the competition by removing from their use the only convenient access point society has developed for accommodating delivery, and then to elevate rates to the point that these handicapped competitors can just barely make a go of it anyhow. The obligation of the Postal Service is to provide services where it is able, at reasonable rates, not to elevate those rates until its customers leave.

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[22] My contention concerning Periodicals was explained in Docket No. C2004-1, and no evidence to the contrary was presented or discussed. Publishers Express grew from serving two ZIP Codes in one city to serving 1,000 ZIP Codes in 32 cities. The difficulties it had did not relate to the level of its rates relative to those of the Postal Service, nor to its costs, nor to a lack of interest and support from publishers. Rather; it was the persistent preference of recipients for receiving their magazines in their mailboxes. *See* Docket No. C2004-1, TW *et al*.-T-1, p. 49, fn. 40, Tr. 3/846, and MH/TW *et al*.-T1-10, Tr. 3/1014.

H. Effects of Standard Nonprofit Mail.

When Commercial Regular and Commercial ECR were created as separate subclasses in Docket No. MC95-1, they did not include the Nonprofit categories. Therefore, it was the case that when a markup was selected for the Commercial categories, that markup affected only Commercial Regular and Commercial ECR. P.L. 106-384, however, required that the costs of each Commercial category be combined with the corresponding Nonprofit category, and thus that a markup be selected and applied to Commercial and Nonprofit Regular jointly, and to Commercial and Nonprofit ECR jointly. This change has several implications that need to be recognized.

When the Nonprofits were separate subclasses and had markups prescribed by RFRA, any burden associated with providing the lower Nonprofit rates was carried by all mailers. It is my belief that Congress did not intend to shift this burden from *all* mailers to the associated Commercial category. If the markups are not selected appropriately, however, this could happen. I believe we should be aware of this possibility and guard against it.

Suppose Commercial Regular and Nonprofit Regular were a single subclass with no deference for Nonprofit mailers, and the cost coverage were 188.4 percent. If, from this position, the Nonprofit rates were set according to the 60-percent rule instead, the coverage would decline to 175.8 percent. If, under these conditions, the coverage applied to the joint costs were to be increased back to 188.4 percent, the result would be Commercial Regular

mailers paying for the entire benefit to Nonprofit Regular. Corresponding calculations for ECR show that a cost coverage of 205.8 percent would be decreased to 199.6 percent.

The implication of these figures is that cost coverages on Regular and ECR should have declined by about 12.6 and 6.2 percentage points, respectively, when the costs were combined. Otherwise, the Nonprofit burden is carried by the corresponding Commercial mailers. This effect should be considered as trends in coverages are considered.

Another implication is equally important. It seems implicit in Congress's decision on the 60-percent rule that the 40-percent reduction should be taken from a fair and equitable set of rates for the Commercial categories. I understand that such a set of rates already was required by the Act, but the presence of the Nonprofits makes it all the more important. This is because an elevation in the cost coverages for Regular and ECR places a burden on the Nonprofits as well; *i.e.*, the Nonprofits are carried up or down with their corresponding Commercial categories. Specific to the concerns of my testimony is that if the cost coverages are not adjusted to the levels appropriate to separate subclasses, as anticipated by the recommendation in Docket No. MC95-1, the Nonprofits also are kept from their appropriate rate levels.

I. The Markup on ECR Is Too High.

Once the subclasses are selected, rate development can begin. The first step is to develop costs for the subclasses, as has been done in USPS-LR-L-96. The second step is to select markups for the subclasses, which, for Regular and ECR, is the subject of much of my testimony, including this section. Applying the markups to the costs yields the revenue requirements, which the rates are developed to yield. Based on the rates developed, volumes, costs, and corresponding revenues are estimated. A constraint on the selection of the markups is that, when the rates are developed for all subclasses together, the Postal Service must break even.

The focus here is on the selection of the markups. I do not have the resources to treat all subclasses together and estimate a systemwide net income. Nevertheless, a considerable amount can be said about whether a markup is too high or two low, relative to others, and the Commission is proficient at taking such testimony, deciding what weight to give it, and building it into a breakeven position for the Postal Service. There is no requirement that I calculate a difference between a contribution aligned with my recommendations and those proposed by the Postal Service, or that I reconcile that difference with contribution levels that I believe should be obtained from other subclasses and services.[23]

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[23] Nevertheless, the contribution from the rates recommended herein for (continued...)

Subclasses are developed to warrant an independent application of the various policies of the Act. The Commission has affirmed this principle many times, and this characteristic of subclasses has guided numerous recommendations, including the one that established Regular and ECR in Docket No. MC95-1. In one of the earlier dockets where a subclass decision was faced, the Commission said, for example: "If presorted first-class constitutes a 'class of mail' or 'type of service' for purposes of [section 3622(b)], it follows that the rate adopted *must* be based on an independent application of the § 3622(b) factors."[24] [25] Docket No. R77-1, *Op. & Rec. Dec.*, p. 241, fn. 1, emphasis added.

Under the Act and Commission precedent, the Commission considers the various characteristics of the subclasses, with an eye toward breakeven, and selects markup for them. While each different Commissioner may select a somewhat different set of markups, no one set of markups is less "legal" than another, I define the set of markups that results from this process as the best set of markups under current law. That is how the law, as developed and

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[23] (...continued)
Standard Mail is approximately the same as that proposed by the Postal Service, and thus no adjustment is required in the coverages of other classes.

[24] The Postal Service agrees with this position, including for ECR. *See* response of witness Taufique to VP/USPS-T28-21, Docket No. R2005-1, Tr. 3/653.

[25] The independence of ECR as a subclass is supported by Postal Service witness Tolley's finding that the cross elasticity effects between ECR and Regular are small. *See* Docket No. MC95-1, *Op. & Rec. Dec.,* ¶ 5425.

implemented by the Commission and approved by the courts, is written. I do not contend that another set would not be legal.

Although other policies of the Act may be brought to bear, such as the admonition against undue discrimination or the caution that "costs ... shall not be apportioned to impair the overall value of such service to the people," 39 U.S.C., section 101(a), the process of considering a subclass and selecting a markup is described generally as one that is guided by the non-cost factors in section 3622(b). And, without being inconsistent with the court's explanation in AAP v. Governors that "the factors listed are not analogous to a table of atomic weights, or to the multiplication table," 485 F.2d at 774, it is common to discuss the factors individually.

Such discussion takes the rather abstract form of the following question: "If this were the only factor being considered, what level of cost coverage, or what set of relative cost coverages, would be suggested?" When this approach is taken, there remains the task of combining the various considerations into a final position. But, before the combining is done, it is not proper to critique a discussion of a specific factor by referring to it as a recommendation for a final outcome.

Before discussing the non-cost factors and their implications, the notion of a markup index needs to be introduced. If 50 percent of total Postal Service costs were attributed, it is clear that an average markup of 100 percent (cost coverage of 200 percent) would be needed to allow breakeven. Alternatively, if

80 percent of costs were attributed, the average markup would need to be only 25 percent (cost coverage of 125 percent). Because the proportion of costs that are attributed changes over time, a certain degree of difficulty attaches to making cost coverage comparisons over time. For example, a subclass receiving an average cost coverage in each of the two attribution situations just discussed would shift from a coverage of 200 percent to a coverage of 125 percent, which should not be considered a decrease.

To facilitate comparisons over time, the Commission has used a markup index. This index is a dimensionless number obtained by dividing the markup of a subclass by the systemwide average markup. If a subclass has a markup of 100 percent and the systemwide average markup is 50 percent, then subclass has a markup index of 2.0 (100/50). If in the next case the same subclass has a markup of 150 percent and the systemwide average has increased to 75 percent, the subclass again would have a markup index of 2.0 (150/75). In markup index terms, the two markups would be the same.

In view of the merits just described, the Commission has explained that it tends to preserve markup indexes over time, unless consideration of some factor or factors, including all of the non-cost factors of section 3622(b), suggests a reason for change. In the discussion that follows, I do not mean to suggest that any markup or cost coverage should not be adjusted for changes in the systemwide average.

In the subsections below, I discuss each of the non-cost factors, except factors 7 and 8. Factor 7 deals with questions of simplicity and identifiable relationships among subclasses. I do not see this as an issue in Standard. All Standard rates are bulk rates. I do not believe anything in my testimony raises a simplicity issue.

Factor 8 calls for the recognition of the educational, cultural, scientific, and informational value of the mail matter in the subclasses, commonly referred to as "ECSI" value. This factor is taken generally to apply primarily to Periodicals and Media/Library Mail, not to Standard Mail.[26]

a. Non-cost Factor Number 1: "the Establishment and Maintenance of a Fair and Equitable Schedule" (Section 3622(b)(1)).

If fairness were the only consideration in rates, and Congress had stopped at this point, the presumptive approach to the setting of rates might be to estimate the costs associated with *each mailer's* mail, and apply a uniform markup factor, multiplicative in nature, sufficiently high to allow breakeven. I doubt if anyone would suggest a uniform per-piece markup at, say, 10 cents per piece. After all, what sense would it make to require the same 10-cent contribution from a lowly letter, a 14-ounce insurance policy (or catalog), and a

[26] It should not be thought, however, that Standard Mail does not provide information. It *does* provide information and that information is *vital* if consumers are to make well informed decisions. The wide availability of information in the United States is undoubtedly one of the factors associated with its productivity.

30-pound wedding gift? The unacceptability of such a solution is rooted in a broadly accepted notion of equity that it is fair to require contributions in such matters of taxing and pricing that are in proportion to the investment being made to cover direct costs. Also, unless something is known about elasticity, the value being received by high postal-cost pieces would presumably be higher than that of low postal-cost pieces, again suggesting a higher contribution.

Further consideration would point to the difficulty of estimating specific costs for each mailing and to the difficulties of administering such a complex arrangement. This might lead to subclasses and to tariff schedules applicable to groups of mailers.

Mailers and the Commission have struggled with these issues under the Act since 1970. No one would expect everyone to agree on what is fair. As the Commission has said: "The Commission is a collegial body with five members, each of whom has a separate, distinct view of what is fair and what is equitable. These five views become balanced as rate recommendations are being developed." Docket No. R90-1, *Op. & Rec. Dec.*, ¶ 4124.

Logicians have tried to help define what is fair. We are told that similarly-situated people should be treated similarly and, presumably, dissimilarly-situated people should be treated dissimilarly. The message may be that if different treatment, from some presumptive default position, is to be accorded, there should be some good reason for it. At such a point, discrimination would become due instead of undue.

The Commission's position has been expressed on a number of occasions, and it is consistent. In the context of a standard applicable to mail classification changes, the Commission has stated:

> it is our view that in the exercise of our classification responsibilities pursuant to § 3623, the requirement of a "fair and equitable classification system for all mail" compels us to strive for a classification structure which permits the establishment of cost-based rates. [Docket No. MC78-2, *Op. & Rec. Dec.*, ¶ 5124.]

Similarly, this time in the "context of presorted first-class mail," the Commission said: "Questions of fairness ... primarily involve the relationship of costs and rates." Docket No. R80-1, *Op. & Rec. Dec.*, ¶ 0686. Other references can be supplied. "The discounts comply with the fairness and equity criterion of the Act, 39 U.S.C. § 3622(b)(1), as the recommended rates are cost-based." Docket No. R97-1, *Op. & Rec. Dec.*, ¶ 5525. "The proposal meets the fair and equitable criterion (criterion 1) by deaveraging the cost of parcels from the cost of flats, thereby setting the stage for rates that reflect cost differences." *Id.*, *Op. & Rec. Dec.*, ¶ 5479. And: "In general, the Commission continues to believe that overall considerations of fairness and equity and an interest in cost-based rates overcome opponents' objections." Docket No. R2000-1, *Op. & Rec. Dec.*, ¶ 5436.

Since other considerations often come into play between subclasses, as discussed further below, much of the discussion of fairness occurs on intra-subclass issues. On this issue specifically, the Commission said:

> The Commission begins the rate design process assuming equal implicit markups. This is a neutral starting position which seems to be implied by § 3622(b)(1), a fair and equitable schedule. It is consistent with the Commission's general policies that the rates for each rate category be above cost; that rates reflect the costs developed in the record; and that rate design results in identifiable relationships between rate categories. Equal implicit markups, however, are only a starting place, and often may not be practicable or appropriate. The Commission frequently has good reason to depart from them in actual practice. [Docket No. R2000-1, *Op. & Rec. Dec.*, ¶ 5533.]

Particularly in regard to inter-subclass questions, the notion of fairness has been extended. In considering the subclass proposals made by the Postal Service in Docket No. MC95-1, the Commission said:

> The Commission agrees that more "cost-based" rates are appropriate, and it is recommending rates which achieve that goal. The Commission also believes that the fairness standard of § 3623(c)(1) has a broader application than what is suggested by the Postal Service. To be fair, rates should not only reflect direct and indirect attributable costs, but also the "noncost" factors set forth in the ratemaking section of the Act, § 3622. [*Id., Op. & Rec. Dec.*, ¶ 3056.]

Another dimension of fairness was emphasized by Hallmark in its Brief in the same case (at page 15): "The notion of 'fairness,' whatever else it may imply, at least requires that everyone with a substantial claim to consideration actually be considered."

In short, fairness requires recognition of costs, consideration of the other factors in the Act, including policy considerations, and that interested parties be

given an opportunity to express their concerns. If no considerations beyond fairness were given weight, I would find it difficult to conclude that subclass markups different from the systemwide average are in order.

One other issue of fairness deserves note. The Postal Service has been established to provide services to mailers and the American people. The presumption is that by aggregating mail from all sources and having one carrier, a low-cost, highly efficient operation can be achieved, and these low costs can allow corresponding low rates. Partly through extensive preparation of mail by mailers, an issue discussed further under non-cost factor No. 6 below, low costs have been achieved in ECR in considerable degree. Accordingly, the resources drawn from the nation to provide the service are low. Benefits from this achievement can be realized only if the low-cost mailstream is made available to mailers at reasonable rates. An excessive cost coverage subverts this process (unfairly, I think) and prevents the benefits from being received.

1. Fairness and the Nonprofit Rates. Whether under the heading of fairness or of national policy, it needs to be recognized that the rates for all Nonprofit mail in the Standard class are derivative of the markups selected for Regular and ECR. This is discussed specifically in section IV-H, above. When the rates for Commercial Regular or ECR Regular are elevated unduly, consistent with a high cost coverage, then the rates for the associated Nonprofit categories will also be elevated unduly. One has to ask, then, whether it is fair

and appropriate for a category like Nonprofit ECR to have an extremely high cost coverage, particularly relative to the cost coverage of Nonprofit Regular.

A context for this question is as follows. My house receives saturation mailings (paying Nonprofit ECR rates) from a hospital that is approximately two miles away. The pieces sent are impressively prepared and provide information on programs and activities of the hospital, seminars being offered, and other health information. I also receive targeted mailings (paying Nonprofit Regular rates) from various charities (such as the Salvation Army), no doubt because I am on some kind of list. As a member of my local community, I think highly, for example, of both my local hospital and the Salvation Army. In all fairness, however, I would not find myself able to explain to my local hospital: "The costs for your saturation mail are very low. However, we are placing a substantial markup on those costs, much higher than the markup we place on the mail of the Salvation Army, just because a similar type of saturation mail has been charged a high markup in the past." I realize that there may be alternative explanations, but I see no explanation that is consistent with the apparent message of Congress that these mailers be treated fairly with preferred rates. In short, the markup on ECR is too high, absolutely and relative to Regular, and this is affecting Nonprofit ECR negatively.

b. Non-cost Factor Number 2: "the Value of the Mail Service Actually Provided Each Class or Type of Mail Service to Both the Sender and the Recipient, Including but Not Limited to the Collection, Mode of Transportation, and Priority of Delivery" (Section 3622(b)(2)).

In Section IV-F above, I discuss the concept of value in some detail, including its relation to notions of economic efficiency. I point out, and show graphically, that value is lost when, through application of a cost coverage, rates are increased above costs, and that the problem is particularly acute when the elasticity is high. Also, I explain that the losses in value rise exponentially as the cost coverage rises. The problem is obvious. According to the FY 2005 Cost and Revenue Analysis ("CRA"), PRC version, the cost coverage of ECR, at 200 percent, is the highest of any subclass. *See* USPS-LR-L-94. The loss of potential value to ECR mailers is too high.

In considering what cost coverage might be appropriate, an additional dimension of value should be recognized. As explained above, mailers receive value from using the mail. For example, a mailer spending $1 million on postage must be receiving $1 million or more of value. But, as applied to the question of how far to raise rates above costs, which *is* the question faced when cost coverages are selected, the question is how much value beyond $1 million is available to be drawn upon. Mailers spending $1 million dollars on postage could be getting, say, $9 million in value. The realization of such high values is the hope when the service is provided. The nation is certainly better off when

such mailers receive value of $9 million than when they receive value of, say, $1.5 million. But mailers spending $1 million on postage could in fact be receiving a value of $1.5 million. A circumstance such as this would not suggest that the provision of the service should be discontinued, but it would be clear that little value exists to draw upon in increasing rates above costs.

If there is a substantial amount of value to draw on, the cost coverage can be elevated and volume will diminish only a little. If volume diminishes only a little, the reduction in value received will also be small, although more of the value will be paid out in postage. Alternatively, if only a small amount of value is available to be drawn on, then an elevation in the cost coverage will reduce the volume substantially, and the reduction in value received will be much larger. The importance of recognizing value to mailers when selecting markups is to reduce the occurrence of the large losses in value that result from large volume reductions.

The measure of the sensitivity of volume to price increases, and therefore of value to price increases, is the own-price elasticity of quantity demanded. Acknowledging this measure, the Commission said: "Large differences in own-price elasticities are clearly important evidence supporting separate treatment under § 3622(b)(2)." Docket No. MC95-1, *Op. & Rec. Dec.*, ¶ 3120.

Measures of elasticity are developed by the Postal Service as part of the volume forecasting process. In this docket, Postal Service witness Thress estimates the own-price elasticity of Commercial ECR to be -1.079 and of

Commercial Regular to be -0.296. USPS-T-7 at 9. This means that when rates for the former third class were increased, a substantial amount of value was lost by now-ECR mailers and a much smaller amount was lost by now-Regular mailers. In Docket No. R2001-1, these two elasticities were estimated to be, in order, -0.770 and -0.390. That is, the own-price elasticity of Commercial ECR now is estimated to be 40.1 percent *higher*, and the corresponding own-price elasticity of Commercial Regular now is estimated to be 24.1 percent lower. The importance of recognizing value of service has increased.

An elasticity of -1.079 is substantial. It means a rate increase of 10 percent will cause the volume will decline 10.79 percent, *ceteris paribus*, and therefore that total revenue actually will decrease. Total revenue less cost, however, which is the contribution obtained from the subclass, will increase as long as the elasticity, in absolute value, is less than the price divided by the per-piece markup. For Commercial ECR, this critical level is about -1.88.[27] Therefore, despite the volume loss, which is substantial, an increase in price *will* increase net revenue, but the rate at which net revenue will increase is not large. Furthermore, the gain comes from the cost reductions resulting from reduced volume, not from mailers.

[27] Calculated under proposed TYAR conditions, using data in USPS-LR-L-36, WP-STDECR.xls, sheet 'Financial Summary,' using volumes from sheets 'TYAR Commercial Pieces & Pounds' and 'TYAR Nonprofit Pieces & Pounds.'

The elasticity measures vary among the subclasses of mail. In general, the elasticity of Commercial ECR (at -1.079) is relatively high (in terms of the response to a rate change) and the elasticity of Commercial Regular (at -0.296) is relatively low. The difference is due to a number of factors, including: (i) the importance attached to sending or receiving the piece, (ii) closeness of substitutes, (iii) preferences of the users, and (iv) response rates of recipients (the later applying primarily to advertising materials). The respective measures also do reflect, then, the value to recipients.

1. A Note on Intrinsic Value. In past proceedings, some attention has been focused on what have been called intrinsic indicators of value, leading to intrinsic value of service. These indicators relate to such things as deferability, speed of service, whether air transportation is used, whether delivery is guaranteed, options available for acceptance or postage payment, whether the piece is sealed against inspection, whether Delivery Confirmation Service is provided, which special services can be used, and whether forwarding service is provided. For the most part, these are *characteristics* of the product or service offered (and they are identical for all subclasses within Standard). But, however impressive the list of characteristics might be, whether and to what extent they are associated with value that is available to be drawn upon in pricing is another matter. A product can have laudable characteristics and yet not present value

suited to supporting a high cost coverage.[28] In the end, identifying a product's characteristics may highlight its features and facilitate thinking about the value mailers might place on the product. However, the ultimate – and only relevant – question is whether the value is actually there. The test for this is the decisions made by customers in the marketplace, which are reflected in the elasticity measure.

I do not see that any notions of intrinsic value of service are relevant to determining cost coverages for Regular, for ECR, or for any other subclass. The Commission has had the same difficulty. After reviewing arguments relating to the value of Priority Mail in Docket No. R2000-1, for example, the Commission stated: "Taken together, these indicia do not bear out the high value of service that Priority Mail's intrinsic features would otherwise imply." *Id., Op. & Rec. Dec.*, ¶ 5304.

[28] Suppose a product is defined by a certain list of characteristics and, accordingly, has a certain cost. Suppose further that the price is set equal to this cost and that, say, 5 billion pieces are purchased, for a total postage bill of $1 billion. The fact that customers are willing to spend $1 billion on this product is certainly evidence that they find much value in it (in the sense that $1 billion is a lot of money on almost any scale), and certainly the decision to purchase 5 billion pieces is a reflection of the product's characteristics. In fact, we know that the value being received must be something in excess of $1 billion. But knowing this and understanding the product's characteristics tells us nothing about (i) how far the value being received is above $1 billion, (ii) how rapidly the volume will drop off when the price is increased, or, accordingly (iii) how much value is available to draw upon in increasing the price. If the volume falls off substantially when the price is increased, the attempt to obtain more revenue largely will fail, due to the disappearance of the volume, and the value received by customers consuming the product will decline substantially as well.

2. Conclusion. The principal reason for creating the Regular and ECR subclasses was to facilitate recognition of their market characteristics. The measures of these characteristics that received primary attention were their elasticities. It is apparent that the value available to draw upon in the case of ECR is considerably lower than the value available in the case of Regular or, for that matter, of any other subclass except Express Mail. To the extent that recognition is given to this low reservoir of value, a lower-than-average cost coverage is suggested.

With respect to value of service, a logical comparison to the assessment of third class, before reclassification, is possible. In Docket No. R94-1, the elasticity of bulk-rate regular was -0.502, a weighted average of -0.331 for what is now Commercial Regular and -0.662 for what is now Commercial ECR. The markup index for bulk-rate regular was 0.897. This reflected, among other things, the elasticity of -0.502. To the extent, then, that elasticity is recognized in selecting the markup index, the markup index for Commercial Regular should be above, and the markup index for Commercial ECR should be below, 0.897.

In the recognition of value, the Commission has noted that much of the inelasticity in First-Class is due to restrictions against private carriage as well as to the requirement that some materials, if mailed, *must* be sent First-Class.[29]

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[29] Witness Thress found the elasticity of single-piece First-Class letters and flats to be -0.184 and of workshared First-Class letters and flats to be -0.130. USPS-T-7 at 9.

Therefore, it has considered it somewhat unfair to elevate the markup of First-Class on the basis of elasticity, even though it is clear that considerable value exists. In Docket No. R90-1, for example, the Commission said: "Specifically, we find that it would violate the principles of postal ratemaking as set forth in the Postal Reorganization Act to set First-Class rates to produce a markup index significantly higher than average...." Docket No. R90-1, *Op. & Rec. Dec.*, ¶ 4059. For related reasons, the Commission has declined to recommend a low markup to Standard Mail based on its low value. In the same docket, it said: "Similarly, we have consistently found that third-class bulk regular, another subclass which is largely subject to the statutory monopoly, should also bear an approximately average markup." *Id.*, ¶ 4022.

Accepting the preference for not lowering the markup on what is now Standard Mail, and recognizing that Commercial ECR is far more elastic than Commercial Regular, the question in regard to value should be whether the markup on Commercial ECR should be both lower than the systemwide average markup and lower than the markup on Commercial Regular. Even if this question were answered by a Commission preference for applying its "approximately average markup" to both ECR and Regular, the current markup on ECR, 106.7 percent in the Test Year at the proposed rates, is too high, by a wide margin. *See* USPS-LR-L-114. If the markup on ECR is not lowered, then ECR thereby is prevented from having its market characteristics recognized appropriately, which was a primary purpose of making it a separate subclass.

c. Non-cost Factor Number 4: "the Effect of Rate Increases upon the General Public, Business Mail Users, and Enterprises in the Private Sector of the Economy Engaged in the Delivery of Mail Matter Other than Letters" (Section 3622(b)(4)).

If an otherwise meritorious and justifiable rate position is identified, and the rate increase required to get there is unusually large, concern over the effect of the rate increase on the general public and business mailers might lead to some tempering of the cost coverage or, in the case of rate differences within subclasses, to some tempering of associated passthroughs. Any such tempering, however, should be temporary. That is, the Commission might decide to get to the desired rate position in two or three steps instead of one, but I see no justification for rejecting the meritorious position. Moreover, the admonition to consider effects on the "general public" does not apply, since users of Regular and ECR are business mailers. Indeed, Regular and ECR are bulk subclasses. Also limiting the applicability of factor (b)(4) is its focus on the "effect of rate **increases**" (emphasis added) and, therefore, on what is commonly referred to as rate shock. It does not focus on the effect of rate decreases, nor does it focus on the level of the rates.

In the instant docket, however, as explained in the Introduction, the attention given to this factor should be soft-pedaled, or muted entirely. In short: 1) this case needs to step fully to any indicated rate position, so that it could be a suitable base for any possible future statutory regime of price caps; and 2) in support of the across-the-board nature of Docket No. R2005-1, the last omnibus

rate case, the settling parties that otherwise might be concerned about any effects associated with large rate adjustments knowingly waived their right to claim benefit from this factor. The Commission recognized this development in its Opinion. *See* Docket No R2005-1, *Op. & Rec. Dec.,* p. ii, and ¶¶ 5030 and 5032. Therefore, I do not believe this factor should play an important role in this case, particularly between subclasses.[30]

Beyond the general public and business mailers, this factor requires consideration of "the effect of rate increases upon ... enterprises in the private sector of the economy engaged in the delivery of mail matter other than letters." Again, the focus is on increases, not levels. Nevertheless, despite this focus, factor (b)(4) sometimes has been interpreted to raise the question of whether a rate is so low that it competes unfairly with such enterprises.

Insofar as the restrictions on private carriage are concerned, "letters" are generally defined as addressed pieces having no more than 24 pages. "Mail matter other than letters," then, which can be delivered by private enterprises, would be pieces without addresses and pieces with over 24 pages, the latter category pointing to pieces not light in weight. However, private enterprises may

[30] Under a simple rate cap, the Postal Service could proceed to make further adjustments in relative rates within a subclass, as in the case of moving passthroughs toward 100 percent one year at a time, but it would not be well-positioned to change the average level of the rates in one subclass relative to those in another subclass.

not use the mailbox. That is, they are permitted to take pieces to the delivery points, and leave them on door knobs or in front yards, but not in mailboxes.

I explained above that the greatest barrier keeping private carriers from handling a much greater portion of eligible mail now, indeed perhaps all eligible mail now, is the mailbox rule. The Private Express Statutes as such are not the issue, although relaxing them would undoubtedly have an effect. Acknowledging this, I believe it is poor national policy and fundamentally unfair to mailers who wish to receive value from using the mail (which is the primary reason for having a Postal Service) to handicap potential competitors through the mailbox rule, and then to use the effects of that rule as a reason to elevate rates through high coverages, in effect setting up a hurdle and then overcharging mailers so that the hurdle is impotent.

In summary, reasons for not using this non-cost factor as a reason for the continued elevation of ECR rates, or even as a reason to refrain from lowering ECR rates, are:

1. The coverage on ECR is already well above the systemwide average, and the coverage on Regular is below it. *See* USPS-LR-L-114. There is no accepted guideline on how high a coverage must be in order to compete fairly. It is not difficult to argue that this should not be an issue until the coverage enters a neighborhood that is *below* the average for all mail.

2. Much of the mail that is candidate for being handled by alternative carriers weighs more than 3.3 ounces, and therefore pays the pound rates of either ECR or Regular. Private carriers have less difficulty competing for relatively heavy mail than for relatively light mail.

3. Any steps to elevate Commercial ECR rates for competitive reasons also elevates Nonprofit ECR rates, and it is difficult to understand why Nonprofit mailers should be affected negatively by such steps.

4. The Court of Appeals in Direct Marketing Association, Inc. v. USPS, 778 F.2d 96,106 (2d Cir. 1985) said: "In evaluating competition-related arguments under subsection (b)(4), it must be remembered that the PRC's task is to protect *competition*, not particular competitors" (emphasis in original), and the Commission has agreed. *See, e.g.,* Docket No. R2000-1, *Op. & Rec. Dec.*, ¶ 5788. Since ECR rates already are above stand-alone costs, my position is that the effectiveness of private carriers is impaired primarily by the mailbox rule, not rates, and competition is being adequately protected.

5. If private carriers were found to be having trouble competing with the Postal Service, that by itself should not be given weight as evidence that the Postal Service is competing unfairly, since the reason for the Postal Service's existence, with its monopoly protection, is to use its economies of joint production and scale to provide services of value that might not be available otherwise.

6. The Association of Alternative Postal Systems was a signatory to the Settlement Agreement in Docket No. R2005-1, presumably understanding that arguments relating to this non-cost factor would not be given weight in this case.

The situation faced by private delivery enterprises may be perplexing, but it should not be protected by unduly elevated postal rates.

d. Non-cost Factor Number 5: "the Available Alternative Means of Sending and Receiving Letters and Other Mail Matter at Reasonable Costs" (Section 3622(b)(5)).

When this factor was applied to the former third class, it was applied to Commercial Regular and Commercial ECR as a joint subclass. Now that they

are separate subclasses, and the rates for each must be set jointly with the Nonprofits, it must be applied separately.

As discussed above, limited portions of the mail matter in Regular and ECR can be carried by private competitors, those being merchandise, pieces having over 24 pages, and saturation pieces whose addresses can be removed. Most of the pieces, however, cannot be carried privately. If it is assumed that pieces weighing over the breakpoint have over 24 pages, some of these proportions can be laid out, as shown in Table 1.

Table 1: Proportions of Regular and ECR that Are Non-Saturation and that Generally Cannot Be Delivered Privately

	Regular		ECR	
	Comm	**NP**	**Comm**	**NP**
Non-Saturation	100%	100%	56.8%	61.7%
	Of the Non-Saturation Portion			
Letters	76.9%	83.4%	24.1%	28.9%
	Of Non-Saturation Non-Letters			
Under 3.3 ounces	47.5%	69.6%	49.8%	86.7%

Very little non-saturation mail is candidate for private delivery. Of non-saturation, 76.9% of Commercial Regular is letters, which generally weigh under 3.3 ounces and many of which cannot be carried privately. The corresponding

proportion for ECR is 24.1%, and the proportions for the Nonprofit categories in both cases are higher. Of non-saturation non-letters, 47.5% of Regular is under 3.3 ounces, which generally cannot be carried privately. The corresponding proportion for ECR is 48.8%. Again, the proportions for the Nonprofits are higher. (Calculated from FY 2005 Billing Determinants, USPS-LR-L-77.) For both Regular and ECR then, Commercial and Nonprofit, the number of pieces that may not be handled privately is substantial. The usual conclusion is that a greater proportion of ECR than Regular is a candidate for being carried privately, partly because of its saturation content and partly because of its larger proportion of non-saturation non-letters (although almost half of these weigh under 3.3 ounces), and, therefore, that ECR eligible mailpieces have more alternatives to the use of the mail. Such a view is consistent with the proportions in Table 1 and with its higher (in absolute value) elasticity.[31] However, it is also clear that (i) a substantial proportion of each cannot be handled privately, and (ii) this proportion is higher for the nonprofit categories. Therefore, elevating the cost coverage because of the proportion that can be carried privately would affect a great deal of mail that has no private alternative and would affect the Nonprofit, more than the Commercial, categories.

[31] Note, however, that a high elasticity can be, and usually is, the net result of a string of factors, and competition from alternative delivery is just one of them. I do not know how much of the elasticity of ECR is due to such competition, but it may not be high.

For the most part, the Commission has applied this factor to reduce the markup when concern exists that alternatives are not available. As explained by witness O'Hara, this might be done "when the availability of alternatives for some portion of [the] population is substantially below the national average (e.g., because they reside in rural areas)." *See* response to VP/USPS-T31-2(b), Tr. 17/5096. In its *Opinion and Recommended Decision* in Docket No. R97-1, in regard to Book rate (now Media Mail), it said: "Finally, the § 3622(b)(5) 'available alternative means' factor applies because this subclass constitutes the primary service for delivering books sent by individuals, who often find it the most convenient and affordable means of doing so. PRC Op. R94-1, para. 5370." *Id.*, ¶ 5754. In its Opinion in Docket No. R2000-1, in regard to the application of (b)(5) to Priority Mail rates, it said: "The Commission finds it appropriate to moderate Priority Mail's coverage to this level in order to protect its users — especially those users whose mail falls within the monopoly segment of Priority Mail — from the impact of even higher rate levels." *Id.*, ¶ 5317.

With respect to the cost coverage on ECR, the Commission said in Docket No. R97-1: "The high coverage assigned Standard A ECR also recognizes that reasonably priced alternatives are available (§3622(b)(5)), ..." *Id., Op. & Rec. Dec.,* ¶ 5552. The Commission did not specify what alternatives it had in mind or how it reached a conclusion that its cost was "reasonable," the latter being required by (b)(5). But (b)(5) presumes that "letters and other mail matter" exist and are to be "sen[t] and receiv[ed]," and requires attention to

"alternative means" of doing just that. Therefore, (b)(5) requires attention to competitors offering "sending and receiving" services, not to the possibility that some other kind of alternative might be used, such as radio, television, or the Internet.

To charge more in situations where competitors offer similar services runs counter to recognizing the value of the mail service. This was recognized in Docket No. MC95-1, for example, where the Commission said: "The Commission has long recognized that these two factors must be balanced." *Id., Op. & Rec. Dec.,* ¶ 5491. It also runs counter to being competitive. In this regard, the Commission pointed in Docket No. R2000-1 to a statement of the court in United Parcel Service v. U.S. Postal Service, that: "'As to § 3622(b)(5), the Commission has consistently, and reasonably, held that it authorizes a reduction in rates to maintain the position of the Postal Service as a competitor in the mail delivery industry.' United Parcel Service v. U.S. Postal Service, 184 F.3d 827, 845 (D.C.Cir. 1999)." *See Id., Op. & Rec. Dec.,* fn. 76.

The situation that frames the question of giving weight to the availability of alternate delivery services is that portions of Regular and ECR can be carried privately, while others cannot, just as for Priority Mail, as discussed above. I believe there are several reasons why the presence of alternative carriers should not be used as a basis for an unusually high cost coverage for either ECR or Regular.

1. As discussed in earlier sections, considerable importance attaches to recognizing the value of the mail service, and the value of ECR is low.

2. Rates for ECR, particularly those of the saturation categories, are above stand-alone costs now, as discussed in earlier sections of my testimony.

3. The alternative provided by private carriers is not as attractive as is often presumed. It is the mailbox rule and not postal rates that is reducing their competitiveness.

4. Although private delivery options may be available legally to significant portions of ECR mail, many ECR mailers of these portions do not view private delivery as an attractive option, partly because of the mailbox rule and, therefore, view themselves as constrained to use the Postal Service.

5. It is not fair to those ECR mailers that legally cannot use private services to elevate their rates because they are grouped with some mailers who legally can use such services.

6. It is neither competitive nor fair to elevate rates purposefully to levels that allow competition to exist, even though handicapped by the mailbox rule, and then to use the alternatives provided by that competition as a basis for keeping the rates elevated.

7. The proportion of Nonprofit mail that can legally be carried privately is smaller than the proportion of Commercial mail, and rates must be fair to the Nonprofit mailers as well.

8. As between Regular and ECR, there is no reason for a policy preference favoring one more than the other due to any limitation in their alternatives. Both are used primarily if not exclusively by businesses, and both have a growing list of alternatives.

If ECR mailers have more alternatives than mailers in other subclasses, or than Regular mailers, the position could be taken that an elevation in their rates would not leave them in the lurch, despite the low value available to be drawn on through increased rates. Also, no one denies that it is important to compete

fairly with these other media. But it is also important not to disadvantage the mail option. The Postal Service exists to serve mailer needs and a high rate inhibits that from occurring, thereby limiting value and achievable benefits.

On balance, exclusive of considerations relating to value and other factors, arguments relating to the availability of alternatives and fairly competing with providers of alternatives could be taken to suggest a markup at or near the systemwide average, but would not support the exceedingly high markup on ECR that exists under the Postal Service proposal.

e. Non-cost Factor Number 6: "the Degree of Preparation of Mail for Delivery into the Postal System Performed by the Mailer and its Effect upon Reducing Costs to the Postal Service" (Section 3622(b)(6)).

The cost incurred by the Postal Service to process and deliver mail is affected by the preparation activities of mailers. This factor codifies the principle that it is efficient for the ratesetting process to recognize and encourage the degree of mail preparation.

Mailers have a wealth of capability and should be viewed as partners. They are well-positioned to work with the Postal Service in analyzing preparation alternatives that could result in lower costs for all concerned. In general, however, they cannot be expected to invest where there is no return. That is, the rates need to support the preparation. Sometimes this is done through worksharing arrangements and at others through an elementary process of

deaveraging (which can increase the competitiveness of the Postal Service at the same time). Responses to resulting price signals bring about the desired result.

ECR mailers engage in preparation activities in greater degree than any other subclass. They presort, barcode, prepare mail in line-of-travel or walk sequence, and dropship more extensively. In addition, some practices that are a natural part of their operations tend to result in lower postal costs, such as container usage, acceptance processes, and postage payment procedures. Also important is that the mailings' density, which may be thought of as the number of pieces per carrier route, as well as their bulk nature, help to result in reduced costs. As a result, the Postal Service's costs for ECR mail are notably low — especially saturation mail.

When costs are low, a natural outcome of the competitive process is low rates. This allows benefits from the low costs to be realized. It makes no sense at all for the presence of low costs to be used as a reason for elevating rates to an extreme degree. Such a practice tends to remove from mailers the otherwise reasonable option to use a low-cost mailstream — the kind of service that a national postal service should be expected to provide. Also, elevation of rates on this basis runs directly counter to this non-cost factor, which requires that preparation activities be recognized. This factor, even on a *ceteris paribus* basis, cannot be used to support a markup on ECR anywhere near the current level. At the most, it should support a subclass markup in the neighborhood of the

systemwide average. This conclusion does not mean that (b)(6) is unimportant as a consideration in rate design *within* subclasses.

In fact, particularly for rate design within subclasses, it should be recognized as a matter of considerable importance that appropriate recognition of preparation can help bring about improvements in national efficiency. Consider two preparation methods, A and B, that are rated the same. Assume that the mailer can adopt method B at an additional cost of 1 cent per piece, and that *if* B is used instead of A, the costs of the Postal Service will be 3 cents lower. If no rate difference is provided, the mailer will use method A. If a 3-cent rate difference is allowed, the mailer will switch to method B, for an increase in national efficiency of 2 cents. And, under the lower rate for preparation B, it is possible for additional mail to be brought into the Postal Service, possibly because the mailer had been using a higher-cost option. Such efficiency gains exist regardless of whether the various preparation methods are viewed as matters of worksharing.

J. Legacy Rates Should Not Be Perpetuated Through Markups that Are Either Too Low or Too High.

Under the umbrella of one average markup, many differences among rates within subclasses have been set according to the efficient component pricing ("ECP") rule. The Commission explains:

> The [ECP] theory requires the discount to be 100 percent of the cost savings. The Commission tries to

> achieve 100 percent passthrough of the worksharing savings, but again it frequently may depart from this standard for a variety of reasons. [Docket No. R2000-1, *Op. & Rec. Dec.*, ¶ 5535.]

When the ECP rule is followed, pieces moving from one rate category to another tend to take with them their per-piece contributions. Under these conditions, the lower-cost categories will tend to have relatively high percentage contributions. This phenomenon is well recognized in rate proceedings.

Prior to reclassification, the ECP rule played a role in developing rates for the categories in third class. And, as one would expect, the implicit cost coverages of the categories differed. Specifically, as presented by witness McBride, the cost coverage of the proposed Regular subclass (then non-carrier-route) was 126 percent, and the cost coverage of the proposed ECR subclass (then carrier-route) was 202 percent, for a subclass average of 140 percent. *See* Docket No. MC95-1, USPS-T-1, Table 1, p. 14. But, as one would *not* expect, the per-piece contributions were widely different. The same table showed the per-piece contribution of Regular to be 4.4 cents and of ECR to be 8.7 cents. Thus, even by the precepts of the ECP rule, something was wrong — the coverage of Regular was too low and the coverage of ECR was too high.

The problem, however, involved more than just an expectation of equal per-piece contributions. The conclusion of Docket No. MC95-1 was that Regular and ECR should be separate subclasses, warranting the selection of separate coverages, which would be expected to result in a per-piece contribution for ECR

that is smaller than the per-piece contribution for Regular, and cost coverages which are much closer.

Separate subclasses would allow costs and demand to be recognized, and they would bring rates into better alignment with costs and in line with economic efficiency. The ECP rule does not apply between subclasses. The appropriate way to recognize costs in the former third class thus became quite different. Reclassification recognized that different markets and different mailers were involved. In effect, Regular and ECR became separate products.

Under these conditions, no justification exists for continuing the historic cost coverages of Regular and ECR, case after case, much as though they are worksharing categories within the same subclass. In response to the possibility of doing just that for the proposed split of Regular into two subclasses, the Commission said:

> The alternative of creating separate subclasses and considering the issue of lowest combined cost when selecting the associated markups is not a rational alternative. Selecting the markups in such a constrained way provides rates that are no different from those that result from offering worksharing discounts through rate categories.... One has to question the logic of creating subclasses and then constraining the outcome in accordance with a result that would be obtained without creating the subclasses. [Docket No. MC95-1, *Op. & Rec. Dec.*, ¶ 5388.]

The pattern must be broken. The link between the two subclasses is long gone. It is time to apply the non-cost factors in the Act separately. When this is

done, as explained herein, it becomes clear that the appropriate coverage for Regular should be higher than it is and that the appropriate coverage for ECR should be lower than it is. An opportunity to take steps toward appropriate coverages was passed over in Docket Nos. R2001-1 and R2005-1, with the argument that it would be better to take corrective action later. Not only is "later" here, it appears that the opportunity to take another step may not be presented. Appropriate cost coverages should be set now.

K. Recommendation.

The Commission has explained its general position that the average cost coverage for Standard Mail, once designated third class bulk rate regular, should be somewhat below the coverage on First-Class and, generally, below the systemwide average. In its *Opinion and Recommended Decision* in Docket No. R90-1, it said: "Over time we have consistently found that First-Class should bear a markup at, or only slightly above, systemwide average. Similarly, we have consistently found that third-class bulk regular, another subclass which is largely subject to the statutory monopoly, should also bear an approximately average markup." *Id.*, ¶ 4022. Similarly, in its *Opinion and Recommended Decision* in Docket No. R94-1, it said: "As in past dockets, the Commission considers the higher demand elasticity of third-class mail as an important reason for maintaining a lower third-class markup relative to First-Class letters." *Id.*, ¶ 4037.

Present conditions are that third class has been divided into Regular and ECR, that high elasticity (in absolute value) is a characteristic of ECR only, and that the importance of lower rates of the Nonprofit categories support a reduction in the overall Regular and ECR cost coverages, to keep the burden of the lower Nonprofit rates from falling entirely on the corresponding commercial category and to continue to treat the Nonprofit mailers in a fair and unbiased way. Accordingly, application of the Commission's findings, as well as my arguments above, supports a cost coverage on Regular that is below the coverage on First-Class, and a cost coverage on ECR that is below the coverage on Regular.

Although the Commission reached its position based in part on how the incidence of the Private Express Statutes should be recognized, the elasticities also provide support. The elasticity of First-Class (at 0.184 for single piece and 0.130 for workshared) is not significantly lower than the elasticity of Commercial Regular, at 0.296 (which is very close to the 0.306 elasticity of Nonprofit Regular). *See* USPS-T-7 at 9. First-Class is transported by air and gets free forwarding, but the costs for these are attributed to it. Furthermore, these characteristics are part of its features as a product, and thus are part of its value. First-Class also is sealed against inspection, but I see no reason to increase its markup because of that. In short, in view of the considerations discussed in Sections A through J above, I see very little reason for a fair and equitable cost coverage on Regular Standard to be much below the cost coverage on First-Class. And, based on the same considerations, plus the Commission's position

that the recognition of elasticity should be limited in the monopoly subclasses, the cost coverage on ECR should be somewhat below the coverage on Regular.

According to the figures in USPS-LR-L-114, at PRC costing and Postal Service proposed rates, the systemwide coverage is 178.4 percent. The coverage of First-Class is 212.6 percent, of Regular is 170.4 percent, and of ECR is 206.7 percent. I believe these are out of alignment. My assessment is that the coverage on Regular should be somewhat above the systemwide average and that the coverage of ECR should be somewhat below the systemwide average.

Therefore, a dilemma is presented. Under normal circumstances, 5 or 10 percentage points of movement could be made in one case, and another 5 or 10 percentage points in the another. The first problem with this approach is that mailers chose against gradual change by settling two consecutive omnibus rate cases. Another problem is that there may not be a next case.

In an ideal world, the Commission might provide guidance relating to the most appropriate course for these coverages in future periods, and the Postal Service might agree that the course recommended is appropriate and in its best interests. However, if price caps of the normal kind are implemented by statute, the cost to the Postal Service of following through with any such plan would be far too high. That is, in order to change relative cost coverages, the Postal Service would have to allow one coverage to be determined by the cap and to

set one or more others below the cap. Undoubtedly, however, this would not provide adequate revenue and would cause the Postal Service to go into the red.

The only reasonable course at this point, it seems to me, is to move directly to an appropriate set of coverages for the Standard Mail subclasses. That an adjustment of some magnitude might be needed was foreshadowed in preceding cases and should have been understood by all. Accordingly, I propose a cost coverage for Regular of 180.2 percent and for ECR of 177.0 percent. At these coverages, the average rate increase for Regular is 17.56 percent, and for ECR is -8.47 percent. The contribution of Regular and ECR combined is $16.9 million greater than under the Postal Service proposal.

If, however, at the time the Commission is formulating its recommendation, it seems clear either that statutory rate caps are not a possibility, in the near future or that another rate case under the current rules will occur, the Commission could decide to accommodate the changes needed in two steps. In that case, I would recommend a cost coverage for Regular of at least 175 percent and for ECR of not more than 192 percent.

V. SPECIFIC RATE DESIGN PROPOSALS

Rate design involves the selection of a rate structure and rate elements that, when multiplied by the corresponding volumes, yield the desired revenue. The desired revenue is defined for subclasses of mail as the cost multiplied by the cost coverage, consistent with systemwide breakeven.[32] The rates proposed by the Postal Service for Standard Mail are developed by witness Kiefer, USPS-T-36 (revised June 21, 2006). His workpapers are contained in USPS-LR-L-36.

I begin with the Commission version of TYBR costs, provided in USPS-LR-L-96, which are developed for Regular (including Commercial Regular and Nonprofit Regular) and ECR (including Commercial ECR and Nonprofit ECR).[33] I

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[32] In more detail, the revenue to be obtained directly from the full set of rate elements of a "subclass" is (i) the revenue desired from the subclass (ii) less the after-rate fees at before-rate volume levels (iii) plus any revenue that will be lost to negotiated service agreements, (iv) all this divided by a CRA adjustment factor, (v) less any revenue to be received from pieces electing to pay First-Class or Priority rates (vi) less any revenue to be received from the proposed surcharge on detached address labels. The revenue desired from the Commercial and the Nonprofit categories can be calculated from the joint Commercial and Nonprofit cost, the markup, the 60-percent rule, and the volumes.

The volume projections were based on a volume history that predated the negotiated service agreements ("NSAs"). *See* response to VP/USPS-T36-10(g)(iii). Therefore, the TYBR volumes include the NSA volumes. The final revenue per piece is equal to (the revenue actually obtained from the category, after rounding) ÷ (TYBR volume - volume loss due to NSAs).

[33] *See* R2006_TY2008BR_PRC.DRpt.xls in USPS-LR-L-96. These costs include the proposed 1% contingency. The cost used in rate development is the TYBR

(continued...)

do not take a position on whether these costs are the most appropriate ones that can be developed. If the Commission were to decide that different costs are indicated, it would be a simple matter to adjust my costs and the spreadsheet will generate alternative rates. The costs and cost coverages are inputs to my workpapers, on the 'Inputs' sheet of my workbook[34] VP-RWM-Workpaper-8.xls, cells C7 through E8, in VP-LR-L-1. The rates I recommend are contained in the same workbook, sheet 'Comm' for Commercial Regular and Commercial ECR, and sheet 'NP' for Nonprofit Regular and Nonprofit ECR.[35]

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[33] (...continued)
cost + any cost reduction caused by NSA volume migrating (that the TYBR projection has already removed) ± any cost reduction/increase due to basic automation pieces in ECR moving from ECR to Regular (an adjustment already made in the TYBR projection).

[34] Because traditional spreadsheets now contain the potential for numerous sheets of some internal independence and identity, sometimes called pages or sheets or "tabs," the Microsoft Excel designation is to call them "workbooks" instead of spreadsheets. As a convention, single quotes are sometimes used around individual sheet or tab names, a convention that honors the nomenclature of the internal references in formulas in Excel.

[35] The rate schedules shown on these two sheets are complete, in the sense that they can be transferred rather directly to the schedules proposed by the Postal Service on pages 11 through 32 of the Attachment A of its Request. I do not change any of the Postal Service's footnotes to the schedules, except that the note providing the rate for Customized Market Mail must be adjusted to equal the 5-digit, origin entered, minimum-per-piece rate for the NFM category. The principal difference between my two schedules and those of the Postal Service is that I show separate columns for each entry point, instead of just providing the associated discounts for dropshipping. Also, my schedules do not show current rates. When printed, my schedules are contained on four pages. My dropship discounts are implicit in the schedules on these two sheets, and are shown separately in the schedule shown in cells C95 through H109 of my 'Inputs' sheet, which is included in my testimony as Schedule 1.

My rate design includes review of the costs and rates of previous cases (as recommended by the Commission), and focuses on how the Test Year Before Rates costs should be recognized in rates. Except to allude to the reasonableness of his proposed rate changes, witness Kiefer virtually ignores this history and the deliberations of the Commission that have led us to where we are now. Also, although his workpapers contain much of the cost information available on the various categories, and he applies certain passthroughs to cost differences and cost avoidances, particularly for presort discounts, it is often unclear what role the costs played in his rate design.[36] Rather than emphasizing costs, he seems to rely instead on notions of what he finds to be reasonable. For example, in his response to NAA/USPS-T36-4, he says: "These steps were repeated many times over many iterations in an attempt to balance the need to generate increased revenue from ECR and NECR with considerations of achieving *reasonable* rate changes and maintaining reasonable rate relationships."[37] (emphasis added) Similarly, in response to NAA/USPS-T36-9, he says: "The rates produced by these passthrough selections maintain what

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[36] Witness Kiefer referred to costs in his response to NAA/USPS-T36-6, saying: "When the piece and pound rate elements were changed I would refer to the 'Mail Processing + Delivery Costs' total shown in cell E6 (for flats) of my workpaper WP-STDECR-16 to ensure that these costs were likely to be covered by the proposed rates." The reference here suggests that costs were employed in some kind of after-the-fact check, and then only as a floor.

[37] On its face, it is not clear what this statement means. Witness Kiefer indicates that the "cost coverage targets [were] provided to [him] by witness O'Hara (USPS-T-31)." (USPS-T-36, p. 14, fn. 5) Therefore, he had no choice concerning the revenue to be received, and he did not "balance" a target revenue with anything.

are, in my judgment, *reasonable* rate relationships between ECR letters and flats, between Saturation flats and High Density flats, and between High Density flats and Basic flats. The proposed rate changes are also *reasonable* in my judgment." (emphasis added)

I will refer to costs regularly, and the role they play in my rates will be made clear. I contend that the relation of rates to costs is an important determinant of both their reasonableness and their appropriateness. This kind of attention to costs is all the more important in the instant case, because of the history preceding it. In its filing that was designated Docket No. R2005-1, in particular, the Postal Service forwent the opportunity to recognize costs. Instead, it proposed an across-the-board increase, even though such a change would be expected to make cost/rate discrepancies worse instead of better. In response to this situation, the Commission said: "After careful consideration, the Commission agrees that under these unique circumstances, small equal increases now, to be followed by a proceeding to 'true-up' rates after a thorough examination of postal costs, is consistent with sound public policy." *Id.*, *Op. & Rec. Dec.*, p. ii. Then, it added:

> The Commission's preference is to develop rates that accurately reward mailers' worksharing. It is concerned that the delay in recognizing the impact of recent innovations and improvements in postal operations, coupled with the passage of time, will probably result in unusually disproportionate increases and decreases in different rates in the next case. The Postal Service and mailers seem prepared for that possibility as they too recognize that proper

> cost-based rates foster efficiency and promote a healthy postal system. [*Id.*]

As part of this introduction, several *up-front* issues are discussed, in numbered subsections. These issues are important in their own right and have application that is broader than a specific subclass or category. Then, Sections A and B develop the rates for, respectively, (i) Commercial Regular and Nonprofit Regular and (ii) Commercial ECR and Nonprofit ECR. Finally, Section C contains percentage increase charts, comparing the rates recommend here to current rates.

One other issue requires emphasis. As already discussed, the possibility of a regime of price caps places unusual emphasis on appropriate rate levels for subclasses. *Within* subclasses, however, the situation may be somewhat different. One course would be for the Commission to (1) find that preferred, cost-based levels exist for the various rate elements, and specify what those levels are, (2) partially achieve those levels, and then (3) hope that the Postal Service goes the rest of the way under any flexibility provided by any new regulatory scheme. The other approach is for the Commission to recommend the preferred rate levels now.

As I understand it, one purpose of the legislation being considered is to give the Postal Service greater *flexibility* in setting its rates. Indeed witness Kiefer begins a key rate design section by pointing to the use of methods that allow *flexible* ratesetting. (P. 13, ll. 25-26.) Except for hints provided in this

case, which, as I explain at various points in my testimony are not all that comforting, it is not clear where such flexibility might lead. It is clear, however, that an organization like the Postal Service, with monopoly protection, should not be free to select rates on any just any basis, and under any scenario the continuing role of the Commission will be critical.

1. Reliance On the Presort Tree. The presort tree was introduced in Docket No. R90-1, at the time of an increase in the number of rate cells in then third class. The tree provided a vehicle for displaying and evaluating the various costs and rate relationships. Today, and particularly as proposed in the instant docket, the number of rate cells has grown, and the difficulty of visualizing rate relationships without some sort of schematic is greater than before. The presort tree provides a framework that makes things easier; it provides no constraints.

In addition, the tree encourages a certain discipline. To wit, it focuses attention on relevant costs and on the relationship of the rates to those costs. Given the importance of costs, this is a good thing. On this point, the Commission has referred to "[c]ost-based rates [as having] been the touchstone of postal ratemaking for 35 years...." Docket No. R2005-1, *Op. & Rec. Dec.*, p. i. Also, the tree makes clear that certain rate relationships are implied by others.[38]

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[38] For example, consider the rates for machinable and non-machinable letters. The first step might be to select a rate for each at the mixed ADC level, based on their respective costs at that level. Then, a discount for pieces sorted to the ADC level might be selected for each. At this point, the passthrough of the cost difference at the ADC level has been determined, and cannot be changed without going back and (continued...)

More important than just calling attention to costs, however, the tree can help guide the application of theories and ratemaking principles. For example, the Commission has given considerable weight to arguments that notions of ECP should be applied in determining certain rate relationships. In its *Opinion and Recommended Decision* in Docket No. R2005-1, it said on this point:

> Facing an additional, imminent rate case most participants are willing to accede to the Postal Service's preference, and defer the complex cost analyses necessary to apply efficient component pricing principles until that case. [*Id*., p. ii.]

> Given the Commission's oft-expressed preference for efficient component pricing (ECP), this is not to say that these are (or are not) the rates the Commission would recommend in a fully litigated, general omnibus rate case. *See* PRC Op. R2001-1, ¶¶ 3039-65. [*Id*., ¶ 5080.]

> It should be noted that if the next rate case follows a traditional approach to rate design whereby recommended rates more fully reflect efficient component pricing, i.e., passthroughs for all worksharing discounts and letter-flat differentials that would be closer to 100 percent, there may be substantial increases in some rates. [*Id.*, ¶ 6057.]

See also id., ¶ 6062, and *id*., Concurring Opinion of Commissioner Goldway, p. 2. The tree can be of considerable help in applying such theories.

In apparent reference to the presort tree, and to rate development formulas that the tree helps make evident, witness Kiefer says: "To achieve the

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[38] (...continued)
changing the discounts or the initial (mixed ADC) rates.

Postal Service's goals of having more finely disaggregated and flexible rate structures for Standard Mail, I have developed a rate design methodology that differs from the 'formula' approach in use (with modifications) since Docket No. R90-1." (P. 12, l. 25 through p. 13, l. 1.) Thus, although he does use formulas, if not explicit then implicit (*see* his response to VP/USPS-T-36-6 and 7), his goal is to achieve "flexible rate structures," the path to which, apparently, involves obscuring costs and relying on notions of reasonableness. My preference, however, is to recognize the costs explicitly and to make decisions on articulated bases. I would not argue for iron clad restrictions, following one theory or another, on *how* costs should be reflected in the rates, but costs are well recognized as an attribute of considerable importance — they should be recognized and reasons for deviating from them should be made clear. Witness Kiefer's reasons seem to involve his own thoughts on reasonableness, which are virtually unexplained.

One issue that requires attention to costs is that of discrimination. In Notice of Inquiry No. 2, the Commission pointed to definitions of discrimination contained in the late Professor George Stigler's *The Theory of Price*. (Third edition, Macmillan, New York, 1966, p. 209, fn. 10.) To be non-discriminatory, Stigler's first definition requires a constant ratio of price to cost, which would seem to apply to products like letters and flats, in the same subclass, which are not generally considered to be worksharing variants of each other. Stigler's second definition requires a constant difference between price and cost, which

would seem to apply to workshare variants of the same product, where the notion of ECP might apply, which was a central issue raised by the Commission in the Notice. What is important is that if prices and costs are not recognized in appropriate ways, price discrimination is involved.[39] I do not take the position that all discrimination is undue, but reasons for it should generally be given and, in the case of the Postal Service, should generally be grounded in the policies of the Act.

My rate design uses the presort tree as a vehicle for the systematic display of cost and rate relationships. The presort trees for all of Standard are shown on the 'Inputs' sheet of my workpapers, cells K1 to AL167. The entire

[39] Professor Stigler said that the "essence of discrimination" involves segmented markets and differences in elasticities, which are often difficult to achieve for a given product. Then he broadens his discussion to "two or more similar goods." Within the context of letters and flats, witness Kiefer was asked on oral cross examination whether discrimination between two products exists when the markups (defined in one way or another) differ. He agreed that it would if the products "met the appropriate similarity test," which he apparently views as a major hurdle. He explained: "But I am not aware that Professor Stigler or anywhere else in the economics profession have come to let's say an absolute consensus on how similar products might be before these would apply." Tr. 5/1169-70, respectively. As a practical matter, the Commission considers issues of discrimination broadly among postal products. *See* Docket No. R2001-1, *Op. & Rec. Dec.*, ¶ 3154, where the Commission points to the importance of questions relating to "any undue or unreasonable discrimination or preference under 39 U.S.C. § 403(c) [which does not, incidentally, contain any kind of similarity hurdle], or is inconsistent with the Act's nine ratemaking criteria under 39 U.S.C. § 3622. *Cf.* National Easter Seal Society v. U.S. Postal Service, 656 F.2d 754, 761-62 (D.C. Cir. 1981)." (Material in brackets added.) Questions relating to workshare variants of a category like, say, automation letters, come very close to Professor Stigler's discussion of discrimination among customers of a given product, or, in his words, "of the same commodity." It is difficult to see that any "similarity test" would preclude the relevance of notions of discrimination to families of kindred products, including pairs like letters and flats, especially when they are categories of the same subclass.

class, then, is displayed in one place. As needed in the discussion below, I will import sections of the trees.

It should be noted that even though witness Kiefer does not show a tree explicitly, there is a tree behind all of his rates. That is, the costs underlying his rates are there, regardless of whether he displays or recognizes them. The relationships cannot be avoided. My preference is to make them explicit.

In Question 3 of POIR No. 5, the Commission asked for an "evaluat[ion]" of the tree that *is* behind the rates proposed and for a discussion of the "rationale for abandoning the presort tree methodology" in the Standard subclasses. Witness Kiefer provided the Postal Service response. *See* Response of USPS to POIR No. 5, Questions 2-19 (June 29, 2006). His evaluation placed passthrough percentages on variously arranged trees, but stopped short of providing an assessment of those percentages. *See* WP-STDECR-R0621-POIR5-Q3-Resp.xls and WP-STDREG-R0621-POIR5-Q3-Resp.xls, sheet 'Presort Tree' in each workbook, in USPS-LR-L-148. On the point of the rationale for abandonment, he provided a number of observations. Several are discussed in the following paragraphs.

a. Presort Tree as a Visual Aid. Witness Kiefer appears to distinguish between the presort tree as a "visual aid" and as a method for the mechanical calculation of rates. He agrees that as a visual aid it "retains some conceptual value." Response of USPS to POIR No. 5, Questions 2-19 (June 29, 2006). My position is that the conceptual value is considerable, especially if the

categories are displayed in rational and relevant ways.[40] As for the mechanical calculation of rates, an issue does not exist. If a rate relationship can be decided, implementation requires some sort of calculation. The tree does nothing more than make the relationships transparent. If a rate relationship cannot be decided, or if there is an interest in obscuring either the bases for it or its links to relevant factors, then we have a different kind of problem. Neither the Postal Service nor the Rate Commission should be selecting rates without regard to the setting, including due attention to costs.

b. Benchmarks. Witness Kiefer says use of the tree requires "[c]hoosing the most costly piece in the subclass as the single benchmark piece...." Response of USPS to POIR No. 5, Questions 2-19, June 29, 2006. Such a view misrepresents the tree. For one thing, the cost differences are what the cost differences are, and standing on one limb or another does not make them any different. For another, it is not the case that using the tree as a schematic subordinates all categories but one to being mechanical links. Instead, the tree helps make clear that, for example, an automation category might be linked to a non-automation category and that presort levels within the

[40] As an example of an irrelevant application, witness Kiefer points to "calculating a 'passthrough' for the 'cost differences' between, for example, 3-digit nonmachinable parcels and 3-digit nonautomation flats...." Response of USPS to POIR No. 5, Questions 2-19 (June 29, 2006). I agree. It is incumbent on an analyst to focus on meaningful comparisons.

automation category might be linked among themselves. Also, the tree makes horizontal relations between presort tiers evident.

On this point, it should be noted that valuable perspective can be gained by thinking of a *low-cost* point as a benchmark. For example: if a 5-digit presorted piece is taken as a benchmark, and one looks up the tree to see 3-digit presorted pieces, the obvious question becomes whether the 3-digit pieces are being charged at least enough to cover the additional costs they cause, relative to the 5-digit pieces.

c. Multiple Benchmarks. Witness Kiefer holds out that a "multiple benchmark approach" is needed to deal with complexities that are evolving. The meaning of this is not altogether clear. It could mean that there are now too many categories, that thinking about their inter-relationships is too difficult, and that the only thing to do is to remove the categories from the tree and to set their rates in isolation, through some iterative process, without paying much attention to costs. If so, I disagree. Automation letters are a variant of machinable letters, as are non-machinable letters, and similar links exist among flats and parcels. So long as these categories are in the same subclass, I see no better way to get a handle on them than to consider their relative costs, which is exactly the handle that the presort tree provides. Costs are important. What is done with them may be a matter for deliberation, but they should not be sacrificed on the altar of someone's subjective notion of reasonableness.

2. Rates For the Nonprofit Categories. As required by law, I develop rates for the Nonprofit categories consistent with the 60-percent rule, with allowance for normal rounding conventions. But this rule goes only so far. It specifies the average revenue per piece, but does not specify any of the rate relationships between and among the various rate cells and does not specify the relationships between these rates and their corresponding costs.

Prior to Docket No. R2001-1, the Postal Service developed separate cost avoidances and cost differences for the Nonprofit categories. This provided the basis for different discounts and other rate differences. Since that docket, however, joint cost avoidances and differences have been presented. This raises the question of why the rate pattern for the Nonprofit catagories has not moved to be the same as that of the Commercial categories.

Very few adjustments were proposed in Docket No. R2001-1, which was settled, and no adjustments at all were made in Docket No. R2005-1. The potential exists now to bring the Nonprofit catagories into alignment with the Commercial categories. The question is: Is there any reason why this should not be done? The following paragraphs suggest several reasons why it *should* be done.

First, under the 60-percent rule, the Nonprofit rates are moved to be closer to the actual costs of service than are Commercial rates, and recognizing intra-subclass costs fully would do nothing but improve that relation. For example, suppose the cost coverage on Commercial Regular is 166.7 percent. If

the characteristic mix and associated costs of Nonprofit were the same as Commercial, the 60-percent rule would require a cost coverage for Nonprofit of 100 percent (166.7 percent * 0.6). If intra-subclass passthroughs of 100 percent were applied, it would be implied that the cost coverage of each rate cell is 100 percent. This outcome achieves the economic ideal of marginal cost pricing.[41] Accordingly, we can say that fully recognizing the cost avoidances moves the Nonprofit categories in considerable degree toward marginal cost pricing.[42]

Second, setting different discounts for the Nonprofits is a process of discrimination, and serious questions exist about the basis for such discrimination. If, for example, a Commercial mailer receives a worksharing discount of 4 cents for a particular activity, what basis is there for setting a smaller discount for the Nonprofits, particularly since setting the same discount would move them more uniformly toward costs? A related question came up in National Easter Seals Society v. USPS. In reviewing the matter, the court said: "By performing the same worksharing functions as regular third-class mailers,

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[41] The Commission noted this, for example, in its *Opinion and Recommended Decision* in Docket No. R94-1, saying: "It is widely accepted in the field of economics that marginal cost prices lead to the most efficient allocation of the society's resources (*i.e.*, economic efficiency)." *Id.*, Appendix F, ¶ 105.

[42] Note should be made that if some passthroughs in the Commercials were over 100 percent, such as the passthrough of the letter-flat cost differential (which I argue would be appropriate), then it might not be appropriate to adopt the same rate differences for the Nonprofits, as doing so would move its rates away from costs. More specifically, under a very low average markup for the Nonprofits, it could require a substantial contribution from some categories and leave the rates of other categories below cost.

nonprofit mailers may save the Postal Service an equal amount of time and money and may incur the same costs associated with presorting. They may therefore be entitled immediately to the full benefit of the discount, which the phase-in acts to deny them during the phasing period." 656 F.2d 754, 761 (D.C. Cir. 1981). On the whole, I see no basis for discriminating against the Nonprofits. Their discounts need to be brought into alignment with those of the Commercial categories.

Third, I believe there is a practical basis for not having different discounts in Commercial and Nonprofit. Mail preparation firms work with both nonprofit and for-profit firms. They need to develop systems for making decisions on worksharing issues, including presorting and dropshipping. It makes their choices more difficult and their systems less efficient to have to deal with two different sets of discounts and corresponding rules for preparing mail. This is the reason the dropship discounts were made the same in the nonprofit and commercial categories in Docket No. R90-1. I believe the same reasoning applies here.

Fourth, perspectives on fairness and effects do not argue for the maintenance of any set of current relationships. In each case where a particular rate increases by a substantial amount, there is another case where a rate decreases. The mailer whose rate decreases has a greater right to have his costs recognized properly, than the mailer whose rate increases does, to continue to receive the benefit of a lower rate. Also, if mailers are informed

through rates of the cost consequences of alternatives they have, they may well change their patterns of mailing, avoiding sharp rate increases and bringing about a net increase in efficiency. Changes of this kind move toward a more effective Postal Service, but will not be made without appropriate signals in rates.

Therefore, I propose that the Nonprofit discounts be made equal to the Commercial discounts. It is an appropriate thing to do and it would be expected to help lead to a more effective postal system. Witness Kiefer does not discuss these issues.

One last matter relating to the development of Nonprofit rates needs clarification. As one of the differences between his approach and former approaches to rate development in general, witness Kiefer notes "that the latest version of the former model [for developing Nonprofit rates] required the user to develop an artificial apportionment of the combined Regular/Nonprofit costs between the two subclasses ...." He goes on to point out that his approach does not require such an apportionment. *See* response to VP/USPS-T36-7(d). But the problem he highlights does not exist, and therefore cannot be used as a reason supporting any procedural changes. Yes, the "former model" multiplied a cost (no longer available) by a cost coverage (no longer applicable) to get a revenue requirement for the Nonprofits, which was then honored. Under the 60-percent rule, however, the revenue requirement can be calculated directly, with no "artificial apportionment," no guessing, and no iterations, as I show in my

workpapers, sheet 'Rates,' cells C13 and C35.[43] The revenues result from solving two relatively simple equations. The first equation is that the Commercial revenue plus the Nonprofit revenue equals the revenue requirement for the combined subclass (the joint cost times the joint cost coverage). The second equation is that per-piece revenue of the Nonprofit category equals 0.6 times the per-piece revenue of the Commercial category. Since the volumes are known, the solution is straightforward.

3. Letter-Flat Rate Differential – General Observations. A key rate relationship in Standard Mail is that between the minimum-per-piece rate for letters and the corresponding rate for flats. Fully 88.5% of the pieces in Commercial Regular pay the minimum-per-piece rates, and the proportion for Commercial Nonprofit is even higher, at 94.7%. In ECR, these proportions are 66.8% and 91.6%, respectively. This rate difference becomes all the more important when these rates (for both letters and flats) may be used for pieces weighing up to 3.3 ounces but this allowance is used primarily by flats. The basic non-automation letters sent at the minimum-per-piece rates in Commercial Regular, for example, weigh on average 0.80 ounces, while the corresponding flats weigh 1.92 ounces, fully 2.4 times as much. And origin rates are usually

[43] Witness Kiefer may have found it difficult to go directly to rates that satisfied the 60-percent rule. In response to NAA/USPS-T36-9, he referred to the passthroughs on presort discounts as "levers" that he adjusted "to meet [among other things] the 60% average rate requirement." I believe it is preferable to set Nonprofit rates on a different basis.

taken as the reference point, which means that the mail paying these rates may be carried considerable distances by the Postal Service, which translates easily into two or more truck-loads of flats for each truckload of letters, and suggests considerably more handling. Other examples could be given, but the pattern does not change.

A rate differential between letters and flats was first proposed for now Standard Mail by the Postal Service in Docket No. R90-1, to improve the efficiency of the rates. The initial proposal was to recognize 50% of the differential and that this proportion would increase in subsequent cases, although the question of an upper bound was undecided. The proposal of the Service in the instant docket, 15 years later, is to recognize approximately 58 percent of a similarly-estimated cost difference in Commercial Regular and 45 percent in Nonprofit Regular. The situation in ECR is even worse, where the passthrough at the basic level is now and is proposed to be, zero. I find this lack of progress to be stupefying.

The Postal Service, if it is anything, is a carrier of letters. Its greatest achievement in automation has been in the processing of letters, primarily because the task of automating them has been found less formidable than that of automating flats. The dimensions and the weight of letters fall within a narrow range, and the propensity of letter mailers to use envelopes is very high. Flats, on the other hand, can be much thicker, can weigh much more, come in a wide range of sizes, and can be more difficult to handle. As a result, the costs of

processing letters are much lower than they would otherwise be. A goal of the Postal Service should be to make this low-cost mailstream available to mailers on favorable terms. Yet it continues to propose substantially higher contributions from letters than from flats, on both a per-piece and a percentage basis.

Unless it is the case that the sensitivity of volume to price is much greater for flats than for letters, and I know of no evidence on this issue, this allocation of contribution burdens runs counter to notions of value and of fairness. One of the most fundamental prescriptions for regulation is to seek to emulate outcomes that would be generated by a competitive process, were such competition feasible.[44] Markup relationships like those proposed for letters and flats are not a competitive result and run counter to the recognition of competitive pressures. Furthermore, they are not supported by any compelling public policy preference of flats over letters.

Evidence of the outcome of competitive processes is all around us. Americans are accustomed to being asked by salesmen to "trade up," which means to shift to the purchase of products with higher prices that generate more profit. Strangely, the Postal Service seems to find itself in just the opposite position — it is encouraging its customers to "trade down." Testimony to this effect is contained in the Postal Service's proposal for a Negotiated Service

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[44] *See* Alfred E. Kahn, *The Economics of Regulation*, Cambridge, The MIT Press, 1988, Vol. I, p. 17. A similar prescription has been espoused by Professor Baumol. *See* Direct Testimony of William J. Baumol, Docket No. R87-1, at 6 and 14-17.

Agreement with Bookspan, Docket No. MC2005-3. A key element in that case is, in my words, a statement that: "We make a lot more money on letters, so please convert your flats to letters. To get you to do it, we will even give you a discount off our high rates for letters." *See* Direct Testimony of Michelle K. Yorgey, USPS-T-2, *especially* p. 9 of Appendix A, which shows no contribution from flats, and considerable financial gain from flats converting to letters. A situation allowing this kind of arrangement should not exist.

Also, as I discuss in Section IV-I above, a general outcome of larger contributions on *less costly* products runs counter to the broadly accepted notion of equity that it is fair to require contributions in matters of taxation and pricing that are in proportion to the investment being made to cover the underlying direct costs.[45] In other words, products absorbing greater shares of the nation's resources are required to make proportionately greater contributions (*e.g.*,

[45] Witness Kiefer does not agree with this notion that I contend is broadly accepted. In his response to VP/USPS-T36-5(g), he says: "I see no reason why the sole fact that one group's or product's unit volume variable cost is higher than another's should mean that the first product must be required, for that reason alone, to make a higher unit contribution to the Postal Service's institutional costs." Obviously, he is free to view something else as fair. But he is out of line with the pricing counsel of the economic literature, which, while not vetoing the consideration of other factors as well, does suggest that "that reason alone" points to a higher unit contribution. I see no reason for a policy preference or social welfare constraint that rates should be tilted to favor flats over letters; nearly all Standard mailers are businesses who advertise, and they should face cost-based rates.

income taxes and sales taxes are paid on percentage bases, and many retail establishments base prices on a fixed markup over cost).[46]

I discussed the letter-flat differential in my testimony in Docket No. R2005-1, and incorporate that analysis here. *See* Docket No. R2005-1, VP-T-1, Tr. 9/5264, *especially* pp. 81-84, Tr. 9/5347-5350. Letters and flats tend to be separate products with separate processing streams, which will be true in even greater degree in the Flats Sequencing Sorter ("FSS") environment of the future. The difference between them is not a matter of worksharing. The default recognition for a cost difference under these conditions is the subclass cost coverage, but certainly at least 100 percent. No theory of which I am aware suggests that two products, even though related, should have the same per-piece markups, and there is no reason why the rate difference should be less than the cost difference.

In its *Opinion and Recommended Decision* in Docket No. R2005-1, the Commission referred to Valpak's "thoughtful discussion of why the letter/flat differential should be recognized in basic ECR rates" and, after noting that some of the costs available are undoubtedly affected by weight as well as shape, said: "The Commission finds persuasive witness Mitchell's arguments for decoupling the ECR basic and Standard Regular 5-digit automation rates, *and expanding*

[46] The antithesis of a system of proportionate contribution is a head tax, which most people find abhorrent. Except in special cases, head taxes have no relation to ability to pay or to benefits received, and do nothing but distort outcomes and cause unrest.

the letter/flat differential at the basic level to better reflect cost differences." *Id.*, ¶¶ 6074 and 6075, emphasis added. (I discuss issues relating to weight and the 5-digit decoupling below.)

One more element calls for note. It is common in discussions of the letter-flat rate differential to ask whether the difference in cost between letters and flats is actually due to shape. The concern is that part of the cost difference could be due to something else, such as differences in weight or containerization or some other aspect of mail makeup. I agree that it is often advisable to recognize separate influential factors (cost drivers) separately, and to set rates accordingly. But when information on these other factors is not available, a focus on costs is usually in order.

In other words, suppose minimum-per-piece flats weigh more and cost more than minimum-per-piece letters. If the difference between these two categories were viewed as a matter of worksharing, attention could be given to the cost consequences of flats converting to letters of the same weight. But if the difference is not viewed as a matter of worksharing, as it should not be, then it seems entirely reasonable to recognize the fact that, on average, minimum-per-piece flats weigh more than minimum-per-piece letters. Furthermore, there is no basis for assuming that pieces changing their shape would keep their same weight. A shift to a flat format, for example, might well be accompanied by a decision to use different weight paper and to include different graphic design, including photographs.

In the end, for reasons discussed in detail in the rate design sections below, I propose that 95 percent of the cost difference be recognized in Regular and that 100 percent be passed through in ECR. It may be that the Commission will be concerned about going further, due to issues relating to the effect of weight on costs, and that the Commission will call for improved cost information, but that should not stop progress at this time.[47]

The shape-based rate differences proposed by the Postal Service (58 percent of costs in Commercial Regular, 45 percent of costs in Nonprofit Regular, and precisely zero percent of costs in both categories of ECR) are exceedingly low. The passthroughs in Regular are a result, apparently, of witness Kiefer selecting rates that he thought reasonable. His explanation for the passthrough in ECR is contained in one sentence: "I also continued the practice of setting the Basic letter rates equal to the corresponding flats rates." USPS-T-36, p. 31, ll. 19-20. He did not provide a discussion of the costs of the categories, nor did he acknowledge the Commission's analysis of this issue in its Opinion in Docket No. R2005-1.

Witness Kiefer was asked in an interrogatory about his proposal for ECR to continue what he calls "the practice of setting the Basic letter rate equal to the corresponding flats rate." His response was: "In the end, it was believed that

[47] The Commission may also wish to consider its role in providing guidance to the Postal Service on what should be done if it finds itself under a regime of price caps. National policy would seem to support the fair pricing of letter mail, and additional steps toward that end may need to be taken.

continuing the present arrangement would best support the Postal Service's goal of promoting automation and sequencing of letters at plants to the extent possible." Response of witness Kiefer to NAA/USPS-T36-1.

Witness Kiefer left unexplained how setting equal rates for letters and flats supports the Postal Service's automation goals or the sequencing of letters on automation equipment. Certainly the rate charged for letters has no influence on the alternatives available for processing them. Further insight into witness Kiefer's reasoning was provided in his response to Question 9 of POIR No. 7, where he explained that if the rates for basic ECR letters are kept artificially high, the mailers sending those letters might decide to use instead the rates for 5-digit automation letters in the Regular subclass. *See also* response of witness Kiefer to NAA/USPS-T36-13. He does not refer to the Commission's statement in its *Opinion and Recommended Decision* in Docket No. R2005-1, cited above, that it finds the arguments for "decoupling the ECR basic and Standard Regular 5-digit automation rates" to be "persuasive."

It is *inappropriate* to rely on a coupling of the kind apparently behind the Postal Service proposal, for two reasons. First, basic letters qualify fully for the ECR subclass and should pay rates that recognize their characteristics and their costs, in line with accepted ratesetting principles. Once this is done, mailers should be allowed to decide what mail to send and what rate categories to use, and the Postal Service should be happy to process the resulting mail. It is not fair to jack up the rates unduly, to the neglect of costs, in hopes that the mail will

go somewhere else, in this case to the 5-digit automation category in Regular. This is not an appropriate way to design rates. And it is not as if similar matters have not come up before. As I discuss in Section IV-J above, the Commission observed in response to a proposal to constrain another pair of rates: "One has to question the logic of creating subclasses and then constraining the outcome in accordance with a result that would be obtained without creating the subclasses." Docket No. MC95-1, *Op. & Rec. Dec.*, ¶ 5388.

The second reason why witness Kiefer's approach is inappropriate is more practical in nature. Unless an extraordinary adjustment is made,[48] the rates for high-density and saturation letters depend on discounts from the rate for basic letters. Thus, any elevation in the rates for basic letters elevates at the same time the rates for high-density and saturation letters. Allowing this to happen would be unfair. And making it even worse is that both high-density and saturation letters are *required* to be barcoded and automation compatible, and therefore present the Postal Service with full automation options, among others. Their rates should not be so elevated.

In Sections A and B below, which discuss more particularly the actual rates recommended for letters and flats in Regular and ECR, I discuss certain

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[48] Note should be made at this point that witness Kiefer apparently did make an extraordinary adjustment to the rates for high-density and saturation letters to keep them from being affected by his proposal to keep the rates for basic letters elevated, as he explains in his response to Question 9 or POIR No. 7. Happily, if the rates for basic letters are designed to recognize their costs, no difficulties arise, and no such adjustment is necessary.

other issues relating to the rates for letters and flats, including a suggestion that the letter-flat rate differential should be based on a more inclusive cost than just the mail processing and delivery costs, and therefore that my recommendations in this case should be viewed as conservative.

4. Postal Service Proposal to Eliminate the Basic Automation Letter Rate from ECR. The Postal Service proposes to eliminate the rate category for basic automation letters in ECR, both Commercial and Nonprofit, and assumes that these letters (all 2.283 billion of them) will use the 5-digit automation rate in the Regular subclass. *See* USPS-T-36 at 30-31. As a justification for this change, witness Kiefer explains that the Postal Service plans "to further centralize the sequencing operations in plants to the greatest extent possible" and that under these conditions "a two-track pricing scheme for automation letter mail is not warranted." *Id.*, p. 31, ll. 2-3 and 5-6, respectively. It may also be that part of his justification is that the "rate is currently available *only* for mail sent to sites that do not receive letters from the plant in delivery point sequence," though 2.283 billion pieces is hardly negligible.[49] *Id.*, pp. 30, l. 28 to p. 31, l. 1, emphasis

[49] The question of whether a rate should be withdrawn because *only a few* mailers use it or because it is used for *only a few* destinations is an interesting one. Certainly a case might be made in some instances that the complexities and costs of administration are too great to warrant allowing the continuation of a rate. The Postal Service, however, has not made this argument in regard to basic automation letters, and it is not clear that it could. The volume at issue is still large, much larger than the volume associated with some other rates, such as the volume of CMM pieces or of parcels in all of the Standard Mail subclasses combined. Issues of fairness also present a view. Specifically, from the point of view of the user of a rate, it is not clear that the unfairness associated with withdrawing the rate has anything at all to do with how many (continued...)

added. In response to an interrogatory on this subject, witness Kiefer essentially reiterated his testimony cited above: "The decision to propose elimination of separate ECR Automation Basic rates was taken to support the Postal Service's move to further centralize the delivery point sequencing of automation compatible letter mail at plants." Response to VP/USPS-T36-9(b).

This is unpersuasive. Simply put, the Postal Service's processing options for 5-digit automation letters in Regular are no different, no better, and no broader that its processing options for subject automation letters in ECR. But, making the justification even more perverse, the processing options for ECR basic automation letters are broader than those for 5-digit automation letters in Regular. This is because the ECR letters are more finely presorted, are in line-of-travel sequence (or are walk sequenced), and are well-suited for processing on all Delivery Point Sequence ("DPS") equipment still in use in smaller offices (CSBCSs), even if the use of this equipment is dwindling. Moreover, the costs of record for the ECR letters are lower than the costs of the 5-digit letters in Regular.

The issue, however, is even more fundamental. Basic automation letters in ECR are fully qualified to be there. They are prepared according to all Postal Service regulations, and they meet the density requirement of 10 pieces per carrier route. They should be accorded any benefit available to ECR mailers.

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[49] (...continued)
others might be using the rate in question.

And, as I explain and document fully in Section IV above, the primary reason for the Postal Service's proposal and the Commission's subsequent recommendation to create the ECR subclass was to recognize differences in demand, elasticity, market characteristics, density, and costs. None of these can be recognized if the pieces are diverted to the Regular subclass; in effect, all recognition is being withdrawn. When asked about this history and these issues, witness Kiefer stated: "While the Commission did not specifically call these 'the primary reason' and gave other reasons as well to support its decision, I agree that differences in demand, elasticity, market characteristics and costs appear to have been important factors in the Commission's decision." Response to VP/USPS-T36-9(a). He did not identify any "other reasons," however.

On oral cross examination, witness Kiefer was given further opportunity to discuss the factors considered by the Commission in creating the classification for automation basic letters. He was asked: "Did you discuss those factors in your proposal to dis-create, un-create, dissolve, what the Commission did in MC95-1?" He responded: "What I said was that this in some sense does not preclude those pieces from remaining in ECR." Then he pointed again to the fact that automation basic letters is a "limited" category. Tr. 5/1177. I find it strange logic to take the position that the reasons for creating basic automation letters are irrelevant because the letters involved are perfectly free to stay in ECR at 23.3¢ instead of going to 5-digit automation Regular at 21.9¢. (The specific rates of 23.3¢ and 21.9¢ are those proposed by the Postal Service.)

The Postal Service proposal on this issue clashes with the justification for the creation of ECR, as espoused by both the Commission and, indeed, the Postal Service itself. It may be that part of the difficulty of thinking about basic automation letters in ECR relates to their position in the classification scheme. They are an automation variant, with restrictions, of basic non-automation letters, which are in turn host to high-density letters and saturation letters. However, high-density letters and saturation letters are required by Postal Service regulations to be barcoded and automation compatible. It would be more logical for their host to be an unrestricted category of automation basic letters. The one that exists, though, is for non-automation letters, and does not even have a machinability requirement.

In this setting, the Commission should consider the possible merits of creating an unrestricted category of basic automation letters, consistent with the categories of high-density and saturation. Then, if there is an interest in making a non-automation or a non-machinable version of basic letters available, there should be a surcharge for it. The layout that exists now is troublesome on its face, may be causing difficulties in costing, and certainly keeps some qualified mail from receiving the recognition it deserves. Changes should be considered, but any changes should go in the opposite direction from removing qualified letters entirely from ECR, as the Postal Service proposed.

Partly because of the awkwardness of the classification for basic ECR letters, as I just outlined, the Postal Service has in the past sought to keep the

rate for basic (non-automation) ECR letters above the rate for 5-digit automation letters in Regular. This issue is discussed above in the section on the letter-flat rate differential.

The rates I develop below include separate rates for basic automation letters, in ECR.

5. Adoption of a Number of Parts of the Postal Service Proposal.

The Postal Service proposal for Standard Mail has many parts, some of which I support and adopt. These include: (1) the proposal to recognize the non-machinability of letters in Regular, with rate tiers by presort level; (2) most aspects of the general rate structure, including the breakpoint of 3.3 ounces; (3) separate rates for machinable and non-machinable parcels, including the NFM category; (4) the proposal to deaverage basic presort into mixed AADC (hereinafter MxAADC) and AADC (or mixed ADC [hereinafter MxADC] and ADC), and 3/5-digit into 3-digit and 5-digit; (5) the proposal to apply the 5-digit origin NFM rate to CMM pieces; and (6) all of the pound rates proposed, as I have no basis for changing them. In addition, I adopt witness Kiefer's TYBR billing determinants (which he refers to as "Recategorized" in Regular, as they have been adjusted to accommodate the new categories proposed); they form the basis for the development of my rates.

Also, I adopt generally the Postal Service proposal on dropship discounts. I have modified the cost avoidances to align with PRC costing and have applied the same passthroughs and parcel multipliers as witness Kiefer. These

discounts and their development have changed little in recent cases. For some of the parcel categories that are new, the Postal Service proposes dropship discounts that are different from the ones applied generally; in most or all such cases, the volumes are small.[50] If they are used to a significant extent, it should be possible to review them with greater perspective in some future period. The dropship discounts I recommend are shown in Schedule 1. They should be added to the rate schedules at the end of my testimony, as part of a complete set of rates.

Schedule 1 Dropship Discounts for Regular and ECR Standard Mail, VP

Dropship Point	DBMC	DSCF	DDU
All categories, if applicable, including NFM and ECR parcels, exceptions below			
Per-piece	2.9	3.6	4.3
Per-pound	13.9	17.2	21.1
Regular parcels, non-machinable			
Per-piece	3.4	7.8	11.7
Regular parcels, machinable and non-machinable			
Per-pound	16.6	37.9	56.9

[50] In the Commercial Regular category, for example, about two one-thousandths of one percent of the pieces are parcels.

Finally, I adopt the proposal to place a surcharge of 1.5¢ on the use of detached address labels ("DALs"). It seems clear that the use of DALs may not align well with future mail processing and delivery systems, which will involve the automated sequencing of flats and three bundles for carriers, before the possibility of an extra bundle of saturation pieces.[51] It is also clear that saturation flats with DALs cost more to handle and deliver than addressed saturation flats. Witness Kelley has estimated that the cost of DALs in the Test Year is expected to be $165 million. Dividing this by the TYAR volume of DALs estimated by witness Kiefer gives a cost of 4.39¢ per piece. Witness Kelley goes on to say that the level of savings could be below this, due to an "offset," if it takes carriers longer to handle addressed saturation flats than they are taking now to handle unaddressed saturation flats with DALs. *See* response of witness Kelley to VP/USPS-T-30-17(b). While I lay no claim to being an expert in the details of carrier operations, I think it is evident that the offset would be reasonably small, relative to 4.39¢, and thus that a net savings of over 1.5¢ would result from DAL-accompanied pieces converting to addressed saturation pieces.

It might be argued that as long as the cost of DALs is included in the cost of saturation flats, and are thus recognized when the rates are set, there is nothing amiss associated with not having a DAL surcharge. But there is another

[51] In the future system, carriers are expected to have a bundle of DPS'd letters, a bundle of flats sequenced on the FSS machines, and a bundle of residual pieces from the traditional carrier case.

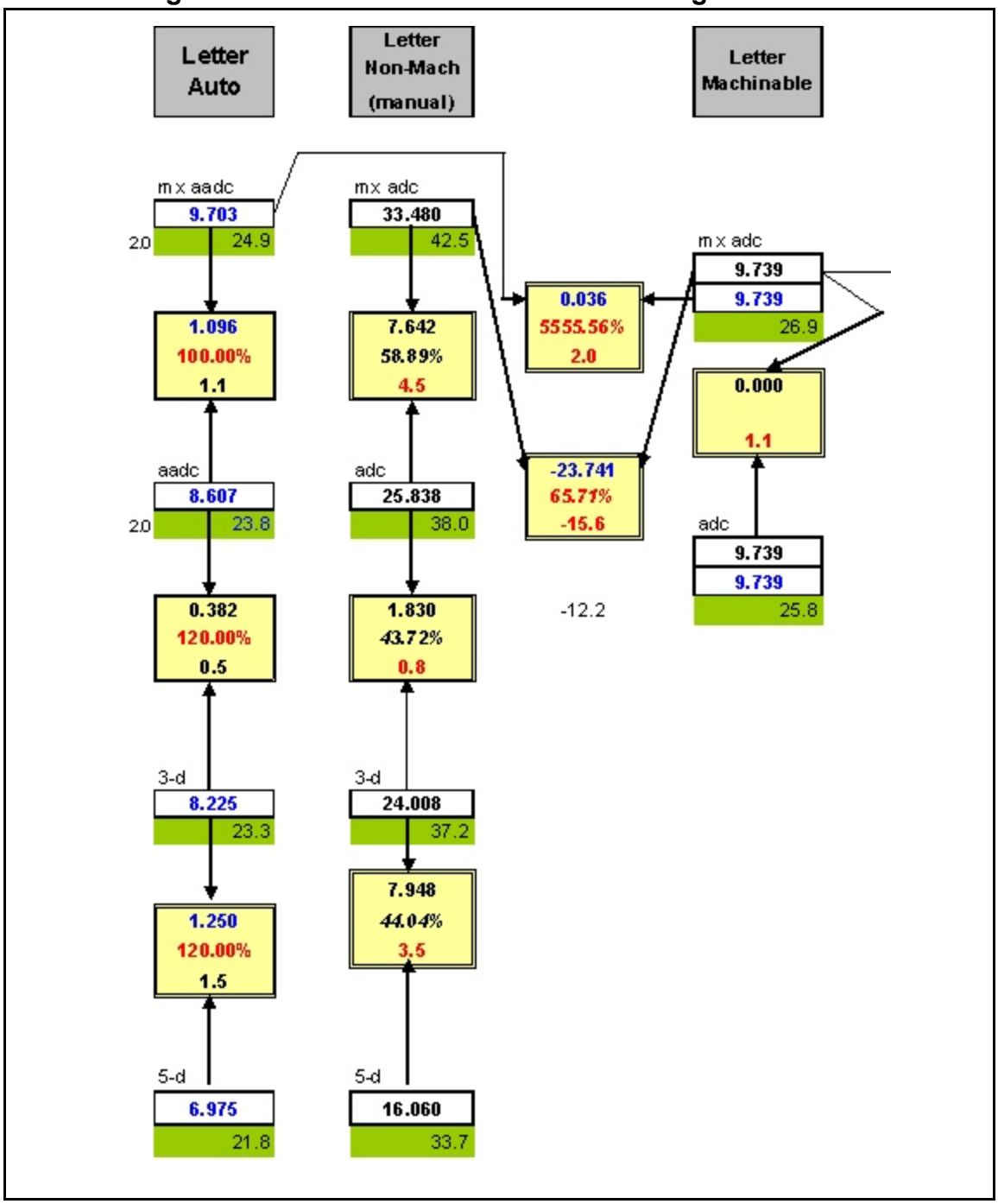
point that needs to be recognized: a considerable number of *addressed* saturation flats exist, and it is unfair to rate-average them with unaddressed flats that use DALs. Accordingly, a DAL surcharge is fair and appropriate on all counts, and a 1.5¢ surcharge seems a reasonable first step.

A. Rate Design for Commercial and Nonprofit Regular Mail.

In this section, rates for letters are developed first, and then for flats and parcels. After this is done, the letter-flat differential is discussed. Finally, a section discusses the Nonprofits. The presort tree is used as a schematic to organize thought and keep things together. It will be introduced in sections, since the entire tree is rather large.

1. Letter-Size Pieces in Regular. Figure 1 shows the presort tree for Regular letters. Since it is notably complex, an introduction should be helpful. The original is in color, but little is lost in a black and white version. The tree is composed of 1-level, 2-level, and 3-level boxes, and the 1- and 2-level boxes have letters or numbers, respectively, immediately above and below them. In all cases, the 1-level and the 2-level boxes contain the sum of mail processing and delivery costs, Commission version, in cents (¢) per piece.

Figure 1: Presort Tree for Commercial Regular Letters



In the case of 2-level boxes, the upper cost is an unrestricted total cost and the lower cost is a workshare-related cost.[52] In some cases, these two costs are the same, depending on the cost study done by the Postal Service.

The 3-level boxes generally have double-line borders and contain the key rate design information. The top level contains the cost difference; the middle level contains the percentage passthrough; and the bottom level contains the resulting rate difference, rounded. If the middle level is missing or is in italics, it means the rate difference in the bottom level was selected instead of calculated from the passthrough.

The 1- and 2-level boxes contain identifiers just over them, justified to the left. Just under them is a shaded figure, justified to the right; it is the final resulting minimum-per-piece rate, which, of course, is not known at the time the tree is used to make decisions on rates. The arrows show which direction the cost information flows. The order in which the material in the tree is considered is immaterial. I will go from the top down, although horizontal comparisons are often made. All trees shown in my testimony, Figures 1 through 4, are for the rates I develop.

2. Automation Letters in Regular. Basic automation letters were deaveraged in Docket No. R2001-1 into MxAADC letters and AADC letters. The difference generally is that AADC letters do not need to be sorted at an origin

[52] In general, a workshare-related cost is a cost that is constrained to have a given mix of attributes, and is sometimes called a constant profile cost.

facility and can be taken in trays directly to a destination AADC. As shown in Table 2, the Postal Service proposed in that docket a discount for AADC preparation of 0.7¢, which was about 90% of the cost difference. The case was settled and the discount of 0.7¢ was recommended. In Docket No. R2005-1, the Postal Service proposed to increase the discount to 0.8¢, a passthrough of about 86%. That case was also settled. In the instant docket, the Postal Service's proposal is to increase the discount to 1.0¢, a passthrough of 100% at Postal Service costing and 91% at Commission costing. I see no reason why the cost difference of 1.096¢ should not be recognized fully. It is clearly a good thing when groups of letters can be transported directly to a destination facility without piece sorting at the origin. Rounded, the resulting discount is 1.1¢. This is very much in line with recent trends, and I see nothing about avoiding processing at an origin office that makes this discount seem large.

Table 2: Discounts, Costs, and Passthroughs for Regular Automation Letters

	USPS Proposed				PRC Recommended		
Docket Number	Disc	Cost	Pass		Disc	Cost	Pass
R97-1							
R2000-1							
R2001-1	0.7¢	0.78¢	90%		0.7¢	1.00¢	70%
R2005-1	0.8¢	0.93¢	86%		0.8¢	1.07¢	75%
R2006-1	1.0¢	0.97¢	100%				
	Valpak Recommended						
	1.1¢	1.10¢	100%				

The next step is to move from the AADC level down to the 3-digit level. In Docket No. R2005-1 and earlier, the 3-digit automation rate was set relative to the rate for 3/5-digit *non-automation* letters, instead of relative to a less-sorted automation category. In the instant docket, that reference point is proposed to be eliminated, to align with processing capabilities, and there is no choice but to relate the discount to the AADC letters immediately above. Because of these changes, the history is not smooth, and no table is provided.

If costs are recognized fully, the reference point for a discount is relatively immaterial. That is, approaching a cost from a different direction does not make it any different. However, if the passthroughs are less than 100%, the path one

takes to a rate can make a difference. I will discuss some of these issues as we proceed, in situations where there is a choice on path.

In Docket No R2000-1, the 3-digit automation rate was proposed by the Postal Service to be 3.2¢ below the 3/5-digit nonautomation rate, which was 0.7¢ below the basic automation rate. On the latter basis, the Commission recommended a discount of 1.0¢. In Docket Nos. R2001-1 and R2005-1, it was proposed to be 0.9¢ below the newly-deaveraged AADC automation rate (the same in both dockets), and both cases were settled. In the instant docket, the proposal is for a discount of 0.7¢ (from the same AADC automation rate), a passthrough of 207% on a cost difference of 0.339¢, at Postal Service costing.

Three-digit preparation allows mail to be taken to a destination 3-digit processing center before any piece sorting occurs. The cost avoidance associated with this option appears to be declining, perhaps because the processing received by many AADC and 3-digit trays is the same, although there could be other reasons. Witness Kiefer does not address this issue. But it is not clear to me that these costs should be neglected.[53] The proposed passthrough

[53] It does not seem in order to me to pay minuscule tribute to the Postal Service's costing results. The Postal Service has been building and improving its costing models for some time now, and they are getting complex and detailed. Also, they have numerous inputs from actual operations, such as information relating to productivity levels and mail flows. The results should be taken to mean something important. I am not suggesting that anomalous costing results cannot occur. But when they do, they should be looked into and they should be discussed. I have not found the results of any such inquiry.

is high by any measure. My proposal is to reduce the passthrough to 120%, which yields a discount of 0.5¢.

It is sometimes reasoned that reducing discounts for automation mail is a failure to support the Postal Service's automation program; but this is not the case. The Postal Service has invested heavily in automation equipment and, according to the costs, it can process mail very efficiently, particularly machinable letters. To give an excessive discount to encourage mailers to help circumvent use of this equipment actually undercuts the automation program, and fails to allow its use for its intended purpose, which is to help mailers. The Postal Service should be pleased to have mail to process, not unhappy, particularly when it is so well-positioned to do the work.

The next step is to set the discount for 5-digit automation letters, relative to the corresponding 3-digit letters. The history is shown in Table 3.

Table 3: Discounts, Costs, and Passthroughs for Regular 5-Digit Automation Letters

	USPS Proposed				PRC Recommended		
Docket Number	Disc	Cost	Pass		Disc	Cost	Pass
R97-1	1.8¢	1.36¢	132%		1.6¢	1.64¢	100%
R2000-1	2.1¢	1.34¢	157%		1.3¢	1.25¢	100%
R2001-1	1.3¢	1.02¢	128%		1.3¢	1.17¢	111%
R2005-1	1.4¢	1.13¢	124%		1.4¢	1.30¢	109%
R2006-1	1.6¢	1.11¢	145%				
	Valpak Recommended						
	1.5¢	1.25¢	120%				

In Docket No. R97-1, the Postal Service proposed this discount to be 1.8¢, a passthrough of 132%. The Commission recommended a discount of 1.6¢, equal to 100% of a cost difference it estimated to be 1.642¢. In Docket No. R2000-1, the Postal Service proposed a discount of 2.1¢, a passthrough of 157%. The Commission recommended a discount of only 1.3¢, 100% of its costs, again. In Docket Nos. R2001-1 and R2005-1, the Postal Service proposed discounts of 1.3¢ and then 1.4¢, passthroughs of 128% and 124%, respectively. In the instant docket, it proposes a discount of 1.6¢, a passthrough of 145%.

The pattern on this discount is clear. The Postal Service has proposed passthroughs well above costs in Docket No. R97-1 and since. The Commission, except in the case of settlements, lowered it every time, back to a passthrough of 100%. As discussed above, giving high passthroughs does not support the Service's automation program. Witness Kiefer provides no discussion on this point, even though 42.1 billion of the 48.8 billion letters in Commercial Regular use either the 3-digit or the 5-digit automation rate. (One would think that categories this large would be worthy of discussion, but the only observation provided is that the rates are viewed as reasonable.)

My proposal is to lower the passthrough on the 5-digit discount to 120%, yielding a discount of 1.5¢, and specify that further consideration should be given to this issue in the future.

As a final step, the relation of automation letters to other letters needs to be specified. In the past, automation letters have been considered a workshare variant of non-automation letters, and the cost of non-automation letters has been used as a reference point. In the instant docket, however, non-automation letters are to have a machinability requirement. This changes the comparison somewhat.

Since, as categories, automation letters are machinable and non-automation letters are to become machinable, the comparison should be from the costs of automation letters to the costs of *machinable* letters, the latter being 9.739¢, at least as shown in Figure 1. Witness Kiefer shows (the Postal Service

version of) this cost in his workpapers, but it is not clear what he does with it. If one goes to his principal rate development sheet (labeled 'Proposed Rates') and does a forward trace on this cost (shown in cell D7), it goes nowhere. He also shows a cost for automation letters on his 'Inputs' sheet (cell D103 being the mail processing component), but does nothing with it either. In his testimony, at the end of a sentence pointing to discounts for presorting, dropshipping, and automation, he adds: "(automation pieces reflect a further $0.040 discount off nonautomation prices)." (P. 14, ll. 11-12.) Despite the fact that 96.5% of all letters in Regular use the automation rates, that is the end of the discussion.

In Docket No. R97-1, as shown in Table 4, the Postal Service proposed a discount of 5.8¢ for basic automation letters, relative to basic non-automation letters, a passthrough of 142%. The Commission reduced this to 5.2¢, 100% of its cost difference. In Docket No. R2000-1, the Service proposed to reduce this discount to 4.2¢, a passthrough of 111%. The Commission increased it to 5.3¢, again 100% of its cost difference. In Docket Nos. R2001-1 and R2005-1, the Service proposed increases to 4.9¢ (90% of costs) and then 5.1¢ (50% of costs).

Table 4: Discount Information for Basic Automation Letters Relative to Basic Non-Automation Letters, in Regular Standard

	USPS Proposed				PRC Recommended		
Docket Number	Disc	Cost	Pass		Disc	Cost	Pass
R97-1	5.8¢	4.11¢	142%		5.2¢	5.18¢	100%
R2000-1	4.2¢	3.78¢	111%		5.3¢	5.33¢	100%
R2001-1	4.9¢	5.58¢	90%		4.9¢	7.22¢	68%
R2005-1	5.4¢	10.12¢	50%		5.1¢	10.82¢	47%
R2006-1	4.0¢	-0.09¢					
	Valpak Recommended						
	2.0¢	0.04¢					

In the instant docket, at the MxAADC level, the cost of machinable letters is 9.739¢, as noted above, and of automation letters is 9.703¢, yielding a cost difference of only 0.036¢, influenced no doubt by the fact that USPS-LR-L-110 shows the same cost for machinable letters at both the MxAADC level and the AADC level. If these costs were developed separately, the cost of machinable letters at the MxAADC level would undoubtedly increase and the cost difference would be larger.

Some insight into the effect of having only a joint cost for MxAADC letters and AADC letters can be gained by looking at the costs from Docket No. R2005-1. There, the cost at the basic level was 22.817¢ and at the 3/5-digit level was

21.314¢, a not substantial difference of 1.503¢. Therefore, deaveraging might increase the MxAADC cost by about 3/4 of a cent. Another comparison suggesting a small adjustment is that the difference between the MxAADC level and the AADC level for automation letters is shown in Figure 1 to be only 1.096¢. One countervailing factor deserves mention – the cost for MxAADC letters has a small non-machinable component, and the new category is to be a machinable one. In the face of this situation, the Postal Service, as noted above, proposes a rate difference of 4¢, with no discussion of any of these difficulties.[54]

I believe the cost trends are showing that the Postal Service's automation equipment is processing machinable letters for a cost that is not much above the cost of processing corresponding automation letters. Under these conditions, I see no basis for a discount of 4¢. The Postal Service's equipment should be made available to mailers on reasonable terms. Based on a presumption that the cost difference would be at least a cent higher than 0.036¢ if appropriate costs for machinable, MxAADC letters were available, my proposal is to set the discount at 2.0¢, and to suggest that further study would be in order. The

[54] In Question 3(c) in POIR No. 5, the Commission asked about the selection of automation discounts and why passthroughs were not applied to relevant costs. Witness Kiefer responded by pointing out that the discount of 4¢ is an exogenous input to his worksheet, and that this discount enters directly into the rate calculation. He did not, however, say what the relevant cost difference is or how he selected the 4¢. As discussed in the text, I find the cost difference to be 0.036¢, a good deal less than 4¢.

passthrough shown in italics in Figure 1 (5555.56%) is implied by the cost of 0.036¢ and the discount of 2¢.

3. Non-Machinable Letters in Regular. Relevant cost information for non-machinable letters is shown in the second column from the left in Figure 1. For a host, they are linked to the machinable letters in the right column. The proposal to separate non-machinable letters and to give them full rate recognition is new in this case.[55] In my words, the message is: "If you want to send letters that cost us more to process, you must bear the additional costs; no one else is going to pay them for you." At the same time, the mailer is given choices. If he is not receiving adequate value from sending non-machinable pieces, he can change them, for a net improvement in efficiency. I approve of this change in structure. It is in line with making the Postal Service a more effective organization.

There are 48.8 billion letters in the Commercial Regular category. Of these, only 0.112 billion are non-machinable (just over 2 tenths of 1 percent). Non-machinable letters are recognized in the Postal Service's costing models, however, and have been for some time.

[55] Currently, non-machinable letters pay a surcharge of 4.2¢, a charge that does not vary with presort level, even though costs do. I see no argument that would support continuing such a uniform charge. If a piece costs the Postal Service a lot more, the additional charge should be high. On the other hand, if the Postal Service can process the piece at a small additional cost, the additional charge should be low. My proposed structure does just this.

At the MxAADC level, the Postal Service proposal is to charge non-machinable letters an extra 15.6¢, which is 65.71% of the additional cost, at Commission costing. As a first step, even though this rate differential is substantially larger than the non-machinability surcharge of 4.2¢ that currently applies, I see no reason to question it. In all likelihood, the Postal Service will propose to increase it further in the future, particularly if the cost difference associated with it continues. These are professional mailers making business decisions, and they should bear the consequences of their decisions.

Once the difference of 15.6¢ is selected, it is necessary to select the density discounts, which means to move down the presort tree from the MxAADC level to the 5-digit level. The Postal Service proposes density discounts of 4.5¢, 0.8¢, and 3.5¢, respectively. Adopting these discounts, along with the other rates developed herein, results in rate increases (relative to the current level) of 31.2% at the MxAADC level, 17.3% at the AADC level, 22.8% at the 3-digit level, and 11.2% at the 5-digit level. If the passthroughs were increased, these increases would be even more disparate. At this point, I see no reason not to adopt the proposed discounts. It may well be in order to increase the passthroughs in the future. The passthroughs shown in the tree are Postal Service proposed discounts relative to the cost differences.[56]

[56] Note that the surcharge for non-machinable letters relative to machinable letters is 15.6¢ at the MxAADC level and 12.2¢ at the AADC level. It is clear that this relationship is in the right direction.

Two aspects of the Postal Service proposal for non-machinable letters deserve note. First, the 3-digit discount (at 0.8¢) is much smaller than the AADC discount (at 4.5¢). This may suggest that many AADC and 3-digit trays get the same processing, as discussed above for automation letters. Second, setting all four passthroughs (from machinable to non-machinable letters and then down the non-machinable column) in the 50-percent range, tends to result in a situation where the MxAADC letters are undercharged and the 5-digit letters are overcharged (because they get small discounts). Under such conditions, it could be reasonable to set the passthroughs on the density discounts at a higher passthrough than that from the MxAADC machinable category to the MxAADC non-machinable category.

4. Machinable Letters in Regular. The Postal Service proposes two changes to the rates for machinable letters. The first is to deaverage the basic level into a MxAADC level and an AADC level. In my opinion, this is a good change. Second, it proposes to eliminate separate rates for machinable letters prepared at 3-digit and the 5-digit levels, because suitable equipment is not available to process them. This means that the only discount to select is the one between the MxAADC level and the AADC level.

Unfortunately, as noted above, USPS-LR-L-110, and the corresponding USPS version, USPS-LR-L-48, do not develop separate costs for these two levels. In view of this difficulty, witness Kiefer proposes a discount of 0.5¢. I find this discount to be problematic. Certainly there is some advantage to being able

to process letters first at a destination AADC instead of first at an origin processing facility, and 0.5¢ is meager recognition. Also, it is difficult to see any reason why a savings of this kind should be smaller for machinable letters than for automation letters, and the corresponding discount for the latter is 1.1¢, as discussed above. In fact, one would expect that the discount for machinable letters might be larger than the discount for automation letters. My recommendation is to set this discount at 1.1¢, the same as the corresponding discount for automation letters, and to seek more disaggregate costs in the future. When it can be done on a cost effective basis, avoiding sortations at origin facilities is certainly a worthwhile goal.

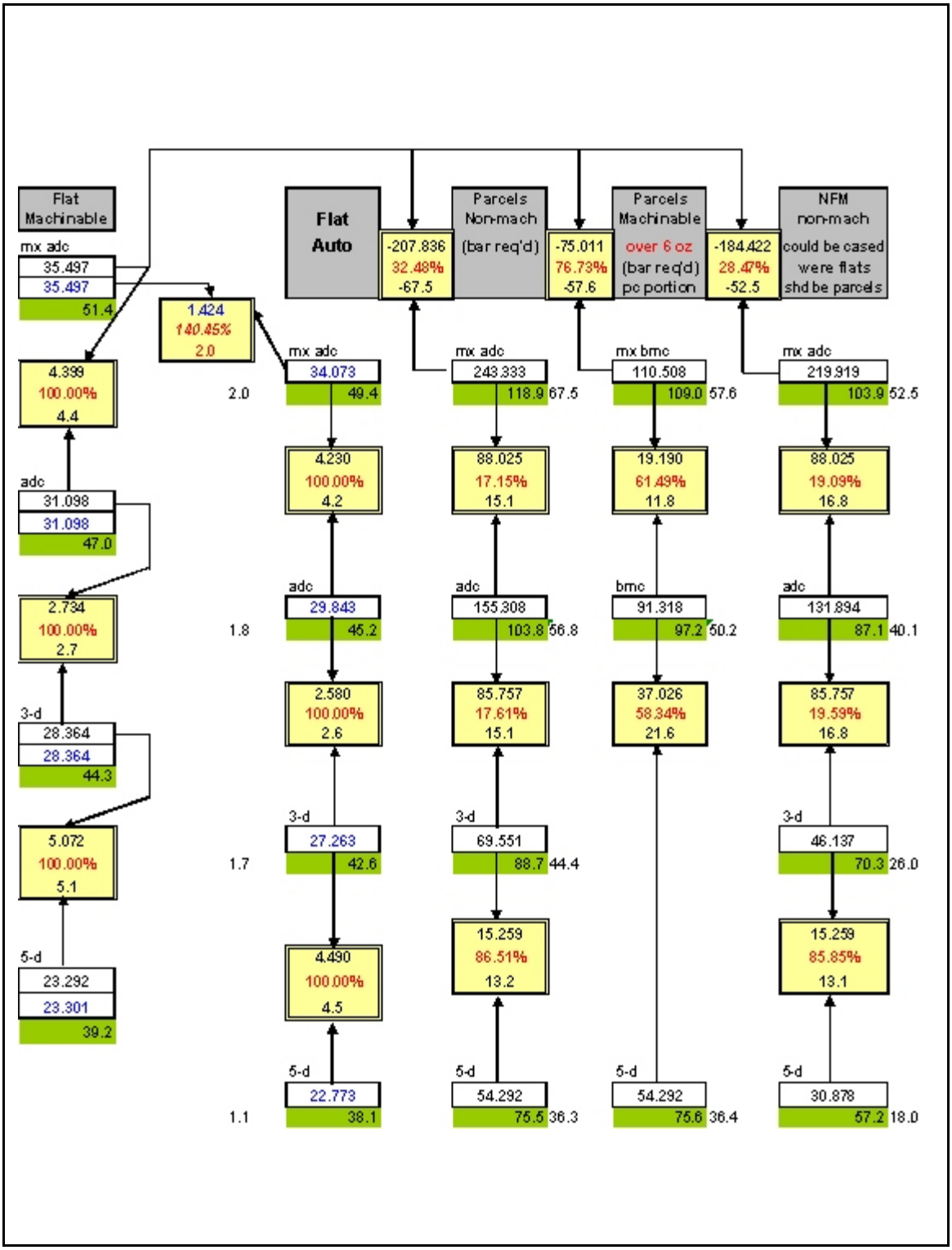
Adopting a discount of 1.1¢ has another virtue. Under the Postal Service proposal, at the MxAADC level, automation letters receive a 4¢ discount relative to machinable letters, while at the AADC level, the same comparison shows a discount of 4.5¢. If automation letters are viewed as a workshared variant of their corresponding non-workshared category, this outcome makes no sense at all. Under the rates I recommend, both of these comparisons yield the same discount.

5. Flat-size Pieces and Parcels in Regular. Figure 2 shows the presort tree for flats and parcels. It is obvious immediately that the Postal Service proposal to recognize the costs of parcels goes well beyond the Residual Shape

Surcharge of 24.2¢ that exists currently.[57] Of 13.6 billion non-letters, 12.4 billion are flats. The remaining 1.2 billion pieces are parcels, falling into one of the three columns on the right of the tree.

[57] The Residual Shape Surcharge (frequently abbreviated "RSS") is a specific rate element contained in the footnotes to relevant Rate Schedules.

Figure 2: Presort Tree for Commercial Regular Flats and Parcels



In effect, non-letters that cannot be processed on flats machinery will fall into either the machinable parcel category or the non-machinable parcel category, with barcodes required.[58] Machinable parcels must weigh over 6 ounces, for processing reasons, and must be prepared to align with the BMC network, which implies slightly different presort levels. Flats that have at times been processed on some of the flats machinery but cannot be processed on the newer equipment, and will therefore be viewed as parcels, will be eligible for a temporary category called NFM, the term meaning "not flat-machinable." I do not take issue with these changes.

6. Automation Flats in Regular. Currently, only two density tiers exist for automation flats, a basic tier and a 3/5-digit tier. Rates for the basic tier have been set relative to the basic tier of non-automation flats, and rates for the 3/5-digit tier have been set relative to the 3/5-digit tier of non-automation flats. This procedure has the virtue of beginning by recognizing the characteristics of the mailing in terms of the presort level it can achieve, and then focusing on whether the mailer decides to barcode it and ensure its automation compatibility. As Figure 2 shows, however, the category of automation flats is proposed to be

[58] Parcels without barcodes will be assessed a surcharge of 5¢. Since the volume paying this surcharge is expected to be *de minimis*, revenue from it is not accounted for in the estimation of after-rates revenues.

disaggregated into four tiers, and the progression of discounts is being viewed vertically, after the rate for the initial (MxADC) tier is set.

As long as the costs of the various categories are fully recognized in the rates, it makes no difference whether a presort tier, such as automation 3-digit flats, is tied to MxADC automation flats or to 3-digit non-automation flats. But if the passthroughs vary, it can make a significant difference. This issue was discussed above for automation *letters*. The same consideration needs to be given here.

The history of these discounts is shown in Tables 5 and 6.

Table 5: Discounts, Costs, and Passthroughs for Regular Basic Automation Flats, Relative to Basic Non-Automation Flats

	USPS Proposed				PRC Recommended		
Docket Number	Disc	Cost	Pass		Disc	Cost	Pass
R97-1	5.7¢	5.72¢	100%		5.9¢	5.94¢	100%
R2000-1	4.4¢	1.91¢	230%		4.4¢	2.72¢	162%
R2001-1	4.4¢	2.72¢	162%		4.4¢	2.87¢	153%
R2005-1	4.7¢	1.48¢	318%		4.7¢	1.85¢	254%
R2006-1	NA						

Table 6: Discounts, Costs, and Passthroughs for Regular 3/5-Digit Automation Flats, Relative to 3/5-Digit Non-Automation Flats

	USPS Proposed				PRC Recommended		
Docket Number	Disc	Cost	Pass		Disc	Cost	Pass
R97-1	3.3¢	3.33¢	100%		3.7¢	3.68¢	100%
R2000-1	2.7¢	0.55¢	494%		2.7¢	0.81¢	334%
R2001-1	2.7¢	1.20¢	224%		2.7¢	1.20¢	225%
R2005-1	2.9¢	0.66¢	439%		2.9¢	0.74¢	391%
R2006-1	NA						

In Docket No. R97-1, the Postal Service proposed passthroughs of 100% for both the basic and 3/5-digit tiers of automation flats, relative to their non-automation counterparts, at discounts of 5.7¢ and 3.3¢, respectively. The Commission agreed with 100% passthroughs, but recommended rates of 5.9¢ and 3.7¢, respectively, based on its costs. In Docket No. R2000-1, the cost avoidances declined quite substantially, and the Postal Service proposed discounts of 4.4¢ and 2.7¢, in the same order, reflecting passthroughs of 230% and 494%. The Commission recommended the discounts, accepting high passthroughs. In Docket No. R2001-1, the cost avoidances increased some, but were still below R97-1 levels, and the discounts were maintained at their then current level. Still, the passthroughs were 153% and 225%, respectively, at Commission costing. In Docket No. R2005-1, the cost avoidances declined

again, generally to new lows, but the Service proposed *increases* for the discounts, consistent with passthroughs of 318% and 439%, in the same order. It is noteworthy that the cost avoidances in each case were lower for the more highly prepared mail, which is what one would expect.

In the instant docket, as discussed above, the categories are being deaveraged and they are being compared vertically. But horizontal comparisons are still possible; for example, 3-digit automation flats can be compared to 3-digit non-automation flats. Viewed horizontally, the Postal Service proposes a 4¢ discount at the MxADC level, a 4.7¢ discount at the ADC level, a 5.0¢ discount at the 3-digit level, and, reversing this upward pattern, a 4.3¢ discount at the 5-digit level, which is still higher than the 4.0¢ discount at the MxADC level. This pattern is counterintuitive. Viewed vertically, the Service is proposing passthroughs of 102%, 117%, and 73%, based on its costing. Witness Kiefer does not discuss why he thinks these discounts are reasonable. Similarly, the Service provides no reasons for believing that any of the costs are of limited usefulness and no discussion of what kinds of discount patterns make sense in terms of operations.

My assessment is two-fold. First, it appears that the cost avoidances are declining over time, possibly due to the Postal Service's success in reading pieces that are not pre-barcoded. Second, I see no reason here for exceedingly high passthroughs. Certainly no argument relating to support for the automation program would support such discounts; that program should prefer volume to no

volume, especially when it is the most efficient supplier. Accordingly, I recommend passthroughs of 100%.

Viewed horizontally, this recommendation receives additional support. Compared to non-automated pieces at the same presort level, MxADC pieces get a discount of 1.4¢, ADC pieces get 1.2¢, 3-digit pieces get 1.1¢, and 5-digit pieces get 0.5¢. This is more in line with what one would expect. The value of a barcode should decline for more highly presorted pieces.

The rate difference between MxADC machinable flats and MxADC automation flats must be set – a link is shown in the upper left of Figure 2, with a cost difference of 1.424¢. The Postal Service proposes a rate difference of 4.0¢, which is a passthrough of 278.7% (332.5% on USPS costing). This is another cost difference that has been declining over time, quite possibly indicating that the Service is processing non-barcoded pieces more effectively. I see no justification for an unusually large passthrough. However, I also do not see any reason why this discount should be smaller than the corresponding discount for automation letters, which, as discussed above, is recommended to be 2.0¢, despite lower costs. Accordingly, I recommend that this discount be set at 2.0 cents, which is an implied passthrough of 140.45%. When the definition of non-automation flats is tightened, an even higher proportion of them will be read with an OCR and processed successfully.

7. Parcels in Regular. All of the parcel categories are newly proposed in the instant docket. Except that NFM parcels are pieces that are currently

classified as flats, parcels are pieces that have paid the Residual Shape Surcharge of 24.2¢. Some of the underlying costs are rough. Some of the passthroughs are rather low. I have no basis for recommending alternatives.

The rates shown maintain all absolute rate differences in the Postal Service proposal, linking them to the rate for MxADC flats. The passthroughs shown in Figure 2 are calculated to link the cost evidence to the rates.

8. Machinable Flats in Regular. Information relating to the development of rates for machinable flats is shown in the left-hand column of Figure 2.[59] Defined on its costing, the passthroughs proposed by the Postal Service, from top to bottom, are: 79.6%, 98.2%, and 82.0% percent. Witness Kiefer does not discuss specific passthroughs, but does say he selected them to mitigate the effects on mailers. (P. 16, ll. 23-24.)

As for several other categories of Standard Mail, these categories are proposed to be more disaggregate than they are currently, in that basic and 3/5-

[59] I refer to this category as machinable flats (which corresponds to the category of machinable letters) instead of as non-automation flats. There are several reasons for this preference. First, I believe there should be a category of machinable flats. The Postal Service needs low-cost categories that can make effective use of its automation equipment, and non-machinable pieces just cause difficulty – they should be surcharged or classified as parcels. Second, witness Kiefer says that the definition of the pieces eligible for the category will be "tightened" and that "pieces that are inflexible or too thick will no longer be afforded flats rate treatment." (p. 15, l. 25, and p. 22, ll. 13-15) Third, although the Postal Service says the new rules are not ready, only 89.3% "of currently categorized nonautomation flats will continue to be categorized as nonautomation flats." *See* Response of witness Kiefer to VP/USPS-T36-12(d) and the workpaper cited therein, and Response of the Postal Service to VP/USPS-T36-12(b), redirected from witness Kiefer. My presumption would be that the other 10.7% comprise most or all of the non-machinable pieces.

digit are being deaveraged into MxADC, ADC, 3-digit, and 5-digit. I believe these changes are in order.

It is worthy of note that the cost differences in the machinable flat column are each a little larger than the corresponding differences in the automation flats column. For example, in going from the MxADC level to the ADC level, the cost difference for machinable flats is 4.399¢ and the corresponding difference for automation flats is 4.230¢. Similarly, the two differences in going from the ADC level to the 3-digit level are 2.734¢ and 2.580¢, and those going from the 3-digit level to the 5-digit level are 5.072¢ and 4.490¢, in the same order. This appears appropriate. The Postal Service should save more from not having to process less-automation-compatible pieces. (If the costs had not come out this way, I think it would raise questions about the usefulness of the cost studies.)[60]

General comparisons over time can be made, despite the deaveraging proposed. In Docket No. R97-1, as shown in Table 7, the Postal Service proposed a 3/5-digit discount (from basic) of 6¢, amounting to a passthrough of 75%. The Commission increased the discount to 6.4¢, a passthrough of 76% on its higher costs. In Docket No. R2000-1, the Postal Service proposed to reduce the discount to 5.3¢ (a passthrough of 94%), and the Commission recommended

[60] The results from cost studies can be surprising, such as barcoded pieces costing more than non-barcoded pieces, because they are heavier or travel further, but these kinds of outcomes would raise questions even if they were right. In terms of sending effective signals in rates, more interest centers on the effects of a mailer changing from one category to another than on whether the average piece in his old category is different from the average piece in his new category.

5.6¢ (a passthrough of 87%). In Docket No. R2001-1, the Postal Service proposed to maintain the discount at 5.6¢, showing a passthrough of 82%. In Docket No R2005-1, the discount was increased to 5.9¢, with costs of record showing a passthrough of 54% at Commission costing. Except for settlements, the Commission has recommended a larger discount in each case, although the passthroughs are notably below 100%.

Table 7: Discount, Cost, and Passthrough Information for Regular 3/5-digit Non-Automation Flats

	USPS Proposed				PRC Recommended		
Docket Number	Disc	Cost	Pass		Disc	Cost	Pass
R97-1	6.0¢	7.94¢	75%		6.4¢	8.39¢	76%
R2000-1	5.3¢	5.61¢	94%		5.6¢	6.46¢	87%
R2001-1	5.6¢	6.86¢	82%		5.6¢	7.91¢	71%
R2005-1	5.9¢	8.62¢	68%		5.9¢	10.91¢	54%
R2006-1	NA						

If the discount levels for the tiers of machinable flats proposed by the Postal Service were maintained, and the rates for these flats were compared with the rates for automation flats at the same presort level, it turns out that mailers would receive larger barcode discounts (comparing, for example, the rate for 3-digit machinable flats with the rate for 3-digit automation flats) for the mail further down the tree (*i.e.*, for mail that needs less processing). As discussed above, this is a nonsensical outcome. Therefore, I recommend that all

passthroughs for machinable flats be set at 100%. If this were not done, it would be necessary to change the passthroughs for the automation flats, which constitute most of the volume.

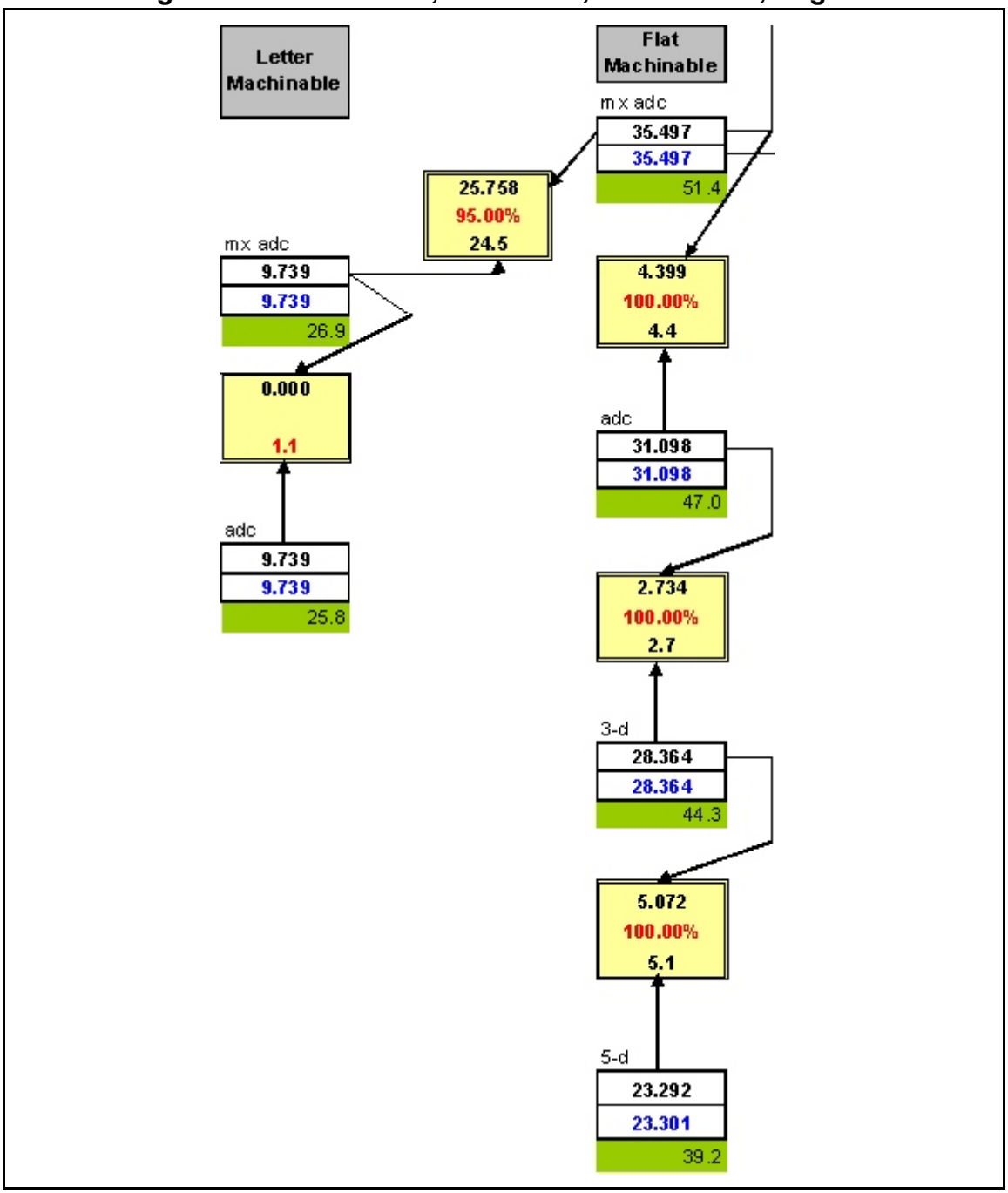
Two concerns should be noted. First, when rates are built from cost differences in this way, down a column in the tree, the rates for the mail in the lower tiers depend on the discounts in the upper tiers. If the discounts for mail in the upper tiers are tempered, in order to limit the effect of increases (possibly due to the deaveraging taking place in the first tier), the mailers in the lower tiers suffer. The Postal Service proposal, with a 79.6% passthrough in the first tier (at Postal Service costing), has this characteristic. I believe it should be avoided.

Second, whenever deaveraging occurs, such as converting a basic level into a MxADC level and an ADC level, significant impacts on mailers should be expected, and accepted. The interests of mailers in the lower tier, whose rate may have been elevated for years due to the averaging, should receive just as much consideration as the interests of the mailers in the upper tier. It is also the case that mailers in the upper tier, if their rate increases, may find a way to change their mailing practices, resulting in an overall gain in efficiency. But note that such a gain in efficiency is most likely to occur when the full cost difference is reflected in the rates.

9. Letter-Flat Rate Differential in Regular. As an up-front matter at the beginning of Section V, I discuss my recommendation that the recognition of the letter-flat cost difference should be equal to the subclass cost coverage, and

certainly at least 100%, unless there is a reason for selecting a different figure. In Section V-B below, the specifics of ECR are discussed. At this point, the focus is on Commercial Regular. Figure 3 shows the presort tree for machinable letters and machinable flats.

Figure 3: Presort Tree, Letter-Flat, Commercial, Regular



The 3-layer box in the center (near the top) shows the difference in cost between letters and flats, origin entered,[61] at the MxADC level, to be 25.758¢. This is a rather large cost difference. Recognition at 100% would yield a rate difference between machinable flats and machinable letters, at the MxADC level of 25.8¢, after rounding. For reasons discussed below, I recommend a 95% recognition at this time, which yields a rate difference of 24.5¢, and results in a minimum-per-piece rate for machinable letters of 26.9¢ and for machinable flats of 51.4¢. Relative to current rates, this is a rate *decrease* for machinable letters of 4.6% and a rate *increase* for machinable flats of 41.6%. Such changes require discussion.

The reasons for a 95% recognition are as follows. First, the cost for letters is a combined cost for MxADC letters and ADC letters, which might make it somewhat low. However, it also contains a small portion of non-machinable pieces, which would tend to make it high. At this point, its applicability is somewhat uncertain. Second, the cost for flats may decline as the definition of flats is tightened, although most pieces there are already machinable. Third, the effects on mailers are not insignificant, as suggested in the example in the previous paragraph. Fourth, as discussed in the following paragraphs, the rates that result have some good characteristics. (My recommendation should not be taken to mean that recognition above 100% would not be appropriate.)

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[61] All of the costs in the presort tree are applicable to origin-entered mail, as confirmed by witness Kiefer in his response to VP/USPS-T36-18(d).

The assessment of the letter rate is relatively straightforward. USPS-LR-L-135, last sheet, suggests costs beyond mail processing and delivery for Regular letters in the neighborhood of 0.714¢, a figure that could vary some by presort level and entry point. If 0.714¢ is added to the cost shown for letters of 9.739¢, a cost for letters at the MxADC level of 10.453¢ is obtained. If the Postal Service had developed separate costs for MxADC and ADC letters, instead of averaging them together, this cost would have been somewhat higher. Using the cost of 10.453¢ as a rough estimate suggests an implicit cost coverage for these letters of 257.3%. This is not low and certainly does not suggest that letters are being favored. Also, it is a relatively robust outcome. If, say, 2¢ were added to the cost of letters, to allow for any limitations in the costs being used, the coverage would be 216.0%, still not low.

For flats, the assessment is more complex. The mail processing and delivery costs for flats, at the MxADC level, are estimated to be 35.497¢. This is much higher than the 9.739¢ cost of letters, perhaps testimony to the success of the Postal Service in automating the letters mailstream. USPS-LR-L-135 suggests costs beyond mail processing and delivery for flats of 2.855¢. This provides an estimated cost for these flats of 38.352¢, a cost that is an average for flats of all weights, from zero to 16 ounces.

For both piece- and pound-rated flats, at the MxADC level, the revenue per piece if all pieces were entered at an origin facility would be 58.366¢. Due to the effect of the pound rate, this is higher than the minimum-per-piece rate of

51.4¢. Comparing this revenue to the cost of 38.352¢ suggests an implicit cost coverage for flats of 152.2%.[62] This result is considerably lower than the corresponding figure for letters of 257.3%.

Similar comparisons can be made of the associated unit contributions – letters 16.447¢, and flats 20.014¢.

10. Nonprofit Regular Rates. For reasons explained above, the Nonprofit rates have been developed using the same presort tree as used for the Commercial rates, with the same passthroughs. Relative to current rates, the percentage increases that result are shown on Chart 2 at the end of my testimony. For origin-entered pieces, excepting parcels and the per-piece charges for pound-rated pieces, the largest increase shown is for MxADC, automation, minimum-per-piece flats – 102.6%. Although this is large, it can be explained. First, the proposal to deaverage basic flats into a MxADC tier and an ADC tier would be expected to cause a greater increase for the MxADC pieces. Second, the reduction in the automation discount, as discussed above for Regular, tends to make this percentage increase larger than the one for machinable flats. Third, as shown in the presort tree, flats cost 25.785¢ more than the letters, at the MxADC level, without any markup, and the current rate difference is only 6.7¢. Rectification of such an imbalance would be expected to

[62] Under a tightening of the definition of flats, the cost of flats could decrease some, and this coverage would increase. Also, as occurs under passthroughs of 100%, this coverage would be expected to increase as one moved to lower tiers in the tree.

cause MxADC flats to have a large rate increase. Of course, offsetting some of the large increases are some rate decreases, such as -6.5% for machinable ADC letters. Approximately 83% of the Nonprofit pieces are letters.

11. Resulting Rate Schedules for Regular Standard. The rates that result are shown below in Schedule 2 and Schedule 3. These schedules show the rates for origin-entered mail. The corresponding schedules in my workpapers show the rates at each entry level. Since my dropship discounts (as shown above in Schedule 1) are very close to those proposed by the Postal Service, the relationship of my rates to those proposed does not change much with entry point. Shaded boxes relate to categories that do not exist. Numbers in shaded boxes relate to phantom minimum-per-piece rates, and should be disregarded. See the Rate Schedules in the Postal Service Request for applicable footnotes.

Schedule 2: VP Recommended Rates, Commercial Regular (cents)

		Origin			DBMC		
Letters @ minimum-per-piece		**N-mach**	**Mach**	**Auto**	**N-mach**	**Mach**	**Auto**
Mx ADC/AADC	per pc	42.5	26.9	24.9	39.6	24.0	22.0
ADC/AADC	per pc	38.0	25.8	23.8	35.1	22.9	20.9
3-d	per pc	37.2		23.3	34.3		20.4
5-d	per pc	33.7		21.8	30.8		18.9
Letters @ pound rate		**N-mach**	**Mach**	**Auto**	**N-mach**	**Mach**	**Auto**
Mx ADC/AADC	per pc			9.7			9.7
ADC/AADC	per pc			8.6			8.6
3-d	per pc			8.1			8.1
5-d	per pc			6.6			6.6
Entry point pound rate				73.9			60.0
Flats @ minimum-per-piece		**see NFM**	**Mach**	**Auto**	**see NFM**	**Mach**	**Auto**
Mx ADC/AADC	per pc		51.4	49.4		48.5	46.5
ADC/AADC	per pc		47.0	45.2		44.1	42.3
3-d	per pc		44.3	42.6		41.4	39.7
5-d	per pc		39.2	38.1		36.3	35.2
Flats @ pound rate		**see NFM**	**Mach**	**Auto**	**see NFM**	**Mach**	**Auto**
Mx ADC/AADC	per pc		36.2	34.2		36.2	34.2
ADC/AADC	per pc		31.8	30.0		31.8	30.0
3-d	per pc		29.1	27.4		29.1	27.4
5-d	per pc		24.0	22.9		24.0	22.9
Entry point pound rate			73.9	73.9		60.0	60.0
Parcels @ minimum-per-piece		**N-mach**	**Mach**	**NFM**	**N-mach**	**Mach**	**NFM**
Mx ADC/AADC	per pc	118.9	109.0	103.9	115.5	105.6	101.0
ADC/AADC	per pc	103.8	97.2	87.1	100.4	93.8	84.2
3-d	per pc	88.7		70.3	85.3		67.4
5-d	per pc	75.5	75.5	57.2	72.1	72.2	54.3
Parcels @ pound rate		**N-mach**	**Mach**	**NFM**	**N-mach**	**Mach**	**NFM**
Mx ADC/AADC/BMC	per pc	98.3	88.4	83.3	98.3	88.4	83.3
ADC/AADC/BMC	per pc	83.2	76.6	66.5	83.2	76.6	66.5
3-d	per pc	68.1		49.7	68.1		49.7
5-d	per pc	54.9	55.0	36.6	54.9	55.0	36.6
Entry point pound rate		100.1	100.1	100.1	83.5	83.5	86.2

Schedule 2: VP Recommended Rates, Commercial Regular (cents) (cont'd.)

		DSCF			DDU		
Letters @ minimum-per-piece		**N-mach**	**Mach**	**Auto**	**N-mach**	**Mach**	**Auto**
Mx ADC/AADC	per pc	38.9	23.3	21.3			
ADC/AADC	per pc	34.4	22.2	20.2			
3-d	per pc	33.6		19.7			
5-d	per pc	30.1		18.2			
Letters @ pound rate		**N-mach**	**Mach**	**Auto**	**N-mach**	**Mach**	**Auto**
Mx ADC/AADC	per pc			9.7			
ADC/AADC	per pc			8.6			
3-d	per pc			8.1			
5-d	per pc			6.6			
Entry point pound rate				56.7			
Flats @ minimum-per-piece		**see NFM**	**Mach**	**Auto**	**N-mach**	**Mach**	**Auto**
Mx ADC/AADC	per pc		47.8	45.8			
ADC/AADC	per pc		43.4	41.6			
3-d	per pc		40.7	39.0			
5-d	per pc		35.6	34.5			
Flats @ pound rate		**see NFM**	**Mach**	**Auto**	**N-mach**	**Mach**	**Auto**
Mx ADC/AADC	per pc		36.2	34.2			
ADC/AADC	per pc		31.8	30.0			
3-d	per pc		29.1	27.4			
5-d	per pc		24.0	22.9			
Entry point pound rate			56.7	56.7			
Parcels @ minimum-per-piece		**N-mach**	**Mach**	**NFM**	**N-mach**	**Mach**	**NFM**
Mx ADC/AADC	per pc	111.1	101.2	100.3	107.2	97.3	99.6
ADC/AADC	per pc	96.0	89.4	83.5	92.1	85.5	82.8
3-d	per pc	80.9		66.7	77.0		66.0
5-d	per pc	67.7	67.8	53.6	63.8	63.9	52.9
Parcels @ pound rate		**N-mach**	**Mach**	**NFM**	**N-mach**	**Mach**	**NFM**
Mx ADC/AADC/BMC	per pc	98.3	88.4	83.3	98.3	88.4	83.3
ADC/AADC/BMC	per pc	83.2	76.6	66.5	83.2	76.6	66.5
3-d	per pc	68.1		49.7	68.1		49.7
5-d	per pc	54.9	55.0	36.6	54.9	55.0	36.6
Entry point pound rate		62.2	62.2	82.9	43.2	43.2	79.0

Schedule 3: VP Recommended Rates, Nonprofit Regular (cents)

		Origin			DBMC		
Letters @ minimum-per-piece		**N-mach**	**Mach**	**Auto**	**N-mach**	**Mach**	**Auto**
Mx ADC/AADC	per pc	32.6	17.0	15.0	29.7	14.1	12.1
ADC/AADC	per pc	28.1	15.9	13.9	25.2	13.0	11.0
3-d	per pc	27.3		13.4	24.4		10.5
5-d	per pc	23.8		11.9	20.9		9.0
Letters @ pound rate		**N-mach**	**Mach**	**Auto**	**N-mach**	**Mach**	**Auto**
Mx ADC/AADC	per pc			2.2			2.2
ADC/AADC	per pc			1.1			1.1
3-d	per pc			0.6			0.6
5-d	per pc			-0.9			-0.9
Entry point pound rate				62.2			48.3
Flats @ minimum-per-piece		**see NFM**	**Mach**	**Auto**	**see NFM**	**Mach**	**Auto**
Mx ADC/AADC	per pc		41.5	39.5		38.6	36.6
ADC/AADC	per pc		37.1	35.3		34.2	32.4
3-d	per pc		34.4	32.7		31.5	29.8
5-d	per pc		29.3	28.2		26.4	25.3
Flats @ pound rate		**see NFM**	**Mach**	**Auto**	**see NFM**	**Mach**	**Auto**
Mx ADC/AADC	per pc		28.7	26.7		28.7	26.7
ADC/AADC	per pc		24.3	22.5		24.3	22.5
3-d	per pc		21.6	19.9		21.6	19.9
5-d	per pc		16.5	15.4		16.5	15.4
Entry point pound rate			62.2	62.2		48.3	48.3
Parcels @ minimum-per-piece		**N-mach**	**Mach**	**NFM**	**N-mach**	**Mach**	**NFM**
Mx ADC/AADC	per pc	109.0	99.1	94.0	105.6	95.7	91.1
ADC/AADC	per pc	93.9	87.3	77.2	90.5	83.9	74.3
3-d	per pc	78.8		60.4	75.4		57.5
5-d	per pc	65.6	65.7	47.3	62.2	62.3	44.4
Parcels @ pound rate		**N-mach**	**Mach**	**NFM**	**N-mach**	**Mach**	**NFM**
Mx ADC/AADC/BMC	per pc	90.4	80.5	80.8	90.4	80.5	80.8
ADC/AADC/BMC	per pc	75.3	68.7	64.0	75.3	68.7	64.0
3-d	per pc	60.2		47.2	60.2		47.2
5-d	per pc	47.0	47.1	34.1	47.0	47.1	34.1
Entry point pound rate		90.3	90.3	64.1	73.7	73.7	50.2

Schedule 3: VP Recommended Rates, Nonprofit Regular (cents) (cont'd.)

		DSCF			DDU		
Letters @ minimum-per-piece		**N-mach**	**Mach**	**Auto**	**N-mach**	**Mach**	**Auto**
Mx ADC/AADC	per pc	29.0	13.4	11.4			
ADC/AADC	per pc	24.5	12.3	10.3			
3-d	per pc	23.7		9.8			
5-d	per pc	20.2		8.3			
Letters @ pound rate		**N-mach**	**Mach**	**Auto**	**N-mach**	**Mach**	**Auto**
Mx ADC/AADC	per pc			2.2			
ADC/AADC	per pc			1.1			
3-d	per pc			0.6			
5-d	per pc			-0.9			
Entry point pound rate				45.0			
Flats @ minimum-per-piece		**see NFM**	**Mach**	**Auto**	**N-mach**	**Mach**	**Auto**
Mx ADC/AADC	per pc		37.9	35.9			
ADC/AADC	per pc		33.5	31.7			
3-d	per pc		30.8	29.1			
5-d	per pc		25.7	24.6			
Flats @ pound rate		**see NFM**	**Mach**	**Auto**	**N-mach**	**Mach**	**Auto**
Mx ADC/AADC	per pc		28.7	26.7			
ADC/AADC	per pc		24.3	22.5			
3-d	per pc		21.6	19.9			
5-d	per pc		16.5	15.4			
Entry point pound rate			45.0	45.0			
Parcels @ minimum-per-piece		**N-mach**	**Mach**	**NFM**	**N-mach**	**Mach**	**NFM**
Mx ADC/AADC	per pc	101.2	91.3	90.4	97.3	87.4	89.7
ADC/AADC	per pc	86.1	79.5	73.6	82.2	75.6	72.9
3-d	per pc	71.0		56.8	67.1		56.1
5-d	per pc	57.8	57.9	43.7	53.9	54.0	43.0
Parcels @ pound rate		**N-mach**	**Mach**	**NFM**	**N-mach**	**Mach**	**NFM**
Mx ADC/AADC/BMC	per pc	90.4	80.5	80.8	90.4	80.5	80.8
ADC/AADC/BMC	per pc	75.3	68.7	64.0	75.3	68.7	64.0
3-d	per pc	60.2		47.2	60.2		47.2
5-d	per pc	47.0	47.1	34.1	47.0	47.1	34.1
Entry point pound rate		52.4	52.4	46.9	33.4	33.4	43.0

B. Rate Design for Commercial and Nonprofit ECR.

The definitions of the various rate categories in ECR have been reasonably stable; the costs of these categories, however, have not. In Docket No. R2000-1, the mail processing costs of basic automation letters *decreased* 43.8% while the corresponding cost of saturation (automation) letters *increased* 30.7%. In Docket No R2001-1, in a reversal from the prior year, the mail processing costs of the same two categories increased 8.2% and decreased 8.3%, respectively. Then, in Docket No. R2005-1, looking at the same two categories again, the costs decreased 6.3% and increased 54.4%, respectively. In the instant docket, these two categories see positive changes of 212.3% and 15.0%, respectively. A trend does not exist.

I understand that there have been changes in costing methods, represented as improvements, and that some of these are Postal Service presentations of Commission costs. Also, the sum of mail processing and delivery costs is in some cases more stable than just mail processing costs. Nevertheless, these variations do not instill confidence.

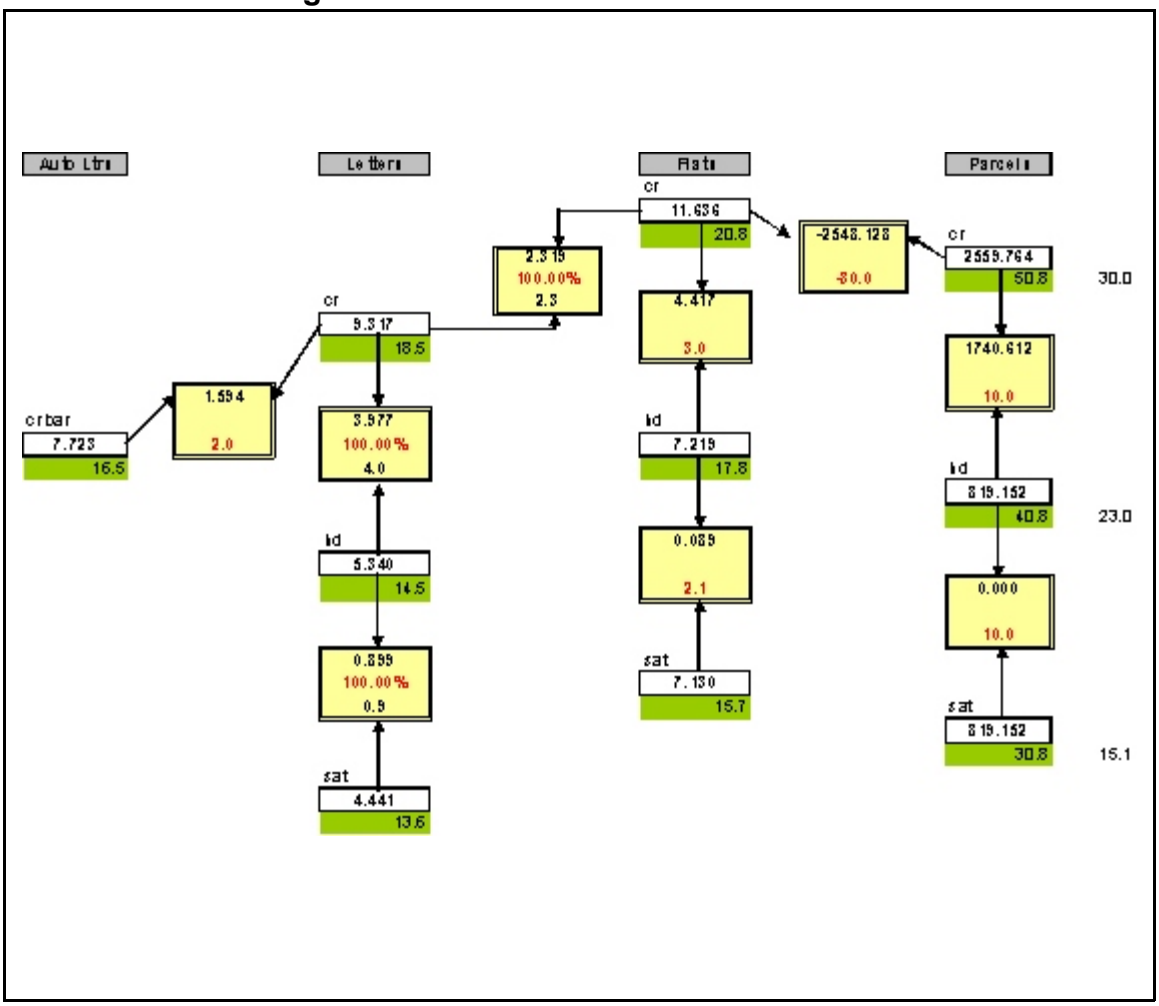
A specific problem that has evolved in steps, or perhaps devolved, relates to the costs for DALs. Due at least in part to questions raised by Valpak in prior Commission proceedings, it has become clear that, in the past, delivery costs caused by DALs have been attributed to saturation letters instead of to

saturation flats. This problem may now have been corrected, although it is far from clear that a good estimate of the volume of DALs exists.[63] The volume estimate used by the Postal Service in this case is based on an estimate developed in the last case, which covered a limited number of for-profit firms. It is widely known that other firms use them as well.

The presort tree for Commercial ECR is shown in Figure 4. Basic automation letters, which the Postal Services proposes to eliminate, are shown in a separate column on the left. The letter column applies to basic letters, high-density letters, and saturation letters, even though the latter two have automation requirements and the first one does not.

[63] The collection of volume on the number of DALs began only recently. Regular reports are not yet available.

Figure 4: Commercial ECR Presort Tree



1. Rates for High-Density Letters in ECR. The cost difference between basic letters and high-density letters is 3.977¢ at Postal Service costing, after disaggregating the carrier costs of basic and high-density. The discount proposed by the Service is 4.3¢.

In Docket No. R97-1, the discount for high-density pieces was proposed to be 2.1¢, as shown in Table 8. The Commission recommended 2.3¢, at 100% passthrough of its costs. In Docket No. R2000-1, the Postal Service proposed to maintain the discount of 2.3¢, which it estimated to be 125% of the cost difference. The Commission found the cost difference to be moderately higher, but recommended a discount of 2.5¢, based on a passthrough of only 76%. In Docket No. R2001-1 the Service proposed a discount of 3.0¢, on still higher costs, a passthrough of 79%. The case was settled. At costs in the Commission's workpapers, the passthrough was 75.0%. In Docket No. 2005-1, the Service proposed a discount of 3.1¢, a passthrough of 85%. In the instant docket, the proposal is for a discount of 4.3¢, at a passthrough of 96%, which is an increase in the discount of 39%.

Table 8: Discounts, Costs, and Passthroughs for High-Density ECR Letters

	USPS Proposed				PRC Recommended		
Docket Number	Disc	Cost	Pass		Disc	Cost	Pass
R97-1	2.1¢	2.11¢	100%		2.3¢	2.31¢	100%
R2000-1	2.3¢	1.85¢	125%		2.5¢	3.30¢	76%
R2001-1	3.0¢	3.80¢	79%		3.0¢	4.00¢	75%
R2005-1	3.1¢	3.67¢	85%		3.1¢	3.25¢	96%
R2006-1	4.3¢	4.48¢	96%				
	Valpak Recommended						
	4.0¢	3.98¢	100%				

Several patterns are apparent. In each case, the Postal Service proposed a higher discount than the one proposed in the previous case. And, in each succeeding case, the Commission recommended a discount that was the same or higher than the one proposed. In the two cases that were not settled, the recommended discount was higher than the one proposed. For the last three dockets in the table, the cost avoidances were 3.80¢, 3.67¢, and 4.48¢, respectively, at Postal Service costing. The trend is upward but irregular.

The setting of the cost difference underlying this discount is worthy of note. It is the difference between the cost for basic letters, which have no automation or machinability requirement, and the cost of high-density letters, which are required to be barcoded and automation compatible. Furthermore, although I believe such a constraint to be unwarranted, the Postal Service has sought to set the rate for the basic category higher than the rate for 5-digit automation letters in Commercial Regular, so that most of its volume, particularly that which is machinable, would migrate to Regular. As I have explained elsewhere, I believe this constraint should be removed. Also, I believe consideration should be given to placing an automation requirement on the basic category, so it aligns better with the high-density and the saturation categories.

Regardless of this recommendation, a rate for the category must be set. There is no better basis for doing this than to recognize the cost difference, which is high because of the nature of the two categories involved. I recommend a passthrough of 100%. This is approximately equal to the passthrough

proposed by the Postal Service and is in reasonable alignment with historical precedent. The resulting discount is 4.0¢, somewhat above the current level of 3.1¢. I see no reason to set the passthrough below 100%, which also would affect the rates for saturation mailers.

2. Rates for Saturation Letters in ECR. Table 9 shows discount, cost, and passthrough information for saturation ECR letters.

Table 9: Discounts, Costs, and Passthroughs for Saturation ECR Letters

	USPS Proposed				PRC Recommended		
Docket Number	Disc	Cost	Pass		Disc	Cost	Pass
R97-1	0.9¢	0.91¢	100%		0.9¢	0.93¢	100%
R2000-1	0.9¢	0.91¢	100%		0.8¢	0.84¢	100%
R2001-1	1.1¢	1.31¢	84%		1.2¢	1.31¢	92%
R2005-1	1.3¢	0.34¢	383%		1.3¢	0.54¢	240%
R2006-1	1.8¢	0.89¢	201%				
	Valpak Recommended						
	0.9¢	0.90¢	100%				

The discounts proposed have increased steadily over time, and the Commission's recommendation has always been equal to or greater than that proposed, except for R2000-1. Saturation letters present the Postal Service with all possible processing opportunities, *i.e.*, maximum flexibility. They can be cased manually, they can be sequenced in 3-pass CSBCS machines in small

offices, they can be DPS'd, and they can be taken directly to the street as a sequenced bundle. On city routes currently, 31.8% of them are taken directly to the street. *See* Response of Witness Kelley to VP/USPS-T30-2. In addition, these pieces present bulk handling opportunities that less dense mailings do not. I recommend a passthrough of 100%. The resulting discount is 0.9¢, one-half of the proposed discount.

3. Rates for High-Density Flats in ECR. Table 10 shows the discount and cost information for high-density flats in ECR. The (carrier) costs in USPS-LR-L-67 have been adjusted to align with the additional disaggregation provided by witness Kelley in response to NAA/USPS-T30-7 and VP/USPS-T30-27. This affected the costs for basic flats and high-density flats. On this basis, the R2006-1 cost difference is 4.434¢, notably higher than the 3.303¢ difference in Docket No. R2005-1.

Table 10: Discounts, Costs, and Passthroughs for High-Density ECR Flats

	USPS Proposed				PRC Recommended		
Docket Number	Disc	Cost	Pass		Disc	Cost	Pass
R97-1	1.1¢	2.82¢	39%		1.1¢	3.05¢	36%
R2000-1	2.1¢	3.36¢	63%		2.2¢	3.87¢	57%
R2001-1	2.5¢	3.39¢	74%		2.5¢	3.66¢	68%
R2005-1	2.6¢	3.30¢	79%		2.6¢	3.30¢	79%
R2006-1	2.9¢	4.43¢	65%				
	Valpak Recommended						
	3.0¢	4.42¢	68%				

The costs available here raise questions. The cost avoidance has increased 39.7% on a very small volume (there are 1.9 billion high-density flats, representing only 7.4% of all flats), and is out of line with historic trends. If 100% of this avoidance were passed through into rates, the discount would increase 83%, placing it considerably out of line with historical levels. Since the principal advantage to the Postal Service of high-density is generally understood to be faster casing, and since it is difficult to see a reason why a casing advantage would increase this much, I am recommending that the discount be set at 3¢ and that the additional 1.4¢ be transferred to the saturation discount. This will leave saturation unaffected by what is done here, and will allow its rates to be based

on its costs. This might not be viewed as fair by high-density mailers, but 3.0¢ is in line with historic trends and it is difficult to see a justification for going further.

4. Rate for Saturation Flats in ECR. Of 25.3 billion flats in Commercial ECR, 10.9 billion fall into the saturation category. The history of the discounts, relative to high-density flats, is contained in Table 11.

Table 11: Discounts, Costs, and Passthroughs for Saturation ECR Flats

	USPS Proposed				PRC Recommended		
Docket Number	Disc	Cost	Pass		Disc	Cost	Pass
R97-1	1.2¢	1.66¢	72%		1.1¢	1.69¢	65%
R2000-1	0.6¢	0.71¢	84%		0.7¢	0.67¢	100%
R2001-1	0.9¢	0.83¢	108%		0.9¢	0.83¢	108%
R2005-1	0.9¢	0.45¢	200%		0.9¢	0.38¢	237%
R2006-1	2.2¢	0.09¢	2,444%				
	Valpak Recommended						
	2.1¢						

The discount declined after R97-1 and then remained at 0.9¢, but the passthroughs have increased to a point well over 100%. The discount proposed by the Postal Service (from a current level 0.9¢ to a proposed level of 2.2¢) is an increase of 144%, which is large by any measure. The passthrough of 2,444% on Postal Service costing is due to a cost avoidance of 0.09¢ after disaggregating basic and high-density. One factor contributing to this outcome is that saturation costs have increased 26.2% since R2005-1. Because some of

this increase is undoubtedly due to corrections relating to the cost of DALs, the cost cannot be ignored.

One other factor, however, needs to be considered. The Postal Service proposal, which I support, is to impose a 1.5¢ surcharge on DALs. This means that a modification in the ratesetting process is needed, if not in the tree. That is, one could think of the tree as having one branch for addressed saturation flats and another branch for DAL-accompanied saturation flats. Since about 41.4% of saturation flats are estimated to be DAL-accompanied, I recommend that rates be set as though the cost difference associated with DALs is 1.5¢, and thus that the discount for saturation flats be increased above the costs shown in the tree by 0.6¢ (41.4% * 1.5¢). When some of the pieces pay the ordinary rate and others pay the ordinary rate plus 1.5¢, then, the correct revenue will be obtained, and the cost will be honored. Under these conditions, I recommend a discount of 0.09¢ + 0.6¢ + 1.4¢ (the latter cost carried over from the high-density tier), which equals 2.1¢. This is 0.1¢ below the discount proposed by the Postal Service. In effect, saturation flats are being given a discount relative to basic flats of 100% of the cost difference between these two categories. With the exception discussed above for high-density flats, setting rates in this way honors all of the costs in the tree.

5. Rate for Basic Automation Letters in ECR. The question of whether these letters should continue to exist in ECR was addressed above in Section V. The task that remains here is to set a rate for them.

The history of basic automation letters in Commercial ECR, beginning with Docket No. R97-1, is shown in the Table 12.

Table 12: Costs, Rates, and Passthroughs for Basic Automation ECR Letters

	USPS Proposed				PRC Recommended		
Docket Number	USPS Cost	USPS Rate	USPS Pass		PRC Cost	PRC Rate	PRC Pass
R97-1	0.606	0.7¢	116%		0.603	0.6¢	100%
R2000-1	1.207	1.2¢	100%		2.841	2.1¢	74%
R2001-1	2.939	2.3¢	78%		3.15	2.3¢	73%
R2005-1	4.766	2.4¢	50%		4.396	2.4¢	55%
R2006-1		none					
	Valpak Recommended						
		2.0¢					

The cost avoidance associated with these pieces has increased in every case, at both Postal Service and Commission costing. Similarly, the discount (from basic non-automation letters in ECR) has increased steadily. The passthroughs, however, have decreased to a level of about 50%. This is a strange situation. In response to an interrogatory on the subject, witness Kiefer said neither he nor the Postal Service has analyzed it. *See* Response to VP/USPS-T36-9(f).

In the instant docket, the costs available for the automation letter category are limited. At Postal Service costing, USPS-L-84 shows a mail processing cost of 4.748¢, an increase of 225.9% from the last case, possibly reflecting

additional delivery point sequencing. A corresponding delivery cost, however, is not available. As a rough estimate, at both Postal Service and Commission costing, I have used a cost for this category of 7.723¢, which appears to be the cost witness Page used to adjust for the proposal to move automation letters out of ECR. See Response of Witness Page to VP/USPS-T23-4. Since witness Page used all costs, not just mail processing and delivery costs, the avoidance for automation basic letters is something in excess of 1.594¢, at Commission costing. My recommendation is to set the discount at 2.0¢. This is roughly in line with recent discounts and allows a rate that is below the rate for 5-digit automation letters in Regular, as it should be.[64]

6. Letter-Flat Rate Differential in ECR. In my discussion of the letter-flat differential, at the start of Section V, I note my recommendation that 100% of the cost difference be passed through into rates, at the basic level, in ECR. This is far less than a passthrough equal to the subclass cost coverage, which, in theory, I see no reason should not be the default prescription for letters and flats, which are for all practical purposes separate products.

In the past, due to its application to costs that are not ideal, questions have been raised about this passthrough. The cost shown for basic letters,

[64] An alternative approach would be to set the basic automation letter rate in ECR equal to the 5-digit automation letter rate in Regular less a selected amount, possibly one or two cents, to recognize its ECR characteristics. Witness Kiefer said that he did not consider such an approach. Response to VP/USPS-T36-9(e). If this approach were taken, the volumes, revenues, and costs would remain in ECR.

dropship adjusted, is 9.317¢. All letters causing this cost pay the minimum-per-piece rate. Thus, this cost is highly appropriate as a reference point for determining the minimum-per-piece rates for these letters. But the cost shown for basic flats, 11.636¢, is for flats from 0 to 16 ounces, not just for flats paying the minimum-per-piece rate. A good question is whether some other cost should be developed that relates more directly to minimum-per-piece flats. The answer of course is that it should, but the estimate needed remains unavailable.

There are reasons for believing that the cost of minimum-per-piece flats in ECR may not be much different from the cost of *all* flats. The minimum-per-piece rate applies up to the breakpoint of 3.3 ounces. No changes in the breakpoint or its associated rate structure are being considered. On average, basic flats paying the minimum-per-piece rate weigh 1.98 ounces, and basic flats over the entire 0-16 ounce range weigh only 3.52 ounces. Under the presumption that the effects on costs of weight are small in the range of 0 to 3.3 ounces, which would seem to be the only presumption available that would support the extant rate structure, this weight difference does not seem large enough to make the costs inapplicable.[65] Short of proposing to change the

[65] For flats in particular, some support for the presumption that the effects of weight on costs is not large, even for weights up through 7 ounces, is contained in the Response of the Postal Service to NAA/USPS-1. The proportion of volume in the higher weight ranges is also low. *See* Response of the Postal Service to AAPS/USPS-T36-7, Redirected from Witness Kiefer.

minimum-per-piece structure, which would require a great deal of analysis, reliance on these costs is the only course available.

The costs shown in the tree are dropship adjusted, meaning that they have been inflated to apply to a situation where all pieces are entered at an origin office, which makes them an appropriate reference point for setting the rates involved. From any resulting origin rates, dropship discounts are given for mail entered in destination offices. The structure of the dropship discounts for Standard Mail has been reasonably stable since Docket No. R90-1. I have accepted the development and application of witness Kiefer on this point, and have done nothing more than adjust the cost avoidances to PRC costing methods, and apply the same passthroughs. The extent to which they are cost based is not being changed.

The dropship discounts do not, however, have uniform effects on letters and flats. To provide a rough comparison on this matter, suppose the following average hauls: origin-entered pieces – 700 miles; DBMC-entered pieces – 100 miles; DSCF-entered pieces – 40 miles; and DDU-entered pieces – 0 miles. Under this supposition and the dropship proportions in the billing determinants, the average haul of basic *letters* is 158.9 miles and that of basic *flats* is 73.4 miles. If one wants to know how letters and flats are treated in rates, it is clear that the dropship patterns must be considered, and that the effect of such consideration might be reasonably significant. On this score, as with the

questions on the efficacy of the minimum-per-piece structure, no analysis is available. I have no choice but to accept the arrangement that exists.[66]

To compare with these dropship-corrected costs, it is possible to develop dropship-corrected revenues. Under the rates I develop, if all of the basic letters and all of the basic flats were to keep their weight-per-piece and shift to entry at an origin office, the per-piece revenue for *letters* would be 18.5¢ and the per-piece revenue for *flats* would be 24.3¢. The same comparison for *saturation* letters and flats would be 13.7¢ and 18.0¢, respectively, and if the revenue from the proposed DAL surcharge is included in the revenue of saturation flats, the latter two figures would change to 13.7¢ and 18.6¢, respectively.

In addition to being dropship-corrected, the costs being considered are limited to mail processing and delivery costs. For purposes of a rough estimate, these can be supplemented by the estimates of non-delivery, non-mail-processing costs by shape for ECR mail found in USPS-LR-L-135, on the last sheet. These show additional costs of letters of 0.266¢ and for flats of 0.882¢. If these are added to the costs in the tree, the cost for basic letters becomes 9.583¢ and for basic flats becomes 12.518¢. If the dropship-adjusted revenues

[66] This does not mean that I think the arrangement that exists is ideal. One could think, for example, about establishing a piece-pound rate structure for DSCF-entered letters and another for flats, prepared and entered in a low-cost way, and then adding what would in effect be piece and pound surcharges that relate to distance traveled and additional handling needed. These could differentiate among container types, bundle makeup, and the kinds of facilities involved. An advantage of a DSCF focus, or a focus on some other facility playing a similar role, is that competition occurs at that level, and most or all of the processing machinery is there as well. Improved signals to mailers could lead to a much more effective Postal Service.

are compared to these costs, the (implicit) coverages become 193.1% for basic letters and 194.5% for basic flats. The same comparison, in the same order, for *saturation* letters and flats, including the revenue from the DAL surcharge, is 290.8% and 232.5%. The picture painted is hardly one of letters receiving favorable treatment.

Although the above figures include the full range of mailpieces from zero to 16 ounces, it is significant that only 56.8% of flats (at all presort levels) pay the minimum-per-piece rates. This means that the remainder (43.1%) pay a pound rate that rises above the minimum-per-piece rate.[67] However, the average weight of flats paying the pound rate, and thus weighing from 3.3 ounces to 16 ounces, is only 5.1 ounces. This means that most of the pieces are within an ounce or two of the breakpoint. Certainly a lot of pieces in the range of 3.3 to 5.1 ounces are needed to balance out pieces in the range of 5.1 to 16 ounces. Nevertheless, because these flats pay a pound rate, it is argued that their minimum-per-piece rate based on the costs discussed above is too high.

If one takes the position, as I do, that the studies done to date to estimate the effects of weight on the costs of Standard Mail are indicative but not terribly reliable, then no real basis exists for evaluating the pound charges. However, within the framework of the minimum-per-piece rate structure, it is the case that a decrease in the pound rate would cause an *increase* in the minimum-per-piece

[67] These two proportions are 86.0% and 14.0% for Nonprofit ECR.

rate, and there is little reason why letters should be involved in any such adjustment. That is, the rates for letters, that rarely pay the pound rate and even then pay very little of it, should be based on the costs for letters, whatever happens to the pound rates. Adjustments in the pound rates should not affect letters.

I agree that questions could be raised about the appropriateness of the minimum-per-piece rate structure and about differences between letters and flats in the incidence of the dropship discounts. I also agree that more information on the effects of weight is desirable. But until these questions are answered, and consideration is given to changing classification arrangements that have been in place for a considerable number of years, the passthrough of 100%, as I have recommended, is both conservative and the best course. It leaves letter-flat rate differences short of what might exist if the full effects of weight were known and passthroughs were equal to the subclass average cost coverage. The pound rate as it exists today is a flats problem, not a letters problem. If the pound rate were decreased, the minimum-per-piece rate for flats would have to increase commensurately.

Consistent with the above analysis, one further observation supports my contention that the letter-flat differential I recommend is conservatively small. Once it is recognized that the default passthrough on the difference in cost between letters and flats should equal the subclass cost coverage, as would befit separate products, it becomes clear at the same time that the costs supporting

the letter-flat differential should not be limited to those for mail processing and delivery. Instead, they should be some measure of total costs, along the lines of the costs in USPS-LR-L-135, as discussed above. If more inclusive costs were recognized for letters and flats, it is clear that the letter-flat differential would increase above the levels I have recommended, even without a passthrough of over 100%. In short, the USPS-LR-L-135 costs make it clear that the letter-flat differential I recommend is conservative.

Much of my review has focused on the distance of rates above costs, and therefore on the contributions to fixed costs associated with the various rates that must be set. This is because I believe that the distance of rates from costs is important to all notions of fairness, to the efficiency of the nation, and to the effectiveness of the Postal Service. As I discuss in Section IV above, particularly Sections IV-F and IV-G, the guidance that economic theory provides to ratemaking under regulation dictates a strong role for costs. Indeed, as noted above, the Commission has emphasized the importance of costs as recently as the first page of the Summary of its Opinion in Docket No. R2005-1, stating that "[c]ost-based rates have been the touchstone of postal ratemaking for 35 years." It is difficult to misunderstand such a statement.

Witness Kiefer, however, gives relatively little weight to costs. In NAA/USPS-T36-12, he was asked if he "consider[ed] it desirable to achieve similar unit contributions from any particular categories of [ECR] mail." His answer was "No." He went on to explain: "Measuring unit contribution in

Standard Mail below the subclass level is difficult because, unlike First-Class Mail, Standard Mail does not have CRA costs below the subclass level." Then he went on to say: "Even if appropriate cost data were available at the detailed rate category level, achieving the same unit contribution by rate category is not an overriding goal of the Postal Service in its Standard Mail rate designs." NAA/USPS-T36-12. He did not say if it was a goal of less than "overriding" importance, nor did he say what other goals might be important, overriding or not. Both of these statements are troublesome.

Witness Kiefer's statement that the costs available present "difficulties" because they are not costs generated in a direct way by the CRA raises a series of questions. These are:

> (1) Does the Postal Service invest heavily in the development of complex cost studies and flow models, over a period of decades, involving literally hundreds of library references presented to the Commission, subject these studies to review in adversary proceedings, at substantial cost to interested parties, defend the studies vigorously, and then take the position that the costs are not good enough to be useful in ratesetting?
>
> (2) When cost studies go beyond the CRA by supplementing it with detailed data relating to mail preparation and mail flows throughout the postal system, then add cost information from operating cost pools nationwide, then add actual productivities and reject rates and wage rates and nighttime premiums, and then adjust the result to conform to the CRA control totals (using a CRA adjustment factor), is it the case that the results should be viewed as useless because they did not come directly from the CRA to which they are tied?
>
> (3) Are mailers being told that rate design theories are nice, but when it comes to actual ratesetting, someone's notion, or some collective notion, of what seems reasonable will determine what they pay?

(4) Are the cost studies good enough to be used as the basis for setting rates in NSAs and for estimating their financial effects on the Postal Service, as required by the Act, but not good enough to be used as guides to set the rates that form the reference point for all discounts in the NSAs?

My position is that the Postal Service's cost studies are of substantial value. They have been used for ratesetting by the Commission throughout its existence. Costs are important. The studies should continue to be used. Nothing I am saying here, however, should be taken to suggest that the studies cannot be improved or that improvement is undesirable, or even that there would be an inadequate return from investment in improved studies.

7. Rates for Parcels in ECR. The proposed rate arrangement for parcels is new in this case. Heretofore, going back to Docket No. R97-1, parcels have paid a Residual Shape Surcharge, the level of which is currently 21.1¢. This charge has been applied regardless of the presort level or the entry point, in disregard for what must be the pattern of costs. I support a more detailed tracing of parcel costs.

Because the proposed rate structure for parcels is new, as well as because the volumes of parcels are particularly low (there are only 752,000 parcels in all of ECR, Commercial and Nonprofit combined), the costs available for parcels are rough, and some are beyond all bounds of reasonableness. For example, USPS-LR-L-84 shows a cost for basic ECR parcels of $30.03, which is an anomaly. Partly for this reason, as well as to limit the adjustment burden on parcel mailers, witness Kiefer selects parcel rates on a relatively *ad hoc* basis.

Specifically, he proposes to charge parcels 20¢ more than they would pay if they were flats, at each presort level, and thus to provide a uniform adjustment burden, on the presumption that "in the future" (p. 33, l. 19), parcels will be pieces that were flats. On the other hand, he presumes that in the present a "relatively small number" (p. 33, l. 12) of flats will be moved out of the flats category by any changes in its definition. This means, as I see it, that most parcels will be pieces that have been paying the Residual Shape Surcharge.

The obvious question is: If the current Residual Shape Surcharge is 21.1¢, and it is clear that (1) the additional cost (relative to flats) for less presorted parcels is greater than the additional cost for more presorted parcels and (2) the additional cost of saturation parcels (which are required to be accompanied by DALs) is probably smallest of all (given that carriers can take them directly to the street, with very little individual handling), why is it reasonable for the surcharge to be the same at each presort level and, in addition, less than the current Residual Shape Surcharge? Witness Kiefer does not address this question, though it seems to be an obvious candidate for attention.

My recommendation is to set the parcel rate 30¢ higher than the *basic* flat rate, which is a surcharge somewhat higher than the current Residual Shape Surcharge, and then to give density discounts of 10¢ each. Under these rates, the surcharge at the saturation level is 15.1¢, which, given the low costs associated with taking such pieces directly to the street, may still be too high.

This issue should studied further. If the Postal Service has the facility to deliver saturation parcels (which are generally product samples) at an additional cost that is small, I see no reason why it should discourage this volume with high rates. Providing a way to meet mailer needs, which would bring value to them, is one reason we have a Postal Service.

8. Rates for Nonprofit ECR. For the reasons discussed, and as done within Regular, the Nonprofit ECR rates were developed using the same presort tree as for Commercial ECR, with the same passthroughs. The resulting percentage increases are shown in Chart 4 at the end of my testimony. The rates for letters decline, as expected. The rates for flats increase, with the highest increase being 9.3%.

9. Resulting Rate Schedules for ECR Standard. Schedules 4 and 5, on following pages, show the resulting rates for ECR, Commercial and Nonprofit, respectively.

C. Percentage Rate Increase Charts, Regular and ECR.

The four pages following Schedules 4 and 5 contain Charts 1 through 4. For the rate elements proposed, these charts show the percentage changes, relative to current rates. Note that the increases shown for the per-piece rate element for pound-rated pieces tend to be volatile. This is because, as currently, these per-piece rate elements are linked in a leveraged way to the pound rate,

the breakpoint, and the associated minimum-per-piece rate. They are usually small and are only a portion the total postage bill; the percentage increase in them is relatively unimportant. Also: (1) the percentage increases for NFM mail assume automation flat rates for the current rates; (2) the percentage increases for the parcel rates in ECR assume that the pieces are currently paying the Residual Shape Surcharge; and (3) the percentage increases shown for saturation flats are for addressed flats, and thus do not include the 1.5¢ surcharge for DALs.

Schedule 4: VP Recommended Rates, Commercial ECR

		Origin			DBMC		
Letters @ minimum-per-piece		Entered	Mach	Auto	Entered	Mach	Auto
Basic	per pc	18.5		16.5	15.6		13.6
High density	per pc			14.5			11.6
Saturation	per pc			13.6			10.7
Letters @ pound rate		Entered	Mach	Auto	Entered	Mach	Auto
Basic	per pc			3.3			3.3
High density	per pc			1.3			1.3
Saturation	per pc			0.4			0.4
Entry point pound rate				64.1			50.2
Flats @ minimum-per-piece		Entered	Mach	Auto	Entered	Mach	Auto
Basic	per pc	20.8			17.9		
High density	per pc	17.8			14.9		
Saturation	per pc	15.7			12.8		
Flats @ pound rate		Entered	Mach	Auto	Entered	Mach	Auto
Basic	per pc	7.6			7.6		
High density	per pc	4.6			4.6		
Saturation	per pc	2.5			2.5		
Entry point pound rate		64.1			50.2		
Parcels @ minimum-per-piece		Entered	Mach	Auto	Entered	Mach	Auto
Basic	per pc	50.8			47.9		
High density	per pc	40.8			37.9		
Saturation	per pc	30.8			27.9		
Parcels @ pound rate		Entered	Mach	Auto	Entered	Mach	Auto
Basic	per pc	37.6			37.6		
High density	per pc	27.6			27.6		
Saturation	per pc	17.6			17.6		
Entry point pound rate		64.1			50.2		

		DSCF			DDU		
Letters @ minimum-per-piece		Entered	Mach	Auto	Entered	Mach	Auto
Basic	per pc	14.9		12.9			
High density	per pc			10.9			
Saturation	per pc			10.0			
Letters @ pound rate		Entered	Mach	Auto	Entered	Mach	Auto
Basic	per pc			3.3			
High density	per pc			1.3			
Saturation	per pc			0.4			
Entry point pound rate				46.9			
Flats @ minimum-per-piece		Entered	Mach	Auto	Entered	Mach	Auto
Basic	per pc	17.2			16.5		
High density	per pc	14.2			13.5		
Saturation	per pc	12.1			11.4		
Flats @ pound rate		Entered	Mach	Auto	Entered	Mach	Auto
Basic	per pc	7.6			7.6		
High density	per pc	4.6			4.6		
Saturation	per pc	2.5			2.5		
Entry point pound rate		46.9			43.0		
Parcels @ minimum-per-piece		Entered	Mach	Auto	Entered	Mach	Auto
Basic	per pc	47.2			46.5		
High density	per pc	37.2			36.5		
Saturation	per pc	27.2			26.5		
Parcels @ pound rate		Entered	Mach	Auto	Entered	Mach	Auto
Basic	per pc	37.6			37.6		
High density	per pc	27.6			27.6		
Saturation	per pc	17.6			17.6		
Entry point pound rate		46.9			43.0		

Schedule 5: VP Recommended Rates, Nonprofit ECR

		Origin			DBMC		
Letters @ minimum-per-piece		Entered	Mach	Auto	Entered	Mach	Auto
Basic	per pc	13.0		11.0	10.1		8.1
High density	per pc			9.0			6.1
Saturation	per pc			8.1			5.2
Letters @ pound rate		Entered	Mach	Auto	Entered	Mach	Auto
Basic	per pc			1.7			1.7
High density	per pc			-0.3			-0.3
Saturation	per pc			-1.2			-1.2
Entry point pound rate				45.2			31.3
Flats @ minimum-per-piece		Entered	Mach	Auto	Entered	Mach	Auto
Basic	per pc	15.3			12.4		
High density	per pc	12.3			9.4		
Saturation	per pc	10.2			7.3		
Flats @ pound rate		Entered	Mach	Auto	Entered	Mach	Auto
Basic	per pc	6.0			6.0		
High density	per pc	3.0			3.0		
Saturation	per pc	0.9			0.9		
Entry point pound rate		45.2			31.3		
Parcels @ minimum-per-piece		Entered	Mach	Auto	Entered	Mach	Auto
Basic	per pc	45.3			42.4		
High density	per pc	35.3			32.4		
Saturation	per pc	25.3			22.4		
Parcels @ pound rate		Entered	Mach	Auto	Entered	Mach	Auto
Basic	per pc	36.0			36.0		
High density	per pc	26.0			26.0		
Saturation	per pc	16.0			16.0		
Entry point pound rate		45.2			31.3		

		DSCF			DDU		
Letters @ minimum-per-piece		Entered	Mach	Auto	Entered	Mach	Auto
Basic	per pc	9.4		7.4			
High density	per pc			5.4			
Saturation	per pc			4.5			
Letters @ pound rate		Entered	Mach	Auto	Entered	Mach	Auto
Basic	per pc			1.7			
High density	per pc			-0.3			
Saturation	per pc			-1.2			
Entry point pound rate				28.0			
Flats @ minimum-per-piece		Entered	Mach	Auto	Entered	Mach	Auto
Basic	per pc	11.7			11.0		
High density	per pc	8.7			8.0		
Saturation	per pc	6.6			5.9		
Flats @ pound rate		Entered	Mach	Auto	Entered	Mach	Auto
Basic	per pc	6.0			6.0		
High density	per pc	3.0			3.0		
Saturation	per pc	0.9			0.9		
Entry point pound rate		28.0			24.1		
Parcels @ minimum-per-piece		Entered	Mach	Auto	Entered	Mach	Auto
Basic	per pc	41.7			41.0		
High density	per pc	31.7			31.0		
Saturation	per pc	21.7			21.0		
Parcels @ pound rate		Entered	Mach	Auto	Entered	Mach	Auto
Basic	per pc	36.0			36.0		
High density	per pc	26.0			26.0		
Saturation	per pc	16.0			16.0		
Entry point pound rate		28.0			24.1		

Chart 1: VP Percentage Increases, Rate Cells, Commercial Regular

		Origin			DBMC		
Letters @ minimum-per-piece		N-mach	Mach	Auto	N-mach	Mach	Auto
Mx ADC/AADC	per pc	31.2%	-4.6%	7.8%	31.1%	-7.7%	5.3%
ADC/AADC	per pc	17.3%	-8.5%	6.7%	16.2%	-11.9%	4.0%
3-d	per pc	22.8%		8.9%	22.1%		6.3%
5-d	per pc	11.2%		9.0%	9.6%		6.2%
Letters @ pound rate		N-mach	Mach	Auto	N-mach	Mach	Auto
Mx ADC/AADC	per pc			26.0%			26.0%
ADC/AADC	per pc			24.6%			24.6%
3-d	per pc			35.0%			35.0%
5-d	per pc			43.5%			43.5%
Entry point pound rate				-0.9%			-6.4%
Flats @ minimum-per-piece		see NFM	Mach	Auto	see NFM	Mach	Auto
Mx ADC/AADC	per pc		41.6%	56.3%		42.2%	58.2%
ADC/AADC	per pc		29.5%	43.0%		29.3%	43.9%
3-d	per pc		45.7%	54.9%		46.8%	56.9%
5-d	per pc		28.9%	38.5%		28.7%	39.1%
Flats @ pound rate		see NFM	Mach	Auto	see NFM	Mach	Auto
Mx ADC/AADC	per pc		73.2%	111.1%		73.2%	111.1%
ADC/AADC	per pc		52.2%	85.2%		52.2%	85.2%
3-d	per pc		94.0%	126.4%		94.0%	126.4%
5-d	per pc		60.0%	89.3%		60.0%	89.3%
Entry point pound rate			-0.9%	-0.9%		-6.4%	-6.4%
Parcels @ minimum-per-piece		N-mach	Mach	NFM	N-mach	Mach	NFM
Mx ADC/AADC	per pc	96.5%	80.2%	228.8%	98.1%	81.1%	243.5%
ADC/AADC	per pc	71.6%	60.7%	175.6%	72.2%	60.9%	186.4%
3-d	per pc	62.5%		155.6%	62.8%		186.4%
5-d	per pc	38.3%	38.5%	108.0%	37.6%	3778.6%	114.6%
Parcels @ pound rate		N-mach	Mach	NFM	N-mach	Mach	NFM
Mx ADC/AADC/BMC	per pc	118.0%	96.0%	414.2%	118.0%	96.0%	414.2%
ADC/AADC/BMC	per pc	84.5%	69.8%	310.5%	84.5%	69.8%	310.5%
3-d	per pc	73.7%		310.7%	73.7%		310.7%
5-d	per pc	40.1%	40.3%	202.5%	40.1%	40.3%	202.5%
Entry point pound rate		34.2%	34.2%	34.2%	30.3%	30.3%	34.5%

Chart 1: VP Percentage Increases, Rate Cells, Commercial Regular (cont'd.)

		DSCF			DDU		
Letters @ minimum-per-piece		N-mach	Mach	Auto	N-mach	Mach	Auto
Mx ADC/AADC	per pc	31.0%	-8.6%	4.4%			
ADC/AADC	per pc	15.8%	-12.9%	3.1%			
3-d	per pc	21.7%		5.3%			
5-d	per pc	9.1%		5.2%			
Letters @ pound rate		N-mach	Mach	Auto	N-mach	Mach	Auto
Mx ADC/AADC	per pc			26.0%			
ADC/AADC	per pc			24.6%			
3-d	per pc			35.0%			
5-d	per pc			43.5%			
Entry point pound rate				-7.7%			
Flats @ minimum-per-piece		see NFM	Mach	Auto	N-mach	Mach	Auto
Mx ADC/AADC	per pc		42.3%	58.5%			
ADC/AADC	per pc		29.2%	43.9%			
3-d	per pc		46.9%	57.3%			
5-d	per pc		28.5%	39.1%			
Flats @ pound rate		see NFM	Mach	Auto	N-mach	Mach	Auto
Mx ADC/AADC	per pc		73.2%	111.1%			
ADC/AADC	per pc		52.2%	85.2%			
3-d	per pc		94.0%	126.4%			
5-d	per pc		60.0%	89.3%			
Entry point pound rate			-7.7%	-765.5%			
Parcels @ minimum-per-piece		N-mach	Mach	NFM	N-mach	Mach	NFM
Mx ADC/AADC	per pc	92.2%	75.1%	247.1%	85.5%	68.3%	244.6%
ADC/AADC	per pc	66.1%	54.7%	188.9%	59.3%	47.9%	186.5%
3-d	per pc	55.9%		169.0%	48.4%		166.1%
5-d	per pc	30.4%	30.6%	116.1%	22.9%	23.1%	113.3%
Parcels @ pound rate		N-mach	Mach	NFM	N-mach	Mach	NFM
Mx ADC/AADC/BMC	per pc	118.0%	96.0%	414.2%	118.0%	96.0%	414.2%
ADC/AADC/BMC	per pc	84.5%	69.8%	310.5%	84.5%	69.8%	310.5%
3-d	per pc	73.7%		310.7%	73.7%		310.7%
5-d	per pc	40.1%	40.3%	202.5%	40.1%	40.3%	202.5%
Entry point pound rate		1.3%	1.3%	35.0%	-29.6%	-29.6%	28.7%

Chart 2: VP Percentage Increases, Rate Cells, Nonprofit Regular

		Origin			DBMC		
Letters @ minimum-per-piece		N-mach	Mach	Auto	N-mach	Mach	Auto
Mx ADC/AADC	per pc	70.7%	0.0%	1.4%	75.7%	-4.7%	-4.0%
ADC/AADC	per pc	47.1%	-6.5%	-0.7%	49.1%	-12.2%	-6.8%
3-d	per pc	52.5%		0.8%	55.4%		-5.4%
5-d	per pc	33.0%		0.8%	33.1%		-6.3%
Letters @ pound rate		N-mach	Mach	Auto	N-mach	Mach	Auto
Mx ADC/AADC	per pc			-8.3%			-8.3%
ADC/AADC	per pc			-31.2%			-31.2%
3-d	per pc			-33.3%			-33.3%
5-d	per pc			50.0%			50.0%
Entry point pound rate				3.3%			-2.8%
Flats @ minimum-per-piece		see NFM	Mach	Auto	see NFM	Mach	Auto
Mx ADC/AADC	per pc		75.1%	102.6%		79.5%	111.6%
ADC/AADC	per pc		56.5%	81.0%		59.1%	87.3%
3-d	per pc		82.0%	91.2%		88.6%	100.0%
5-d	per pc		55.0%	64.9%		58.1%	69.8%
Flats @ pound rate		see NFM	Mach	Auto	see NFM	Mach	Auto
Mx ADC/AADC	per pc		154.0%	276.1%		154.0%	276.1%
ADC/AADC	per pc		115.0%	216.9%		115.0%	216.9%
3-d	per pc		232.3%	323.4%		232.3%	323.4%
5-d	per pc		153.8%	227.7%		153.8%	227.7%
Entry point pound rate			3.3%	3.3%		-2.8%	-2.8%
Parcels @ minimum-per-piece		N-mach	Mach	NFM	N-mach	Mach	NFM
Mx ADC/AADC	per pc	127.6%	106.9%	382.1%	131.1%	109.4%	426.6%
ADC/AADC	per pc	96.0%	82.3%	295.9%	98.0%	83.6%	329.5%
3-d	per pc	82.8%		253.2%	84.4%		285.9%
5-d	per pc	52.2%	52.4%	176.6%	52.1%	52.3%	198.0%
Parcels @ pound rate		N-mach	Mach	NFM	N-mach	Mach	NFM
Mx ADC/AADC/BMC	per pc	154.6%	126.8%	1038.0%	154.6%	126.8%	1038.0%
ADC/AADC/BMC	per pc	112.1%	93.5%	801.4%	112.1%	93.5%	801.4%
3-d	per pc	96.1%		904.3%	96.1%		904.3%
5-d	per pc	53.1%	53.4%	625.5%	53.1%	53.4%	625.5%
Entry point pound rate		50.0%	50.0%	6.5%	48.3%	48.3%	1.0%

Chart 2: VP Percentage Increases, Rate Cells, Nonprofit Regular (cont'd.)

		DSCF			DDU		
Letters @ minimum-per-piece		N-mach	Mach	Auto	N-mach	Mach	Auto
Mx ADC/AADC	per pc	76.8%	-6.3%	-5.8%			
ADC/AADC	per pc	49.4%	-14.0%	-8.8%			
3-d	per pc	55.9%		-7.5%			
5-d	per pc	32.9%		-8.8%			
Letters @ pound rate		N-mach	Mach	Auto	N-mach	Mach	Auto
Mx ADC/AADC	per pc			-8.3%			
ADC/AADC	per pc			-31.2%			
3-d	per pc			-33.3%			
5-d	per pc			50.0%			
Entry point pound rate				-4.3%			
Flats @ minimum-per-piece		see NFM	Mach	Auto	N-mach	Mach	Auto
Mx ADC/AADC	per pc		80.5%	113.7%			
ADC/AADC	per pc		59.5%	88.7%			
3-d	per pc		90.1%	102.1%			
5-d	per pc		58.6%	70.8%			
Flats @ pound rate		see NFM	Mach	Auto	N-mach	Mach	Auto
Mx ADC/AADC	per pc		154.0%	276.1%			
ADC/AADC	per pc		115.0%	216.9%			
3-d	per pc		232.3%	323.4%			
5-d	per pc		153.8%	227.7%			
Entry point pound rate			-4.3%	-4.3%			
Parcels @ minimum-per-piece		N-mach	Mach	NFM	N-mach	Mach	NFM
Mx ADC/AADC	per pc	123.9%	102.0%	438.1%	115.3%	93.4%	433.9%
ADC/AADC	per pc	90.5%	75.9%	338.1%	81.9%	67.3%	333.9%
3-d	per pc	75.7%		294.4%	66.1%		289.6%
5-d	per pc	43.1%	43.3%	203.5%	33.4%	33.7%	198.6%
Parcels @ pound rate		N-mach	Mach	NFM	N-mach	Mach	NFM
Mx ADC/AADC/BMC	per pc	154.6%	126.8%	1038.0%	154.6%	126.8%	1038.0%
ADC/AADC/BMC	per pc	112.1%	93.5%	801.4%	112.1%	93.5%	801.4%
3-d	per pc	96.1%		904.3%	96.1%		904.3%
5-d	per pc	53.1%	53.4%	625.5%	53.1%	53.4%	625.5%
Entry point pound rate		11.5%	11.5%	-0.2%	-28.9%	-28.9%	-8.5%

Chart 3: VP Percentage Increases, Rate Cells, Commercial ECR

		Origin			DBMC		
Letters @ minimum-per-piece		Entered	Mach	Auto	Entered	Mach	Auto
Basic	per pc	-9.3%		-8.3%	-14.3%		-13.9%
High density	per pc			-16.2%			-23.2%
Saturation	per pc			-15.0%			-22.5%
Letters @ pound rate		Entered	Mach	Auto	Entered	Mach	Auto
Basic	per pc			-29.8%			-29.8%
High density	per pc			-67.5%			-67.5%
Saturation	per pc			-85.2%			-85.2%
Entry point pound rate				0.0%			-0.6%
Flats @ minimum-per-piece		Entered	Mach	Auto	Entered	Mach	Auto
Basic	per pc	2.0%			-1.6%		
High density	per pc	0.0%			-4.5%		
Saturation	per pc	-7.1%			-12.9%		
Flats @ pound rate		Entered	Mach	Auto	Entered	Mach	Auto
Basic	per pc	7.0%			7.0%		
High density	per pc	2.2%			2.2%		
Saturation	per pc	-30.6%			-30.6%		
Entry point pound rate		-0.3%			-0.6%		
Parcels @ minimum-per-piece		Entered	Mach	Auto	Entered	Mach	Auto
Basic	per pc	22.4%			21.9%		
High density	per pc	4.9%			3.3%		
Saturation	per pc	-18.9%			-22.1%		
Parcels @ pound rate		Entered	Mach	Auto	Entered	Mach	Auto
Basic	per pc	33.3%			33.3%		
High density	per pc	7.8%			7.8%		
Saturation	per pc	-28.7%			-28.7%		
Entry point pound rate		-0.3%			-6.7%		

		DSCF			DDU		
Letters @ minimum-per-piece		Entered	Mach	Auto	Entered	Mach	Auto
Basic	per pc	-15.8%		-15.7%			
High density	per pc			-25.3%			
Saturation	per pc			-24.8%			
Letters @ pound rate		Entered	Mach	Auto	Entered	Mach	Auto
Basic	per pc			-63.7%			
High density	per pc			-77.6%			
Saturation	per pc			-90.0%			
Entry point pound rate				-0.8%			
Flats @ minimum-per-piece		Entered	Mach	Auto	Entered	Mach	Auto
Basic	per pc	-2.8%			-3.5%		
High density	per pc	-6.0%			-6.9%		
Saturation	per pc	-14.8%			-16.2%		
Flats @ pound rate		Entered	Mach	Auto	Entered	Mach	Auto
Basic	per pc	7.0%			7.0%		
High density	per pc	2.2%			2.2%		
Saturation	per pc	-30.6%			-30.6%		
Entry point pound rate		-84.6%			-1.4%		
Parcels @ minimum-per-piece		Entered	Mach	Auto	Entered	Mach	Auto
Basic	per pc	21.6%			21.7%		
High density	per pc	2.8%			2.5%		
Saturation	per pc	-22.9%			-23.6%		
Parcels @ pound rate		Entered	Mach	Auto	Entered	Mach	Auto
Basic	per pc	33.3%			33.3%		
High density	per pc	7.8%			7.8%		
Saturation	per pc	-28.7%			-28.7%		
Entry point pound rate		-8.2%			-9.9%		

Chart 4: VP Percentage Increases, Rate Cells, Nonprofit ECR

		Origin			DBMC		
Letters @ minimum-per-piece		Entered	Mach	Auto	Entered	Mach	Auto
Basic	per pc	-7.1%		-6.0%	-14.4%		-14.7%
High density	per pc			-20.4%			-33.0%
Saturation	per pc			-22.9%			-37.3%
Letters @ pound rate		Entered	Mach	Auto	Entered	Mach	Auto
Basic	per pc			-46.9%			-46.9%
High density	per pc			-110.7%			-110.7%
Saturation	per pc			-160.0%			-160.0%
Entry point pound rate				8.9%			1.0%
Flats @ minimum-per-piece		Entered	Mach	Auto	Entered	Mach	Auto
Basic	per pc	9.3%			5.1%		
High density	per pc	0.8%			-6.0%		
Saturation	per pc	-12.1%			-22.3%		
Flats @ pound rate		Entered	Mach	Auto	Entered	Mach	Auto
Basic	per pc	9.1%			9.1%		
High density	per pc	-18.9%			-18.9%		
Saturation	per pc	-71.0%			-71.0%		
Entry point pound rate		10.0%			2.3%		
Parcels @ minimum-per-piece		Entered	Mach	Auto	Entered	Mach	Auto
Basic	per pc	29.1%			28.9%		
High density	per pc	6.0%			4.2%		
Saturation	per pc	-22.6%			-26.6%		
Parcels @ pound rate		Entered	Mach	Auto	Entered	Mach	Auto
Basic	per pc	35.3%			35.3%		
High density	per pc	4.8%			4.8%		
Saturation	per pc	-33.9%			-33.9%		
Entry point pound rate		10.0%			2.3%		

		DSCF			DDU		
Letters @ minimum-per-piece		Entered	Mach	Auto	Entered	Mach	Auto
Basic	per pc	-16.8%		-17.8%			
High density	per pc			-37.2%			
Saturation	per pc			-42.3%			
Letters @ pound rate		Entered	Mach	Auto	Entered	Mach	Auto
Basic	per pc			-46.9%			
High density	per pc			-110.7%			
Saturation	per pc			-160.0%			
Entry point pound rate				-1.1%			
Flats @ minimum-per-piece		Entered	Mach	Auto	Entered	Mach	Auto
Basic	per pc	3.5%			2.8%		
High density	per pc	-8.4%			-10.1%		
Saturation	per pc	-25.8%			-28.9%		
Flats @ pound rate		Entered	Mach	Auto	Entered	Mach	Auto
Basic	per pc	9.1%			9.1%		
High density	per pc	-18.9%			-18.9%		
Saturation	per pc	-71.0%			-71.0%		
Entry point pound rate		0.4%			-1.6%		
Parcels @ minimum-per-piece		Entered	Mach	Auto	Entered	Mach	Auto
Basic	per pc	28.7%			28.9%		
High density	per pc	3.6%			3.3%		
Saturation	per pc	-27.7%			-28.6%		
Parcels @ pound rate		Entered	Mach	Auto	Entered	Mach	Auto
Basic	per pc	35.3%			35.3%		
High density	per pc	4.8%			4.8%		
Saturation	per pc	-33.9%			-33.9%		
Entry point pound rate		0.4%			-1.6%		