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BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

Postal Rate and Fee Changes, 2006	))	Docket No. R2006-1

REPLY BRIEF OF
MAGAZINE PUBLISHERS OF AMERICA, INC.,
AND ALLIANCE OF NONPROFIT MAILERS
ON PERIODICAL RATES

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CONTENTS

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The Magazine Publishers of America, Inc. ("MPA") and the Alliance of Nonprofit Mailers ("ANM") respectfully submit this reply brief on rates for Outside County Periodicals Mail.

I. SUMMARY

A. Attribution of mail processing costs

The Commission should adopt the Postal Service's econometric estimates of mail processing volume variability. The empirical data supplied in this docket by USPS witness McCrery show that setup and takedown time in mail processing is better characterized as fixed than as variable with respect to volume changes. As a result, alternate estimates of mail processing variability, which are derived from the new IOCS data and properly categorize setup and takedown time as fixed, demonstrate a remarkable consistency with the Postal Service's econometric estimates. After a decade of refinements in the USPS econometric analysis, the demonstrated consistency between those results and the operational evidence presented in this case warrant acceptance of those econometric estimates.

The initial briefs of the other participants take little issue with the augmented Commission approach offered by MPA and ANM. (1) The Postal Service endorses this method as an fallback to the econometric analysis offered by the Postal Service's witnesses. (2) OCA and UPS focus exclusively on econometric issues in their initial briefs. Neither participant addresses the augmented Commission approach proposed by MPA and ANM, or our treatment of setup and takedown times. (3) Valpak, while asserting that setup and takedown time would be variable in some circumstances, tries to brush off the issue on the theory that the "extent to which identical sort schemes are run on multiple machines is an empirical matter that needs to, and can, be settled only by relevant data, which have not been submitted in this docket." This statement is incorrect. USPS witness McCrery has, in fact, submitted such data in response to an interrogatory from MPA and ANM.

B. Attribution of city carrier costs

The Commission should adopt the attribution of city carrier costs proposed by the Postal Service. The testimony of OCA witness Smith (OCA-T-3) does not provide a reliable basis for any adjustment to the Postal Service study. Contrary to Dr. Smith's claim, inclusion of the density variable is required to correctly capture all impacts on City Carrier Street Time. OCA's continuing attempt to discard this variable reflects an incomplete understanding of spatial impacts on City Carrier Costs. Dr. Bradley's calculation of density correctly adjusts for expected variations in actual density from the CCSTS. The OCA has not identified a CCSTS model that improves on the Postal Service treatment of multicollinearity. The OCA mischaracterizes the desirability of using the DOIS database. Its proposal to use statistical adjustments to remedy missing or incomplete DOIS data would itself cause serious data quality issues.

C. Cost classification of payments into the Postal Service Retiree Health Benefits Fund under Section 803 of PAEA

Section 803 of the Postal Accountability and Enhancement Act of 2006, Pub. L. No. 109-435, 120 Stat. 3198 (Dec. 20, 2006) ("PAEA" or "the Act"), to be codified in part at 5 U.S.C. § 8909a(d)(3)(A), requires the Postal Service to pay specified amounts annually over the next ten years into the Postal Service Retiree Health Benefits Fund. The payment required for Fiscal Year 2008, the Test Year of this rate case, is $5.4 billion. *Id*., § 8909a(d)(3)(A)(i).

For the reasons explained herein, approximately $0.4 billion of the $5.4 billion payment should be treated as a current service cost of labor, and attributed to individual classes and subclasses of mail to the same extent, and in the same manner, that any other current labor cost is attributed. The annual pay-as-you-go retiree health benefit payment, $2.1 billion in FY 2008, should be treated in the same way. The balance of the $5.4 billion annual payment to the Retiree Health Benefits Fund mandated by PAEA, however, is a sunk and fixed cost that must be classified as an institutional cost and therefore allocated among the classes and subclasses of mail pursuant to the factors of 39 U.S.C. § 3622(b).

D. Worksharing cost avoidance estimates

The initial brief of MPA and ANM explained why the Commission should adopt the improved methodologies and models proposed by MPA/ANM witness Glick for estimating the costs avoided by mailer worksharing. Most of the bases advanced by MPA and ANM were not challenged by other participants' initial briefs. Moreover, the intervenors' briefs raise no significant issue concerning the cost avoidance methodologies that was not covered in our initial brief. Two particular inaccuracies in the Postal Service's brief merit a response, however.

First, the Postal Service asserts that using Periodicals Outside County unit costs for all nonletters in the CRA adjustment is inappropriate because "the CRA cost-by-shape estimates for flats have already been modified to account for differences in how mail pieces are categorized in Postal Service data collection systems." This criticism is misplaced. Although the Postal Service did modify its estimates of the cost of processing flat-shaped Standard Regular mail to account for inconsistencies in shape definitions used in different USPS data collection systems, the Service left unmodified its estimates of the cost of processing flat-shaped Periodicals Outside County mail.

Second, the Postal Service's claim that Mr. Glick treated the Function 1 Support ("1SUPPF1") cost pool as proportional is also inaccurate. In fact, he proposed treating this cost pool as proportional only to the same extent as costs in the supported operations.

E. Rate design for Periodicals Outside County Mail

The welter of arguments, assertions and rhetoric offered by the various participants on the issue of Outside County rate design leave several fundamental points essentially undisputed. *First*, while there is general agreement that avoiding undue rate shock for small publishers is important, there is also a consensus that the existing rate design includes too much rate averaging, too many internal cross-subsidies, and too little cost recognition and incentives for efficiency. *Second*, the MPA/ANM proposal clearly represents a middle ground in the debate. The interests that ask the Commission to go slow—ABM, McGraw-Hill and the Postal Service—assail our rate design for giving too much weight to efficiency, and too little to the avoidance of rate impact. The efficiency hard-liners—Time Warner and U.S. News—assail MPA/ANM for not going far enough. Being assailed from both extremes merely underscores the reasonableness of the balance struck by the MPA/ANM rate design between promoting efficiency and minimizing rate impact.

The initial briefs of ABM, McGraw-Hill and the Postal Service fail to justify adoption of the Postal Service's proposed rate design for Periodicals Outside County Mail. The USPS brief cannot obscure the fact that its proposal only modestly increases existing incentives to commingle and dropship periodicals. Moreover, USPS and McGraw-Hill simply ignore the fact that the proposal would create a disincentive to the efficient preparation of periodicals on 5-Digit pallets. The arguments raised by USPS and McGraw-Hill cannot alter the conclusion that the Postal Service's proposed container charge would create rate shock for some small publishers and perverse incentives for inefficiency. Furthermore, the proposed Carrier Route and destination entry discounts are too small because they are based upon inaccurate and understated cost avoidance estimates as well as inappropriate assumptions about test year costs. Although the Postal Service claims that its proposed Carrier Route discounts would equal or exceed avoided costs, its statement, is based on an estimate of Carrier Route cost avoidances that grossly understates the actual cost avoidances. Finally, the 18 percent rate increase proposed by the Postal Service in the Periodicals Ride-Along rate is excessive; a rate increase in line with the subclass average would be more appropriate, and would still allow the Ride-Along rate to make a significant contribution to institutional costs.

The initial briefs also confirm that the Commission should adopt the Periodicals Outside County rate design proposed by MPA and ANM. Contrary to the arguments of McGraw-Hill, the MPA/ANM rate design provides stronger incentives for efficient mail preparation than does the USPS rate design. Publishers and printers will respond to these greater incentives: hence, notwithstanding McGraw-Hill's arguments to the contrary, discounts are more than just a "reward" for existing worksharing. Moreover, none of the other briefs dispute the fact that increased commingling and dropshipping will benefit the subclass as a whole, because cost avoidances still exceed the discounts proposed by Mr. Glick. Further, contrary to the assertions of ABM, USPS and McGraw-Hill, the MPA/ANM proposal will not cause undue rate shock for small publications. Finally, the Commission should recommend the 5-digit pallet discount, which would significantly increase efficiency while causing very little revenue leakage to existing volume.

II. THE COMMISSION SHOULD ADOPT THE POSTAL SERVICE'S ECONOMIC ESTIMATES OF THE MAIL PROCESSING COSTS ATTRIBUTABLE TO PERIODICALS OUTSIDE COUNTY CLASS MAIL.

MPA and ANM demonstrated in Section II of their initial brief that the Commission should adopt the Postal Service's econometric estimates of mail processing volume variability. The empirical data supplied in this docket by USPS witness McCrery show that setup and takedown time in mail processing is better characterized as fixed than as variable with respect to volume changes. As a result, alternate estimates of mail processing variability, which are derived from the new IOCS data and properly categorize setup and takedown time as fixed, demonstrate a remarkable consistency with the Postal Service's econometric estimates. By contrast, when those IOCS data are used to update the Commission's method of estimating volume variability, the results are inconsistent with the econometric estimates by OCA witness Roberts and UPS witness Neels despite their claims of consistency with the Commission's method. After a decade of refinements in the USPS econometric analysis, the demonstrated consistency between those results and the operational evidence presented in this case warrant acceptance of those econometric estimates. Finally, Valpak witness Haldi has failed to provide a valid economic justification for treating mail processing costs as attributable that the current record indicates to be largely fixed with respect to volume changes. MPA/ANM Br. 5-13.

The initial briefs of the other participants take little issue with the augmented Commission approach offered by MPA and ANM.

(1) The Postal Service endorses this method as a fallback to the econometric analysis offered by the Postal Service's witnesses. USPS Br. 108-110.

(2) OCA and UPS focus exclusively on econometric issues in their initial briefs. Neither participant addresses the augmented Commission approach proposed by MPA and ANM, or our treatment of setup and takedown times. OCA Br. 12-41; UPS Br. 13-19.

(3) Valpak, while asserting that setup and takedown time would be variable in some circumstances, acknowledges that the examples suggested in its brief "may arise only on limited occasions." Valpak Br. II-7. Valpak tries to brush off the issue on the theory that the "extent to which identical sort schemes are run on multiple machines is an empirical matter that needs to, and can, be settled only by relevant data, which have not been submitted in this docket." *Id*. at II-11. This statement is incorrect. USPS witness McCrery has, in fact, submitted such data in response to an interrogatory from MPA and ANM. *See* MPA/ANM Br. 6-7 (discussing record).

The data, which provide a nationwide snapshot of the sort schemes running on the Postal Service's DBCS and AFSM 100 machines at five different times of day on May 18, 2006, show that the majority of schemes are run on a single machine for all types of sorts. For incoming secondary sorts—the majority of sort schemes—essentially all schemes are run on a single machine. 11 Tr. 2896-97 (response of USPS witness McCrery to MPA/USPS-T42-22(e)).

Mr. McCrery confirms that most sort schemes are incoming secondaries, which are almost always run on a single machine at a facility. 11 Tr. 2896 (response of USPS witness McCrery to MPA/USPS-T42-22(c), (d)). For letters, of which 79 percent of the incoming secondary volume is sorted to DPS, the DPS sorting procedure requires that each sort scheme be run on only a single machine. McCrery Direct (USPS-T-42) at 12, n. 10; *Id.* at 36, lines 15-18. Even non-DPS incoming secondary sort schemes are almost always run on only a single machine. 11 Tr. 2896 (response of USPS witness McCrery to MPA/USPS-T42-22(d)).

III. THE COMMISSION SHOULD ADOPT THE ATTRIBUTION OF CITY CARRIER COSTS PROPOSED BY THE POSTAL SERVICE

A. The Postal Service's analysis of city carrier street time is the best evidence of record

In our Initial Brief, we explained that the OCA witness Smith's analysis of the Postal Service model of city carrier street time was superficial and incorrect. Moreover, his proposal to use DOIS data to model street time costs is premature . Dr. Smith has not attempted a thorough analysis or cleaning of the data, and there are serious problems inherent in that data that may never allow them to be usable for street time cost modeling. See MPA/ANM Br. at 18-20 and 22-24. Other than the OCA, no participant disputes these facts in its initial brief.

Our Initial Brief also acknowledged that problems exist with the CCSTS data used by the Postal Service to develop its street time cost model. And we recognize that more investigation should be conducted on both the data and the model. The Postal Service also recognizes this. Bradley Direct (USPS-T-14) at 10. The OCA, however, has not provided any alternative treatments that seriously address the issues, and the OCA cannot claim that any of its models truly improve the results provided by the Postal Service.

Because the Commission plans a proceeding to focus on the street time cost issue, the best course of action is to deal with the issue further in that more extensive and detailed investigation. Because the rates of virtually all postal services and most postal products in this case are based on the USPS city carrier analyses, it makes no sense to perturb all rates and rate levels already litigated in this case using unverified costing models. MPA/ANM Br. at 15-16.

B. The testimony of OCA witness Smith (OCA-T-3) does not provide a reliable basis for any adjustment to the Postal Service study.

In its initial brief, the OCA attempts to refute the Postal Service and MPA/ANM arguments for continuing to use the city carrier volume variability analysis that witness Bradley presented in Docket No. R2005-1. As an alternative, OCA continues to press its case for use of one of several recommended volume variability results presented by witness Smith in Docket No. R2006-1 (OCA-T-3). OCA's argument continues to rely on assumptions that were shown to be superficial and incomplete by witnesses Crowder and Bradley. Crowder Reb. (MPA et al.-RT-1) and Bradley Reb. (USPS-RT-4).

In particular, OCA offers the following claims in support of Dr. Smith's recommendations:

- The density variable is endogenous to the delivery cost minimization process and therefore does not belong in the city carrier delivery cost models. OCA Br. at 44-50.
- Dr. Bradley computed the density variable incorrectly. OCA Br. at 51.
- Dr. Bradley's reliance on a restricted quadratic model to address the known CCSTS multicollinearity problem is unnecessarily constraining. Either Dr. Smith's CC5A full quadratic (with the three-bundle approach and no density variable) or POIR No. 25 CC3 model (with elimination of the SPR cross-product and density variables) is an improvement. OCA Br. at 52-56.
- The DOIS data set is the most suitable for the city carrier street time modeling process. OCA Br. at 65. The major deficiencies in the DOIS data can be overcome by applying appropriate statistical adjustments to the database. OCA Br. at 57-59.

These assertions are all incorrect, and, except for the proposed "statistical" adjustments to correct for the potentially fatal missing or incomplete data in the DOIS, have all been raised and refuted previously in this case by MPA/ANM witness Crowder, USPS rebuttal witness, and the initial Brief of MPA/ANM. The OCA's 11th-hour adjustments to the DOIS data are not properly before the Commission. OCA witness

Smith did not offer them, and other participants therefore had no opportunity to submit testimony rebutting them. Even if OCA's belated arguments were timely, however, neither the adjustments nor any of the OCA's other defenses can uphold Dr. Smith's analysis.

1. Inclusion of the density variable is required to capture correctly all impacts on City Carrier Street Time. OCA's continuing attempt to discard this variable reflects an incomplete understanding of spatial impacts on City Carrier Costs.

a. The OCA itself recognizes that square mileage and density affect city carrier street time.

Citing the testimony of Dr. Smith, the OCA claims that the density variable should not be used in the carrier cost model. OCA Br. at 44. Despite the sophisticated economic terms and literature citations offered by OCA, its argument on this point is unclear and inchoate. As shown by Dr. Bradley, Dr. Smith has made numerous unclear references describing the density variable as both an output and an input to the cost minimization process. These expository attempts by Dr. Smith parallel his ambiguous statements on what density means in the delivery model. Bradley Reb. (USPS-RT-4) at 6-7 (34 Tr. 11559-11560). By contrast, in Docket No. R2005-1, Dr. Bradley clearly defined density as applied to his model and conceptual framework. Most recently, he also provided citations to research that has used the same notion of density. Bradley Direct (USPS-T14) at 27 and Bradley Reb. (USPS-RT- 4) at 2-5 (34 Tr. 11555-11558). Yet, despite the wide understanding and usage of Dr. Bradley's concept of density for city carrier street time costing, OCA persists in supporting Dr. Smith's call for rejection of this variable based on a still-unspecified alternative notion of density.

In direct testimony, Dr. Smith rejected Dr. Bradley's definition of density and then proceeded to explain at length that supervisors account for "tradeoffs" in using various inputs to minimize city carrier costs. Smith Direct (OCA-T-3) at 3-6. At the end of his long description, though, Dr. Smith jumped to the conclusion that density is an output of this cost minimization effort without defining what he means by output, much less describing, even in general form, how that output is suddenly achieved when costs are minimized. *Id*. at 6. Dr. Smith's responses to discovery on this point were largely unrevealing. *See* Smith response to USPS/OCA-T3-26 (22 Tr. 8123-8124). Thus, what constitutes density in Dr. Smith's modeling framework is still left unclear.

To add to the confusion, OCA has now introduced another word—"subsumed" — into the lexicon. In brief, OCA now states that the density variable is "subsumed into the production process", and "subsumed in reaching a solution. . ." or "subsumed in some type of maximization or adjustment process. . ." OCA Br. at 46 and 48. It appears that OCA's position is the same, but that OCA is indicating that the density variable disappears all together when subsumed by the cost minimization effort.

Despite these ambiguities, OCA concedes that the cost of mail delivery is affected by ZIP code square miles and route miles. *Id*. at 45. Moreover, OCA accepts Ms. Crowder's contribution in defining city carrier costs in terms of three primary workload or input variables: volumes, possible deliveries, and area. Crowder Reb. (MPA et al.-RT-1) at 8-9 (34 Tr. 11647-11648) and OCA Br. at 46. Stated differently, apparently OCA now accepts that city carrier street costs are ultimately explained by changes in these fundamental workload variables.[1] Further, the OCA states:

> However, as indicated by witness Crowder, postal managers perform a minimization process that takes the multitude of factors into account; accordingly, square mileage, density, etc. are variables that are addressed

[1] Ms. Crowder's connotation of the term "primary" as applied to these variables means that values for these variables are given by ZIP code and therefore management minimizes costs, given the effective constraints represented by these variables, by varying variables under their control (through means such as route type technology, route configuration and number of routes, use of overtime, or use of part-time carriers).

by the least cost solution of the production process and are not necessary in the estimation of the cost curve."

OCA Br. at 46.

In other words, OCA appears to recognize that not only square mileage but also density, in the sense described by Dr. Bradley, are variables affecting the least cost solution by ZIP code. However, if this is so, OCA's assertion that these variables are not necessary in the estimation of the cost curve is puzzling.

The OCA would have the Commission believe that independent variables affecting an explained variable – in this case, the value for the least cost solution – can now suddenly become unnecessary as explanatory variables in a cost function that describes variations in the explained variable.[2] But this makes no sense. Any independent variable systematically affecting an explained or dependent variable should be included in the function explaining changes in the dependent variable. As described by Ms. Crowder, exclusion of any fundamental explanatory variable in a cost function mis-specifies the true model and leads to biased coefficient estimates for the included variables. Crowder Reb. (MPA et al.-RT-1) at 7 (34 Tr. 11646).

Perhaps OCA's confusion comes from relying on a two-dimensional visual representation of the cost function, the cost curve, to explain cost impacts. A curve that depicts costs on the ordinate (Y axis) and volume output on the abscissa (X axis) of a two-dimensional graph shows only how costs vary with changes in volume. The cost variation relative to output is represented by movement *along* the curve. By definition, movement along the cost curve on a two-dimensional graph of this kind cannot explain

[2] Dr. Smith appears to use the terms "cost function" and "cost curve" interchangeably. For example, he states "A cost curve for a firm models cost as a function of output." OCA-T-3 at 4. The OCA also appears to use the terms interchangeably in its brief. Compare, e.g., OCA Br. at 45 and 46.

cost variations caused by changes in any of the other workload variables such as square mileage, density or possible deliveries for that matter.

That a chart of this kind cannot display the effects of more than one independent variable at a time clearly does not mean changes in the other independent variables have no effect on cost, as OCA appears to assert. OCA appears to have overlooked that the effects on costs caused by changes in the other workload variables are represented in a two-variable chart by upward or downward shifts in the cost curve itself. The city carrier street cost function proper, in the form of a testable mathematical statement, captures both movements along the curve (from changes in volume) and shifts in the curve (from changes in the other workload variables including possible deliveries) through variations in all primary workload variables.

OCA dismissed the effect of square mileage and density on cost estimation apparently because OCA either overlooked or ignored the shift effect on the cost curve caused by these other explanatory variables.[3] Regardless of the reason for the omission, however, now OCA does seem to acknowledge the cost effects of the three workload variables identified by Ms. Crowder. The only way that all cost effects can be captured in a cost model of city carrier costs, however, is to use all three workload variables as independent variables, in their appropriate form and level of detail.

b. The density variable necessarily affects route miles because density affects average distances between stops or delivery points.

The OCA recognizes that route miles affect delivery time. OCA Br. at 45. Density affects route miles by causing variations in average distances between delivery points or stops. Accordingly, any change in density must cause a change in the total

[3] In view of this, OCA's insistence that possible deliveries be included but square mileage and density be excluded as explanatory variables is illogical because changes in all these variables shift the cost-volume output curve.

route miles component of city carrier street time, as described by witness Crowder. Crowder Reb. (MPA et al.-RT-1) at 9 (34 Tr. 11648). Dr. Bradley also demonstrated the same effect through a graphical example showing how inter-stop distances increase for any number of delivery points when ZIP-code density decreases. Bradley Reb. (USPS-RT- 4) at 8-9 (34 Tr. 11561-11562).

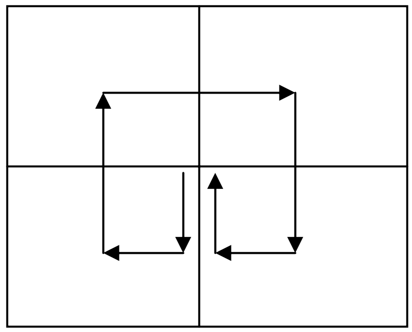
During cross-examination and now in its brief, OCA attempts to counter Dr. Bradley's simple example on the theory that different route mileage results can be obtained by simply varying the placement of his stop locations inside the ZIP code "box". OCA Br. at 49. OCA overlooks, however, that the locations of stops or delivery points within ZIP-codes boundaries are not random, but are situated along existing and new lines of travel as new points are added. Random location of delivery points would involve unstructured or haphazard development patterns, an assumption that is counterfactual.

The fallacy in OCA's argument is best exposed by returning to Dr. Bradley's description. FIGURE 1 below shows Dr. Bradley's original example in a slightly revised way. Instead of locating the stops at the ZIP code "corners," the four stops are now placed uniformly inside a square-shaped ZIP code with the station located at the center. The stop-to-stop routing pattern shown is essentially the same as that in Dr. Bradley's original example, except that the carrier proceeds directly South and then West to reach the first stop, and returns to the station by proceeding directly West and then North from the last stop.

FIGURE 1

20 miles

20 miles



Assuming Dr. Bradley's initial condition of 10 miles between stops, the carrier in this case would need to cover 50 route miles.[4] The calculation is given directly by:

Total Route Miles = Number of Stops*Distance Between Stops + Vertical Distance Transited to and from Station

50 = 4*10 + 10.

The 50 route miles can also be determined in a more roundabout way to reveal the impact of density on distance between stops, and therefore on total route miles. As shown by the diagram, each side of the ZIP code square is 20 miles long, so that the total ZIP code area is 400 square miles (400 = 20*20). This means that the average area per stop (each of the inner squares) is 100 square miles (100 = 400/4). It is also clear from the diagram that the inter-stop distance must be equal to the length of one side of any of the inner squares. This distance therefore can be calculated from:

Distance Between Stops = Square Root of Area per Stop

10 = (400/4)½

[4] This is slightly more than Dr. Bradley's calculation of 44.14 route miles because in the above-described scenario the carrier proceeds at right angles instead of diagonally from and to the station.

Because the value for density or average stops per square mile is just the inverse of average square miles per stop – in this instance, 0.01 miles (4/400) – the 10 mile distance between stops can also be expressed by:

Distance Between Stops = Square Root of 1/Density

$10 = (1/.01)^{½}$.

Therefore, total route miles are shown dependent on the total number of stops and density from:

$50 = 4*(1/.01)^{½} + (1/.01)^{½}$.

Similarly, the route miles from Dr. Bradley's second example involving the same number of stops but now spread 100 miles apart can be calculated in the same way. In this case, the 500 route miles can be calculated from:

$500 = 4*(1/.001)^{½} + (1/.001)^{½}$.

In this scenario, average square miles per stop is 1000 = 4,000/4 and density is .001 stops per square mile.

The two calculations show that as density decreases from .01 to .001 stops per square mile, total route mileage increases from 50 to 500, clearly indicating an inverse relationship between density and average inter-stop distances. Moreover presented in this way, Dr. Bradley's examples show that for any given number of possible deliveries, variations in density cause opposing variations in route miles. The negative relationship is caused by ZIP code square miles alone acting through the density variable. Ms. Crowder described this effect in her rebuttal as delivery point "crowding" when density increases. Crowder Reb. (MPA et al.-RT-1) at 9 (34 Tr. 11648). OCA appears not to have grasped this point.

The route mile calculations also illustrate the underlying idea behind Dr. Bradley's graphical example and Ms. Crowder's explanation of inter-stop distance effects from density. If all or most stops are situated along existing lines of travel and these lines of travel are evenly or close to evenly distributed inside ZIP code borders, ZIP code density is a useful descriptor of average inter-stop distances. In particular, the examples show that ZIP code density affects ZIP code route miles inversely in a predictable and systematic way.[5] This inverse relationship is precisely the effect indicated by the coefficient values on Dr. Bradley's density variable from his restricted quadratic model.

As OCA notes, if stops deviate from the established routing pattern, any number of different route mile solutions can be generated. However, the OCA's underlying assumption of systematic deviations from existing lines of travel is simply unrealistic. Stops can be expected to be arranged in an orderly pattern with small deviations from average inter-stop distances for any pair of contiguous stops. Dr. Bradley's own modeling efforts and the previous studies cited by him support this expectation empirically.[6]

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[5] The above-described calculations have assumed one entry and exit point into and from the run time portion of the diagram (the square formed by the arrows) and, therefore, only one route. Changing the number of routes to minimize costs or because of various other constraints affects the number of entry points and therefore travel time and not the run time distance all carriers need to cover on all routes. However, even total travel time can be shown to be affected by density.

[6] OCA also argues that use of density is a very crude tool compared to using disaggregated delivery point variables as "environmental" variables. It also attempts to disparage the spatial aspects of Dr. Bradley's description by claiming that each stop can have multiple delivery points and therefore that "[t]he focus on density is misplaced." OCA Br. at 48-49. However, nothing precludes combining use of a density variable with disaggregated delivery point variables. In fact such attempts should be encouraged. Otherwise exclusion of the density variable mis-specifies the run time spatial effects that both Dr. Bradley and Ms. Crowder described in different ways. Further, contrary to OCA's suggestion, the presence of multiple delivery stops, in dismount portions of routes for example, does not invalidate these spatial effects in any way. OCA's comments in this regard just provide further confirmation of its fundamental misunderstanding of the spatial component of run time explained by the density variable.

2. Witness Bradley's calculation of density correctly adjusts for expected variations in actual density from the CCSTS.

Besides challenging the density variable on conceptual grounds, OCA argues that Dr. Bradley misapplied the variable by failing to compute it correctly in his model. OCA Br. at 51. In calculating density for a ZIP-code-day, Dr. Bradley adjusted the figure to reflect the failure of all routes in some ZIP codes to report CCSTS data on all sampled days. Dr. Bradley made this adjustment to account for differences between the density of the reporting routes and the density of all routes in the ZIP.

According to Dr. Smith, however, density, if used at all, should be based on ZIP code land area and the maximum number of delivery points that can be reported – i.e., density should be unaffected by the number of routes reporting in the ZIP code. Smith Direct (OCA-T-3) at 7-8. Accordingly, he estimates ZIP code density as a constant: housing units per ZIP-code area. [7] The real issue here, however, is not the true ZIP code density but how to properly control for density effects on city carrier street costs when there is missing route data.

Dr. Bradley calculated density for each ZIP-day observation by summing both ZIP code possible deliveries and land area across the number of reported ZIP-route-day observations within each ZIP-day and then divided the former by the latter. He describes this calculation as providing a proper "weighting" of density values for any under-reporting of route data on particular ZIP-days. Bradley response to OCA/USPS-T14-2. Thus, Dr. Bradley recognized that actual density on a particular ZIP-day depends on the routes that report on a ZIP-day and that ZIP-day density may vary depending on which routes report on that ZIP-day. Bradley Reb. (USPS-RT-4) at 15-16

[7] Despite his rejection of the use of the density variable, Dr. Smith still used his own version of a density variable in many of his 24 CCSTS models.

(34 Tr. 11568-11569). His adjustment provides an estimate of density variation from day to day that needs to be captured in order to properly control for spatial effects in developing city carrier street cost models.

By contrast, Dr. Smith's calculation produces a density value that would be constant across ZIP-days for each ZIP code regardless of the number of routes reporting data on particular ZIP-days. In essence, Dr. Smith asserts that any effect from the missing routes should just be ignored and that density should be calculated as if all possible deliveries on all routes are reported. This approach clearly biases the reported CCSTS model results.

A simple example will show why Dr. Bradley's calculation makes the correct adjustment, whereas Dr. Smith's does not. Suppose that a particular ZIP code has three routes. The first route has 110 possible delivery points, the second route has 100 possible delivery points and the last route has 90 possible delivery points. The total ZIP code area is three square miles, and the area serviced by each route is one square mile. Densities for each route "section" are then the same as the number of corresponding possible deliveries. However the ZIP code density is 100 possible deliveries per square mile, the average of all three.

Assume that on one day only carriers on the first two routes report data and on the next day only the carrier on the last route reports data. For the first day, the true but unknown density for the reporting routes is 105 (the average of the first two routes); for the second day, it is 90 (for the last route alone). On the other hand, Dr. Bradley's calculation for the "density" value for the first and second ZIP-days would be 35 = (100+110)/(2*3) and 30 = 90/3, respectively. [8] Contrary to OCA's assumption, Dr.

[8] These are calculated as: (total delivery points from reporting routes) divided by (total reporting routes multiplied by total ZIP area).

Bradley was not trying to calculate a true density figure, but rather density figures that properly control for spatial effects. His calculated "density" figures do this because their ZIP-day to ZIP-day percentage variations are the same as that for the true but unknown density figures: 16.7% = (35 – 30)/30 = (105 –90)/90. And, for modeling purposes, relative variation is the only thing that matters. As long as the true and calculated relative density variations are the same or minimally different, minimal or no bias is introduced into the CCSTS models.[9]

By contrast, Dr. Smith proposed a ZIP-code density figure (housing units per square mile) that does not vary with the number of reporting routes and has little meaning for purposes of delivery carrier operations. City carriers deliver mail to business, and governmental delivery points – not merely to residential delivery points. Because it ignores this reality, Dr. Smith's proposed variable is simply unacceptable for city carrier modeling purposes. Thus, it should be rejected.

3. The OCA has not identified a CCSTS model that improves on the Postal Service treatment of multicollinearity.

As noted in our initial brief, witness Smith and the OCA clearly recognize that the CCSTS data are multicollinear and that more modeling investigation is required in order to address it. MPA/ANM Br. at 20-22; OCA Br. at 52-54. Indeed, the OCA describes Dr. Smith's alternative models as follows:

> Even though there appear to be significant problems associated with the underlying CCSTS database, OCA witness Smith performed an analysis

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[9] To the extent that there are any differences in relative variations between the two measures, they would be due to some difference in land area among routes to compensate for differences in densities among different ZIP code sections. However even in this case, differences in the relative variations should be minimal and certainly much more controlling in effect than to reflect no variation at all by using the same density value for all ZIP-days.

> investigating possible alternatives to witness Bradley's models. . . He evaluated the models on the basis of their economic meaning.

OCA Br. at 54.

While acknowledging the problems with the CCSTS data, the OCA implies that Dr. Smith's preferred approach nonetheless has some "economic meaning." But it does not and, as we have already explained in our initial brief, Dr. Smith himself has admitted that he has not performed all the conceptual work necessary to determine what economic costs are "reasonable" or which model is the most appropriate. MPA/ANM Br. at 29-31.

The OCA's claim on brief regarding the superiority of Dr. Smith's CC5 full quadratic model (without the density variable) to Dr. Bradley's restricted quadratic from Docket No. R2005-1 is a perfect example of how little attention the OCA has given to the multicollinearity problem, and how misleading apparently "reasonable results" can be. The OCA claims:

> Witness Smith recommended adoption of the CC5 variabilities in his testimony as the preferable model, based on the elimination of the density variable, positive signs for volume variabilities, and a reasonable relationship between letters and flats in terms of cost. He noted that the reason for the rejection of the full quadratic case for CC3 was a negative sign for volume variability in the case of small packages.

OCA Br. at 54.

Dr. Smith himself recognizes fully the problems associated with multi-collinear data and therefore the unreliability of coefficients in full quadratic models that include a full set of cross-product terms. Smith Response to POIR No. 25 at 7-9. However the above-quoted OCA statement create the impression that Dr. Smith's CC5 full quadratic model is devoid of such problems because (1) a negative volume variability is precluded for the SPR volume variable and (2) "a reasonable relationship" appears with respect to letter and flat costs.

The OCA, however, ignores the extreme unreliability of the individual SPR coefficients generated by Dr. Smith's preferred CC5 model as a result of the multicollinearity of its independent variables. Table 2 from his direct testimony show that most t-statistics for his SPR and SPR-related (cross product) variables are statistically insignificant. Smith Direct (OCA-T-3) at 15. Worse, the coefficient of his single SPR variable is negative -- a nonsensical result. Moreover, the unstable values for the SPR coefficients are reflected in the calculated marginal costs for small parcels. These values are extremely low and almost equal to the marginal cost for collections volume. *Id.* at 10. Thus, the SPR marginal cost appears outside the range of "reasonable" values.

As noted by Dr. Bradley, the failure of a full quadratic model to produce negative variabilities does not necessarily mean that multicollinearity and resulting estimation problems are absent. Bradley Reb. (USPS-RT-4) at 13 (34 Tr. 11566). And, as we have discussed in our initial brief, there are several ways to deal with multicollinearity. All of these should be investigated before a treatment is selected. MPA/ANM Br. at 24. The OCA, however, has not followed that approach.

The OCA's simplistic assessments should therefore be disregarded. Neither Dr. Smith's recommended CCSTS Model CC5 nor the CC3 model he developed in response to POIR No. 25, at the behest of the Commission, can be considered an improvement on the Postal Service proposed model. *Id*. at 17-22 and 24-31. Notably, the OCA has now abandoned CC5 to propose the Commission's version of CC3 (from POIR No. 25), despite its substantial differences compared to CC5. This is clear evidence that the OCA really has little confidence in any of Dr. Smith's models. Moreover, even the OCA states that it "does not believe that CC3 as revised should be the final word in volume variability. " OCA Br. at 64-65.

4. The OCA mischaracterizes the desirability of using the DOIS database.

In rebuttal testimony, Ms. Crowder showed that pertinent data quality issues relating to the DOIS database must first be sufficiently investigated before relying on such data for any city carrier street cost analysis. Crowder Reb. (MPA et al.-RT-1) at 14-17 (34 Tr. 11653-11656). As she acknowledged, the DOIS database is appealing in several respects that could prove useful in future city carrier costing analysis. However, as currently constituted, the data base is fatally deficient because of missing data for collection and accountable volumes, and the lack of disaggregated data for package and priority mail. The missing volume data means that the DOIS cannot be used to estimate variability for collection and accountable volumes. Also, since shape differences are known to affect mail-handling characteristics, the lack of detail in the packages and priority mail data in the DOIS database would severely distort variability results for these mail types. Crowder Reb. (MPA et al.-RT-1) at 15 (34 Tr. 11654). By contrast, the CCSTS volume data are complete and sufficiently differentiated for purposes of city carrier street cost modeling and variability estimation.

In response to Ms. Crowder's comments, the OCA now contends that these deficiencies can be overcome through a series of "statistical adjustments" to the DOIS data using available information from the updated CCSTS. It asserts that using the updated CCSTS data would somehow, in an unspecified manner, make it "possible to back out the accountables delivery time" from the DOIS observations. The OCA proposes a similar adjustment for collections time, and also suggests adjusting the data by using some measure of mean parcel volume and corresponding delivery time from the CCSTS data. OCA Br. at 58-59. In other words, the OCA's proposal involves an attempt to artificially match DOIS volume variables and the time variable at an adequate level of disaggregation for city carrier street costing.

That the OCA even proposes this type of solution is astonishing, given Ms. Crowder's discussion of the errors-in-variables problem. Crowder Reb. (MPA et al.-RT-1) at 16-17 (34 Tr. 11655-11656). In rebuttal, Ms. Crowder described why Dr. Smith's setting of missing DOIS ZIP-day volume data to zero is a cause of model bias. Now, in an apparent effort to salvage Dr. Smith's DOIS modeling approach, OCA seems to be advocating tampering even further with the data – using the CCSTS data that even OCA believes are flawed.

Even in the impossible event that proper estimates for time and volume data could be formed in order to adjust the DOIS data by observation as the OCA proposes, the estimates forming the basis for the adjustment would remain just that – estimates and not actual data. If the estimates are wrong, then the remaining data used for model development must be wrong. Surely, there is no reasonable justification for developing nonsensical variability estimates using erroneous data.

OCA recognizes that this approach would not enable the development of accountable, large parcel and collection variabilities through DOIS models developed through this procedure. To remedy this problem, OCA further proposes that variabilities for accountables and large parcels be set equal to 100 percent. OCA reasons that "If accountables and large parcels are delivered, the Postal Service knows exactly how much time is incurred and that time arises solely from the route deviation needed to make a non-routine delivery." OCA Br. at 57, 59.

Although the OCA statement appears to refer to the CCSTS actual parcel/accountables delivery and route deviation times, collected by ZIP/route/day, the approach is fatally flawed. Because there is no distinction in the actual delivery and deviation time for portions "caused" separately by large parcels and accountables, there is no way to distribute that total time to each volume type to develop unit volume variable costs directly from the data. A separate CCSTS based parcel/accountables model is required to determine parcel/accountables volume variabilities.[10] Therefore OCA's claim that "Witness Bradley's estimation procedures for Parcels and Accountables are irrelevant" makes no sense. *Id*. at 57. Further, the OCA provides no explanation of how collections volume variabilities would be estimated under its proposal.

Apparently, the OCA is asking the Commission to return to the old, pre-CCSTS days when city carrier street time models and variabilities were developed by relying on separate surveys and data bases and then combining separate model results to form a "variability stew". That surely is not the answer. Until a reasonable answer is devised, the DOIS data are not appropriate to the task.

IV. COST CLASSIFICATION OF PAYMENTS INTO POSTAL SERVICE RETIREE HEALTH BENEFITS FUND UNDER SECTION 803 OF THE POSTAL ACCOUNTABILITY AND ENHANCEMENT ACT OF 2006.

On December 20, 2006, the day before the filing deadline of parties' initial briefs, the President signed the Postal Accountability and Enhancement Act of 2006, Pub. L. No. 109-435, 120 Stat. 3198 ("PAEA" or "the Act"). Section 803 of the Act, to be codified in part at 5 U.S.C. § 8909a(d)(3)(A), requires the Postal Service to pay specified amounts annually over the next ten years into the Postal Service Retiree Health Benefits Fund. The payment required for Fiscal Year 2008, the Test Year of this rate case, is $5.4 billion. *Id*., § 8909a(d)(3)(A)(i).

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[10] In describing its 100 percent variability proposal for large parcels and accountables, OCA appears to be favoring an incremental costing approach for attributing costs to these two shapes. However this approach would be inconsistent with the marginal costing approach for variability estimation used for all other volume shapes. Further even if actual CCSTS parcel and accountable costs could somehow be "divided" fully between these two shapes, these incremental costs would ignore longer-term route restructuring effects on costs caused by the entire elimination of two volume types.

The initial brief of MPA and ANM discussed briefly the extent to which contributions to the Retiree Health Benefits Fund should be attributed to individual classes and subclasses of mail. MPA/ANM Br. 31-33. Because of the importance of the question, and its 11th-hour ripening into a material issue with the enactment of PAEA, MPA and ANM ask the Commission to consider the fuller explanation of the same point provided in this section. For the reasons that follow, approximately $0.4 billion of the $5.4 billion payment should be treated as a current service cost of labor, and attributed to individual classes and subclasses of mail to the same extent, and in the same manner, that current labor costs are attributed. The annual pay-as-you-go retiree health benefit payment, $2.1 billion in FY 2008, should be treated in the same way. The balance of the $5.4 billion annual payment to the Retiree Health Benefits Fund mandated by PAEA, however, is a sunk and fixed cost that must be classified as an institutional cost and therefore allocated among the classes and subclasses of mail pursuant to the factors of 39 U.S.C. § 3622(b).

Until now, the Postal Service has made two sets of payments each year for the health insurance of present and retired employees:

- For *current* employees, the Postal Service has paid premiums each year for health insurance coverage in that year. The Commission included these costs as part of the fringe benefit portion of employee costs in each Cost Segment, and treated the costs as attributable to the same extent, and in the same manner, as other current labor costs.

- For *retired* employees, the Postal Service has made an annual health benefit payment in an amount equal to the amounts currently expended for health benefits for retirees for that year. In FY 2008, the amount of the payment is expected to be $2.1 billion. *See* Waterbury Direct (USPS-T-10), Exh. USPS-10L (Cost Segment 18.3.6). The Commission treats the $2.1 billion as a current labor cost, and attributes it to individual classes and subclasses of mail to the same extent, and in the same manner, as any other current labor cost. The result is that approximately 55 percent of the $2.1 billion, or about $1.2 billion, is attributed; the remaining $900 million is treated as an institutional cost.

It is important to emphasize that the $2.1 billion payment is calculated according to cash (or pay-as-you-go) accounting principles. This means that the payment covers only what the Postal Service actually spends out-of-pocket on retiree health benefits in a particular year. The payment does *not* equal the amount that the Postal Service would record as a "current service expense" under *accrual* accounting principles , which form the basis of Postal Service costing. That figure, which accountants define as the year-to-year increase in the present value of the Service's *future* health care benefit obligations to its *current* employees as a result of their service during the year,[10] will equal approximately $2.5 billion in the test year.

PAEA changes the Postal Service's payment obligations for retiree health insurance benefits. Under PAEA, the Postal Service must make *three* sets of payments from 2007 to 2016:

- For *current* employees, the Postal Service must continue to pay premiums each year for health insurance coverage in that year.

- For *retired* employees, the Postal Service must continue to make an annual health benefit payment in an amount, about $2.1 billion in the test year, that equals the Postal Service's cash expenditure for health benefits for retirees for each year.

- *In addition*, PAEA § 803(a)(1)(B) requires the Postal Service to pay to the Treasury an annual amount specified in 39 U.S.C. § 8909a(d)(3)(A). The payment for FY 2008 is $5.4 billion. *Id*., § 8909a(d)(3)(A)(i).

Proper attribution of these payments requires some understanding of accounting history. The Postal Service's use of the cash method rather than the accrual method to account for the cost of retiree health care benefits had its genesis in the accounting principles that were generally accepted when the Postal Reorganization Act was enacted. Most government and private sector employers in that era used the cash

[10] See PAEA § 803, to be codified at 39 U.S.C. § 8909a(d)(1).

method to account for retiree health care benefit obligations and other deferred compensation. The main advantage of the cash method was its ease of use: the expense reported on the income statement in any year essentially equaled the total cash expenditure by the employer on deferred benefits in that year. By contrast, the accrual method requires estimates of the year-to-year change in the present value of future benefit obligations—a value that necessarily depends on inherently uncertain predictions about future interest rates, mortality rates, and other actuarial values.

Beginning in the 1980s, however, the cash method came under increasing scrutiny and then attack from accountants, economists and financial regulators. The accrual method reflects the principle that the costs of retiree health care benefits and other deferred compensation should be recognized *as they accrue*—i.e., when employees *perform the labor or other service* that entitles them to the future benefits—not upon the subsequent outlay of cash when the promised benefits are ultimately paid. *See* Financial Accounting Standards Board ("FASB"), Statement of Financial Accounting Standards No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions* ¶¶ 2-4, 29, 47; *accord*, FASB Statement No. 87, *Employers' Accounting for Pensions*; Office of Management and Budget, Statement of Federal Financial Accounting Standards Number 5 ("SFFAS No. 5"), Executive Summary ¶ c (the "liability and associated expense for pensions and other retirement benefits (including health care) should be recognized at the time the employee's services are rendered"); *see also* SFFAS No. 5 ¶¶ 56-59.

In the 1980s, a consensus began to develop among accountants and economists that cash method accounting, by deferring recognition of retiree obligations as expenses until the year of the cash outflow, violates economic principles of cost causation, leading to intergenerational cross-subsidies and, to the extent that accounting costs are used to set prices, inappropriate price signals. Second, for mature or shrinking enterprises, the back-end loading of payment obligations produced by the cash method began to raise questions about the future solvency of the benefits program—a problem subsequently underscored by the increasingly acute underfunding of the analogous retiree benefits programs of many public and private employers, the Social Security System, and its counterparts abroad.[11]

The issuance of FAS 106 in 1990 marked a turning point in this debate. In that pronouncement, the FASB decisively rejected the "practice of accounting for postretirement benefits on a pay-as-you-go (cash) basis by requiring accrual, during the years that the employee renders the necessary service, of the expected cost of providing those benefits to an employee and the employee's beneficiaries and covered dependents." *Id*. Summary. FAS 106 reflected the judgment that

> a defined postretirement benefit plan sets forth the terms of an exchange between the employer and the employee. In exchange for the current services provided by the employee, the employer promises to provide, in addition to current wages and other benefits, health and other welfare benefits after the employee retires. . . . The employer's obligation for that compensation is incurred *as employees render the services necessary to earn their postretirement benefits*.

Id. (emphasis added).

FAS 106 and similar pronouncements did not cause the Postal Service to abandon the cash method. The new accounting standards still allowed the use of the cash method for multi-employer benefit plans (on the theory that the annual year-to-year change in the present value of the future benefits paid by such plans was too uncertain for any individual employer to estimate reliably); and the Postal Service argued that its own retiree benefit plans fell within this exception.[12] By 2002, the unfunded portion of

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[11] *See* FAS 81, *Disclosure of Postretirement Health Care and Life Insurance Benefits* (issued November 1984; superseded by FAS 106), FAS 106 ¶¶ 2-3.

[12] *See* FAS 106 ¶¶ 79-82; United States General Accounting Office ("GAO"), *Financial Reporting: Accounting for the Postal Service's Postretirement Health Care Costs*, GAO/AFMD-92-32 (May 20, 1992) (http://archive.gao.gov/d32t10/146641.pdf).

the Postal Service's retiree health care obligations had grown to nearly $50 billion. Report of the President's Commission at 4. As the financial outlook of the Postal Service deteriorated, however, it faced increasing pressure to switch to accrual accounting of postretirement benefit obligations despite the nominally multi-employer form of the benefit plans.[13]

The cost savings resulting from the enactment of Public Law No. 108-18 presented Congress with an opportunity to make the Postal Service's health care benefit plan fully funded. The annual catch-up payments mandated by Section 8909a(d)(3)(A) are an integral part of this transition plan. Although the purpose of the $5.4 billion payment and the subsequent fixed payments required by Section 8909a(d)(3)(A) is not stated explicitly in the PAEA itself, Senator Carper explained during the final floor debates on the PAEA last month that the purpose of these payments is to fund the currently unfunded portion of the Postal Service's retiree health benefit obligation, a shortfall estimated to be nearly $50 billion in 2002. Senator Carper stated:

> [F]or many years folks thought the Postal Service was underpaying its pension costs for its employees. A couple years ago the Office of Personnel Management did a study and found that rather than underpaying pension obligations, they are overpaying, and if they continue at the rate they are going, they will be making a big overpayment in the years to come.
>
> This legislation corrects that situation. It says that in the future, the Postal Service, 10 years out, will have access to a fair amount of money that would have gone into overpayments. In the meantime, a lot of money

[13] *See* GAO, *United States Postal Service: Information on Retirement Plans* GAO-02-170 (December 2001) at 20-21 (www.gao.gov/new.items/d02170.pdf); Letter from David M. Walker, Comptroller General, to PMG John E. Potter (Sept. 12, 2002) (www.gao.gov/new.items/d02916r.pdf); President's Commission on the United States Postal Service, *Embracing the Future: Making the Tough Choices to Preserve Universal Mail Service* 123-24 (July 31, 2003).

is going to be used to pay down the unamortized cost of health care. Tens of billions of costs will be paid off, and that will put the Postal Service in stronger financial shape going forward.

Congressional Record, December 8, 2006, at S11676. *See also* Report of the President's Commission on the USPS, at 124; Pub. L. No. 108-18, § 3(d).

The foregoing history provides a clear roadmap for the proper attribution of the Postal Service's retiree health care benefit expenditures in the Test Year. Specifically:

(1) Premiums paid by the USPS for *current* employees for health insurance coverage in a given year should be attributed in the same manner that the Commission currently attributes those expenditures. As noted above, those costs are included as part of the fringe benefit portion of employee costs in each Cost Segment, and treated the costs as attributable to the same extent, and in the same manner, as other current labor costs.

(2) The Postal Service will pay a total of $7.5 billion for retiree health benefits in the test year: the $2.1 billion annual health benefit payment that the Postal Service must continue to make for retired employees, plus the additional payment of $5.4 billion mandated by 39 U.S.C. § 8909a(d)(3)(A)(i). Of $7.5 billion total, approximately $2.5 billion—the current service cost in FY 2008 of the Postal Service's deferred health care obligations earned by *current* employees as a result of their service during the test year—should be attributed in the same way as the Postal Service's payments for current health insurance coverage of those employees.

(3) The balance of the $7.5 billion payment, or approximately $5.0 billion, is a catch-up payment that is not attributable to any classes or subclasses of mail (or any combination thereof) in the test year. Rather, this amount should be treated as an institutional cost, and allocated to individual classes and subclasses of mail pursuant to 39 U.S.C. § 3626(b).

Cost attribution is a function of causation. *National Association of Greeting Card Publishers v. USPS*, 462 U.S. 810, 826 (1983). None of the services that the Postal

Service expects to provide in the Test Year bears any causal responsibility whatsoever for the $5.0 billion amount. The payment will fund future health care obligations that the Postal Service has *already committed to paying* as compensation for service provided by Postal Service employees *in past years.* The Postal Service faces those obligations *regardless of* how much of any class of mail service is provided in the Test Year (or, indeed, in any future year). Stated otherwise, the *cause* of the obligation that the $5.0 billion payment will cover was mail volume that the retirees serviced in *past* years in exchange for the future health care benefits promised by the Postal Service. From the perspective of the Test Year, the $5.0 billion payment therefore represents costs that are not only fixed but sunk. Without the requisite causal relationship between the $5.0 billion obligation and any class or classes of mail in the Test Year, the $5.0 billion cannot be attributed to any Test Year volumes under 39 U.S.C. § 3622(b)(3).[14]

The Postal Service has recognized in analogous contexts that sunk costs are properly excluded from attributable costs. In Docket No. R2001-1, for example, the Postal Service properly contended that the "termination for convenience" costs incurred in terminating several dedicated air transportation networks—i.e., the payments made to the operators to compensate them for costs they may incur because of early contract

[14] This conclusion is also consistent with economic analysis and legal precedent involving other regulated network industries. As Alfred Kahn has stated, sunk costs are "bygones, unchangeable past history, and best forgotten." 1 Alfred E. Kahn, *The Economics of Regulation* 118 (1970); *accord*, *id*. at 71 and 73; Kahn & Shew, "Current Issues in Telecommunications Regulation: Pricing," 4 *Yale J. on Regulation* 191, 224 (1987); Kahn, "Deregulation: Looking Backward and Looking Forward," 7 *Yale J. on Regulation* 325, 333-34 (1990); III P. Areeda & H. Hovenkamp, *Antitrust Law* ¶ 741e (2d ed. 2002); Richard Posner, *Economic Analysis of Law* 7-8, 39, 560 (4th ed. 1992) ; *Coal Rate Guidelines—Nationwide*, 1 I.C.C.2d 520, 540, 544-45 (1985), *aff'd*, *Consolidated Rail Corp. v. United States*, 812 F.2d 1444 (3rd Cir. 1987).

termination—should be treated as institutional costs rather than attributed to any class of mail. The Postal Service provided two reasons for this treatment:

> "*Sunk" Nature of Costs:* From an economic point of view, these costs are backward looking, "sunk" costs associated with specific dedicated air network contracts that operated in the past. These costs do not generate any asset going forward, and therefore should not be capitalized/amortized for ratemaking purposes. *Sunk costs should have no bearing on cost attribution.*
>
> *"Fixed" Nature of Costs*: These costs are "one-time", non-recurring costs. Because they are non-recurring, they are "fixed" (i.e., they do not vary with volume), and therefore cannot be treated as volume variable. Furthermore, *they are not specific to any particular product, and therefore cannot be considered "specific fixed" or "product specific."*

Docket No. R2001-1, Direct Testimony of William M. Takis filed Oct. 2, 2001 (USPS-T-19) at 19-20 (emphasis added). The same result is warranted here. Like the costs of terminating a contract, the $5.0 billion payment will not buy any additional capacity to provide mail service in the Test Year. It is a sunk cost, and therefore not attributable.

V. THE COMMISSION SHOULD ADOPT THE IMPROVED WORKSHARING COST AVOIDANCE METHODOLOGIES AND MODELS PROPOSED BY MPA/ANM WITNESS GLICK.

The initial brief of MPA and ANM also explained why the Commission should adopt the improved methodologies and models proposed by MPA/ANM witness Glick for estimating the costs avoided by mailer worksharing. Specifically:

1. The benchmarks used by MPA and ANM to estimate the Carrier Route and nontransportation destination entry cost avoidances represent the mail that is mostly likely to convert at the margin to worksharing and they should be adopted. MPA/ANM Br. 33-37.

2. The Postal Service's flats mail processing cost model (USPS-LR-L-43) understates presort cost avoidances in general and the Carrier Route presort cost avoidance in particular, and thus should be rejected. MPA/ANM Br. 37-43.

3. The MPA/ANM model of flats mail processing costs (MPA/ANM-LR-2) should be adopted because it is more accurate than the USPS model (USPS-LR-L-43). MPA/ANM Br. 43-45.

4. MPA/ANM-LR-2 appropriately reflects mail processing cost differences between non-Carrier Route flats and Carrier Route flats in the flat preparation cost pool. MPA/ANM Br. 46.

5. MPA/ANM-LR-2 appropriately treats all costs that are incurred sorting Periodicals Outside County flats and bundles as proportional costs. MPA/ANM Br. 46-47.

6. MPA/ANM's estimates of the nontransportation destination entry cost model (Glick Direct (MPA/ANM-T-2) at 34) should be used to estimate the nontransportation costs avoided through destination entry. MPA/ANM Br. 47.

7. Witness Glick's estimates of the cost of pallets and sacks and the unit cost avoided through palletization should be used because they include container-handling costs and cost differences at both destination and non-destination facilities. MPA/ANM Br. 38.

None of the other participants' initial briefs challenge the first, sixth or seventh of these points. Moreover, the intervenors' briefs raise no significant issue concerning the cost avoidance methodologies that was not covered in our initial brief. Two particular inaccuracies in the Postal Service's brief merit a response, however.

First, the Postal Service asserts that using Periodicals Outside County unit costs for all nonletters in the CRA adjustment is inappropriate because "the CRA cost-by-shape estimates for flats have already been modified to account for differences in how mail pieces are categorized in Postal Service data collection systems." USPS Br. 358. This criticism is misplaced. While the Postal Service did modify its estimates of the cost of processing flat-shaped Standard Regular mail to account for inconsistencies in shape definitions used in different USPS data collection systems, the Service left unmodified its estimates of the cost of processing flat-shaped Periodicals Outside County mail. USPS-T-13 (Smith) at 33-35. The use of unit costs for all Periodicals Outside County nonletters in the CRA adjustment, as proposed by MPA/ANM witness Glick, serves the same purpose as the adjustments proposed by the Postal Service itself for flat- and parcel-shaped Standard Regular mail.

Second, the Postal Service's claim that Mr. Glick treated the Function 1 Support ("1SUPPF1") cost pool as proportional (USPS Br. 360) is also inaccurate. In fact, he proposed treating this cost pool as proportional *only to the same extent as* costs in the supported operations. *See* MPA/ANM Br. 47. This treatment is consistent with the "piggyback" approach that USPS witness Van-Ty-Smith (USPS-T-11) uses to distribute costs in this pool to classes and subclasses of mail. *See* Glick Direct (MPA/ANM-T-2) at 22 (discussing issue).

VI. RATE DESIGN FOR PERIODICALS OUTSIDE COUNTY MAIL

The welter of arguments, assertions and rhetoric offered by the various participants on the issue of Outside County rate design[15] leave several fundamental points essentially undisputed. *First*, while there is general agreement that avoiding undue rate shock for small publishers is important, there is also a consensus that the existing rate design includes too much rate averaging, too many internal cross-subsidies, and too little cost recognition and incentives for efficiency.

Second, the MPA/ANM proposal clearly represents a middle ground in the debate. The interests that ask the Commission to go slow—ABM, McGraw-Hill and the Postal Service—assail our rate design for giving too much weight to efficiency, and too little to the avoidance of rate impact. Thus, they argue, the rate increases proposed by MPA/ANM, "though unfair in practice . . . are apparently fair in theory." ABM Br. 4. Compared with the USPS proposal, the MPA/ANM proposal would offer both "greater incentives/rewards" and "greater penalties for unfortunate sack dwellers." *Id*. at 5. MPA

[15] ABM Br.; MPA/ANM Br. 49-76; McGraw-Hill Br.; Time Warner Br. 13-23, 49-58; U.S. News Br.; USPS Br. 343-56.

and ANM "ignore these heavy, additional front-end costs [of commingling] in their impact discussion, so that the naked assertion that mailers can avoid the very large cost increases that their proposals would cause is unsupported . . ." *Id*. at 22-23. The MPA/ANM proposal "would primarily increase rewards to Periodicals mailers who are already efficient rather than incenting those who are less efficient to become more so." McGraw-Hill Br. 3. "It also tends to have an adverse rate impact on high-editorial publications . . ." *Id*. The factor of "adverse rate impact . . . clearly favors the Postal Service proposal" over the MPA/ANM proposal. *Id*. at 23. In sum, the MPA/ANM rate proposal "fall[s] short of the balance found in the Postal Service proposal." USPS Br. 346.

The efficiency hard-liners—Time Warner and U.S. News—assail us for not going far enough. "The proposal of ANM/MPA does not even pretend to move in the direction of recognizing the cost drivers that the Commission has said should be recognized." Time Warner Br. 14. The "MPA proposal would be like pumps on the Titanic, keeping it afloat a bit longer but not changing the fact that it is doomed. We need a new ship." U.S. News Br. 11.

These criticisms prove the point. Being assailed from both extremes merely underscores the reasonableness of the balance struck by our rate design between promoting efficiency and minimizing rate impact.

Third, while reasonable people certainly can differ over the optimum balance between these two goals, the Commission will search in vain for useful guidance in the briefs of ABM, McGraw-Hill or the Postal Service. ABM predictably strikes the same pose that it has assumed in virtually every major rate case during the past two decades: greater cost recognition in the periodicals rate structure is good in theory—but not in practice, or not quite yet:

The concept of discounts for non-use of the Postal Service is acceptable to a point, *but only to a point*. In our view, discounts have gone far enough.[16]

ABP proposes that *upon the conclusion of R87*-1, the Commission institute a Mail Classification proceeding to thoroughly study palletization and containerization.[17]

ABP is not opposed to reasonable and legitimate steps that might be taken to reduce the costs of the Postal Service, reduce postage costs to mailers, and improve the "efficiency" with which the Postal Service handles mail. . . . [T]here is substantial interest in pursuing fair and effective cost-saving measures outside of the crucible of this case, and such discussions can commence *immediately upon its conclusion*.[18]

[T]he Commission should encourage the Postal Service to work with Periodicals mailers of all sizes to develop measured changes that . . . will not impose undue hardship on large segments of the Periodicals class. . . . [O]n the other hand . . . the radical restructuring proposed by the Complainants will . . . "provide millions of dollars of rate reductions to those periodicals already paying the lowest rates while imposing much higher postage costs on those unable to participate in the proposed 'race to efficiency.'"[19]

[ABM] recognizes that some changes in the existing rate design to provide both incentives and rewards for worksharing by Periodicals mailers are inevitable and, in fact, in many respects desirable. . . . On the other hand . . . one must tread lightly and analyze impact fully before implementing rates that would jeopardize a large or even a relatively small segment of the Periodicals class in the name of "efficiency."[20]

All agree that rate design changes to promote the presentation of less costly mail are appropriate. . . . Moderate rate movement would increase the amount of co-mailing and co-palletizing that is accomplished, would afford limited protect to those that cannot avoid sacks and would give the

[16] Docket No. R87-1, Testimony of ABP witness Moeller (R87-1 Tr. 28/21540) (emphasis added).

[17] Docket No. R87-1, ABP Initial Br. (Dec. 23, 1987) at 43 (emphasis added).

[18] Docket No. MC95-1, ABP Initial Br. (Nov. 6, 1995) at 78-80 (emphasis added).

[19] Docket No. C2004-1, ABM/McGraw-Hill Initial Br. (Dec. 23, 2004) at 1-2.

[20] Docket No. R2006-1, Cavnar Direct (ABM-T-1) (Sept. 6, 2006) at 2 & 4.

> Postal Service time to do its part. . . . American Business Media and its members are not opposed to measured changes . . . Pushing the incentive accelerator to the floor will do far more harm than good.[21]

ABM's notion of progress toward cost recognition is reminiscent of the famous prayer of St. Augustine: "Oh, Master, make me chaste and celibate—but not yet!"[22]

McGraw-Hill's position is similar to ABM's. While professing to endorse a movement toward "promoting more efficient Periodicals practices," McGraw-Hill endorses the Postal Service's rate design as an "incremental approach" that "has not tried to accomplish too much too soon." McGraw-Hill Br. 2. McGraw-Hill objects to MPA/ANM's rate design on the grounds, *inter alia*, that it would impair "diversity of editorial content" and create larger rate impacts than the USPS proposal. *Id*. at 23-24. McGraw-Hill neglects to mention, however, the record data showing that the maximum rate increase produced by the MPA/ANM rate design for any small publication in the POIR 19 sample would be approximately *half* the maximum produced by the USPS rate design.

The Postal Service offers even less analysis of the record, contenting itself with a brief summary of the Postal Service and ABM testimony, and several self-congratulatory characterizations of the USPS proposal as "gradual" and "the most balanced." USPS Br. 346-51.

A. The Commission should reject the Postal Service's proposed rate design for Periodicals Outside County Mail.

1. The USPS proposal only modestly increases existing incentives to commingle and dropship periodicals.

As MPA and ANM explained in their initial brief, the Postal Service's proposed rate structure does not go far in increasing worksharing incentives. The proposed

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[21] Docket No. R2006-1, ABM Initial Br. (Dec. 21, 2006) at 1, 25 and 26.

[22] St. Augustine, *Confessions*, Book 8, Chapter 7.

increases in the existing rate incentives to co-mail publications would barely differ from the subclass average rate increase, and would be well below the increase in incentives offered by the MPA/ANM proposal. The Postal Service's proposed increase in incentives to co-palletize would be even smaller. Moreover, the new rate elements intended to improve containerization and entry practices—a container charge and editorial dropship discounts—would be largely offset by the elimination of pallet and co-pallet discounts. MPA/ANM Br. 51-54. The halting progress offered by these rate changes is unacceptable. The Commission specifically found in Docket No. C2004-1 that "significant inefficiencies" exist in the Periodicals rate structure, and that "progress toward a more cost-based structure is both possible and necessary." Order No 1446 at 4 & 6. *See generally* MPA/ANM Br. 49-51.

The USPS, in its brief, offers little more than the bromide that "gradual change has been very successful, so we'll want to continue with that approach." USPS Br. 347 (quoting Taufique). But any progress, no matter how glacial, would satisfy that test. The real question, which the Postal Service ignores, is a *comparative* one: would *less gradual* progress toward full cost recognition be better? Even ABM, a supporter of the USPS rate proposal, acknowledges that it "would increase the present incentives and rewards by less than the two alternatives" proposed by MPA-ANM and Time Warner. ABM Br. 5.

The Postal Service also cites an analysis by USPS witness Tang purportedly showing that the Postal Service's rate design would create significant incentives for greater copalletization. USPS Br. 345. The Postal Service fails to mention, however, that Ms. Tang *disavowed* that study. 7 Tr. 1700, 1706, 1716 (Tang).

2. The USPS proposal would create a *disincentive* to the efficient preparation of periodicals on 5-Digit pallets.

MPA and ANM also showed in their initial brief that the USPS rate proposal would create a postage disincentive for preparation of mail on 5-digit pallets, by imposing higher total container charges on mail entered on multiple 5-digit pallets than combined on a smaller number of 3-digit pallets. MPA/ANM Br. 54-55. The Postal Service does not discuss this issue. McGraw-Hill, while parroting the Postal Service's claim that the container charge would create the "right type of incremental efficiency incentive" (McGraw-Hill Br. 12-13), simply ignores the specific problem identified by MPA/ANM.

3. The Postal Service's proposed container charge would create rate shock for some small publishers and perverse incentives for inefficiency.

MPA and ANM also showed in their initial brief that the Postal Service's proposed container charge would create perverse incentives for inefficiency:

- The proposal would unfairly overcharge the outside-county portion of in-county publications by charging 85 cents for all containers with *any* Periodicals Outside County pieces.

- The container charge would discourage the efficient practice of mixed-class comail, again by charging 85 cents for all containers with *any* Periodicals Outside County pieces.

- The container charge would have a disproportionate impact on small publications entered in small sacks, or without containers at all.

- The container charge would also create major administrative problems for commingled publications. The participants in a commingling pool would have to allocate the charge among the individual publications in the container (e.g., by piece vs. pound). Moreover, in states that apply sales tax to postage except when it is paid directly to the Postal Service, a container charge could subject the participants in a co-pallet or co-mailing pool to additional tax liability unless the Postal Service agreed to charge each participant directly for an allocated share of the container charge.

MPA/ANM Br. 55-57.

None of the supporters of the USPS rate design dispute that the container charge would create the perverse incentives described above.

McGraw-Hill urges the Commission to ignore the disproportionate increases facing the outside county portion of in-county publications, on the theory that those publications already receive "preferential In-County rates" for most of their copies. McGraw Hill 14-15. The statutory rate preference for in-county publications, however, is not a piggy bank to be raided for the purpose of cushioning otherwise-unacceptable rate increases for outside-county copies. The purpose of the in-county rate preference, which dates to 1851 and was reaffirmed by Congress just last month, is to encourage the dissemination of small publications as a public service to small communities.[23] Diverting the benefits of the rate preference to cover the losses resulting from disproportionate rate increases on *outside-county* subscriptions would be clear misuse of the rate preference. *See also* 7 Tr. 1878-79 (statement of Commissioner Hammond expressing concern about the likely impact of the USPS proposal on outside county copies of in-county publications).

The Postal Service speculates that significant rate increases for outside-county copies of in-county publications could be avoided through the implementation of Section 1003(2) of the Postal Accountability and Enforcement Act, which makes in-county rates available to "some" outside-county portions of in-county publications, and "possible flexibility in [Docket No. R2006-1] implementation rules". USPS Br. 348. There is no reason to believe that either will eliminate the problem, however. The provision of PAEA § 1003(2) to be codified at 39 U.S.C. § 3626(g)(3) applies only to outside-county copies distributed on postal carrier routes "originating in the county of publication," and thus does not cover copies mailed to snowbirds and other subscribers distant from the

[23] *See* Richard B. Kielbowicz, "A Policy History of Selected Preferred Mail Categories," in PRC, *Report to the Congress: Preferred Rate Study* (June 18, 1986), App. A at 20-46 (discussing history of rate preference for in-county publications); PAEA § 1003 (retaining rate preference for in-county publications).

county of publication. The provision to be codified at 39 U.S.C. § 3626(g)(4) has not been implemented; and the Postal Service has not filed a request for the establishment of such rates under 39 U.S.C. § 3622—or even indicated when such a request might be forthcoming. Absent any realistic possibility that relief will be available to the vast majority of Outside-County pieces entered by in-county publications under PAEA § 1003(2) before the statutory deadline for issuance of a recommended decision in this case, the Postal Service's speculation is too insubstantial to receive any weight in setting rates in *this* case.

Also, the Postal Service has offered no evidence that there will be any "flexibility in implementation rules." In fact, if the following heading to a section of its Initial Brief is any indication – "The container rate should apply to all Periodicals mailings, including those entered in flats tubs and in unsacked bundles" – the Postal Service will be quite rigid in its implementation. USPS Br. 351.

Equally insubstantial is McGraw-Hill's speculation that the publications hit hardest by the USPS rate design can readily mitigate increases if the Postal Service would just waive the container requirement (McGraw-Hill Br. 15-16). The Postal Service has not proposed such a waiver, and has offered no indication of that it intends to do so—let alone that it will implement a waiver before the rates established in this case take effect.

Finally, McGraw-Hill's assertion that the publications hardest hit by the rate design could readily mitigate the rate increases by consolidating mailpieces into fewer sacks (McGraw-Hill 2 & 15) is another exercise in wishful speculation. There is no doubt that *some* publishers would respond to adoption of the Postal Service rate proposal by increasing sack size, just as publishers would respond more aggressively to the MPA/ANM proposal by comailing, co-palletizing, and dropshipping. It is equally clear, however, that some publications (particularly small publications) will remain in small sacks in the test year, and will thus experience substantially larger rate increases under the USPS proposal. 30 Tr. 10438 (Glick) (explaining circumstances in which mailers are likely to continue using small sacks).

McGraw-Hill itself emphasized this fact only two years ago in Docket No. C2004-1. In response to Time Warner's suggestion that small publications could avoid very large rate increases from its proposed rate structure by "the very simple action of using higher sack minimums," McGraw-Hill dedicated an entire subsection of its initial brief to the proposition that "There Is No Sound Basis To Conclude That Adverse Impact On Small Publications Could Be Avoided Simply By Consolidating Sacks Of Mail." Joint Initial Br. of ABM and McGraw-Hill in C2004-1 (filed Dec. 23, 2004) at 26-31. Such "simple actions may well have complex consequences, both in terms of costs and service," McGraw-Hill instructed the Commission. *Id*. at 26.

McGraw-Hill was even more emphatic about this point in its reply brief. Surveying the extensive publisher-specific data collected in Docket No. C2004-1, McGraw-Hill found "no basis in the record for Complainants' suggestions-without-citations . . . that all mailers would supposedly be able to avoid 'large' rate increases" by abandoning skin sacks. Joint Reply Br. of ABM and McGraw Hill in C2004-1 (filed Jan. 10, 2005) at 7-13. The Complainants' claims to the contrary were "extravagant," "shamelessly sweeping" and "unfair." *Id*.

Finally, the data in Library Reference MPA/ANM-LR-7 show that the recipients of the largest rate increases under the USPS proposal would be very small publications (most likely newspapers) with 125 or fewer Outside County pieces per issue. If any publications are going to have problems changing their mailing practices to avoid rate shock, it is these publications.

4. The proposed Carrier Route and destination entry discounts are too small because they are based upon inaccurate and understated cost avoidance estimates as well as inappropriate assumptions about future costs.

In their initial brief, MPA and ANM also explained that the Carrier Route presort and destination entry discounts proposed by the Postal Service are too small. MPA/ANM Br. 58-59.

The Postal Service claims that its proposed Carrier Route discounts would equal or exceed avoided costs. USPS Br. 345-46. This statement, however, is based on an estimate of Carrier Route cost avoidances that grossly understates the actual cost avoidances. A more accurate estimate of the Carrier Route cost avoidance indicates that the Postal Service rate design would pass through far less than 100 percent of worksharing cost savings. Even the deeper discounts proposed by MPA/ANM witness Glick would pass through only about 80 percent of accurately-estimated avoided cost. MPA/ANM Br. 67.

5. The proposed disproportionate 18 percent increase in the Ride Along rate is an example of mechanistic ratemaking at its worst.

As MPA/ANM explained in their initial brief, the 18 percent rate increase proposed by the Postal Service in the Periodicals Ride-Along rate is excessive; a rate increase in line with the subclass average would be more appropriate, and would still allow the Ride-Along rate to make a significant contribution to institutional costs. MPA/ANM Br. 59.

The Postal Service appears to offer two arguments in support of the large increase it proposes: (1) the Ride-Along Rate should be “developed based on accepted principles, rather than to just match the overall increase for the Outside County subclass”; and (2) revenue from the Ride-Along Rate “is included in the total Periodicals revenue and improves the overall class contribution.” USPS Br. 350-51. The first of these arguments appears to be little more than a euphemism for “we did it that way before, so we'll do it that way again." That kind of logic does not begin to rise to the level of reasoned ratemaking.

The second argument, while indisputably correct, begs the question. The rate design proposed by MPA and ANM *also* includes the revenue from the Ride-Along Rate "in the total Periodicals revenue," and this inclusion *also* "improves the overall class contribution." While the contribution from Ride-Along revenue is smaller under the MPA/ANM proposal, our proposed rate design offsets this reduction by slightly increasing the TYAR revenue generated from *other* Periodicals Outside County rates. This is a tradeoff that MPA and ANM was willing to make. Other Periodicals mailers apparently agree; no other party has raised concerns about this aspect of the MPA/ANM proposal.

B. The Commission Should Adopt The Periodicals Outside County Rate Design Proposed By MPA And ANM.

1. The MPA/ANM rate design provides stronger incentives for efficient mail preparation than does the USPS rate design.

In its initial brief, MPA and ANM demonstrated that their rate design provides more incentive to commingle and dropship periodicals than does the USPS proposal. MPA/ANM Br. 59-60. ABM agrees that the MPA-ANM proposal would create "greater incentives/rewards than the Postal Service proposal." ABM Br. 5 (showing that the incentives under the MPA/ANM proposal are larger than under the USPS proposal).

McGraw-Hill disagrees, however, claiming that the MPA/ANM proposal "offers no new incentive to improve the efficiency of small mailers." McGraw-Hill Br. 10 & 19. This is nonsensical. The MPA-ANM proposal not only includes major new editorial pound dropship discounts, but also a deepening of existing discounts. The notion that progress toward greater efficiency in rate design only occurs through the introduction of new rate elements, as opposed to the deepening of passthroughs of existing rate elements, is refuted by two decades of Commission attention to the latter as well as the former.

McGraw-Hill, citing the testimony of USPS witness Taufique, also asserts that the USPS proposal is superior to the MPA/ANM proposal because the USPS proposal offers stronger incentives to move pieces from sacks to pallets, and from multiple small sacks to fewer, bigger sacks, while the MPA/ANM proposal assertedly focuses primarily on moving mail "from ADC pallets or SCF pallets to five digit pallets," a change that McGraw-Hill characterizes as less valuable. McGraw-Hill at 12-13. The record refutes this claim.

It is clear that (1) moving mail from sacks to pallets is far more critical than moving mail from sacks to fuller sacks; and (2) the MPA/ANM proposal provides more incentive to move mail from sacks to pallets than does the USPS proposal. The implementation of the 24-piece minimum for most periodical mail in May 2006 has greatly reduced the potential efficiency gains from encouraging the use of larger sacks. *See* MPA/ANM Br. 70 n. 46; *Sack Preparation Changes for Periodicals Mail*, 71 Fed. Reg. 1976 (Jan. 12, 2006). Moreover, palletization—unlike the use of fuller sacks—significantly improves bundle integrity. McCrery Direct (USPS-T-42) at 26, 28-29. Mr. Taufique, the very witness quoted by McGraw-Hill, has specifically testified about the importance of encouraging mail to migrate from sacks to pallets. 39 Tr. 13471-72. And the Postal Service's "aggressive" efforts to reduce dependency on sacks underscore the value that the Service attaches to increased palletization. *See* McCrery Direct (USPS-T-42) at 28-29.

And it is also clear that MPA provides more incentive for copalletization than does the USPS rate design. MPA/ANM witness Glick provided an arithmetic demonstration of this fact (*see* 30 Tr. 10281). Neither Mr. Taufique nor any other Postal Service disputed Mr. Glick's calculations. 39 Tr. 13470, lines 17-19 (Taufique).

2. Publishers and printers will respond to these greater incentives: hence, discounts are more than just a "reward" for existing worksharing.

In their initial brief, MPA and ANM showed that their proposed rate design would in fact induce additional worksharing. The cost and feasibility of additional co-mailing and co-palletizing is a continuum, not the discontinuous, all-or-nothing, or bipolar state assumed by the defenders of the status quo. As a result, increased incentives will most definitely result in improved mail preparation. In particular, mailers will seek out printers that offer comailing and copalletizing, and printers will respond to this demand by increasing their capacity. The record contains substantial evidence of actual mailer and printer behavior confirming this fact. *See* MPA/ANM Br. 60-67 (discussing record).

ABM, while contending that many smaller publishers cannot respond profitably to the rate incentives proposed by MPA/ANM (a contention we discuss below in response to ABM's rate shock claims), does not dispute that other publishers can respond profitably, and that the MPA/ANM rate design would in fact induce additional worksharing at the margin. ABM witness Bradfield conceded on cross-examination that marginal changes in incentives for comailing and copalletizing would affect the break-even point for this activity, and thus logically would induce more comailing and copalletizing. *See* 35 Tr. 12066, 12101, 12102 ((conceding that level of incentives affects tradeoff point for publisher). *Accord*, *Mailing Options for Small and Medium-Sized Publishers*, Folio Magazine (Jan. 2006) at 24 (reproduced at 30 Tr. 10159). "[L]ogically if the incentives" for comailing and copalletizing "were increased, then there would probably be more," 35 Tr. at 12100 (Bradfield). For Mr. Bradfield's own company, a widening in the incentives to palletize "would change the tradeoff point for us." *Id*. at 12102. Changes in incentives for co-palletizing and co-mailing could also affect the extent to which Mr. Bradfield's company divides its titles into multiple versions, which in turn would affect the amount of volume entered by the company on pallets. *Id*. at 12103-04.

McGraw-Hill, while renewing its perennial claim that deeper worksharing incentives would merely offer a greater "reward" for existing worksharing (McGraw-Hill Br. 20-21), ignores virtually all of the voluminous evidence to the contrary. *See* MPA/ANM Br. 59-60 (discussing evidence that MPA/ANM proposal would provide stronger incentives for worksharing); *id*. at 62-65 (discussing evidence that mailers and publishers would respond to these incentives). The one specific example asserted by McGraw-Hill—that the proposed 5-digit pallet discount would merely reward mailers that are already palletizing (McGraw-Hill Br. 20-21)—is refuted by the undisputed record evidence that (1) pieces on 5-digit pallets currently represent less than 10 percent of total Outside County Periodicals pieces; (2) the revenue leakage from the 5-digit pallet discounts proposed by MPA/ANM would represent less than one-half of one percent of total Outside County Periodicals revenue; and (3) the potential for migration of additional periodical volume to 5-digit pallets is large. MPA/ANM Br. 75-76 (citing record).

3. Increased commingling and dropshipping will benefit the subclass as a whole, because cost avoidances still exceed the discounts proposed by Mr. Glick.

The record makes clear that the stronger incentives for commingling and dropshipping proposed by MPA/ANM would benefit the Outside County Periodicals subclass as a whole, because the cost avoidances would significantly exceed the proposed discounts. MPA/ANM Br. 67 (citing record). None of the other initial briefs dispute this fact.

4. The MPA/ANM proposal will not cause undue rate shock for small publications.

a. Smaller maximum impact on mailers who don't change their mailing practices.

The initial briefs of the other parties do not seriously dispute that the MPA/ANM rate design would have a smaller impact on small publications than would the USPS proposal. Even mailers that refused to change their behavior would face maximum increases only about half as large as those resulting from the USPS proposal. MPA/ANM Br. 68-71 (citing record).

ABM tries to brush off the analysis of this issue by MPA/ANM witnesses Cohen and Glick (and the corresponding analyses of Time Warner witness Stralberg) as the "elegant yet sterile theories" of individuals who never spent "a single day, or a single minute, in the employ of a periodical publisher, or a printer." ABM Br. 2-3.[24] ABM neglects to mention, however, the testimony of its own witness, Lou Bradfield. Mr. Bradfield indisputably speaks from hands-on industry experience: he has "more than 25 years of experience in the periodical industry," including "small and medium circulation" and "very large" publications; has "substantial experience with Postal Service/industry groups"; and knows "first hand what it is like to mail publications that simply cannot be moved out of sacks." *Id*. at 12-13. What does this experienced industry executive think about the relative impact of the USPS and MPA/ANM rate designs on small publishers? Mr. Bradfield *agrees* with MPA/ANM witnesses Cohen and Glick that a rate design with the maximum impact of USPS rate design would be "more destructive" to small mailers than a rate design with the maximum impact MPA/ANM rate design. 35 Tr. 12098, line 12, to 12099, line 18 (Bradfield).

ABM also seizes upon an item in an ANM member newsletter as a supposed admission by ANM that its own rate design would inflict an "unfair penalty for mailers who cannot prepare Periodical mailings on pallets." ABM Br. 3-4. But even a cursory reading of the quoted newsletter item makes clear that it was describing the effect not of the MPA/ANM rate design, but of the *Postal Service* rate design, which would require a

[24] ABM's antipathy to "elegant yet sterile theories" did not deter ABM from co-sponsoring the testimony of two other MPA/ANM economists whose views are more congenial to ABM's litigation posture. ABM Br. 1 n. 1.

particular ANM member to absorb a rate increase of 13-17 percent *in addition to the container charge proposed by the Postal Service* (but not by MPA/ANM).[25]

Finally, ABM, apparently aware that the percentage increase benchmark favors the MPA/ANM rate design, asserts that the Commission should compare instead (or in addition) the maximum *absolute* dollars-and-cents rate increase produced by each of the rival rate designs. ABM Br. 7-12. The short answer to ABM is that, although the MPA/ANM proposal produces a bigger *average* rate increase for small mailers than does the USPS proposal, the difference is small: 16.5 percent under the MPA/ANM proposal vs. 16.0 under the USPS proposal. 39 Tr. 13484. Hence, the competing rate designs should have essentially the same average impact in absolute dollar terms as well as percentage terms.

Moreover, the absolute dollar standard proposed by ABM suffers from two serious disadvantages. First, it tends to cause worksharing rate differentials to *narrow* over time in real terms, since a fixed absolute rate differential equates to a declining real (i.e., inflation-adjusted) rate differential as inflation cause rates to increase in nominal terms. This, of course, would be movement *away from* fuller cost recognition—the very opposite of the change that even ABM concedes is overdue.

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[25] Mr. Bradfield's prefiled testimony, after quoting the same item from the ANM newsletter, asserted that the "penalty under the MPA and ANM proposal for mailers who cannot prepare periodical publications on pallets appears to be even larger than that proposed by the Postal Service." Bradfield Reb. (ABM-RT-1) at 10, 35 Tr. 12068. Cross-examination of Mr. Bradfield, however, made clear that he was unaware of the actual maximum impacts of the MPA/ANM rate design and—in particular—that the maximum increase of 22.6 percent for small publications included publications that were entered on sacks. 35 Tr. 12099. He ultimately agreed that, if these figures were correct, then the MPA/ANM rate design would indeed be "less destructive" for small mailers than the USPS design. *See* 35 Tr. 12098 ("common sense would say 40 [percent] is worse than 20"); *id*. at 12099, lines 12-18 (agreeing that, if the highest rate increase produced by the MPA/ABM for publications in the POIR 19 sample is 22.6 regardless of whether the pieces are entered in sacks or on pallets, "you know that the highest rate increase for sacks in the sample can't be higher than 22.6 percent").

A simple example should make this fact clear. Suppose that, in year one, the rates for a pair of rate categories, one for more highly workshared mail and one less workshared mail, were 10 and 20 cents, respectively. Suppose that, five years later, inflation were to cause all costs and prices to double in nominal terms. A benchmark that held preserved existing *percentage* rate differentials would yield rates of 20 and 40 cents, respectively, and would therefore maintain the *real* (inflation adjusted) difference between the two rates. By contrast, a benchmark that maintained uniform *absolute* rate differentials would hold the nominal rate differential at five cents—thereby *reducing the real (inflation adjusted) rate differential and cost passthrough by 50 percent*.

Second, ABM ignores the likely correlation between the absolute per-piece postage costs of a publication and the market value of that publication (and, hence, its ability to bear higher postage costs). All other things being equal, big heavy titles have higher postage costs and generate more advertising revenue, than smaller, lighter titles. Adoption of tighter editorial deadlines and splitting a publication into multiple versions also tend to increase the per-copy revenue generated by a publication as well as its per-copy postage. *See* MPA/ANM Br. 73-74. Comparisons of absolute postage increases should take account of these (which ABM has not done, but which is accomplished automatically when rate increases are compared in percentage terms).

It is telling that ABM cites no Commission precedent for the proposition that worksharing rate designs should be evaluated for rate impact by comparing absolute rate increases rather than percentages. That certainly is not how the Commission has evaluated potential changes in the periodicals rate structure in recent years. *See, e.g.,* Presiding Officer's Information Request No. 19 (Oct. 2, 2006) at 2-3 (emphasis added):

> The Commission further requests that the Postal Service provide a table comparing the *percentage changes* from current postage to its Outside County rate proposals based on these new, more recent mailings.

> After the Postal Service provides more recent data on the 251 publications, the Commission requests that Time Warner and MPA-ANM provide calculations of the *percentage changes* of their respective proposals on the 251 publications using these more recent data.

Sterile theory, indeed.

The Postal Service's analysis of rate impact is equally contorted. The Postal Service, like USPS witness Taufique, insists that the "standard deviation" of all rate increases is a better measure of rate impact than the *maximum* percentage increase. USPS Br. 347. Like Mr. Taufique, however, the Postal Service fails to explain why this measure is economically relevant, or cite any prior Commission decision adopting it as a test of rate impact. *See* MPA/ANM Br. 71.

The Postal Service also cites ABM witness Bradfield for the proposition that the MPA/ANM proposal "falls short" of the USPS proposal, albeit to a lesser extent than the Time Warner proposal. USPS Br. 348. On cross-examination, however, Mr. Bradfield admitted that his testimony did not actually "compare the MPA/ANM rate design with the Postal Service rate design" (35 Tr. 12094, lines 22-25). When shown the data on the actual percentage impacts of the two rate designs, he agreed that the USPS rate design would be "more destructive" than the MPA/ANM rate design. *Id*. at 12098-99. The Postal Service mentions none of these facts.

b. Mailers can co-mail and co-palletize a lot more readily than ABM *et al*. claim.

The initial brief of MPA and ANM also summarized the record evidence demonstrating that greater commingling and destination entry are far more effective means for avoiding or mitigating the rate increases that low-circulation publications—including tabloids and polywrapped publications, weekly publications and publications with multiple versions—would face under the MPA/ANM rate design than ABM, McGraw-Hill and the Postal Service have portrayed. MPA/ANM Br. 72-75. MPA and ANM also noted two of the most significant obstacles to use of co-mailing and co-palletizing—air shipping and versioning—are in fact the results of voluntary business choices by publishers. While these choices are both common and entirely legitimate, neither fairness nor economic efficiency justify requiring other mailers to subsidize the extra costs that these practices force the Postal Service to incur. *Id*. at 74-75. None of the parties that oppose greater cost recognition--ABM, McGraw-Hill and the Postal Service—come to grips with these realities.

ABM grossly overstates the minimum volume needed for commingling pools to be cost effective. ABM suggests that merging four 20,000-piece publications into an 80,000-piece mailing will not result in "many, if any, pallets." ABM Br. 15 n. 14. This is clearly untrue. For the four non-commingled publications reported in MPA/ANM/LR-1 that have a circulation per issue between 75,000 and 100,000 pieces (i.e., publications 53, 55, 57, and 60) the percentage of pieces that are palletized ranges from approximately 50 to 80 percent. Thus, contrary to ABM's assertion, mailings of approximately 80,000 periodicals do result in "many pallets" and in fact are highly palletized.

ABM, while conceding that at least one printer, R.R. Donnelley, is willing to co-mail tabloid publications, retreats to the fallback defense that tabloid publications cannot be held long enough to build up co-mail pools. ABM Br. 21. But the only actual publisher offered as an example by ABM, Crain Communications, is a publisher of weekly titles whose editorial deadlines are extremely tight. 30 Tr. 10405-10406.

Citing a co-palletization pool comprised of weekly titles published by Crain Communications, ABM also suggests that the MPA/ANM rate design would result in larger rate increases for copalletized titles than would the USPS proposal. ABM Br. 21. This is clearly incorrect as a general principle. The characteristics of Crain's co-palletization pool are atypical because of the publications' "need for speed." More typical is the situation shown by Glick in response to ABM/MPA/ANM-T2-33, which shows clearly that the rate increase for co-palletized and dropshipped publications will be lower under the MPA/ANM proposal than under the USPS proposal. Tr. 30/10282-10283, 10405-10406.

Equally important, ABM does not explain why either equity or economic efficiency justify requiring other publishers to subsidize the extra costs that some publishers impose on the postal system by choosing to use air shipping or publish multiple versions. This issue cannot be brushed off as a "sterile theory" or one unrelated to the "real world of periodicals publishing and distribution" (ABM Br. 2-3, 12-24). There is nothing theoretical about the extra postage costs that other publishers must bear to cover the extra costs that the USPS incurs when ABM's members make mailing decisions in the absence of accurate cost signals. There is nothing theoretical about the losses that society incurs from these cross-subsidies, and nothing theoretical about their unfairness. If anyone proposed to require ABM's members to subsidize in a similar fashion the costs incurred by other publishers for paper, printing, surface transportation, or air freight, ABM would be howling in protest, not defending such subsidies as the "most balanced" approach, or the one "most compliant with . . . practical realities." *Cf.* ABM Br. 5.

ABM's appeal to experience is ironic in another sense as well. When ABM witnesses Bradfield and McGarvy were cross-examined, it became clear that these highly experienced witnesses *agreed* with MPA/ANM's position on a variety of key points not acknowledged by ABM in its brief. They agreed, for example, that:

- Quad/Graphics co-mailed publications down to 1,500 pieces even back in 2004. 35 Tr. 12063 (Bradfield).

- Two ABM publications with less than 5,000 copies might begin comailing or co-palletizing soon. ABM-T-1 at 3 (Cavnar).

- At least one publisher of tabloid publications has been co-palletizing its publications since 1987. McGarvy Reb. (ABM-RT-2) at 4 (35 Tr. 12177).

- R.R. Donnelley was willing to co-mail Crain's tabloid publications, and other tabloids are currently being co-bound. 35 Tr. 12178-12179, 12186-12187 (McGarvy).

- Also, although polywrapped publications are not generally comailed with other non-polywrapped publications, polywrap-only pools are available, according to an executive at Quad/Graphics. Docket No. C2004-1, Schick Direct (TW *et al*.-T-4) at 7.

- Crain, despite the time sensitivity of its weekly editorial content, is able to co-palletize the portion of its circulation that can be shipped by surface carrier. 35 Tr. 12177 (McGarvy).

- For a centrally located publisher such as Crain, about 80 percent of total circulation can be shipped by surface transportation. *Id*. at 12190-91.

- Airshipping and other practices that publishers may take to maintain the tightest possible editorial deadline are voluntary business decisions that involve deliberate economic tradeoffs. Tighter editorial deadlines increase the costs of a publication (e.g., by requiring air shipping of copies to distant subscribers, foreclosing the use of pallets for those copies, and reducing the window of time for coordinating and assembling comailing pools; but it also increases the attractiveness of a publication to potential subscribers (and therefore advertisers), 35 Tr. 12188-89 (McGarvy).

- There is no reason, economic or equitable, for requiring other publishers to subsidize the additional costs that these voluntary choices cause. *Id*. at 12187-89 (McGarvy).

- Publishers do not expect air freight providers, trucking companies, or printers to subsidize such decisions. *Id*. at 12197 (McGarvy).

- Even Quebecor World, the printer cited by ABM witness Bradfield, allows publications with multiple versions to participate if the each version exceeds a minimum required size. 35 Tr. 12065 (Bradfield).

- Furthermore, versioning, like the implementation of tight editorial deadlines, is a business decision undertaken to generate revenue, either through additional advertising revenue generated by the ability to offer a demographically selected audience, or through the targeting of attachments ("cover tips") designed to "renew people or track new subscribers." 35 Tr. 12064-65, 12102-04 (Bradfield).

McGraw-Hill's analysis of the financial impact issue is equally wide of the mark. McGraw-Hill cites the Commission's finding in C2004-1 ¶ 4033 that co-mailing and co-palletizing are infeasible for small mailers. McGraw-Hill at 21. The record demonstrates, however, that the cost and availability of commingling services have advanced markedly during the 15 months since the issuance of that decision. *See* MPA/ANM Br. 63-64. For the remaining subset of small publications that cannot commingle, the MPA/ANM proposal tempers the recognition of cost differentials enough to limit the maximum rate increase to 22.6 percent. *See id*. at 69-70.

c. Allegedly "adverse impact on editorial diversity and dissemination" is just another variant of rate shock argument.

In its initial brief, McGraw-Hill argues that the MPA/ANM rate design should be rejected because it "tilts against small high-editorial publications that tend to provide diversity in focus and perspective, and bind the nation together . . . McGraw-Hill Br. 22-24. The Commission has made clear, however, that the goal of promoting a diversity of small high-editorial publications is a factor to be balanced against other ratemaking goals, not an absolute value that trumps every other ratemaking goal. *See* Docket No. C2004-1, Order No. 1446 (10/21/2005) at 4-6, 45-49. The MPA/ANM proposal strikes a balance that is eminently reasonable. As discussed above, even the largest rate increases resulting from the proposal have been limited to less than 23 percent.

Requiring even greater protection for low-address-density, high editorial content publications would stop in its tracks any further progress toward greater cost recognition. McGraw-Hill appears to be arguing that "we should not have any progress toward better incentives unless progress is painless" – which is just another way of arguing that "we should have no progress at all."

The Commission in C2004-1 clearly rejected this approach. By finding that movement toward greater cost recognition must occur, it made clear that high editorial publications are going to have to share the pain, along with everyone else. While rate impact must be considered, that consideration is not an open-ended license to continue feeding indefinitely at the subsidy trough, as McGraw-Hill effectively proposes.

5. Special issues raised by 5-digit pallet discount

MPA and ANM agree with USPS witness Taufique that the major focus of changes to the Periodicals Outside County rate design in this case should be on moving mail from sacks to pallets. Our proposal provides more incentive for such movement than does the USPS proposal. *See* Section VI.B.1., *supra*. The Postal Service's single-minded focus on increased palletization, however, appears to have blinded the Service to the potential for *additional* cost savings from an appropriately designed discount for periodicals entered on *5-digit* pallets.

For the reasons summarized in our initial brief, the Commission should recommend this discount, which would significantly increase efficiency while causing very little revenue leakage to existing volume. MPA/ANM Br. 75-77.

USPS reiterates its claim that the discount would merely reward existing use of 5-digit pallets (USPS Br. 349), but offers no response to the substantial evidence that the potential additional volume of 5-digit pallet volume from the discount is large. MPA/ANM Br. 75-76.

The Postal Service's concern that our proposal would encourage upstream entry and "skin" pallets is legitimate. That is why MPA and ANM have agreed to a 250-pound minimum on qualifying pallets, as well as a requirement that qualifying pallets be entered at DSCFs or DDUs. MPA/ANM Br. 76.

Finally, the Commission has jurisdiction to recommend this proposal even if the Postal Service refuses to propose the discount itself. The 5-Digit pallet discount (as now envisioned) is simply a refinement (in fact, a narrowing) of the existing dropship pallet discount. *See* DMCS 421.49; *see also Dow Jones & Co. v. USPS*, 110 F.3d 80, 83-85 (D.C. Cir. 1997), and cases cited therein.

CONCLUSION

MPA and ANM respectfully request that the Commission recommend rates for Outside County Periodicals Mail as set forth herein and in the MPA/ANM initial brief.

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