DOCKET SECTION

BEFORE THE
POSTAL RATE COMMISSION

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DOCKET NO. R97-1

POSTAL RATE AND FEE CHANGES, 1997

BRIEF OF UNITED PARCEL SERVICE

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TABLE OF CONTENTS

Page

I. INTRODUCTION AND SUMMARY 1

II. STATEMENT OF THE CASE 4

III. THE INTEREST OF UPS 4

IV. ARGUMENT 5

A. ALL OF THE COSTS CAUSED BY PROVIDING A CLASS OF MAIL MUST BE INCLUDED IN THE ATTRIBUTABLE COST FLOOR, TO WHICH A REASONABLE PORTION OF UNATTRIBUTED COSTS MUST THEN BE ADDED 5

1. The Attributable Costs of a Class of Mail Include the Incremental Costs Caused by Providing the Entire Class of Service 5

2. All Attributable Costs Must Be Included in the Cost Floor to Which Markups Apportioning All "Other" Costs Are Then Applied 10

3. All Alaska Air Costs Incurred to Handle Parcel Post Must Be Attributed to Parcel Post 14

B. THE COMMISSION SHOULD REJECT THE POSTAL SERVICE'S FLAWED PROPOSAL TO REDUCE THE ATTRIBUTION OF MAIL PROCESSING LABOR COSTS 15

1. The Postal Service's Study Fails to Measure Long Run Variability 17

2. The Postal Service's Study Does Not Properly Measure Short Run Variability 18

(a) The Study Uses Inappropriate Proxies for Costs and for Volume 18

(i) Labor Hours Are Not a Suitable Proxy for Costs 18

(ii) "Total Piece Handlings" Is Not a Suitable Proxy for Volume 20

(b) There Are Other Serious Flaws in the Study 22

(i) The Study Relies on Highly Suspect Data 22

(ii) The Study Ignores Much of the Available Data 23

(iii) The Study Fails Statistical Tests of Reliability 25

C. THE COMMISSION SHOULD ADOPT THE POSTAL SERVICE'S MODS-BASED APPROACH TO DISTRIBUTE MIXED MAIL AND OVERHEAD MAIL PROCESSING LABOR COSTS 25

1. The MODS Methodology Is an Improvement over LIOCATT 26

2. Rejection of Dr. Bradley's Volume Variabilities Does Not Preclude the Use of a MODS-Based Approach to Distribute Attributable Mail Processing Labor Costs 30

D. ABSENT REASONS FOR CHANGE, THE ASSIGNMENT OF INSTITUTIONAL COSTS SHOULD BE BASED ON THE COMMISSION'S ESTABLISHED INTER-SUBCLASS MARKUP RELATIONSHIPS 33

1. Express Mail 35

2. Priority Mail 36

3. Parcel Post 37

E. THE PROPOSED PARCEL POST RATE DESIGN SHOULD BE REVISED 39

1. The Worksharing Discounts Are Overstated, Are Based on Excessive Passthroughs, and Deviate from Past Commission Rate Design Methodology 39

(a) The Postal Service Has Overstated Estimated Avoided Costs 39

(1) DBMC 39

(2) OBMC 42

(3) DSCF 43

(4) DDU 45

(5) Prebarcoding 45

(b) No More than 77% of the Estimated Avoided Costs Should Be Passed Through 46

(c) The Postal Service Has Not Followed the Commission's Rate Design Approach in Developing Its Suggested Discount Rates 48

2. The Postal Service's Proposed New Treatment of Intra-BMC "Intermediate" Transportation Costs Is Counterintuitive and Results in Serious Rate Anomalies 49

3. Parcel Post Non-Transportation Weight Related Costs Should Be Reduced in the Case of the Worksharing Rate Categories 51

F. THE COMMISSION SHOULD RECOMMEND A SURCHARGE ON PRIORITY MAIL PARCELS TO RECOGNIZE THE HIGHER COST OF HANDLING SUCH PARCELS 52

G. THE POSTAL SERVICE'S PROPOSAL TO SUBSIDIZE DELIVERY CONFIRMATION SERVICE FOR PRIORITY MAIL USERS IS A BLATANT VIOLATION OF THE ACT 53

V. CONCLUSION 55

TABLE OF AUTHORITIES

PAGE

CASES

National Association of Greeting Card Publishers v. United States Postal Service, 462 U.S. 810 (1983) 5, 6, 7, 11, 12, 15

STATUTES

Postal Reorganization Act of 1970, as amended, 39 U.S.C. § 101 et seq.

39 U.S.C. § 403(c) 3, 54

39 U.S.C. § 3621 29

39 U.S.C. § 3622(b) 5, 6, 33

39 U.S.C. § 3622(b)(1) 3, 54

39 U.S.C. § 3622(b)(3) 2, 3, 5-6, 8, 10, 11, 12, 14, 15, 33, 37, 55

39 U.S.C. § 3622(b)(4) 3, 54

39 U.S.C. § 3622(b)(5) 38

39 U.S.C. § 3622(b)(7) 3, 54

39 U.S.C. § 3626 12

OTHER AUTHORITIES

62 Fed. Reg. 39660 (July 23, 1997) 4

S. Rep. No. 912, 91st Cong., 2d Sess. (1970) 5

Merriam Webster's Collegiate Dictionary (10th ed. 1997) 12

Mail Classification Schedule, 1995, Docket No. MC95-1,
Opinion & Recommended Decision (Jan. 26, 1996) 46-47, 52

Postal Rate & Fee Increases, 1973, Docket No. R74-1,
Opinion & Recommended Decision (Aug. 28, 1975)..... 1, 6

Postal Rate & Fee Changes, 1983, Docket No. R84-1,
Opinion & Recommended Decision (Sept. 7, 1984)..... 6, 30, 35

Postal Rate & Fee Changes, 1987, Docket No. R87-1,
Opinion & Recommended Decision (Mar. 4, 1988). 8, 9, 12,
15-16, 34, 35

Postal Rate & Fee Changes, 1990, Docket No. R90-1,
Opinion & Recommended Decision (Jan. 4, 1991) 8, 14, 15, 33-34,
39-40, 46, 47

Postal Rate & Fee Changes, 1994, Docket No. R94-1,
Opinion & Recommended Decision (Nov. 30, 1994)..... 6, 15, 16, 26, 27 34-35,
36, 37, 38, 39-40, 46, 47

BEFORE THE
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POSTAL RATE AND FEE CHANGES, 1997	:	DOCKET NO. R97-1

BRIEF OF
UNITED PARCEL SERVICE

I.

INTRODUCTION AND SUMMARY

In this proceeding, the United States Postal Service (the "Postal Service") has requested a recommended decision on changes in postal rates and fees. In doing so, the Postal Service has suggested a number of costing improvements that would greatly advance the process of determining postal rates that comply as closely as possible to the policies and criteria of the Postal Reorganization Act of 1970, as amended, 39 U.S.C. § 101 et seq. In particular, the Postal Service has, for the first time, presented the Commission with estimates of the incremental costs caused by providing each subclass of mail. It has also proposed an improved method of distributing mail processing labor costs -- the largest of the Postal Service's cost segments -- to the various subclasses of mail.

However, the Postal Service also proposes changes to the Commission's established ratemaking policies and practices that would negate these advances. In fact, under the Postal Service's proposal, total attributable costs would regress to 56%, a level that has not existed since Docket No. R74-1. The Postal Service asks the Commission to abandon its well-established treatment of mail processing direct labor and variable overhead costs as fully volume variable -- a change that would shift a

significant amount of costs from the attributable cost category into the institutional cost category -- on the basis of a flawed econometric analysis that (a) does not use either cost data or volume data but rather substitutes suspect "proxy" data, (b) ignores substantial amounts of the proxy data, and (c) fails other tests of reasonableness and reliability. In addition, it proposes to depart from the Commission's consistently applied interpretation of section 3622(b)(3) of the Act, pursuant to which the Commission has always marked up all of the costs attributable to each subclass in apportioning the other, unattributed (or "institutional") costs of the Postal Service; it instead proposes to mark up only a subset of attributable costs, i.e., the volume variable costs of the various subclasses.

In assigning institutional costs, the Postal Service has deviated from the Commission's policy of treating the established markup relationships as presumptively reasonable. Rather, it has used a new method of adjusting institutional cost assignments that changes those relationships even in the absence of any showing of a reason for change.

Furthermore, the Postal Service's rate design for the competitive Priority Mail and Parcel Post services is defective. The proposed Parcel Post worksharing discounts are based on overestimates of avoided costs. In at least one case, the Postal Service deducts estimated avoided costs from the wrong base rate. And the proposed passthroughs of the estimated avoided costs are excessive, especially in light of Commission policy on passthroughs for new discounts and the uncertainty of these particular avoided cost estimates. The proposal to treat all intra-BMC "intermediate" transportation costs as if they were not related to the distance a parcel travels is counterintuitive and unnecessarily creates serious rate design issues.

The rate design for Priority Mail is also deficient. It fails to reflect the fact that Priority Mail packages cost significantly more to handle than do Priority Mail flats.

Finally, the delivery confirmation fee structure is blatantly discriminatory. It violates not only section 403(c) of the Act, but also sections 3622(b)(1), (3), (4), and (7).

Accordingly, United Parcel Service ("UPS") submits that the Commission should:

(1) Attribute and then mark up all of the incremental costs of each subclass of mail, so that each subclass covers the "direct and indirect postal costs attributable to that class . . . plus that portion of all other costs . . . reasonably assignable to such class," 39 U.S.C. § 3622(b)(3);

(2) Reject the Postal Service's flawed proposal to substantially reduce the attribution of mail processing labor costs and reaffirm its traditional attribution of all mail processing direct labor and variable overhead costs;

(3) Distribute attributable mail processing labor costs using the MODS-based approach proposed by the Postal Service, as modified by UPS witness Sellick;

(4) Apply its established markup relationships in assigning institutional costs, except for subclasses where the evidence shows a change in circumstances relevant to the assignment of institutional costs;

(5) Correct the Postal Service's overestimates of avoided costs for the proposed Parcel Post worksharing discount categories and reduce the proposed passthroughs of estimated avoided costs to no more than 77%;

(6) Revise the Postal Service's proposed rate design for Parcel Post as recommended by UPS witness Luciani;

(7) Recommend a surcharge of at least ten cents per piece for Priority Mail parcels; and

(8) Reject the undue preference proposed by the Postal Service for Priority Mail users of delivery confirmation service by recommending a fee structure of

25 cents per transaction for all electronic delivery confirmation users and 60 cents per transaction for all manual delivery confirmation users.

II.

STATEMENT OF THE CASE

This omnibus rate proceeding to change postal rates and fees is governed by the Postal Reorganization Act of 1970, as amended, 39 U.S.C. § 101 et seq. (the "Act"). Notice of the Postal Service's request for a recommended decision was published in the Federal Register on July 23, 1997, 62 Fed. Reg. 39660, and UPS intervened.

Hearings were held before the Commission en banc, with Chairman Edward J. Gleiman presiding. UPS presented the testimony of four expert witnesses: Kevin Neels, a Director of Putnam, Hayes & Bartlett, Inc., an economic and management consulting firm ("PHB"); Ralph L. Luciani, also a Director of PHB; J. Stephen Henderson, a Principal of PHB and the former Associate Director of the Office of Economic Policy of the Federal Energy Regulatory Commission; and Stephen E. Sellick, a Principal of PHB.

III.

THE INTEREST OF UPS

UPS provides a full range of parcel delivery services for the general public. It also provides expedited delivery services for documents. Through its surface and air services, UPS competes with, among other postal services, Express Mail, Priority Mail, and Standard Mail. UPS and the Postal Service also compete in providing international delivery services.

UPS's primary interest in this proceeding is to ensure fair competition between the Postal Service and its private enterprise competitors through proper application of the costing requirements and ratemaking principles of the Act, as interpreted by the United States Supreme Court in National Association of Greeting Card Publishers v. United States Postal Service, 462 U.S. 810 (1983) ("NAGCP-IV"). It is the position of UPS that the Commission must apply those costing methods and ratemaking principles which best ensure that the Postal Service will be a fair supplier of monopoly services and a fair competitor in the provision of competitive services.

IV.

ARGUMENT

A. ALL OF THE COSTS CAUSED BY PROVIDING A CLASS OF MAIL MUST BE INCLUDED IN THE ATTRIBUTABLE COST FLOOR, TO WHICH A REASONABLE PORTION OF UNATTRIBUTED COSTS MUST THEN BE ADDED.

1. The Attributable Costs of a Class of Mail Include the Incremental Costs Caused by Providing the Entire Class of Service.

Congress' overriding intent in adopting the Postal Reorganization Act and establishing the Commission as an independent ratemaking body was to guard against the inevitable temptation for the Postal Service to exploit its monopoly over letter mail by imposing the lion's share of postal costs on First Class Mail. See S. Rep. No. 912, 91st Cong., 2d Sess. 13 (1970). To this end, section 3622(b) of the Act provides that the Commission must recommend rates that comply with the policies contained in the Act and eight specifically enumerated factors. The third of these, section 3622(b)(3), sets forth "the requirement that each class of mail or type of mail service bear the direct and indirect postal costs attributable to that class or type plus that portion of all other

costs of the Postal Service reasonably assignable to such class or type." 39 U.S.C. § 3622(b)(3).

Unlike the other section 3622(b) factors, section 3622(b)(3) is a requirement, not a discretionary consideration; it is "the only immutable pricing requirement of the Act," and it must be considered independently from and prior to applying the other section 3622(b) criteria. Postal Rate & Fee Changes, 1983, Docket No. R84-1, Opinion and Recommended Decision at 259 (¶ 4001) ("R84-1 Opinion") (emphasis added). See also Postal Rate & Fee Changes, 1994, Docket No. R94-1, Opinion and Recommended Decision at IV-17 (¶ 4046) ("R94-1 Opinion") ("[T]he first imperative of rate-making under the Postal Reorganization Act is the recovery of attributable costs in rates").

The Supreme Court has held that "causation is both the statutory and the logical basis for attribution" of postal costs under § 3622(b)(3). NAGCP-IV, 462 U.S. at 820, citing Postal Rate & Fee Changes, 1973, Docket No. R74-1, Opinion and Recommended Decision at 110 ("R74-1 Opinion"). The Court has upheld the Commission's interpretation that there is no one single method that should be used to the exclusion of all others for determining what costs are caused by a class of mail; instead, the Act "requires that all costs reliably identifiable with a given class, by whatever method, be attributed to that class." Id. (footnote omitted) (emphasis added). As the Court concluded, "[t]he statute's plain language and prior legislative history, . . . indicate that Congress' broad policy was to mandate a rate floor consisting of all costs that could be identified, in the view of the expert Rate Commission, as causally linked to a class of postal service." Id. at 833 (emphasis added).

The Supreme Court's language highlights the consistent theme underlying the Court's decision, the Commission's historic approach, and the language of the Act itself -- that costs which bear a causal relationship to a particular class of mail must be allocated to the class on that basis. The Court delivered a clear

message -- if a particular cost is "capable of being considered the result of providing a particular class," the Commission has no choice but to attribute that cost. NAGCP-IV, 462 U.S. at 833-34 n. 29. Moreover, in deciding what costs are attributable, the Commission must use "all appropriate costing approaches" in meeting "Congress' broad policy . . . to mandate a rate floor consisting of all costs that could be identified . . . as causally linked to a class of postal service." Id. at 826, 833.

Historically, the Commission has based its attributable cost determinations on findings of volume variability, supplemented by instances where certain fixed costs, known as "specific fixed costs," are incurred to provide only one subclass of mail. See, e.g., USPS-T-30 at 11 (Dr. O'Hara); Tr. 9/4624-25 (Dr. Panzar). As Postal Service witnesses Panzar, Takis, and Christensen have all testified, the volume variable costs presented by the Postal Service to the Commission in prior cases -- and in this case -- represent estimates of short run marginal costs. USPS-T-11 at 4, 21-23 (Dr. Panzar); USPS-T-41 at 3-4 (Dr. Takis); Tr. 34/18217 (Dr. Christensen); Tr. 34/18445, 18476 (Dr. Panzar). See also Tr. 34/18464 ("The costing methodology used by the Postal Service is designed in such a way that unit volume variable costs correspond to economic marginal costs") (Dr. Panzar). They are based on the cost of providing an additional unit of a subclass. USPS-T-11 at 4 (Dr. Panzar); USPS-T-41 at 3 (Dr. Takis); Tr. 34/18446, 18476 (Dr. Panzar).

However, in this proceeding the Postal Service has greatly advanced the process of determining cost causation by estimating, for the first time, the incremental costs of each subclass. USPS-T-30 at 12, n.4 (Dr. O'Hara); USPS-T-11 at 5 (Dr. Panzar); USPS-T-41 at 1 (Dr. Takis). Every witness to address the point agreed that "incremental costs are, indeed, caused by the totality of the mail subclass in question." Tr. 34/18464 (Dr. Panzar). See also, e.g., USPS-T-41 at 3 (incremental cost "is merely the cost caused by the provision of the entire amount of a product") (Dr. Takis); Tr.

25/13557 (Dr. Henderson); Tr. 34/18266-67 (Dr. Christensen). Perhaps Dr. Panzar put it best when he testified,

> The second type of volume change to consider is that of an entire mail subclass. The cost savings resulting from removing this volume of mail from the system are the *incremental costs* of that subclass.

USPS-T-11 at 4. Because the incremental costs of a subclass are the costs caused by providing the entire subclass, under section 3622(b)(3) the attributable costs of a class include the incremental costs of the class.

The Commission has already reached this conclusion on at least two occasions. In Docket No. R87-1, the Commission determined that the long run incremental costs of a class should be included in the attributable costs of the class because "whenever a reliable causal relationship appears between a class of mail and a defined cost function, that function becomes a candidate for attribution, or . . . inclusion as part of the incremental cost of the class." Postal Rate and Fee Changes, 1987, Opinion and Recommended Decision ("R87-1 Opinion") at 102 (¶ 3007) (emphasis added). The Commission there held that "[t]he relation between incremental cost and the class it is associated with thus appears to be the same relation as 'attributability' under the Act." Id. at 101 (¶ 3007). The Commission reaffirmed this holding in Docket No. R90-1 when it echoed Congress' concerns by recognizing the need for "postal ratemaking . . . to assure that every piece of mail pays rates sufficient to compensate the Postal Service for whatever costs the Service incurs in order to provide that service." Postal Rate & Fee Changes, 1990, Docket No. R90-1, Opinion and Recommended Decision at IV-3 (¶ 4006) ("R90-1 Opinion") (footnote omitted) (emphasis added).

To the extent that the Postal Service seeks to equate attributable costs with "economic marginal costs," Tr. 34/18464, its argument is clearly based on the wrong costing concept. Under the Act, the relevant economic cost test for attribution is

not the "costs caused when an additional unit of a subclass volume is provided." Tr. 34/18446. Rather, the Act requires that the costs attributable to "each class of mail" be identified. In other words, under the Act the relevant "unit" for measuring attributable costs is the entire class of service.

Moreover, the Commission has specifically held that, in determining attributable costs, it is the long run cost consequences of providing a class of service that count. R87-1 Opinion at 105-06 (¶ 3012).

However, the Commission should not be unduly concerned about the copious and confusing testimony on how to define the "short run" and the "long run." The danger of blind adherence to any specific theoretical formulation to the exclusion of other methods of establishing causation -- including logic and common sense -- is highlighted by the cross-examination of Dr. Panzar on his rebuttal testimony. Dr. Panzar there testified that the cost of a ten year contract to advertise only Express Mail would not be an incremental cost of Express Mail and therefore would not be attributable to Express Mail. Tr. 34/18470-71, 18473-74. In his world of economic theory, those costs "would be irrelevant" to determining Express Mail's attributable costs. Tr. 34/18471. Dr. Panzar went so far as to say that since "[a]ny analysis of economic costs . . . hinge[s] upon the concept of avoidability, so . . . it is the case that on one day those costs are avoidable . . . , but the next day they are no longer avoidable and hence no longer incremental to that service." Tr. 34/18475.[1]

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1. Dr. Panzar characterized the hypothetical he was addressing as "a little bit extreme." Tr. 34/18475. But the point is not whether such a situation may actually exist (although the Postal Service's long-running Priority Mail advertising program could possibly represent such an actual situation). Rather, the hypothetical illustrates the conceptual limits of strict reliance solely on economic analysis to determine causality and therefore attribution. That is particularly so here, where even the economist experts cannot seem to agree with each other.

It would clearly violate not only the spirit but also the letter of the Act to rely solely on a theory that would not attribute to Express Mail the costs of a contract to advertise only Express Mail. Debates about how long the short run lasts and how long the long run extends muddle rather than illuminate the search for causation. Congress did not mandate that the Commission adhere strictly to a specific economic theory -- or to economic theory in general -- in identifying attributable costs.

In short, the Commission's long-held interpretation of the statute and all of the evidence in the record on this issue establish beyond doubt that the attributable costs of each class of mail include the incremental costs of the class. Those costs are estimated by Mr. Takis (USPS-T-41).[2] In accordance with the plain meaning of section 3622(b)(3) as interpreted by the Supreme Court and under the Commission's well-established practice, Dr. Takis' incremental costs for each subclass should be included in the rate floor for each subclass.

2. All Attributable Costs Must Be Included in the Cost Floor to Which Markups Apportioning All "Other" Costs Are Then Applied.

Even though attributable costs include incremental costs, the Postal Service nevertheless argues that in assigning institutional costs the Commission should not mark up incremental costs but instead should use the Postal Service's incremental cost estimates after the fact, solely to make sure that the rates derived from marking up volume variable costs generate revenues sufficient to cover incremental

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2. To the extent that Mr. Takis' incremental cost estimates may deviate from true incremental costs, his estimates almost certainly understate true incremental costs. Tr. 25/13560 n.13 and associated text (Dr. Henderson).

costs.[3] It bases its view on the testimony of its economist experts that "economic marginal costs" -- i.e., short run volume variable costs -- are the appropriate starting point for determining economically efficient rates.

However, it is the statute, not the Postal Service's economists' views of proper ratemaking, that controls here. Indeed, the Postal Service's economic experts seem not to understand -- or just do not wish to accept -- the statutory requirements.[4]

The plain language of section 3622(b)(3) establishes a two-step ratesetting process. NAGCP-IV, 462 U.S. at 823-25, 833-34. The first step mandates a rate floor for each class of mail consisting of the costs attributable to the class. Id. The language requiring that each class of mail "bear" the costs attributable to it reflects Congress' intent to prevent cross-subsidy by actually allocating to each class the costs caused by it and building the rate on top of the attributable cost floor. Id. at 829 n. 24. Once the Commission determines "the direct and indirect postal costs attributable to" each class of mail, it must then assign some "portion of all other costs of the Postal Service reasonably assignable to such class." 39 U.S.C. § 3622(b)(3) (emphasis added).

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3. Under the Postal Service's proposal, specific fixed costs would not be part of the markup base, even though the Commission has always marked up both volume variable and specific fixed costs.

4. For example, Dr. Christensen testified that, under his "understanding," rates which generate revenues that are just sufficient to cover only attributable costs and make no contribution to institutional costs satisfy section 3622(b)(3). Tr. 34/18268, 18282-84. See also Dr. Panzar's testimony at Tr. 34/18470-71 (the fact that only one product is advertised under a long-term advertising contract "would be irrelevant" to the attribution of the contract's cost). Compare with Tr. 9/4791-96 (testimony of Dr. Takis that Postal Service advertising for the promotion of a particular product is part of the incremental cost of the product, but advertising is not for a particular product so long as the Postal Service puts its generic "Eagle" logo somewhere in the advertisement).

In short, section 3622(b)(3) divides postal costs into two types, "attributable" costs which are caused by a class of mail and are to be allocated on that basis, plus "other" costs which are not attributable and which therefore must be assigned on top of the attributable costs on the basis of the non-cost factors of the Act.[5] There is no gray category of costs which are caused by a class of mail but which may be assigned to other classes of mail on the basis of non-cost considerations, such as demand or intrinsic value of service. Thus, the second step of the ratesetting process mandates the assignment of those "costs remaining above the rate floor." NAGCP-IV at 829 n.24, 834.[6] This mandate reflects Congress' intent to make sure that all classes (except those specifically singled out by Congress, see, e.g., 39 U.S.C. § 3626) contribute to the recovery of those costs which are not caused by a class of mail and which therefore cannot be attributed.

The Postal Service proposes to substitute for this two-step ratemaking what is in essence a three-step ratemaking process under which the Commission would first determine the volume variable costs of each subclass, mark up those volume variable costs, and then calculate incremental costs to be used solely to make sure that a class is not being cross-subsidized. That approach is not only a significant departure from Commission practice, but it is also contrary to the statute.

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5. The dictionary defines the preposition "plus" as meaning "increased by," or "with the addition of." Merriam Webster's Collegiate Dictionary at 896 (10th ed. 1997).

6. Ever since NAGCP-IV was decided, the Commission's approach to section 3622(b)(3) has been consistent with this view of the Act. Indeed, the Commission has explicitly stated that Congress expected an attributable cost floor to be constructed for each class [with] the rate built upon it." R87-1 Opinion 103 (¶ 3009) (emphasis added).

In his written testimony, Dr. Christensen argues that "the Commission should reject witness Henderson's proposal" that "the estimates of incremental costs presented by the Postal Service be used as the basis for markups," Tr. 34/18240. However, on cross-examination he agreed that "shared" or "joint and common" costs "are different from incremental costs because incremental costs . . . go away when one service is eliminated" (Tr. 34/18266-67) whereas "shared costs are not avoidable with respect to individual products or services." Tr. 34/18267 (quoting Tr. 34/18234). He also agreed that the Postal Service's institutional costs "correspond to the notion of shared costs in the economic literature." Tr. 34/18267. See also Tr. 34/18233. Since shared costs correspond to institutional costs and do not include incremental costs, and since only institutional costs are to be allocated on the basis of the statute's non-cost factors, incremental costs of necessity must be part of those costs which are marked up to take account of the non-cost factors.[7]

Moreover, as Dr. Henderson testified, there are other sound economic reasons to mark up estimated incremental costs. Tr. 25/13558-59. Without some markup over the Postal Service's estimates of incremental costs, the prices for some services could easily turn out to be below actual incremental costs.[8] In addition to violating the Act, such a situation would, as testified by Dr. Henderson and Dr. Panzar,

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7. It appears that Dr. Christensen agrees that the non-cost factors are intended to determine institutional cost allocations. Tr. 34/18232, 18233-36. Of course, his agreement is not necessary, since both the Act and the Commission's prior decisions make clear that the non-cost factors are intended to govern the assignment of institutional costs, and not any other costs. See, e.g., pages 13-15, supra.

8. Dr. Panzar agreed on cross-examination that incremental cost estimates necessarily involve less accurate extrapolations from current experience. Tr. 34/18479. This highlights the need for a margin of error as suggested by Dr. Henderson. Tr. 25/13558-59.

also create a risk for inefficient entry into the market in question. Tr. 25/13558-59 (Dr. Henderson); Tr. 34/18459-60, 18476-79 (Dr. Panzar).

In his rebuttal testimony, Dr. Panzar argued that "In the absence of systematic bias, measured incremental costs may be greater than or less than 'true' incremental costs," and that there is also an efficiency cost to "applying an incremental cost floor that is above true incremental costs." Tr. 34/18459. However, that danger is more theoretical than real, at least in this proceeding, where Mr. Takis' first attempt to estimate incremental costs is far more likely to understate true incremental costs.[9]

In conclusion, "Economic efficiency is a valid consideration, but it is not the primary objective of postal pricing." Tr. 25/13554 (Dr. Henderson); see also Tr. 9/4630 (Dr. Panzar). While the Act certainly requires economic considerations to be taken into account in setting postal rates, its emphasis is on achieving "fair and equitable" rates. See Tr. 25/13551-52. The only effect of overestimating incremental (and therefore attributable) costs would be to increase by the amount of the overestimate the share of institutional costs borne by the class. That certainly is more in accord with the statute than is an underestimate of incremental costs, which would result in rates below cost, in clear violation of section 3622(b)(3).

3. All Alaska Air Costs Incurred to Handle Parcel Post Must Be Attributed to Parcel Post.

In Docket No. R90-1, the Commission did not attribute to Parcel Post a significant portion of the intra-Alaska air costs incurred to transport and deliver Parcel Post shipments sent to Alaska. Instead, it constructed a hypothetical cost said to

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9. See Tr. 25/13560 n.13 and accompanying text, citing a study by Postal Service witnesses Christensen and O'Hara (and others) estimating that attributed costs may be about 80% of total postal costs.

represent what it would cost to deliver these shipments if ground transportation rather than air transportation could be used to deliver them. In this case, only about 20 percent of the Alaska non-preferential air costs incurred to handle Parcel Post would be attributed to Parcel Post. Tr. 26/14335.

This represents a unique and unjustified departure from the Commission's standard practice of attributing a cost whenever it is "capable of being considered the result of providing a particular class" of mail. NAGCP-IV, 462 U.S. at 833-34 n.29. Delivering Parcel Post to remote areas of Alaska is no different from delivering it to remote areas of the contiguous 48 states. Alaska air costs should be fully attributed, as are those similar costs.

The record here is clear that the intra-Alaska air costs in question are incurred to handle Parcel Post. Ms. Mayes so testified. Tr. 8/4228, 4259. So did Dr. Henderson. Tr. 25/13571. And so did Mr. Luciani. Tr. 26/14334-35. In fact, no witness has testified to the contrary. These costs are therefore attributable to Parcel Post under section 3622(b)(3). As a result, in its filing the Postal Service quite properly attributed to Parcel Post 100 percent of the Alaska air costs incurred to handle Parcel Post. So too should the Commission.

B. THE COMMISSION SHOULD REJECT THE POSTAL SERVICE'S FLAWED PROPOSAL TO REDUCE THE ATTRIBUTION OF MAIL PROCESSING LABOR COSTS.

In every previous postal rate proceeding, the Commission has attributed 100 percent of mail processing direct labor and variable overhead costs. See, e.g., R94-1 Opinion, Appendix D at 1; R90-1 Opinion, Appendix D at 1; R87-1 Opinion,

Appendix D at 1.[10] In this proceeding, however, the Postal Service urges the Commission to reject its long-standing treatment of these costs.

In its effort to persuade the Commission to depart from its well-established and consistent precedent, the Postal Service relies on an econometric study presented by Postal Service witness Bradley (USPS-T-14). Dr. Bradley's study relates the number of labor hours in specific activities, facilities, and accounting periods to the total number of piece handlings for those activities, facilities, and accounting periods. Tr. 28/15588.

Dr. Bradley's study looks not at costs, but at labor hours. And it looks not at volume, but at "total piece handlings." As Dr. Neels explained, there is no evidence that these variables are proper proxies for costs and volume. Tr. 28/15589-90, 15594-600.

But even if labor hours and piece handlings were adequate proxies for costs and volumes, Dr. Bradley relies upon a dataset for total piece handlings that internal Postal Service investigations have criticized. Moreover, Dr. Bradley uses arbitrary data "scrubbing" procedures that result in the elimination of enormous quantities of data from his analysis, thus significantly changing the results.

Perhaps most important, Dr. Bradley's approach sets out to measure the wrong thing ("economic marginal costs," or the variability of "small sustained increases in volume," Tr. 33/17932, 17947-48, 17951). It does not seek to provide estimates of the long run response of costs to changes in volume. Tr. 28/15591, 15626.

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10. The Commission has treated some mail processing labor costs as fixed. Those costs amounted to approximately $478 million in the last general rate case. R94-1 Opinion, Appendix D, page 1. In addition, significant amounts of other Cost Segment 3 costs (such as the costs of Window Service and of Administrative Clerks) are not fully attributed. Id.

In short, the study relied on by the Postal Service to support its position is flawed and is inadequate to justify the about-face which the Postal Service advocates. As a result, the Commission should adhere to its traditional treatment of mail processing labor costs.

1. The Postal Service's Study Fails to Measure Long Run Variability.

Dr. Neels testified that Dr. Bradley's study could not capture the long run variability of costs with volume. Tr. 28/15625. Although Dr. Bradley seems at times in his written rebuttal testimony to suggest that his analysis "can certainly generate long run results," Tr. 33/17906, there is no doubt that in fact his results are short run; indeed, that was his goal. Tr. 33/17904, 18163.

As Dr. Neels testified, Dr. Bradley's study relates mail processing labor hours in a four-week accounting period to the number of piece handlings in that same accounting period and in the previous accounting period. Tr. 28/15625. Consequently, his study is not capable of detecting changes in cost resulting from changes in volume that take place over longer periods of time.[11]

Dr. Christensen endorsed Dr. Bradley's analysis precisely because it was designed to measure "economic marginal costs," i.e., short run marginal costs. But, as we have already shown, that is not the test for attribution, since it ignores the full impact of volume changes on cost and thereby understates volume variability.

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11. Dr. Neels' testimony on this point is based on the specification of Dr. Bradley's model as set forth in Dr. Bradley's direct testimony. Thus, contrary to the assertion of rebuttal witness Ying, Tr. 33/18151, Dr. Neels' conclusion regarding the short run nature of Dr. Bradley's results are not based upon the "frequency of data observations," but rather on "the specification of variables in the cost equation."

2. The Postal Service's Study Does Not Properly Measure Short Run Variability.

Dr. Bradley's study does not even capture all of the shorter run variability of costs with volume. He specifically sought to eliminate from his variability estimates the impact of seasonal volume increases on costs. Tr. 33/17933-34, 17947, 17948, 17949, 17951. He also agreed that his analysis would not capture the impact on costs of non-seasonal volume peaks (Tr. 33/17951-54), although it is clear from Postal Service witness Steele's testimony that such peaks occur and cause overtime and staffing changes. Tr. 33/17865-66, 17868, 17869. In fact, Dr. Bradley's study does not even analyze volumes and costs.

(a) The Study Uses Inappropriate Proxies for Costs and for Volume.

The first step in an economic analysis of cost causation is to determine the extent to which postal costs vary with volume. See Tr. 28/15594.[12] Thus, "Any empirical study of the volume variability of costs must relate a suitable measure of cost to a suitable measure of volume." Tr. 28/15594. Dr. Bradley's study fails this test.

(i) Labor Hours Are Not a Suitable Proxy for Costs.

Instead of focusing on actual labor costs, Dr. Bradley relies upon labor hours as a proxy for costs. He asserts that, "For mail processing labor cost, the variations in mail processing hours are the variations in costs." USPS-T-14 at 12.

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12. Dr. Bradley initially agreed with this proposition on cross-examination, Tr. 34/17926, but then seemed to want to retreat from his agreement. Tr. 34/17926-27, especially Tr. 34/17927 at lines 3-10.

Despite Dr. Bradley's testimony to the contrary ("an hour's an hour no matter who's working it," Tr. 33/17945), not every hour is equal in cost to every other hour. For example, if the type (and therefore the cost) of labor used to process mail changes (i.e., if the "mix" of hours shifts) as the result of volume increases, the number of hours worked may not -- indeed, it almost certainly will not -- reflect the full impact on costs resulting from the increased volume. See, e.g., Tr. 28/15595 (". . . the cost associated with a given number of labor hours will also increase if the *mix* of hours shifts in the direction of more highly paid types of time") (Dr. Neels). For example, high volume periods could easily be characterized by more extensive use of less efficient part-time or casual workers. Tr. 28/15595-97.[13]

Overtime is perhaps the best illustration of the defect in Dr. Bradley's use of hours as a proxy for costs. The straight time hours and the overtime hours of the same employee do not cost the same. Tr. 33/17871 (Mr. Steele). Thus, using hours as a proxy for costs does "not capture the total impact of increased volume on costs when [an] increase in volume leads to a need for higher paid overtime hours." Tr. 28/15595-96 (Dr. Neels). See also Tr. 33/17933 (Dr. Bradley).[14]

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13. Although at one point he testified that "an hour's an hour no matter who's working it," Tr. 33/17945, Dr. Bradley also testified that he does not know whether the hours of a casual worker are as productive as those of a full-time employee performing the same work. Tr. 33/17946. It would be surprising if they were. In fact, he later testified that productivity could change as the result of volume increases during a seasonal peak, and that costs could thereby increase because of the volume increase. Tr. 33/17947-48. However, because of his restrictive view that only certain types of cost variability with volume matter, he took steps to make sure that cost increases resulting from seasonal volume increases did not "confound" his variability measurement. Tr. 33/17954. See also Tr. 33/17947, 17948-49.

14. Perhaps because of his lack of operational knowledge (see Tr. 33/17935, 17936-37, 17937-38, 17946), Dr. Bradley seems to associate the need for higher paid overtime only with seasonal increases in volume. Tr. 33/17933. As Postal

(Footnote continued to next page)

Before the Commission can rely on hours as a proxy for costs, it must have convincing empirical evidence of a proportional relationship between labor hours and costs. Tr. 28/15594, 15596 (Dr. Neels). There is no such evidence in this record. As a result, Dr. Bradley has not supported his use of labor hours as a proxy for costs. His failure to do so could easily result in an underestimate of the variability of costs with volume. Tr. 28/15590 (Dr. Neels).

(ii) "Total Piece Handlings" Is Not a Suitable Proxy for Volume.

Dr. Bradley likewise does not use a suitable proxy for volume. His "total piece handlings" variable is conceptually different from volume; there is no evidence that piece handlings and volume are directly proportional. Tr. 28/15590 (Dr. Neels).[15]

(Footnote continued from previous page)

Service witness Steele -- an experienced operations expert (Tr. 33/17845-46) -- testified, the Postal Service incurs overtime other than during seasonal peaks. Tr. 33/17868. Again, Dr. Bradley's model would not capture this impact of random volume spikes on costs. Tr. 33/17933-34, 17952-53.

15. Dr. Bradley pointed to Mr. Degen for information on the relationship between total piece handlings and volume. Tr. 33/17962, 17964-65. However, Mr. Degen did not do any empirical investigation of that relationship. Tr. 12/6598-6604, 6685-89. Thus, the Postal Service's case rests on an assumption that total piece handlings are proportional to volume. See Tr. 34/17965 (Dr. Bradley), 18256, 18261 (Dr. Christensen). That is surprising, since Dr. Bradley himself testified that "we have to be careful in how we are measuring volume here." Tr. 33/17969. He felt that Dr. Neels' criticism in this regard "should not be directed at my testimony," but rather "would be directed at the total Postal Service unit volume variable cost measurement." Tr. 33/17962. UPS agrees that the Postal Service's assumption that total piece handlings are proportional to volume undercuts the Postal Service's total mail processing volume variable cost measurement, but it does so because, as explained by Dr. Neels, in the absence of evidence that total piece handlings and volume are proportional, "using [total piece handlings] as a proxy for volume can easily lead to erroneous conclusions regarding the volume variability of costs." Tr. 28/15598.

Hence, Dr. Bradley's use of piece handlings as a proxy for volume is unsupported and also could result in an underestimate of volume variability. Tr. 28/15590, 15598, 15600 (Dr. Neels).

A study of the variability of mail processing costs with changes in volume should analyze changes in cost with respect to the volume of mail to be delivered (or, stated differently, the volume of originating mail). Tr. 28/15598 (Dr. Neels).[16] Conclusions about the volume variability of costs cannot be based on an analysis of the relationship between piece handlings and costs without knowing the relationship between volume and piece handlings. Tr. 28/15598-99. If, as is likely, the number of times a piece of mail is handled tends to increase with volume, Dr. Bradley's analysis would understate the volume variability of costs. Tr. 28/15599.

A variety of factors affect the relationship between piece handlings and volumes. Tr. 28/15599. Changes in that relationship could mask significant diseconomies of scale. For example, as Dr. Neels explained, increases in volume could lead to increases in error sorting rates, which could thereby result in the same mail being resorted. Tr. 28/15599. Dr. Bradley's analysis would not pick up this clear impact of volume on costs, but rather would incorrectly interpret it as an increase in productivity. Tr. 28/15599-600.

Since the Postal Service has failed to present necessary information on the relationship between piece handlings and volume, Tr. 28/15600, its study cannot be used as a measure of the volume variability of costs.

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16. In his rebuttal testimony, Dr. Bradley attempted to make much of Dr. Neels' use of the term "volume of mail delivered." Tr. 33/17887, 17958-67. This focus on semantics is misplaced. The purpose of setting postal rates is to determine how much mailers should pay to have the different types of mail they tender to the Postal Service delivered to the intended recipients. Tr. 33/17966-67. Rates are based on the pieces of mail so tendered, not on piece handlings.

(b) There Are Other Serious Flaws in the Study.

Apart from these fundamental deficiencies, Dr. Bradley's study suffers from other significant problems.

(i) The Study Relies on Highly Suspect Data.

Econometric studies are especially sensitive to data errors. Tr. 28/15601, 15604. Much of the piece handlings data upon which Dr. Bradley relies has been criticized by the Postal Service's own Inspection Service. See Tr. 28/15601 (Dr. Neels), 26/14170 (Mr. Sellick). That investigation identified large variances between piece handling figures and actual piece counts. Tr. 28/15601-02, 33/17976-78. In one instance, the projected count for 57 trays of mail was 29,637 pieces while the actual piece count was 17,842 pieces -- a 66% error. Tr. 28/15601-02.

On rebuttal, Dr. Bradley and MPA witness Higgins attempted to minimize these errors by arguing that they would affect only the results for manual activities. Tr. Tr. 33/17898, 18012. Even if that were the case, Dr. Bradley's analysis would still be thrown into serious question; in Dr. Bradley's analysis the manual activities show the lowest variabilities. Tr. 28/15605-07.

Moreover, there is evidence that the Inspection Service's criticisms extend, at least to some extent, to automated and mechanized activities as well. Tr. 28/15602. See also Library Reference H-147, §§ 222.13(i) (stating, with respect to "Mechanization Operation Rework Second Handling Mail," that if meters are not installed on the equipment, "this mail must be weighed").

There are other indications of serious data deficiencies in the piece handlings data. For example, there are hundreds of instances in which a site reported piece handlings for a specific activity for only a single accounting period out of nine years. Tr. 28/15602-03. Data entry errors are the most likely cause of these

anomalies. Tr. 28/15603. There are also numerous gaps in the data -- an activity at a site disappears for one or more accounting periods, only to reappear later. Id. The large number of these gaps indicate that the piece handlings data used by Dr. Bradley simply are not reliable.

(ii) The Study Ignores Much of the Available Data.

Dr. Bradley's volume variability estimates are based on the data left over after he engages in an elaborate "scrubbing" process. In 21 of the 23 activities considered, he discarded over ten percent of the data. Tr. 28/15590-91, 15609-11. In seven instances, he discarded over 20% of the data. Id. In two others, he discarded over 30% of the data. Id. In the case of the SPBS activity, he eliminated almost half (49%) of the data! Id. In all, an enormous amount of data -- over 50,000 observations -- were so "dirty" that they were "scrubbed" away. Tr. 28/15610, 15612.

A perceived need to "scrub" so much data raises serious questions about the entire dataset, including the observations that were not discarded. Tr. 28/15612.

Dr. Bradley's "threshold" scrub systematically eliminated low volume facilities and low volume time periods. Tr. 28/15609, 15613, 15632. This results in a loss of important information about the actual relationship between costs and volume. Absent some independent evidence that these observations represent data errors rather than actual information on actual operations, the impact of low volume facilities and low volume time periods on costs should be reflected in the analysis. Tr. 28/15632. In fact, their elimination guarantees that Dr. Bradley's results are not representative of the cost-volume relationship that actually exists over all postal facilities. Id.

Dr. Bradley's "productivity" or "outlier" scrub is not based on an actual connection between the test used to eliminate the observations and any independent

evidence that the eliminated observations represent data errors. Tr. 33/17972. While the justification for this scrub is said to be the elimination of observations representing physically impossible throughputs, the test was not pegged to any measure of physically impossible throughputs. Tr. 33/17971.[17]

The selective data (representing only two activities) belatedly produced by Mr. Higgins on cross-examination do not support the suggestion in his written testimony at Tr. 33/18014 that only physically impossible throughput values were eliminated. The "1% tail" test eliminated not only high values, but also many low values that certainly do not represent "physically impossible throughputs." Tr. 33/17972-73.[18] In short, the "1% tail" test is arbitrary.

Dr. Bradley's continuity "scrub" appears to be especially arbitrary. See Tr. 33/18150, 18164-65 (Dr. Ying). Dr. Ying testified that reducing this scrub to 26 observations seemed to have no effect on the results. Tr. 33/18150. However, there is no independent basis for a scrub requiring a minimum of 26 observations, either.

One fact is crystal clear: running Dr. Bradley's analysis on the full dataset (i.e., using all of the observations for which complete data were available) shows that

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17. When asked if he compared the data eliminated by the "1% tail" test with maximum throughput information, Dr. Bradley said, "I think informally I did. I did no statistical test of it, but informally, I believe we looked at the data." Tr. 33/17971.

18. Mr. Higgins seems not to have realized the significance of the fact that the "productivity" scrub eliminated low values as well as high values. When asked whether it is possible that this scrub "eliminated many values that are not physically impossible," he stated, "No. I wouldn't stipulate that at all, sir." Tr. 33/18061. Perhaps that is not surprising, since Mr. Higgins testified that "I did not make a deep study of this. I didn't go out and make a special study." Tr. 33/18063.

Dr. Bradley's decision to discard enormous amounts of data substantially changed the results. Tr. 28/15616, 15798.

(iii) The Study Fails Statistical Tests of Reliability.

In Notice of Inquiry No. 4, the Commission asked the parties to conduct a statistical test of the reliability of Dr. Bradley's study. Each of the three witnesses who offered testimony in response -- including Dr. Bradley himself -- rejected Dr. Bradley's model on statistical grounds. Tr. 28/15646-48, 15777-81 (Dr. Neels), 16070-92, 29/16122-33, 33/18141. All of the "econometric smoke" generated in the effort to rehabilitate Dr. Bradley's study (see, e.g., 33/18064-69) cannot change that inescapable fact.

In short, the Postal Service's study does not provide any reliable evidence to justify a departure from the Commission's traditional attribution of essentially all mail processing labor costs. Accordingly, the Commission should continue to attribute those costs.

C. THE COMMISSION SHOULD ADOPT THE POSTAL SERVICE'S MODS-BASED APPROACH TO DISTRIBUTE MIXED MAIL AND OVERHEAD MAIL PROCESSING LABOR COSTS.

The Postal Service has formulated a new approach to distributing mail processing labor costs. That approach, sponsored by Mr. Degen (USPS-T-12), is based on MODS workhours data as well as improved information on the contents of containers observed in the In-Office Cost System ("IOCS").

As UPS witness Sellick testified (Tr. 26/14163), Mr. Degen's approach is a significant improvement over the LIOCATT methodology used in prior rate cases. With minor modifications described by Mr. Sellick in his direct and supplemental

testimony (Tr. 26/14171-77, 14183-89, 36/19487-90), the Commission should adopt Mr. Degen's MODS methodology.

1. The MODS Methodology Is an Improvement over LIOCATT.

As Mr. Degen testified, the LIOCATT cost distributions were vigorously criticized in previous cases by a number of intervenors (including in particular the Periodicals mailers) and have been questioned by the Commission. USPS-T-12 at 5. Nevertheless, for lack of a viable alternative, the Commission used LIOCATT in Docket No. R94-1, even though it expressed substantial concerns about the distribution of mixed mail tallies and of the "working but not handling mail" and break time categories. R94-1 Opinion at III-8, 9 (¶ 3023).

In Mr. Degen's MODS approach, (1) cost pools are derived from MODS workhour data partitioned on the basis of specific mail processing activities and machine types; (2) mixed mail tallies are stratified by and distributed within these cost pools; and (3) IOCS information on item and container contents is used to distribute the mixed mail item and container tallies, respectively. This approach addresses each of the criticisms directed at LIOCATT and represents a significant improvement over LIOCATT. USPS-T-12 at 5, 10. See also Tr. 26/14163-70 (UPS witness Sellick).

The MODS cost pools are based on actual operational activities which are more detailed than the highly aggregated CAG/Basic Function cost pools previously used, and which therefore are more homogeneous in terms of the functions performed and their class and subclass composition.[19] This results in a more accurate

19. CAGs represent different sizes of facilities based on the amount of revenue generated by the facility. Tr. 26/14166. CAGs do not correspond to cost characteristics.

distribution of labor costs. Thus, the MODS approach makes far greater use of the available data in distributing mixed mail tallies. For example, the mixed mail, working but not handling mail, and overhead tallies of employees in OCR operations are distributed based on the direct mail tallies taken in OCR operations. Tr. 26/14167. This recognizes that the mail handled in OCR operations is likely to be similar in terms of shape and subclasses of mail. Id. Under LIOCATT, these OCR mixed mail tallies would be distributed based on all direct letter-shape tallies in the respective CAG/Basic Function cost pools, including activities other than OCR operations. Id.

The MODS methodology addresses the Commission's previously stated concerns about the growing percentage of overhead tallies. R94-1 Opinion at III-8, 9 (¶ 3023). It distributes overhead tallies among the subclasses of mail processed on the same machine type or in the same operation with which the overhead is associated. For example, tallies of employees working but not handling mail (e.g., moving empty equipment) or not handling mail (e.g., on break) in the manual Priority Mail processing operation are distributed based on the direct tallies of the employees handling mail in that same operation. Tr. 26/14167-69. This furthers the proper distribution of mail processing labor costs to the associated subclasses of mail.

Mr. Degen's methodology also uses information on counted container contents in distributing mixed mail tallies. Tr. 26/14169. Under this approach, the volume percentage occupied by the various items and shapes of loose mail in mixed mail containers is observed and the associated labor costs are proportionally distributed to the observed shapes and subclasses. Labor costs associated with unidentified mixed mail containers are distributed based on the proportion of direct containers plus identified mixed mail containers of the same type. Tr. 26/14169-70. This recognizes that certain types of mail are associated with certain types of containers.

Similarly, Mr. Degen's approach recognizes that certain types of items are associated primarily with certain types of mail. Tr. 26/14169. For example, the labor processing costs associated with unidentified Orange & Yellow sacks, which are used primarily for Priority Mail, are distributed in proportion to the subclasses observed in the direct and counted Orange & Yellow sacks. Tr. 26/14169, 36/19478-79. On the other hand, LIOCATT ignores the fact that different types of sacks are used in different proportions for different types of mail.

The distribution method advocated by the Periodicals mailers is similar to the LIOCATT approach. As a result, under their approach only 3.4% of the cost of processing Orange & Yellow sacks would be distributed to Priority Mail, even though Priority Mail represents 86% of the contents of Orange & Yellow sacks. Tr. 36/19478-79. On the other hand, under Mr. Degen's approach, 86% of the costs of processing Orange & Yellow sacks would be distributed to Priority Mail, with the remaining 14% distributed to other subclasses of mail in the proportion that they represent of the contents of Orange & Yellow sacks. Similarly, under the Periodicals mailers' approach, only 0.6% of the costs of processing Blue & Orange sacks would be distributed to Express Mail, even though 76% of the contents of Blue & Orange sacks consists of Express Mail. Tr. 36/19479. On the other hand, Mr. Degen's approach would distribute 76% of the costs of processing Blue & Orange sacks to Express Mail, with the remaining 24% distributed to the other subclasses of mail observed in Blue & Orange sacks. And under the method championed by the Periodicals mailers, only 4.6% of the costs of processing Brown sacks would be distributed to periodicals, even though periodicals constitute 72% of the contents of Brown sacks.[20] Id.

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20. It is no wonder that the Periodicals mailers prefer their LIOCATT-like approach to Mr. Degen's approach.

The Periodicals mailers also claim that at least some of Mr. Degen's cost distributions are suspect because they are based on "thin" tallies, i.e., five or fewer tallies in the cost pool. However, even assuming the validity of their claim, it affects less than 5.7% of mixed mail costs. Tr. 36/19483. Moreover, as Mr. Sellick testified, the counterproposals of the Periodicals mailers also exhibit data thinness. Tr. 36/19484, 19485. Such situations will always exist in any sampling system.

The Periodicals mailers claim that a significant portion of mail processing labor costs that have been found to be volume variable should not be attributed at all, but rather should be deemed to be institutional costs. They assert that a significant portion of "not handling mail" costs results from "automation refugees" and represent the cost of inefficiencies resulting from switching excess labor from certain activities where productivity is measured to other activities where productivity is not measured. See, e.g., Tr. 26/13841-43.

The "automation refugee" hypothesis remains just that -- a hypothesis, unsupported by any evidence. In fact, the only evidence (as opposed to speculation) in the record rebuts the Periodicals mailers' claims. Tr. 33/17843-55 (Postal Service witness Steele).

In any event, the Periodicals mailers' request does not square with the statute or with common sense. There is no mechanism in the Act for turning attributable costs into institutional costs. If in fact the costs in question would not be incurred "under honest, efficient, and economical management," 39 U.S.C. § 3621, then the solution is to deduct those costs from the revenue requirement, not to allocate them as institutional costs.[21]

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21. A similar claim is made by the Florida Gift Fruit Shippers Association with respect to so-called "excess capacity" costs in the purchased transportation cost segment. That argument should be rejected as well, for the same reasons.

To the extent that the complaint of the Periodicals mailers is based on concerns over the accuracy of Mr. Degen's distribution keys, those concerns are misplaced. There will never be a completely accurate distribution key. Nevertheless, the Commission must distribute attributable costs to the classes of mail using the best distribution key available. As the Commission has previously stated, "If the Commission finds that a group of classes causes a particular cost, the statute, as construed by the Supreme Court, does not allow us to ignore that finding simply because the next step -- assessing relative responsibility as among those classes -- requires the use of a distribution key." R84-1 Opinion at 140 (¶ 3044).

In summary, the Commission should adopt Mr. Degen's cost distribution approach, with minor modifications so that his distribution keys are applied to all mail processing labor volume variable costs. Mr. Sellick has produced just such a distribution in his direct and supplemental testimony. Tr. 26/14171-77, 14183-89, 36/19487-90.

2. Rejection of Dr. Bradley's Volume Variabilities Does Not Preclude the Use of a MODS-Based Approach to Distribute Attributable Mail Processing Labor Costs.

In an apparent effort to salvage its flawed mail processing labor cost volume variability study, the Postal Service argues that the Commission cannot use Mr. Degen's improved distribution key analysis without also adopting Dr. Bradley's volume variability analysis. That is just not so.

The Periodicals mailers echo the Postal Service's claim. However, their arguments are, as in the case of their automation refugee hypothesis, merely rhetoric that does not rest on any facts or analysis. See Tr. 36/19223-25. Moreover, their rhetoric flies in the face of their actual cost distribution proposals.

On the one hand, Ms. Cohen claims that Mr. Sellick's use of Mr. Degen's distribution keys without at the same time adopting Dr. Bradley's reduced variability estimates "ignored the inherent balance in the analysis between various operations and groups of operations, particularly between allied and distribution operations," Tr. 33/19224, which supposedly "takes into account the support nature of allied operations and the interrelationships between the sets of operations." Tr. 33/19225 (emphasis added). On the other hand, Periodicals witness Stralberg attacks Mr. Degen's approach on the ground that it ignores the interrelationships among different activities (cost pools). Indeed, Mr. Stralberg repeatedly points out that Mr. Degen's approach is no different from Mr. Sellick's approach in this respect. See, e.g., Tr. 36/19281 ("Sellick -- like Degen before him -- ignores all such interactions, treating the numerous 'cost pools' as separate compartments") (footnote omitted).

Moreover, Ms. Cohen acknowledged on cross-examination that she "suggested revisions to Witness Degen, but -- so, I don't think it had to be done exactly as Witness Degen had proposed it," and that she "really substituted what was the basic function and CAG approach from the LIOCATT system." Tr. 36/19236. In short, Ms. Cohen did not hesitate to break the link between Dr. Bradley and Mr. Degen by using distribution keys different from those used by Mr. Degen.

The fact is that, while the determination of the amount of costs which are variable and the distribution of those costs based on distribution keys are two steps of the same process, sensible distribution keys continue to make sense regardless of the outcome of the volume variability analysis. Dr. Christensen acknowledged this on cross-examination:

> Q Okay. Let me ask you to assume, Dr. Christensen, another hypothetical here. Let me ask you to assume that the results of Dr. Bradley's analysis was that mail processing costs are in fact 100 percent volume variable. He did his analysis exactly the way he did it, and

> the result turned out that there was 99.9 or 100 percent volume variability. Could you then still use Dr. Degen's cost distribution methods to arrive at economic marginal costs under that assumption?
>
> A Yes.

Tr. 34/18258.

Even Dr. Christensen -- the witness most heavily relied on by the Postal Service to establish that Dr. Bradley's volume variability analysis and Mr. Degen's cost distribution analysis "must be closely linked" (Tr. 34/18217) -- explicitly testified that "I wouldn't say it is the only way to proceed" in response to the Chairman's inquiry whether "the only proper way to proceed here is to accept Bradley and Degen together in toto." Tr. 36/18280-81.[22] Dr. Christensen would only say that "accepting in toto the framework and the results put forward by the Postal Service in this package of Dr. Panzar, Dr. Bradley, and Mr. Degen, is by far preferable to any of the other alternatives that are available at this time." Tr. 36/18282 (emphasis added).

More importantly, Dr. Christensen's opinion that it is "preferable" to accept both Dr. Bradley's volume variability results and Mr. Degen's distribution keys is explicitly based on Dr. Panzar's (and Dr. Christensen's) belief that the relevant costs for attribution purposes are "economic marginal costs. "Tr. 34/18255-56, 18287." But, as we have shown, that is just not so. The Postal Service's attempt to imply that there is

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22. Careful scrutiny of Dr. Christensen's written rebuttal testimony reveals that he never testified that Mr. Degen's distribution keys could not be divorced from Dr. Bradley's volume variability analysis. Rather, he testified that the two are "closely linked." He testified not that Mr. Degen's distribution keys could not be used in connection with a volume variability analysis other than Dr. Bradley's, but rather that "Witness Bradley's analysis . . . requires a consistent distribution method to produce economically meaningful cost by subclass . . . ." Tr. 36/18219 (emphasis added) (citation omitted).

some immutable link between Dr. Bradley's volume variability results and Mr. Degen's distribution keys and that therefore Mr. Degen's distribution keys may not be used without adopting Dr. Bradley's results not only is an illusion that is not fully embraced by its own experts, but, to be accepted, it would require the Commission to reject the long run incremental cost test the Commission has always held to be essential to determining economic cost causation.

The bottom line is that Mr. Degen's distribution keys stand on their own. Either they represent a sensible method of distributing the mail processing labor costs determined to be variable with volume -- however that is determined, and to whatever extent costs are found to be volume variable -- or they do not.

UPS submits that, for the reasons given by Mr. Degen and Mr. Sellick, Mr. Degen's distribution keys represent a vast improvement over the LIOCATT methodology. Those distribution keys should be adopted by the Commission.

D. ABSENT REASONS FOR CHANGE, THE ASSIGNMENT OF INSTITUTIONAL COSTS SHOULD BE BASED ON THE COMMISSION'S ESTABLISHED INTER-SUBCLASS MARKUP RELATIONSHIPS.

The Commission's rate recommendations must insure that the rates for each class of mail cover all costs attributable to the class "plus that portion of all other [unattributed] costs of the Postal Service reasonably assignable to such class or type." 39 U.S.C. § 3622(b)(3). The reasonable assignment of those costs that cannot be attributed is governed by the non-cost factors in section 3622(b) and the other policies of the Act.

In prior cases, in assigning unattributed costs the Commission has evaluated each class or type of mail in light of the statutory pricing policies. In so doing, the Commission

> has ameliorated potential uncertainty about the effects of each of the policy guidelines by adhering to a consistent, evolutionary application of these standards over the 20-year history of quasi-judicial postal ratemaking.

R90-1 Opinion at IV-2 (¶ 4004). Since the section 3622(b) non-cost factors have been incorporated into the Commission's deliberative process in establishing the institutional cost markups in prior rate cases, those prior determinations should be preserved unless a demonstrable change in circumstances warrants some departure from them. As the Commission has stated, the previously established markups are "presumptively reasonable." R87-1 Opinion at 367 (¶ 4026).

UPS witness Henderson applies the Commission's prescription to arrive at rate recommendations for Express Mail, Priority Mail, and Parcel Post, using the inter-subclass markup relationships established by the Commission in Docket No. R94-1. Tr. 25/13556, 13563, 13566-67. His recommendations (compared to those of the Postal Service) incorporate the recommendations of UPS's other witnesses and are as follows:

	Postal Service Proposal		Henderson Recommendation	
	Average Rate	Cost Coverage	Average Rate	Cost Coverage
Express Mail	$13.41	204.9%	$13.51	118.1%
Priority Mail	$3.78	192.1%	$4.66	193.1%
Parcel Post	$3.34	103.9%	$3.90	107.1%

Tr. 25/13567.

Postal Service witness O'Hara proposes to use a cost coverage index rather than the Commission's markup index to adjust cost coverages. USPS-T-30 at 17-19. However, the Commission has found that markup relationships are a better

guide to sound ratemaking than the rate relationships reflected in a cost coverage index. R94-1 Opinion at IV-16 (¶ 4043). That is so because the purpose is to preserve the relative shares of institutional costs borne by the respective classes of service, not to preserve the overall rate relationships, which reflect attributable cost shares as well as institutional cost assignments. See Tr. 25/13562-63.

1. Express Mail

Using the Commission's markup relationships, Dr. Henderson recommends an average rate of $13.51 for Express Mail, reflecting a cost coverage of 118% and a resulting rate increase of approximately 4%. Tr. 25/13573. The Postal Service suggests an average rate of $13.41 based on a cost coverage of 205%, representing a rate increase of 3.7%. USPS-T-30 at 28; Tr. 25/13567.

The Postal Service's proposed cost coverage of 205% is more in line with the fact that Express Mail is the Postal Service's premium service offering. It also accords with Express Mail's historic cost coverage prior to Docket No. R87-1. R84-1 Opinion, Appendix G, Schedule 1.[23] However, the cost coverage established in Docket No. R94-1 translates into a cost coverage of 118% in this case, and the record in this case does not contain any evidence of substantial relevant change since Docket No. R94-1. Tr. 25/13556, 13566-68.

Although UPS believes that a cost coverage of 118% is extraordinarily low for the Postal Service's premium service, it does not at the present time propose to depart from the Docket No. R94-1 markup relationships in the case of Express Mail.

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23. In Docket No. R87-1 Express Mail's cost coverage was 169%, still far in excess of that adopted in Docket Nos. R90-1 and R94-1. R87-1 Opinion, Appendix G, Schedule I.

2. Priority Mail

Using the Commission's historic approach, Dr. Henderson recommends for Priority Mail an average rate of $4.66 based on a cost coverage of 193% and representing a rate increase of 32%. Tr. 25/13567-68, 13573. The Postal Service suggests an average rate of $3.78 based on a cost coverage of 192%, for a rate increase of 7.4%.[24] USPS-T-30 at 26-27; Tr. 25/13567.

The large recommended increase in Priority Mail rates is driven by the fact that a 31% increase is necessary just to cover the increase in Priority Mail's attributable costs since Docket No. R94-1. Tr. 25/13568. There is no evidence in the record to support a change in the share of institutional costs borne by Priority Mail. Tr. 25/13556, 13570. Priority Mail is a high value service. It receives greater use of air transportation than does First Class Mail. It offers the convenience of a collection system for the unzoned two-pound rate packages, which comprise a large share of its volume. The Postal Service proposes to make available to Priority Mail users a delivery confirmation service which will not be available to First Class Mail users. Priority Mail has experienced significant growth since Docket No. R94-1, and it has averaged 11% annual growth during the 1990s. Tr. 25/13569. All of these factors support a cost coverage at least as high as that adopted by the Commission in Docket No. R94-1.

Using the existing markup relationships will preserve the balance between Priority Mail (93%) and First Class Mail (71%), commensurate with the higher

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24. The Postal Service originally proposed a cost coverage of 198% for Priority Mail. USPS-T-33 at 24; Tr. 4/2100-01, 2137-38. However, when it discovered that it had understated Priority Mail's attributable costs by $71 million, it did not change its proposed rates but merely reduced the coverage it proposed. Tr. 4/2135-38. That approach plays fast and loose with the Act's costing and pricing factors.

comparative value of service provided to Priority Mail. Tr. 25/13569. The Postal Service's proposal (First Class Mail -- 100% markup; Priority Mail -- 92% markup, USPS-T-30 at 22, 26-27) would destroy the balance struck by the Commission in Docket No. R94-1, despite the fact that the Postal Service has not presented any new circumstances that warrant such a change.

Accordingly, Dr. Henderson's recommendation for Priority Mail should be adopted by the Commission.

3. Parcel Post

Based on the Commission's decision in Docket No. R94-1, Dr. Henderson recommends an average rate of $3.90 for Parcel Post, including a cost coverage of 107% with a corresponding rate increase of 28%. Tr. 25/13567, 13570, 13573. The Postal Service suggests an average rate of $3.34 based on a cost coverage of 104% (Tr. 25/13567), for a rate increase of 10.2%. USPS-T-30 at 37.

Dr. Henderson's recommended increase is necessary to avoid the cross-subsidy of Parcel Post by other subclasses of mail. The Postal Service acknowledges that the average rate for Parcel Post is currently substantially below cost. USPS-T-37 at 24.[25] An increase in attributable costs since Docket No. R94-1 on top of the existing cost shortfall necessitates Dr. Henderson's recommended increase. Tr. 25/13570.

The record contains evidence that certain aspects of the service accorded to Parcel Post has improved since Docket No. R94-1. Tr. 24/12951; 20/10189. Moreover, the testimony of intervenors corroborates the fact that the Postal Service's Parcel Post volume has increased recently. Tr. 24/12951-52. Indeed, the record

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25. UPS's and the Postal Service's proposals both attribute 100% of Parcel Post's Alaska Air costs to Parcel Post, in accordance with section 3622(b)(3). Tr. 26/14334-35.

shows that Parcel Post's share of the volume sent by mail order shippers to residences has increased dramatically, undoubtedly because of its improved service and the DBMC rate discounts. Tr. 24/12947-48, 12951-52 (PSA witness Jellison). The Postal Service appears to have a dominant position for all package deliveries to residences. See Tr. 36/19845-47.[26]

The extremely low cost coverage for Parcel Post suggested by the Postal Service and the low contingency allowance proposed by the Postal Service create a substantial risk that Parcel Post will not cover attributable costs for the entire time that the rates set in this case will be in effect. Tr. 25/13571-72. Indeed, Mr. Degen's "Estimated Costs and Associated Confidence Limits" suggest that Parcel Post's projected 107% cost coverage could be negated simply by normal cost estimation uncertainty. USPS-T-12 at 13-14, 24.

In Docket No. R94-1, the Commission stated why cross-subsidy is impermissible: "The Postal Service is competing with firms in the private sector, which cannot afford to run continued operating losses. Consequently, the Postal Service appears to have an unfair advantage over these firms." R94-1 Opinion at II-32 (¶ 2089). Congress has mandated that the Postal Service must be a fair competitor in addition to not being an abusive monopolist. The existing cost coverage of 107% is dangerously low. It cuts against the proper application of section 3622(b)(5), which counsels that "the Commission need not be as concerned about a high cost coverage when mailers have readily available alternatives." Tr. 25/13553 (Dr. Henderson). However, UPS recommends that 107% be the absolute minimum cost coverage for Parcel Post.

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26. The Postal Service's Household Diary Study for Fiscal Year 1996 shows that in that year the Postal Service delivered 85.1% of all packages sent to households. Tr. 36/19845-47.

E. THE PROPOSED PARCEL POST RATE DESIGN SHOULD BE REVISED.

1. The Worksharing Discounts Are Overstated, Are Based on Excessive Passthroughs, and Deviate From Past Commission Rate Design Methodology.

The Postal Service proposes five new Parcel Post worksharing discounts in addition to the existing intra-BMC and DBMC rates: a new rate category for destination sectional center facility (DSCF) entry; a new category for destination delivery unit (DDU) entry; an originating BMC (OBMC) discount off of the inter-BMC rate; a BMC presort discount for qualifying inter-BMC shipments; and a pre-barcoding discount for qualifying inter-BMC, intra-BMC, and DBMC packages.

As explained by UPS witness Luciani (Tr. 26/14290-328), the proposed worksharing discounts as a group suffer from a number of defects. The proposed DBMC, OBMC, DSCF, DDU, and pre-barcoding discounts overstate the costs that the Postal Service will avoid as a result of the worksharing activity. Moreover, the Postal Service proposes passing through 98% to 100% of its estimates of avoided costs, contrary to prudence and prior Commission practice. The Postal Service also has not derived the proposed discounted rates from an appropriate base in some instances.

(a) The Postal Service Has Overstated Estimated Avoided Costs.

(1) DBMC

Postal Service witness Crum estimates that DBMC parcels will avoid 46.9¢ per piece in non-transportation costs (9.2¢ in window and acceptance costs and 37.7¢ in mail processing costs). USPS-T-28 at 1-3. The estimated 37.7¢ per piece mail processing cost avoided is a substantial increase from that found by the

Commission in Docket Nos. R90-1 (11.3¢ estimated and 8.7¢ passed through) and R94-1 (13.4¢ estimated and 10.3¢ passed through). Tr. 26/14291.

In past cases, DBMC avoided costs have not included mail preparation costs. Tr. 26/14292. In this case, however, Mr. Crum includes these costs as avoided costs. Id.

There is no question that DBMC parcels incur mail preparation costs at the DBMC. Postal Service witness McGrane specifically testified that when parcels are entered at the DBMC, they still must undergo activities that prepare the mail for distribution. Tr. 35/18998. DBMC parcels still must be rewrapped on occasion (Tr. 35/18999); they still may be separated and broken down (Tr. 35/19000); the sacks or other containers in which they are transported still must be opened and dumped (id.); and they still must be transported within the DBMC (id.).

The record does not contain any evidence which permits an estimate of the extent to which the cost of performing these particular mail preparation activities for DBMC parcels may be less than the cost of the same type of mail preparation activities if the parcels are entered at facilities other than the DBMC. Indeed, Mr. Crum initially testified that he counted mail preparation costs as avoided costs only because he could not separately isolate them. Tr. 5/2285, 2294. It was only after UPS witness Sellick did isolate them (Tr. 26/14179-80) that the Postal Service searched for a substantive rationale to support Mr. Crum's approach.

Postal Service witness Acheson, whose testimony in Docket No. R90-1 formed the basis for the original adoption of the DBMC discount, did not count these costs among the costs avoided by DBMC parcels. Tr. 35/18950, 18998. Mr. McGrane stated in his rebuttal testimony that it was his "understanding" that Mr. Acheson did so in order to be conservative. Tr. 35/18950, 18998. Yet, Mr. McGrane (quite properly) could not speculate why Mr. Acheson chose to exclude from his estimate of avoided costs these particular costs, as opposed to some other costs, in his effort to be

"conservative." Tr. 35/18998. The only sensible explanation is that Mr. Acheson did not have sufficient information to know the extent to which mail preparation costs are less for DBMC parcels than for non-DBMC parcels.

In the absence of such evidence, the Commission should adhere to Mr. Acheson's methodology, which was adopted by the Commission when it originally recommended the DBMC discount and was used by Mr. Crum in the Postal Service's recent Docket No. MC97-2 filing. Under that method, mail preparation costs are not counted as avoided by DBMC parcels.

Mr. Luciani's testimony clearly shows that the Postal Service has double-counted the acceptance costs avoided by DBMC parcels. Tr. 26/14292-93. His testimony in this respect was not attacked on oral cross-examination, nor was it rebutted by any Postal Service witness when the Postal Service filed its rebuttal testimony. Here too, the only reason given by Mr. Crum in support of his approach to these costs is that he was unable to isolate them. Tr. 5/2285, 2294. However, UPS witnesses Sellick and Luciani have done so. Tr. 26/14179-80, 26/14293-94.

Mr. Luciani shows that the combined effect of revising the Postal Service's estimates of the costs avoided by DBMC parcels for these two adjustments is to reduce the costs avoided by DBMC parcels by 5¢ per piece. Tr. 26/14294. The Commission should adopt Mr. Luciani's adjustments.

Mr. Crum also overstated the costs avoided by DBMC parcels by not adjusting outgoing mail processing costs to take account of the fact that, as Mr. Luciani testified (Tr. 26/14295) and as Postal Service witness McGrane confirmed on cross-examination (Tr. 35/19000), ASFs sometimes act as DBMCs, so that not all ASF outgoing mail costs are avoided by DBMC parcels. Based on the data available to him, Mr. Luciani reduced DBMC avoided costs by $3.4 million to reflect this reality of postal operations. Tr. 26/14296. While Mr. McGrane agreed with Mr. Luciani that a reduction

in Mr. Crum's DBMC avoided costs is appropriate, he calculated a reduction of approximately $1.3 million rather than the $3.4 million calculated by Mr. Luciani.[27]

Unfortunately, there is no way for the Commission to verify that Mr. McGrane's reduction of Mr. Luciani's ASF adjustment is appropriate, since Mr. McGrane's numbers are based on information that was not available to Mr. Luciani and is not available to the Commission; that information was intentionally "masked" by the Postal Service when it filed the data in question with the Commission. Tr. 35/19000-02. Under these circumstances, the Commission has no choice but to ignore that information and to use instead Mr. Luciani's estimate of Mr. Crum's overstatement of DBMC avoided costs.

Accordingly, the Commission should reduce the Postal Service's estimate of the non-transportation costs avoided by DBMC entry by 10.3¢ per piece, from 46.9¢ per piece to 36.6¢ per piece. Tr. 26/14297.

(2) OBMC

The Postal Service proposes a new OBMC discount off of the inter-BMC Parcel Post rates. To qualify for the OBMC discount, mailers must deposit at a BMC 50 or more parcels presorted to DBMCs. The OBMC discount is intended to reflect the non-transportation costs avoided by BMC entry and presortation.

Mr. Crum's estimate of the non-transportation costs avoided by OBMC entry is the same as the non-transportation costs avoided by DBMC entry. USPS-T-28

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27. Mr. McGrane originally testified that Mr. Crum's DBMC avoided costs should be reduced by approximately $1 million (Tr. 35/18953), but on cross-examination he agreed that correcting a volume calculation error in his original rebuttal testimony results in decreasing Mr. Crum's DBMC avoided costs by approximately $1.3 million. Tr. 35/19004-07.

at 3-4. Thus, the same infirmities in his overstated DBMC avoided costs also infect his OBMC avoided cost estimate. Accordingly, as Mr. Luciani shows, the OBMC discount should be reduced by 10.3¢ to 47.3¢ per piece. Tr. 26/14297-98.

(3) DSCF

The Postal Service proposes a new DSCF rate category. To qualify for DSCF rates, mailers must deposit 50 or more parcels presorted to the five-digit level at the DSCF. In developing the DSCF rates, the Postal Service overstates both the non-transportation and the transportation costs avoided by DSCF entry.

In estimating that DSCF parcels will avoid non-transportation costs of 31.4¢ per piece, Mr. Crum merely assumed that shipments entered at the DSCF will contain an average of 10 machinable parcels per sack and 25 non-machinable parcels per general purpose mail container ("GPMC"). USPS-T-28 at 5-6. However, Mr. Crum's assumption is contrary to the actual Postal Service data used by the Postal Service's witnesses in arriving at their proposed Parcel Post rates.

Based on actual data, Postal Service witness Daniel has estimated that, on average, sacks of Parcel Post contain 5.8 machinable parcels. USPS-T-29, Appendix V at 17. Similarly, Ms. Daniel's data indicates that parcels on average take up 88% of the cubic capacity of a container, so that a GPMC will, on average, contain 17.4 non-machinable parcels. Tr. 26/14340. Based on Ms. Daniel's numbers, Mr. Luciani has determined that the non-transportation DSCF discount should be reduced by 4.8¢ per piece. Tr. 26/14300, 14339-40.

Furthermore, in estimating the non-transportation costs avoided by DSCF parcels, Mr. Crum assumed that the mailer will unload the dropshipped containers without any assistance from Postal Service employees. Tr. 5/2282, 2397. However, Mr. Crum acknowledged that this assumption is contrary to the Postal Service's procedures, which explicitly provide that Postal Service employees will unload

dropshipped containers and will assist in unloading dropshipped bedloaded mail. Tr. 5/2310. Indeed, CTC Distribution Services witness Clark -- an actual dropshipper -- testified that it is the Postal Service's employees who unload the vehicles. Tr. 20/10195, 36/19831, 19834.

Clearly, Mr. Crum's estimate of the costs avoided by DSCF entry is overstated. Mr. Luciani has determined that the non-transportation DSCF discount should be reduced by an additional 1.9¢ per piece. Tr. 26/14301, 14341. Accordingly, the non-transportation costs avoided by DSCF parcels should be 24.7¢ per piece (31.4¢ – 4.8¢ – 1.9¢).

In addition, Postal Service witness Hatfield (USPS-T-16) has estimated that DSCF parcels will avoid transportation costs of 31.38¢ per cubic foot. Mr. Hatfield's estimate is based on the assumption that all parcels are transported from the DSCF to the DDU. USPS-T-16 at 24-25. However, as noted by Ms. Daniel and Mr. Crum, only 87.7% of Parcel Post volume travels from a DSCF to a DDU; the remaining 12.3% travels directly from a DBMC to a DDU. USPS-T-29, Appendix V at 1; USPS-T-28 at 5. Since 12.3% of DSCF parcels do not travel from a DSCF to a DDU, the transportation costs incurred by those DSCF parcels which do travel from the DSCF to the DDU are actually 12.3% higher than those estimated by Mr. Hatfield. Tr. 26/14302. Mr. Luciani calculates that the total transportation cost incurred by DSCF parcels will be 44.65¢ per cubic foot (38.05¢ per cubic foot from the DSCF to the DDU, and 6.6¢ per cubic foot below the DDU). Tr. 26/14302-04. Thus, the transportation costs avoided by DSCF parcels are only 26.7¢ per cubic foot. Tr. 26/14304.

Mr. Luciani's testimony is unrebutted on these points. Thus, the Commission should adopt all of his adjustments.

(4) DDU

To qualify for the proposed DDU rates, mailers must deposit 50 or more parcels at designated delivery units. The DDU discount is based on Mr. Crum's estimate of the mail processing costs avoided at the DBMC and at the DSCF in addition to the costs avoided by DBMC entry. The DSCF discount also includes estimated avoided transportation costs to the DDU.

Again, Mr. Crum has overstated the mail processing costs avoided by DDU entry. Mr. Crum assumes that mailers will shake DDU parcels out of sacks after unloading them. Tr. 5/2316. However, current Postal Service procedures do not require mailers to shake out their sacks, and it is unlikely that they will do so. Tr. 5/2310. It is more likely that mailers will leave their DDU sacks for Postal Service employees to shake out.

Mr. Luciani has estimated that the cost of shaking out sacks amounts to 1.1¢ per piece, and the DDU costs avoided should be reduced to 44.8¢ per piece. Tr. 26/14305-06, 14342. Here too, Mr. Luciani's testimony is unrebutted.

(5) Prebarcoding

The Postal Service proposes a discount of 4¢ per piece for inter-BMC, intra-BMC, and DBMC parcels that are pre-barcoded by mailers . Ms. Daniel arrived at this figure by modeling the cost of keying a barcode label (5.76¢ per piece) plus an "engineering estimate" of saved ribbon costs (0.5¢ per piece) less the cost of a scan of the prebarcoded piece (3.6¢ per piece) (USPS-T-29 at 20; Exhibit USPS-29E at 6), and then adjusting the modeled avoided costs upward by an additional 62.1% to account for alleged non-modeled costs. Tr. 26/14306.

The evidence is insufficient to support the existence of any such non-modeled avoided costs. The alleged non-modeled costs hypothesized by Ms. Daniel

are not unique to pre-barcoded pieces. It is just as likely that a pre-barcoded label might fall off a parcel, be incorrect, or be obstructed or otherwise unreadable as it is that a barcode label keyed by the Postal Service might be incorrect or fall off.

As a result, Mr. Luciani reduces the avoided cost to 2.16¢ per piece. Tr. 26/14307. In addition, the estimated ribbon cost avoided of 0.5¢ per piece is not adequately supported and should be deducted from the estimated avoided cost, leaving an avoided cost estimate of 1.66¢ per piece.

(b) No More Than 77% of the Estimated Avoided Costs Should Be Passed Through.

The Postal Service proposes passing through between 98% to 100% of non-transportation costs avoided and 100% of transportation costs avoided on all but one of the proposed Parcel Post worksharing discounts. (The BMC presort discount passthrough is 90%.) Such high passthroughs depart from the Commission's prior practice, have a significant impact on non-worksharing mailers, and, perhaps most importantly, fail to account for the substantial uncertainties surrounding the discounts.

In Docket Nos. R90-1 and R94-1, the Commission passed through 77% of estimated DBMC non-transportation avoided costs. The circumstances counseling against a 100% passthrough of the DBMC discount have not changed. In fact, although the DBMC discount was initially adopted in Docket No. R90-1, the basis for it was not re-examined in Docket No. R94-1. There still is no hard cost data on the costs actually avoided by DBMC entry.

With respect to the newly proposed discounts, the Commission has always held that "Where a workshare discount is new and its impact is uncertain, the Commission has concluded that a narrow cost avoidance analysis minimizes the risk that a discount will reduce revenue more than costs." Mail Classification Schedule, 1995, Docket No. MC95-1, Opinion and Recommended Decision at IV-101 (¶ 4225)

("MC95-1 Opinion"). The circumstances in this case support the Commission's use of a cautious approach for the proposed discounts. The Commission should apply no more than a 77% passthrough, as it did when the DBMC discount was first adopted.

As Mr. Luciani notes, a 100% passthrough of the worksharing discounts would have a major impact on non-worksharing Parcel Post mailers. Tr. 26/14310. The revenue lost as a result of many of the new discounts will exceed the additional costs avoided because many mailers already perform the same worksharing activities without any discount. For example, 96% of the parcels that will qualify for the pre-barcoding discount are already barcoded by the mailers. The net revenue lost must be recovered from non-worksharing mailers, who will experience rate increases from 16% to 20% under the Postal Service's proposed rates. Id. Perhaps this could be justified as rate de-averaging if there were no uncertainties in the avoided cost estimates, but that is not the case. Thus, reducing the passthroughs to 77% will mitigate the effect of the new discounts on smaller shippers.

The substantial uncertainty of the avoided cost estimates for the proposed discounts also extends to the impact of the discounts on revenues. Parcel Post has an extremely low cost coverage. That leaves very little margin for error. If avoided costs are over-estimated, Parcel Post may not (yet again) cover its attributable costs. Mr. Luciani lists a number of significant uncertainties concerning the avoided cost estimates. Tr. 26/14312-17. In proposing 100% passthroughs, the Postal Service unrealistically assumes perfect implementation. Even as staunch an advocate of the discounts and of the Postal Service's ability to look into the future as CTC witness Clark agreed that "in the real world" estimates are never certain. Tr. 36/19820-21, 19824.

We will not repeat Mr. Luciani's list of uncertainties here. They are enumerated in his testimony at Tr. 26/14312-16, and they have not been rebutted. Those uncertainties establish that the proposed worksharing discounts should be

based on passthroughs of no greater than 77% in order to guard against below cost Parcel Post rates. Tr. 26/14317.

(c) The Postal Service Has Not Followed the Commission's Rate Design Approach in Developing Its Suggested Discount Rates.

In developing its proposed discounts, the Postal Service departs from the methodology followed by the Commission in previous cases in a number of respects.

DBMC rates have always been derived as a deduction of avoided costs from the intra-BMC rates. Tr. 26/14317. In this case, however, Ms. Mayes relies on Mr. Hatfield's separate estimates of DBMC and intra-BMC transportation costs. This approach implicitly passes through a 15% markup factor on DBMC avoided transportation costs by eliminating the markup for institutional costs on transportation. Tr. 26/14317-18. As Mr. Luciani recommends, the DBMC discount should be determined by subtracting the DBMC transportation and non-transportation costs avoided from the intra-BMC rates. Tr. 26/14318.

The Postal Service, following the Commission's logic, developed the proposed DSCF discount as a reduction of costs avoided from the DBMC rates. However, it developed the proposed DDU rates as a deduction of avoided costs from the intra-BMC local rates. The DDU discount should reflect costs avoided from the DBMC zone 1/2 rates, as recommended by Mr. Luciani. Tr. 26/14319. Mr. Hatfield estimates DDU transportation costs avoided by using local transportation costs for DBMC and DSCF parcels, and that approach should be followed in the rate design. Using intra-BMC rates as the base for the DDU discount is problematic because intra-BMC rates are the least certain of Parcel Post rates. Id.

Finally, Ms. Mayes' rate design results in a decrease from the existing rates for DBMC zone 1/2. The consequence is that the rates of a staggering 41% of DBMC volume would thereby be decreased. Tr. 8/4245. The Commission has not

allowed existing rates to decrease when the overall rates of the entire subclass are increasing. Tr. 26/14320. It should continue that practice here and not decrease the rates in any existing Parcel Post rate cell.

2. The Postal Service's Proposed New Treatment of Intra-BMC "Intermediate" Transportation Costs Is Counterintuitive and Results in Serious Rate Anomalies.

Postal Service witness Hatfield (USPS-T-16) proposes a new method for distributing transportation costs within Parcel Post. To a large degree, his new approach is an improvement over prior practice. However, Mr. Hatfield's treatment of intra-BMC intermediate transportation costs as non-distance related is counterintuitive and produces anomalous results.

Mr. Hatfield divides Parcel Post transportation costs into local (between AOs and SCFs), intermediate (between SCFs and BMCs), and long distance (between BMCs) cost pools. In determining whether each pool should be treated as distance related or not distance related, he asks whether the distance travelled is related to the great circle distance (or "GCD") between the origin SCF and the destination SCF, which is used to determine the zone. Transportation costs that are not necessarily related to changes in GCD are non-distance related under Mr. Hatfield's approach. USPS-T-16 at 6.

Mr. Hatfield treats intermediate intra-BMC transportation costs as not distance related. USPS-T-16 at 10; Tr. 8/3930. However, he treats intermediate DBMC transportation costs as distance related. USPS-T-16 at 11. The result is that the estimates of transportation costs for DBMC zone 4 and 5 parcels ($2.2764 and $4.4457 per cubic foot, respectively) exceed that of intra-BMC zone 4 and 5 parcels ($1.7527 per cubic foot for both). Exhibit USPS-T-16A. As Mr. Luciani notes, this

means that, contrary to common sense, parcels dropshipped at a DBMC cause (and pay) increased rather than decreased transportation costs. Tr. 26/14321.

Ms. Mayes attempts to deal with this crossover problem by capping DBMC rates at the intra-BMC rate for the same weight and zone. This reduces almost 150 separate DBMC rate cells from their cost-based level. Tr. 26/14321. Since these rates would be equal to intra-BMC rates, the incentive for mailers to workshare in these instances would be removed, even though the Postal Service claims to avoid 25¢ per parcel in mail processing costs when parcels are entered at the DBMC. Id.

Moreover, treating all intra-BMC intermediate transportation costs as not distance related is counterintuitive. Mr. Hatfield has not shown that all intermediate intra-BMC transportation costs are completely non-distance related. Tr. 26/14321-23. On the contrary, as Mr. Luciani shows, intermediate intra-BMC transportation costs are at least partially distance related. Tr. 26/14322-23. Since there is no data on the extent to which intermediate intra-BMC transportation costs are and are not distance related, Mr. Luciani recommends that intra-BMC transportation costs by zone should be reduced by an equal amount from the corresponding inter-BMC transportation costs by zone. Tr. 26/14323, 14343-44. The result not only would help resolve the rate crossover anomalies, but is also consistent with the Commission's existing approach of increasing transportation costs for all Parcel Post categories as zone increases.

Some crossover anomalies between intra-BMC rates and DBMC rates would remain. Ms. Mayes' rate-capping solution unfairly recovers the lost DBMC revenues from all Parcel Post mailers. It is more equitable to recover the lost revenue from the DBMC mailers who would benefit from the capped rates by increasing the rates in the unaffected DBMC rate cells to make up for the lost DBMC revenues. Additionally, DBMC rates should be set at the intra-BMC rate less the non-transportation costs avoided.

3. Parcel Post Non-Transportation Weight Related Costs Should Be Reduced in the Case of the Worksharing Rate Categories.

Under the existing rate design, the Commission has added 2¢ per pound to all Parcel Post rates to account for non-transportation weight related costs. While this add-on may have been appropriate in the absence of worksharing, applying the full add-on to the Parcel Post worksharing rate categories likely overstates the effect of weight on non-transportation costs for workshared mail. If inter-BMC non-transportation weight-related costs are 2¢ per pound, then DDU non-transportation weight related costs, for example, must be something less, since fewer mail handling operations are needed to process DDU parcels than to process inter-BMC parcels.

Logic dictates that the greater the worksharing, the less the impact of weight on non-transportation costs. Decreasing the non-transportation weight related cost add-on for worksharing rate categories is also consistent with the Commission's rate design for Bound Printed Matter, which includes a different non-transportation cost per pound for each of its worksharing categories.

Mr. Luciani suggests that the DBMC, DSCF, and DDU rate categories each incorporate a diminishing add-on for non-transportation weight related costs. Tr. 26/14325-27. Inter-BMC and intra-BMC rates would continue to incorporate the 2¢ per pound add-on. However, DBMC, DSCF, and DDU rates would incorporate a pro rata share of the add-on to reflect the decreased number of times the workshared piece is handled.

As is the case for almost all of Mr. Luciani's recommendations, his proposal in this regard stands unrebutted. Accordingly, the Commission should adopt Mr. Luciani's recommendations. Tr. 26/14346-53.

F. THE COMMISSION SHOULD RECOMMEND A SURCHARGE ON PRIORITY MAIL PARCELS TO RECOGNIZE THE HIGHER COST OF HANDLING SUCH PARCELS.

In Docket No. MC95-1, the Commission considered at length the relative costs caused by parcels compared to flats in Standard A Mail and concluded that Standard A parcels incur greater costs than do Standard A flats. MC95-1 Opinion at V-226-30 (¶¶ 5559-69); see also Dissenting Opinions of Vice Chairman LeBlanc and of Commissioner Haley.[28] The Postal Service has demonstrated in this case that a surcharge should be imposed on Standard Mail A parcels. The same concerns apply in this case to Priority Mail parcels. The evidence shows that a surcharge on Priority Mail parcels is necessary to equitably allocate the additional costs caused by such parcels.

UPS witness Sellick has derived the additional costs incurred by Priority Mail parcels compared to Priority Mail flats using the Postal Service's own data. Tr. 26/14177-78. Mr. Sellick determined that Priority Mail parcels cost 19.5¢ more per piece to process than do Priority Mail flats. Id.

The conclusion that Priority Mail parcels cost more to handle than do Priority Mail flats is buttressed by the publicly available portions of the Postal Service's Priority Mail Processing Center ("PMPC") contract.[29] Under the PMPC contract, the Postal Service pays the contractor different prices to handle parcels as opposed to flats. Tr. 4/2139-41, 2145-46. The contract requires the contractor to separate parcels and flats, and to return them to the Postal Service in different containers. Tr. 4/2141-

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28. The Postal Service has demonstrated in this case that a surcharge should also be imposed on Standard Mail A parcels.

29. UPS is filing under seal a supplement to this brief discussing the PMPC information that is subject to Presiding Officer's Ruling No. R97-1/62 (November 17, 1997).

44. To facilitate the separation of parcels from flats, the Postal Service requests its retail units to segregate Priority Mail by shape prior to its transfer to the PMPC network. Tr. 4/2086.

An average Priority Mail flat weighs 1.02 pounds and an average Priority Mail parcel weighs 3.34 pounds (2.32 pounds more). Tr. 26/14329-30. Thus, the 19.5¢ per piece processing cost difference between parcels and flats is not recovered by the higher rates for heavier Priority Mail pieces. Priority Mail rates include a 4¢ per pound add-on for non-transportation weight related costs (2¢ per pound plus the contingency allowance and institutional cost markup). The average additional charge for non-transportation weight related costs of 9.3¢ (4¢ x 2.32 pounds) does not cover the 19.5¢ per piece additional processing cost caused by Priority Mail parcels. Tr. 26/14330.

Accordingly, Mr. Luciani recommends a 10¢ per piece surcharge for Priority Mail parcels (19.5¢ - 9.3¢). Tr. 26/14330. Such a surcharge will also help mitigate the rate crossover problems between Priority Mail rates and Parcel Post rates. It should be recommended by the Commission.

G. THE POSTAL SERVICE'S PROPOSAL TO SUBSIDIZE DELIVERY CONFIRMATION SERVICE FOR PRIORITY MAIL USERS IS A BLATANT VIOLATION OF THE ACT.

The Postal Service's proposal for the new delivery confirmation special service clearly results in an illegal subsidy in favor of certain Priority Mail users of the service, in violation of section 3622(b)(3).

In particular, the Postal Service proposes to charge large Priority Mail users no fee at all for electronic delivery confirmation service, and a below-cost fee for

manual delivery confirmation service for other Priority Mail users.[30] Thus, Priority Mail users would pay rates that do not cover attributable costs and make no contribution to institutional costs. Since the costs of rendering delivery confirmation service to Priority Mail users is identical to that for Standard B users (Tr. 3/1027-30, USPS-T-22 at 17), charging lower rates to Priority Mail users is not fair and equitable. This discriminatory treatment violates section 403(c) as well as section 3622(b)(1). It would also create still another rate crossover problem between Priority Mail and Parcel Post. Tr. 24/13054-56.

The testimony of Postal Service witness Rios shows that the Postal Service's goal in proposing a below-cost fee structure is to take business away from the Postal Service's competitors in contravention of section 3622(b)(4). Tr. 35/19035. Moreover, a dual fee structure in the face of identical costs for Priority Mail users and Standard B mailers hardly comports with section 3622(b)(7) ("simplicity of structure . . . and simple, identifiable relationships between the rates or fees charged").

Clearly, the Postal Service's proposal to give away this costly and valuable service runs afoul of virtually every requirement in the Act. To correct this, Mr. Luciani recommends that the Commission adopt one fee structure for delivery confirmation service. Tr. 26/14332.

The inequity of the Postal Service's delivery confirmation proposal is made even worse by the fact that the Postal Service proposes to allocate only 0.5% of the capital costs for the delivery confirmation scanners to the Priority Mail and Standard B Mail users of the service. Tr. 26/14332-33. Mr. Luciani therefore recommends that the estimated volume variable capital costs of the scanners be allocated to Priority Mail

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30. Its proposed 35¢ fee for manual delivery confirmation would cover only 72% of the estimated costs of providing the service. Tr. 26/14331.

and to the Standard B Mail subclasses in proportion to their respective revenues. Tr. 26/14333-34.

V.

CONCLUSION

WHEREFORE, for the reasons set forth above and on the basis of the evidence in the record, UPS respectfully requests the Commission to:

(1) Attribute and then mark up all of the incremental costs of each subclass of mail, so that each subclass covers the "direct and indirect postal costs attributable to that class . . . plus that portion of all other costs . . . reasonably assignable to such class," 39 U.S.C. § 3622(b)(3);

(2) Reject the Postal Service's flawed proposal to substantially reduce the attribution of mail processing labor costs and reaffirm its traditional attribution of essentially all mail processing direct labor and variable overhead costs;

(3) Distribute attributable mail processing labor costs using the MODS-based approach proposed by the Postal Service, as modified by UPS witness Sellick;

(4) Continue its established markup relationships in assigning institutional costs, except for subclasses where the evidence shows a change in circumstances relevant to the assignment of institutional costs;

(5) Correct the Postal Service's overestimates of avoided costs for the proposed Parcel Post worksharing discount categories and reduce the proposed passthroughs of estimated avoided costs to no more than 77%;

(6) Revise the Postal Service's proposed rate design for Parcel Post as recommended by UPS witness Luciani;

(7) Recommend a surcharge of at least ten cents per piece for Priority Mail parcels; and

(8) Reject the undue preference proposed by the Postal Service for Priority Mail users of delivery confirmation service by recommending a uniform fee structure of 25¢ per transaction for all electronic delivery confirmation users and 60¢ per transaction for all manual delivery confirmation users.

Respectfully submitted,

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Of Counsel

Dated: April 1, 1998

CERTIFICATE OF SERVICE

I hereby certify that I have caused to be served the foregoing Brief of United Parcel Service upon all participants of record in this proceeding on this date in accordance with Section 12 of the Rules of Practice.

John E. McKeever

Dated: April 1, 1998