

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

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**POSTAL RATE AND FEE CHANGES    }**

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**DOCKET No. R2006-1**

**INITIAL BRIEF  
OF  
PARCEL SHIPPERS ASSOCIATION**

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## TABLE OF AUTHORITIES

### Other Authorities

MC95-1 Op.....	7, 8
MC2006-1 Op. ....	passim
R97-1 Op.....	18
R2000-1 Op.....	6, 8, 10
R2005-1 Op.....	21

## TABLE OF CONTENTS

PARCEL SHIPPERS ASSOCIATION STATEMENT OF THE CASE AND STATEMENT OF THE PARCEL SHIPPERS ASSOCIATION.....	1
1. GIVEN THE DIFFERENT DEMAND CHARACTERISTICS OF NON-DESTINATION ENTRY PARCEL POST AND PARCEL SELECT, MARKING UP TRANSPORTATION COSTS IN SETTING PARCEL POST RATES IS REASONABLE. LOOKING FORWARD, THE POSTAL SERVICE SHOULD CONSIDER BREAKING PARCEL POST INTO TWO SUBCLASSES. ....	5
2. WITNESS LUCIANI'S "INTERIM IMPROVEMENT" TO THE POSTAL SERVICE'S PARCEL POST MAIL PROCESSING COST AVOIDANCE MODEL SHOULD BE REJECTED BECAUSE IT SIGNIFICANTLY OVERSTATES MAIL PROCESSING COSTS FOR DDU-ENTERED PARCEL POST.....	9
3. THE NONMACHINABLE AND OVERSIZED PERCENTAGES FOR DDU PARCELS AND THE NUMBER OF PIECES PER CONTAINER FOR DDU PARCELS IN THE PARCEL POST COST MODEL (USPS-LR-L-46) ARE REASONABLE. ....	12
4. AS DISCUSSED BY PSA WITNESS FINLEY (PSA-T-1), THE COMMISSION SHOULD TAKE THE INCREASED MAIL PREPARATION AND ENTRY COSTS THAT THE EVOLUTIONARY NETWORK DEVELOPMENT (END) WILL IMPOSE ON PARCEL SHIPPERS AND THE RESULTING USPS COST SAVINGS INTO CONSIDERATION WHEN EVALUATING THE RATE INCREASES FOR DBMC-ENTERED PARCELS.....	14
5. THE POSTAL SERVICE'S FINAL ADJUSTMENT TO SHIFT A PORTION OF ELECTRONIC DELIVERY CONFIRMATION COSTS TO PARCEL POST IS TOO LARGE BECAUSE IT INCORRECTLY ASSUMES THAT THERE WILL BE MORE PARCEL SELECT NO-FEE ELECTRONIC DELIVERY CONFIRMATION PIECES	

THAN TOTAL PARCEL SELECT PIECES. TO CORRECT THIS PROBLEM, A MORE REASONABLE ESTIMATE OF PARCEL SELECT NO-FEE ELECTRONIC DELIVERY CONFIRMATION VOLUME SHOULD BE USED IN THE FINAL ADJUSTMENT PROCESS.....17

6. PARCEL SELECT NO-FEE ELECTRONIC DELIVERY CONFIRMATION PIECES WILL NOT INCUR WINDOW SERVICE ACCEPTANCE COSTS BECAUSE, AS DISCUSSED BY PSA WITNESS ZWIEG (PSA-RT-2), PARCEL SELECT IS NOT ENTERED AT POSTAL WINDOWS. THUS, THE COST OF PARCEL SELECT NO-FEE ELECTRONIC DELIVERY CONFIRMATION PIECES, WHICH IS USED FOR BOTH PARCEL POST RATE DESIGN AND FINAL ADJUSTMENT PURPOSES, SHOULD EXCLUDE WINDOW SERVICE ACCEPTANCE COSTS.18

7. PRS PIECES SHOULD BE TREATED AS NON-DESTINATION ENTRY PARCEL POST VOLUMES FOR CALCULATING THE PARCEL SELECT WINDOW SERVICE COST AVOIDANCE BECAUSE PRS COSTS ARE COUNTED AS PARCEL SELECT COSTS.....19

8. PER THE COMMISSION'S RECOMMENDATION IN DOCKET NO. MC2006-1, PARCEL RETURN SERVICE (PRS) PASSTHROUGHS SHOULD BE INCREASED; AND COMPETITION IN THE MARKET SUPPORTS THE COMMISSION'S RECOMMENDATION.....21

9. THE POSTAL SERVICE'S SHAPE-BASED RATE DESIGN PROPOSALS IN FIRST-CLASS MAIL AND STANDARD MAIL HAVE GONE TOO FAR, TOO FAST. USPS HAS PROPOSED ENORMOUS RATE INCREASES FOR PARCELS AND NOT FLAT-MACHINABLES BASED UPON INADEQUATE DATA AND WITHOUT GIVING DUE CONSIDERATION TO IMPACT. ....23

a) The rate increases should be reduced simply to avoid rate shock. ....24

- b) The quality of data underlying the Postal Service’s proposal does not meet the “high bar” that should be required in support of huge rate increases. ....26
- c) The rate increases for Standard Mail and First-Class Mail parcels are inappropriately based upon passthroughs of 100 percent or more of shape-based cost differences. Given the combination of rate shock and data quality concerns, less-than-full passthroughs are more appropriate. ....28

10. PSA SUPPORTS THE POSTAL SERVICE’S PROPOSAL TO ENHANCE  
 DROPSHIP DISCOUNTS FOR STANDARD MAIL PARCELS AND  
 RECOMMENDS EXTENDING THESE ENHANCED DISCOUNTS TO STANDARD  
 MAIL NFMS AND STANDARD MAIL DBMC PARCELS.....29

CONCLUSION.....31

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**PARCEL SHIPPERS ASSOCIATION STATEMENT OF THE CASE AND STATEMENT  
OF THE PARCEL SHIPPERS ASSOCIATION**

It is the position of the Parcel Shippers Association (PSA) that the USPS-proposed rates for Standard Mail parcels and Not Flat-Machinables (NFMs) and First-Class Mail parcels are inequitable because the Postal Service has attempted to guess what the impact of shape is on cost, without adequate data, and without due consideration given to the dramatic rate increases resulting from those guesses.

The proposed increases for Standard Mail parcels and NFMs and First-Class Mail parcels are wrongly based upon passthroughs of 100 percent or more of “estimated” shape-based cost differences. Given the data quality problems and rate shock, passthroughs of less than 100 percent are appropriate.

The rate increase for Standard Mail parcels should be capped at 30 percent; similar downward adjustments should be made to the USPS-proposed rates for Standard Mail NFMs and First-Class Mail parcels. For example, while USPS witness Kiefer limited rate increases for each Parcel Post rate cell to 30 percent, the average increases that he proposed for Standard Mail parcels and NFMs are much higher.

The average increase for Standard Mail parcels is nearly 50 percent with the increases for some parcels exceeding 80 percent. The proposed rate increase for First-Class Mail parcels averages 30 percent, with the rate increase for 20 percent of these parcels approaching 100 percent and the rate increase for nearly half of them exceeding 40 percent. For Standard Mail NFMs, the rate increases range from 60 percent to more than 200 percent. As further evidence of how unreasonable these proposed rate increases are, the Postal Service pricing witness proposing them himself stated that he had never proposed, nor did he have any knowledge of any other Postal Service pricing witness having proposed, rate increases as high as 80 percent. Tr. 5/1112-1113, 1120 (Kiefer).

The quality of the data underlying these shape-based cost increases does not meet the “high-bar” that should be required for increases of this size. For example, the Postal Service’s “estimated” mail processing costs for First-Class Mail Presort Parcels are \$3 while Standard Mail Enhanced Carrier Route parcels are \$24 – eight times as much – costs that even the witness sponsoring them concedes are clearly anomalous. For Standard Mail NFMs, there is simply no data and only guesses.

For the above reasons, passthroughs of shape-based cost differences should be less than 100 percent. Further, as discussed in PSA's response to Notice of Inquiry (NOI) No. 2, shape-based passthroughs must be calculated by comparing entire revenue differences by shape with entire cost differences. Unlike the traditional approach for calculating passthroughs, this approach ensures that the higher weight-based revenue of parcels is given due consideration.

The Postal Service's proposal to enhance dropship discounts for Standard Mail parcels is appropriate and should be extended to Standard Mail NFM and DBMC-entered parcels; this offers sufficient incentives for mailers to change behavior to offset the large proposed increases.

The Postal Service has inflated Parcel Post costs in general and Parcel Select costs in particular by overstating the cost of Parcel Select no-fee electronic delivery confirmation pieces. First, it estimates that Parcel Select no-fee electronic delivery confirmation costs will incur 2.85 cents per piece in window service acceptance even though, as PSA witness Zwieg testified, Parcel Select pieces are never presented at the window. Second, in calculating these costs, the Postal Service incorrectly estimates that there will be more Parcel Select no-fee electronic delivery confirmation pieces – 267.8 million – than total Parcel Select pieces – only 244.1 million – not all of which will use electronic delivery confirmation.

Parcel Return Service (PRS) volumes should be treated as non-destination entry Parcel Post volume for calculating the Parcel Select window service cost avoidance.

Because PRS costs are counted as Parcel Select costs, there is no basis for allocating any window service costs to PRS.

Despite the Commission's Docket No. MC2006-1 recommendation to increase PRS passthroughs, the Postal Service only marginally increased them. Consistent with the efficient component pricing rule, PRS passthroughs should be increased by reducing the USPS-proposed PRS rates by 20 cents.

The Postal Service failed to, but the PRC should take account of the increased mail preparation and entry costs that will result from the implementation of END in the Test Year.

United Parcel Service's complaint about marking up transportation cost differences in setting rates for Parcel Select, compared to non-destination entry parcels, is without basis. Non-destination entry parcels and Parcel Select have different demand characteristics and therefore they should be treated differently. Thus, marking up transportation costs in setting Parcel Select is reasonable, despite the application of efficient component pricing. Further, the passthrough for Parcel Select, 106 percent, only slightly exceeds 100 percent; that passthrough is closer to efficient component pricing than UPS witness Luciani's proposed 90 percent passthrough.

Also, the PRC should reject UPS witness Luciani's "improved" model of mail processing costs. He estimates a 53.1-cent cost for DDU-entered parcels versus the 37.5-cent unit cost for DDU parcels that the In-Office Cost System (IOCS) yields. One

reason why Luciani overstates the cost of DDU parcels is that he adds, as does the USPS, 15.59 cents of mail processing costs at postal plants (which DDU parcels avoid) to the cost of DDU-entered parcels. Such costs should not be allocated to DDU parcels since they do not in any way cause their incurrence.

Contrary to claims by UPS, the Postal Service has reasonably estimated the percentages of DDU parcels that are nonmachinable and oversized and the number of pieces per DDU-entered container. The testimony of PSA witness Zwieg, whose company tenders a substantial majority of all DDU parcels, confirmed the reasonableness of the Postal Service's estimates.

The Commission should not forget that there is fierce competition with UPS and other competitors for all parcels. Because UPS and these other competitors are unregulated, they are not required to divulge any information to any public body; it is not possible to know the extent of the price competition between USPS and these competitors.

We do not have actual knowledge of the deals that many large parcel shippers have with UPS and other competitors; they are secret, but indeed they undercut current parcel rates. Certainly history tells us that any increase in package rates will simply provide UPS and other competitors with an opportunity to increase their own prices without suffering volume losses, thereby damaging competition.

- 1. GIVEN THE DIFFERENT DEMAND CHARACTERISTICS OF NON-DESTINATION ENTRY PARCEL POST AND PARCEL SELECT, MARKING UP TRANSPORTATION COSTS IN SETTING PARCEL POST RATES IS**

**REASONABLE. LOOKING FORWARD, THE POSTAL SERVICE SHOULD CONSIDER BREAKING PARCEL POST INTO TWO SUBCLASSES.**

Docket No. R2006-1 is the first fully litigated rate case in which the Postal Service has developed separate econometric demand equations for non-destination entry Parcel Post and destination entry Parcel Post (commonly referred to as “Parcel Select”).<sup>1</sup> These demand equations show that Parcel Select is nearly four times as price elastic as non-destination entry Parcel Post. USPS-T-7 at 178 and 185 (Thress). Further, there appears to be no meaningful cross-price elasticity between non-destination entry Parcel Post and Parcel Select.<sup>2</sup>

The different demand and cost characteristics of non-destination entry Parcel Post and Parcel Select suggest that they are distinct products and thus are in the same

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<sup>1</sup> In this docket, the separate econometric demand equations for these two products are on pages 178 and 185 of USPS witness Thress’ testimony (USPS-T-7). In Docket No. R2000-1 (the last fully litigated case), the econometric demand equation for Parcel Post is on page 73 of USPS witness Thress’ testimony (USPS-T-7).

<sup>2</sup> In his testimony, USPS witness Thress (USPS-T-7) identifies the price of UPS Ground delivery and the price of non-destination entry Parcel Post mail as the factors that principally affect non-destination entry Parcel Post volume and the price of competitor products and the price of Parcel Select as the factors that principally affect Parcel Select volume. USPS-T-7 at 173, 181 (Thress). Further, witness Thress does not even include cross-price terms between non-destination entry Parcel Post and Parcel Select in his econometric demand equations. USPS-T-7 at 176-178, 184-185 (Thress). During the cross examination of PSA witness Glick (Tr. 33/11275), Counsel to UPS suggested the possibility that Thress did not include cross-prices between non-destination entry Parcel Post and Parcel Select in his econometric demand equations because he simply “did not think about it.” This speculation seems quite unlikely given that Thress included other cross-price terms (e.g., the price of competitor products) in his econometric demand equations and had ready access to non-destination entry Parcel Post and Parcel Select price data. USPS-T-7 at 177-178, 184-185 (Thress). Counsel to UPS also attempted to short-circuit the econometric demands of estimating cross-price elasticities in his cross examination of witness Glick by suggesting that a simple comparison of quarterly SPLY growth figures could be used to determine whether a relationship exists between the two products. Tr. 33/11278-11280. Such a simplistic comparison is uninformative because it ignores important events in the evolution of the markets for non-destination entry Parcel Post and Parcel Select over the last decade, other factors that have been determined by Thress to have affected non-destination entry Parcel Post and Parcel Select volumes during this period, and difficult technical issues in working with volume data series with overlapping quarterly information. To ensure that there is no need for further speculation in the future, PSA recommends that the Postal Service explicitly discuss the cross-price elasticity between non-destination entry Parcel Post and Parcel Select in its testimony in the next case. Further, even if there is a modest cross-price elasticity between non-destination entry Parcel Post and Parcel Select, PSA believes that the Postal Service’s slight deviation from a 100 percent passthrough between non-destination entry Parcel Post and Parcel Select is appropriate in this case based upon the larger own-price elasticity of Parcel Select.

subclass in name only. Tr. 33/11264 (Glick). This point was best illustrated during the cross examination of Dr. Panzar (PB-T-1). When presented with the information discussed above, he stated:

Looking at this example, my reaction would be, why are these two services in the same subclass?"

Tr. 26/9259 (Panzar).

Further, the Postal Rate Commission's Docket No. MC95-1 discussion of subclasses indicates that non-destination entry Parcel Post and Parcel Select should be in separate subclasses due to their very different own-price elasticities and minimal cross-price elasticity.

The distinguishing property of a market is the ability to maintain a single common price among participants that is at least somewhat independent of the prices charged for similar products or services in other markets. The absence of high cross-price elasticities of demand with other subclasses is the most relevant evidence of the existence of a distinct market for a proposed subclass. Two subclasses with high cross-price elasticities occupy the same market and cannot sustain different prices without virtually eliminating the demand for some categories of the higher-priced subclass.

However, establishment of subclasses wherever 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. Approximate uniformity of own-price elasticities is desirable among worksharing categories grouped as a subclass even though such uniformity is not required by the economic concept of a market. Such uniformity is broadly desirable because equity and efficiency considerations are foundations of Commission rate recommendations. If the own-price elasticities of two proposed subclasses are substantially dissimilar, then there is a potential benefit from setting separate rates provided that distinct markets are being served.

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 more equitable for mailers is the presentation of reliable estimates showing that

a proposal separates mailers with distinctly different own-price elasticities of demand into more homogeneous subclasses.

MC95-1 Op., Para. 5446-5448.

Thus, PSA urges the Postal Service to consider proposing separate non-destination entry Parcel Post and Parcel Select subclasses in the next rate case and pricing them based upon a full consideration of all of the non-cost factors of the Postal Reorganization Act. Tr. 33/11265 (Glick).

Further, while PSA generally believes that rates within a subclass should be set according to the efficient component pricing rule (Tr. 33/11263 (Glick)), the USPS proposal in this case to mark up transportation cost differences is a reasonable (albeit quite modest) way to reflect the greater price sensitivity (and thus lower economic value)<sup>3</sup> of Parcel Select. Tr. 33/11265 (Glick). Even Dr. Panzar (PB-T-1), a strong proponent of the use of ECPR to set rates within subclasses, agrees that deviating from ECPR may make economic sense in the case of Parcel Post.

But taking that [non-destination entry Parcel Post and Parcel Select are in the same subclass] as a given, the difference in elasticities that you pointed out suggest that, in weighing the advantages of productive efficiency, as reflected through ECPR-based discount policy versus the Ramsey-type elasticity-based price differences, that the argument in this particular example shifts more to the use of price-elasticity-based differences in setting the market....Based on these elasticities with no cross-elasticities, the inverse elasticity rule would apply fairly directly, and we would say that the markup on the workshared product would be less.

Tr. 26/9259, 9261 (Panzar).

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<sup>3</sup> As the Commission noted in Docket No. R2000-1, “[w]hile the Commission recognizes the potential perils of undue reliance on the use of own-price elasticity to guide pricing recommendations, it remains the pre-eminent empirical measure available across all classes of postal services to gauge the economic value of each.” R2000-1 Op., Para 5302.

PSA would note that the Postal Service's approach of marking up transportation costs in setting Parcel Post rates stops well short of Ramsey pricing. As discussed by Dr. Panzar, under Ramsey pricing, the markup on Parcel Select would be lower than on non-destination entry Parcel Post. On the other hand, under the Postal Service's proposal in this case, the implicit TYAR markup on Parcel Select (27 percent) would be more than double the implicit markup on non-destination entry Parcel Post (12 percent). Tr. 33/11266 (Glick).

Also, despite marking up transportation costs, the USPS rate design proposal for Parcel Post does not deviate significantly from efficient component pricing. The effective passthrough between non-destination entry Parcel Post and Parcel Select – 106 percent – only modestly exceeds 100 percent and is closer to ECP-based 100 percent passthroughs than UPS witness Luciani's proposed 90 percent passthrough of the mail processing cost avoidance. Tr. 33/11266 (Glick).

**2. WITNESS LUCIANI'S "INTERIM IMPROVEMENT" TO THE POSTAL SERVICE'S PARCEL POST MAIL PROCESSING COST AVOIDANCE MODEL SHOULD BE REJECTED BECAUSE IT SIGNIFICANTLY OVERSTATES MAIL PROCESSING COSTS FOR DDU-ENTERED PARCEL POST.**

PSA urges the Commission to reject UPS witness Luciani's "interim improvement" to the Postal Service's Parcel Post cost avoidance model (USPS-LR-L-46) because it significantly overstates the cost of DDU-entered Parcel Post, a fatal flaw since DDU parcels will comprise a majority of parcels in the Test Year. Tr. 33/11267 (Glick).

Specifically, UPS witness Luciani's "interim improvement" – changing the cost of a manual parcel sort at the delivery unit from 10.7 cents to 24.0 cents (UPS-T-2 at 14

(Luciani)) – increases the unit CRA-adjusted mail processing cost for DDU-entered parcels from 41.9 cents per piece to 53.1 cents per piece. Tr. 33/11267 (Glick).

A comparison of this 53.1-cent figure to data from the In-Office Cost System (IOCS) indicates that the cost estimate for the DDU-entered model from Luciani’s “improved” model is unrealistically high. Tr. 33/11268 (Glick). As discussed by PSA witness Glick:

In general, DDU-entered parcels avoid costs at mail processing plants<sup>4</sup> (because these parcels are deposited at the destination delivery unit and thus bypass processing at plants) and also avoid outgoing costs<sup>5</sup> at the delivery unit (because DDU-entered parcels are not “outgoing” from DDUs to other facilities).<sup>6</sup>

Thus, the costs that DDU-entered parcels would generally incur are non-outgoing costs at post offices, stations, and branches.<sup>7</sup> According to IOCS, the Test Year unit non-outgoing costs for Parcel Post parcels at

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<sup>4</sup> While he is “not familiar enough with the activities embodied within each MODS cost pool [which contain the costs for postal plants] to provide a definitive list” of MODS pools that DDU-entered parcels avoid, even witness Luciani agrees that “[i]t is likely that the activities in certain MODS cost pools treated as fixed by Postal Service witness Miller would not be generally incurred by DDU-entry parcels.” Tr. 27/9423, 9444 (Luciani). Despite his lack of familiarity, witness Luciani does list several examples of activities in MODS cost pools that he is unable to “conclude that DDU-entry parcels can avoid” – verification, computerized forwarding, and empty equipment (Tr. 27/9409 (Luciani)). However, the Test Year unit costs in MODS pools dedicated to these activities – LD49, LD79, and 1EEQMT – are small, totaling only 1.4 cents per piece. USPS-T-11 at 49 (Van-Ty-Smith); USPS-LR-L-46, Parcel Post Rev 8-2-06.xls, page 3. Witness Luciani also indicates that he is “not able to conclude that DDU-entry can avoid the costs for miscellaneous and support operations at MODS facilities.” Tr. 27/9409 (Luciani). While the unit cost in the general MODS miscellaneous and support cost pool (1SUPPF1) is 1.6 cents, the Postal Service distributes these costs to subclasses in proportion to costs in the pools they support. USPS-T-11 at 18-19 (Van-Ty-Smith). Because DDU parcels generally avoid direct costs in the supported cost pools, the Postal Service’s distribution approach indicates they will also generally avoid costs in this general support cost pool.

<sup>5</sup> Witness Luciani agrees that “as a general matter” DDU parcels avoid outgoing costs at Non-MODS facilities. Tr. 27/9410 (Luciani).

<sup>6</sup> Of course, these general rules are not absolute. For example, in Docket No. R2000-1, UPS witness Luciani found that DBMC parcels do incur some costs (outgoing, non-BMC costs) that would not have been expected. Tr. 27/9459-60 (Luciani). However, it is important to note that while DBMC parcels were found to incur some outgoing, non-BMC costs in Docket No. R2000-1, they nonetheless avoided the vast majority of these costs. In that case, the Commission found that while DBMC parcels do incur some outgoing, non-BMC costs, DBMC parcels would nonetheless avoid 56.2 cents per piece in outgoing costs in the Docket No. R2000-1 Test Year. Docket No. R2000-1, PRC-LR-17, LR17pp.xls, worksheet “DropSavings.”

<sup>7</sup> Under USPS costing methods, the mail processing costs for post offices, stations, and branches are now classified as non-MODS costs. USPS-T-11 at 27 (Van-Ty-Smith).

post offices, stations, and branches is 37.5 cents per piece, almost thirty percent less than the cost for DDU-entered parcels according to witness Luciani's "improved" model.<sup>8</sup> While this unit cost figure from IOCS is not a perfect representation of the cost of DDU-entered parcels,<sup>9</sup> the large deviation raises significant concern with the accuracy of witness Luciani's model.

Tr. 33/11268 (Glick).

Further, witness Glick identifies a reason for UPS witness Luciani's substantial overstatement of the cost of DDU-entered parcels:

A reason why witness Luciani's "improved" model results in a much higher cost estimate (53.1 cents versus the 37.5 cents I estimated using IOCS data) is that his cost model (like the Postal Service's) implicitly distributes 15.59 cents (the same amount that is distributed to all other rate categories) of mail processing costs at postal plants to DDU parcels. This results from witness Luciani's (as well as the Postal Service's) treatment of these costs as "fixed" with respect to rate category. Tr. 27/9466 (Luciani). Distributing such a large amount of costs for processing at postal plants to DDU parcels is clearly inappropriate because, as discussed above, DDU parcels bypass postal plants.

Tr. 33/11269 (Glick).

Based upon this finding, PSA recommends that "[i]f the Commission accepts witness Luciani's interim "improvement" to the Postal Service's cost model...it also distribute the vast majority of 'fixed' costs at postal plants only to non-DDU-entered parcels." Tr. 33/11269 (Glick).

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<sup>8</sup> This can be calculated by multiplying the unit non-MODS cost (41.97 cents per piece) from USPS-LR-L-46, Parcel Post Rev 8-2-06.xls, page 3 by the percentage of non-MODS Parcel Post costs that are non-outgoing (89.5 percent) from USPS-LR-L-144. The latter percentage can be calculated by dividing the Test Year non-outgoing non-MODS costs by the total Test Year non-MODS costs in USPS-LR-L-144, LR144PPBF.xls.

<sup>9</sup> For example, according to the Postal Service's parcel cost model, machinable DDU-entered parcels avoid about ten cents per piece in unloading and sack dumping costs at the delivery unit that other parcels incur. USPS-LR-L-46, Parcel Post Rev 8-2-06.xls, pages 9, 12, 15, and 18. The savings are even larger for nonmachinable and oversized parcels. All else being equal, avoiding these costs would cause the unit cost of DDU-entered parcels to be less than 37.5 cents per piece. On the other hand, DDU-entered parcels may incur some costs in MODS cost pools as well as higher non-MODS acceptance costs. Non-MODS acceptance costs represent 14 percent of costs in the non-MODS MISC cost pool. Tr. 10/2456 (Van-Ty-Smith)

**3. THE NONMACHINABLE AND OVERSIZED PERCENTAGES FOR DDU PARCELS AND THE NUMBER OF PIECES PER CONTAINER FOR DDU PARCELS IN THE PARCEL POST COST MODEL (USPS-LR-L-46) ARE REASONABLE.**

The Postal Service's estimates of the percentage of DDU parcels that would be classified as nonmachinable and oversized if entered upstream and the number of pieces per container for DDU parcels are reasonable. Given this, uncertainty in these estimates provides no reason for a reduced passthrough of mail processing cost avoidances.

In support of lower passthroughs, UPS witness Luciani states, "despite the fact that DDU parcels represent more than 50% of total Parcel Post volume, the Postal Service does not know the percentage of DDU parcels that would be classified as nonmachinable if entered upstream of the DDU. Instead, it uses a DBMC-entry/DSCF-entry data proxy for the DDU parcels in the mail processing cost model." UPS-T-2 at 19 (Luciani).

While UPS witness Luciani is correct that the Postal Service does not have data on the "the percentage of DDU parcels that would be classified as nonmachinable if entered upstream of the DDU," FedEx SmartPost (the company that tenders the majority of all Parcel Select DDU parcels to the Postal Service) does have such data for its parcels. Tr. 33/11241, 11243 (Zwieg). As shown in Table 1 below, FedEx SmartPost data indicate that the Postal Service's estimates of the percentage of DDU

parcels that would be classified as nonmachinable or oversized if entered upstream are reasonable.

**Table 1. Percentage of DDU-Entered Parcels  
(USPS Estimate vs. FedEx SmartPost Actuals)**

<b>Category</b>	<b>USPS [1]</b>	<b>FedEx SmartPost [2]</b>
Nonmachinable	6.1%	5.7%
Oversized	0.07%	0.05%

[1] Tr. 33/11244 (Zwieg) (Calculated from USPS-LR-L-46 at 1)

[2] Tr. 33/11244 (Zwieg)

Further, PSA witness Zwieg shows that the Postal Service's assumption regarding the average number of pieces per container of DDU parcels – 50.3 for machinable parcels (USPS-LR-L-46 at 21)<sup>10</sup> – is reasonable. In particular, witness Zwieg states:

While the Domestic Mail Manual (DMM) allows parcel shippers to drop a small number of Parcel Select pieces at a DDU as long as there were at least fifty pieces in the entire mailing, FedEx SmartPost data show that this is not what actually happens. This is, of course, because dropping only a small number of parcels at a DDU simply wouldn't make economic sense for the shipper.

In the company's most recent fiscal year (which ran from June 1, 2005 to May 31, 2006), FedEx SmartPost entered an average of 67 parcels per DDU delivery. In the first quarter of FY 2007, FedEx SmartPost entered an average of more than seventy Parcel Select pieces per DDU delivery.

Tr. 33/11243 (Zwieg).<sup>11</sup>

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<sup>10</sup> The Postal Service's model assumes that DDU-entered containers of nonmachinable and oversized parcels contain a much smaller number of parcels. USPS-LR-L-46 at 22-23.

<sup>11</sup> While Zwieg only has access to data for FedEx SmartPost, the average number of parcels per DDU delivery for all of Parcel Select is likely to be similar to the average for FedEx SmartPost for two reasons.

During cross examination, Zwiieg indicated that FedEx SmartPost sometimes does enter DDU parcels on two pallets. Tr. 33/11251 (Zwiieg). Given that FedEx SmartPost enters approximately seventy parcels per DDU delivery, even if FedEx SmartPost used two pallets for forty percent of DDU deliveries, it would still enter an average of approximately 50 parcels per DDU container, an amount that is equal to the conversion factor used for machinable DDU parcels in the Postal Service's cost model.<sup>12,13</sup>

Finally, it is important to note that the Postal Service's estimate of the cost of DDU-entered parcels is not particularly sensitive to the exact number of pieces per container. Specifically, the Postal Service estimates that the unit cost per machinable parcel at the DDU for moving containers from the dock is 5.3 cents per piece. USPS-LR-L-46 at 21. Changing the average number of pieces per container in the model to 45 parcels, for example, only increases the unit cost per parcel for this operation by 0.6 cents.

**4. AS DISCUSSED BY PSA WITNESS FINLEY (PSA-T-1), THE COMMISSION SHOULD TAKE THE INCREASED MAIL PREPARATION AND ENTRY COSTS THAT THE EVOLUTIONARY NETWORK DEVELOPMENT (END) WILL IMPOSE ON PARCEL SHIPPERS AND THE RESULTING USPS COST**

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First, FedEx SmartPost's Parcel Select DDU parcels comprise a majority of total Parcel Select DDU parcels. Tr. 33/11241 (Zwiieg). Second, "[d]ropping only a small number of parcels at a DDU simply wouldn't make economic sense for [any] shipper." Tr. 33/11243 (Zwiieg). Smaller parcel consolidators can avoid having to enter a small number of parcels at a DDU by entering parcels at a smaller number of DDUs than, or by entering them less frequently than, FedEx SmartPost.

<sup>12</sup> 50 DDU parcels per container = 70 parcels per DDU delivery/(1.4 containers per DDU delivery).

<sup>13</sup> Note that if a particular parcel consolidator entered a smaller number of parcels per DDU delivery, then (all else being equal), it would be less likely to enter its parcels on more than one pallet. Thus, the number of parcels per DDU delivery would be closer to the number of DDU parcels per container.

## **SAVINGS INTO CONSIDERATION WHEN EVALUATING THE RATE INCREASES FOR DBMC-ENTERED PARCELS.**

Over the next few years, the Postal Service plans to realign its network (where efficiencies can be realized) through its evolutionary network development (END) initiative. PSA-T-1 at 1-2 (Finley). As PSA witness Finley states:

Parcel sorting activities that are currently being conducted at the Postal Service's 21 bulk mail centers (BMCs) and 7 auxiliary service facilities (ASFs) will in the future be carried out at "roughly 28-100 [Regional Distribution Centers (RDCs)]." Institutional Response to PSA/USPS-T42-1.

PSA-T-1 at 1-2 (Finley)

PSA believes the goals of the END initiative are laudable and that END will likely reduce USPS costs. PSA-T-1 at 5 (Finley). PSA, however, is concerned that the END initiative is likely to significantly increase mail preparation and entry costs for parcel shippers, particularly those that enter their parcels at destination bulk mail centers (DBMCs). PSA-T-1 at 2, 5-6 (Finley).

This shift in where parcel processing will occur will have a significant impact on how parcels, particularly DBMC parcels, are prepared and entered in the Test Year. In addition to having to transport parcels to a larger number of facilities to qualify for DBMC rates, it is expected that parcels entered at RDCs will have to be prepared on pallets or in pallet boxes, rather than the current practice of bedloading these pieces. Institutional Response to PSA/USPS-T42-1(d), (h).

PSA-T-1 at 2 (Finley).

As estimated by Finley (based upon an analysis of how END will affect The Swiss Colony's parcel preparation and entry practices), the additional cost of entering mail at a much larger number of facilities to qualify for DBMC rates and to meet

expected containerization requirements is likely to be significant and to far exceed the postage savings that would result from qualifying for lower Parcel Post zone rates.<sup>14</sup>

To examine these impacts, we performed a focused study of the cost of parcels being shipped to Texas. Specifically, we compared the cost of entering bedloaded parcels at the Dallas BMC and the cost to enter these parcels at five different RDCs in Dallas, Houston, San Antonio, Austin, and El Paso on pallets. As Table 1 shows, our analysis found that the required changes in preparation would result in a net cost increase of \$0.59 - \$0.98 per parcel.... This is a huge increase (16% to 26%) considering that the postage we currently pay on these parcels averages approximately \$3.75. Further, this cost increase is in addition to any rate increases -- such as the 16 percent increase for DBMC [Parcel Post] parcels it is seeking in this case (USPS-T-37 at 22) -- USPS proposes as it rolls out its future network.

PSA-T-1 at 3 (Finley).

Despite the potential for USPS cost savings and increases in parcel preparation and entry costs for shippers from the END initiative(which are in addition to the significant increases in postage that the Postal Service is already proposing for DBMC parcels), the Postal Service has not adjusted its revenue requirement or DBMC cost avoidance models to reflect the shift in costs from the Postal Service to shippers. PSA-T-1 at 5-6 (Finley). PSA urges the Commission to take the impact of END on preparation and entry costs into account when recommending postal rates for parcels, particularly those entered at DBMCs. As Finley concluded:

We are not opposed to the progressive rationalization of USPS operational infrastructure; the objectives of END are laudable. Rather, we ask the Commission to take these increased costs into consideration when judging the fairness of the rate increases being proposed for parcels. USPS will achieve considerable cost savings from the rollout of END in the Test Year. However, neither our increased costs, nor the

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<sup>14</sup> Entering mail at a larger number of facilities to qualify for DBMC rates would not reduce postage at all for Standard Mail parcels because, unlike Parcel Post, Standard Mail rates are unzoned.

Postal Service's reduced costs are taken into account in the rates proposed by the Postal Service.

PSA-T-1 at 5-6 (Finley).

5. **THE POSTAL SERVICE'S FINAL ADJUSTMENT TO SHIFT A PORTION OF ELECTRONIC DELIVERY CONFIRMATION COSTS TO PARCEL POST IS TOO LARGE BECAUSE IT INCORRECTLY ASSUMES THAT THERE WILL BE MORE PARCEL SELECT NO-FEE ELECTRONIC DELIVERY CONFIRMATION PIECES THAN TOTAL PARCEL SELECT PIECES. TO CORRECT THIS PROBLEM, A MORE REASONABLE ESTIMATE OF PARCEL SELECT NO-FEE ELECTRONIC DELIVERY CONFIRMATION VOLUME SHOULD BE USED IN THE FINAL ADJUSTMENT PROCESS.**

PSA recommends that the Postal Regulatory Commission correct the Delivery Confirmation Final Adjustment for Parcel Post by basing it on a reasonable estimate of the number of TYAR Parcel Select no-fee electronic delivery confirmation pieces. The Postal Service's Delivery Confirmation Final Adjustment, on the other hand, is clearly wrong because it charges Parcel Post for more TYAR Parcel Select no-fee electronic delivery confirmation pieces than there are total TYAR Parcel Select pieces. Tr. 33/11269 (Glick); Tr. 27/9474-9475 (Luciani).

Specifically, the Postal Service estimates that there will be 267.8 million TYAR Parcel Select no-fee electronic delivery confirmation pieces while there will only be 244.1 million total Parcel Select pieces and not all Parcel Select pieces will take advantage of no-fee electronic delivery confirmation. Tr. 33/11269 (Glick); Tr. 27/9474-9476 (Luciani).

To eliminate this anomaly in this case, PSA urges the Commission to adopt witness Glick's proposed correction to the final adjustment:

The Final Adjustment should be modified to only charge Parcel Post for 209.7 million Parcel Select no-fee delivery confirmation pieces, the best

estimate on the record of Parcel Select no-fee delivery confirmation volume. The 209.7 million piece figure is derived by multiplying the total number of TYAR Parcel Select pieces by the FY 2005 percentage (85.9 percent) of Parcel Select pieces that use no-fee electronic delivery confirmation. Tr. 8/2152 (Kiefer); Tr. 27/9412-9413 (Luciani).

Tr. 33/11269-11270 (Glick).<sup>15</sup>

Further, to avoid anomalous forecasts of Parcel Select no-fee electronic delivery confirmation volumes in future cases, the Postal Service should consider changing its method for forecasting Parcel Select no-fee delivery confirmation to forecast them as a function of Parcel Select volume. Tr. 33/11270 (Glick).

**6. PARCEL SELECT NO-FEE ELECTRONIC DELIVERY CONFIRMATION PIECES WILL NOT INCUR WINDOW SERVICE ACCEPTANCE COSTS BECAUSE, AS DISCUSSED BY PSA WITNESS ZWIEG (PSA-RT-2), PARCEL SELECT IS NOT ENTERED AT POSTAL WINDOWS. THUS, THE COST OF PARCEL SELECT NO-FEE ELECTRONIC DELIVERY CONFIRMATION PIECES, WHICH IS USED FOR BOTH PARCEL POST RATE DESIGN AND FINAL ADJUSTMENT PURPOSES, SHOULD EXCLUDE WINDOW SERVICE ACCEPTANCE COSTS.**

The Postal Service estimates the Test Year unit cost of Parcel Select no-fee electronic delivery confirmation to be 14.67 cents per piece, including 2.85 cents per piece in costs for window service acceptance. USPS-LR-L-59, Attachment 4E. The Postal Service uses this unit cost figure in its Delivery Confirmation Final Adjustment for Parcel Post. Tr. 15/4741 (Page). Further, UPS witness Luciani recommends using this same figure in the Parcel Post rate design model. UPS-T-2 at 16 (Luciani).

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<sup>15</sup> Even though the volume of Parcel Select no-fee electronic delivery confirmation pieces used by USPS witness Page in the final adjustment is clearly wrong, USPS witness Page “would still recommend today what I did for the adjustment.” Tr. 15/4741 (Page). This would be clearly inappropriate because it would attribute to Parcel Post costs that are not reliably caused by Parcel Post. This is contrary to the definition of attributable costs. As the Commission has explained, “attributable costs means costs which can be said to be reliably caused by a subclass of mail or special service.” R97-1 Op., para. 4017.

The 14.67-cent unit cost estimate is inappropriate for Parcel Select no-fee electronic delivery confirmation. As explained by PSA witness Zwieg:

While the inclusion of window service costs in the costs for electronic delivery confirmation that is purchased by retail customers may be appropriate, it is clearly inappropriate for Parcel Select no-fee electronic delivery confirmation because Parcel Select is not entered at postal windows.

Parcel Select is a destination entry product requiring shippers to enter bulk shipments of parcels at DBMCs, DSCFs, and DDUs for delivery by the USPS. This product is not entered at the postal window of the local Post Office. FedEx SmartPost collects parcels from several hundred customers and sorts, containerizes and delivers to destination entry points through out the Postal Network. Parcels are prepared in accordance with DMM 455.4.6.1, 455.4.4, and 456.2.0.

Tr. 33/11244 (Zwieg).

To better reflect the operational reality that Parcel Select pieces do not incur window service acceptance costs, PSA urges the Postal Regulatory Commission to use a unit cost estimate of 11.82 cents per piece (the Postal Service's 14.67-cent Parcel Select no-fee electronic delivery confirmation unit cost minus the 2.85-cent unit window service cost) in the Delivery Confirmation Final Adjustment for Parcel Post and in designing Parcel Post rates. Tr. 33/11271 (Glick)

**7. PRS PIECES SHOULD BE TREATED AS NON-DESTINATION ENTRY PARCEL POST VOLUMES FOR CALCULATING THE PARCEL SELECT WINDOW SERVICE COST AVOIDANCE BECAUSE PRS COSTS ARE COUNTED AS PARCEL SELECT COSTS.**

PSA recommends that the Postal Regulatory Commission adopt USPS witness Miller's method of estimating the window service cost avoided by Parcel Select ("dropshipped") parcels because, unlike UPS witness Luciani's proposal, it is based upon a consistent treatment of PRS costs and volumes.

To calculate the window service cost avoided by Parcel Select, USPS witness Miller (USPS-T-21) subtracted the unit window service cost of Parcel Select from the unit window service cost of non-destination entry Parcel Post. USPS-LR-L-46 at 34. In developing the separate unit cost estimates for non-destination entry Parcel Post and Parcel Select, witness Miller treated Parcel Return Service (PRS) volumes as Parcel Select volumes because “it is [his] understanding that PRS mail would likely be treated as ‘dropship’ mail in the IOCS activity codes [which is the source of window service cost data]. It is also [his] understanding that it is not possible to distinguish between any PRS-related tallies and non-PRS Parcel Select tallies at this time.” Tr. 3/333 (Miller).

UPS witness Luciani, on the other hand, recommends that “[t]he Window Service worksharing cost avoidances should be calculated using PRS pieces counted as non-dropship pieces” (UPS-T-2 at 16 (Luciani)) despite Miller’s statement that “PRS mail would likely be treated as ‘dropship’ mail in the IOCS activity codes.” Tr. 3/333 (Miller). Upon cross examination, he defended his approach essentially by stating that he did not understand what Miller meant by “likely:”

The Postal Service says it was likely, therefore [USPS] included it with dropshipped. Again, without knowing how likely this was, whether it was systematic as I note in my result, or simply it happened on occasion without really knowing I’m not really sure why you would put all of it in one, in one category versus another.

Tr. 27/9478 (Luciani).

Fortunately, there is no longer a need to guess at how Miller defined “likely” in his interrogatory response because the Postal Service has since indicated that “PRS mailpieces will be systematically assigned to dropship. Institutional Response to

PSA/USPS-2.” Tr. 33/11272 (Glick). Since PRS costs will be systematically assigned to the “dropship” category, consistency dictates that PRS volumes be classified in the same manner and thus Miller’s approach is appropriate. Ibid.

**8. PER THE COMMISSION’S RECOMMENDATION IN DOCKET NO. MC2006-1, PARCEL RETURN SERVICE (PRS) PASSTHROUGHS SHOULD BE INCREASED; AND COMPETITION IN THE MARKET SUPPORTS THE COMMISSION’S RECOMMENDATION.**

In Docket No. MC2006-1 (Parcel Return Service), the Postal Rate Commission urged the Postal Service to increase PRS passthroughs in the next omnibus case to better comport with the principle of efficient component pricing. Specifically, in its decision, the Commission stated:

The Parcel Shippers Association comments that with the recent approval of an “across-the-board” rate increase for Parcel Return Service and most other postal rates and the expectation that the Postal Service will soon be filing another omnibus rate case, it is appropriate for the Settlement Agreement to maintain the discounted Parcel Return Service rates that were approved in Docket No. R2005-1. The Parcel Shippers Association acquiesces in passthroughs of roughly 50 percent as “[c]onsistent with the longstanding practice of steadily increasing passthroughs as new worksharing discounts mature[.]” The Parcel Shippers Association, however, advocates increasing these passthroughs in the next omnibus rate case to better comport with the principle of efficient component pricing. Initial Brief and Comments on Proposed Settlement of Parcel Shippers Association, January 20, 2006, at 3. The Commission concurs.

Docket No. MC2006-1 Op. at 14.

Despite this, the Postal Service proposes to only marginally increase PRS passthroughs in this case – from roughly 50 percent in Docket No. MC2006-1 to about 61 percent for RDU parcels and about 54 percent for RBMC parcels in this case. USPS-LR-L-82, WP-PP-39. PSA urges the Commission to correct this by lowering all of the

Postal Service's proposed PRS rates by 20 cents. PSA/POSTCOM-T-1 at 14 (Glick).

As Glick states:

This will yield rates that better comport with the Commission's longstanding practice of steadily increasing passthroughs as worksharing discounts mature while still guarding against a potential overstatement of cost savings, USPS-T-37 at 13, and would comport with the Commission's Opinion in Docket No. MC2006-1. Op at 14.

PSA/POSTCOM-T-1 at 14 (Glick).

In addition to being more consistent with the Commission's longstanding practice, PSA's proposal will benefit consumers. As PSA witness McAlpin testified:

Since consumers typically pay for the return shipping, higher Postal prices are likely to trickle down to the consumer and directly impact the consumer's shopping experience.

PSA-T-1 at 2 (McAlpin).

As PSA witness McAlpin further pointed out, UPS Ground has increased its focus on the returns market opportunity and has aggressively targeted direct mailers with a "bundle" offering, aggregating retailers' forward and return volumes under one discount structure. PSA-T-2 at 4 (McAlpin). He also pointed out that UPS has offered very aggressive return service focusing on gaining returns clients in the direct retail market, offering prices at 21 percent below their closest competitor, and 33 percent below USPS Parcel Post rates, often in an effort to secure the client's forward shipping volume. *Id.* at 5.

Mr. McAlpin also points out, however, that given the choice, customers overwhelmingly choose USPS to ship their returns. PSA-T-2 at 7 (McAlpin). USPS's core return service is a pre-paid, pre-addressed label. McAlpin points out the continuing, growing importance of the return service to the customer; they see the return process as an essential part of buying direct mail. *Id.* at 9. McAlpin points out that "USPS Parcel Return Service rates are not competitive with the market." *Id.* However, as the Commission itself recommended in MC2006-1, more of the costs

savings need to be passed through to justify lower and more competitive Parcel Return Service rates.

**9. THE POSTAL SERVICE'S SHAPE-BASED RATE DESIGN PROPOSALS IN FIRST-CLASS MAIL AND STANDARD MAIL HAVE GONE TOO FAR, TOO FAST. USPS HAS PROPOSED ENORMOUS RATE INCREASES FOR PARCELS AND NOT FLAT-MACHINABLES BASED UPON INADEQUATE DATA AND WITHOUT GIVING DUE CONSIDERATION TO IMPACT.**

As discussed in the testimony of PSA/POSTCOM witness Glick (PSA/POSTCOM-T-1), PSA urges the Commission to significantly moderate the huge rate increases that the Postal Service is proposing for Standard Mail parcels and NFM<sup>16</sup> and First-Class Mail parcels for three reasons.

The rate increases should be reduced simply to avoid rate shock.

The quality of data underlying the Postal Service's proposal does not meet the "high bar" that should be required in support of huge rate increases.

The rate increases for Standard Mail and First-Class Mail parcels are inappropriately based upon passthroughs of 100 percent or more of shape-based cost differences.<sup>17</sup> Given the combination of rate shock and data quality concerns, less-than-full passthroughs are more appropriate.<sup>18</sup>

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<sup>16</sup> In general, NFM<sup>s</sup> are Standard Mail pieces that are "rigid" or between ¾" and 1¼" thick. USPS-T-36 at 21-22 (Kiefer).

<sup>17</sup> The shape-based passthrough underlying the rate increases for Standard Mail NFM<sup>s</sup> is unknown because the Postal Service has no IOCS data at all on the costs for these pieces and the modeled cost data are questionable. PSA/POSTCOM-T-1 at 11-12 (Glick).

<sup>18</sup> In the absence of elasticity differences, PSA agrees with Dr. Panzar that, to promote efficiency, shape-based passthroughs within a subclass should ultimately be set equal to 100 percent based upon the

As discussed below, a better approach is to implement the classification changes proposed by the Postal Service, but based upon less than-full passthroughs.<sup>19</sup> This will allow the Postal Service to develop better information on the costs and characteristics of Standard Mail parcels and NFMs and First-Class Mail parcels without the rate shock that the Postal Service proposal would impose.

Specifically, PSA urges the Commission to lower the average rate increase for Standard Mail parcels to no more than thirty percent and to make similar downward adjustments to the Postal Service's proposed rates for First-Class Mail parcels and Standard Mail NFMs. PSA/POSTCOM-T-1 at 8-13 (Glick).

**a) *The rate increases should be reduced simply to avoid rate shock.***

According to USPS estimates, the proposed rate increases for Standard Mail parcels and NFMs and First-Class Mail parcels are huge and much larger than rate increases that the Postal Service has found to be acceptable in other classes of mail.

While USPS witness Kiefer limited all Parcel Post rate increases to 30 percent because “[i]f I had not constrained the preliminary rates, many Parcel Post rate cells would have experienced unacceptably larger rate increases,” USPS-T-37 at 17 (Kiefer), the average rate increases proposed for Standard Mail parcels and NFMs are much

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efficient component pricing rule (ECPR). PB-T-1 at 45-47 (Panzar). As Dr. Panzar explains, “The basic economic argument in support of cost-based rate differentials is the same as that for avoided cost worksharing discounts. Mailers can act to minimize end to-end costs only if the difference in rates for mail with differing characteristics reflects differences in the costs incurred by the Postal Service.” PB-T-1 at 45-46 (Panzar). In this case, progress towards the efficient component pricing of shape-based cost differences should, however, be tempered by rate shock and data quality concerns.

<sup>19</sup> PSA believes that this approach is consistent with the Postal Service's principal goal in this docket – “establish[ing] separate classifications with meaningful price differentials that lead to the efficiencies that the proposals intend to induce.” USPS-RT-11 at 6 (Kiefer).

higher than thirty percent and the average rate increase for First-Class Mail parcels equals thirty percent.

The proposed rate increase for Standard Mail parcels averages nearly fifty percent with the rate increase for some Standard Mail parcels exceeding eighty percent. Tr. 5/949 (Kiefer); USPS-LR-L-36, WP-STDREG-27.

The proposed rate increase for First-Class Mail parcels averages thirty percent with the rate increase for 20 percent of First-Class Mail parcels approaching 100 percent and the rate increase for nearly half of First-Class Mail parcels exceeding 40 percent. Tr. 16/4867-8, 4874 (Taufique).

The proposed rate increases for Standard Mail NFMs range from nearly sixty percent to more than 200 percent. USPS-LR-L-36, WP-STDREG-27.

Further, the increase for many Standard Mail parcels and NFMs will be even more severe than estimated by the Postal Service. As discussed in Section 4 above, shippers that enter their Standard Mail parcels at DBMCs will incur additional mail preparation and entry costs in the test year due to the Postal Service's END initiative. PSA-T-1 at 3 (Finley). Also, changes in mail preparation rules will cause many NFMs to fall back in presort and thus pay a higher rate than estimated by the Postal Service. PSA/POSTCOM-T-1 at 12-13 (Glick).

Thus, simply to avoid rate shock, PSA urges the Postal Regulatory Commission to moderate the rate increases proposed for Standard Mail parcels and NFMs and First-Class Mail parcels.

- b) *The quality of data underlying the Postal Service’s proposal does not meet the “high bar” that should be required in support of huge rate increases.***

As discussed by USPS witness Kiefer (USPS-T-36), one benefit of the Postal Service’s parcel pricing proposal in this case is that “[i]t gains visibility for these parcels in the Postal Service’s cost and volume reporting systems. Because of this enhanced visibility, we will expect to have much better information on which to base pricing decisions for parcels in the future.” USPS-T-36 at 17 (Kiefer). PSA agrees. However, the Commission must base its recommendation in the case on the “much worse” information that is currently available.

PSA thus urges the Commission to mitigate the rate increases for Standard Mail parcels and NFMs and First-Class Mail parcels<sup>20</sup> based upon the significant uncertainty in existing USPS cost by shape data for parcels and NFMs in subclasses where they

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<sup>20</sup> As PSA/POSTCOM witness Glick noted in his testimony, “the Commission could reduce the proposed first-ounce rate for First-Class Mail parcels by ten cents and still generate more revenue than the Postal Service originally projected from these pieces. This is because Taufique recently filed errata shifting First-Class Mail Business Parcel volumes back to higher-revenue categories. This change, which increased TYAR parcel revenue by nearly \$50 million, was necessary to ensure that the mail mix assumptions underlying his revenue forecast are consistent with those underlying the USPS TYAR cost estimate.” PSA/POSTCOM-T-1 at 10 (Glick). Since witness Glick’s testimony was filed, the Postal Service has advocated fixing the inconsistency in mail mix assumptions between Taufique’s revenue and cost estimates by adjusting the Postal Service’s cost estimate, rather than adjusting the revenue estimate. Response of USPS witness Taufique to POIR No. 16, Question 10. PSA believes that this approach is inferior because it requires the use of cost data for which “[t]here are important caveats and concerns...suggesting caution in their use.” Response of USPS witness Smith to POIR No. 16, Question 1.

represent only a small portion of volume. As discussed by witness Glick, the data quality “bar” should be set high when huge rate increases are being proposed.

The data quality “bar” should be set much higher in support of huge rate increases than for those that are in line with the overall average increase. Due to concerns about rate shock, it should be undeniably clear that the data used to justify huge rate increases support the proposal.

PSA/POSTCOM-T-1 at 5 (Glick).

The quality of USPS financial information for parcels in mail classes where they comprise only a small percentage of volume does not meet this high bar and the quality of data regarding NFM’s is even worse. For example:

“On their face, the test year unit attributable mail processing costs for parcels are clearly anomalous for at least some subclasses, with unit costs for First-Class Presort Parcels at \$3 and for Standard ECR Parcels at more than \$24. USPS-T-13, Attachment 14. Such results make it impossible to have complete confidence in the unit costs provided for parcels.” PSA/POSTCOM-T-1 at 6 (Glick).

“An unknown number of Standard Mail pieces that have parcel characteristics are not identified as such in the RPW by Shape Report totals. In contrast, the principal source of mail processing information, the IOCS, identifies the shape of Standard Mail based on its physical characteristics so there are cases where IOCS would identify a Standard Mail item as a parcel when the RPW would report it as a flat.” Tr. 5/956 (Kiefer).<sup>21</sup>

In discussing Periodicals, USPS witness Harahush stated, “A very small error in classification from major shape (flat) to one of the minor shapes (parcels) would be magnified in the small shape estimate.” Tr. 13/3631 (Harahush).

“The Postal Service has even less data regarding the unit cost and mail characteristics of Standard Mail NFM’s than for parcels. The Postal Service has no CRA unit cost data at all for these pieces. Rather, as discussed above, these pieces are often counted as parcels by IOCS and flats by RPW. USPS-T-36 at 22. Also, while witness Miller (USPS-T-21) modeled the mail processing costs for these pieces, the accuracy of these cost estimates is questionable given that, according to McCrery, “the [mail] flows [for these pieces] can not be mapped out

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<sup>21</sup>While USPS witness Smith (USPS-T-13) makes an adjustment to Standard Regular parcel costs to attempt to fix this inconsistency, an alternative adjustment would have resulted in a much larger downward adjustment to these costs. PSA/POSTCOM-T-1 at 7-8 (Glick).

until the preparation is finalized.” Response to POIR No. 5, Question 1(e)-(l) (Tr. 11/3009).” PSA/POSTCOM-T-1 at 11-12 (Glick).

“Further, as noted by Loetscher (USPS-T-28), USPS does not have much data on the characteristics of NFMs either – ‘we don't know much about how the pieces that will be hybrid will shake out and how large the mailings are, what type of entry.’ Tr. 7/1569.” PSA/POSTCOM-T-1 at 12 (Glick).

“The Postal Service’s estimate of the volume of NFMs is also quite uncertain. The Postal Service’s NFM volume estimate is based upon a study of only 1,743 Standard Mail non-letter pieces. Consequently, the confidence intervals around the NFM volume estimates are large. Responses of USPS witness Loetscher to Questions by Commission During Oral Testimony, Questions 1 and 2.” PSA/POSTCOM-T-1 at 12 (Glick).

- c) *The rate increases for Standard Mail and First-Class Mail parcels are inappropriately based upon passthroughs of 100 percent or more of shape-based cost differences. Given the combination of rate shock and data quality concerns, less-than-full passthroughs are more appropriate.***

As discussed above, given the combination of rate shock and data quality concerns, Standard Mail and First-Class Mail parcel rates should be based upon less-than-full passthroughs in this case. This, however, is not the case under the Postal Service’s proposal. As PSA explained in its response to Notice of Inquiry (NOI) No. 2, the appropriate way to calculate shape-based passthroughs is by comparing the entire revenue difference by shape with the total cost difference by shape.

As the Commission accurately noted in its NOI, “it is often difficult to separate the cost effects of shape from weight.” Comparing the *entire* shape-based revenue difference with the *entire* shape-based cost difference does not require these two effects to be disentangled. The comparison we recommend simply ensures that the combined effect of differences in shape and weight are appropriately reflected in the combination of shape-based and weight-based rates.

Ensuring the proper relationships between shapes by analyzing passthroughs at the aggregate level provides significant flexibility to

design shape-specific rates that are appropriate for the particular shape at a more detailed level.

PSA Response to NOI No. 2 (July 26, 2006) at 3.

Calculated using this appropriate approach, the effective shape-based passthrough for Standard Mail parcels under the Postal Service proposal is 112 percent while the shape-based passthrough for First-Class mail parcels is 100 percent.

PSA/POSTCOM-T-1 at 4, 10 (Glick). These passthroughs are clearly inappropriate given the rate shock and data quality concerns discussed above.

**10. PSA SUPPORTS THE POSTAL SERVICE'S PROPOSAL TO ENHANCE DROPSHIP DISCOUNTS FOR STANDARD MAIL PARCELS AND RECOMMENDS EXTENDING THESE ENHANCED DISCOUNTS TO STANDARD MAIL NFMS AND STANDARD MAIL DBMC PARCELS.<sup>22</sup>**

PSA urges the Commission to recommend USPS witness Kiefer's proposal to enhance dropship discounts for Standard Mail parcels. In addition to providing shippers with the opportunity to "offset some of the increases" (USPS-T-36 at 5 (Kiefer)), the enhanced dropship discount better reflect the higher cost savings from dropshipping parcels than letters and flats.

While one goal of my parcel pricing is to increase the coverage on Standard Mail parcels, it is also designed to encourage cost-saving behavior. To further this end, I have increased the discounts for dropshipping parcels above what is being offered to letters and flats. Higher destination entry discounts recognize the fact that parcels generally are more costly to transport and move about due to their larger size, so avoiding these operations would be expected to result in larger postal savings.

USPS-T-36 at 18-19 (Kiefer).

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<sup>22</sup> The Postal Service does propose enhanced dropship discounts for Standard Mail parcels, but the "enhancement" to the DBMC discount for Standard Mail parcels is much smaller than for DSCF and DDU parcels. USPS-LR-L-36, WP-STDREG-26; PSA/POSTCOM-T-1 at 9 (Glick).

PSA, however, does recommend that the Commission make two changes to the USPS proposal to further encourage cost-saving behavior and allow additional opportunities to offset some of the huge rate increases being proposed for parcels and NFMs. First, the “enhancement” to the DBMC discount should be increased to bring it in line with those for DSCF and DDU entry.

Kiefer...did not significantly “enhance” the dropship discounts for DBMC-entered parcels. Kiefer increases the dropship discounts for parcels through the use of multipliers (1.2 for DBMC entry, 2.2 for DSCF entry, and 2.7 for DDU entry) on the “normal” Standard Mail dropship discounts for Standard Mail letters and flats. USPS-LR-L-36, WP-STDREG-26. Consistent with the multipliers for DDU and DSCF entry, I recommend increasing the multiplier for DBMC parcels to 2.2.

Enhancing the DBMC discount is particularly important for two reasons. Currently, about half of Standard Regular parcels are origin-entered. USPS-LR-L-36, WP-STDREG-30. These parcels are much more likely (in the short term) to be able to “offset some of the increases” by converting to DBMC entry. Second, as discussed above, shippers will likely incur more costs to enter parcels at the DBMC in the Test Year.

PSA/POSTCOM-T-1 at 9-10 (Glick).

Second, the enhanced dropship discounts should be offered to Standard Mail NFMs because NFMs, like parcels, “generally are more costly to transport and move about due to their larger size, so avoiding these operations would be expected to result in larger postal savings.” Further, extending the enhanced dropship discounts to NFMs will “encourage efficient entry of NFMs and [the efficient practice of] merging of these pieces into the Standard Mail parcel mailstream.” PSA/POSTCOM-T-1 at 11 (Glick).

## CONCLUSION

Because of changes in the methods used for attributing mail processing, delivery, and other costs, there has been a significant increase in the attributable cost of packages. By itself, this would tend to yield larger increase in the rates for packages. However, in this case, the Postal Service has compounded the impact of these increased costs through the allocation of costs that will not be incurred by Parcel Post (e.g., the allocation to Parcel Post of window service acceptance costs for Parcel Select parcels that are not entered at postal window); and the use of very flawed data to guess at the impact of shape on cost. The combination of these two factors has led to very large increases for almost all parcels and what can only be described as astronomical rate increases for packages in certain classes.

The Postal Service's zeal to obtain additional revenue from differently shaped mail, that is, non-letter non-flat mail, in First-Class Mail and Standard Mail has led it to totally disregard the inadequacy of its cost by shape data and the application of criterion 4 to the gigantic increases the Postal Service has proposed:

Rate increases for some First Class Mail parcels that approach 100 percent;

Rate increases for Standard Mail NFMs that range from 60 percent to more than 200 percent;

An average rate increase for Standard Mail parcels of 50 percent with some increases exceeding 80 percent.

So much of the imputation of costs to justify these large increases is based upon Postal Service guesses of the impact of shape, and when the data is not that firm, it

should not become the basis for increases of these amounts in contravention of the impact criteria of the Act.

A viable approach to eliminate these kinds of horrendous rate increases is to implement the Postal Service's new approach using less than full passthroughs, and giving due account to the larger weight-based revenues for packages as compared to letters and flats.

There is no reason to limit Parcel Post increase to 30 percent (a reasonable limit that we support), but not apply that same cap to Standard Mail and First-Class Mail packages.

Finally, it is inexplicable why the Postal Service would not follow the admonitions of this Commission in Docket No. MC2006-1 to increase the percentage of the cost avoidance passthroughs for the Parcel Return Service.

Respectfully submitted,

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