

**BEFORE THE
POSTAL REGULATORY COMMISSION**

POSTAL RATE AND FEE CHANGES, 2006

DOCKET NO. R2006-1

**REPLY BRIEF OF
UNITED PARCEL SERVICE**

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United Parcel Service submits this reply brief to respond to a number of the arguments made in the initial briefs. We have already dealt with many arguments in our initial brief, so we discuss only those which seem most likely to confuse or mislead concerning the evidence in the record.

I. The Postal Service Has Failed to Raise Any Meaningful Criticism of Dr. Geddes' Priority Mail Cost Coverage Proposal.

The Postal Service brands Dr. Geddes' modest cost coverage proposal of 163% for Priority Mail -- among the lowest Priority Mail cost coverages ever adopted by the Commission outside of a settled case (Docket No. R2005-1, PRC Op., App. G, Sch. 3) -- as "self-serving." See, e.g., Postal Service Brief at 156. Dr. Geddes has a long and distinguished career of independently addressing postal policy issues outside of the adversarial rate case context. See Attachment to UPS-T-3. His testimony is no more "self-serving" than that of any of the other experts who have testified on behalf of mailer groups, which seek the lowest possible rates for their subscribing members. He has presented a detailed and thoughtful analysis of Priority Mail and how the statutory ratemaking factors should be applied to such a competitive service, an analysis that is

far more complete than that of the Postal Service's rate level witness. See USPS-T-31 at 20-23 and Tr. 32/10742-55. He deserves better than the Postal Service's back-of-the-hand "self-serving" label.

The Postal Service centers its own "self-serving" arguments on brief almost exclusively on its apparent preoccupation with "avoid[ing] harm to the Postal Service's market position." Postal Service Brief at 155. For reasons explained by Dr. Geddes (UPS-T-3 at 9-11), that preoccupation is misplaced. As the Commission stated in its comprehensive decision in Docket No. MC95-1 at ¶ 2122: "In those areas not protected by the statutory monopoly, the overall welfare of both mailers and society as a whole may be better served if mail moves at the lowest combined cost for the sender and the Service, regardless of its impact on postal volume." At any rate, and contrary to the Postal Service's protests (Postal Service Brief at 155), Priority Mail volume is actually growing at a rate greater than its historical average (Tr. 26/9119-20), despite a substantial volume shift to First-Class Mail from the weight breakpoint change in 1999. See Tr. 32/10758-60.

We will not respond in detail to the Postal Service's mischaracterization of Dr. Geddes' testimony on the effect of the settlements in Docket Nos. R2001-1 and R2005-1, which occupies such a large part of the Postal Service's discussion. See Postal Service Brief at 151-54. Suffice it to say that neither UPS nor Dr. Geddes has ever claimed that any parties were "denied the opportunity to raise any issue" in those

cases, nor have we ever sought to “devalue[] the Commission’s careful deliberations” in those cases. Postal Service Brief at 152. As the Postal Service acknowledges (Brief at 152-53), UPS supported the settlements in those cases. But, as the Commission noted in Docket No. R2005-1 at ¶ 5080, this “fully litigated, general omnibus rate case” provides an “opportunity to revisit [the settled] issues.” It is now time to return to rate relationships that are not skewed by such unusual circumstances.

II. The Postal Service’s Short Run Marginal Cost Attribution of the FedEx Day-Turn Network Costs Should Be Rejected in Favor of 100% Attribution.

The central reason why **all** of the FedEx Day-Turn Network costs should be attributed is that those costs are not fixed, and the classes of mail which cause them can be identified with sufficient precision. See UPS Initial Brief at 10-12. The Postal Service never comes to grips with those basic facts. Instead, it continues to rely on a math-without-logic short run marginal costing exercise (Postal Service Brief at 128-33) to argue that over \$226 million of these costs, or 17%, should be shifted into the institutional cost pool, even though the network was designed for, and 94% of the mail capacity flown is used by, Priority Mail and First-Class Mail. Tr. 19/7040; USPS-T-14 at 7; USPS-LR-L-5, B_Workpapers, CS14.xls.

The Commission has repeatedly rejected short run marginal costing. See, e.g., Docket No. R97-1, PRC Op. at ¶¶ 3035-39. And the Supreme Court and the Commission have recognized that the Commission should “employ bases other than volume variability” to attribute costs. Docket No. R84-1, PRC Op. at ¶ 3016 (citing *NAGCP*, 462 U.S. at 830-32). It should do so whenever “a reliable causal connection

[can] be identified and appropriate distribution keys developed” *Id.* at ¶ 3000. All of the FedEx Day-Turn Network costs are incurred on a cubic foot basis, and the number of cubic feet carried per class is known. As a result, 100% of these costs should be attributed on that basis.¹

III. The Commission Should Assure That Single-Piece Parcel Post Mailers Do Not Subsidize Sophisticated High-Volume Parcel Select Mailers.

A. Transportation Cost Differences Between the Parcel Select Rate Categories and the Non-Destination Entry Parcel Post Rate Categories Should Not Be Marked Up.

In defense of marking up the transportation cost differences between the Parcel Select rate categories and the non-destination entry Parcel Post rate categories (“Retail Parcel Post”), the Postal Service has argued that these cost differences “cannot simply be identified as worksharing cost avoidances.” Postal Service Brief at 334. This argument defies common-sense: the difference in transportation costs between, for example, DBMC parcels and DDU parcels must primarily (if not completely) result from the mailer transporting the parcels to the DDU instead of the Postal Service doing so.

In Docket No. R97-1 the Commission was confronted with the same zone definition variance among rate categories that the Postal Service cites here (Postal Service Brief at 334-35) to justify its markup approach. Docket No. R97-1, PRC Op. at ¶ 5681 (citing Tr. 8/4116-17). Yet, the Commission was able to take these differences into account and rejected marking up worksharing cost differences. *Id.* Here, Mr.

1. Similarly, contrary to the argument of the Magazine Publishers of America, Inc., and the Alliance of Nonprofit Mailers (Brief on Periodical Rates at 31-33), the Commission should attribute the costs of the Retiree Health Benefits Fund “to all mail according to the weighted average attributable cost of all labor.” See Docket No. R2005-1, PRC Op. at ¶ 4027.

Luciani replicated the Commission's Docket No. R97-1 method using current cost data. Exhibit UPS-T-2A. No party has criticized his calculations.

PSA seeks to justify the Postal Service's markup of transportation cost differences on the ground that Parcel Select and Retail Parcel Post have different demand elasticities. PSA Initial Brief at 5. PSA's argument that there is "no meaningful cross-price elasticity between non-destination entry Parcel Post and Parcel Select" (*id.* at 6) has not been adequately scrutinized or established on the record in this case, and is untenable. It is simply impossible to believe that a mailer would incur the costs of transporting its parcels to a DDU instead of to its local SCF or AO if there were no rate incentive to do so. Moreover, as Postal Service witness Thress noted, the historical volume changes of Parcel Select and non-destination entry Parcel Post largely mirror one another: when Parcel Select volume has grown, non-destination entry Parcel Post volume has fallen, and vice-versa. USPS-T-7 at 167-70. Although PSA witness Glick opined that this does "not necessarily" demonstrate cross-price elasticity (Tr. 33/11278-80), it is a logical conclusion.

By pointing to not fully tested elasticity differences to justify a greater than 100% passthrough, PSA is really suggesting that the Commission adopt Ramsey Pricing. Were the Commission to accept PSA's suggestion, individual consumers and other small mailers who cannot take advantage of worksharing discounts will be left paying

for the 6% of costs -- over \$76 million -- that are inappropriately passed through to sophisticated commercial, high-volume Parcel Select mailers.²

The Postal Service's markup of these transportation-related cost differences should again be rejected, as it was in Docket No. R97-1.

B. The Commission Should Not Pass Through More Than 90% of Mail Processing Worksharing Cost Avoidances.

UPS witness Luciani has identified several serious problems with the Postal Service's Parcel Post cost model, and he has proposed improvements that can and should be adopted in this case. See UPS-T-2 at 7-18. However, until the Parcel Post cost model is readdressed in its entirety, no more than 90% of mail processing cost avoidances should be passed through to Parcel Select mailers.

The contrary arguments advanced by the Postal Service and PSA should be dismissed. See Postal Service Brief at 333-39; PSA Initial Brief at 1-13, 18-23. The basic undisputed fact is that more than 50% of Parcel Post volume is now entered at the DDU, yet there has never been any study of the resulting costs incurred at the DDU. UPS-T-2 at 7.

PSA's comparison of UPS's proposed maximum 90% passthrough to the post-rate constraints 106% passthrough which results from the Postal Service's proposed rates (PSA Initial Brief at 9) is inappropriate: UPS's proposal applies only to the mail processing worksharing cost avoidances input into the Parcel Post rate design (UPS-T-2 at 18), whereas the 106% "passthrough" reflects the combined impact of mail

2. See Tr. 33/11267 (citing Exhibit PSA-RT-1b, served November 20, 2006), showing 31 cents per piece difference between per piece revenue and per piece assigned cost, and Tr. 33/11269, showing 244.1 million TYAR Parcel Select pieces.

processing and transportation cost differences as well as the Postal Service's rate change constraints.

PSA's argument that mailer preparation costs should be taken into account in setting DBMC rates (PSA Initial Brief at 14-17) is contrary to sound Commission policy that worksharing rate differences should "reflect the costs that **the Postal Service** would avoid (or incur) if the mailer were to move from one workshared category of mail to another." See PRC NOI No. 2 at 1 (emphasis added). Otherwise, the Commission would be left with the impossible task of measuring the costs incurred by various mailers, who have any number of different mailing practices and expenses, in order to derive the Postal Service's rates. Instead, only the Postal Service's avoided costs should be considered. Mailers can always choose not to workshare if they cannot perform the worksharing tasks more cheaply than the Postal Service does.

IV. The Postal Service's Defense of Its Incomplete Mail Processing Cost Model Falls Far Short of Meeting Its Burden for Overturning Long-Established Commission Precedent.

The Postal Service's mail processing labor cost model is conceptually the same as the models rejected by the Commission in Docket Nos. R97-1 and R2000-1, and the Postal Service continues to use data that is no better than the data it used in Docket No. R2000-1. Other parties agree that it should be rejected in favor of the Commission's traditional attribution of almost all mail processing labor costs. See OCA Brief at 40-41; Val-Pak Brief at II-1.

The Postal Service begins with a table which purports to show that results presented by Professor Roberts in an earlier study "updated" by the Postal Service and those derived by Dr. Neels in this case are not drastically different from the Postal

Service's results. Postal Service Brief at 69. We disagree. Table 1 below provides a more appropriate listing of the mail processing variability estimates sponsored in this case:

TABLE 1
Reported Mail Processing Variabilities
(Variability Estimates Not Cited by the Postal Service)

Witness	Method	Weighted Average Variability	Source
Bozzo	Plant Level Models, strict sample, applied to LDC 17	1.04	USPS-LR-L-192, Section C, in USPSmod_output_LDC.log; see Tr. 36/12495-98.
	Plant Level Models, strict sample, applied to "whole plant"	1.08	USPS-LR-L-192, Section C, in USPSmod_output_LDC.log; see Tr. 36/12495-98.
Roberts	March 2006 Paper, letter and flat-shape operations only	0.89	USPS-T-12 at 104 (using FY2004 data)
	R2006-1 Testimony, letter and flat-shape operations only	1.27	OCA-T-1 at 2*
Neels	Plant Level Models, loose sample	1.03	UPS-T-1 at 54
	Plant Level Models, strict sample	1.14	UPS-T-1 at 54

* Letter weight for weighted average variability is 0.778, calculated from the FY05 weights used in USPS-T-12 at 104, Table 28, column 1.

Despite the assertions of the Postal Service to the contrary, the record does not reflect a consensus that the volume variability of mail processing is less than 100 percent.

The test is not whether one party can modify the approaches endorsed by other experts enough to argue that those experts' models actually produce results that

contradict their own testimony. The real test is whether the Postal Service has met its burden of demonstrating that the Commission's long-established view is wrong. It has not.

The Postal Service argues that the consistency of its results over time demonstrates that they are correct. Postal Service Brief at 90. Of course, incorrect methods that are consistently applied will yield consistently wrong results.

On the data quality issue, the Postal Service continues to assert that data aggregation corrects "[m]any of the analytically relevant errors." Postal Service Brief at 83. But aggregation clearly does not cure all errors. See Docket No. R2000-1, PRC Op., Appendix F at 39-41. Moreover, aggregation can mask errors that affect the analysis. *Id.* The Postal Service acknowledges that the MODS data are subject to "data transmission and aggregation errors." Postal Service Brief at 83. Aggregation cannot possibly cancel out data transmission errors.

Dr. Neels' approach to the data in this case is not inconsistent with his testimony in Docket No. R97-1. See Postal Service Brief at 86. He did not testify in that case that all of the data should be used, regardless of errors in it. Instead, Dr. Neels testified that one should not discard data without objective, external evidence that the discarded data is erroneous or seriously suspect. See Docket No. R97-1, UPS-T-1 at 26, 33. That is vastly different from the circumstances in Docket No. R2000-1 and in this case, where it has been shown that there is a strong basis for questioning the accuracy of much of the data. See, e.g., Tr. 23/8499-501.³

3. The Postal Service mischaracterizes Dr. Neels' R97-1 testimony on pooled versus fixed effects models (Postal Service Brief at 90-91), as Dr. Neels' response to interrogatory USPS/UPS-T1-22 makes clear. See Tr. 23/8502-03.

The Postal Service dismisses Dr. Neels' evidence on the extent of misclocking, asserting that it "suffers from major conceptual and technical errors, which when resolved show MODS and IOCS activities to be substantially in agreement." Postal Service Brief at 86-87. Resolution of these supposed "conceptual and technical errors" shows nothing of the kind. Using the backup materials prepared by Dr. Bozzo in support of his rebuttal testimony, one can easily see the effect of Dr. Bozzo's changes on the extent of misclocking as presented in Dr. Neels' testimony. Comparing them to those in Dr. Neels' direct testimony shows that even after Dr. Bozzo's corrections, the misclocking story does not change appreciably. For some MODS cost pools, the extent of misclocking is even higher than reported by Dr. Neels. Thus, Dr. Neels' findings on the extent of misclocking are not changed by taking account of nuances of the IOCS data.

In any event, as cross-examination of Dr. Bozzo demonstrated, the fact remains that there are a significantly large number of instances where the IOCS data show that employees were clocked into the wrong operations at the level of analysis used by Dr. Bozzo. Tr. 36/12481-93.

In an effort to minimize the importance of cross-pool effects, the Postal Service argues that manual operations are rare. Postal Service Brief at 74. But these operations account for significant costs, especially in the case of Parcels and Priority Mail. See USPS-T-11 at 32-33 (Attachment, Table 1).⁴ And when the Postal Service is

4. The Postal Service's mail processing testimony contains very little discussion of Parcel and Priority Mail processing. See USPS-T-12 and USPS-T-42. Given the lack of such discussion, it is difficult to see how the Postal Service's results for those cost pools could supplant the Commission's unwavering treatment of them.

forced to resort to manual sortation for letters or flats (for example, when equipment breaks down), the impact on costs can be dramatic. Postal Service Brief at 75.

Changes in the composition of the mail stream in a cost pool (such as those which occur when a new sorting activity is installed -- a not infrequent event, UPS-T-1 at 39-40) can also affect the cost structure of the original operation. So too can changes in technology; Drs. Bradley, Roberts, and Neels have all so testified. See UPS-T-1 at 40-41; OCA-T-1 at 17-18, 46; Docket No. R97-1, USPS-T-14 at 13.

The Postal Service argues that a fixed effects model adequately accounts for idiosyncratic facility-specific productivity differentials. Postal Service Brief at 75. However, no evidence is offered in support of this assertion. The fixed effects model assumes that even though cost levels may differ across plants, they will respond to changes in volume in the same way. However, Dr. Neels and Dr. Roberts both present evidence indicating that plants may differ in ways not captured by the fixed effects model. OCA-T-1 at 16; UPS-T-1 at 31, 36-38. Nevertheless, how and to what extent plants actually differ in their responses to changes in volume remains largely unknown.

The Postal Service and MPA/ANM urge the Commission to use Dr. Elliott's analysis should the Commission again decide to reject Dr. Bozzo's analysis. Postal Service Brief at 108; MPA/ANM Brief at 8-10. Dr. Elliott's analysis is patently incomplete and defective. Not only is it limited to sorting activities -- thereby ignoring two-thirds of all mail processing labor costs -- but it is also based on a snapshot of only one day in May. Tr. 36/12357. Dr. Elliott did not even know whether that day was a high volume day, a low volume day, or a medium volume day. Tr. 36/12370-71. And Dr. Elliott somehow thought, incorrectly, that he was constrained by the Commission's

approach to treat setup and takedown time as either fully variable, or not variable at all. Tr. 36/12371. Finally, all of the principal conceptual criticisms of Dr. Bozzo's short run study also apply to Dr. Elliott's one-day analysis.

The Commission should not turn its back on more than thirty years of precedent based on such flimsy efforts, especially given the results of Professor Roberts' and Dr. Neels' far more rigorous and complete analyses.

V. Conclusion

Wherefore, for the reasons set forth above and in its Initial Brief, United Parcel Service respectfully requests that the Commission:

1. Adopt cost coverages of at least 163% and 115%, respectively, for the competitive Priority Mail and Parcel Post subclasses of mail;
2. Continue its long-established attribution of 100% of mail processing labor costs;
3. Attribute all of the Federal Express Day-Turn Network costs in proportion to the cubic feet of the classes of mail actually carried on that network;
4. Modify the Postal Service's Parcel Post cost model, including a reduction in the Parcel Post CRA adjustment factor, as recommended by UPS witness Ralph Luciani;
5. Return to its Docket No. R97-1 approach by eliminating the markup of transportation cost avoidances for Parcel Post; and

6. Pass through no more than 90% of the resulting Parcel Post estimated cost avoidances for the DDU, DSCF, and DBMC rate categories.

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