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POSTAL REGULATORY COMMISSION
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Postal Rate and Fee Changes, 2006

Docket No. R2006-1

**REPLY BRIEF OF THE
NEWSPAPER ASSOCIATION OF AMERICA**

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The Newspaper Association of America (“NAA”) hereby respectfully submits this reply brief in response to the opening brief of certain intervenors and of the Postal Service.

I. INTRODUCTION AND SUMMARY

In its opening brief, NAA respectfully urged the Commission:

- To reduce the Postal Service’s proposed exorbitant rate difference (a 2200 percent passthrough of cost differences) between Standard Enhanced Carrier Route high density and saturation flats by basing the discount on high density costs, rather than aggregated basic and high density costs as proposed by the Postal Service, and adjusting discount passthroughs consistently with Efficient Component Pricing;
- To recommend approval of a surcharge for the use of detached address labels (“DALs”) as an optional rate element that does not affect the base rate for mailers that do not use DALs;
- To reject the unsupported reduction in the Standard ECR pound charge for pound-rated mail;
- To adjust to the historic shift in the mailstream composition and the changing nature of postal finances by relieving First Class Mail of some of its institutional cost burden and by allocating a greater share of institutional costs to Standard ECR and Regular mail, such as proposed in the record; and
- To reject unwarranted increases for Periodicals In-County and Outside County mail rates relied upon by small newspapers for circulation distribution.

For the most part, NAA's brief anticipated many of the arguments raised by the Postal Service and certain other intervenors. Accordingly, in this reply brief, NAA will address only certain new contentions made by other parties.

II. THE COMMISSION SHOULD RECOMMEND RATES FOR STANDARD ENHANCED CARRIER ROUTE MAIL PROPOSED BY NAA WITNESS INGRAHAM

NAA's initial brief demonstrated why Dr. Allan Ingraham's (NAA-T-2) proposed alternative rate designs for Standard Enhanced Carrier Route mail were superior to the Postal Service's proposed rates.¹ In particular, Dr. Ingraham, unlike the Postal Service, used deaveraged delivery cost data and passed through 100 percent of reliably demonstrated cost differences between basic, high density, and saturation flats, while preserving the Postal Service's proposed revenue requirement and a surcharge for the use of detached address labels. He also make the appropriate cost adjustment to account for the likely conversion of the majority of DALs to on-piece addressed flats. Dr. Ingraham's second alternative (assuming conversion of DAL mailings) also generally maintained the current rate relationship between high density and saturation flats assuming conversion of a majority of DAL mailings to on-piece addresses.²

Although the Postal Service did not offer any rebuttal testimony to Dr. Ingraham's proposal (despite filing extensive rebuttal to those of other witnesses), it offers several criticisms of his proposals on brief.³ In addition, the joint brief of the Saturation Mailers

¹ As explained in NAA's initial brief, the difference between Dr. Ingraham's two proposed rate designs is in the assumption made regarding DAL conversions. His first alternative assumed, as did the Postal Service, no conversion of DALs. His second alternative reasonably assumed significant conversion.

² Preserving comparable rate relationships was a goal of the Postal Service. Tr. 5/1072 (Kiefer).

³ These are: (1) that the use of the same mail processing costs as relied upon by the Postal Service's own witness and in previous cases justifies a passthrough of greater than 100 percent (2200 percent, in fact, under the Postal Service's proposal); (2) an assertion that the Postal Service's proposed

Coalition and ADVO, Inc., also criticized Dr. Ingraham’s proposal, relying largely on surrebuttal testimony of witness Crowder that, because it was filed in the last round of the hearings, was never subjected to thorough discovery and cross-examination. These criticisms lack merit, and the Commission should recommend the rates proposed by Dr. Ingraham.

A. Dr. Ingraham’s Use Of The Same Mail Processing Costs As Did The Postal Service Does Not Undermine His Rate Design Proposals

The Postal Service notes correctly that the mail processing costs used by Dr. Ingraham were averaged among high density and saturation flats. USPS Br. at 322. It goes on to contend that the use of these averaged mail processing costs together with the disaggregated delivery costs “weakens” NAA’s proposed alternative rates.⁴ *Id.* This implies that the Commission should set rates using averaged costs and arbitrarily excessive passthroughs rather than on the best available cost data and Efficient Component Pricing principles. To state such a proposition shows its illogic.

Dr. Ingraham’s alternative rate designs corrected the Postal Service’s flawed proposals by using the most reliable data available. In the case of delivery costs, these were the disaggregated delivery costs provided by witness Kelley during discovery (which Dr. Ingraham used in lieu of the aggregated basic/high density costs relied upon by the Postal Service’s rate proposal). In the case of mail processing costs, both Dr. Ingraham *and* the Postal Service used cost estimates from witness Talmo that did not separate costs for high density and saturation flats. This was because, as in past

rate design does not depend on the level of DAL usage; (3) that the Postal Service’s proposed rates were needed to “mitigate” mailers’ costs of shifting to on-piece addressing; (4) that Dr. Ingraham’s proposed retention of the current pound rate should be rejected; and (5) that Dr. Ingraham’s proposals would result in higher rates for saturation flats using DALs than the rates for high density flats.

⁴ The argument is that mail processing costs that are averaged between high density and saturation mail understate the “true” cost differences.

cases, the Postal Service simply did not have a reliable estimate of mail processing costs for high density and saturation flats due to the thinness of the data. When asked about this during discovery, Mr. Talmo explained:

Estimated costs by shape for High Density ECR demonstrate considerable sample variation. Combined with sample variation in Saturation ECR costs, the estimated cost difference by shape between High Density and Saturation costs also shows considerable variation. Due to the uncertainty in the estimated difference in costs, High Density and Saturation cost by shape are treated as having the same mail processing costs.

Tr. 13/3610 (Talmo). In other words, the Postal Service has no reliable evidence of any mail processing cost differences between high density and saturation flats mail.⁵ This is not surprising, because high density and saturation flats are walk-sequenced and make little use of mail processing. Thus, the Postal Service materially overstates the case when it contends that Dr. Ingraham understated “true” costs differences (Br. at 322); in fact, the Postal Service does not have any more reliable estimate of the “true” costs than that used both by Dr. Ingraham and by the Postal Service’s own ECR rate design witness Kiefer.

Furthermore, the Postal Service has used averaged high density/saturation mail processing costs in past cases without contending that their use justified a greater than 100 percent passthrough.⁶ Finally, it has made no effort to justify anything close to the 2200 percent cost difference passthrough in its proposal.⁷

⁵ SMC rebuttal witness Crowder ignored these disclaimers and used in her rate design the unreliable disaggregated figures provided by Mr. Talmo in an interrogatory response. The SMC/ADVO joint brief repeats this error, ignoring the “considerable variation” in the data and treating the Talmo responses as reliable despite his disclaimers to the contrary.

⁶ Indeed, on brief the Postal Service does not even contend that mail processing cost data justifies its greater than 100 percent passthrough; it says merely that it “may” do so. USPS Br. at 322.

⁷ The Postal Service’s claim of a “120 percent “ passthrough is an illusory number – the actual passthrough of the only known cost differences under the USPS proposal was, as noted above, 2200

The Postal Service criticism lacks merit. Consistent with Efficient Component Pricing, the high density discount should be set at 100 percent of the most reliably estimated cost differences, as proposed by Dr. Ingraham.

B. Dr. Ingraham Correctly Treated The Proposed DAL Surcharge As An Optional Rate Element, Not An “Offset” To The Base Charge

As explained in NAA’s initial brief, the Postal Service’s use of the proposed DAL surcharge as an “offset” for increasing the rate difference between high density and saturation flats to 2.2 cents from the current 0.9 cents is poor rate design and flawed even as applied. NAA Br. at 7-9. In its brief, the Postal Service states: “The rate design does not depend on the level of DAL usage, as can be seen by witness Kiefer not changing the rate design when he changed his usage assumption.” USPS Br. at 323. The Postal Service’s characterization of its proposal is correct -- however, the Postal Service misapprehends the issue.

The problem is that the Postal Service has attempted to justify the 2.2 cent rate differential between high density and saturation flats base rates by contending that including the DAL surcharge lessens the rate differential is 0.7 cents. The Postal Service cannot maintain that the base rate is independent of the amount of DAL usage and simultaneously assert that the DAL surcharge should be included when comparing rate differences. The Postal Service’s position treats an optional rate element (the DAL

percent as explained by Dr. Ingraham (NAA-T-2 at 9) and in NAA’s brief. The 2200 percent passthrough compares the proposed 2.2 cent discount between high density and saturation flats to the 0.1 cent cost difference resulting from the use of the disaggregated delivery costs supplied by Mr. Kelley (without any caveats such as offered by Mr. Talmo regarding mail processing costs). The Postal Service attains the putative 120 percent in its proposal by using aggregated “nonsaturation” delivery costs, which greatly overstate the cost difference between high density and saturation flats. The Postal Service may have used an excessive passthrough to offset its lack of reliable mail processing data on a disaggregated basis between high density and saturation flats, but that was unnecessary. If disaggregated delivery costs are used, as did Dr. Ingraham, “comparable” past rate differences can be achieved with a 100 percent passthrough consistent with Efficient Component Pricing. NAA Br. at n.9.

surcharge) as an inherent component of the base charge that all saturation mailers must pay.

Currently, there exists a 0.9 cent rate difference between high density and saturation flats. Under the Postal Service proposal, this difference will expand to 2.2 cents for the vast majority of saturation flats at a time when the Service's own data show that the cost difference is decreasing. This means that the majority of saturation flats that today already use on-piece addressing would receive an enormous rate windfall (and a material rate advantage over high density mailers) without making *any* change in their mailing practices.

The Postal Service hides this fact by including in its comparison to high density rates the optional DAL surcharge (1.5 cents) which will be paid by only a minority of saturation mailers (if no conversion) and a tiny minority (in reality). This is the tail wagging the dog. More than *85 percent* of all saturation flats would have to use DALs before the differential paid by high density and saturation flats would approach the current 0.9 cents. NAA-T-2 at Table 4. The record demonstrates that it is far more likely that 85 percent of saturation flats mailers will use *on-piece* addressing in the Test Year. The Postal Service's ECR proposal cannot reasonably be said to maintain current rate relationships in any meaningful manner.

C. Dr. Ingraham's Reasonable Estimate Of The Test Year Costs Of DALs Is Superior To Those Of Witnesses Mitchell And Crowder

There is no dispute that saturation flats mailings that convert from DALs to on-piece addressing should reduce postal costs. USPS Br. at 323. However, disagreement exists over the size of that cost reduction.

To address this issue, when designing his rate proposal, Dr. Ingraham adjusted the Postal Service's estimated Test Year costs to eliminate costs that should be avoided

by the conversion of a substantial proportion of DALs to on-piece addressing. NAA-T-2 at 20-22; NAA Br. at 17-18. Based on Mr. Kelley's testimony, Dr. Ingraham made the reasonable assumption that a 75 percent reduction in the number of DALs in the system would reduce costs associated with DALs by 80 percent. The Postal Service has not criticized Dr. Ingraham's adjustment, either in rebuttal testimony or on brief. For its part, the Postal Service's case makes the formal assumption that no conversion will occur, thereby avoiding having to address the cost issue.

Some ECR mailers, however, assert the cost reductions from DAL conversion will be much larger than calculated by Dr. Ingraham. SMC/ADVO Br. at 5 & 19-20. Val-Pak and SMC/ADVO appear to assume that the unit cost of DALs exceed the proposed surcharge. *Id.* This matters because SMC/ADVO assert that cost savings from DAL conversion will be so large as to result in ECR making a larger contribution to institutional costs than proposed by the Postal Service. SMC/ADVO Br. at 5. NAA submits that those parties overstate the net cost savings from DAL conversion, and that the actual Test Year cost difference will likely be much closer to Dr. Ingraham's estimate than to witness Crowder's.

SMC/ADVO and Val-Pak arrive at their assumption by simplistically dividing estimated Test Year costs associated with DALs by the estimated number of DALs, arriving at a cost per DAL above 3 cents. *E.g.*, SMC-RT-1 at 8, 12-13. Although NAA is skeptical of the unit cost figure arrived at in this fashion,⁸ the SMC/ADVO and Val-Pak approach is plainly incorrect for purposes of estimated Test Year DAL costs.

⁸ Beyond the discussion in the text, at least two considerations fuel NAA's skepticism as to these numbers. One is the accuracy of data collection. DAL costs have not previously had rate implications, so the quality of the DAL costs estimated by the postal accounting systems has never undergone close scrutiny. Second, the costing data associated with this approach do not appear to have taken into account the cost effects of bulk and weight of the accompanying flats, the cost consequences of which are unknown but presumably understated.

The first error arises from the notion that the costs of the DALs remaining in the system in the Test Year can be determined using the simplistic assumption that all DALs disappear from the system and that the converted flats – that will bear addresses for the first time – do not impose any offsetting costs. That assumption is contrary to the more cautious position taken by the Postal Service. Postal Service witness Kelley, an expert on carrier costs, testified he was: “not confident that two or three billion DALs (from a current base year estimate of approximately four billion) could be eliminated from the delivery network without some material possibility of such reduction causing unanticipated changes in operational processes for city carriers and compensation implications for rural carriers.” Tr. 12/3430-32. His testimony meant that the cost savings of a partial conversion might not be linear.

Such reasonable caution about the possible cost consequences of the removal of billions of DALs from the mailstream did not deter SMC/ADVO rebuttal witness Crowder from simply assuming that all DAL costs will evaporate at a one-to-one rate as DALs convert to on-piece addressing and that the Postal Service will incur no additional costs from the newly-addressed flats. *See generally*, SMC/ADVO Br. at 45-47. Unlike Ms. Crowder, Dr. Ingraham credited Mr. Kelley’s judgment that the cost savings from removing a massive number of DALs would likely be substantial but not a one-to-one reduction. This is why Dr. Ingraham calculated a cost elasticity to account for DAL conversion, using cost data from Mr. Kelley. The resulting calculation showed that the incremental costs of a DAL is about 0.751 cents.⁹

Witness Crowder also committed a second error in calculating the costs of post-conversion saturation flats. In her testimony, she used an average unit delivery cost of

⁹ NAA’s initial brief showed that this incremental cost rises to about 1.28 cents even if one includes mail processing and in-office costs, as urged by witness Crowder. NAA Br. at n.16.

saturation flats of 3.489 cents in her ECR rate design. See SMC-LR-1, AC-WP-STEER.xls, Inputs, Cell D84. That figure, in turn, was developed in her companion worksheet UDCmodel.xls. An examination of that worksheet shows that her 3.489 cents cost figure necessarily implicitly assumed that post-converted saturation flats (formerly unaddressed because they were accompanied by the DALs) would have the same delivery costs of today's unaddressed flats, rather than making the more logical assumption that they will have the costs of addressed flats – which is what they will become. See AC-UDCmodel.xls, page 2, Summary TY, Cell P84.¹⁰ By failing to recognize that the replacement of DALs by on-piece addressing will increase the costs of the previously unaddressed flats to the higher cost of addressed flats (but still by less than the cost of the DAL), Ms. Crowder incorrectly estimated the delivery costs of converted flats as 2.411 cents, rather than the 4.313 cents cost of addressed flats.

This error presumably arose from a misunderstanding of statements by the Postal Service that the converted flats will be handled exactly as they are today when they are unaddressed. SMC/ADVO Br. at 46.¹¹ For example, witness Coombs testified that moving the address from the DAL to the host flat piece “is not likely to change the in-office treatment of a saturation flat mailing that otherwise would have gone directly to the street.” USPS-T-44 at 13.

Properly understood, statements of that nature meant only that the Postal Service expects that the presence or absence of a DAL will not affect its current practice

¹⁰ Ms. Crowder's estimated cost of Test Year saturation flats (including those converted to on-piece addresses) is 3.489 cents (Cell P85), which is a weighted average of the costs of ECR saturation addressed label flats (4.313 cents found in Cell L82), DALs (Cell L83), and saturation flats with DALs host pieces (2.411 cents found in Cell L84), divided by the total volume of saturation flats (Cell M85).

¹¹ Ms. Crowder also assumed that a recent Postal Service “statement” about a Do Not Deliver mechanism on rural rates – the details and cost implications of which appear nowhere in the record – will have material cost implications. However, there is no record evidence which the Commission could make a cost adjustment on this basis.

of taking many saturation flats mailings directly to the street. That does *not* mean that the currently unaddressed flats will have the same costs that they do today, because their characteristics will be different.¹² In particular, when converted they by definition will bear on-piece addresses. Postal Service data plainly show that addressed flats impose higher costs (4.313 cents per piece) than the unaddressed flats for which DALs supply the address (2.411 cents per piece), disregarding any additional costs that might arise in other operations.

In other words, the cost savings that the Postal Service should expect from the conversion of DALs to on-piece addressing reside in the difference between the 6.357 cent cost of saturation flats with DALs and the 4.313 cent cost of a saturation flat with on-piece address. This two cent difference (which assumes full capture of cost savings) is a different way of looking at the issue that actually supports Dr. Ingraham's calculation. Assuming that the Postal Service can capture 80 percent of the cost savings, the costs saved by eliminating a DAL are close to 1.5 cents under this way of looking at the issue, a figure much closer to Dr. Ingraham's estimate than witness Crowder's.

Ms. Crowder also contends that Dr. Ingraham should have taken into account the mail processing and in-office costs associated with DALs. SMC-RT-1 at 8. Including in-office costs (which Mr. Kelley omitted) in Dr. Ingraham's cost elasticity methodology would increase the incremental DAL cost to 1.029 cents. Ms. Crowder also identified mail processing costs (not part of Mr. Kelley's delivery cost analysis) associated with DALs as \$10 million (which even under her methodology amounts to about 0.25 cents per DAL). Even if this sum were added to Dr. Ingraham's estimate of delivery costs, the

¹² An unaddressed flat simply is not the same as an addressed flat. In the words of MOAA, "calling a duck an eagle does not transform the duck into an eagle." MOAA Br. at 31.

result would be an incremental DAL cost of approximately 1.28 cents, still below the proposed surcharge level even without applying his cost elasticity adjustment, but close to the figure arrived at in the preceding paragraph.

D. Pleas For “Mitigating” ECR Saturation Rates Due To The DAL Surcharge That Affects Only A Minority Of Saturation Flats Mail Are Unsubstantiated And Would Distort Rates For Other Mailers

The Postal Service asserts on brief that the admittedly “modest” rate increase of merely 0.4 cents for saturation flats or (from 13.6 cents to 14.0 cents for DDU entry) was partly a “cost mitigation” effort to offset presumed higher costs of DAL mailers converting to on-piece addressing. USPS Br. at 323; accord SMC/ADVO Br. at 12 (stating that the transition from DALs to on-piece addressing “will be extremely complex and costly”). This argument is simply not supported by the record and would distort the rate design.

First, a party seeking to raise a cost mitigation argument has an obligation to introduce evidence in support of its position. On this point, there is a complete failure of proof. Despite rhetoric and generalized assertions of great risk and expense, no party has even troubled to try to quantify such costs for the record. Neither the Postal Service nor any saturation mailer chose to provide *any* data as to the costs of this conversion, perhaps in the hopes that the Commission might imagine them to be large.¹³ Unsubstantiated assertions cannot substitute for record evidence. Lacking concrete evidence as to the likely costs of conversion, there is no record basis upon which the Commission could mitigate saturation rate increases by any amount.

¹³ In this regard, ADVO’s 10-K filing for the year ended September 30, 2006, with the Securities and Exchange Commission apparently contains no figure for the cost of converting to its “in line on-piece” addressing system, although the 10-K does list, as major items driving operating expenses in its 2006 fiscal year, items as small as \$3.2 million (for its new billing project).

Two, the plain fact is that **every other mailer** in the postal system – including the majority of saturation flats mailers today as well as all saturation letter mailers -- uses on-piece addressing on a regular basis, and has incurred whatever costs it takes. Certainly high-density mailers do.¹⁴ The Commission reasonably can presume from this fact that the costs are not exorbitant.

Three, at least some mailers that use DALs may already have the capability for on-piece addressing. This is evidenced by the offering by some saturation mailers of solo saturation mailing services.

Four, costs incurred in converting to on-piece addressing can be amortized and/or depreciated over a longer period of time, providing accounting benefits that may truly offset the cost. Tr. 5/W80 (Kiefer). For these reasons, those urging “mitigation” have failed to meet their burden of proof.

Finally, what “mitigating” saturation rates means is the trivial 0.4 cent increase in the base rate for all saturation flats is purportedly justified on the basis of the unknown costs of a minority of the subclass abandoning what always has been an optional form of address. The Postal Service has cited no precedent for relying on unquantified out-of-system costs for a minority of a rate category to mitigate rates for the majority of the category especially where, as here, the increasing of the rate gap could have material effects in the competition between newspaper Total Market Coverage programs that rely on high density mail and their saturation mail competitors.

¹⁴ SMC/ADVO speculates that some high-density mailers may use DALs in violation of postal regulations and argues that the DAL surcharge should also apply to high density mailings. SMC/ADVO Br. at 18. Since postal regulations already forbid the use of DALs for high density mailings, SMC/ADVO's modification seems unnecessary.

E. The Pound Charge Should Remain Unchanged

NAA's initial brief demonstrated that the pound charge component should remain unchanged, as in the rate designs by Dr. Ingraham. NAA Br. at 19-22. The Postal Service argues for the reduction proposed by Mr. Kiefer. USPS Br. at 324. SMC/ADVO, while nominally supporting the Postal Service's proposal, argue for a still lower pound charge.

The Postal Service's advocacy of reducing the pound charge is curious, because only a few pages earlier the Service acknowledges that the Commission is reluctant to lower the pound rate even moderately absent substantial evidence. USPS Br. at 319, *citing R2000-1 Op.* at 362-393. But no such substantial evidence exists in this record. The Postal Service cites to a spare two pages in the transcript at which, it says, witness Kiefer "discussed" the pound rate proposal – both in response to interrogatories. Neither citation supports the reduction. At the first (Tr. 5/901), Mr. Kiefer argues that his proposed reduction really is an increase over where the pound charge was a year ago (overlooking the larger increase that occurred due to R2005-1). The second citation (Tr. 5/909), addressed in NAA's initial brief, merely recites various "considerations" that influenced the Postal Service's rate design without providing any real justification for *any* of the proposed ECR rate changes, much less a reduction in the pound charge.

For its part, SMC/ADVO again is undeterred by the absence of reliable cost data, arguing that the pound charge should be reduced substantially. This argument deserves little credence. First, it is based on testimony (SMC-RT-1 [Crowder]) that was filed only in the last round of rebuttal, thus receiving less scrutiny than other proposals, and which was generally positioned as supportive of the Postal Service's rate proposals rather than an alternative. Second, the testimony depends on data supplied by the

Postal Service about which the Service itself expressed severe caveats. See NAA Br. at n.18 and accompanying text.¹⁵

Earlier rounds of testimony were no more informative. Both Mr. Prescott (for MOAA) and Mr. Mitchell (for VP) asserted that alternate delivery competition for Standard ECR pound-rated mail is increasing. Neither, however, offered any data in support of this contention. The record contains no analysis of the alternate delivery industry – the number of firms, the amount of their business, their profitability, or whether any of these measures are increasing or decreasing.

For a more realistic assessment of the evidence relating to the pound charge, NAA respectfully commends to the Commission's attention the brief filed by the Association of Alternate Postal Systems. AAPS represents the direct competitors to the Postal Service who are affected most by the pound rate. The AAPS brief summarizes the lack of evidence providing by either the Postal Service or any intervenor as to the effect of the rate change on competitors of the Postal Service (criterion 4). AAPS Br. at 5-6. Of particular note, AAPS points out the absurdity of the Postal Service's position that the Commission can ascertain the effects of the pound charge on the alternative delivery industry by looking at the "average" increase for ECR, rather than for the portion of the ECR mailstream where the competition exists.

For these reasons, NAA respectfully urges the Commission to reject the Postal Service's proposed reduction in the pound charge, adopting instead Dr. Ingraham's proposed alternative rate design.

¹⁵ In response to an interrogatory, the Postal Service presented FY08 unit costs for ECR mail by ounce increment, complete with caveats warning of the "appropriate use of the data." NAA/USPS-1. Indeed, the Postal Service conceded that individual ounce increments are unreliable, noting that "substantial sampling variability, particularly higher ounce increments for letters and flats" could distort unit costs."

F. Pricing DAL-Addressed Mailings Higher Than High Density Mailings Creates A Sound Incentive For Conversion To On-Piece Addressing

Finally, the Postal Service notes that because Dr. Ingraham correctly treats the DAL surcharge as an optional rate element, his resulting rates for saturation mailers using DALs are higher than for high density flats mailers. The Postal Service asserts, without elaboration, that it “would be preferable to avoid such a relationship.” USPS Br. at 324. No explanation of this “preference” is given.

In fact, having higher rates for saturation flats with DALs than for high density flats would be an entirely reasonable outcome of the application of an optional rate element for an optional service feature – a DAL – that imposes distinct costs and that offers the mailer distinct benefits. Indeed, Dr. Ingraham’s proposed rates would more fully support the Postal Service’s objective of reducing the usage of DALs than the Postal Service’s own proposal. The latter, even with the DAL surcharge, still would leave DAL mailers with a 0.7 cent rate advantage over high density mailers. Dr. Ingraham’s rates would give saturation mailers a clear rate incentive to shift to on-piece addressing.

III. THE COMMISSION SHOULD RECOMMEND RATES THAT RECOGNIZE THE FUNDAMENTAL CHANGE IN THE BUSINESS MODEL OF THE POSTAL SERVICE AND SHIFT MORE OF THE INSTITUTIONAL COST BURDEN TO OTHER CLASSES OF MAIL, INCLUDING STANDARD MAIL

Predictably, some Standard ECR mailers argue that they should pay even fewer institutional costs of the Postal Service than they presently do. VP Br. at I-12 – I-16; SMC/ADVO Br. at 19-25. While their position is understandable and self-serving, their recommendations would simply aggravate the Postal Service’s dependence on a outdated business model and do nothing for the long-term financial stability of the Postal Service.

A. Some ECR Mailers Are Unwilling To Face The Need To Make A Greater Contribution To Institutional Costs

In the rebuttal testimony of NAA witness Gregory Sidak and in NAA's initial brief, NAA made the point that the Postal Service is experiencing marketplace changes that have rendered its traditional business model – which relied on growth in First-Class Mail to pay the vast majority of the costs of the system – obsolete. NAA demonstrated that the Commission has a legal and policy obligation to revisit institutional cost assignments in light of these materially changed circumstances. NAA Br. at 30. NAA also noted that a necessary and prudent first step of that review would be to reduce the burden on First Class mail and that “other classes—and, due to its sheer size, Standard Mail in particular—must play an increasingly important role in the funding of institutional costs both now and in the future.” NAA Br. at 30; NAA-RT-1 at 22 (Sidak).

Several parties argue that there is no need to trim the proposed increase in First-Class letter rates on the grounds that doing so might have little effect on electronic diversion of First-Class Mail.¹⁶ Although the effect of a penny reduction in the First-Class single piece rate on mail volumes and electronic diversion may be debatable, whether or not it does so misses entirely the point of Mr. Sidak's rebuttal testimony. His point is that Standard Mail inevitably will need to make substantially larger contributions to the institutional costs of the postal system, and that the time to begin is now, not sometime in the indefinite future. This need is all the more urgent in light of the recent

¹⁶ *E.g.*, SMC/ADVO Br. at 6. Erecting a classic strawman, SMC/ADVO seem to suggest that Mr. Sidak advocated cross-subsidizing single-piece First-Class mailers by Standard Mail, a contention that appears nowhere in Mr. Sidak's testimony. SMC/ADVO at 25. If there is a cross-subsidy, it is in the sense that First-Class Mail has for far too long paid the vast majority of the overhead costs of the postal system, allowing other classes of mail to flourish without having to pay a proportionate share of the overhead cost, which is the now outmoded business model that has produced the current fiscal dilemma.

enactment of postal reform legislation that will impose a price cap regime in the not-too-distant future.

Despite acknowledging the problem, other ECR mailers offer no solutions. In its brief, MOAA acknowledges that First-Class Mail volumes “will continue to erode” and that erosion “presents a serious dilemmas for the Service and mailers.” Br. at 19. However, MOAA continues to say that the “worst possible response . . . would be to attempt to ‘cure’ the problem by shifting the institutional costs to Standard Mail.” *Id*; see *also* SMC/ADVO Br. at 6. Such a head-in-the-sand approach simply wishes the problem would go away. It does nothing to address the dire need for the Postal Service to look for more substantial contribution from other classes of mail in order to sustain its long-term financial viability.¹⁷ Rather, one might suspect that these ECR matters seek only to preserve their comparatively low rates and disproportionately small contributions until rate caps take effect, which they may hope will protect them from having to make a larger contribution to overhead costs in the future.

Similarly, some ECR mailers criticize Mr. Sidak for lumping Standard ECR and Standard Regular together and for not analyzing the two subclasses separately. MOAA Br. at 17; SMC/ADVO Br. at 22; *accord* DMA/ANM Br. at 4, n.16. They are correct that Mr. Sidak did not focus on each subclass separately; however, their criticism also misses the mark. While different factors affect the volumes in Standard Regular and ECR mail (which is why they are separate subclasses), the decline of First-Class Mail will require both to contribute more.

¹⁷ SMC/ADVO argue that the solution is to place more emphasis on “market factors” and “relative price elasticities” in setting rates. Br. at 6. However, they do not explain how doing so would generate greater net contribution. SMC/ADVO seek lower rates for ECR mail. However, reducing rates at the elasticities estimated in this case would merely increase volumes, but would *reduce* net contribution from ECR.

NAA notes that the Postal Service on brief agrees with NAA that institutional cost contributions should be set on the basis of the future, not on statements from past cases that fail to recognize changed realities. In addressing Val-Pak witness Mitchell's plea to reduce the ECR cost coverage, the Postal Service says:

The Postal Service commends the Commission to contrast witness Mitchell's longing for the rate level relationships of yester-year with the rebuttal testimony of Newspaper Association of America witness Gregory Sidak (NAA-RT-1; Tr. 32/10819 et seq.) which, at least, argues that institutional cost allocations in this docket should be based on current and anticipated mail volume trends and market realities, as opposed to hopes expressed in the mid-1990's.

USPS Br. at 158.

The world in which the Postal Service operates has changed fundamentally. As First-Class Mail declines in the face of marketplace changes and technological innovation, it is necessary for other classes of mail to pick up more of the overhead. The Commission should begin this process in this case, as recommended in NAA's initial brief.

B. The Attempts Of Some ECR Mailers To Reduce Their Institutional Cost Contributions Are Fatally Flawed

In addition to ignoring the big picture, some ECR mailers advance a number of other arguments for lowering their institutional cost contribution even below that proposed by the Postal Service. NAA addressed most of these contentions in its initial brief in discussing the testimony of witnesses Mitchell and Prescott. NAA Br. at 41-45. Here, NAA will address only a few additional points.

First, it merits mention that these ECR mailers speak exclusively in terms of reducing the "cost coverage" of ECR mail. MOAA Br. at 7; VP Br. at I-12; SMC/ADVO Br. at 19. As NAA has demonstrated, a subclass's cost coverage – a mathematical

construct having no real economic substance – is a misleading measure of its contribution to institutional costs. NAA Br. at 32-33. The Commission increasingly has made use of other measures, including comparative markup indices and unit contributions. *R97-1 Op.* at ¶ 4984.¹⁸ And, as NAA showed in its initial brief, by all of these measures the contribution of Standard ECR mail has been declining in relative terms and pales in comparison to that of First-Class Mail.¹⁹

An exclusive focus on cost coverages distracts attention from more meaningful measures such as unit contributions, comparative markups over systemwide averages, and total dollar contributions. By all of these measures, Standard ECR mail's contribution is comparatively paltry. In fact, the Postal Service's proposed relative markup of ECR to the system-wide average is lower than it has ever been since reclassification. Tr. 17/5122 (O'Hara).

Second, in a moment of silliness, MOAA asserts that the decline in ECR volumes since 1998 entirely "is a result of excessive rates for this price sensitive subclass." MOAA Br. at 3. This assertion is simply absurd. Blaming the entire decline in ECR volume over the past few years on postal rates in this manner simply ignores any effects of market conditions, the economy, the events of September 11, 2001,

¹⁸ Mr. Prescott's direct testimony stated that historically the PRC has not relied on contributions per piece to validate rates. MOAA-T-1 at 13. However, on cross-examination he conceded that the Commission has done precisely that, including Docket No. R97-1. His statement that "I do not believe that setting the rates should start with the objective of determining the contribution per piece for the subclass" (NAA/MOAA-T1-2) is merely a disagreement with Commission practice.

¹⁹ For example, MOAA witness Prescott's own testimony concedes that the increase in unit contribution of First Class mail (both in the aggregate, and single piece and presort separately) has increased far more rapidly than ECR. In 1997, the first year of Mr. Prescott's analysis, First-Class letters paid 11.7 cents per piece, while ECR mail paid 6.6 cents per piece, slightly more than half. By 2005, however, First-Class letters were paying 18.8 cents on average, while ECR paid only 8.7 cents, less than half. NAA/USPS-T31-9.

consolidation in the retail industry, and the many other factors that affect advertising generally, and conflicts with the forecasting model of Mr. Thress.

Third, some ECR mailers persist in placing undue weight on the price elasticities estimated by Postal Service witness Thress. Dr. Ingraham's rebuttal testimony demonstrated that the notion that ECR may be marginally price elastic is simply unsound as a matter of statistics, and that Mr. Thress's elasticity estimates are far too slender a reed on which to base any major change. The response of MOAA and SMC/ADVO is to resort to name-calling. *E.g.*, MOAA Br. at 13. This is what one says when one lacks any substantive response. Dr. Ingraham's rebuttal testimony was and is correct.

Finally, SMC/ADVO, again relying on the misleading measure of cost coverage, make the novel argument that the Commission should "mitigate" ECR institutional cost contributions until a price cap regime takes effect. Br. at 4. This argument is both wrong and dangerous for the Postal Service's future. It is wrong because it assumes that cost coverages are an appropriate measure, a notion about which the Commission has expressed considerable caution in the case of heavily-workshared subclasses such as ECR. The argument is dangerous because it would reduce the institutional cost contributions of this important subclass at a pivotal time in postal history, when Standard Mail of all classes (and other mail as well) will have to make larger contributions as First-Class Mail declines. The approach of a price cap regime makes increasing the unit and total contribution of ECR more important, and more urgent.

IV. CONCLUSION

For the foregoing reasons, the Newspaper Association of America respectfully urges the Commission to recommend rates according to the positions set out herein and in its Initial Brief.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that I have this date served the instant document on all participants in accordance with section 12 of the Rules of Practice.

January 4, 2007

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