
**BEFORE THE
POSTAL REGULATORY COMMISSION**

Docket No. R20061

POSTAL RATE AND FEE CHANGES, 2006

JOINT REPLY BRIEF

CONCERNING THE REVENUE REQUIREMENT

OF

**DIRECT MARKETING ASSOCIATION, INC.
ALLIANCE OF NONPROFIT MAILERS
ASSOCIATION FOR POSTAL COMMERCE
CONTINUITY SHIPPERS ASSOCIATION
DMA NONPROFIT FEDERATION
DOW JONES & COMPANY, INC.
MAGAZINE PUBLISHERS OF AMERICA, INC.
THE MCGRAW-HILL COMPANIES, INC.
MAIL FULFILLMENT SERVICES ASSOCIATION
MAIL ORDER ASSOCIATION OF AMERICA
MAJOR MAILERS ASSOCIATION
NATIONAL NEWSPAPER ASSOCIATION, INC.
NATIONAL POSTAL POLICY COUNCIL
PARCEL SHIPPERS ASSOCIATION
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**BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, D.C. 20268-0001**

POSTAL RATE AND FEE CHANGES, 2006

Docket No. R2006-1

**JOINT REPLY BRIEF
CONCERNING THE REVENUE REQUIREMENT**

I. INTRODUCTION

On behalf of itself and the other parties identified on the front cover (referred to collectively as the “Consortium”),¹ Direct Marketing Association, Inc. (“DMA”) respectfully submits this joint reply brief, which responds to several arguments made by the Postal Service in its initial brief (“USPS Br.”) concerning the size of the revenue requirement. In the proper exercise of its statutory authority and responsibility, the Postal Regulatory Commission (the “Commission”) should reduce the revenue requirement in accordance with the principles enumerated herein and in our initial brief (“Cons. Br.”).

As an initial matter, the Consortium is disappointed that the Postal Service has treated the important matter of the overall revenue requirement in a summary, almost offhand, manner. The entire presentation takes a mere nine pages.² The Postal Service devotes barely one page to the issue of the proper treatment of costs of supervisors³ and fewer than four pages supporting its

¹ DMA has been authorized to state that these parties wish to associate themselves with the views expressed herein.

² USPS Br. at 6-14.

³ *Id.* at 10-11.

claim that it needs a contingency provision of \$767,000,000.⁴ The brevity of the USPS presentation on matters of this importance, where substantially more than three-quarters-of-a-billion dollars is at stake, is a tacit acknowledgement of the weakness of the USPS position.

II. THE COMMISSION SHOULD MAKE ITS DECISIONS IN THIS CASE WITH A SHARP EYE ON THE REVISED REGULATORY LANDSCAPE CREATED BY THE POSTAL ACCOUNTABILITY AND ENHANCEMENT ACT.

As an initial matter, we would like to re-emphasize the importance of a critical point made by the Consortium in its initial brief,⁵ to which the Commission's attention is respectfully directed. The Consortium urges the Commission, with its new responsibilities, to make its rate recommendations in this case on the basis of a careful analysis of the Postal Accountability and Enhancement Act⁶ and an understanding of where the instant proceeding fits into the larger postal-rate-making picture.

In this connection, the Consortium would like to emphasize the following salient feature of the postal-rate landscape of the future.

The new system is "heads the USPS wins; tails the mailers lose" -- in the following sense. If the Postal Service is able to keep its cost increases below the overall rate of inflation,⁷ it can charge rates high enough to realize significant positive net revenue, which it is authorized

⁴ *Id.* at 8-10, 11-13. USPS witness Loutsch devoted fewer than three pages to this subject in his direct testimony, USPS-T-6 at 62-64, and USPS rebuttal witness Lyons spent only slightly more than four pages on this subject in his rebuttal testimony, USPS-RT-3 at 9-13.

⁵ Cons. Br. at 16-19.

⁶ Public Law 109-435 (hereinafter, the "PAEA").

⁷ *See* 39 U.S.C. §3622(d)(1)(A), as amended by section 201 of the PAEA. (For ease of reference, sections of Title 39 of the United States Code as amended by the PAEA will be referred to hereinafter as, *e.g.*, "New Section" 3622(d)(1)(A)).

to retain.⁸ Thus, the USPS wins. If, on the other hand, the Postal Service is not able to keep its cost increases below the rate of inflation, it has the right to seek higher rate increases pursuant to a truncated proceeding under New Section 3622(d)(1)(E).⁹ Under these circumstances, the mailers lose, because the bargain underlying the PAEA (*i.e.*, that the USPS will gain pricing flexibility in exchange for keeping rate increases below the rate of inflation) will have been eviscerated.

As a result, the Commission should take particular care to avoid building fat into the revenue requirement in this case. The Postal Service should have to earn any “profits” in FY 2008 and future years. It should not have a three-quarters-of-a-billion revenue cushion handed to it on a silver platter at the mailers’ expense.

⁸ H. R. Rep. No. 109-66, 109th Cong., 1st Sess. 43 (April 22, 2005) [to accompany H.R. 22] (“By maximizing gains and minimizing costs, the Postal Service could generate earnings that would be retained, and which could be distributed as incentives to management as well as to employees through collective bargaining.”)

⁹ New Section 3622(d)(1)(E) provides for an “expedited” proceeding to last no more than 90 days during which the Commission will need to decide only whether the increase is “due to either extraordinary or exceptional circumstances,” whether the increase is “reasonable and equitable,” and whether the increase is “necessary to enable the Postal Service, under best practices of honest, efficient, and economical management, to maintain and continue the development of postal services of the kind and quality adapted to the needs of the United States.” The details of how such a proceeding will be handled remain to be worked out, of course. One critical aspect remains clear, however. As in 1970, the Postal Service does not have shareholders or other sources of capital that can be tapped if the standards for rate adjustments under New Section 3622(d)(1)(E) are not met. If the Postal Service really needs more money, there is only one place to get it -- from the mailers. Thus, the need for vigilance over USPS expenditures will be more important than ever before.

III. THE USPS UNDERESTIMATES THE SAVINGS CREATED BY THE ROLLFORWARD PROGRAM FOR SUPERVISORS.

As the Consortium explained in its initial brief, the logic of the rollforward implies that cost reductions for supervisors should accompany those for the crafts supervised.¹⁰ Rather than adhering to this logic, the Postal Service applies an ad hoc procedure to supervisors cost reductions, which substantially understates their savings and overstates the revenue requirement.¹¹

The Postal Service's position – that supervisory hours do not change in proportion to changes in hours of the craft supervised – depends on the unsupported conjecture that cost reductions programs for crafts somehow change the work environment, thus changing the supervisory span of control. The Postal Service, however, provides no record evidence to support this conjecture. To the contrary, DMA witness Buc examined the descriptions of the cost reduction programs and found that many programs will not change the work environment to any substantial degree. His analysis of the Postal Service's own job descriptions also contradicts this critical USPS assumption.

On the other hand, testimony from the Service does support DMA's position. Specifically, Postal Service rebuttal witness Oronzio stated that the ratio of craft to supervisors has been 22 to 1 recently. Thus, according to Oronzio's own numbers, the workhours of supervisors do retain a proportionality with the craft hours, just as witness Buc's method suggests.

¹⁰ Cons. Br. at 4-8.

¹¹ See USPS Br. at 10-11.

In short, the Postal Service’s lengthy descriptions of its cost reduction programs is a red herring, which should not be allowed to mask the way supervisor costs behave in reality. The Commission should adopt the approach to estimating supervisor costs in the test year proposed by witness Buc.

IV. A CONTINGENCY OF ZERO PERCENT IS REQUIRED IN THIS CASE.

The weakness of the Postal Service’s attempt to justify its request for a contingency of \$767,000,000 is reflected in the brevity of its presentation, which comprises no more than four pages in its 400-page initial brief.¹² Moreover, those four pages are replete with important errors and misstatements, the most significant of which are listed below.

1. At page 8 of its initial brief, the Postal Service repeats its position that the size of the contingency is a matter of “postal management’s financial policy decision.”¹³ To the contrary, as the Consortium explained in its initial brief, a contingency must be no larger than is “reasonable,” and the size of a “reasonable” contingency depends on the facts of each case and is properly a matter for Commission determination.¹⁴

2. At page 9, the Postal Service repeats witness Lyons’ testimony that a contingency “is designed to maintain stability in achieving the break-even mandate.”¹⁵ As the Consortium explained in its initial brief, the contingency was never designed to maintain rate stability, and

¹² USPS Br. at 8-10, 11-13.

¹³ *Id.*, at 8; see also *id.* at 9 (“judgment of postal management”).

¹⁴ Cons. Br. at 9-13.

¹⁵ USPS Br. at 9.

any role that it may have played in maintaining rate stability in the past has dissolved in the annual-rate-increases environment ushered in by the PAEA.¹⁶

3. At page 9, the Postal Service states that, “[t]he passage of postal reform legislation brings new uncertainties in the context of a changed business and regulatory environment.”¹⁷ The only elaboration on this rather amorphous statement is contained in a footnote, where the Postal Service claims that the costs imposed by the PAEA will “outweigh” the savings made possible by the PAEA and that the PAEA will have “a significant negative effect on estimated test year net income.”¹⁸ The Consortium readily admits that the new environment contains many uncertainties, but the claim that the PAEA will have a “significant negative” impact on USPS finances is another matter. This claim is totally unsupported and is contradicted by a number of provisions of the PAEA, such as New Section 603 and New Title IX – Compensation for Work Injuries. The former shifts the funding of the Postal Regulatory Commission and the Office of the Inspector General of the Postal Service from the Postal Service to the Congress, and the latter provides that, “[a] Postal Service employee is not entitled to compensation or continuation of pay for the first 3 days of temporary disability.” Both of these provisions will reduce Postal Service costs. Thus, it appears to us to be equally likely that the PAEA will contribute positively to USPS finances, in which case it would provide yet another reason for a zero-percent contingency.

4. At page 9 of its initial brief, the Postal Service claims that a contingency of one percent is “significantly below the reasonable expected range for contingencies intended by the

¹⁶ Cons. Br. at 16-19.

¹⁷ USPS Br. at 9

¹⁸ *Id.* at 7, fn 5.

Act.”¹⁹ Then, at page 11, the Postal Service asserts that, “the legislative history [of the Postal Reorganization Act] cites a range of 3 to 5 percent as reasonable” for a contingency provision.²⁰

These assertions are made without citation, and counsel knows of no evidence that Congress had formed any intent concerning the size of a “reasonable” contingency when it passed the Act in 1970.²¹ Nor is counsel aware that such evidence has ever been cited to this Commission in connection with its many deliberations on this issue over the past 35 years.²²

¹⁹ *Id.* at 9.

²⁰ *Id.* at 11.

²¹ The statutory language that the revenue requirement include a “reasonable provision for contingencies” was contained in the original House Committee bill, H.R. 11750, 91st Cong., 1st Sess. §1201(b) (May 28, 1969), and was simply carried over into the Act without modification. Moreover, the contingency provision was not the subject of any significant Congressional attention. It was mentioned only once in the various committee reports, and at no time was the size of a “reasonable” contingency addressed. H.R. Rep. No. 988, 91st Cong., 2d Sess. 15-16 (April 8, 1970) [To accompany H.R. 4] (no mention of a contingency provision); H.R. Rep. No. 1104, 91st Cong., 2d Sess. 18-20 (May 19, 1970) [To accompany H.R. 17070] (no mention of a contingency provision); S. Rep. No. 912, 91st Cong., 2d Sess. 14 (June 3, 1970) [to accompany S. 3842] (“Starting with the estimated total costs for the period, including a reasonable reserve for contingencies, the Board must first . . .”); (H.R. Rep. No. 1363, 91st Cong., 2d Sess. 87 (August 3, 1970) [Conference Report - Statement of the Managers on the Part of the House] (no mention of a contingency provision). Some have argued over the past 35 years that the Report of the Kappel Commission (“Towards Postal Excellence -- The Report of the President’s Commission on Postal Organization”) is helpful in interpreting Congressional intent. That is a difficult case to make in most circumstances. On the size of a contingency provision, that issue does not arise, because the Kappel Report did not address the issue, either. It stated simply,

“*The Budgetary Standard.* The principal purpose of a rate structure is to provide the revenues necessary to sustain the enterprise. Privately-owned utilities are entitled to recover all of their legitimate economic costs, such as operating expenses, depreciation, interest on debt, profit for equity capital, a reserve for contingencies and an allowance for research and development, where appropriate. This overall revenue requirement may be termed the ‘budgetary standard.’” (Kappel Report at 129).

Thus, counsel is at a loss to understand the basis on which the Postal Service thinks that the legislative history of the Act supports a contingency provision of any particular size, much less one in the range of 3 - 5 percent.

²² This issue is discussed in more detail in the Consortium’s initial brief. Cons. Br. at 16, fn 49.

5. At pages 12-13, the Postal Service discusses the size of its anticipated cash balance at the end of the test year and certain issues related to the size of the Postal Service's equity, including issues relating to its very substantial real estate holdings. Regardless of the relative merits of the various statements made by witnesses Buc, Loutsch and Lyons on these subjects,²³ the Postal Service simply fails to address the critical point -- thereby tacitly acknowledging it. The point is that the Postal Service is in a strong financial position and has the ability to withstand any reasonably foreseeable financial challenge during the test year.²⁴

V. CONCLUSION

Even if the PAEA had not been enacted, the record in this proceeding would not have justified imposing on mailers a financial obligation of more than three-quarters-of-a-billion dollars to pay for a "contingency." The financial position of the Postal Service is more than ample to permit it to cope with any reasonably foreseeable adverse financial event(s).

Now that the PAEA has become law, however, and now that annual increases in postal rates are virtually assured, the case against a contingency of any significant size is compelling. Any such contingency would operate against the incentives incorporated into the PAEA, and it would be contrary to the basic principles underlying the flexibility that the PAEA gives to USPS

²³ The Postal Service has made no attempt to rebut the DMA analysis (Buc, DMA-T-1 at 15-17) showing that the market value of its real estate holdings substantially exceeds book value. Thus, the value the Postal Service will realize from real estate sales between now and the Test Year will increase the equity shown on the USPS financial statements by some amount, which will be substantial even if the precise amount is currently unknown. The point is that the TYAR equity currently estimated by the Postal Service is understated -- or at least extremely conservative.

Also, for the purpose of gauging the ability of the Postal Service to cope with unexpected outcomes, the average cash balance during the year is the relevant measure, not the cash at the end of the year, as argued by the Service. This number is \$5.588 billion. Thus, the Postal Service can easily cope with adverse outcomes without a contingency.

²⁴ For further discussion, *see* Cons. Br. at 13-15.

management. The Commission simply cannot, consistent with its new statutory responsibilities, ignore these realities.

Accordingly, for the reasons stated above and in our initial brief, the Commission should reduce the Postal Service's estimated revenue requirement for the Test Year by reducing supervisors' costs and incorporating a provision for contingencies of zero percent. It should then recommend rates that are estimated to produce revenues the equal the total revenue requirement "as nearly as practicable."

Respectfully submitted,

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