

DOCKET SECTION

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

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POSTAL RATE AND FEE CHANGES, 1997

)
) Docket No. R97-1
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**DIRECT TESTIMONY OF

MICHAEL DONLAN

ON BEHALF OF

THE NEWSPAPER ASSOCIATION OF AMERICA**

Dated: December 30, 1997

1 AUTOBIOGRAPHICAL SKETCH

2 My name is Michael Donlan, and I am a Senior Associate with Industrial
3 Economics, Inc. of Cambridge, Massachusetts. I have been employed by Industrial
4 Economics for approximately five years. I am a regulatory economist, with expertise in
5 utility restructuring and rate setting. I have worked on rate setting issues in the electric
6 utility industry, and have assisted in the analysis of the restructuring of Pennsylvania
7 Power and Light and West Penn Power. This is my first appearance before the Postal
8 Rate Commission. I received a Bachelor of Arts from Dartmouth College in 1989, and a
9 Masters in Business Administration from Stanford University in 1995.

10 SUMMARY OF TESTIMONY

11 On behalf of the Newspaper Association of America, I was asked to review the
12 analysis included as Exhibit A in USPS-ST-44, "Standard Mail (A) Mail Processing ECR
13 Costs." The Postal Service originally filed this analysis as Library Reference H-109.
14 This testimony presents the results of my review.

15 In Exhibit USPS-44A, Postal Service Witness McGrane provides estimates of the
16 mail processing costs for Standard A Commercial Enhanced Carrier Route (ECR)
17 "walk-sequenced" and "non walk-sequenced" mail. On the basis of these cost
18 estimates, Postal Service Witness Daniel (USPS-T-29) calculates the unit mail
19 processing costs for ECR mail. Relying upon the unit costs computed by Witness
20 Daniel, Postal Service Witness Moeller (USPS-T-36) proposes increases in the presort
21 discounts for ECR high density and saturation letters and non-letters. Based upon my
22 review of these data and analyses, I conclude that the proposed increases in the
23 presort discounts are not justified and I recommend that the Commission maintain the
24 current discounts for these categories of mail.

1 The remainder of my testimony is divided into four sections:

- 2 • Section I presents the proposed discounts for the commercial ECR subclass.
- 3 • Section II summarizes the methodology used by Postal Service Witness
4 McGrane to separately calculate mail processing costs for the presort tiers
5 within ECR mail. As indicated in this summary, the Postal Service has never
6 before attempted to separately estimate these costs, nor has Witness
7 McGrane provided any statistical or other measures of uncertainty in his
8 analysis. As a result, the Postal Service has not demonstrated that these
9 cost estimates are reliable.
- 10 • Section III analyzes the effect of the recent reclassification changes on the
11 unit cost differences between walk-sequenced and non walk-sequenced
12 commercial ECR non-letters. Analysis of data provided by the Postal Service
13 indicates that the cost difference between walk-sequenced and non walk-
14 sequenced non-letters has declined by approximately 0.7 cents per piece
15 since reclassification.
- 16 • Section IV identifies a methodological problem underlying the proposed
17 discounts for letter mail: Delivery point-sequenced (DPS) mail processing
18 costs have been incorporated into the Postal Service analysis, yet the
19 savings in in-office carrier costs associated with DPS mail have not been
20 estimated or recognized in the Postal Service's cost analyses. Therefore, the
21 Postal Service cost estimates overstate the actual cost difference between
22 basic and high-density/saturation letter mail.

1 I. PROPOSED COMMERCIAL ECR RATE INCREASES

2 As shown in Table 1, the Postal Service's proposed rates for the commercial
3 ECR subclass result in larger percentage increases for basic letters and non-letters
4 than for high-density and saturation letters and non-letters.

Table 1			
COMPARISON OF PROPOSED AND EXISTING COMMERCIAL ENHANCED CARRIER ROUTE RATES ¹			
	Proposed Rate (\$)	Existing Rate (\$)	Percentage Change
Letters			
Basic	0.164	0.150	+9.33%
High-Density	0.143	0.142	+0.70%
Saturation	0.134	0.133	+0.75%
Non-letters			
Basic	0.164	0.155	+5.81%
High Density	0.153	0.147	+4.08%
Saturation	0.141	0.137	+2.92%
¹ Sources: Proposed rates (Docket No. R97-1, USPS-T-36); Existing rates (United States Postal Service, <u>Domestic Mail Manual: Ratefold</u> , June 8, 1997). Rates provided in the table do not reflect dropshipping discounts and are for pieces below the breakpoint.			

5 As shown above, the rate increase is greatest for ECR basic letters. The proposed
6 percentage rate increase for ECR basic letters is more than 12 times the proposed rate
7 increase at the high-density and saturation tiers. Within the non-letter rate structure,
8 the proposed percentage rate increase is also higher at the basic tier, although the
9 disparity among tiers is smaller.

1 These differences in rate increases result from the proposed increases in the
2 presort discounts for high density and saturation mailers shown in Table 2 below.

Table 2			
COMPARISON OF EXISTING AND PROPOSED DISCOUNTS FOR HIGH-DENSITY AND SATURATION COMMERCIAL ECR MAIL			
	Proposed Cumulative Discount from Basic (cents)	Existing Cumulative Discount from Basic (cents)	Percentage Change
Letters			
High-Density	2.1	0.8	+162.5%
Saturation	3.0	1.7	+76.5%
Non-letters			
High Density	1.1	0.8	+37.5%
Saturation	2.3	1.8	+27.8%

3 The greatest percentage increase in the discounts is for commercial ECR high-density
4 letters (162.5 percent) and saturation letters (76.5 percent). Increases in the discounts
5 for commercial ECR high-density and saturation non-letters are 37.5 percent and 27.8
6 percent, respectively.

7 Postal Service Witness Moeller based these discounts upon differences in the
8 mail processing and delivery costs provided by Postal Service Witness Daniel (Exhibit
9 USPS-29C). Table 3 compares the proposed discounts with the estimated cost savings
10 for the commercial ECR presort tiers.

11 As can be seen from the table, Postal Service Witness Moeller passes through
12 virtually all of the presort cost savings for ECR letter mail. The passthroughs for
13 commercial ECR non-letters are 39.8 percent at the high density tier and 52.0 percent
14 at the saturation tier.

Table 3			
COMPARISON OF PROPOSED DISCOUNTS AND ESTIMATED COST SAVINGS FOR HIGH-DENSITY AND SATURATION COMMERCIAL ECR MAIL			
	Proposed Cumulative Discount from Basic Tier (cents)	Estimated Cost Savings (cents)	Percentage Passthrough
Letters			
High-Density	2.1	2.1996	95.5%
Saturation	3.0	3.1066	96.6%
Non-letters			
High Density	1.1	2.7616	39.8%
Saturation	2.3	4.4226	52.0%

1 The above cost saving estimates are based upon differences in the mail
2 processing and delivery costs at the different tiers. Prior to this proceeding, mail
3 processing costs were assumed to be the same for the basic, high-density and
4 saturation presort tiers; that is, the mail processing differential was assumed to be zero
5 between all three tiers. (See the testimony of Postal Service Witness Moeller, USPS-T-
6 36, page 29 and Witness Takis, Docket No. MC95-1, USPS-T-12.) Thus, historically
7 the high density and saturation discounts have been based upon estimated differences
8 in delivery costs only. In this proceeding, the Postal Service has estimated differences
9 in the mail processing costs between the different tiers.

10 As shown in Table 4 below, the Postal Service estimates that mail processing
11 unit costs for the basic presort tier are more than four times the mail processing unit
12 costs for the high-density and saturation presort tiers.

Table 4		
COMPARISON OF ESTIMATED MAIL PROCESSING AND DELIVERY UNIT COSTS FOR THE COMMERCIAL ENHANCED CARRIER ROUTE SUBCLASS IN R97-1 AND MC95-1 ¹		
	Mail Processing Costs (cents)	
	R97-1	MC95-1
Letters		
Basic	2.0693	1.2050
High-Density	0.4777	1.2050
Saturation	0.4777	1.2050
Non-letters		
Basic	2.7552	1.4153
High Density	0.6856	1.4153
Saturation	0.6856	1.4153
Sources: Docket No. R97-1, USPS-29C, page 2, revised 10/1/97; Docket No. MC95-1, USPS-12C, page 2, revised 6/7/95.		

1 Thus, for the first time, the Postal Service has separately estimated the mail processing
2 costs for the presort tiers within ECR mail. These unit costs are derived by dividing the
3 total mail processing costs calculated in USPS-44A by the mail volumes from Library
4 Reference H-145.

5 II. SUMMARY OF POSTAL SERVICE COST ESTIMATION METHODOLOGY

6 In Exhibit USPS-44A, Postal Service Witness McGrane separates mail
7 processing costs for Standard ECR mail into costs for "walk-sequenced" mail, which
8 include the high density/saturation presort tiers, and costs for "non walk-sequenced"
9 mail, which include the basic presort tier. He makes this separation on the basis of the
10 endorsements recorded on the In-Office Costing System (IOCS) direct tallies for ECR
11 mail. Witness McGrane computes total mail processing costs for the different tiers of
12 ECR mail as follows:

1. Witness McGrane first groups the ECR mail processing IOCS direct tallies according to mail processing cost pool, subclass/shape (i.e., Commercial and Non-Profit ECR letters and non-letters) and walk-sequence status. For example, in Table 1 of Exhibit USPS-44A, the mail processing costs associated with the direct tallies for Standard (A) Regular ECR letters total \$4,854,000 for non walk-sequenced letter mail and \$127,000 for walk-sequenced letter mail for barcode sorters. (See Exhibit USPS-44A, Table 1, page 1, line 1.)
 2. Witness McGrane then computes the percent of the direct costs associated with non walk-sequenced versus walk-sequenced mail. For example, the direct tallies for non walk-sequenced letter mail for barcode sorters represent 97.5 percent ($\$4,854,000$ divided by the sum of $\$4,854,000$ and $\$127,000$) of the total letter direct tallies for this MODS pool. The remaining 2.5 percent ($\$127,000$ divided by the sum of $\$4,854,000$ and $\$127,000$) of the direct tallies in this cost pool are associated with walk-sequenced mail.
 3. In the next step of his analysis, Witness McGrane uses the percentages of direct tallies (97.5 percent and 2.5 percent in the example provided above) to allocate total volume variable mail processing costs for each cost pool to walk-sequenced and non walk-sequenced mail.
 4. The variable mail processing costs are then summed across the mail processing cost pools to arrive at the total mail processing costs for walk-sequenced and non walk-sequenced ECR letters and non-letter mail.
- Witness Daniel then relies on these total mail processing cost estimates to derive the unit mail processing costs for ECR basic and saturation/high density mail.

1 It is important to note that neither Postal Service Witness McGrane nor Witness
2 Daniel provides any statistical or other measure of uncertainty that indicates the
3 appropriate level of confidence to place on the results of the cost analyses.¹ In
4 addition, the Postal Service has never before developed mail processing cost estimates
5 by distributing IOCS tallies² to MODS cost pools for ECR walk-sequenced and non
6 walk-sequenced mail.³ Thus, no comfort can be taken based upon consistent patterns
7 from historical data, since no such data exist. Overall, the Postal Service has failed to
8 provide any supporting evidence that the cost estimates produced in Witness
9 McGrane's and Witness Daniel's analyses are reliable.

10 III. RECLASSIFICATION IMPACTS

11 Witness McGrane relies upon Base Year 1996 data for his analysis. Yet, as the
12 Commission is well aware, reclassification changes went into effect on July 1, 1996. As
13 a result of reclassification, preparation and entry requirements for ECR letters and flats

¹ Witness McGrane states that he has "no opinion as to the standard errors of the unit cost estimate[s]" derived in Exhibit USPS-44B. (Response to Interrogatory NAA/USPS-ST44-19.) As the same data are relied upon to derive the unit cost estimates computed based upon data in Exhibit USPS-44A, the same problem exists for these unit cost estimates.

² Witness McGrane's analysis relies solely on IOCS data. Since ECR mail bypasses many mail processing steps, there are a limited number of mail processing direct tallies for this mail.

³ When questioned regarding the adequacy of the data in Exhibit 44A, Witness McGrane stated that he is not troubled by a "thinness of tallies problem because similar analysis over past years has produced fairly similar results." (Tr. Volume 15, p. 7770, lines 8-23.) This statement appears unfounded, for no such similar analysis has been performed prior to this proceeding.

1 were changed. According to Postal Service Witness McGrane, the major changes
2 included: changes in the required endorsements; letter shaped mail was required to be
3 presented in trays; pallet makeup was made optional at 250 pounds; and ECR basic
4 mail was required to be presented in line of travel order (Response to Interrogatory
5 NAA/USPS-ST44-3). As described below, available data indicate that reclassification
6 has affected ECR mail processing costs.

7 The Base Year 1996 data used in Witness McGrane's analysis consists primarily
8 of information collected prior to the implementation of the reclassification changes.
9 Postal Service Witness McGrane confirms that data for 10.5 Accounting Periods (APs)
10 were collected prior to reclassification, while data for the remaining 2.5 APs were
11 collected after reclassification. (Response to Interrogatory NAA/USPS-ST44-2.) As
12 presented in Cross-Examination Exhibit NAA-XE-1 (Tr. Volume 15, page 7765) and as
13 replicated here in Table 5 below, there is a substantial difference in the cost data
14 between the pre-reclassification and post-reclassification periods.

15 As shown in Table 5, the cost difference between walk-sequenced and non walk-
16 sequenced non-letters has declined by approximately 0.7 cents per piece since
17 reclassification. (Tr. Volume 15, page 7763, lines 2-7.) However, instead of
18 recognizing the cost changes resulting from reclassification, the Postal Service relies
19 upon the data from the entire period, which gives the greatest weight to pre-
20 reclassification data. (Tr. Volume 15, page 7763, lines 9-11.) Further, Witness
21 McGrane admits that postal workers could get more efficient as they gain experience
22 with the new requirements. (Tr. Volume 15, page 7763, lines 22-5 and page 7764,
23 lines 1-3.) This additional experience could lead to further declines in the unit cost
24 difference.

Table 5			
COST DIFFERENCES BETWEEN WALK SEQUENCED AND NON-WALK SEQUENCED STANDARD A COMMERCIAL ECR NON-LETTER MAIL			
	Total Cost	Volumes	Unit Cost (cents/pc)
<u>Pre-Reclassification (before July 1, 1996)</u>			
Non Walk-Sequenced Non-Letters	163,178	6,685,291	2.441
Walk-Sequenced Non-Letters	18,895	6,829,506	0.277
Unit Cost Difference			2.164
<u>Post-Reclassification (after July 1, 1996)</u>			
Non Walk-Sequenced Non-Letters	29,915	1,777,605	1.683
Walk Sequenced Non-Letters	3,706	1,699,084	0.218
Unit Cost Difference			1.465

Therefore, the data used by Witness McGrane to estimate mail processing costs by walk-sequence status are not representative of current operating conditions. Furthermore, since Witnesses Daniel and Moeller rely on these data, their estimates of mail processing unit costs and the proposed discounts do not properly account for the impact of new ECR preparation and entry requirements.

IV. INCONSISTENT TREATMENT OF DPS COSTS AND BENEFITS

Data issues are not the only significant problem with Postal Service's derivation of proposed discounts. As described below, the Postal Service methodology accounts for increases in mail processing costs related to delivery point sequencing (DPS) but fails to account for DPS-related delivery cost savings. As a result, ECR basic letter mailers are charged for additional DPS costs but do not receive credit for DPS cost savings.

1 Postal Service efforts to increase the amount of DPS mail have resulted in an
2 increase in ECR basic mail processing costs relative to the high density and saturation
3 tiers, as noted by Postal Service Witness Moden in his direct testimony (USPS-T-4,
4 page 8, lines 15-21):

5 *"Our delivery units have worked closely with the plants to increase*
6 *the amount of DPS mail. They have worked together to identify*
7 *and capture bundles of non-barcode Enhanced Carrier Route*
8 *(ECR) Basic letters in order to barcode them at the plant. By doing*
9 *so, they have been able to incorporate these pieces into the*
10 *carriers' DPS mail, thus eliminating the need for manual casing. As*
11 *barcoding non-barcode ECR basic letters has become a common*
12 *practice and as the number of DPS zones has increased, the value*
13 *of ECR Basic letters has diminished."*

14 Thus, the Postal Service has purposefully identified and captured ECR basic
15 letters in order to barcode them and incorporate them into carriers' DPS mail. This
16 processing results in additional mail processing costs for ECR basic letters, an
17 observation confirmed by Postal Service Witness McGrane in response to Interrogatory
18 NAA/USPS-ST44-10(b). (See also Tr. Volume 15, page 7771, lines 16-25 and page
19 7772, lines 1-3.) The Postal Service willingly incurs this additional cost to achieve
20 subsequent in-office carrier cost savings, as the need for manual casing of this mail is
21 eliminated. (Tr. Volume 15, page 7772, lines 4-6.)

22 Yet, while Witness McGrane recognizes the additional mail processing costs
23 incurred for ECR basic letters, neither he nor any other Postal Service witness adjusts
24 the delivery costs to account for the associated savings in carrier in-office costs. Postal
25 Service Witness Hume addresses carrier in-office costs savings due to the DPS
26 program, but assumes the percentage of DPS mail is zero for all ECR letters and non-
27 letters in his analysis (USPS-18B, page 6). Postal Service Witness McGrane
28 recognizes this omission in his response to Interrogatories NAA/USPS-ST44-10(c) and
29 (e), stating that "I am not aware of any Postal Service witness whose testimony

1 addresses city carrier in-office cost savings due to delivery point sequencing of ECR
2 basic mail." (See, also, Tr. Volume 15, page 7772, lines 16-21.)

3 By ignoring offsetting delivery cost savings for DPS letters, the Postal Service
4 cost estimates overstate the actual cost difference between basic and high-
5 density/saturation letter mail. As a result, the discounts proposed by Postal Service
6 Witness Moeller are based on incorrect cost information to the detriment of ECR basic
7 letter mailers.

8 CONCLUSION

9 In this proceeding, the Postal Service has for the first time calculated mail
10 processing costs for the presort tiers within ECR mail. Historically, the Postal Service
11 assumed no difference in mail processing costs among the ECR presort tiers. The new
12 analyses result in processing unit costs for the commercial ECR basic presort tier that
13 are more than four times the unit costs for the high-density and saturation presort tiers.
14 As a result, the Postal Service has proposed increases in the discounts for high-density
15 and saturation mail.

16 Based upon my review of the supporting data and analyses, I conclude that the
17 proposed increases in the discounts are not justified. The Postal Service has not
18 demonstrated that its analysis reliably measures cost differences among ECR presort
19 tiers. In addition, the available data do not represent current operating conditions.
20 Finally, the analytical approach used by the Postal Service accounts for DPS-related
21 mail processing costs but ignores offsetting delivery cost savings. For all of these
22 reasons, I recommend that the Commission maintain the current discounts.