

# DOCKET SECTION

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

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POSTAL RATES AND FEE CHANGES, 1997

Docket No. R97-1

## TRIAL BRIEF OF

VAL-PAK DIRECT MARKETING SYSTEMS, INC.,  
VAL-PAK DEALERS' ASSOCIATION, INC., AND  
CAROL WRIGHT PROMOTIONS, INC.

William J. Olson  
John S. Miles  
Alan Woll  
John F. Callender, Jr.  
WILLIAM J. OLSON, P.C.  
8180 Greensboro Dr., Suite 1070  
McLean, Virginia 22102-3823  
(703) 356-5070

Counsel for Val-Pak Direct  
Marketing Systems, Inc.,  
Val-Pak Dealers' Association, Inc., and  
Carol Wright Promotions, Inc.

February 10, 1998

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## I. INTRODUCTION

This trial brief is presented on behalf of Val-Pak Direct Marketing Systems, Inc. (VPDMS) and Val-Pak Dealers' Association, Inc. (VPDA), hereinafter collectively referred to as "Val-Pak," and Carol Wright Promotions, Inc., d/b/a "Cox Direct," hereinafter referred to as "Carol Wright." Both Val-Pak and Carol Wright are leaders in the direct mail cooperative advertising industry, and are substantial users of the U.S. mails.

## II. PURPOSE OF THE TRIAL BRIEF

In his discussion of the requirement that parties file trial briefs in this proceeding (Tr. 1/27), the Presiding Officer expressed the hope that each party would "set forth in detail its theory of the case" and noted that each party "should include an explanation of the theoretical and public policy considerations which it believes the Commission should give weight to" (*id.*). Pointing out that intervenors' cases "often focus on selected issues," the Presiding Officer stated that the trial briefs "should explain how the proffered evidence should be used in reaching a recommended decision." (Tr. 1/29.)

Val-Pak/Carol Wright have sponsored the testimony of Dr. John Haldi (VP/CW-T1), who, rather than focusing on "selected issues," has developed a new, comprehensive approach in this proceeding concerning the appropriate use of bottom-up costing and rate design within the Standard Mail A ECR subclass. This trial brief presents an overview of Dr. Haldi's testimony, together with an analysis of two topics relevant to bottom-up approaches to postal ratemaking, as discussed in Dr. Haldi's testimony: (i) the advantages of using a bottom-up approach to determining the unit cost of each product within a subclass; and (ii) the advantages of using a bottom-up approach to rate design.

### III. THE POSTAL SERVICE'S REQUEST

The Postal Service's Request for a Recommended Decision initiating this proceeding proposed rate and fee changes affecting all classes of mail, and asserted that without those changes the Postal Service would incur a revenue deficiency of \$2.4 billion in the proposed test year (1998). According to the Postal Service, the proposed rates would generate a revenue surplus in that year of approximately \$41.9 million.<sup>1</sup> The Postal Service requested lower-than-average rate increases for the Standard Mail A ECR subclass, based on maintaining that subclass' already high cost coverage.

### IV. VAL-PAK/CAROL WRIGHT'S MAIL INTERESTS

#### A. Mailing Practices of Val-Pak and Carol Wright

As described more fully in the testimony of Dr. John Haldi (VP/CW-T-1), Val-Pak's mail consists primarily of letter mail sent at the Standard Mail A ECR Saturation rate, and Carol Wright's mail consists of both letter mail and non-letter mail sent primarily at the Standard Mail A ECR High-Density rate.

Both Val-Pak and Carol Wright are leaders in the "coupons-in-an-envelope" segment of the direct mail advertising market. Local Val-Pak franchisees send an average of seven geographically targeted mailings per year containing coupons from national and local advertisers. Carol Wright sends geographically and demographically targeted mailings on behalf of national

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<sup>1</sup> The estimated TYAR revenue surplus was later reduced to \$35.6 million USPS-T-9, p. 47 (revised 8/22/97).

advertisers. Together, Val-Pak and Carol Wright send over 800 million pieces of mail per year, all of which is time sensitive.

**B. Direct Testimony of Val-Pak/Carol Wright**

Dr. Haldi's testimony addresses the importance of bottom-up costing and rate design and provides the foundation for a bottom-up approach to costing and rate design for Standard Mail A ECR mail in this proceeding.

Dr. Haldi first discusses the principles of bottom-up costing and bottom-up rate design, and more specifically the development of bottom-up costs for products within Standard Mail A ECR. VP/CW-T-1, pp. 10-20. Dr. Haldi next uses a bottom-up cost approach to evaluate the Postal Service's Standard Mail A ECR rate proposal. For each rate cell in the ECR subclass, he calculated the margins and percentage markups implicit in the Postal Service's proposal. He found that, with the rates proposed by the Postal Service, Saturation ECR letters would contribute proportionately more per piece (cost coverage equivalents from 312 percent to 316 percent depending on entry point) than any other Standard Mail A ECR product. Dr. Haldi concludes his analysis by pointing out the aberrant situation created by the Postal Service's proposal, whereby the ECR products which cost the least for the Postal Service to handle and have the most non-postal alternatives available, namely Standard Mail A ECR Saturation letters, would make the greatest per-piece contribution within the subclass. VP/CW-T-1, pp. 21-36.

Dr. Haldi then proposes a three-step approach to designing rates within the Standard Mail A ECR subclass. First, he calculates a set of **bottom-up costs** for each rate cell within Standard Mail A ECR. Next, he determines **initial rates** for each cell based on the unit cost for the cell

and a combination target contribution (percentage of cost) and target margin (dollar amount).

Finally, he adjusts such initial rates by considering and balancing the pricing criteria set forth in 39 U.S.C. §3622(b) that the Commission will consider when it recommends rates in this proceeding. VP/CW-T-1, pp. 37-46.

Finally, Dr. Haldi proposes rates for Standard Mail A ECR which, by following his recommended approach to rate design, better reflect the actual unit costs of each operation, and are more consistent with the rate design principles in §3622(b) than those proposed by the Postal Service. VP/CW-T-1, pp. 47-53.

## V. ARGUMENT

### A. The Advantages of Bottom-Up Costing Over Top-Down Costing

Theoretically, the bottom-up and top-down approaches to determining costs should yield the same result. The unit cost for a particular workshared product within a subclass can be determined either (i) from the top-down — *i.e.*, by starting with a benchmark product (typically the least workshared product in the subclass) and subtracting costs avoided by the workshared product, or (ii) from the bottom up — *i.e.*, by starting from the most workshared ("bare bone") product and adding the costs incurred for services provided to products that are less workshared. From either the top-down or the bottom-up, the cost differential between any two products should reflect the difference in the unit attributable cost between the two products. This means that the cost differential should properly reflect: (i) the cost of providing optional competitive services such as sortation or transportation; (ii) any intrinsic cost differences; and (iii) the contingency. That is, as between two products, cost differentials should reflect all distinguishing cost

characteristics using either approach. Top-down and bottom-up costing are ideally two sides of the same coin. *See* VP/CW-T-1, pp. 10-12.

With top-down costing, however, unit costs, margins and markups for individual products (rate categories) are never explicitly calculated. A strength of the bottom-up approach to cost estimation is that it explicitly estimates unit costs for each product. Bottom-up costing not only lays the basis for bottom-up rate design, but also makes possible a complete analysis of costs, margins and markups. This bottom-up method of determining costs was used for Standard Mail A ECR in Docket No. MC95-1, when the new Standard A class and its subclasses were established because, since IOCS data were not available at that time, the top-down approach to costing could not have been used in any event. VP/CW-T-1, pp. 10-12. Development of unit costs from the bottom up provides an alternative way of examining costs and evaluating rates which the Commission, as well as other parties, may find helpful.

#### **B. The Advantages of Bottom-up Rate Design Over Top-down Rate Design**

In the current docket, the Postal Service utilized a top-down approach to rate design for Standard Mail A ECR. Top-down rate design involves making adjustments to a base rate for a subclass, by passing through some percentage of costs directly avoided by worksharing. With this approach, the rate differential between products within a subclass is based on costs of the worksharing operation, so the relationship between the rate and the underlying unit cost for a product can result in widely varying implicit cost coverages for similar products within a subclass. This approach is sometimes justified by reference to the theory of efficient component pricing, which assumes a perfect monopoly in the end product (which, in the case of the Postal

Service, is delivery). The price, or fee, for non-monopoly services is reflected in rate differences, and the implicit rate for such services is often at or below cost, which has the effect of leaving the entire markup on the delivery function. Top-down rate design, in short, ignores *totally the possibility of competition in the delivery function*. For ECR saturation mail, however, such an assumption is not altogether appropriate.

Bottom-up rate design begins by focusing on the cost of each product within the subclass, rather than the cost differentials between products in the subclass. A unit cost is first determined for each rate cell. Rates are determined by making some provision for a contribution to institutional costs (either a percentage markup or a fixed target margin is suggested).

Bottom-up rate design in comparison to top-down rate design for ECR mail offers three advantages: (i) it ensures that each product cover its costs and make an appropriate contribution to institutional costs; (ii) it helps ensure that the rate differential between any two products reflect at least the full difference in the respective unit attributable costs of the two products (VP/CW-T-1, pp. 40-41); and (iii) it takes into explicit consideration the possibility of competition in the delivery function, as well as the other core functions provided by the Postal Service, such as sortation and transportation.

**VI. CONCLUSION**

Val-Pak and Carol Wright urge the Commission to modify the Postal Service's request with respect to the rate design for the Standard Mail A ECR subclass as set forth in Dr. Haldi's testimony.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "William J. Olson", is written over a horizontal line.

William J. Olson

John S. Miles

Alan Woll

John F. Callender, Jr.

WILLIAM J. OLSON, P.C.

8180 Greensboro Dr., Suite 1070

McLean, Virginia 22102-3823

(703) 356-5070

Counsel for Val-Pak Direct Marketing Systems,  
Inc., Val-Pak Dealers' Association, Inc., and  
Carol Wright Promotions, Inc.

CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing document upon all participants of record in this proceeding in accordance with Section 12 of the Rules of Practice.

  
William J. Olson

February 10, 1998